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Editorial Office
139 MacDougal Street
New York, New York 10012
212-998-6080
law.jlb@nyu.edu

Administrative Office
110 West Third Street
New York, New York 10012
212-998-6590
nyulawjournals@nyu.edu

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THE NEW SHARING ECONOMY: THE ROLE OF
PROPERTY, TORT, AND CONTRACT LAW FOR
MANAGING THE AIRBNB MODEL

CHAD MARZEN,* DARREN A. PRUM,**
AND ROBERT J. AALBERTS***

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INTRODUCTION

A new world of property sharing has dawned.¹ As exemplified by the Airbnb model,² more property owners are now sharing their homes and apartments with others through technological platforms.³ The economic motivations are clear: with a dearth of affordable housing, many are struggling to pay their notes and rents. On the demand side, many tourists cannot afford or don't wish to pay for pricey hotels, particularly in expensive yet popular destinations, such as New York and San Francisco.

1. Real estate is not the only kind of property sharing now occurring. For example, Uber and Lyft operate by sharing car services with those needing transport, thereby reducing the need for taxis. Such uses of property are enabled by applications on consumers' cell phones that let them easily and efficiently fulfill their needs. Other examples of the peer-to-peer approach include Taskrabbit (for odd jobs, handymen, etc.), Vayable (designed tours), Tutorspre (linking people to tutors), and Getaround (for driving and sharing another's car).

2. For the purposes of this Article, we will use the Airbnb brand when discussing the peer-to-peer real estate sharing model, since it is arguably the most widely recognized. Competing brands include HomeAway and FlipKey. Alexa Tsotsis, *Will Airbnb Ever Be "The Airbnb for X?"*, TECHCRUNCH (June 5, 2011), <http://techcrunch.com/2011/06/05/will-airbnb-ever-be-the-airbnb-for-x/> (discussing how Airbnb is generating such publicity and investment capital that writers now use its name as a stand-in for the best company providing a certain product or service—for example, the "Airbnb of Office Space"). Due to its undeniable success, there are numerous but distinguishable competitors to Airbnb, including VRBO, HomeAway, Flipkey, Couchsurfing, Wimdu, 9Flats, House Trip, and Roomorama.

3. It is noteworthy that home sharing in the United States is not new. Americans seeking shelter in others' homes, better known as boarding houses, began with new American settlements, such as New York City. See PAUL FAFLICK, *BOARDING OUT: INHABITING THE AMERICAN LITERARY IMAGINATION, 1840–1860* (2012); see also Jamila Jefferson-Jones, *Airbnb and the Housing Segment of the Modern "Sharing Economy": Are Short-Term Rental Restrictions an Unconstitutional Taking?* 42 HASTINGS CONST. L.Q. 557, 561 (2015) (discussing the history of home sharing in the United States).

The legal reaction to home sharing has been palpable. New and existing laws in some locations are challenging the model.⁴ Policymakers argue that the laws protect the public from unsafe lodging conditions and are required to collect needed tax revenue. Still, the laws, particularly the older ones, were written to regulate a vertical business model in which hotel and motel lodgers are protected from a more distant and diffused corporate ownership; a model quite distinguishable from the new peer-to-peer Airbnb model which, as we will discuss, might be better served by private legal arrangements.

Existing regulatory ordinances and statutes cover wide-ranging legal categories. In general, they limit property sharing by usage,⁵ number limitations,⁶ operations,⁷ and licensing

4. See generally Sofia Ranchordas, *Does Sharing Mean Caring? Regulating Innovation in the Sharing Economy*, 16 MINN J.L. SCI. & TECH. 413 (2015) (discussing the clash between those who innovate in the new sharing economy, the economic and societal problems that sometimes result from these clashes, and possible solutions).

5. For example, New York City provides that residential “class A multiple dwelling” housing “shall only be used for permanent housing purposes.” N.Y. MULTIPLE DWELLING LAW, § 4.8(a) (McKinney 2011). Some have pointed out that New York City’s “all or nothing” approach has done little to stop home sharing, but instead has driven it underground, thereby creating a black market. See Dylan Love, *Airbnb Is Declared Illegal in New York*, BUS. INSIDER (May 21, 2013), <http://www.businessinsider.com/airbnb-illegal-in-new-york-city-2013-5>; see also Catherine Yang, *Illegal Hotel Operator Made Nearly \$7 Million Using Airbnb*, EPOCH TIMES (Oct. 16, 2014), <http://www.theepoch-times.com/n3/1024373-illegal-hotel-operator-made-nearly-7-million-using-airbnb/> (discussing how these illegal businesses exist in some of New York City’s wealthiest neighborhoods).

6. See, e.g., SANTA FE, N.M., Ordinance § 14–6.2(A)(6)(a)(i) (2011). (limiting short-term rentals to 350 rental units, with some exceptions for accessory unit, owner-occupied, or units within a development that contain resort facilities). By comparison, Amsterdam allows homeowners to rent to up to four tourists for a maximum of three months. See Jarl van der Ploeg, *Amsterdam Akkoord Met Huis Verhuren aan Toeristen*, DE VOLKSKRANT (Feb. 15, 2014), <http://www.volkskrant.nl/vk/nl/2686/Binnenland/article/detail/3597693/2014/02/15/Amsterdam-akkoord-met-huis-verhuren-aan-toeristen.dhtml>.

7. SONOMA COUNTY, CAL., ORDINANCE § 26–88–120(f)(2) (2010). This ordinance limits overnight stays based on how the septic tank is designed for the handling of more occupants.

requirements.⁸ In some of these cases, property owners are finding it difficult to stay in business.⁹

The purpose of this Article is three-fold. In Part I, we will first describe how the Airbnb model works, and discuss the private laws of property, tort, and contract to demonstrate how these traditional laws might serve well the task of defining the respective rights and duties for both hosts and guests. In particular, we discuss possible liabilities arising under tort law, which is arguably where the greatest legal risks reside. In Part II, we will broaden our discussion of tort law in the context of protecting both hosts and guests from personal and property losses. In our Conclusion, specific recommendations will be offered with a focus on how insurance can provide a private solution to these losses.

I.

THE AIRBNB MODEL: THE ROLE OF PROPERTY, TORT, AND CONTRACT LAW

A. *The Airbnb Model*

We begin with a short discussion of Airbnb itself and its operational model. This is to better present and understand the legal issues involved. Simply put, Airbnb is a website that property owners or hosts employ to find guests who are seeking short-term lodging.¹⁰ To register the host's premises on the Airbnb site, a potential host must create a personal profile. If the profile is accepted, the host can then begin renting to guests. To ensure ongoing accountability once the renting be-

8. TILLAMOOK COUNTY, OR., ORDINANCES §§ 6 & 9.A.B (2012). These ordinances require that property owners be inspected for fire extinguishers, smoke detectors, escape standards, and structural requirements to gain a license. *Id.*

9. See, e.g., Ron Lieber, *A \$2,400 Fine for an Airbnb Host*, N.Y. TIMES: BUCKS (May 21, 2013), <http://bucks.blogs.nytimes.com/2013/05/21/a-2400-fine-for-an-airbnb-host/> (discussing how a host in New York City was fined for renting his apartment on Airbnb).

10. Vanessa Grout, *How to Use Airbnb to Profit from Your Second Home*, FORBES (Nov. 4, 2013) <http://www.forbes.com/sites/vanessagrout/2013/11/04/how-to-use-airbnb-to-profit-from-your-second-home/#2aefeca72f1d>. See generally HOW DO I BOOK A PLACE ON AIRBNB?, <https://www.airbnb.com/help/article/380/how-do-i-book-a-place-on-airbnb#> (last visited June 23, 2016) (this webpage explains the rules and guidelines for hosts and how to book reservations on Airbnb.com).

gins, the site also provides recommendations from former guests, a response rating, and a private messaging system.¹¹ Hosts do not pay for their listing page, but will be charged a three percent “service fee” once the guest’s reservation has been confirmed.¹² Airbnb provides a \$1 million “Host Guarantee” with considerable conditions, limitations, and exclusions if a guest damages a host’s property, an event that Airbnb claims is “rare.”¹³

The Airbnb model is relatively simple and appears to be user friendly for both hosts and guests.¹⁴ For these reasons as well as price, space, kitchen facilities, WIFI connections, locations in residential as opposed to business districts or suburbs, lack of rigid check-in and check-out rules, and even information on what to do locally from knowledgeable hosts, the site has grown dramatically since its 2008 inception. By 2015, the company’s website claimed to have hosts in 34,000 cities and 190 countries.¹⁵ Indeed, according to Techcrunch, Airbnb is seeking additional funding of \$1 billion to give it a potential \$20 billion market capitalization. This would rank it third after Hilton and Marriott.¹⁶

As discussed, there are some urban areas in which Airbnb hosts are being regulated in various ways ostensibly to protect their guests and collect taxes.¹⁷ Many of the laws were created

11. See EARN MONEY AS AN AIRBNB HOST, <https://www.airbnb.com/host/homes> (last visited June 23, 2016) (listing the requirements for new hosts).

12. See WHAT ARE HOST SERVICE FEES?, <https://www.airbnb.com/help/article/63/what-are-host-service-fees> (last visited June 23, 2016).

13. THE \$1,000,000 HOST GUARANTEE, <https://www.airbnb.com/guarantee> (last visited June 23, 2016) [hereinafter AIRBNB HOST GUARANTEE]. Protected property includes “cash and securities, pets, personal liability and shared or common areas.” See *infra* notes 187–210 (discussing the Airbnb Host Guarantee in detail).

14. Robert J. Aalberts, *Airbnb: Will It Become the Next Battle Ground over Property Rights?* 44 REAL EST. L.J. 1 (2015); see also *8 Great Airbnb Advantages*, MCCOOL TRAVEL, <http://www.mccooltravel.com/2015/08/8-great-airbnb-advantages> (last visited March 2, 2017).

15. AIRBNB OPEN 2015 WILL WELCOME 6000 HOSTS IN PARIS, FRANCE, <https://www.airbnb.com/press/news/airbnb-open-2015-will-welcome-6000-hosts-in-paris-france> (last visited June 23, 2016).

16. Jason Clampet, *Airbnb’s New \$1 Billion Funding Would Value It at \$20 Billion*, SKIFT (Feb. 28, 2015), <http://skift.com/2015/02/28/airbnbs-new-1-billion-funding-would-value-it-at-20-billion/>.

17. See *supra* text accompanying notes 5–8 (discussing types of regulatory laws being imposed upon Airbnb).

to control traditional hotels, motels, and bed and breakfasts, while some are quite frankly, according to popular press sources, in place to protect these businesses from Airbnb's competition.¹⁸ Yet, the Airbnb model's peer-to-peer setup together with its other advantages, is distinguishable from the traditional lodging model, the whole package and brand of which was made possible by the power of the internet. Indeed, without the internet it almost certainly would not exist today. It is not an understatement to say that many of these regulations are arguably a serious challenge to traditional property rights.¹⁹ In fact, this model might be better regulated by applying existing common law legal rights and duties, including the private laws of tort, contract, and property, which have for centuries been adapted to meet the legal needs of the time.

In economic terms, the imposition of unduly burdensome regulatory laws is important to many. The Airbnb model has enabled thousands worldwide to transform their property into an important source of personal wealth.²⁰ Allowing cumbersome and sometimes irrelevant laws to impinge on wealth formation, when the risks can be better controlled by well-established private laws, is an economic and societal mistake.²¹

18. The hotel industry in New York City has been particularly aggressive in fighting the Airbnb model, and lobbies for laws to outlaw it. See Lisa Fickenscher, *Hotels Girding for a Fight Against Airbnb*, CRAIN'S N.Y. BUS. (Aug. 19, 2013), http://www.craainsnewyork.com/article/20130819/HOSPITALITY_TOURISM/130819909/hotels-girding-for-a-fight-against-airbnb.

19. See Jefferson-Jones, *supra* note 3, at 560 (discussing how laws regulating the Airbnb model might arguably be a regulatory taking).

20. See Jefferson-Jones, *supra* note 3, at 560–61 (“[S]uch [Airbnb] exchanges can help to preserve property values by providing income to homeowners that can be used to offset mortgage and maintenance costs—in other words, *sharing* the burden of ownership. If homeowners are able to do so, they are more likely to be able to maintain their homes in the short-term and, in the long-term to maintain ownership.”); see also Ron Klain, *Airbnb's Biggest Disruption: America's Laws*, FORTUNE (Sept. 10, 2014), <http://fortune.com/2014/09/10/airbnbs-biggest-disruption-americas-laws/> (criticizing the regulatory burdens being placed on Airbnb and Uber, the car sharing company, by comparing their development to the deregulation of the airline industry in the 1970s, which resulted in the price of airfares plummeting seventy-five percent in real dollars and the rise of cheaper airlines like Southwest).

21. See Ranchordas, *supra* note 4, at 438–39; see also Jefferson-Jones, *supra* note 3, at 561 (arguing that those who share and make more to maintain their homes improve the entire municipality).

B. *The Airbnb Model and Traditional Liability Issues*

When considering a torts claim in relation to the Airbnb model, hosts and guests both face the prospect of liability for personal and property losses suffered by one another as well as other individuals affected by a home sharing event. As a starting point, we will begin with an evaluation of the premises liability, and then turn to other issues such as nuisance, invasion of privacy, and property damage.

Depending on the specific circumstances, many of the different causes of action will occur on a primary basis, while some may follow on a secondary basis.²² For purposes of this Article, we will focus on a few of the primary torts that are likely to occur out of the Airbnb arrangement.

In addition, many of the liability issues may result with one of the parties raising the cause of action invoking the special body of law that applies to innkeepers. Since the courts may find precedent in either landlord–tenant or the laws that apply to innkeepers, we will consider the tort claims with respect to both sets of doctrines. The Supreme Court of Alabama articulated in 1923 that a basic definition of the terms hotel, inn, and tavern “are all used to describe a house where travelers or others are entertained and furnished with food and lodging, and sometimes other conveniences”²³ Subsequently, a New Jersey court further clarified in 1955 that as progress occurred with regard to transportation along with a change in customs, the requirement that a hotel or inn provide food, drink, and stabling accommodations ceased to be pertinent.²⁴ As such, the possibility exists that a court may consider applying the innkeeper laws to a liability claim arising out of an Airbnb transaction.

22. For example, a situation may occur where the tortfeasor commits negligence, but the recklessness of the action also manifests as emotional distress. For purposes of this discussion, we will consider the negligence claim as primary and emotional distress as secondary because the subsequent allegation would not occur but for the first action. This does not mean that a potential plaintiff may not claim the secondary tort, but for the sake of brevity we will limit our discussion to those torts we believe are mainly primary in nature.

23. *City of Birmingham v. Bollas*, 209 Ala. 512, 514 (1923).

24. *Schermer v. Fremar Corp.*, 114 A.2d 757, 760 (N.J. Super Ct. Ch. Div. 1955).

However, it is noteworthy that as far back as the common law courts of the 17th century in England actually grappled with whether a person who rents their vacation home to families or persons who might contact them for lodging fits within the definition and meaning of an innkeeper.²⁵ In an English case from 1698 regarding the lodging of soldiers at a vacation home, the court applied the applicable statutes that allowed constables to quarter military personnel at inns, alehouses, and livery stables.²⁶ This court pointed out that the property owner in this case required reservations to stay at the home, whereas an inn accepts *all* travelers regardless of prior arrangements, along with other distinguishing factors like a duty to protect guests and to charge a reasonable rate.²⁷ These factors allowed the court to make the distinction between providing hospitality towards a guest and general hospitality, and found the quartering of soldiers lawful.²⁸

Applying the same statute in a King's Bench case from 1699, the court considered the identical issue.²⁹ The court explained that the statutes exempted private houses from the quartering of soldiers, and that an innkeeper runs afoul of the law if he refuses lodging to strangers but a public house does not.³⁰ The court further noted that even though the property owner furnished meat for purchase and stables for horses, the vacation home did not fit within the four statutory requirements necessary to receive consideration as an inn or public house.³¹

Bringing this doctrine to the United States as applicable precedent, the Georgia Supreme Court considered the innkeeper issue on another vacation home that was rented seasonally under a claim against an adjacent landowner for a private nuisance.³² After reviewing the ample English precedent and the appropriate statutes, the court held that a landlord-tenant

25. *See, e.g.*, *Parker v. Flint* (1698) 88 Eng. Rep. 1303 (K.B.); *Parkhurst v. Foster* (1699) 91 Eng. Rep. 337 (K.B.).

26. *Parker*, 88 Eng. Rep. at 1303.

27. *Id.*

28. *Id.*

29. *Parkhurst*, 91 Eng. Rep. at 337.

30. *Id.*

31. *Id.*

32. *Bonner v. Welborn*, 7 Ga. 296 (1849).

relationship existed after classifying the vacation home as a private boarding house.³³

More specifically, a New York appellate court clarified that,

The distinction between an inn and a boarding-house has been held to be, that in a boarding-house, the guest is under an express contract, at a certain rate, for a certain period of time, while at an inn the guest being on his way, is entertained from day to day, according to his business, upon an implied contract. The innkeeper is bound to receive every one who applies, if in a fit condition to be received, while the boarding-housekeeper is not bound to receive any one, except upon special contract.³⁴

The court continued to review a statute that required every hotel, restaurant, boarding house, or inn to conspicuously post in a public place a copy of the statute in conjunction with policies for changing lodging rates along with meals and items furnished.³⁵ In recognizing that the legislature could have included private residences in the statute but did not, the court held the relationship in question as one of a private housekeeper who entertained a boarder, and not within the jurisdiction of the statute.³⁶

Recently, another court elected to ignore common law definitions and based its approach entirely on a state's statutory definition for a tort claim that occurred at a beach cottage rental.³⁷ This court determined that the arrangement did not qualify as a hotel or an inn within the statute because of a requirement for ten rooms, so it held that a landlord-tenant relationship existed for the case at hand.³⁸

Given that the courts continue to revisit on a case-by-case basis whether a particular factual situation may apply landlord-tenant or innkeeper precedent, a jurisdiction may decide to distinguish centuries old decisions when considering the

33. *Id.* at 309.

34. *Cady v. McDowell*, 1 Lans. 484, 486 (N.Y. Gen. Term 1869).

35. *Id.* at 487.

36. *Id.*

37. *Williams v. Riley*, 289 S.E.2d 102 (N.C. Ct. App. 1982).

38. *Id.* at 104-05.

Airbnb model. Accordingly, we will present both options when examining some of the possible tort liability claims.

1. *Premises Liability*

As part of the doctrine of negligence, premises liability sets forth the fundamental standards that concern the duties owed by an owner or occupier of land to protect those entering it from suffering an injury due to a dangerous condition or defect.³⁹ Unless a landowner acts negligently, the mere ownership of a parcel will not support liability for injuries that occur on the property.⁴⁰ To further underscore this point, the occurrence of an injury on a particular parcel will not suffice as evidence of negligence nor provide even the inference of this tort.⁴¹ As such, the defendant in an action must adhere to the negligence requirements by having to meet a duty towards the plaintiff whereby a breach occurs that proximately causes damages.⁴²

With this in mind, a court begins by determining whether the defendant owes a duty of care to the plaintiff.⁴³ Traditionally, many jurisdictions look to the status of the entrant upon the land to determine the duty owed by the owner or occupant of the premises.⁴⁴ In electing to categorize the entrant's status,

39. LOUIS A. LEHR, JR., 2 PREMISES LIABILITY 3D § 36:1 (2016 ed). Generally, the discussion of premises liability solely pertains to real property, but the courts in Indiana decided to extend it to a large houseboat used by its owners as a weekend getaway and equipped with a kitchen and bathroom. See *Harris v. Traini*, 759 N.E.2d 215, 221–22 (Ind. Ct. App. 2001). Given the diversity of listings on Airbnb, it is possible that this type of precedent may become applicable.

40. See LEHR, *supra* note 39.

41. *Id.*

42. See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 30 (5th ed. 1984).

43. *Id.* at § 57.

44. See LEHR, *supra* note 39, at § 38:1. A minority of jurisdictions decided to reject the traditional approach as “harshly mechanical, unduly complex, and overly protective of property interests at the expense of human safety.” See KEETON ET AL., *supra* note 42, at § 62. England elected to statutorily change the duty imposed upon the owner or occupier to a “common duty of care” concerning all lawful entrants of the premises in 1957. Occupiers’ Liability Act 1957, 5 & 6 Eliz. 2 c. 31 (Eng.).

In 1958, the Supreme Court sparked the movement in the United States when it declined to apply the traditional distinctions in an admiralty case. *Kermarec v. Compagnie Generale Transatlantique*, 358 U.S. 625 (1959). A

the majority of jurisdictions distinguish between licensees, invitees, and trespassers, along with an examination as to whether the injury emanated out of an artificial condition, a natural condition, or active operations.⁴⁵

Under the traditional approach, an owner or occupant of land or building maintains a duty to warn of or make safe any known conditions that are nonobvious and dangerous to any licensee,⁴⁶ which includes social guests.⁴⁷ Similarly, an owner or occupant of land or building maintains a duty to undertake reasonable inspections to discover nonobvious dangerous conditions and provide warnings or take appropriate actions that make the premises safe for any invitee, which includes business visitors or members of the public.⁴⁸ In both the licensee and invitee categories, the previously articulated general rule applies to any artificial or natural conditions, but only turns into a duty of reasonable care when the circumstances change to active operations on the premises.⁴⁹

In contrast, the traditional approach towards adult trespass separates the entrant into the two separate subcategories of undiscovered trespasser and discovered or anticipated trespasser.⁵⁰ With the lowest standard of duties owed to an entrant, the landowner of the premises owes nothing to the undiscovered trespasser, regardless of whether the condition occurs artificially or naturally, or if it emanates out of active

decade later, the California Supreme Court initiated the change in approach at the state level by replacing the three categories with ordinary negligence principles of foreseeable risk and reasonable care, which also found traction within the courts in Hawaii, Colorado, District of Columbia, Rhode Island, New York, New Hampshire, Louisiana, Alaska, and Missouri. *See KEETON*, *supra* note 42, at § 62 nn.4, 5. Other jurisdictions such as Minnesota, Massachusetts, Wisconsin, North Dakota, and Maine decided to remove the distinctions between licensees and invitees while keeping the traditional approach with trespassers. *See id.* at § 62 n.6.

45. *See KEETON ET AL.*, *supra* note 42, at § 57.

46. *See LEHR*, *supra* note 39, at § 38:1; *KEETON ET AL.*, *supra* note 42, at § 60.

47. RESTATEMENT (SECOND) OF TORTS § 330 cmt. 3 (AM. LAW INST. 1965).

48. *See LEHR*, *supra* note 39, at § 38:1; *KEETON ET AL.*, *supra* note 42, at § 61.

49. *See KEETON ET AL.*, *supra* note 42, at §§ 60–61.

50. *See id.* at §§ 58–59. A third subcategory for child trespassers exists at common law, but it is not included in this discussion because a child cannot enter into an Airbnb contract.

operations.⁵¹ However, with the knowledge of a trespasser's presence, an elevation in the landowner's duty towards the entrant occurs for nonobvious and highly dangerous artificial conditions such that the landowner must post warnings or take remedial measures for these known conditions, or take reasonable actions when active operations become the issue.⁵²

Based on the traditional approach in a majority of jurisdictions, a guest under the Airbnb model holds the legal status of an invitee regardless of whether the laws of an innkeeper or landlord-tenant apply. This occurs because the guest came to the host's property at the invitation of the landowner or occupant, which also furthers any business objective to use an existing asset towards generating revenue. As such, the guest is entitled to the highest legal duty owed to any party on the host's premises: the duty to keep the guest safe from unreasonable risks and dangers that the host knows about or "should have known about." Accordingly, a host would face liability if she failed to exercise reasonable care to discover dangerous risks in a situation where guests would not be expected to identify or protect themselves from that risk, and where the landowner or occupant failed to exercise reasonable care to protect the guest from the danger.

Moreover, these liability issues may emanate from a third party rather than from the owner or occupier of the premises. In these situations as applied to innkeepers, the plaintiff must follow the same negligence standard previously stated,⁵³ but the innkeeper must be put on notice of an offending party's vicious or dangerous propensities by some act or threat, must have adequate opportunity to protect the injured patron, must fail to take reasonable steps to protect injured guest, and the injury must be foreseeable.⁵⁴

For example, ESPN reporter Erin Andrews sued a hotel in Nashville for negligence and other claims following an incident in which a stalker recorded and subsequently distributed nude videos taken of her in her hotel room without her knowledge. The premises liability in connection with a third-party

51. *See id.* at § 58.

52. *Id.*

53. *See supra* text accompanying note 42.

54. *See Boone v. Martinez*, 567 N.W.2d 508, 510 (Minn. 1997).

action became an issue for the courts to decide.⁵⁵ A jury held the hotel liable, in part, because the staff granted the stalker's request to receive a room adjacent to hers—which enabled him to film her through a peephole—and acknowledged her room reservation at their property.⁵⁶ While the stalker's action ultimately ended in a criminal conviction and sentencing,⁵⁷ the liability imposed by the jury in the civil case demonstrated that an owner or occupier of a premise who allows others to stay for a short duration maintains a duty to protect her guests from dangers, such as the one in Ms. Andrews' case.

Should a court apply the laws of an innkeeper to the Airbnb model, Andrews' case demonstrates the expansion of premises liability doctrine upon hosts to include the recognition and placement of guests by the owner or occupier of the property, along with the need to recognize that an unreasonable risk or danger may come from other invitees and their actions. Hence, hosts using Airbnb to attract guests to stay on their premises must account for numerous different possibilities that may create a dangerous condition and attach liability.

2. Nuisance

In some instances, the landowners of an adjoining parcel may pursue a nuisance claim due to repeatedly having guests present or due to their conduct on the host's property that causes a disturbance. Over time, the courts elected to draw a distinction between the two types of nuisance.⁵⁸ A "public" nuisance is one that affects an entire neighborhood or community, whereas a "private" nuisance disturbs only a single parcel of land.⁵⁹

55. See Fourth Amended Complaint, *Andrews v. Marriott Int'l, Inc.*, No. 11C-4831, 2016 WL 915595 (Tenn. Cir. Ct. Mar. 4, 2016).

56. See Verdict Form, *Andrews v. W. End Hotel Partners, LLC*, No. 11C-4831, 2016 WL 915534 (Tenn. Cir. Ct. Mar. 8, 2016).

57. See Alex Johnson, *Erin Andrews Settles Stalking Suit Against Nashville Hotel*, NBC NEWS (Apr. 25, 2016), <http://www.nbcnews.com/news/us-news/erin-andrews-settles-stalking-suit-against-nashville-hotel-n562036>.

58. See KEETON ET AL., *supra* note 42, at § 86.

59. *Id.* Even though private nuisance and public nuisance both fit within the description of nuisance actions, Prosser and Keeton explain that "[t]he two have almost nothing to do with one another, except that each causes inconvenience to someone, and it would have been fortunate if they had been called from the beginning by different names." *Id.*

More specifically, “an unreasonable interference with a right common to the general public” defines a public nuisance.⁶⁰ For instance, an unreasonable interference with a public right includes conduct that significantly inhibits public health, public safety, public peace, or public convenience.⁶¹

A private nuisance, on the other hand, may occur due to actions of the guest on the host’s property that disturb an adjoining parcel. This tort is often tricky to define because it can become confused with trespass.⁶² As such, a private nuisance focuses on the interference with the right to use and enjoy the land, whereas a trespass deals with the exclusive possession of the property.⁶³

Accordingly, a private nuisance covers a state of affairs whereby another person interferes with a landowner or occupier’s use and enjoyment of the land.⁶⁴ The courts further clarify this definition to describe the activity or condition as “unreasonable,” along with the need for it to “substantially” or “unreasonably” interfere with the use and enjoyment of the land.⁶⁵ This means that the injured parties must suffer a personal injury to themselves or their property beyond a mere inconvenience, whereby a person in the community of normal sensitivity would be seriously bothered.⁶⁶

Generally, the intentional interference requirement manifests due to a condition caused by the defendant that creates or continues to cause the hindrance with complete awareness that the injury to the plaintiff will most likely occur or

60. RESTATEMENT (SECOND) OF TORTS § 821B (AM. LAW INST. 1979).

61. *Id.*

62. Page Keeton, *Trespass, Nuisance, and Strict Liability*, 59 COLUM. L. REV. 457, 466 (1959).

63. *Id.* at 464–65.

64. ROGER A. CUNNINGHAM ET AL., *THE LAW OF PROPERTY* § 7.2 (2d ed. 1993).

65. *Id.*

66. See KEETON ET AL., *supra* note 42, at § 88. In an ongoing debate between the authors of the Restatement of Torts, the courts, and other commentators on whether strict liability applies to a private nuisance, liability tends to depend upon the nature of the conduct and the extent and amount of the damage caused. See Keeton, *supra* note 62, at 474. This requires that the plaintiff demonstrate that the defendant’s conduct was negligent, intentional, or abnormally dangerous. See CUNNINGHAM ET AL., *supra* note 64, at § 7.2. For a defendant’s conduct to meet the intentional standard, the tort only requires proof that the defendant knew with substantial certainty that the interference will occur. See KEETON ET AL., *supra* note 42, at § 88.

already occurred.⁶⁷ There is no question that a nuisance occurs when the interference affects the material condition of the land, but when the disturbance involves physical discomfort or annoyance, a recovery for damages faces difficulties.⁶⁸

Furthermore, the mere fact that a parcel of land falls within an articulated governmental zoning scheme will not preclude a court from granting relief based on a nuisance claim.⁶⁹ The Pennsylvania Supreme Court stated, “[a]cts of municipal officers under zoning legislation permitting the use of property for what is or may be a nuisance, do not oust the jurisdiction of equity to determine whether a nuisance in fact exists and should be restrained.”⁷⁰ As such, a court retains the ability to offer injunctive relief as an equitable remedy despite applicable governmental regulations permitting a defendant’s existence and activity.

With these rules in mind and considering the application of public and private nuisance, the courts do not appear to distinguish innkeepers from other property owners.⁷¹ An appellate court in Indiana found persuasive authority and joined the following two opinions to develop a rule of law from the courts in the District of Columbia (D.C.) and Pennsylvania to determine a nuisance claim in a tavern.⁷² Using common law, the D.C. appellate court explained that the duty a landowner owes is the same as that owed to the public with respect to unruly crowds at a retail store.⁷³ This court turned to the previously articulated rules of negligence as applied to those entering someone else’s land for guidance.⁷⁴ The court explained that while “the public assume the ordinary risks of ordinary crowds,” the storekeeper must use due care or risk liability

67. See KEETON ET AL., *supra* note 42, at § 87.

68. *Id.* Prosser and Keeton suggest that a good guideline for determining damages should focus on whether the interference results in a depreciation in the property’s market or rental value. *Id.*

69. See *Mazeika v. Am. Oil Co.*, 383 Pa. 191, 195 (1955).

70. See *Perrin’s Appeal*, 305 Pa. 42, 51 (1931).

71. See *e.g.*, *Ember v. B.F.D., Inc.*, N.E.2d 764, 773 (Ind. Ct. App. 1986).

72. *Id.*

73. See *Schwartzman v. Lloyd*, 82 F.2d 822 (D.D.C. 1936). It may seem far reaching to cite a case on crowd control liability that gets incorporated into conduct surrounding a tavern as applied to the Airbnb model, but the laws of innkeepers extended to include taverns and bars as well. See *Bonner v. Welborn*, 7 Ga. 296 (1849); *Parker v. Fling*, (1698) 88 Eng. Rep. 1303 (K.B.).

74. See *supra* text accompanying notes 75–84.

when a crowd is kept or controlled in a manner likely to cause injury.⁷⁵

Providing additional precedent pertaining to the inn-keeper application, the Supreme Court of Pennsylvania upheld an injunction to cease operations against a tavern whose unruly patrons were responsible for the deteriorating conditions in the immediate area surrounding the bar.⁷⁶ Although the offensive conduct of the patrons primarily occurred outside the bar, the manner in which bar operated bore responsibility for the offensive conduct.⁷⁷

In another case, the Indiana appellate court considered both public and private nuisance claims against a motel after a guest discharged a pistol that injured the plaintiff in another room.⁷⁸ This court followed earlier precedent that the plaintiffs needed to show an interference with their property rights, rather than a personal injury, in order to claim a private nuisance.⁷⁹

In addition, the court considered a public nuisance claim based on the motel's voluntary and habitual acceptance of high-risk guests.⁸⁰ This court held that a lower court's summary judgment decision in favor of the motel was proper because the defendant's business operations were not in a manner that would cause injury to the general public and allow recovery under a public nuisance claim.⁸¹

Given this precedent and the Airbnb model, a host will need to consider whether or not the frequency of guests will trigger a public nuisance claim. Neighbors may take issue with the constant comings and goings of guests or with their activities. Should the activity deteriorate the neighborhood with undesirable behaviors and impede traffic or parking, the host may face claims from adjoining landowners, especially if the

75. See *Schwartzman v. Lloyd*, 82 F.2d at 827.

76. See *Commonwealth v. Graver*, 461 Pa. 131 (1975). The court found persuasive the testimony that the patrons engaged in boisterous and violent conduct, urinated, and littered on the adjacent property, and even attacked a resident on one occasion. *Id.*

77. *Id.*

78. See *Hopper v. Colonial Motel Props.*, 762 N.E.2d 181, 184 (Ind. Ct. App. 2002).

79. *Id.* at 186.

80. *Id.*

81. *Id.* at 187.

activity lowers the value of their property. An occasional loud guest will probably not constitute a nuisance.

Thus, the person who casually hosts guests on a less regular basis probably avoids most of these issues and any potential claims. Accordingly, for an Airbnb host, it will be unlikely that she will see a nuisance claim unless the rental business operates in a manner that will likely injure the public or an adjacent landowner.

3. *Right to Privacy: Intrusion on Seclusion*

Privacy sometimes becomes a liability issue for a host, often serving as the primary tort claim.⁸² More specifically, an intrusion upon seclusion occurs when an unreasonable and highly offensive unlawful entry upon someone's privacy takes place.⁸³ This may include disturbing someone's physical solitude or entering a home or other quarters, yet some courts extend the reach of this tort to embrace electronic eavesdropping of private conversations, looking closely into a window of a home, and continually receiving unsolicited telephone calls.⁸⁴

In an innkeeper setting, any interference with the guest's peace and quiet enjoyment without reasonable cause will trigger liability.⁸⁵ This means that a guest has a right to privacy and to occupy her guestroom without intrusion from any unauthorized person.⁸⁶ However, situations like routine house-

82. Interestingly, the proposition that "The Right to Privacy" is actionable as a tort only began after Samuel Warren and Louis Brandeis published their *Harvard Law Review* article in 1890 making their arguments based on their review of case law. Samuel Warren & Louis Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193, 205 (1890). While the courts were initially reticent to adopt the proposition, Professor Prosser developed a quadripartite model that separated the tort into intrusion, public disclosure, false light, and appropriation in 1960. William L. Prosser, *Privacy*, 48 CALIF. L. REV. 383, 389 (1960). The American Law Institute eventually adopted it in the 1976 version of The Restatement (Second) of Torts. See DAVID A. ELDER, *PRIVACY TORTS* § 1.1 (2016).

83. See KEETON ET AL., *supra* note 42, at § 117.

84. *Id.*

85. L. W. B., Annotation, *Liability of Innkeeper for Interference with Guest*, 17 A.L.R. 139 (1922).

86. *Theftford v. City of Clanton*, 605 So. 2d 835, 838 (Ala. 1992).

keeping and maintenance, nonpayment, unauthorized stayover, or imminent emergency do not trigger liability.⁸⁷

Clarifying this doctrine, the Alabama Supreme Court addressed a case with these issues when a guest sued a hotel after discovering holes in the wall of their room at the same level as scratches in the back of a mirror that allowed for someone to secretly watch their activities without any notice.⁸⁸ The court explained that a guest pretty much maintains an absolute right to privacy and need not demonstrate that they saw someone's eyes watching them through the mirror in order for a claim to be successful under intrusion on seclusion.⁸⁹ The actual proof that someone watched goes to the amount of damages they will be entitled to recover, but is not a prerequisite for liability to attach.⁹⁰

In contrast, the application of this tort to a landlord–tenant situation occurs infrequently.⁹¹ The courts tend to eschew giving relief for trivial intrusions, yet cases that involve highly unusual events that cause genuine mental anguish beyond hurt feelings achieve success.⁹² Hence, the courts will apply intrusion on seclusion in the landlord–tenant situation and impose liability when the facts dictate that the actions created an unreasonable and highly offensive unlawful entry.⁹³

Considering both the landlord–tenant and the laws of innkeeper applications, the courts appear to uniformly attach liability to instances where the privacy of the guestroom can be invaded on an ongoing basis without the perpetrator physically entering the space, especially with the proliferation of cell phone and security cameras along with other portable or miniature video devices. Thus, an Airbnb host faces potential liability for those situations where a guest feels that an unrea-

87. See L.W.B., *supra* note 85.

88. See *Carter v. Innisfree Hotel, Inc.*, 661 So. 2d 1174 (Ala. 1995).

89. *Id.* at 1179 (stating, further, that even if a third party caused the scratches to the mirror and hole in the wall, the hotel still maintained an affirmative duty to prevent and block unauthorized parties from gaining access to the guest rooms).

90. *Id.*

91. George E. Stevens, *Intrusion into Solitude and the Tenant's Right to Privacy*, 16 REAL EST. L.J. 324, 327 (1988).

92. *Id.* at 330.

93. See generally *id.*

sonable and highly offensive unlawful entry violates her privacy.

4. *Property Damage or Loss*

In turning to claims for property damage or loss, both the host and guest may each face their own liability issues. For instance, a host may bear responsibility for a loss of personal property that a guest might incur due to theft should a court decide to apply the laws applicable to innkeepers.⁹⁴ Under common law, the courts follow the well-established precedent that an innkeeper practically insures the goods of any guest, as long as an act of god does not occur and the guest does not act negligently.⁹⁵ Should a court classify a guest as a boarder, then the inquiry shifts to the previously described negligence standard⁹⁶ when attempting to hold a host liable for a loss of personal property.⁹⁷

Conversely, the guest may incur liability for any actions that may injure or destroy the host's property. While Airbnb allows a host to require a security deposit during the guest's booking process, it also comes with some conditions.⁹⁸ These conditions include the requirement that a host notify Airbnb of a claim within fourteen days of the checkout date or before the next guest checks in, whichever is earlier.⁹⁹

Should a host elect to file a claim, Airbnb will only mediate and collect the payment from the guest.¹⁰⁰ This means that if either party to the claim refuses to alter their position with regard to liability for the property damage or loss, the mediation will fail to resolve the dispute.¹⁰¹ Therefore, the security

94. *See* Fisher v. Bonneville Hotel Co., 188 P. 856, 859–60 (Utah 1920); *see also* Kerr v. Hudson Hotel Co., 37 So. 2d 630, 631 (Miss. 1948).

95. *See* Fisher, 188 P. 856 at 859–60; *see also* Kerr, 37 So. 2d at 631.

96. *See supra* text accompanying notes 74–75.

97. *See* Manning v. Wells, 28 Tenn. 746, 748 (1849).

98. *See* HOW DOES AIRBNB HANDLE SECURITY DEPOSITS?, <https://www.airbnb.com/help/article/140/how-does-airbnb-handle-security-deposits> (last visited Sept. 22, 2016) [hereinafter AIRBNB SECURITY DEPOSITS].

99. *Id.*

100. *Id.*

101. *See generally* FRANK B. CROSS & ROGER LEROY MILLER, WEST'S LEGAL ENVIRONMENT OF BUSINESS: TEXTS AND CASES 66 (6th ed. 2007). Interestingly, Airbnb elected to mediate any dispute rather than placing itself as an arbitrator to determine a final resolution. AIRBNB SECURITY DEPOSITS, *supra* note 98.

deposit option offers very little protection for a host, and creates situations whereby the only option for recovery comes through the pursuit of a legal claim for either conversion or negligence against the guest.

a. Conversion

From its early beginnings as part of the tort of trover, a conversion occurs when “an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.”¹⁰² Nonetheless, the amount a plaintiff will recover depends on the duration or severity of the damage, so a minor injury will only offer a diminished value, whereas complete destruction will call for full value.¹⁰³

In determining whether a conversion occurred, the defendant must wrongfully acquire possession of the plaintiff’s chattel and not merely change its location.¹⁰⁴ The taking, detaining, or disposal of the chattel will complete the conversion, which will allow for the recovery of the property’s value.¹⁰⁵

Taking into account the reality of the Airbnb model, the host places a great number of personal belongings located within the property offered to guests at risk. Should a guest affirmatively or inadvertently acquire possession of the host’s chattels when departing, the elements of conversion would be satisfied. This would provide the foundation for a host to move forward with a conversion claim against the guest.

102. RESTATEMENT (SECOND) OF TORTS § 222A (AM. LAW INST. 1975). In essence, conversion is analogous to a forced judicial sale where the defendant receives title to the chattel and pays for it. *Id.* at cmt c. The extent of the interference with the chattel owner’s property rights provides the distinction between conversion and trespass to chattels. *See* KEETON ET AL., *supra* note 42, at § 15.

103. *See* KEETON ET AL., *supra* note 42, at § 15.

104. *Id.* According to Keeton and Prosser, three jurisdictions require that the owner must demand the other party return the chattel as a prerequisite to acquiring possession, while the remainder of the country views the acquisition as complete when custody of the item occurs.

105. *Id.* The converter may not try to undo the acquisition by forcing the chattel back on the owner in an effort to mitigate damages or as a means to bar the legal action.

b. Negligence

In addition, a guest may cause damage to the host's property during a stay. In these types of situations, a host may look to recover any out-of-pocket costs through a negligence claim against the guest. As previously explained, the courts will begin the negligence inquiry by determining whether the guest owes a duty towards the host's real and personal property used in the transaction.¹⁰⁶ This standard will apply regardless of whether the court classifies the guest as a licensee under the innkeeper laws or finds that a landlord-tenant relationship exists.

Furthermore, under a landlord-tenant relationship, the guest's present possessory estate followed by the host's reversion would invoke the rules against waste, along with the affirmative duty to abstain from causing specific damage to the premises intentionally or negligently.¹⁰⁷ In turn, any breach in the affirmative duty under either classification will most likely fulfill the required elements necessary for negligence when a guest damages the host's property, resulting in the opportunity to put forward a claim to recover damages.

Consequently, a guest may face liability for any actions that cause a loss to the host's property through conversion or negligence. While Airbnb appears to offer a solution through a security deposit, the fact that the company only mediates a claim and doesn't arbitrate it only increases the likelihood of legal action by an aggrieved host or guest to obtain a final resolution and the appropriate damages. Hence, the liability issues between hosts and guests will also become a major concern in need of a solution as Airbnb continues to grow and events occur. The courts maintain ample precedent on how to treat the Airbnb model, but have yet to determine the type of relationship and law that applies when resolving a liability claim.

Accordingly, the Airbnb model creates a whole host of liability issues that arise out of property, tort, and contract law. While some attempts to use property law to reign in the Airbnb model will compete with the rights of the owners and

106. See *supra* text accompanying note 74.

107. See CUNNINGHAM ET AL., *supra* note 64, at § 6.23 (The rules against waste basically restrict the holder of a present estate from permanently damaging the land or the improvements on it when a reversion interest is held).

occupiers of the land and attract the attention of government regulators, the liability issues continue to quietly exist and need solutions before they become a financial impediment to the concept and future growth. Nonetheless, private industry may offer mechanisms, such as risk management and insurance, outside the traditional legal system to address and mitigate many of the issues discussed while we wait for guidance from a court.

II.

INSURANCE AS A PROPOSED SOLUTION

A. *Introduction*

Amidst the liability risks posed by the Airbnb model, insurance stands as a private market solution to risk mitigation.¹⁰⁸ Insurance not only serves the function of spreading and aggregating risks to the insurer,¹⁰⁹ but also insurance policies and contracts provide insureds the peace of mind and promise of security that the financial (and often emotional and psychological) pain of a catastrophic loss will be lessened in the event of an unforeseen occurrence.¹¹⁰ Academic commentators have focused on a number of issues raised by the

108. See generally Jeffrey W. Stempel, *The Insurance Policy as Social Instrument and Social Institution*, 51 WM. & MARY L. REV. 1489 (2010) (discussing generally the role of insurance policies to serve a risk management function, among others).

109. See Sean B. Hecht, *Climate Change and the Transformation of Risk: Insurance Matters*, 55 UCLA L. REV. 1559, 1564 (2008) (“Insurers are able to bear risks that other individuals and businesses are unable to bear, by aggregating those risks to make the insurer’s overall risk predictable. Policyholders pay a relatively small, certain amount (called a premium) in order to avoid the risk of a larger payout later. This enables policyholders to use their capital rather than hold it in reserve in case a risk materializes.”).

110. See Jay M. Feinman, *The Law of Insurance Claims Practices: Beyond Bad Faith*, 47 TORT TRIAL & INS. PRAC. L.J. 693, 711 (2012) (“The individual insurance relation bears a promise of security, and each individual relation is an instance of the process of providing collective security through insurance. The purpose of insurance is to ameliorate the financial consequences of risk that come to pass among the members of the group. More broadly, insurance provides a social safety net for individuals and businesses. Most Americans are only a car accident, a fire in the home, a lawsuit, or an injury away from having the wealth, the comfort, and the lifestyle accumulated over a lifetime of work wiped out. Insurance does not remove all of the consequences of a catastrophic loss, but it can make it something other than a catastrophe.”).

Airbnb model, such as how states may regulate the sharing economy,¹¹¹ the potential for race discrimination in the sharing economy,¹¹² how the example of Europe can inform Airbnb regulations,¹¹³ municipal legislation,¹¹⁴ and tort liability,¹¹⁵ including a recent article which focused on insurance for both the ride sharing and home sharing sectors.¹¹⁶

A key hurdle in the home sharing economy is that the typical homeowner's insurance policy excludes liability coverage for the "business pursuits" of any insured.¹¹⁷ The "business pursuits" and rental exclusions pose a distinct hurdle to private insurance coverage for the Airbnb model. Over the past

111. See Gregory E. Lines, Note, *Hej, Not Hej då: Regulating Airbnb in the New Age of Arizona Vacation Rentals*, 57 ARIZ. L. REV. 1163 (2015); Brittany McNamara, Note, *Airbnb: A Not-So-Safe Resting Place*, 13 COLO. TECH. L.J. 149 (2015); Joseph Shuford, Note, *Hotel, Motel, Holiday Inn and Peer-to-Peer Rentals: The Sharing Economy, North Carolina, and the Constitution*, 16 N.C. J.L. & TECH. 301 (2015).

112. See Michael Todisco, Essay, *Share and Share Alike? Considering Racial Discrimination in the Nascent Room-Sharing Economy*, 67 STAN. L. REV. ONLINE 121 (2015).

113. See Johanna Interian, Note, *Up in the Air: Harmonizing the Sharing Economy Through Airbnb Regulations*, 39 B.C. INT'L & COMP. L. REV. 129 (2016).

114. See Roberta A. Kaplan & Michael L. Nadler, *Airbnb: A Case Study in Occupancy Regulation and Taxation*, 82 U. CHI. L. REV. DIALOGUE 103 (2015); Dayne Lee, Note, *How Airbnb Short-Term Rentals Exacerbate Los Angeles's Affordable Housing Crisis: Analysis and Policy Recommendations*, 10 HARV. L. & POL'Y REV. 229 (2016); Dana Palombo, Comment, *A Tale of Two Cities: The Regulatory Battle to Incorporate Short-Term Residential Rentals into Modern Law*, 4 AM. U. BUS. L. REV. 287 (2015).

115. See Talia G. Loucks, Note, *Travelers Beware: Tort Liability in the Sharing Economy*, 10 WASH. J.L. TECH. & ARTS 329 (2015).

116. See Alexander B. Traum, *Sharing Risk in the Sharing Economy: Insurance Regulation in the Age of Uber*, 14 CARDOZO PUB. L., POL'Y & ETHICS J. 511 (2016).

117. See Roger O. Steggerda, Note, *Watching Your Neighbor's Child: Is Babysitting Really a Business Pursuit? A Comment on Dwello v. American Reliance Insurance Company*, 1 NEV. L.J. 323, 327 (2001) ("Several types of personal liability policies, and the liability sections of virtually all homeowners insurance policies, contain a business pursuit exclusion. Commonly, the business pursuits provision is fairly broad, stating that personal liability and medical payments to others do not apply to bodily injury or property damage 'arising out of business pursuits of any insured' Often, the exclusion carries with it an exception almost equally broad, which states that the exclusion does not apply to 'activities which are ordinarily incident to non-business pursuits'").

several years, Airbnb has affirmatively taken steps in attempting to ameliorate home sharing risks. The trend over the past several years has been a movement toward steadily increasing coverage for liability risks through the private mechanism of insurance-like coverage. First, in 2012 Airbnb launched a “Host Guarantee” program, discussed more fully in Section II.C, to address property damage risks.¹¹⁸ In early 2015, Airbnb expanded beyond the Host Guarantee program and mere property damage coverage, and began providing coverage for third-party claims of both bodily injury and/or property damage through a Host Protection Insurance program.¹¹⁹ However, the Host Protection Insurance program initially only offered secondary coverage.¹²⁰ Later in 2015, the Host Protection Insurance program was amended to offer primary coverage.¹²¹ Most recently, in May 2016, a major insurer, Allstate, announced plans to offer a “Host Advantage” personal property insurance protection endorsement in several states (starting in mid-August 2016).¹²²

While Airbnb and other companies have already implemented a number of steps to incorporate insurance into risk mitigation of the liability risks posed by the Airbnb model, much work is left to be completed to fully incorporate insurance. No states currently require home sharing companies to offer minimum personal property and liability insurance coverages for home sharing hosts. Also, no states require that home sharing sites provide disclosures to home sharing hosts concerning insurance coverages on their websites. Significant coverage gaps remain for home sharing hosts, and states are in a position to enact legislation to promote wider insurance coverage to mitigate home sharing risks.

118. See AIRBNB HOST GUARANTEE, *supra* note 13.

119. See Ron Lieber, *The Insurance Market Mystifies an Airbnb Host*, N.Y. TIMES (Dec. 19, 2014), http://www.nytimes.com/2014/12/20/your-money/the-insurance-market-mystifies-an-airbnb-host.html?_r=0.

120. *Id.*

121. See Steven Musil, *Airbnb Beefs up Liability Insurance Offering for Hosts*, CNET (Oct. 22, 2015), <http://www.cnet.com/news/airbnb-beefs-up-liability-insurance-offering-for-hosts/>.

122. See *Allstate Debuts Insurance Coverage for Homeowners Sharing Their Homes*, INS. J. (May 25, 2016), <http://www.insurancejournal.com/news/national/2016/05/25/409819.htm> [hereinafter INSURANCE JOURNAL].

B. *The “Business Pursuits” and Rental Exclusion*

Traditional homeowner’s insurance policies cover losses to the home and its physical contents, as well as provide coverage for liability claims by third persons visiting the home.¹²³ While homeowner’s policies provide a great degree of insurance coverage for the insured, there are a number of exclusions, including losses due to flood damage,¹²⁴ ordinance or law,¹²⁵ losses due to earth movement,¹²⁶ and war.¹²⁷ In addition, standard policies typically exclude losses for property

123. See Jay Feinman, *Fragmented Risk: An Introduction*, 11 RUTGERS J.L. & PUB. POL’Y 1 (2013) (“Most homeowners have only the vaguest sense of the extent of coverage provided by their homeowners’ insurance policy, particularly the breadth of coverage it provides. Using as an example the HO-3 policy, the most widely used policy, most homeowners would not be surprised to know that it covers physical damage to their home and its contents and their tort liability for accidents to visitors to their home.”).

124. See Christopher C. French, *Insuring Floods: The Most Common and Devastating Natural Catastrophes in America*, 60 VILL. L. REV. 53, 61 (2015) (“[B]y the 1960s, insurers had seen enough of flood losses, and they decided that insuring losses due to flooding generally was not a risk they wanted to accept. Almost uniformly, they have refused to insure flood losses for non-commercial entities despite selling ‘all risk’ homeowners property policies.”).

125. See Scott G. Johnson, *Insurance Coverage for Building Code Upgrades*, 44 TORT TRIAL & INS. PRAC. L.J. 1031, 1039 (2009) (“Policy provisions limiting coverage for building code upgrades have been in insurance policies for more than one hundred years. The 1896 New York Standard Policy, for example, included such a limitation. The limitation has remained in every subsequent version of the standard fire policy. Today, many other policy forms also exclude or limit coverage for the costs of complying with building laws or ordinances.”).

126. See Robert P. Dahlquist, *Perspectives on Subsidence Exclusions and the Role of Concurrent Causation in Earth Movement Cases*, 37 TORT & INS. L.J. 949, 953 (2002) (“The most commonly used types of earth movement exclusions include: (1) exclusions for damage caused by earth movement regardless of the cause of the earth movement; (2) exclusions for earth movement caused by the operations of the insured or the operations of others for whose acts the insured may be held liable; (3) exclusions for earth movement caused by the operations of the insured but not the operations of others; and (4) exclusions for specific earth movement events.”).

127. See Lucien J. Dhooze, *A Previously Unimaginable Risk Potential: September 11 and the Insurance Industry*, 40 AM. BUS. L.J. 687, 728 (2003) (“‘Acts of war’ have long been an excluded peril from various forms of insurance coverage. War exclusions generally consist of those included in standard policy forms developed by industry associations and nonstandard forms drafted by individual insurers based upon the language contained within the standard forms.”).

damage and personal injury arising out of the “business pursuits” of an insured.¹²⁸ The “business pursuit” exclusion has been applied by courts in cases such as operating a business out of a home,¹²⁹ providing child care services in a home,¹³⁰ the activities of a limited partnership in buying and selling real estate investments,¹³¹ and agricultural activities such as driving a tractor to haul hay for a profit.¹³²

The question often arises as to what exactly constitutes a “business pursuit.” Courts generally utilize a two-part test to determine a business pursuit—first, if there is continuity in the insured’s activity,¹³³ and second, the presence of a profit motive.¹³⁴ It is arguable in the case with home sharing in the Airbnb model that an insured under a homeowner’s insurance policy who rents out the home through Airbnb or another home sharing service, that a court would find “continuity” if the insured rents the home multiple times in a given time period. The “profit motive” element is much easier to establish, as it is likely that the primary motivation of those listing their homes on Airbnb and similar home sharing websites is to earn extra money.

An additional exclusion which some homeowner’s insurance policies contain is the “rental exclusion.” A rental exclusion typically will exclude bodily injury or property damage “arising out of the rental or holding for rental of any part of any premises by an insured.”¹³⁵ However, there is typically an

128. See *Personal Umbrella Insurance Policy: The “Business Pursuits” Exclusion*, SETNOR BYER INS. & RISK (Oct. 18, 2010), <https://www.setnorbyer.com/risk-briefs/post/Personal-Umbrella-Insurance-Policy-The-Business-Pursuits-Exclusion.aspx>.

129. See, e.g., *Welch v. Gulf Ins. Co.*, 190 S.E.2d 101 (Ga. Ct. App. 1972).

130. See, e.g., *Stanley v. Am. Fire & Cas. Co.*, 361 So. 2d 1030, 1033 (Ala. 1978) (“Supervising children on a regular basis for compensation is ordinarily a business pursuit.”).

131. See, e.g., *Vallas v. Cincinnati Ins. Co.*, 624 So. 2d 568 (Ala. 1993).

132. See, e.g., *LeBlanc v. Broussard*, 396 So. 2d 535 (La. Ct. App. 1981).

133. See *Springer v. Erie Ins. Exch.*, 94 A.3d 75, 87 (Md. 2014). The court defined continuity as “a continued or regular activity for the purpose of earning a livelihood.” *Id.*

134. *Id.* The court defined a profit motive as “the showing that the activity was undertaken for monetary gain.” *Id.*

135. See, e.g., *Citizens Prop. Ins. Corp. v. Wise*, 926 So. 2d 403, 403 (Fla. Ct. App. 2006).

exception for the rental or holding for rental of an insured location on an “occasional basis.”¹³⁶

Courts have struggled to find consistent results on a clear bright-line interpretation of an “occasional basis.” In *State Farm Fire and Cas. Co. v. Piazza*, two parents and their daughter purchased a house which the daughter occupied for two years.¹³⁷ After two years, the daughter left the home to attend school in Scotland.¹³⁸ The mother’s property management company rented out the house to two different groups of tenants over the course of twenty-six months.¹³⁹ The second group of tenants, a couple, alleged they contracted an illness caused by mold in the home and filed a liability claim against the homeowners.¹⁴⁰

The homeowners’ liability insurer sought a declaratory judgment and contended they did not have a duty to defend the homeowners on the basis of the rental exclusion in the homeowner’s policy.¹⁴¹ In examining the facts surrounding the rentals of the home, the Washington Court of Appeals held the “occasional basis” exception to the rental exclusion did not apply and thus the insurer did not have a duty to defend the homeowners in the underlying liability case.¹⁴² The court noted that “a continuous rental arrangement of over twenty-six months cannot be called ‘occasional’ under any definition of the term,” and that both the absence of the homeowners from the home as well as long-term rental arrangements are more typical of a landlord–tenant relationship than a rental made on an “occasional basis.”¹⁴³

Courts sometimes have found coverage in a rental situation. For example, in *Villanueva v. Preferred Mut. Ins. Co.*, the plaintiffs leased their summer home to two individuals in a five-month “ski season” lease.¹⁴⁴ During the lease, the home

136. *Id.* at 404.

137. *See* *State Farm Fire & Cas. Co. v. Piazza*, 131 P.3d 337 (Wash. Ct. App. 2006).

138. *Id.*

139. *Id.* at 337–38.

140. *Id.* at 338.

141. *Id.*

142. *Id.*

143. *Id.*

144. *See* *Villanueva v. Preferred Mut. Ins. Co.*, 48 A.D.3d 1015, 1016 (N.Y. App. Div. 2008).

was destroyed in a fire and the plaintiffs incurred \$121,000 in damages.¹⁴⁵ The insurer offered to pay only \$2500, which was a limited coverage amount for personal property used for business purposes.¹⁴⁶ The “business purposes” exclusion in the policy at issue in the case included the “rental of property to others” in the definition of “business.”¹⁴⁷

The insurer contended that it would be unreasonable for the plaintiffs to expect coverage in a situation where they relinquished the property to the renters for five months.¹⁴⁸ Despite this argument, the New York Appellate Division of the Supreme Court cited¹⁴⁹ the Illinois Court of Appeals case of *State Farm Fire & Cas. Co. v. Wonnell*, which stated that “the purpose behind the ‘occasional’ rental exception was to allow the insured to rent his or her residence while living elsewhere temporarily, but with the intention to return there to live.”¹⁵⁰ In examining the purposes of the “occasional” rental exception, the New York Appellate Division of the Supreme Court held that a one-time rental of a summer home for five months fell within the “occasional rental” exception of the “business purposes” exclusion, and thus the exclusion did not apply.¹⁵¹ It also emphasized that other courts examining the “occasionally rented,” “occasional rental,” or “occasional basis” language found that it applied to vacation rentals.¹⁵²

Although an insured who lists her home on Airbnb or another home sharing service may be able to find insurance coverage if a court finds an ambiguity in her policy, the likely scenario is that coverage will not exist for the Airbnb model through the traditional homeowner’s insurance policy. Some insurance companies may be more generous than others with regard to the “business purposes” and rental exclusions. For instance, a representative of USAA has indicated that liability coverage may be available for insureds who “very occasionally” rent a room out, and Chubb provides coverage to insureds

145. *Id.*

146. *Id.*

147. *Id.* at 1016–17.

148. *Id.* at 1017.

149. *Id.*

150. See *State Farm Fire & Cas. Co. v. Wonnell*, 533 N.E.2d 1131, 1133 (Ill. App. Ct. 1989).

151. See *Villanueva*, 48 A.D.3d at 1017–18.

152. *Id.* at 1017.

who earn up to \$15,000 annually in rental income.¹⁵³ Ultimately, however, the presumption is likely in the majority of cases that there would be no coverage through the typical homeowner's insurance policy. Likely with these limitations in mind, Airbnb began offering a "Host Guarantee" program to cover certain property damage risks incurred by hosts.

C. *The Airbnb "Host Guarantee" Program*

In early 2012, Airbnb announced it would provide coverage for up to \$1 million for hosts who incur property damage in their home during guest Airbnb stays through a "Host Guarantee" program.¹⁵⁴ The coverage provides up to \$1 million in coverage for not only personal property, but for real property as well.¹⁵⁵ Significantly, the "Host Guarantee" is not traditional insurance and Airbnb represents that it is not meant to "replace your homeowner's or renter's insurance."¹⁵⁶

As a condition precedent to filing any claim under the Host Guarantee program for property damage caused by guests, a host is required to contact and to try to resolve the property damage concern with the guest within fourteen days of discovery of the physical loss or damage.¹⁵⁷ If resolution of the issue is unsuccessful, then the host must complete and file an Airbnb Host Guarantee Payment Request Form within thirty days, the earlier of fourteen days after the guest's end of booking, or the date on which the host's next booking occurs.¹⁵⁸ In addition, if property damage is incurred as a result of a crime or other violation of law, a host is required to file a police report as a condition precedent to recovery under the

153. See Ron Lieber, *A Liability Risk for Airbnb Hosts*, N.Y. TIMES (Dec. 5, 2014), https://www.nytimes.com/2014/12/06/your-money/airbnb-offers-homeowner-liability-coverage-but-hosts-still-have-risks.html?_r=0.

154. See Chenda Ngak, *Airbnb Will Insure up to \$1 Million in Property Damage*, CBS NEWS (May 23, 2012, 3:58 PM), <http://www.cbsnews.com/news/airbnb-will-insure-up-to-1-million-in-property-damage/>.

155. See HOST GUARANTEE TERMS AND CONDITIONS, https://www.airbnb.com/terms/host_guarantee (last visited June 26, 2016) [hereinafter AIRBNB HOST GUARANTEE TERMS AND CONDITIONS].

156. See WHAT'S THE DIFFERENCE BETWEEN AIRBNB'S HOST GUARANTEE AND HOST PROTECTION INSURANCE?, <https://www.airbnb.com/help/article/938/what-s-the-difference-between-airbnb-s-host-guarantee-and-host-protection-insurance> (last visited June 26, 2016).

157. See AIRBNB HOST GUARANTEE TERMS AND CONDITIONS, *supra* note 155.

158. *Id.*

Host Guarantee program.¹⁵⁹ Within thirty days, a host must also submit a sworn proof of loss.¹⁶⁰ Any recovery under the Host Guarantee program is reduced by collateral sources, including any payments made by the responsible guest, the security deposit received by the host, and any indemnity under an applicable insurance policy.¹⁶¹

There are a number of provisions in the Host Guarantee program terms and conditions that potentially may be problematic for a host filing a property damage claim. First, in the terms and conditions, Airbnb specifically reserves the right to terminate or modify the provisions of the contract “at any time, in its sole discretion, and without prior notice.”¹⁶² Pursuant to this provision, at essentially any time, Airbnb can announce elimination of the program without any notice given to hosts. While Airbnb has a strong presence in the State of California,¹⁶³ hosts outside of the State of California may be surprised to learn that any dispute under the terms and conditions would be interpreted in accordance with California law.¹⁶⁴ While the terms and conditions of the Host Guarantee program provide that payment for any loss will be in U.S. currency, and a host may reasonably expect such payment in U.S. currency, the program also provides Airbnb the sole discretion to make payment in a different currency if it so wishes.¹⁶⁵ Finally, as most commercial contracts today contain arbitration clauses,¹⁶⁶ the terms and conditions of the Host Guarantee program also provide that any disputes are subject to arbitration.¹⁶⁷ The arbitration provision provides that if a property damage claim for damages does not exceed \$75,000, then

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. See Tim Logan, Emily Alpert Reyes & Ben Poston, *Airbnb and Other Short-Term Rentals Worsen Housing Shortage, Critics Say*, L.A. TIMES (Mar. 11, 2015), <http://www.latimes.com/business/realestate/la-fi-airbnb-housing-market-20150311-story.html>.

164. See AIRBNB HOST GUARANTEE TERMS AND CONDITIONS, *supra* note 155.

165. *Id.*

166. See Anjanette Raymond, *It Is Time the Law Begins to Protect Consumers From Significantly One-Sided Arbitration Clauses Within Contracts of Adhesion*, 91 NEB. L. REV. 666 (2013) (generally discussing arbitration clauses in adhesion contracts).

167. See AIRBNB HOST GUARANTEE TERMS AND CONDITIONS, *supra* note 155.

Airbnb will cover the filing, administrative, and arbitrator fees of the arbitration.¹⁶⁸ In addition, the provision provides that the arbitration will take place in the country of the host's residence and it allows recovery of a host's attorney's fees and expenses if the host prevails in the arbitration.¹⁶⁹

In addition to all of the requirements, to submit a claim under the Host Guarantee program, hosts are also subject to a number of limitations and exclusions. Perhaps the most significant limitation is that it covers only property damage and does not cover personal liability or injury suffered by guests or other third persons.¹⁷⁰ While the Airbnb "Host Protection Insurance" program discussed later in this Article covers certain liability and personal injury claims of third persons, the Host Guarantee program does not cover any personal liability or injury claims. Another significant limitation is that the guarantee does not cover ordinary wear and tear of the host's property as a result of guest bookings.¹⁷¹ Thus, the host who repeatedly rents out property for home sharing or short-term rentals may face denial of a Host Guarantee claim if Airbnb were to make the determination that the loss was due to ordinary wear and tear.

There are also a number of other significant exclusions in the Host Guarantee program. The Host Guarantee program doesn't cover the loss of currency, money, precious metal in bullion form, notes, securities, watercraft, and vehicles.¹⁷² Most fine art, which typically can be covered by endorsements and specialized insurance policies,¹⁷³ also would not be covered under the Host Guarantee program.¹⁷⁴ The program also does not cover any loss after a booking period expiration,¹⁷⁵

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

173. See Rebecca Woan, *What Can Be Covered, What Sometimes Can Be Covered and What is Almost Never Covered*, 13 DEPAUL BUS. & COM. L.J. 479 (2015) (generally discussing fine art insurance policies).

174. See AIRBNB HOST GUARANTEE TERMS AND CONDITIONS, *supra* note 155. The Host Guarantee Terms and Conditions provide the following exclusion: "in the case of Fine Arts, losses or damages if the Fine Arts cannot be replaced with other of like kind and quality and any loss or damage from any repairing, restoration or retouching process." *Id.*

175. *Id.*

and losses due to identity theft and fraud, which resulted in approximately \$15.4 billion in damages in 2014,¹⁷⁶ are specifically excluded from coverage.¹⁷⁷

D. *The Airbnb Host Protection Insurance Program*

In January 2015, Airbnb expanded upon the Host Guarantee program and offered a Host Protection Insurance program to hosts for personal injury claims.¹⁷⁸ The coverage is considered insurance and covers liability claims filed by guests and third persons who are injured on the host's premises during a booking.¹⁷⁹ It currently provides up to \$1 million in coverage per occurrence for personal injury and property damage claims, with a cap of \$1 million per listing location.¹⁸⁰

Originally, the Host Protection Insurance program only offered secondary insurance coverage.¹⁸¹ Through the terms of the first iteration of the Host Protection Insurance program, a host with a claim would first have to file a claim with the host's home insurance company for a coverage determination on the claim as a condition precedent to filing a claim with Airbnb's Host Protection Insurance.¹⁸² As one commentator notes, filing such a claim may potentially lead to the home insurer canceling the host's primary homeowner's insurance for utilizing the property for "business purposes."¹⁸³ Another significant risk faced by a host is that through filing a homeowner's insurance claim, not only will the claim subject the host to a possible cancellation of coverage, but the filing of the claim may very well lead to a rise in the host's annual homeowner's insurance premium. CNBC reported in late 2013 that the average homeowner's insurance premium increased by ap-

176. Andrew Blake, *Identity Theft Affected 17.6M, Cost \$15.4B in 2014: Justice Dep't*, WASH. TIMES (Sept. 28, 2015), <http://www.washingtontimes.com/news/2015/sep/28/identity-theft-affected-176-million-cost-154-billi/>.

177. See AIRBNB HOST GUARANTEE TERMS AND CONDITIONS, *supra* note 155.

178. See HOST PROTECTION INSURANCE, <https://www.airbnb.com/host-protection-insurance> (last visited June 27, 2016) [hereinafter AIRBNB HOST PROTECTION INSURANCE].

179. *Id.*

180. *Id.*

181. See Galen Hayes, *The Scary Insurance Reality for Airbnb Hosts*, PROPERTY CASUALTY 360° (Jan. 5, 2016), <http://www.propertycasualty360.com/2016/01/05/the-scary-insurance-reality-for-airbnb-hosts?slreturn=1467043407>.

182. *Id.*

183. *Id.*

proximately nine percent following the filing of an insurance claim, with double digit increases in premiums in states such as Minnesota, Connecticut, Maryland, California, and Oregon.¹⁸⁴

The expansion of programs from the Host Guarantee program to the Host Protection Insurance program has indicated a trend of increasing coverage of liability risks in the home sharing economy. In October 2015, Airbnb extended this trend with an announcement that the Host Protection Insurance program would provide primary insurance coverage, helping to negate the potential negative consequences for a host who files a claim with only secondary coverage.¹⁸⁵

Although there is generally a trend of increased insurance coverage, the Host Protection Insurance program includes a number of key exclusions in its coverage. Airbnb notes that the following liability items are not included in the coverage: “(1) Intentional Acts including (i) Assault and Battery or (ii) Sexual Abuse or Molestation—by the host or any other insured party; (2) Loss of Earnings; (3) Personal and Advertising Injury; (4) Fungi or Bacteria; (5) Chinese Drywall; (6) Communicable Diseases; (7) Acts of Terrorism; (8) Product Liability; (9) Pollution; and (10) Asbestos, Lead, or Silica.”¹⁸⁶

E. *Other Homesharing Insurance Options*

Beyond Airbnb, there are other entities that have entered the homesharing liability insurance market to provide even expanded insurance coverage. One entity that has entered the homesharing liability insurance market is Peers, which is an organization dedicated to the promotion of the sharing economy.¹⁸⁷ Peers offers a \$1 million commercial general liability insurance policy, which covers bodily injury or property damage to a guest for a \$36 monthly premium.¹⁸⁸ Peers notes that

184. See Herb Weisbaum, *Think Carefully Before Filing a Homeowners Claim*, CNBC (Oct. 22, 2013, 7:44 AM), <http://www.cnbc.com/2013/10/21/filing-a-homeowners-claim-can-raise-your-rate-9-percent.html>.

185. See AIRBNB HOST PROTECTION INSURANCE, *supra* note 178.

186. *Id.*

187. See MAKING THE SHARING ECONOMY WORK FOR THE PEOPLE WHO POWER IT, <http://www.peers.org/about/> (last visited June 27, 2016) (“Peers’ mission is to make the sharing economy work for the people who power it.”).

188. See HOMESHARING LIABILITY INSURANCE FAQ, <http://www.peers.org/homesharing-liability-insurance-faq/> (last visited June 27, 2016).

Airbnb is the only company which provides liability insurance to their hosts, and contends that its product is ideal for hosts who place their property listing on multiple homesharing sites.¹⁸⁹ The homesharing liability policy, which is underwritten by United Specialty Insurance Company, can be activated for month-by-month utilization for hosts who only rent their property during specific months.¹⁹⁰ While the policy limits of the Airbnb Host Protection Insurance program and Peers policy are the same at \$1 million, the Peers policy does provide a reimbursement for ninety days lost rental income (up to a limit of \$5000) in the event a guest causes damages in excess of \$10,000.¹⁹¹

Most recently, in May 2016 Allstate announced plans to offer a homesharing insurance product endorsement to hosts in six states, starting in mid-August 2016.¹⁹² Allstate plans to offer the product initially in Arizona, Colorado, Illinois, Michigan, Tennessee, and Utah with plans to make it available in more states in 2017.¹⁹³ The endorsement will provide coverage on personal property for up to \$10,000 per rental period, and will cost approximately \$50 per year.¹⁹⁴

F. *State Legislative Activity*

As the above developments indicate, the general trend increasingly in industry practice is for an extension of coverage in the forms of guarantees and insurance to cover a host's liability exposure with the Airbnb model. Insurance regulatory offices in at least several states (Arkansas,¹⁹⁵ Louisiana,¹⁹⁶

189. *Id.*

190. *Id.*

191. *Id.*

192. *See* INSURANCE JOURNAL, *supra* note 122.

193. *Id.*

194. *Id.*

195. *See*, ARK. INS. DEP'T, *Navigating Home-Sharing Rentals*, <http://www.insurance.arkansas.gov/Consumers/Alerts/Home-Sharing.html> (last visited June 27, 2016).

196. *See Official Press Release: Department of Insurance Offers Tips on Navigating Risks of Home-Sharing Rentals*, LA. DEP'T OF INS. (May 6, 2015), <http://www.lda.la.gov/news/press-releases/5-6-15-home-sharing-rentals>.

Rhode Island,¹⁹⁷ and Vermont¹⁹⁸) and the former Insurance Commissioner of the State of Florida,¹⁹⁹ have expressed caution on the risks associated with home sharing. With the explosive growth of the home sharing economy, there have been efforts in at least three states (Massachusetts, California, and Florida) to regulate the aspects of home sharing that deal specifically with insurance coverage through legislation.

1. *Massachusetts House Bill 2618*

In early 2015, House Bill Number 2618 was introduced in the Massachusetts House of Representatives to establish a licensing system for short-term residential rentals in the State of Massachusetts.²⁰⁰ The bill seeks to require all home sharing hosts to obtain a “Short-Term Residential License” from their city or town.²⁰¹ It would also establish a “Short-Term Residential Rental Registry” managed by the Massachusetts Department of Housing and Community Development, which would include the names of all hosts who are licensed in the state.²⁰² The bill also would implement a state tax of five percent on renters who rent through home sharing services,²⁰³ and allow cities and towns in the state to impose a local tax of up to six percent on rentals (with Boston permitted to impose a tax of up to 6.5%).²⁰⁴

A unique component of the Massachusetts legislation is that it includes safety requirements for short-term residential rentals. The bill mandates that the home sharing host’s unit and property in which it is located cannot be subject to “any

197. See *Consumer Alert 2015-8: Navigating Home Sharing Rentals*, R.I. DEP’T OF BUS. REGULATION INS. DIV. (July 14, 2015), <http://www.dbr.state.ri.us/documents/divisions/insurance/consumers/ConsumerAlert2015-8.pdf>.

198. See *Be Aware Before You Share*, VT. DEP’T OF FIN. REGULATION, <http://www.dfr.vermont.gov/insurance/insurance-consumer/be-aware-you-share> (last visited June 27, 2016).

199. See Kevin McCarty, *Caution on Home-Sharing Rentals*, TAMPA TRIB. (June 1, 2015), <http://www.tbo.com/list/news-opinion-commentary/kevin-mccarty-caution-on-home-sharing-rentals-20150601/>.

200. See H.R. 2618, 189th Gen. Court (Mass. 2015).

201. *Id.* § 7(a). The provision also notes that a short-term residential license is valid for a time period of two years and can be obtained and renewed for a \$50 fee. *Id.*

202. *Id.* § 6(f)(1)(iv).

203. *Id.* § 2.

204. *Id.* § 3.

outstanding building, electrical, plumbing, mechanical, fire, health, housing, police or planning code enforcement, including any notices of violation, notices to cure, orders of abatement, cease and desist orders, or correction notices.”²⁰⁵ In addition, the legislation requires hosts to post a sign within the front door of the property which provides information on the locations of all fire extinguishers, gas shut-off valves, fire exits, and pull fire alarms.²⁰⁶

Finally, the legislation requires all hosts in the State of Massachusetts to carry at least \$500,000 in liability insurance coverage for home sharing guests, or to conduct transactions through a home sharing platform that carries at least that amount in insurance coverage.²⁰⁷ The legislation mandates that the insurance coverage defend and indemnify the host, named additional insured(s), any tenant(s), and also any owner(s) in the building for bodily injury or property damage incurred during a short-term residential use.²⁰⁸

To date, Massachusetts House Bill 2618 has not been enacted into law.²⁰⁹

2. *California Senate Bill 1092*

In February 2016, California State Senator Bill Monning introduced legislation intended to mandate certain disclosures by home sharing platforms to hosts. Essentially, the disclosures encourage hosts to review their insurance policies and try to ascertain if there is appropriate insurance coverage in the event the host incurs property damage or if the situation in which a guest or third party files a liability claim arising out of a booking were to arise.²¹⁰ The bill states that the following specific disclosure must be made in the home sharing platform: “You should review any restrictions on coverage under your homeowner’s or renter’s insurance policy related to short-term rental activities to ensure that there is appropriate insurance coverage in the event that a person sustains an in-

205. *Id.* § 6(f)(1)(vii).

206. *Id.* § 6(f)(1)(viii).

207. *Id.* § 6(f)(1)(iii).

208. *Id.*

209. *See Bill H. 2618*, THE 189TH GENERAL GEN. COURT OF THE COMMONWEALTH OF MASS., <https://malegislature.gov/Bills/189/House/H2618> (last visited June 28, 2016).

210. *See S. 1092*, Cal. Leg. 2015–2016 Reg. Sess. (Cal. 2016).

jury or loss for which you are responsible, a person damages or causes loss to your personal or real property, or a claim or lawsuit is made against you or otherwise arises out of activities related to this hosting platform.”²¹¹ The legislation recently passed both chambers of the California legislature and it may possibly be enacted into law later in 2017.²¹²

3. *Florida Senate Bill 1298*

In early 2015, Florida State Senator David Simmons introduced Senate Bill 1298 in the Florida Senate.²¹³ The legislation has been described as “benchmark” in the area of insurance and the home sharing economy.²¹⁴ Senate Bill 1298 includes the most extensive proposed home sharing insurance requirements of any state legislation to date. It would have required short-term rental network companies to provide at least \$1 million in liability insurance coverage for participating hosts to cover potential liability claims of guests and third parties, and also would have required providing coverage for physical property damage to hosts which are equal to or greater than the underlying homeowner’s insurance coverage the host maintains on the property.²¹⁵ The liability and property insurance called for by the bill must be primary, not secondary or excess, and it also would be barred from including a condition precedent that any other insurance policy must first deny a claim.²¹⁶

Similar to the Massachusetts legislation, Florida Senate Bill 1298 also included disclosure requirements. The bill required short-term rental network companies to disclose in writing to hosts the insurance limits of liability and coverages the company is providing during short-term rentals.²¹⁷

211. *Id.*

212. *See id.*

213. *See* S. 1298, 2015 S., Reg. Sess. (Fla. 2015), <https://www.flsenate.gov/Session/Bill/2015/1298>.

214. *See* G. Donovan Brown, *National Association of Insurance Commissioners’ Sharing Economy Working Group Reviews Home-Sharing Issues, Benchmark Florida Legislation*, MARTINDALE (Aug. 5, 2015), http://www.martindale.com/insurance-law/article_Colodny-Fass-PA_2212436.htm.

215. *See* Fl. S. 1298.

216. *Id.*

217. *Id.*

Finally, Florida Senate Bill 1298 also would have imposed a statutory duty upon short-term rental companies and their insurers to cooperate with claims investigations.²¹⁸ It would have required short-term rental companies and their insurers to work with other insurers to exchange information, and specifically to provide the number and duration of all short-term rentals in the prior twelve months with regard to the property where a loss occurs.²¹⁹ Senate Bill 1298 passed through the Florida Senate in 2015, but it did not receive a vote in the Florida House of Representatives that year.²²⁰

G. *Solutions to Mitigate Risk*

While the home sharing economy has expanded rapidly in the past several years, states have not yet followed as quickly in implementing legislation intended to reduce risk. Despite the efforts of Airbnb and other entities to expand insurance coverage, significant coverage gaps remain for home sharing hosts. States are in a prime position today to enact legislation to promote broader insurance coverage requirements to address home sharing risks. States can implement a number of requirements, described below, which can have the effect of mitigating risk.

(1) Bar any home sharing company or host to list for short-term rental any unit or property that is subject to any outstanding federal, state, and city/municipal building, electrical, plumbing, mechanical, fire, health, housing, police, or planning code enforcement, including any notices of violation, notices to cure, orders of abatement, cease or desist orders, or correction notices.

This requirement tracks almost exactly the language of Massachusetts House Bill 2618 in its intent to ensure that all units and properties offered for short-term rental meet minimum safety standards. State legislation can encompass federal, state, and city/municipal safety requirements.

(2) Require hosts to ensure that any unit or property being utilized as a short-term rental has at least one functioning

218. *Id.*

219. *Id.*

220. See *Bill History, CS/CB 1298: Minimum Insurance Requirements*, FLA. SENATE, <https://www.flsenate.gov/Session/Bill/2015/1298> (last visited Jan. 27, 2017).

and operating smoke detector, fire extinguisher, carbon monoxide detector, and first-aid kit in the unit or property.

This requirement addresses several risks associated with a home sharing situation. Fire loss is a significant risk. A National Fire Protection Association report indicated that in 2014, approximately 367,500 fires occurred in homes (which includes one and two family homes, apartments, and manufactured homes).²²¹ Carbon monoxide poisoning also presents a risk,²²² and the requirement of a carbon monoxide detector is intended to mitigate that risk. Additionally, the requirement of a first-aid kit in the unit or property can address situations where a smaller injury of a guest or third party may occur, such as a small laceration or insect bite.

(3) Require hosts to provide guests with written information on the locations of fire extinguishers, carbon monoxide detectors, smoke detectors, first-aid kits, gas shut-off valves, fire exits, and/or fire pull alarms.

This requirement closely tracks Massachusetts House Bill 2618, with the exception that it adds carbon monoxide detectors, smoke detectors, and first-aid kits to the required disclosures. In addition, this particular requirement does not necessarily require that the information be provided on a clearly printed sign, but rather in a disclosure generally in writing.

(4) Require hosts to provide guests with the telephone numbers and street address of the nearest hospital to the unit or property, in writing.

This requirement is intended to address the situation where a guest or third party is in a situation where immediate professional medical attention is required.

(5) Require short-term rental network companies to provide for hosts at least \$1 million in liability insurance coverage for guests and third parties. In addition, the required liability insurance must be primary and cannot be excess, secondary, or require a denial of a claim for other insurance as a

221. See HYLTON J.G. HAYNES, NAT'L FIRE PROT. ASS'N, FIRE LOSS IN THE UNITED STATES DURING 2014 at iii (2015).

222. See Will Melehani, *Chapter 19: Requiring a Carbon Monoxide Detector in Every Home*, 42 MCGEORGE L. REV. 628, 628 (2011) ("The Centers for Disease Control and Prevention estimate that each year carbon monoxide poisoning is responsible for 15,200 injuries and 480 deaths nationally.").

condition precedent to trigger the liability insurance coverage furnished.

These requirements closely track the requirements of Florida Senate Bill 1298. Massachusetts House Bill 2618 would have only required \$500,000 in liability coverage, and Florida Senate Bill 1298 would have required \$1 million. The \$1 million figure suggested is also in line with Airbnb's current Host Protection Insurance program and the emerging industry standard for home sharing insurance coverage.

(6) Require short-term rental network companies to provide for hosts at least \$1 million in property insurance coverage.

Airbnb's current Host Guarantee Program currently guarantees for up to \$1 million in property damage that a host may suffer, but is not considered insurance. This requirement ensures that \$1 million of actual property insurance coverage is furnished to hosts. While closely resembling Florida Senate Bill 1298, this would not require short-term rental network companies to furnish property insurance coverage up to the limits of the underlying homeowner's insurance policy.

(7) Require short-term rental network companies to disclose in writing to hosts information concerning the insurance coverages provided for home sharing. In addition, disclosure is required to be made that the insurance coverages provided may be insufficient to cover any loss or judgment that may result out of a rental.

The first requirement is similar to the requirements imposed by Florida Senate Bill 1298. The additional required disclosure is intended to specifically warn hosts of the situations where insurance may be insufficient to cover the costs of a property loss (in excess of \$1 million) or a liability judgment by a guest or third party resulting out of bodily injury or property damage (in excess of \$1 million).

(8) Require short-term rental network companies to cooperate in claims investigations with all insurers and to keep records of the time and duration of guest stays at a host's unit or property.

These requirements essentially track the requirements of Florida Senate Bill 1298 in imposing an affirmative statutory duty to cooperate with claims investigations and to keep records which may assist in claims investigations.

(9) *Bar any property insurance company from canceling a host's underlying homeowner's property insurance coverage for participating in home sharing.*

One of the concerns addressed within the Sharing Economy Working Group of the National Association of Insurance Commissioners during the summer of 2015 was that Florida Senate Bill 1298 did not include any protections for homeowners in the event a homeowner's insurance company cancels coverage due to the insured's participation as a host in home sharing.²²³ Depending upon the state and type of insurance product, an insurance company may not be able to cancel coverage in certain situations.²²⁴ This requirement would address the concern of cancellation of homeowner's insurance for home sharing activity, and at the same time, the suggestions in general ensure that at least minimum levels of insurance coverage are present to address property and liability risks that may arise.

CONCLUSION

As the sharing economy has quickly expanded over the past decade, the Airbnb model's foothold in the short-term home rental market looks to possibly expand beyond just short-term rentals for leisure travelers, and progress as well into the lucrative business travel market.²²⁵ Despite the possible expansion of the model, Airbnb and companies like it face headwinds such as the 2016 attempt in New York to bar the posting of listings of short-term rentals of less than thirty days.²²⁶ The presentation of future legislation concerning

223. See SHARING ECON. (C) WORKING GRP., NAT'L ASS'N OF INS. COMM'RS, *Attachment A (Draft Minutes to July 22, 2015 Conference Call)*, in 2015 SUMMER NATIONAL MEETING MATERIALS 1, 4 (2015).

224. See generally Ronen Avraham, Kyle D. Logue & Daniel Schwarcz, *Towards a Universal Framework for Insurance Anti-Discrimination Laws*, 21 CONN. INS. L.J. 1, 15 (2015).

225. See Kieron Monks, *Airbnb: Budget Luxury for Business Travelers?*, CNN (Aug. 28, 2015), <http://www.cnn.com/2015/08/28/travel/airbnb-for-business-travelers/> (discussing the possibility of Airbnb's expansion into the \$300 billion market in business travel).

226. See Michelle Starr, *New York Passes Bill Banning Entire Home Short-Term Rentals on Airbnb*, CNET (June 20, 2016), <http://www.cnet.com/news/new-york-passes-bill-banning-short-term-rentals-on-airbnb/> (discussing a bill in New York passed by the New York State Senate which would bar the posting of listings in New York of short-term rentals).

short-term rentals through the Airbnb model in cities and states throughout the country appears likely in the next several years as regulation of the Airbnb model catches up to the explosive growth of the sharing economy. The resolution of how the traditional areas of property, contract, and tort law affect the Airbnb model will evolve through the courts and become clearer in time.

As legislation concerning Airbnb in states throughout the country is considered, a significant way to address the liability risks posed by the expansion of the Airbnb model and the home sharing economy is to mandate a corresponding expansion of insurance coverages for hosts. As coverage gaps remain for home sharing hosts, states are in a position to enact legislation to promote wider insurance coverage to mitigate home sharing risks. The implementation of such legislation should only make the Airbnb experience even more safe and consumer-friendly to both hosts and guests alike.

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HOW SHOULD RETIREMENT PLANS
BE ORGANIZED?

S. BURCU AVCI,* M. P. NARAYANAN,**
AND H. NEJAT SEYHUN***†

Americans have a tough time saving for their retirement. To make matters worse, the shift over recent decades from defined benefit plans that are regulated by ERISA to defined contribution plans requires greater investor sophistication, discipline, and sound investment advice. As of the printing of this Article, the fate of the most recent regulation regarding investment advice for defined contribution plans—the fiduciary rule promulgated by the Department of Labor—is uncertain. Even if implemented in its current form, the rule does not address the two critical deficiencies of the current system, namely opacity and conflicts of interest. Instead, we propose that a one-principal standard be instituted along with strict transparency requirements to control the conflicts of interest and improve retirement savings advice. We also recommend that only low-cost, passive, well-diversified index funds for stocks and bonds should qualify as retirement vehicles to address concerns regarding opacity.

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INTRODUCTION

Designing sensible retirement-plan rules is a challenging task since most Americans do not have sufficient financial acumen and self-discipline to manage their own retirement portfolio. In spite of the fact that retirement plans constitute the bulk of their savings, most American families struggle with the management of defined contribution plans. Consequently, their savings are inadequate to meet their retirement needs. According to a recent report, fifty-six percent of Americans

have less than ten thousand dollars in their retirement accounts.¹ One in three Americans reported that they had no retirement savings.² Clearly, the current defined contribution plans for retirement savings are not working very well for the typical American. In this Article, we outline the problems inherent in most retirement plans and propose simple and sensible guidance that can help every American family get the most out of its defined contribution retirement plan.

Since 1975, a structural change has occurred in the private retirement system in the United States, resulting in fewer defined benefit plans and greater reliance upon defined contribution plans, which include self-directed Keogh and IRAs and employer-sponsored 401(k) and 403(b) plans. In defined benefit plans, the pension benefit is set by a calculation based upon employee tenure and salary with the employer made responsible for ensuring that there are sufficient assets in the plan to meet the benefit obligation. In defined contribution plans, the employers' contributions to the retirement plan are set in advance, with the beneficiary made responsible for managing the assets held in the plan.³ Defined contribution plans provide tax-advantaged retirement savings vehicles for individuals and typically represent a large portion of the individual's savings. At the end of 2015, U.S. defined contribution plan assets alone totaled \$6.7 trillion.⁴ This massive shift from defined benefit plans to defined contribution plans has increased the urgency and importance of both transparency and sound investment advice regarding retirement savings.

One of the causes of inadequate retirement savings in defined contribution plans is the poor performance of trillions of dollars of investments in such plans.⁵ The poor perform-

1. Elyssa Kirkham, *1 in 3 Americans Have Saved \$0 for Retirement*, TIME (last updated Mar. 14, 2016), <http://time.com/money/4258451/retirement-savings-survey>.

2. *Id.*

3. See Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 460–62 (2004) (describing defined benefit and defined contribution plans in detail and suggesting that in defined contribution plans employees have more control over and more responsibility for investment than in defined benefit plans).

4. *2016 Investment Company Fact Book*, INV. CO. INST. 136, (2016), https://www.ici.org/pdf/2016_factbook.pdf.

5. During 1990–2012, the geometric average annual return of defined contribution plans was 2.7 percentage points lower than equity returns and

ance itself is a consequence of the lack of investor sophistication and discipline, as well as the complexity of the investment instruments and concepts. Another critical factor that compounded the problem was that regulations did not require investment advice to be in the best interest of plan beneficiaries.

To address these serious and growing problems, policy-makers have targeted the existing standard for providing investment advice, the “suitability rule.” The Department of Labor (DOL) adopted a new rule⁶ under which brokers and investment advisers for defined contribution retirement accounts would be subject to a higher fiduciary standard and investment advisers must recommend investment products with the “best interest” of the beneficiaries in mind. The rule was due to take effect on April 10, 2017. However, President Donald Trump directed the Labor Secretary to study the impact of the rule and to rescind or revise the new standard if it

2.8 percentage points lower than long-term corporate bond returns. Defined contribution plans also returned 0.7 percentage points less than defined benefit plans. See Alicia H. Munnell, Jean-Pierre Aubry & Caroline V. Crawford, *Investment Returns: Defined Benefit vs. Defined Contribution Plans*, 15–21 CTR. FOR RETIREMENT RES. AT B.C., Dec. 2015, at 3–4 (listing the returns of defined contribution plans, long-term corporate bonds, equities, and defined benefit plans).

6. Under the DOL’s definition, any individual receiving compensation for providing advice that is *individualized or specifically directed* to a particular plan sponsor (e.g., an employer with a retirement plan), plan participant, or Individual Retirement Account (IRA) owner for consideration in making a retirement investment decision is a fiduciary. Such decisions can include, but are not limited to, what assets to purchase or sell and whether to rollover from an employer-based plan to an IRA. The fiduciary can be a broker, registered investment adviser, insurance agent, or other type of adviser (together referred to as “advisers” here). Some of these advisers are subject to federal securities laws and some are not. Being a fiduciary simply means that the adviser must provide impartial advice in their client’s best interest and cannot accept any payments creating conflicts of interest unless they qualify for an exemption intended to assure that the customer is adequately protected. DOL’s regulatory impact analysis estimates that the rule and related exemptions would save investors over \$40 billion over ten years, even if one focuses on just one subset of transactions that have been the most studied. The real savings from this new rule are likely much larger as conflicts and their effects are both pervasive and well hidden. See *Department of Labor Proposes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle-Class Families Billions of Dollars Every Year*, U.S. DEPT. OF LABOR, <https://www.dol.gov/sites/default/files/documents/featured/protectyoursavings/factsheetcoi.pdf> (last visited Dec. 16, 2016).

is found to be inconsistent with the administration's priorities.⁷ As this Article went to print, the DOL had delayed implementation of the rule for sixty days.⁸

Though it is unclear whether the fiduciary rule will be implemented in its current form,⁹ the rule, as it was released in 2016,¹⁰ is prima facie laudable. However, there are two provisions in the standard that undermine its primary intent of ensuring that investors get unbiased investment advice at a reasonable cost. If the rule is not implemented or the fiduciary requirements are diluted, there is even greater risk that investors will not be able to receive unbiased advice.

The first concerning provision allows brokers and investment advisers to receive certain non-fee based compensation, such as commissions, from financial institutions whose products they recommend for inclusion in the investors' retirement portfolios.¹¹ By allowing advisers to receive compensation from both the buyer (investor) and the seller (financial institution), this provision creates an obvious conflict of interest between the investor and the adviser. Furthermore, these fees get passed on to the investor, reducing net returns.¹²

The second provision of concern allows brokers and advisers to include proprietary products (privately owned, non-traded assets, also referred to as alternative investments) in the

7. See, e.g., Ryan Tracy & Michael C. Bender, *Trump Signs Actions to Begin Scaling Back Dodd-Frank*, WALL ST. J. (Feb. 3, 2017), <https://www.wsj.com/articles/trump-signs-executive-actions-toward-scaling-back-dodd-frank-financial-regulation-1486148274?mod=BNM>; Michael Wursthorn & Lisa Beilfuss, *Brokers Spared from Fiduciary Rule*, WALL ST. J. (Feb. 3, 2017), <https://www.wsj.com/articles/brokers-spared-from-fiduciary-rule-1486165894>.

8. See Lisa Beilfuss & Michael Wursthorn, *Donald Trump's Labor Department Proposes Delaying 'Fiduciary' Rule*, WALL ST. J. (Mar. 1, 2017), <https://www.wsj.com/articles/fiduciary-rule-to-be-delayed-for-60-days-1488385535>.

9. See Lisa Beilfuss, *How the Fiduciary-Rule Review Is Likely to Play Out*, WALL ST. J. (Feb. 9, 2017), <https://www.wsj.com/articles/how-the-fiduciary-rule-review-is-likely-to-play-out-1486660677>.

10. Conflict of Interest Rule—Retirement Investment Advice, 29 CFR §§ 2509, 2510, 2550); Definition of the Term “Fiduciary”, 81 Fed. Reg. 20946 (Apr. 8, 2016).

11. See 81 Fed. Reg. 20946, *supra* note 10.

12. Cf. Ian Ayers & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and “Dominated Funds” in 401(k) Plans*, 124 YALE L.J. 1476, 1509 (2015) (discussing the double agency issue in service provider's construction of plan menus).

retirement portfolio.¹³ These products are also allowed in defined benefit plans.¹⁴ Alternative and proprietary investments are created by the investment sponsors and they are not publicly available. They require additional education and marketing expenses. In many cases, the structure is a zero-sum game where the investment sponsor shares the return on the underlying assets with the investor. Consequently, higher investment returns for the beneficiary necessarily means lower profits for the investment sponsor.

Alternative and proprietary investments suffer from greater informational asymmetry than traditional investment products—with the seller holding an informational advantage over the investor—and have complex features that are difficult for the average investor to understand and analyze. There is considerable evidence that the average investor is not as financially sophisticated as she needs to be to evaluate non-traded retirement assets.¹⁵ Moreover, proprietary products and alternative investments are also likely to involve higher transaction costs. While either informational asymmetry or complexity alone is sufficient to put the investor at a significant disadvantage, the combination compounds the problem. The above two provisions in combination exacerbate the concern that investors might not get sound advice: brokers and advisers who receive compensation from institutions have a greater incentive to recommend costly alternative investments and proprietary products that earn them greater commissions. In summary, the provisions that create potential conflicts of interest between advisers and investors are further compounded by al-

13. See 81 Fed. Reg. 20946, *supra* note 10; see also, Marlene Y. Satter, *Defined Benefit Plans Shifting Toward Alternatives*, BENEFITSPRO (Sept. 14, 2016), <http://www.benefitspro.com/2016/09/14/cm-defined-benefit-plans-shifting-toward-alternati>.

14. See *Department of Labor's Final Rule Defining Fiduciary Investment Advice and Conflicts of Interest*, DAVIS POLK & WARDWELL LLP (April 16, 2016), https://www.davispolk.com/sites/default/files/2016-04-18_Department_of_Labor%E2%80%99s_Final_Rule_Defining_Fiduciary_Investment_Advice_and_Conflicts_of_Interest.pdf (noting that final rule does not flatly prohibit the sale of proprietary investment products).

15. Jason Furman & Betsy Stevenson, *The Effects of Conflicted Investment Advice on Retirement Savings*, WHITE HOUSE BLOG (Feb. 23, 2015, 9:45 AM), <https://www.whitehouse.gov/blog/2015/02/23/effects-conflicted-investment-advice-retirement-savings>.

lowing non-traded proprietary products and alternative investments.

The relevant policy question is how significant these two issues are. That is, are these potential conflicts of interest likely to result in significant losses to investors due to poor advice? And does the lack of transparency in proprietary products have adverse consequences to investors? In this Article, we provide evidence that the answer to both questions is “yes.”

To answer the first question regarding the effect of conflicts of interest, we chose a unique setting in which a similar potential conflict of interest exists: defined benefit pension funds that are already subject to the fiduciary standard under ERISA. We analyze the performance of defined benefit pension funds in which an executive of the firm that employs the beneficiaries is also a fiduciary of the fund. Such an arrangement creates a conflict of interest with a fiduciary–executive required to serve two principals: the beneficiaries of the defined benefit fund and the shareholders of the firm.

Our evidence indicates that a simple requirement subjecting investment advisers to the fiduciary standard (under ERISA) does not by itself address the conflict of interest issue in defined benefit pension funds. In funds with conflicts of interest, beneficiaries are short-changed for the benefit of shareholders. Returns from insider trades of pension funds in which conflicts of interest are likely to be present underperform the market by more than 5.5% over a year.¹⁶ This figure understates the loss to plan beneficiaries; returns from insider trades in general outperform the market. This loss is significantly greater than the figures reported by others using different methods.¹⁷ Based on this experience from defined benefit pension funds, we can conclude that the adverse effect of conflicts of interest is much bigger than previously documented, and will very likely be to the detriment of the beneficiaries of the defined contribution plans as well. Therefore, without addressing the cause of the conflict of interest issue, the fiduciary rule for defined contribution plans, even if implemented in its current form, is unlikely to be successful in addressing the issue of inadequate retirement savings.

16. See *infra* Table 2 in Section III.C.,

17. See Munnell, Aubry & Crawford, *supra* note 5; see also Furman & Stevenson, *supra* note 15.

To address the second question regarding non-traded alternative assets and proprietary products, we consider two representative products that would continue to be allowed as appropriate retirement investments under the DOL's rule. We simulate the performance of these products and find that, on a risk-adjusted basis, the performance is inferior as compared to both the risk-free rate (ten-year Treasury notes) and the Standard & Poor's 500 Index (S&P 500). Our evidence suggests that without also addressing the transparency problem, the fiduciary standard for defined contribution plans cannot fully protect investors.

The empirical evidence in this Article suggests that the investment advisory rules are deficient. On the one hand, the fiduciary rule requires that brokers and investment advisers act in the best interest of the beneficiaries, yet the rule allows them to receive income from third parties. In addition, the rule does not prohibit opaque, non-traded alternative investments and proprietary products, which would lead to uninformed and costly investment decisions. In fact, the rule, even if implemented in its current form, is likely to lead to continued conflicted investment advice, confusion, and widespread litigation to sort out these internal conflicts in a multi-trillion dollar market.¹⁸ We offer three policy recommendations to remedy these problems.

Our first policy recommendation addresses the current provision that allows brokers and advisers to receive income both from the investor as well as the sponsor of the investment product. Any serious reform in retirement investment area must address the conflict of interest problem caused by this income exemption provision. The key to eliminating conflicts of interest involves ensuring that brokers and investment advisers serve, and therefore receive income from, only one princi-

18. The new rules have already created a wave of lawsuits regarding conflicts of interest and opacity in defined contribution plans. See Anne Tergesen, *Neuberger Berman Latest Financial Firm to Be Hit With 401(k) Suit*, WALL ST. J., Aug. 5, 2016; Anne Tergesen, *MIT, NYU, Yale Sued Over Retirement-Plan Fees*, WALL ST. J., Aug. 10, 2016; see also, Jean Eaglesham, Sarah Krouse & Ben Eisen, *Wall Street Re-Engineers the CD—and Returns Suffer*, WALL ST. J., Sept. 6, 2016. Furthermore, the U.S. Supreme Court recently ruled in favor of the plaintiffs in 401(k) plans and rejected a strict six-year statute of limitations for bringing a lawsuit. See Jess Bravin & Liz Moyer, *High Court Ruling Adds Protections for Investors in 401(k) Plans*, WALL ST. J., May 18, 2015.

pal. Unfortunately, the current advisory rules and the associated exemptions simply fail to address what can be called the multiple-principals problem.

Second, any serious reform must prohibit non-traded alternative investments and proprietary investment vehicles from the menu of investments in retirement plans because their lack of transparency impedes informed decision-making by beneficiaries. As we show, these non-traded investment vehicles are likely to provide lower returns, thereby reducing the retirement savings of beneficiaries. Furthermore, we show that by using non-traded products in retirement accounts, certain wealthy taxpayers can avoid paying any taxes on their income. Thus, allowing alternative and proprietary investment products into retirement accounts does not make any sense either from the average beneficiary's perspective or a public policy perspective. We recommend a very strict transparency rule for any investment to qualify as a retirement asset for both defined benefit and defined contribution plans: All qualified retirement equity securities must be publicly traded in U.S. public exchanges or, in the case of notes and bonds, over-the-counter markets.

Our final recommendation is that only passive index funds or well-diversified exchange traded funds (ETFs) consisting of broadly diversified portfolios, such as ETFs that track the S&P 500 Index, be allowed the tax exemption as retirement accounts. It is our view that simply requiring a fiduciary standard by itself is not going to solve retirement savings problems. Instead, it is likely to lead to additional problems by creating an inconsistent set of rules. Our recommendation of limiting retirement accounts to index funds will prevent conflicts of interests and lack of transparency from creeping back into the retirement-advice business. To this end, we further recommend the establishment of broad age-based minimum, maximum, and target percentages of common stocks, corporate and government bonds, and real-estate securities that can be held in defined contribution plans. Anyone requiring an exception to the well-diversified ETF rule would need to be qualified on the basis of financial education or size of retirement assets. Limiting investment choices to passive funds will also increase investor returns by reducing the fees charged by financial institutions.

The remainder of this Article is organized as follows: Part I provides a historical account of the shift from defined benefit to defined contribution plans and a comparison of the two types of plans. Part II describes the fiduciary standard and analyzes the conflict of interest problem in the context of corporate-sponsored pension funds. Part III uses evidence of conflicts of interest in defined benefit plans to provide insight into the likely effect of continued conflicts of interest in defined contribution plans. Part IV explains the problems with allowing proprietary products in pension funds and provides evidence of the harm it can cause investors. We then present the Article's conclusions and policy recommendations.

I.

THE SHIFT FROM DEFINED BENEFIT TO DEFINED CONTRIBUTION PLANS

In this Part we review the factors that caused the shift from defined benefit to defined contribution plans, as well as the advantages and disadvantages of both.

A. *Historical Background*

For decades, Americans saved for their retirement using employer-sponsored pension plans.¹⁹ Under this system, employers bore the burden of managing the assets prudently, because they promised specific benefits to their employees.²⁰ The beneficiaries did not need to be financially savvy, and yet, they enjoyed the stability and security of a guaranteed retirement income.

After World War II, most employers began to offer pension plans to their employees, and companies used these benefits to compete for the best employees.²¹ Americans began to expect these benefits as they became increasingly popular.²² Older Americans may remember the once-common form of

19. See Zelinsky, *supra* note 3, at 3.

20. *Id.*

21. See Dennis Triplett, *The Great Shift: Moving from Defined Benefit to Defined Contribution*, UMB HEALTHCARE SERVICES (July 24, 2014), https://hsa.umb.com/wps/wcm/connect/hsa/753af08b-25a5-466a-b88e-f9793fd300e6/061653.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=ROOTWORKSPACE.Z18_9QH8H9K0L07P00AL8BTF3J0024753af08b-25a5-466a-b88e-f9793fd300e6.

22. *Id.*

retirement plan, in which an employee received a fixed income after retirement, but only if he or she stayed with an employer for many decades.²³ This arrangement, used by the majority of Americans in previous generations, is a defined-benefit plan in which the money paid out of the pension is set by a calculation involving tenure and salary.

While secure and convenient, that system eventually came under pressure. Employers were burdened with future retirement liabilities that were beyond their control and that created significant uncertainty in the marketplace.²⁴ Some firms deliberately underfunded their pension plans or went bankrupt.²⁵ To deal with firms that failed, the federal government created the Pension Benefit Guaranty Corporation (PBGC) that took over the pension liabilities of failed firms,²⁶ thus transferring the risk and responsibility of the retirement plans to taxpayers. Additionally, Americans began changing jobs more frequently.²⁷ Shorter work tenure often meant that an employee would not qualify for any retirement benefits at all.²⁸ Finally, shorter tenures also meant that Americans were burdened with the task of having to keep track of multiple streams of benefits.²⁹

23. See, e.g., Leora Friedberg & Michael T. Owyang, *Not Your Father's Pension Plan: The Rise of 401(k) and Other Defined Contribution Plans*, FED. RES. BANK OF ST. LOUIS REV., Jan.–Feb. 2002, at 23.

24. Retirement benefits under the defined benefit plans basically amounted to a fixed obligation similar to debt. As such, these obligations raised the risk to the firm and created additional uncertainty similar to debt about the future health of the firm.

25. See, e.g., PATRICK PURCELL & JENNIFER STAMAN, CONG. RESEARCH SERV., RL34443, SUMMARY OF EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) 20 *et seq.*, (2008), <http://www.nccmp.org/resources/pdfs/other/Summary%20of%20ERISA.pdf>; see also Mark Miller, *American Airlines Pension Default Q&A*, REUTERS (Feb. 8, 2012), <http://www.reuters.com/article/us-column-miller-idUSTRE81718S20120208>.

26. *Who We Are*, PUBLIC BENEFIT GUARANTY CORPORATION, <http://www.pbgc.gov/about/who-we-are.html> (last visited Jan. 23, 2017).

27. See, e.g., Quentin Fottrell, *Typical U.S. Worker Now Lasts 4.6 Years on Job*, MARKETWATCH (Jan. 12, 2014, 7:58 AM), <http://www.marketwatch.com/story/americans-less-likely-to-change-jobs-now-than-in-1980s-2014-01-10> (arguing that Americans are no longer tied to a single employer for long periods of time).

28. Friedberg & Owyang, *supra* note 23, at 23.

29. Cf. Fottrell, *supra* note 27.

To deal with these problems, the Employee Retirement Income Security Act (ERISA), enacted in 1974, popularized defined contribution pension plans and changed the American retirement system permanently.³⁰ Following the passage of ERISA, employers shifted employees from the traditional defined benefit plans to employer-sponsored 401(k) and 403(b) plans³¹ (both forms of defined contribution plans), in which the contributions to the retirement plan were determined in advance of distribution, with the ultimate value at the time of retirement dependent upon the performance of the assets held in the plan. Therein lay the danger of defined contribution plans. Unless the retirement savings and investments were managed competently, most Americans could end up in their old age with little savings and at the mercy of various social safety net programs, such as Social Security or Medicaid, which are only meant to be supplementary retirement vehicles.

Several components within ERISA increased the popularity, from the perspective of both employers and beneficiaries, of the defined contribution plans. ERISA imposed an increased regulatory burden on defined benefit plans, making the defined contribution option more appealing to employers: they simply shifted the fiduciary burden to the employees.³² ERISA permitted defined contribution plans to hold more of an employer's stock than defined benefit plans, if desired by employees, which made contribution plans attractive to management trying to ward off hostile takeovers.³³ The creation of the modern Individual Retirement Account (IRA) by ERISA allowed beneficiaries to roll over the amounts in their defined contribution plans to tax-deferred IRAs when they changed

30. See Monique Morrissey, *Private-sector Pension Coverage Fell by Half Over Two Decades*, ECON. POL'Y INST. WORKING ECON. BLOG (Jan. 11, 2013, 9:27 AM), <http://www.epi.org/blog/private-sector-pension-coverage-decline/> (describing the decline of private-sector pension plans).

31. A 401(k) plan is an employer-sponsored, defined-contribution plan that allows employees to save for retirement as a deduction from their paychecks before taxation. Sometimes employees' contributions are matched by the employer. As of 2017, the maximum pre-tax contribution is \$18,000. 403(b) plans are available for employees of certain tax exempt institutions such as public schools.

32. For defined benefit plans, investment advisers are subject to the fiduciary standard, meaning that any investment decisions must be in the "best interest" of the plan beneficiaries.

33. See, e.g., Zelinsky, *supra* note 3, at 479–80.

employers or retired.³⁴ Therefore, once defined contribution plans became available, more assets shifted to these vehicles.³⁵ Following ERISA, the total value of assets in private defined contribution plans jumped from \$104 billion in 1978 to \$6.7 trillion in 2015, according to the Investment Company Institute.³⁶ Evidence shows that Americans have increasingly accepted defined contribution plans, which gave them more control over their retirement assets.³⁷ While trade unions have favored defined benefit plans (especially when managed by the unions), the erosion of unions' power and membership has also contributed to the decline of defined benefit plans.³⁸ It is still important to note that some Americans, notably federal and state government employees, are still defined benefit plan participants.³⁹ Nevertheless, over 100,000 defined benefit plans, with over 7 million total plan participants, have terminated since the early 1980s.⁴⁰ Moreover, the shift from defined benefit pension plans to defined contribution plans appears to be accelerating.⁴¹

The boom in assets in defined contribution plans is also closely linked to the explosion in IRA assets, because a significant majority of the flows into IRAs is a result of rollovers from defined contribution plans, rather than direct IRA contributions.⁴² At the end of 2015, IRA assets totaled \$7.3 trillion.⁴³

34. An IRA account allows an individual to save for retirement on a tax-free or tax-deferred basis to supplement employer sponsored plans. There are limits to how much individuals can save to take advantage of tax benefits.

35. Zelinsky, *supra* note 3, at 474.

36. See Jack L. Vanderhei, *Retirement Security and Defined Contribution Plans: The Role of Company Stock in 401(k) Plans*, EMPLOYEE BENEFIT RESEARCH INSTITUTE 2 (Feb. 27, 2002), <https://www.ebri.org/pdf/publications/testimony/t135.pdf> (noting that pension plan assets totaled \$377 Billion in 1978, 28% of which represented defined-contribution plans); see also INVESTMENT COMPANY INSTITUTE, *supra* note 4.

37. Friedberg & Owyang, *supra* note 23, at 1.

38. Daniel Beller & Helen Lawrence, *Trends in Private Pension Plan Coverage*, in U.S. DEP'T OF LABOR, TRENDS IN PENSIONS 59, 60 (John A. Turner & Daniel J. Beller eds., 1992). Part of the decline of trade unions can be attributed to a shift in employment from manufacturing to the service sectors. *Id.*

39. Zelinsky, *supra* note 3, at 504–06.

40. *Funding Challenge: Keeping Defined Benefit Plan Pension Plans Afloat: Hearing Before the Senate Comm. On Fin.*, 108th Cong. 57–58 (2003).

41. See Triplett, *supra* note 21.

42. See Furman & Stevenson, *supra* note 15.

43. See INV. CO. INST., *supra* note 4.

B. *Investors' Financial Sophistication*

While defined contribution plans provide investors control over their retirement portfolio in terms of its risk profile, timing of trades, etc., they also impose on investors the responsibility of managing the portfolio. Therefore, a key question is whether investors have the education, skills, and self-discipline to manage their own financial assets. According to an Obama-administration White House report, many defined contribution plan participants struggle to understand basic financial concepts such as costs, risks and reward, and diversification.⁴⁴ Many individuals also do not understand the most fundamental concepts and terminology in investing.⁴⁵ The report additionally documents cognitive biases such as over-confidence, over-optimism, and loss aversion.⁴⁶ These deficiencies often lead to lower investment returns, because they lead households to: (1) trade too much by seeking active management or chasing returns; (2) sell sound investments and hold risky, undiversified, underperforming assets based on recent performance; (3) overweight past returns; or (4) under-diversify.⁴⁷ Jill Fisch and Tess Wilkinson-Ryan document that the majority of American investors do not understand basic ideas like diversification, investment costs, inflation, and compound interest.⁴⁸ They conclude that most Americans lack the requisite knowledge to protect them from outright financial fraud.⁴⁹ Further evidence of investors' lack of financial literacy comes from the study undertaken by the SEC at the directive of Congress as part of the Dodd–Frank Act. The study finds that investors hold many fundamental financial misconceptions that lead to

44. COUNCIL OF ECON. ADVISERS, THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS 8 (Feb. 2015), https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf; see Furman & Stevenson, *supra* note 15.

45. COUNCIL OF ECON. ADVISERS, *supra* note 44.

46. *Id.* at 23.

47. *Id.*

48. Jill E. Fisch, & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 606 (2014).

49. *Id.*

investment mistakes.⁵⁰ Further, most Americans are not even aware of how much they pay in fees and other costs.⁵¹

C. *Relative Performance of Defined Contribution and Defined Benefit Plans*

Given the lack of appropriate education, financial skills, and self-discipline to manage their financial assets, coupled with the inability to evaluate conflicted advice, one would expect defined contribution plans to underperform in comparison to defined benefit plans. Defined benefit plans spell out what benefit the enrollee will get upon retirement age, which is often calculated using a set formula and does not depend on the skill of the beneficiary. By contrast, the value of the defined contribution plans at the time of retirement depends on how those assets are managed by beneficiaries.

Conceptually, traditional defined benefit pension plans provide not only more professional management but also a better balance of risks and rewards.⁵² This is because the defined benefit plans place almost all of the risk of performance on the shoulders of the employers. If the defined benefit assets outperform, the employer is able to reduce its contributions. If the plan underperforms, the employer has to increase its contributions to the plan. Because the employer has the ability to hire competent professional staff to assist with employee benefits planning, the system works reasonably well, achieving cost efficiencies, economies of scale, and diversification over generational cohorts.⁵³ Nevertheless, it is conceptually possible that for financially-educated beneficiaries, defined contribution plans can be used to better control for risk.⁵⁴ Additionally, some beneficiaries can custom tailor risk–reward tradeoffs to their own particular needs.⁵⁵

Evidence shows that defined benefit plans significantly outperform defined contribution plans. By design, defined benefit plans handle inflation risk by computing benefits as a fraction of the beneficiaries' salaries during the last few years

50. *Id.* at 608.

51. *Id.* at 622.

52. Zelinsky, *supra* note 3, at 468.

53. *See id.*

54. *Id.* at 458–59.

55. *Id.* at 460.

of their working years.⁵⁶ In contrast, in defined contribution plans the employees are expected to make financial decisions that help protect against inflation risk. In one study, defined benefit plans outperformed defined contribution plans by 76 basis points annually between 1995 and 2011.⁵⁷ Another study found that defined benefit plans outperformed defined contribution plans during 1990–2012 by about 70 basis points annually.⁵⁸ Given that there was over \$6.7 trillion invested in defined contribution plans accounts alone in 2015, underperformance of 70 basis points implies a cost of about \$50 billion per year. Once again, the lagging performance of the defined contribution plans adds an additional burden on the American worker to increase her future contributions as well as to take higher levels of risk.

D. *Conflicts of Interest in Investment Advice*

Because of their lack of financial education or even basic familiarity of investments, the American public needs professional investment advice.⁵⁹ For investors who seek professional advice, there are additional hurdles. Since most investors cannot evaluate the appropriateness of the investment advice, they may receive conflicted advice. In its most basic form, conflicted advice promotes investment options that are profitable for the advisers and their firms but disadvantageous to the investor; these investments tend to underperform, impose higher transaction fees, and result in under-diversification. Hence, it should come as no surprise that conflicted advice

56. NAT'L BUREAU OF ECON. RESEARCH, PENSIONS IN THE U.S. ECONOMY 158 (Zvi Bodie, John B. Shoven & David A. Wise, eds., 1988), <http://www.nber.org/chapters/c6047.pdf>.

57. *Defined Benefit Plans Outperform Defined Contribution Plans Again*, WILLIS TOWERS WATSON (2013), <https://www.towerswatson.com/en-US/Insights/Newsletters/Americas/us-finance-matters/2013/Defined-Benefit-Plans-Outperform-Defined-Contribution-Plans-Again>.

58. See Munnell, Aubry & Crawford, *supra* note 5 (finding that defined benefit plans did better by 0.7%).

59. One may ask whether the average American can even afford a financial advisor given their meager savings. If implemented, our policy recommendations in this article reduce and even eliminate the need for extensive financial advice.

should result in a negative effect on the performance of retirement assets.⁶⁰

Estimates indicate that the aggregate annual cost of conflicted advice in IRA assets is about \$17 billion each year.⁶¹ Retirees who received conflicted advice when rolling over their 401(k) balance to an IRA retirement will lose approximately 12% of the value of his or her savings if drawn down over thirty years.⁶² The average IRA rollover for those aged 55–64 in 2012 was \$100,000,⁶³ so losing 12% to fees is the equivalent to losing \$12,000. This is a significant sum, especially given that the median retirement savings of households in the 55–64 age group is only about \$104,000.⁶⁴ This evidence corroborates the initiative promoted by the DOL, which asserts that reducing conflicted advice will improve the retirement of savings of typical Americans.

II.

INVESTMENT ADVISORY STANDARDS

A. *Evolution Towards the Fiduciary Standard*

The DOL has the authority to set rules and standards under both ERISA and the Internal Revenue Code governing fiduciaries of retirement plans and IRAs, but the DOL has not substantially altered the rules applicable to retirement savings since 1975.⁶⁵ Separately, SEC rules govern the conduct of registered investment advisers and broker-dealers who advise re-

60. As discussed earlier, many alternative and proprietary investments constitute a zero-sum game, pitting the retiree against the sponsor of the investment. Higher investment returns necessarily mean lower profits for the investment sponsor. Consequently, when the interests of the investment sponsor and the retiree are directly opposed, we would expect more conflicted advice that benefits the investment sponsor at the expense of the retiree. See Eaglesham, Krouse & Eisen, *supra* note 18.

61. See, e.g., Furman & Stevenson, *supra* note 15.

62. *Id.*

63. *Id.*

64. U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-419, RETIREMENT SECURITY: MOST HOUSEHOLDS APPROACHING RETIREMENT HAVE LOW SAVINGS (2016).

65. See U.S. DEP'T OF LABOR, FACT SHEET: DEPARTMENT OF LABOR FINALIZES RULE TO ADDRESS CONFLICTS OF INTEREST IN RETIREMENT ADVICE, SAVING MIDDLE CLASS FAMILIES BILLIONS OF DOLLARS EVERY YEAR, <https://web.archive.org/web/20170128162839/https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-con>

tail investors, under the provisions of federal securities laws (the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940).⁶⁶ The current system, established in the 1940s, left it to states to develop separate definitions of what the fiduciary standard should be, which often leads to confusion.⁶⁷

In response to the increased significance of the conflict of interest issue due to the change in the retirement savings environment from defined benefit to defined contribution plans, various government agencies have been floating the idea of a new fiduciary standard for years. The Dodd–Frank Act directed the SEC to consider a uniform standard for investment advisers and broker-dealers, in part to standardize the care that investors get across jurisdictions.⁶⁸ As of the time this Article went to print, the SEC had not released any proposals regarding a uniform fiduciary standard.

A concrete step towards addressing the conflicts of interest inherent in defined contribution plans and IRAs was taken in October 2010, when the DOL proposed amendments to the 1975 regulation. The proposed fiduciary standard included both a duty of care and a duty of loyalty. These duties require the fiduciary to act in the best interest of the consumer and to provide full and fair disclosure of material facts and conflicts of interest.⁶⁹ The proposals prompted an intense debate, with opponents claiming that existing conflicts of interest were not material and that the rule would have an adverse impact on small IRA accounts.⁷⁰ In response, the DOL announced in

flicts-of-interest [hereinafter FACT SHEET] (noting that the rules have not been meaningfully changed since 1975) (last visited Jan. 28, 2017).

66. U.S. DEP'T OF LABOR, REGULATING ADVICE MARKETS 2 (2016).

67. SEC. INDUS. & FIN. MKT. ASS'N., *DOL Fiduciary Standard Resource Center*, <http://www.sifma.org/issues/savings-and-retirement/dol-fiduciary-standard/overview/> (last visited May 3, 2016).

68. *Id.*

69. See FACT SHEET, *supra* note 65.

70. *Redefining Fiduciary: Assessing the Impact of the Labor Department's Proposal on Workers and Retirees: Hearing Before the Subcomm. on Health, Emp't, Labor and Pensions of the H. Comm. on Educ. and the Workforce*, 112th Cong. 1, 14–15 (2011) (statement of Hon. David P. Roe, Chairman, Subcomm. on Health, Emp't, Labor and Pensions); *id.* (testimony of Hon. Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor).

September 2011 its intention to develop a more robust proposal with extensive analysis of the economic impact.⁷¹

In April 2015, the DOL announced its withdrawal of the 2010 proposal and issued a new proposal in its place. After an extensive comment period, the Office of Management and Budget received the DOL's final rule on January 28, 2016.⁷² By broadening the definition of fiduciary investment advice, the rule would subject brokers, among others, to the fiduciary standard, thereby requiring them to put client interests ahead of their own when offering investment advice for retirement plans.⁷³ The rule includes changes to the definition of fiduciary investment advice for purposes of ERISA's standards of fiduciary conduct and the prohibited transaction rules of section 4975 of the Internal Revenue Code.⁷⁴ The new rules include the best interest contract exemption (BICE), which the DOL indicated was intended to preserve common compensation practices while requiring those who provide fiduciary investment advice to adhere to the "best interest" standard of care.⁷⁵ The BICE requires that investment advisers: (1) provide advice in the client's best interest; (2) create policies that deal with any potential conflict of interest; (3) clearly disclose any conflict of interest (an example of this would be hidden fees); and (4) enter into a written agreement contractually committed to these requirements.

While the "final" proposal itself went through multiple iterations, there are two critical changes in the rule that are important for this Article and understanding embedded conflicts of interest:⁷⁶

- Advisers can receive certain forms of compensation that are not based upon assets under management or a set fee structure, such as brokerage or insurance

71. See U.S. DEP'T OF LABOR, *supra* note 59.

72. Daniel R. Kleinman et al., *Department of Labor Sends Fiduciary Rule to OMB for Review*, THE NAT'L LAW REVIEW (Jan. 29, 2016), <http://www.natlawreview.com/article/departments-labor-sends-fiduciary-rule-to-omb-review>.

73. See FACT SHEET, *supra* note 65.

74. *Id.*

75. *Id.* at VII.

76. See, e.g., Jason Furman, *The Obama Fiduciary Rule is Helping American Savers*, WALL ST. J. (February 20, 2017), <https://www.wsj.com/articles/the-obama-fiduciary-rule-is-helping-american-savers-1487635348>.

commissions, 12b-1 fees, and revenue-sharing payments.

- Advisers can include proprietary products in retirement plans.

Unfortunately for retirement beneficiaries, these two exemptions provided in response to last minute industry pressure recreate the preexisting problems—that of multiple-principals and opacity—and can undermine the entire intent of the new rule. If the rule is not implemented at all, even these modest benefits of the current rule, such as disclosure of the potential conflicts, hidden fees, and written contracts would be lost, thus worsening the bargaining position of the retirement beneficiaries.

B. *Commentary on the Advantages and Disadvantages of the Fiduciary Standard*

Some commentators have argued that there is a moral case for the fiduciary standard.⁷⁷ People who are investing other people's money should be providing advice and guidance that are in the best interest of the clients, who might not have the necessary expertise to evaluate such services. The fiduciary standard is in line with this moral view because it requires financial professionals to make decisions based on the question: "Is this really in the client's best interests?" Clearly, the suitability standard falls short of this requirement because it (1) creates conflicts of interest and (2) leads to more expensive and less appropriate services.⁷⁸

Others have pointed to the potential adverse impact of the new rule.⁷⁹ One potential disadvantage is that the fiduciary

77. See Barry Ritholtz, *Find a Financial Adviser Who Will Put Your Interests First*, WASH. POST (Oct. 25, 2014), https://www.washingtonpost.com/business/get-there/find-a-financial-adviser-who-will-put-your-interests-first/2014/10/23/21f3a898-596f-11e4-bd61-346ace66ba29_story.html.

78. The suitability standard requires that a broker make recommendations that are suitable based on a client's personal situation, but the standard does not require the advice to be in the client's best interest. See Peter Lazaroff, *The Difference Between Fiduciary and Suitability Standards*, FORBES (Apr. 6, 2016), <http://www.forbes.com/sites/peterlazaroff/2016/04/06/the-difference-between-fiduciary-and-suitability-standards/#1997640c35bf>.

79. *Inside the Pros and Cons of a New Fiduciary Rule*, BLOOMBERG (Apr. 7, 2016, 2:43 PM), <http://www.bloomberg.com/news/videos/2016-04-07/inside-the-pros-and-cons-of-a-new-fiduciary-rule>.

rule will be costly for financial firms to implement. Stephen Ellis has stated:

We think that the investors and analysts looking at the more studied implementation costs of the rule are vastly underestimating the rule's potential impact on the financial sector. Current government and financial industry reports have a high-end annual cost of \$1.1 billion, but even our low-end prohibited transaction revenue estimate is \$2.4 billion.⁸⁰

Clearly, higher costs of implementation of the new rule for financial firms are an undesirable burden on the entire economy.

Some commentators have argued that the rule may also lead to political fallout for the government and a decline in trust of government agencies by increasing costs and reducing investors' choices. Recently, House Speaker Paul Ryan has become one of the most vocal opponents of the new fiduciary rule.⁸¹ Mr. Ryan has called the rule "Obamacare for financial planning."⁸² His main contention is that the rule will lead to higher costs for the beneficiaries as well as financial firms.⁸³

Mr. Ryan's concerns are also shared by the financial services industry. Some are concerned that the fiduciary rule could increase litigation costs for financial firms,⁸⁴ Some argue that the rule will encourage clients to sue and that the threat of litigation may lead advisers to leave the business.⁸⁵ Some

80. Sheyna Steiner, *DOL to Continue Fiduciary Fight in 2016*, BANKRATE INVESTING BLOG (Jan. 12, 2016, 12:00 PM), <http://www.bankrate.com/financing/investing/dol-to-continue-fiduciary-fight-in-2016/>.

81. Mark Schoeff Jr., *House Speaker Paul Ryan Becomes Leading Opponent of DOL Fiduciary Rule*, INVESTMENT NEWS (Mar. 8, 2016, 1:46 PM), <http://www.investmentnews.com/article/20160308/FREE/160309931/house-speaker-paul-ryan-becomes-leading-opponent-of-dol-fiduciary>.

82. *Id.*

83. *Id.*

84. Several lawsuits have been filed on behalf of fiduciaries against the new rules. See Mark Schoeff Jr., *Thrivent Financial Files Sixth Lawsuit Against DOL Fiduciary Rule*, INVESTMENT NEWS (Sept. 30, 2016, 1:25 PM), <http://www.investmentnews.com/article/20160930/FREE/160939992/thrivent-financial-files-sixth-lawsuit-against-dol-fiduciary-rule>.

85. Andrew Welsch, *Will Fiduciary Rule Spur New Lawsuits Against Advisors?*, ON WALL STREET (Apr. 19, 2016, 6:22 PM), <http://www.onwallstreet.com/news/will-fiduciary-rule-spur-new-lawsuits-against-advisors-1AG2696400>.

experts predict that financial services firms will move more assets to fee-based performance, limiting investors' choices.⁸⁶

As a result of this opposition from the financial services industry, the final version of the rule, currently under review by the Trump administration, has been watered down significantly.⁸⁷ It does not include some previously proposed regulatory requirements, including annual investment projections and disclosures, and 401(k) plan contract requirements. The rule also contains exceptions that allow financial firms and advisers to market themselves to consumers. For example, advisers can engage in marketing and public relations without violating the new rule because public comments, press releases, and marketing materials are exempt.⁸⁸ Though the Obama administration discussed the urgent need for the new rule,⁸⁹ the delay in implementation resulting from President Trump's executive order suggests that the rule will be further modified or even nullified through the political process.⁹⁰

In this Article, we argue that the two most important deficiencies of the fiduciary rule, allowed by the DOL in response to industry pressure, are the exemptions for multiple sources of income for advisers, and for alternative and proprietary investments. These two provisions together can undermine the foundation of the rule by preventing retirement beneficiaries from receiving the best investment advice. Consequently, without transparency and single-principal requirements, we do not expect investors to be the main beneficiaries of the new fiduciary rule because investors will continue to receive conflicted advice.⁹¹ If the fiduciary standard is not implemented or further limited, these conflicts could be exacerbated.

86. *Id.* A fixed fee such as a \$50 per year management or consultation fee may be too heavy a burden for many small investors.

87. Ashlea Ebeling, *DOL Issues Final Fiduciary Rule, Does it Fall Short?*, FORBES (Apr. 7, 2016, 4:28 PM), <http://www.forbes.com/sites/ashleaebeling/2016/04/07/dol-issues-final-fiduciary-rule-does-it-fall-short/#3664cd75548e>.

88. *Id.*

89. *See id.*

90. Critics argue that the fixed costs imposed by the new rules would be hard to cover, especially for those retirees with a small amount of assets, thereby forcing the investment sponsors to cancel these investments.

91. For a more optimistic view see Lisa Kiplinger, *What it Means for Investors: Rules for Financial Advisers are Changing*, USA TODAY (Apr. 6, 2016, 11:41 AM), <http://www.usatoday.com/story/money/personalfinance/2016/04/>

C. *Multiple-Principals Problem*

The first major problem with the new DOL rule is the BICE, which allows investment advisers to receive income from both investors as well as financial institutions such as brokerage firms whose products the adviser may recommend.⁹² This exemption has created potential conflicts of interest when an agent (investment adviser) attempts to serve multiple principals (both investors and financial institutions) whose interests diverge. Benefiting one principal necessarily means hurting the other principal. In effect, the potential conflict of interest caused by this exemption may undermine the entire basis of the fiduciary rule and sets the stage to continued potential conflicts of interest. The conflict of interest caused by this exemption is exacerbated by the exemption for alternative and proprietary investments as explained below.

D. *Problems with Alternative and Proprietary Investments*

Alternative and proprietary investment products refer to specialized investments portfolios created by the brokerage firms. These products can include combinations of stocks, bonds, and derivative assets. They can also include investments in start-ups and other private investment vehicles, or claims on other non-publicly traded assets such as forests, mines, or works of art. The key feature of alternative and proprietary investments is that they are unique to the financial institution offering them. Consequently, there is little or no historical

05/fiduciary-ruling-investor-adviser-adviser/82655312/ (arguing that the rule will require financial advisers to act in investors' best interest).

92. Best Interest Contract Exemption, 81 Fed. Reg. 68 (Apr. 8, 2016) ("The provisions at issue generally prohibit fiduciaries with respect to employee benefit plans and individual retirement accounts (IRAs) from engaging in self-dealing and receiving compensation from third parties in connection with transactions involving the plans and IRAs. The exemption allows entities such as registered investment advisers, broker-dealers and insurance companies, and their agents and representatives, that are ERISA or Code fiduciaries by reason of the provision of investment advice, to receive compensation that may otherwise give rise to prohibited transactions as a result of their advice to plan participants and beneficiaries, IRA owners and certain plan fiduciaries (including small plan sponsors). The exemption is subject to protective conditions to safeguard the interests of the plans, participants and beneficiaries and IRA owners. The exemption affects participants and beneficiaries of plans, IRA owners and fiduciaries with respect to such plans and IRAs.").

performance or risk data and the information about them is limited to what the sponsor provides.⁹³ Valuations are often private.⁹⁴ In addition, fees and expenses can be built into the product parameters and are typically much higher than that of mutual funds and other publicly listed securities.⁹⁵ Given the lack of historical data, public trading records, or an easy way of valuing these assets, brokerage firms typically advertise hypothetical returns for these products rather than actual historical performance.⁹⁶ Because of the lack of full information and hidden fees, it is very likely that these products are highly profitable to the financial institutions offering them. Since financial products are a zero-sum game, any excessive profits for financial institutions and brokers will come at the expense of retirement investors. Given the exemption about receiving compensation from third parties, the sponsoring brokers and financial institutions can share some of these excess profits with investment advisers. As a result, investment advisers are more likely to recommend alternative and proprietary investments over publicly available mutual funds, to the detriment of investors.⁹⁷

Structured products are a common type of proprietary products; they provide investors with modified income streams using options, leverage, and other derivatives. For instance, a structured product can increase in value when the overall market goes down, volatility or interest rates increase, or oil prices decline. By their very nature, structured products constitute a

93. VANGUARD, *ALTERNATIVE STRATEGIES: WHAT YOU DON'T KNOW CAN HURT YOU* (2013), <https://personal.vanguard.com/pdf/a143.pdf>.

94. See Susanne Craig & Jessica Silver-Greenberg, *Former Brokers Say JPMorgan Favored Selling Bank's Own Funds Over Others*, N.Y. TIMES (Jul. 2, 2012, 9:06 PM), <http://dealbook.nytimes.com/2012/07/02/ex-brokers-say-jpmorgan-favored-selling-banks-own-funds-over-others/?ref=susannecraig> ("The bank said it did not provide actual results for the investment models in the Chase Strategic Portfolio because it was standard practice in the industry to wait until all the parts of the portfolio had a three-year return before citing performance in marketing materials.").

95. See, e.g., MORGAN STANLEY, *ALTERNATIVE INVESTMENTS: INNOVATIVE STRATEGIES FOR ASSET ALLOCATION* (2014), <https://www.morganstanley.com/wealth/investmentsolutions/pdfs/altscapabilitiesbrochure.pdf>.

96. See, e.g., Craig & Silver-Greenberg, *supra* note 94; see also Eaglesham et al., *supra* note 18.

97. See Eaglesham et al., *supra* note 18.

black box.⁹⁸ One can observe the investment returns they generate without allowing investors a full and complete picture of how they work, what the costs and fees are, and what the future returns may be.⁹⁹ As a result, structured products may be characterized as offering poor transparency.

An extreme example of an inappropriate proprietary product is a dominated asset. A dominated asset is one that offers lower returns for the same level of risk or higher risk for the same level of return as another asset (typically publicly traded funds). Therefore, investing in a dominated asset is not in the best interest of any rational investor—i.e., one who prefers higher returns and lower risk. The most common reason a particular proprietary product would be dominated is the high expense, which is simply income for the financial institution that created the proprietary product.

Evidence shows that, on average, dominated proprietary products had returns over 60 basis points worse than other similar risk funds.¹⁰⁰ Furthermore, dominated assets are recommended even though they are not in the best interest of the retirement beneficiaries. Given the lack of transparency about the proprietary investment products, investors are unable to judge what product is being recommended, what the risks and expected returns are, whether the product is dominated, and sometimes even what the fees are.

Dominated assets can exist in employer-sponsored defined contribution plans as well. Employers may insert high-fee assets into retirement plan menus presumably to increase employees' choices. In return, employers may receive direct and

98. Typical proprietary products specify what investors will receive as a function of market conditions (say, the future returns on the S&P 500 Index). What is not clarified is the expected returns on the underlying assets, and what proportion of these total returns accrue to the retiree and what proportion accrue to the investment sponsor. Therefore, these products constitute a black box as far as the retiree is concerned.

99. Katrina Lamb, *An Introduction to Structured Products*, INVESTOPEDIA (Jan. 30, 2017, 6:00 AM), http://www.investopedia.com/articles/optioninvestor/07/structured_products.asp; John F. Wasik, *Is a Structured Product Good for Retirement Income*, MORNINGSTAR (Jan. 27, 2011, 6:00 AM), <http://news.morningstar.com/articlenet/article.aspx?id=367646>; see also Eaglesham et al., *supra* note 18.

100. Ian Ayres, *The Problem of Dominated Funds*, FREAKONOMICS (March 13, 2014, 12:56 PM), <http://freakonomics.com/2014/03/13/the-problem-of-dominated-funds/>.

indirect benefits from financial institutions sponsoring these products. In extreme cases, some of these high-cost products can become dominated assets. Over half of these plans have menus with at least one dominated fund.¹⁰¹ For such plans, dominated funds contain over ten percent of total plan assets.¹⁰² While it is up to employees to choose what they believe is the best product for them, their choice is influenced by the options presented in the retirement plan. Financial advisers have an incentive to advise clients to invest more in dominated assets in return for payments from the sponsoring institutions. As discussed earlier, investors' relative lack of financial sophistication combined with the opacity of proprietary products makes it difficult for them to critically evaluate the advice they receive from their financial advisers.

Unfortunately, regulations tend to be weaker when the issue is the cost of the investment products. ERISA focuses mainly on diversification, and regulators have sidestepped their obligation to make sure that fund costs are appropriate. DOL guidelines do not explicitly deal with dominated assets if the availability of these funds can be argued to be in a client's "best interest."¹⁰³ In the case of *Hecker vs. Deere & Co.*, the Seventh Circuit held it "untenable to suggest that all of the more than 2500 publicly available investment options had excessive expense ratios."¹⁰⁴ Thus, courts have granted legal immunity to providers that offer investors the choice of dominated funds that are bad for investors.

III.

EVIDENCE OF CONFLICTS OF INTEREST

A. *Fiduciary Standard and Performance of Corporate Pension Funds*

As we have argued in the previous Part, the problem of multiple principals and the opacity of allowed investment

101. *Id.* ("52% of plans have menus offering at least one dominated fund.").

102. *Id.* ("Dominated funds hold 11.5% of plan assets.").

103. See Ian Ayres, *The Problem of 401(k) Mapping to Dominated Funds*, FORBES (Mar. 29, 2014, 10:48 AM), <http://www.forbes.com/sites/whynot/2014/03/29/the-problem-of-401k-mapping-to-dominated-funds/#5a3595cc7702>.

104. *Hecker v. Deere & Co.*, 556 F.3d 575, 581 (7th Cir. 2009).

products have the potential to create conflicts of interest between the fiduciary and the beneficiaries of defined contribution plans. The relevant policy issue, however, is the extent of harm that can result. We can gain insights into the likely effects of the conflict of interest built into the new fiduciary standard on the performance of defined contribution retirement accounts by examining the performance of defined benefit corporate pension funds. Defined benefit funds are already subject to the fiduciary standard yet attempt to serve two principals. Conflicts of interest arise in the case of defined benefit pension funds whenever corporate executives serve as pension fund fiduciaries (fiduciary–executives). These fiduciary–executives are subject to potential conflicts of interest since they also attempt to serve two principals: their shareholders and their beneficiaries. Such conflicts of interest may, in turn, affect the performance of defined benefit pension funds. Drawing lessons from the impact of conflicts of interest on the performance of defined benefit pension funds is useful for the following reasons. The incentives that create conflicts of interest in defined contribution plans are similar to that in defined benefit plans. Similar to fiduciary–executives, financial advisers are favoring their own pecuniary gain over their fiduciary responsibilities to the pension beneficiaries while choosing what assets to invest in, when to invest, and how much to invest. In addition, studying defined benefit plans will not only prove the presence or absence of conflicts of interest but, more importantly, also enable estimation of the magnitude and economic significance of the adverse effects, if such conflicts of interest do exist. We could, of course, wait to learn the existence and significance of these effects from future experience with defined contribution plans. But from a policy perspective, it clearly makes more sense to learn from past experience and take preemptive action if necessary.

The performance of defined benefit corporate pension funds has also been of great concern to fund beneficiaries, corporate management, and regulatory agencies.¹⁰⁵ These

105. See PENSION BENEFIT GUARANTEE CORPORATION, 2015 ANNUAL REPORT 13 (2015), <http://www.pbgc.gov/Documents/2015-annual-report.pdf> [hereinafter PBGC 2015]; PENSION BENEFIT GUARANTEE CORPORATION, EXCELLENCE IN CUSTOMER SERVICE: 2012 ANNUAL REPORT 8 (2012) <http://www.pbgc.gov/Documents/2012-annual-report.pdf#page=8> [hereinafter PBGC 2012].

concerns have been triggered by the record aggregate deficit of private pension plans, almost tripling from \$26.1 billion in 2011 to \$76.4 billion in 2015.¹⁰⁶ Moreover, the benefits paid, participants receiving benefits, and number of pension plans that are under the trusteeship of the Pension Benefit Guarantee Corporation have also increased dramatically between 2003 and 2012.¹⁰⁷

While part of this problem can be traced to the dismal stock market performance during the post-2000 period,¹⁰⁸ it has brought to the forefront the concern that corporate managers may also be responsible for the deficits of their companies' pension funds. The popular press has been rife with accusations of corporate theft of pension funds.¹⁰⁹ Some of the wealth transfer tactics that corporations are accused of are: (1) projecting an unrealistically high return and claiming the pension plan is overfunded, while reducing contributions to the plan and diverting them to other uses; (2) converting from conventional plans to cash balance plans, which reduces payouts but does not trigger a tax for termination;¹¹⁰ (3) declaring bankruptcy, which typically entails losses to employee pension plans while simultaneously setting up bankruptcy-protected pension plans for senior management that are protected (examples include Enron¹¹¹ and American Airlines¹¹²);

106. See PBGC 2015, *supra* note 105, at 9; PBGC 2012, *supra* note 105, at 13.

107. See PBGC 2012, *supra* note 105, at 22.

108. See Aswath Damodaran, *Annual Returns on Stock, T.Bonds and T.Bills: 1928—Current*, NEW YORK UNIVERSITY, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html (last visited Dec. 17, 2016) (reporting annual S&P 500 returns of -9.03%, -11.85%, and -21.97% for years 2000, 2001, and 2002, respectively).

109. See, e.g., Robert Kuttner, *The Great American Pension-Fund Robbery*, BLOOMBERG (Sept. 8, 2003, 12:00 AM), <http://www.bloomberg.com/news/articles/2003-09-07/the-great-american-pension-fund-robbery>.

110. This tactic was pioneered by Bank of America in 1985. Nevertheless, on July 31, 2003, in response to a lawsuit by IBM workers, a federal judge ruled that such conversions are illegal.

111. PATRICK J. PURCELL, CONG. RESEARCH SERV., RS21115, *THE ENRON BANKRUPTCY AND EMPLOYER STOCK IN RETIREMENT PLANS* (2002), <http://www.ieceusa.org/policy/issues/reports/enronpension.pdf>.

112. Miller, *supra* note 25.

and (4) siphoning pension plan surpluses to pay termination benefits and retirees' medical benefits.¹¹³

We can assess the likely effects of the conflicts of interest on fiduciary-executives of defined benefit pension funds by examining the performance of the fund trading decisions involving their own companies' stock since such decisions often involve balancing the interests of shareholders against that of pension beneficiaries. Consider for instance, the private, confidential corporate information that fiduciary-executives possess as part of their routine managerial engagement with the firm. If they ignore this confidential information, or use it to trade shares in pension funds to benefit their shareholders (for example, to temporarily influence the stock price in order to obtain a favorable price in an acquisition), then they fail in their fiduciary responsibility to the pension beneficiaries. If they use this information to benefit their pensioners, then they violate insider trading laws and fail in their fiduciary responsibility to their own shareholders.¹¹⁴ This is the conundrum that fiduciary-executives face when they serve two principals.

To provide a concrete example, assume that the fiduciary-executives possess some positive, non-public information regarding a possible takeover of their own firm. Based on this positive, non-public information, should the fiduciary-executives buy shares from the marketplace for the pension fund, do nothing, or sell shares from the pension fund to favored third parties? If they buy shares in the marketplace, they would be acting in the best interest of the pension beneficiaries but clearly against the best interest of their shareholders. If they do nothing, they are not actively helping either of their principals. If they sell shares out of the pension assets, they are clearly acting against the best interest of the pension beneficiaries.

Evidence indicates that such potential conflicts are real and not just of academic interest. For example, pension plan beneficiaries have filed several lawsuits accusing fiduci-

113. Lucent Technologies, Inc., Dupont Co., and SBC Communications, Inc. are some of the companies that used this tactic. See Ellen Schultz, *Firms Had a Hand In Pension Plight*, WALL ST. J., Jul. 10, 2003, at A1.

114. Interestingly, the recent fair disclosure regulation (Regulation FD) has exacerbated this conflict of interest. While ERISA requires fiduciary-executive to act in the best interests of pension fund beneficiaries, Regulation FD forbids them from favoring one investor over another.

ary—executives of breaching their fiduciary duty by failing to sell the company stock held by their pension plans before the stock price dropped.¹¹⁵ Critics have pointed to evidence of sub-optimal diversification: more than twenty-seven percent of all employees hold at least half of their 401(k) balances in company stock and nearly seven percent have their entire account in company stock.¹¹⁶ In response to the concern that fiduciary—executives may not always act in the interest of fund beneficiaries, some corporations have hired independent fiduciaries to handle the trading of company stock in their own employee pension funds.¹¹⁷

In order to provide formal evidence regarding conflict of interest issues facing fiduciary—executives of defined benefit pension funds, this Article analyzes the performance of pension fund trades in which the fund attains insider status. A pension fund attains insider status either by acquiring more than ten percent of the outstanding shares in a given firm (typically this is the sponsoring firm's shares), or by appointing a top level executive (an insider) as the fiduciary.¹¹⁸ In these instances, the pension fund acquires a legal-insider status and must report all subsequent transactions to the SEC.¹¹⁹

It is well-documented that insiders, as a group, earn abnormal positive returns from trading in their own companies' stocks, presumably taking advantage of their privileged access to information.¹²⁰ Top executives typically earn a higher rate of return than other officers and directors, who, in turn, earn

115. See Jeff D. Opdyke, *Retirement Plans Get New Safeguards*, WALL ST. J. (Jun. 21, 2005, 12:01 AM), <http://www.wsj.com/articles/SB111930752257264546>. Some of the companies against whom lawsuits were filed in 2005 are American Insurance Group, Delphi, General Motors, Krispy Kreme Doughnuts, and Merck.

116. *Id.*

117. *Id.*

118. DAVID A. COHEN ET AL., *EMPLOYER SECURITIES IN QUALIFIED PLANS* 7 (2009), <http://www.evercoretrustcompany.com/etc-cms.com/wp-content/uploads/2013/08/3c-Employer-Securities-in-Qualified-Plans-20131.pdf>.

119. Legal-insider status ends if the fiduciary is a lower-level executive or a non-executive and/or the pension fund reduces its equity investment to 10% or under.

120. See, e.g., H. NEJAT SEYHUN, *INVESTMENT INTELLIGENCE FROM INSIDER TRADING* (1998).

a higher rate of return than large outside shareholders.¹²¹ Another strand of literature ties the profitability of insider trading to corporate governance and internal control mechanisms.¹²² In the case of insider-pension funds, however, the presence of conflicts of interest can result in positive or negative abnormal returns. If the concerns of the proponents of fiduciary independence are valid, insider trades by pension funds will favor shareholders and executives at the expense of beneficiaries, resulting in negative abnormal returns.

B. Data and Performance Measures

The insider trading data in this study is obtained from a compilation by the SEC, which is then made available for sale.¹²³ The data contains all open market insider trading in publicly traded firms between January 1975 and December

121. See, e.g., H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 210 (1986); Arturo Bris, *Do Insider Trading Laws Work?* 23 (Yale ICF, Working Paper No. 00-19, 2010), http://papers.ssrn.com/paper.taf?abstract_id=248417; H. Nejat Seyhun, *Why Does Aggregate Insider Trading Predict Future Stock Returns?* 107 Q.J. ECON. 1303, 1329 (1992); Bin Ke et al., *What Insiders Know About Future Earnings and How They Use It: Evidence from Insider Trades*, 35 J. ACCT. & ECON. 315, 315 (2003); John E. Core et al., *Stock Market Anomalies: What Can We Learn from Repurchases and Insider Trading?* 11 REV. ACCT. STUD. 49, 68 (2006); Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315, 1315 (1985); H. Nejat Seyhun & Michael Bradley, *Corporate Bankruptcy and Insider Trading*, 70 J. BUS. 189, 203, 214 (1997).

122. Taylan Mavruk & H. Nejat Seyhun, *Do SEC's 10b5-1 Safe Harbor Rules Need to Be Rewritten?*, 2016 COLUM. BUS. L. REV. 133, 154 (2016); Cindy A. Schipani & H. Nejat Seyhun, *Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?*, 21 FORDHAM J. CORP. & FIN. L. 327 (2016); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Ending Executive Manipulations of Incentive Compensation*, 42 J. CORP. L. 277 (2016); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Manipulative Games of Gifts by Corporate Executives*, 18 U. PA. J. BUS. L. 1131 (2016); Hollis A. Skaife et al., *Internal Control over Financial Reporting and Managerial Rent Extraction: Evidence from the Profitability of Insider Trading*, 55 J. ACCT. & ECON. 91, 107 (2013); Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 68 J.L. & ECON. 371, 403 (2005); Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998); Enrichetta Ravina & Paola Sapienza, *What Do Independent Directors Know? Evidence from Their Trading*, 23 REV. FIN. STUD. 962, 1001 (2010).

123. Thomson Reuters is the vendor for the Insider Trading Data.

2014.¹²⁴ For the purposes of this study, only open market purchases and sales are included. Private transactions, shares acquired through exercise of options, and trades with corporations are excluded. The data on stock market returns is obtained from the Center for Research in Securities Prices (CRSP). The final sample contains all insider trades between January 1975 and December 2014 in firms for which stock return data is available by CRSP.

From this sample, we extract trades by insiders identified as pension funds. To be included in this sample, an insider's name (name of trader) in the database must contain the word "pension." As mentioned earlier, for a pension fund to be classified as an insider to a company, either it must hold more than ten percent of any equity class of security of the firm, or the fiduciary of the pension fund must be a top-level executive.¹²⁵ An insider relation code indicates whether the insider status for the pension fund arises as a result of the large shareholdings or interlocking executives.

Table 1 provides the summary statistics of insider trades by pension funds. Panel A provides the statistics by insider type: whether the trade was classified as an insider trade because of ten-percent equity ownership (Shareholder) or fiduciary-executive (Officer). The sample contains 1661 purchases transactions and 1339 sale transactions. The number of shares purchased is about 132 million, while the average purchase size is about 79,000 shares. The total number of shares sold is about 103 million, while the average sale size is about 77,000 shares. The bulk of the trades are by Shareholders (about 121

124. For most of the sample period analyzed here, section 16(a) of the Securities Exchange Act of 1934 requires that insider transactions be disclosed within the first ten days of the month following the month of the trade. section 16(b) prohibits insiders from profiting from short-term price movements defined as profitable offsetting pairs of transactions within six months of each other, while section 16(c) prohibits profiting from short-sales. The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) has modified insider trading regulations in many significant ways. First, the new reporting requirement states that insider transactions must be reported electronically by the end of the second business day following the day on which the transaction is executed, both through EDGAR and corporate public websites. Sarbanes-Oxley also prohibits the purchase and sale of securities during black-out periods. Any profit made from these prohibited transactions shall inure to and is recoverable by the corporation.

125. See *supra* Section III.A.

TABLE 1

SUMMARY STATISTICS OF INSIDER TRADES BY PENSION FUNDS						
<p>This table provides the summary statistics of trades by pension funds that are classified as insider trades. Panel A provides sample statistics on insiders' trades, classified by insider type: Shareholders and Officers. The fund can be classified as an insider if it holds 10% or greater stake in the sponsoring firm (Shareholder) or if an officer of the sponsoring firm serves as a fiduciary of the fund (Officer). Panel B provides the breakdown of pension fund insider trades by separate accounts (a pension fund held for employees of a single firm) and commingled funds (a fund that holds the pension investments of employees of multiple firms).</p>						
PANEL A. INSIDERS' TRADES IN PENSION FUNDS BY INSIDER RELATIONSHIP						
			Purchases	Sales		
Number of trades			1661	1339		
Shares traded (millions)			131.5	102.6		
Average trade size (millions)			0.079	0.077		
Total shares traded by Shareholders (millions)			121.1	89.4		
Total shares traded by Officers (millions)			10.5	13.2		
PANEL B. INSIDERS' TRADES IN PENSION FUNDS BY FUND TYPE						
Fund type	Number of firms	Number of trades	Number of shares traded (millions)		Average number of shares traded (millions)	
			Purchases	Sales	Purchases	Sales
Separate account	69	2220	63.1	35.0	0.030	0.059
Commingled fund	89	780	68.4	67.6	0.135	0.247

million shares purchased and 89 million shares sold) while the trades by the Officers are relatively smaller (about 11 million shares purchased and 13 million shares sold).

Panel *B* of Table 1 classifies pension fund insider transactions based on whether the fund assets are managed in separate accounts or commingled with pension assets of other firms.¹²⁶ A separate account is a pension fund held for employees of a single firm. A commingled fund, on the other hand, holds the pension investments of two or more firms' employees. We use two criteria to identify separate accounts and commingled funds. First, if a pension fund traded in shares of more than one firm with insider status, we identified this fund as a commingled fund. Second, if the pension fund's name contained only the name of a fund management firm and did not include the name of the client firm whose pension money is being managed (e.g. Morgan Guarantee Trust Pension Fund), we classified the fund as a commingled fund.¹²⁷ Panel *B* indicates that separate account transactions involve 2220 transactions in 69 firms with about 98 million shares traded compared with 780 transactions in 89 firms and 136 million shares traded for the commingled accounts.

For all our reported results, we measure market-adjusted abnormal profits computed in the following manner:

$$MAR_{i,T} = \sum_{t=1}^T H \times (r_{i,t} - r_{m,t})$$

where $r_{i,t}$ is the with-dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t .¹²⁸ The parameter H is equal to 1 if the insider trade is a purchase and -1 if it is a sale. Therefore, a negative reported market-adjusted abnormal profit implies that the return following a purchase is negative or the return following a sale is positive. The market-adjusted abnormal returns are computed over the horizon of T trading days, starting from the day following the insider trade date. We report results for four different horizons, measured in calendar days:

126. As described later, these two types of funds differ in the extent of conflicts of interest.

127. To the extent our classification is not perfect, we would tend to blur the distinction between separate and commingled categories, and we would bias our results toward the inability to distinguish between these two.

128. We measured abnormal return using the cumulative abnormal return measure and obtained similar results.

six months, twelve months, eighteen months, and twenty-four months.

C. *Performance of Defined Benefit Funds when Trading as Insiders*

In this Section we report the performance of the trades of defined benefit pension funds as insiders and then compare it to the performance of all insiders. Given the potential conflict of interest in pension funds, arising from the attempt to serve two principals (shareholders and fund beneficiaries), we would expect the returns of pension fund trades to be lower.

TABLE 2

PERFORMANCE OF PENSION FUND INSIDER TRADES					
The table provides the average abnormal market-adjusted returns (MAR) of pension fund trades in which the fund is classified as an insider for different horizons. The fund can be classified as an insider if it holds 10% or greater stake in the sponsoring firm (Shareholder) or if an officer of the sponsoring firm serves as a fiduciary of the fund (Officer). The abnormal return for each trade is computed as					
$MAR_{i,T} = \sum_{t=1}^T H \times (r_{i,t} - r_{m,t})$					
where $r_{i,t}$ is the with-dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t . The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The abnormal returns are computed for 6, 12, 18, and 24 calendar months following the trade date. The t -statistics are in parentheses. Estimates that are statistically significant at the 1% level or better are in bold.					
	Number of Observations	6 months	12 months	18 months	24 months
All trades	3000	-0.80% (-0.25)	-0.85% (-0.97)	-4.85% (-0.99)	-10.54% (-4.55)
Shareholders	1521	-1.29% (-0.82)	-5.57% (-2.64)	-9.89% (-4.90)	-15.03% (-7.10)
Officers	1479	-0.29% (0.50)	3.95% (1.31)	0.28% (3.15)	-5.92% (0.18)

Table 2 reports the market adjusted returns of pension funds insider trades. The mean market-adjusted return (MAR) is reported for all pension fund insider trades as well as for the two classes of insider relationship of the funds (Shareholders and Officers). In the full sample, we see returns statistically insignificant from zero for three of the four horizons with a significantly (at the 1% significance level) negative return of -10.54% in the twenty-four-month sample. When we split the sample into the two classes of insider relationship, we see that the results are driven by the subsample where the insider relationship arises because of the shareholding in excess of ten percent (i.e., Shareholders). In this subsample, the returns are negative and significant at the 1% level for all but the shortest horizon, with the returns ranging from -5.57% to -15.03%.

The implications of these results become more noteworthy when we compare the returns reported in Table 2 with that of all insiders (not just pension funds). These results are reported in the first row of Table 4, *infra*. It can be seen that insiders as a group earn a significantly positive mean MAR over all horizons with returns ranging from 2.40% for the six-month horizon to 6.35% for the twenty-four-month horizon. When we compare these returns with that of pension fund trades of either the Shareholder subsample (negative for most horizons) or the Officer subsample (not different from zero for all horizons), it can be seen that the returns of both these subsamples are significantly lower; the Shareholder subsample performs worse. These results are consistent with the presence of conflicts of interest in defined benefit pension funds. More importantly, the impact of the conflict of interest is significant. For example, over a twelve-month horizon the return of pension trades in the Shareholder subsample is lower than that of all insiders by 9.47%!

As Table 2 shows, the returns are significantly negative when the pension fund acquires a large equity stake in the sponsoring firm. It is possible to argue that holding a large equity stake in the sponsoring firm could never be optimal for the pensioners in the first place. Given that their human capital is already tied up in the fortunes of the sponsor, the optimal holding in their own company stock should be very small or nil. Consequently, acquiring these large equity stakes serves as a clear signal of the potential conflicts of interest, which is confirmed by the evidence.

The conclusion from the above results is that pension funds earn negative market-adjusted returns when they acquire a large equity stake in the underlying firms. Thus, it is clear that the poor performance of pension fund trades when they trade as insiders is an exception to the performance of overall insider trades. This result is consistent with the finding of noted academics that defined-benefit pension funds that invest in equity underperform the S&P 500 Index.¹²⁹

D. *Comparison of Separate Accounts and Commingled Funds*

While the poor performance of insider trades of pension funds as a whole provides preliminary support for the proponents of independent pension fund fiduciaries, the case for independent fiduciaries will be stronger if we find that the degree of independence is positively related to fund performance. We propose the following methodology to test this relationship. As noted earlier, pension funds can be categorized as separate accounts or commingled funds with the former created exclusively for a sponsoring company's employees, while the later commingles the pension investments of multiple companies.¹³⁰ If one is concerned about the conflicts of interest of a fiduciary-executive, an argument can be made that the conflicts of interest are even worse in the case of separate accounts.

In separate accounts, insiders can use pension fund assets either to benefit themselves or their shareholders, at the expense of beneficiaries, without having to coordinate their decisions with anyone else. They can do so by using the pension funds' assets to prop up their stock prices temporarily (by directing the pension fund to buy the shares of their firm prior to the exercise of their executive stock options or prior to an acquisition), or to push stock prices down temporarily (by directing the pension fund to sell shares of their firm prior to granting of executive stock options).

In commingled funds, however, such actions require coordination and collusion with the outside managers of the funds, which is likely to be difficult to achieve and costly for

129. Josef Lakonishok et al., *The Structure and Performance of the Money Management Industry*, BROOKINGS PAPERS ON ECON. ACTIVITY: MICROECONOMICS 339, 339-91 (1992).

130. See *supra* Section III.B.

several reasons. First, the interests of the commingled pension fund manager and an individual firm's executives and/or shareholders may not be congruent. For instance, the timing of key events relating to the compensation contracts of firms' executives (granting and exercise of executive stock options) and that of pension fund managers (evaluation dates of pension fund performance) need not be the same. Second, for commingled fund managers, the performance of a single stock in their portfolio is less critical than for the firm's executives and shareholders. Third, benefiting the insiders might require a quid pro quo payment arrangement with the pension fund manager, which would increase the likelihood of detection. And finally, outside professional pension fund managers have more to lose in terms of their reputation by engaging in these types of manipulations. Consequently, we expect conflicts of interest to be less prevalent in outside-managed commingled funds. Therefore, if conflicts of interest are present, we expect insider trades of commingled funds to outperform that of separate accounts.

Since the results from Table 2 show that the conflict of interest issue is significant in the Shareholder subsample, we investigate whether the returns of comingled funds are greater than that of separate accounts in this subsample. Table 3 presents the results. There are about 817 and 704 trades by separate accounts and commingled funds, respectively. The mean MAR of separate accounts is negative and statistically significant at the 1% level for all but the shortest horizon, with the returns ranging from -7.98% to -19.69%. The mean MAR of commingled funds on the other hand is not significantly different from zero for all but the longest horizon. For the twenty-four month horizon, the mean MAR for commingled funds is -9.08% and significant; however, it is greater than the mean MAR of the separate accounts for the same horizon (and the difference is significantly different from zero). Thus, the evidence is consistent with the hypothesis that there is a conflict of interest between fund managers and fund beneficiaries, and that fund managers act in the interest of the firm's shareholders or themselves at the expense of fund beneficiaries.

TABLE 3

PERFORMANCE OF PENSION FUND INSIDER TRADES GROUPED BY TYPE OF FUND					
<p>The table provides the average abnormal market-adjusted returns (MAR) of pension fund trades by shareholders for two different types of pension funds. A separate account is a pension fund held for employees of a single firm while a commingled fund holds the pension investments of two or more firms' employees. The abnormal return for each trade is computed as</p> $MAR_{i,T} = \sum_{t=1}^T H \times (r_{i,t} - r_{m,t})$ <p>where $r_{i,t}$ is the with-dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t. The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The abnormal returns are computed for 6, 12, 18, and 24 calendar months following the trade date. The t-statistics are in parentheses. Estimates that are statistically significant at the 1% level or better are in bold.</p>					
Type of fund	Number of Observations	6 months	12 months	18 months	24 months
Separate account	817	-2.65% (-0.97)	-7.98% (-4.27)	-12.40% (-5.68)	-19.69% (-7.22)
Commingled fund	704	0.39% (-0.09)	-2.76% (0.24)	-7.03% (-1.56)	-9.08% (-3.25)

E. Investigation of Alternative Explanations for the Results

In this Section, we investigate three alternative explanations for the poor performance of insider trades of pension funds relative to insider trades as a whole. Specifically, we investigate if the performance is the result of some unknown bias in the subsample of firms in our data; if the performance is due to liquidity constraints resulting from unexpected outflows; and finally, if the performance is due to the difference in trading strategies of pension funds. The tests that follow rule out all three alternative explanations for the poor relative performance of pension fund insider trades.

TABLE 4

PERFORMANCE OF TRADES BY INSIDERS OTHER THAN PENSION FUNDS				
The table provides the average abnormal market-adjusted returns (MAR) of trades of all insiders, insiders in firms with pension fund trades, and insider trades of mutual funds and ESOPs for different horizons. The abnormal return for each trade is computed as				
$MAR_{i,T} = \sum_{t=1}^T H \times (r_{i,t} - r_{m,t})$				
where $r_{i,t}$ is the with-dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t . The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The abnormal returns are computed for 6, 12, 18, and 24 calendar months following the trade date. N indicates the sample size. The p -values are in parentheses. Estimates that are statistically significant at the 1% level or better are in bold.				
Type of insider	6 months	12 months	18 months	24 months
All insiders	2.40% (0.00)	3.90% (0.00)	6.09% (0.00)	6.35% (0.00)
N	2,205,681	2,133,895	1,913,550	1,779,879
Insiders in firms with pension fund trades	3.61% (0.00)	4.62% (0.00)	6.08% (0.00)	7.06% (0.00)
N	30,488	29,901	258,586	27,313
Mutual funds	3.42% (0.00)	4.72% (0.00)	5.78% (0.00)	8.14% (0.00)
N	63,298	68,870	55,627	51,746
ESOPs	1.27% (0.00)	2.65% (0.00)	4.04% (0.00)	7.36% (0.00)
N	5,907	5,832	5,702	5,619

1. *Sample Bias*

To test if the subsample of firms with pension fund insider trades has any special characteristics that result in the poor performance of these trades, we analyze the trading performance of other insiders in the same subsample of firms with pension fund insider trades. These tests help us check the possibility that there is something unique about this particular set of firms that leads to trading losses. Perhaps, all other insiders (in addition to pension funds) suffer trading losses in this set of firms due to some unspecified chain of events.

It can be seen from the second row of Table 4 that the mean MAR for all other insiders is positive and significant at the 1% level for all horizons. Hence, while pension funds suffer trading losses, the other insiders in the same set of firms are trading profitably. These results contrast sharply with the performance of pension fund insider trades reported in Table 2. In summary, we find that pension funds do systematically worse than other insiders in the same firms, thus providing no evidence of any bias in the sample of firms with pension fund insider trades.

2. *Liquidity Constraints*

It is possible that the relatively poor performance of pension fund insider trades is due to forced liquidation of assets to meet pension payments to beneficiaries. Open-end mutual funds and employee stock ownership plans (ESOPs) face similar liquidity constraints. One can reasonably argue that mutual funds face greater liquidity constraints than pension funds because flows in and out of mutual funds are less predictable. To test this hypothesis, we compared the performance of pension fund insider trades with that of mutual fund and ESOP insider trades.¹³¹

To identify mutual fund trades we searched the names of traders in our database for words that identify them as a mu-

131. Similar to pension funds, fiduciaries of ESOPs also face conflict of interest situations. They might trade-off private benefits of employees against stock price performance. ESOPs are strong deterrents to takeovers and changes in ownership due to the fact that ESOPs are associated with negative stock price reactions. See Susan Chaplinsky & Greg Niehaus, *The Role of ESOPs in Takeover Contests*, 49 J. FIN. 1451, 1451–70 (1994).

tual fund.¹³² Our algorithm searched for the following specific words: Fund, Principal, Venture Capital, Euroventure, Capital Corporation, Partner, Trust, Investment, and Asset Management. We also ensured that the name of the insider did not contain the word “Pension.” ESOP firms were identified by searching for “employee stock ownership” and “ESOP.”

The performance of mutual fund insider trades is reported in the third row of Table 4. The mean MAR is positive and significant at the 1% level for all horizons. In addition, the monotonic relation between the mean MAR and the horizon indicates that mutual fund insider trades yield positive returns in each of the periods.

A similar result holds for ESOP insider trades as shown in the last row of Table 4. The mean MAR is also positive and significant at the 1% level for all horizons and monotonically increasing with the horizon. Thus, our evidence indicates that liquidity constraints are unlikely to explain the poor relative performance of pension fund insider trades. Trades by mutual funds (which face potentially even greater liquidity constraints) and ESOPs profit from insider trades just like other insiders.

3. *Trading Strategies*

We also investigate whether the differences between the performance of pension fund insider trades and that of all insider trades can be explained by differences in investment styles. We analyze two investment styles: momentum and mean-reversion.¹³³ A trade is classified as a momentum trade if a purchase [sale] is made after a positive [negative] MAR over

132. See *supra* Section III.B.

133. Momentum refers to the finding that a stock's recent performance continues in the same direction for about twelve months. Mean-reversion refers to the reversal of these patterns over the next three- to five-year horizons. Jegadeesh and Titman report that past six-month winners on NYSE-AMEX continue to outperform past six-month losers by about 1% per month over the next six months. See Narasimhan Jegadeesh & Sheridan Titman, *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency*, 48 J. FIN. 65, 65–91 (1993). DeBondt and Thaler document mean-reversions over longer holding periods. They show that a strategy of buying long-term losers and selling long-term winners would have earned about 25% over the subsequent three-year period. See Werner F. M. De Bondt & Richard Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality*, 42 J. FIN. 557, 557–81 (1987).

the six-month period ending in the month preceding the trade date.¹³⁴ A trade is classified as a mean-reversion trade if a purchase [sale] is made after a negative [positive] MAR over the six-month period ending in the month preceding the trade date.¹³⁵ Seyhun finds that insiders tend to follow a mean-reversion strategy for both short horizons of up to one year as well as long horizons up to five years.¹³⁶ While the details are not shown, for the entire sample of insider trades, about 63% of the trades are consistent with a mean-reversion strategy (selling winners and buying losers).¹³⁷ Similarly, when we limit the sample to insider trades in firms in which pension fund insider trades occur, about 60% of the trades are consistent with a mean-reversion strategy. By contrast, the percentage of pension funds trades that can be classified as mean-reversion is much lower—just 50% to 52%.¹³⁸

While there appears to be some evidence that pension fund insider trades follow, on average, a different trading strategy than other insider trades, the difference in performance cannot be explained by the difference in trading strategy. To demonstrate this, we compare the performance of pension fund insider trades that follow a mean-reversion strategy with trades of non-pension fund insiders in firms traded by pension funds, since both groups seem to follow the same pattern in their investment style. The mean abnormal returns for pension fund trades are significantly negative for mean-reversion trades for all horizons. By contrast, the mean-reversion trades of other insiders in the same firms earn a significant positive return for all horizons except the twelve-month horizon, in which they earn returns not significantly different from zero.¹³⁹ Therefore, this evidence does not provide support to

134. See *Momentum vs. Mean Reversion Trading Strategies*, SMART STOCK CHARTS, <http://smartstockcharts.com/momentum-vs-mean-reversion/> (last visited Dec. 18, 2016).

135. See SEYHUN, *supra* note 120, at 293–316.

136. *Id.*

137. *Id.*

138. For the sake of brevity, we do not show these results.

139. For the sake of brevity, we do not show these results.

the hypothesis that the differences in trading strategies are the cause of the lower profit of pension fund insider trades.¹⁴⁰

140. We also ran the various tests we conducted to check the robustness of our results. For the sake of brevity, we summarize the results of our tests, rather than provide detailed tables.

a. *Performance measured by style adjusted returns*

Style adjusted returns are computed by taking into account size and book-to-market ratios. First, at the beginning of each year, we classified all firms in the CRSP universe into ten size groups (using NYSE market capitalization decile cutoffs) and five book-to-market groups (using book-to-market values computed at the beginning of the preceding July). For each month between January 1975 and December 2003, we compute the equally-weighted average returns for each of these fifty benchmark portfolios. We then assign the firms in our sample into one of these fifty portfolios based on their size and book-to-market ratios. Abnormal returns are computed as the difference in returns between the firms in our sample and the matched size and book-to-market benchmark groups.

Using this approach, we find that the mean AR of pension fund insider trades is still negative and significant for the two longer horizons (mean AR of 7.2% and 11.9% with *p*-values less than or equal to 0.002). The mean AR for the twelve-month horizon is not significantly different from zero while the mean six-month AR is positive and significant (mean AR of 3% with *p*-value of 0.000). This is in contrast to the performance of all insiders in the same firms with pension fund insider trades; the trades of these insiders still earn significant positive AR consistently over all four horizons.

The results using the style-adjusted model for the trades of separate accounts and commingled funds are qualitatively similar to the results reported earlier. The mean AR for the trades of separate accounts are significantly negative for all four horizons and monotonically increasing with the horizon; they vary from 3.2% for the six-month horizon to 23.9% for the twenty-four-month horizon. By contrast, the mean AR for the trades of commingled funds are significantly positive for all four horizons (*p* < 0.0001); they vary from 15.6% for the six-month horizon to 17.1% for the twenty-four-month horizon. Thus, using the style-adjusted model confirms our finding that the conflict of interest hurts the beneficiaries of pension funds.

b. *Performance measured using cumulative abnormal returns*

In addition to $MAR_{i,t}$, we also used cumulative market-adjusted abnormal monthly returns of the stock (CAR) starting from the month that follows the trade computed as:

$$CAR_{i,T} = \sum_{t=1}^T (r_{i,t} - r_{m,t})h$$

where $r_{i,t}$ is the with-dividend return to stock *i* for month *t*, and $r_{m,t}$ is the with-dividend return to equally weighted portfolio of all New York Stock Exchange, American Stock Exchange and NASDAQ stocks for month *t*. The parameter *h* is defined as before as equal to 1 if the insider trade is a purchase and -1 if it is a sale.

IV.
ALTERNATIVE AND PROPRIETARY INVESTMENTS
IN RETIREMENT ACCOUNTS

Alternative and proprietary products can be any investment vehicle that the investment sponsor creates. They can include a bundle of securities that already trade on public exchanges.¹⁴¹ They can also include structured products whose payoffs are modified using leverage, option, futures, and other derivative products.¹⁴² Finally, they can include investments in start-ups and other private investment vehicles, shopping malls, residential and commercial real estate, and works of art.¹⁴³ The key feature of these products is that they do not trade on any public exchanges and the information about them is limited to what the sponsor provides.¹⁴⁴

There are multiple problems with allowing alternative and proprietary investment products in retirement accounts. One important problem is valuation. Since these products are unique and do not trade publicly in exchanges, it is not possible to observe a market-determined price or value for them.

The results using CAR are qualitatively similar to those obtained using AR. The CAR of overall pension fund insider trades is negative and significant for all horizons. In addition, CAR of insider trades by separate accounts are negative and significant while that by commingled funds are positive and significant.

c. *Volume of trades and performance*

In order to check if the performance of pension fund insider trades is related to the volume of trade, the sample was divided into four volume groups based on the number of shares traded: less than 100 shares (sample size = 3 trades), 100 to 1000 shares (224 trades), 1000 to 10,000 (1028 trades) shares, and greater than 10,000 shares (794 trades). The mean AR for the top three volume sub-groups are negative (and significant at the 5% level or better) for the eighteen and twenty-four month horizons. There was no clear relationship between the trade volume and the AR.

141. *What is An Alternative Investment*, CNL SECURITIES, <http://www.cnl-securities.com/education/what-is-an-alternative-investment.stml> (last visited Mar. 3, 2017).

142. *Proprietary Trading*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/proprietarytrading.asp> (last visited Mar. 3, 2017).

143. CNL SECURITIES, *supra* note 140; *Alternative Investment*, INVESTOPEDIA, http://www.investopedia.com/terms/a/alternative_investment.asp (last visited Mar. 3, 2017); John Greenwood, *First Class Returns for Alternative Investments*, THE TELEGRAPH (Oct. 6, 2008), <http://www.telegraph.co.uk/finance/personalfinance/investing/3144943/First-class-returns-for-alternative-investments.html>.

144. CNL SECURITIES, *supra* note 140.

Instead, the valuation is made privately by the owner of the product.¹⁴⁵ This private valuation creates problems both for taxpayers as well as retirement investors. From the taxpayers' perspective, these products can be used to create unfair tax shelters. For the small investor, these products constitute black boxes with no way to peer inside and understand the structure, costs, risks, or expected returns.

Some examples would be helpful to illustrate the problems associated with the alternative investment products in retirement accounts. First, we illustrate the conflicts created for taxpayers. Suppose that an entrepreneur creates a start-up with an expected market value of \$20 million. A proprietary investment vehicle is then created using all of the start-up assets and 20 billion shares are issued against it. Consequently, the fair market value of these private shares would be \$0.001. However, since there is no market for this product, the entrepreneur can attach any private valuation on this investment. Assume that the entrepreneur makes a small valuation error (in absolute value) and privately values each proprietary share at \$0.0000001 instead of \$0.001. At this price, the entire start-up is now valued at \$2000. The entrepreneur then simply uses \$2000 to put all 20 billion shares into his IRA account.

At a later date, say three to five years later, when some or all the proprietary investment is offered to the public at the fair market price of \$0.001 per share, the IRA account balance will suddenly grow from \$2000 to \$20 million. In effect, the value increase has taken place in a tax-sheltered account, thereby free from taxation. This tax-free wealth can now be consumed or passed to future generations.¹⁴⁶ If sufficient time passes between when the investment was purchased by the IRA

145. See generally *Valuation Best Practices for Alternative Investment Funds*, MERCER CAPITAL (Feb. 21, 2014), <http://mercercapital.com/financial-reporting-blog/valuation-best-practices-for-alternative-investment-funds/>.

146. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-16, *INDIVIDUAL RETIREMENT ACCOUNTS: IRS COULD BOLSTER ENFORCEMENT ON MULTIMILLION DOLLAR ACCOUNTS, BUT MORE DIRECTION FROM CONGRESS IS NEEDED* (2014), <http://www.gao.gov/products/GAO-15-16>. In 2011 there were more than 600,000 individuals with estimated IRA balances over \$1 million, more than 1000 individuals with estimated IRA balances over \$10 million and more than 300 individuals with estimated IRA balances over \$25 million. The aggregate estimated dollar balance of the \$25 million+ group is \$81 billion, which means this group could be generating significant tax loss for the U.S. Government. *Id.*

account and when the initial public offering took place, it would be difficult if not impossible to determine whether the value increase is due to subsequent improvements in the start-up or the initial misevaluation.¹⁴⁷

A recent Government Accountability Office (GAO) study has found that there are more than 300 taxpayers who own IRA accounts with an aggregate value of about \$81 billion.¹⁴⁸ Thus, the average balance in these accounts is over \$250 million each. While all of the IRA balances are fully taxed as ordinary income when distributed to the taxpayer, there is an easy way of avoiding this taxation as well. After contributing \$5000 to an ordinary IRA account and purchasing privately-valued proprietary products, the taxpayer can simply convert this IRA into a Roth-IRA, pay taxes on the extra \$5000 of income, and, after the valuation step-up, enjoy the \$20 million wealth increase completely tax-free.¹⁴⁹

Another problem with the alternative and proprietary products arising from private valuation is the lack of information regarding the products' risks and expected returns for the retirement beneficiary. While a complete analysis of the various types of proprietary products is beyond the scope of this Article, we examine the potential performance of a representative sample of these products. A common feature of these products is that they limit downside risk and retain upside po-

147. *See id.*, stating:

A small number of taxpayers has accumulated larger IRA balances, likely by investing in assets unavailable to most investors—initially valued very low and offering disproportionately high potential investment returns if successful. Individuals who invest in these assets using certain types of IRAs can escape taxation on investment gains. For example, founders of companies who use IRAs to invest in privately traded shares of their newly formed companies can realize many millions of dollars in tax-favored gains on their investment if the company is successful. With no total limit on IRA accumulations, the government forgoes millions in tax revenue. The accumulation of these large IRA balances by a small number of investors stands in contrast to Congress's aim to prevent the tax-favored accumulation of balances exceeding what is needed for retirement.

148. *See id.*

149. An ordinary IRA account allows the taxpayer to contribute using pre-tax dollars but pay full income taxes upon distribution. In contrast, a Roth IRA allows the taxpayer to contribute from after-tax income, but then enjoy all distributions without taxation upon reaching retirement age.

tential. One representative retirement investment vehicle we analyze,¹⁵⁰ offers the following features:

- Protects the principal from market downturns;
- Limits the upside gains to the investor;
- Grows retirement assets;
- Guarantees rising income for the first ten years of the contract; and
- Doubles retirement income potential if no withdrawals are taken for the first ten years.

Sometimes these products explicitly state that there are no fees or commissions charged.¹⁵¹ In this case, the benefits to the brokerage firm are not zero, but they are hidden in the products' terms which specify how much the investors participate in the upside. While the details of how these objectives are achieved are not disclosed to the investor, the payout structure is disclosed:¹⁵²

- a. Annual accounting: Interest is earned based on annual changes in the S&P 500 Index. If S&P is up at the end of the year, interest is credited up to a four percent cap. If the S&P 500 index is down for the year, no interest is earned.
- b. Monthly accounting: Interest is based on monthly changes in the the S&P 500 Index. If the Index is up at the end of the month, interest is credited up to a two percent cap. If the S&P 500 Index is down for the month, negative interest is earned with no cap. Interest earned at the end of the year is the sum of twelve monthly interest credits with a floor of zero.

A typical investor is completely unprepared to evaluate such a complex financial investment. It is not at all obvious whether these are good or bad investments; nor is it obvious whether annual or monthly accounting is better.

To analyze the potential performance of these structured products, we ran a simulation analysis with one million repeated experiments. We simulate the S&P 500 returns using a normal distribution with an annual arithmetic mean of 8%

150. This is a confidential investment product. Consequently, we are not able to divulge the source for this information.

151. The prospectus for this confidential product, *see supra* note 149, also mentioned that there is no commission.

152. These specific parameter values are taken from the confidential product cited *supra*, note 149.

and annual standard deviation of 16%, in line with observed characteristics of S&P 500 returns. In the case of the monthly accounting product, we use the corresponding monthly arithmetic mean of 0.67% and monthly standard deviation of 4.7%. We analyze the performance of these structured products over a ten-year investment horizon.

The simulated performance of both these products is shown in Table 5. An investment of \$100,000 in the S&P 500 Index grew to a mean value of \$215,113 in ten years, thus producing a mean geometric return of 6.92% per year. The same amount invested in the structured product grew to \$129,114 in ten years, corresponding to a mean geometric return of 2.57% per year. In other words, investors who put their money in the structured product for ten years will, on average, end up with 25% of the dollar return compared to what they would have had if they had invested in the S&P 500 Index (i.e., a return of \$29,114 instead of \$115,113). They are, of course, sacrificing the 75% upside in order to buy downside protection; recall that the structured product guarantees the principal amount. The question, therefore, is whether investors are paying a fair premium for the insurance of downside protection. In this case, they are giving up, on average, 3.35% return per year in exchange for downside protection.

One way to answer this question is to compare the average annual return of the structured product to that of the ten-year Treasury bond. Both the structured product and the bond guarantee the principal amount. The buy and hold return of the bond is fixed, while that of the structured product is variable as it depends on the return of the S&P 500 Index. Given that the structured product is risky (in some years the returns can be less than the risk-free rate), its expected return should be greater than that of the bond. Between 1962 and 2015, only during the last four years of that period has the ten-year Treasury bond yield been lower than 2.57%, the average return of the structured product.¹⁵³ Therefore, it is difficult to make the case that the investor is better off with the structured product.

153. Treasury yields are obtained from Federal Reserve website. *Data Download Program*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, <https://www.federalreserve.gov/datadownload/Build.aspx?rel=H15> (last visited December 6, 2016).

TABLE 5

SIMULATED PERFORMANCE OF STRUCTURED PRODUCTS				
<p>The table provides the simulated results of two structured products described in the paper. We ran a simulation analysis with one million repeated experiments. We simulate the S&P 500 returns using a normal distribution with an annual arithmetic mean of 8% and annual standard deviation of 16%, in line with the observed characteristics of S&P 500 returns. In the case of the monthly accounting product, we use the corresponding monthly arithmetic mean of 0.67% and monthly standard deviation of 4.7%. We analyze the performance of these structured products over a ten-year investment horizon for an investment of \$100,000. We report the mean, maximum, and minimum terminal values of each product and its annual mean geometric return.</p>				
PANEL A: ANNUAL ACCOUNTING				
Invest \$100,000 in	Terminal value			Annual mean geometric return
	Mean	Min.	Max.	
S&P 500 index	\$215,113	\$13,178	\$1,630,151	6.92%
Structured product	\$129,114	\$100,000	\$148,024	2.57%
PANEL B: MONTHLY ACCOUNTING				
Invest \$100,000 in	Terminal value			Annual mean geometric return
	Mean	Min.	Max.	
S&P 500 index	\$227,716	\$17,476	\$2,287,489	7.02%
Structured product	\$115,993	\$100,000	\$264,421	1.44%

The sub-optimality of the structured product is starker when we considered the monthly accounting case. With monthly accounting, an investment of \$100,000 in the S&P 500 Index grew to a mean value of \$221,716 in ten years, producing a mean geometric return of 7.02% per year. The same

amount invested in the structured product grew to \$115,993 in ten years, corresponding to a mean geometric return of 1.44% per year. In other words, investors who invested in the structured product for ten years will, on average, end up with 13% of the dollar return compared to what they would have had if they had invested in the S&P 500 Index (i.e., a return of \$15,993 instead of \$121,716).

The average annual return of the structured product is lower than the Treasury bond yield in each of the years from 1962 to 2015. In other words, the monthly accounting structured product is a dominated asset; the Treasury bond dominates it by providing better returns with lower risk. Thus, investors would have been better off investing in Treasury bonds, which are much simpler investments, than being induced to purchase the complicated structured product they do not fully understand. It is important to note that the superiority of the bond over the structured product is true before we take into account transaction costs. The buying and selling of Treasury bonds involves minimal transaction costs in contrast to the fees and commissions normally associated with the structured proprietary product.

Overall, when all of the facts have been considered, it would be difficult to argue that such a product would be in the best interest of any retiree. Yet, the current rules would continue to allow these types of alternative investment products in being offered as suitable retirement investments. What is never reported is the expected annual returns and risks from this products; this is an important piece of information that can help investors in deciding whether to invest in this structured product. However, under the current rules, such disclosures are not mandated.

CONCLUSION

As this Article outlines, the DOL regulation—the implementation of which had been delayed by the Trump administration as this Article went to print—regarding the fiduciary standard for pension plans and IRAs contains two provisions that are potentially adverse to the best interests of beneficiaries. First, it requires that investment advisers act in the best interest of the beneficiaries, while simultaneously allowing them to receive income from third parties. Second, it permits

opaque, non-publicly-traded alternative investments and proprietary products, which lead to costly and uninformed investment decisions.

This Article provides direct empirical evidence that these two provisions are indeed not in the best interests of plan beneficiaries. These findings support the recommendation that brokers and other fiduciaries must serve only one principal. The evidence supporting the case for independent fiduciaries that serve only one principal is based on the abnormal profitability of company-supported pension fund transactions in firms in which they acquire insider status. Pension funds are considered insiders if the pension fund holds more than ten percent of the shares of the underlying firm or if there is an overlap among the executives of the underlying firm and the pension fund.¹⁵⁴ The fact that a pension fund acquires such a large stake in the company of the retirement investors itself signals a potential conflict of interest.

Our findings indicate that, when the pension fund acquires an insider status, beneficiaries of the pension funds suffer. In fact, pension fund managers exhibit bad timing in the trades of the underlying firm's shares. Stocks tend to underperform after being purchased by the pension fund, and outperform after being sold. The magnitude of the abnormal losses for the beneficiaries of the pension funds is large: for pension funds which have insider status (triggered by greater than ten percent shareholding), the loss is 5.57% after one year and 15.03% after two years.¹⁵⁵ These losses are both statistically and economically significant and support the case for unconflicted, independent fiduciaries. The key to unconflicted advice is to ensure that the investment advisers receive income from only one principal, and thus serve only that principal.

Using simulation, we also show that proprietary investment vehicles are likely to provide lower returns, thus reducing the retirement savings of beneficiaries. We offer three policy recommendations to remedy these serious problems.

Our first policy recommendation addresses the income exemption that would allow fiduciaries to receive income from third parties. We recommend that any regulations which are

154. See *supra* Section III.A.

155. See *supra* Table 2 in Section III.C.

ultimately adopted ensure that investment advisers serve only one principal and therefore receive income only from one principal. With multiple principals, investors' advisers will be tempted to recommend products that are most profitable for themselves, as well as the investment sponsors, instead of those products that are best suited to the beneficiaries. This likely outcome would be higher risk, and lead to higher fees and lower returns to beneficiaries. One consequence would be vastly expanded litigation to sort out the conflicts within the fiduciary standard. Unfortunately, this standard and the associated exemptions completely fail to address the multiple-principles problem.

Our second recommendation addresses the transparency issue regarding investment products, in particular, in alternative and proprietary investment products. It is our opinion, based on the evidence presented here, that only publicly traded assets should be allowed in either defined benefit or defined contribution plans to address the transparency issue. By their very nature, alternative and proprietary products do not trade in public markets and thus require private valuation. Private valuation in turn creates multiple problems both for the taxpayers and for the retirement beneficiaries. From the taxpayers' perspective, private valuation creates potential conflicts. It is easy to undervalue these products, include them in tax-sheltered IRA accounts, and then enjoy the capital gains without taxation after market values are established. These potential conflicts can and should be avoided by banning alternative investments and proprietary products in retirement accounts and requiring that all investments trade on U.S. exchanges or similarly-qualified exchanges.

From retirement beneficiaries' perspective, private valuation of non-publicly traded assets also creates potential conflicts. When it comes to alternative and proprietary products, retirement investors are simply pitted against financially sophisticated investment advisers and brokers, and they are at a significant informational disadvantage. These investment products are complex, yet there is insufficient information to evaluate them. Furthermore, the fiduciary rule does not even require the disclosure of basic information such as hidden fees, or comparison to publicly-available alternatives or simulated expected returns. Without such basic information, informed investment decisions are almost impossible. Second,

even if some information is provided, the average investor is not financially savvy enough to properly evaluate these products. Instead, if only publicly traded investments are allowed, investors would be protected, to some extent through their reliance on the relative informational efficiency of public markets.¹⁵⁶ Consequently, we propose that only publicly-traded securities on public-exchanges should be allowed in either defined benefit or defined contribution retirement accounts.

Our final policy recommendation is to restrict the retirement savings to low-cost, well-diversified funds such as index funds and exchange-traded funds (ETFs). To ensure that risk level of the plan is consistent with the risk-tolerance levels of the beneficiaries, we further recommend that broad age-specific minimums, maximums, and target proportions on large-cap equity, small-cap equity, international equities, fixed-income, consisting of corporate bonds and government bonds, and publicly-traded real-estate securities should be specified. The target proportions of riskier assets should be reduced as the investor gets closer to the retirement age, similar to target-date investments.¹⁵⁷ International equities should be restricted American Depository Receipts (ADRs) only.

156. Market efficiency means that price of publicly traded assets fully reflects all available information. The evidence in the finance literature generally supports the concept of the semi-strong form of market efficiency. Eugene Fama, who won the 2013 Nobel Prize in Economics for his path-breaking work on market efficiency and who is often regarded as the father of the efficient market hypothesis, wrote in 1970, "We shall conclude that, with but a few exceptions, the efficient markets model stands up well," and "[i]n short, the evidence in support of the efficient markets model is extensive, and (somewhat uniquely in economics) contradictory evidence is sparse." See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383-417 (1970). In 1991, Fama updated his analysis and wrote, "The empirical literature on efficiency and asset-pricing models passes the acid test of scientific usefulness." Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1576 (1991). Although some recent studies have uncovered some evidence of anomalous price behavior, numerous peer-reviewed academic studies by leading financial economists have largely concluded that these anomalies have alternative explanations that are consistent with and support market efficiency. There are a number of such surveys. See Eugene F. Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998); G. William Schwert, *Anomalies and Market Efficiency*, in HANDBOOK OF THE ECONOMICS OF FINANCE 937 (G.M. Constantinides et al., eds., 2003).

157. Most defined benefit plans have similar restrictions on asset mix.

The restriction to low-cost well-diversified ETFs would achieve multiple objectives all in line with welfare of the retiree in mind. First, there is no cost to such restrictions. In fact, by only investing in well-diversified funds or ETFs, investors get lower trading costs, as well as better risk–return tradeoffs.¹⁵⁸ Evidence from practice side also shows that low-cost passive index funds in fact beat a large majority of the actively-managed funds year in and year out.¹⁵⁹ Second, the requirement that investors only invest in a select number of well-diversified low-cost index funds or ETFs also eliminates the temptation to

158. Sharpe demonstrates why passive funds should outperform actively managed funds after expenses. William Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7, 7–9 (1991). Market return is the weighted average return of active and passive funds. However, by definition the return of a passive fund that tracks the market must equal the market return. Hence, average return of active funds must also equal the market return. However, since passive funds have lower fees, they outperform active funds. There is considerable empirical support for this argument. See Burton G. Malkiel, *Returns from Investing in Mutual Funds 1971 to 1991*, 50 J. FIN. 549, 549–72 (1995); Burton G. Malkiel, *Passive Investment Strategies and Efficient Markets*, 9 EURO. FIN. MGMT. 1, 1–10 (2003); Alex Frino & David R. Gallagher, *Tracking S&P 500 Index Funds*, 28 J. PORTFOLIO MGMT. 44 (2001) (providing evidence for passive funds' outperformance); see also Lu Zheng, *Is Money Smart?*, 54 J. FIN. 901, 901–32 (1999) (providing evidence that active funds cannot perform the market in the long-run).

159. Standard and Poor's SPIVA U.S. Mid-Year 2016 report states: "During the one-year period, 84.62% of large-cap managers, 87.89% of mid-cap managers, and 88.77% of small-cap managers underperformed the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600, respectively. The figures are equally unfavorable when viewed over longer-term investment horizons. Over the five-year period, 91.91% of large-cap managers, 87.87% of mid-cap managers, and 97.58% of small-cap managers lagged their respective benchmarks. Similarly, over the 10-year investment horizon, 85.36% of large-cap managers, 91.27% of mid-cap managers, and 90.75% of small-cap managers failed to outperform on a relative basis. Over the 10-year investment horizon, managers across all international equity categories underperformed their benchmarks. The hunt for yield has become increasingly challenging for fixed income managers. During the one-year period studied, the majority of managers investing in government and corporate credit bond categories underperformed their benchmarks, with the exception of those managing intermediate-term corporate credit funds. Funds disappear at a meaningful rate. Over the five-year period, nearly 21% of domestic equity funds, 21% of global/international equity funds, and 14% of fixed income funds were merged or liquidated. This finding highlights the importance of addressing survivorship bias in mutual fund analysis." AYE M. SOE & RYAN POIRIER, SPIVA U.S. SCORECARD MID-YEAR 2016 (Sept. 15, 2016), <https://us.spindices.com/search/?ContentType=SPIVA>.

seek recently hot funds, active money managers, or complex alternative investments and proprietary products, thus reducing potential conflicts of interest. With a restricted choice set, the role of the financial adviser is limited. This further reduces the incentives and the ability of the financial advisers to offer conflicted advice. Finally, some exceptions to such a low-cost ETF rule can be considered in special circumstances. One such circumstance is to allow financially savvy investors to invest in any publicly-traded security. Retirement investors can qualify as financially savvy in a number of ways, including formal education in finance or the size of their investment portfolio which would allow them to obtain unconflicted advice from multiple sources.

In summary, the evidence presented in this Article makes a strong case for tightening the current fiduciary rule in order to improve the transparency of financial products offered by retirement plans and reduce fiduciaries' conflicts of interest. By requiring that retirement plans be structured as suggested, policy makers can ensure that these issues are addressed and beneficiaries' interests are served.

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FREEDOM TO MISLEAD: THE FICTITIOUS
FREEDOM TO CONTRACT AROUND FRAUD
UNDER DELAWARE LAW

HAO JIANG*

In the past 15 years, Delaware courts seem to have created a rule that allowed sophisticated parties to contract around fraud by using an unambiguous disclaimer and integration clause. Supposedly, an extra-contractual fraud claim would be dismissed had there been an unambiguous disclaimer. However, a survey of Delaware cases tells a different story. They have not held that even sophisticated parties who have relied on fraudulent misrepresentations are bound by contract with a clear disclaimer and integration clause. In the cases in which the courts have supposedly done so, either the party seeking to uphold the contract did not make any fraudulent misrepresentations on the other party did not rely on them or the case could easily have been decided on other grounds.

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INTRODUCTION

Contracting parties have been protected against fraud throughout the world, in both civil law as well as common law systems. In common law jurisdictions, they have traditionally been protected against fraud in extra-contractual representations even if their contract contains a disclaimer and integration clause, which state that the contract is the complete and final agreement between the parties who have not relied on any representations outside the contract.

Supposedly, Delaware is an exception. The traditional rule was challenged in a series of cases beginning in 2001 with *Great Lakes Chem. Corp. v. Pharmacia Corp.*¹ There, the court concluded that disclaimers in an agreement for purchase of a business barred the buyer's fraud claims, where the contract was entered into between sophisticated parties after extensive due diligence and negotiations.² Finally, in a landmark case in 2006, *ABRY Partners V, L.P. v. F&W Acquisition LLC*,³ then-Vice Chancellor Strine said that an integration and disclaimer clause would be effective, even against a claim of fraud, provided it contains "language that . . . can be said to add up to a

1. 788 A.2d 544 (2001).

2. *Id.* at 555.

3. 891 A.2d 1032 (Del. Ch. 2006).

clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract."⁴ He claimed to be following prior law:

When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has taken a different approach. We have honored clauses in which contracted parties have disclaimed reliance on extra-contractual representations, which prohibits the promising party from renegeing on its promise by premising a fraudulent inducement claim on statements of fact it had previously said were neither made to it nor had an effect on it.⁵

In a 2008 article, corporate attorney Steven Haas applauded this decision because it "sets the outer limit on the ability to contract around fraud."⁶ The effect of the decision, according to Haas, is that "while a party can totally immunize itself for intentional misrepresentations made outside of a contract, a party cannot limit its liability for intentional misrepresentations found within the contract itself."⁷ He claimed that Delaware courts consistently allow sophisticated parties to use integration clauses and disclaimers to contract around fraud.⁸ According to Haas, "there are only minimal checks on what amounts to a contractual freedom to sanction lying outside the contract: the parties must be sophisticated and, the extra-contractual disclaimer must be unambiguous."⁹ When these conditions are met, Delaware courts have allowed "a total exculpation of liability" when the disclaiming party "acted in a morally culpable manner to induce the other party to contract."¹⁰

4. *Id.* at 1059.

5. *Id.* at 1056.

6. Steven M. Haas, *Contracting Around Fraud Under Delaware Law*, 10 DEL. L. REV. 49, 72 (2008), cited in *RAA Mgmt. v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (2012), and *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35 (Del. Ch. 2015).

7. *Id.*

8. *Id.* at 49–50.

9. *Id.* at 50.

10. *Id.*

The Delaware courts are among the most sophisticated in the United States in business matters. So many businesses are incorporated there that Delaware law governs some of the most important transactions among American companies. It is a matter of national—not local—concern whether Delaware law allows the parties to contract around claims of fraud.

Both Strine and Hass believe that such a rule is justified by principles of freedom of contract and efficiency. They have made some novel arguments in support of that position. The first Part of this Article will show why those arguments are unsound. The second Part of this Article will show that, despite the language of their opinions, Delaware courts have not allowed parties to contract around fraud. They have not held that even sophisticated parties who have relied on fraudulent misrepresentations are bound by a contract with a clear disclaimer and integration clause. In the cases in which the courts have supposedly done so, either the party seeking to uphold the contract did not make any fraudulent misrepresentations, the other party did not rely on them, or the case could have been decided just as easily on other grounds.

I.

FRAUD AND FREEDOM OF CONTRACT

Freedom of contract is broadly protected in American law, especially under Delaware law.¹¹ As Melvin Eisenberg has shown, that principle is worthy of protection to the extent that both parties acted voluntarily, were fully informed, and the

11. *See, e.g.*, *Aspen Advisors LLC v. United Artists Theatre Co.*, 843 A.2d 697, 712 (Del. Ch. 2004) (ruling that enforcing the “plain terms” of a contract furthers Delaware law’s goal of promoting reliable and efficient corporate and commercial laws); *Gildor v. Optical Solutions, Inc.*, 2006 WL 4782348, at *7 n.17 (Del. Ch. Jun. 5, 2006) (“It is imperative that contracting parties know that a court will enforce a contract’s clear terms and will not judicially alter their bargain, so courts do not trump the freedom of contract lightly.”); *Douzinis v. Am. Bureau of Shipping, Inc.*, 888 A.2d 1146, 1152 (Del. Ch. 2006) (“[T]his court’s duty is to respect the contract freely entered into by all the members”); *see also* *Marino v. Grupo Mundial Tenedora, S.A.*, 810 F. Supp. 2d 601, 607 (S.D.N.Y. 2011) (“The policy of the Delaware Act is to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”) (citation omitted).

bargaining process was fair.¹² For good reason, then, traditionally, a party is not bound when his assent a contract was induced by fraud. He did not act voluntarily when he was tricked into assenting, nor was his assent fairly procured. Moreover, he lacked the information necessary if contract is to exchange resources in a way that benefits them both and is therefore efficient. Yet, Strine has argued that when sophisticated parties have included a clear integration and disclaimer clause, it is the victim of fraud who is unfairly trying to escape an agreement voluntarily made.¹³ Haas has argued that to hold him bound, despite the other party's fraud, is an efficient allocation of the burdens of acquiring information.¹⁴

Strine argued that to bar the victim's fraud claim is actually to punish that party for "lying" rather than to let the fraudulent party get away with lies:

To fail to enforce non-reliance clauses is not to promote a public policy against lying. Rather, it is to excuse a lie made by one contracting party in writing—the lie that it was relying only on contractual representations and that no other representations had been made—to enable it to prove that another party lied orally or in a writing outside the contract's four corners. For the plaintiff in such a situation to prove its fraudulent inducement claim, it proves itself not only a liar, but a liar in the most inexcusable of commercial circumstances: in a freely negotiated written contract. Put colloquially, this is necessarily a 'Double Liar' scenario. To allow the buyer to prevail on its claim is to sanction its own fraudulent conduct.¹⁵

Strine reasoned that:

A party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a 'it

12. Melvin A. Eisenberg, *The Role of Fault in Contract Law: Unconscionability, Unexpected Circumstances, Interpretation, Mistake, and Nonperformance*, 107 MICH. L. REV. 1413, 1415–16 (2009).

13. *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006).

14. Haas, *supra* note 6, at 55.

15. *ABRY Partners V*, 891 A.2d at 1058.

did rely on those other representations' fraudulent inducement claim.¹⁶

It is wrong to think that the victim of fraud who signs a contract with a disclaimer clause is "lying," in the normal sense of the word. He is unlikely to take the language of the disclaimer clause literally: that is, to believe that the written contract actually contains all of the representations on which he relied. Contracting parties invariably rely on information and representations beyond the four corners of the written contract when they contract. Even when they do not realize the extent of their reliance on the extra-contractual representations, such representations often become a predicate that had induced the contract. Sophisticated parties often lay out a detailed list of representations and warranties that they think they have relied on, but often the list is not, or cannot possibly be, exhaustive. Consequently, one who signs a contract with the magic language that says one does not rely on the extra-contractual promises is unlikely to think it really means that he did not. He signs a contract with a disclaimer clause, without realizing what he has given up, only because the lawyers put them there.

The mere fact that there is a disclaimer and integration clause only reduces the likelihood of extra-contractual reliance but does not bar such reliance as a matter of law. Whether there was reliance and whether the reliance was justifiable is a triable matter of fact. In any event, the victim of fraudulent misrepresentations neither assented voluntarily nor was his assent fairly procured. It would be odd to say that the party who made the fraudulent misrepresentations was himself the victim of fraud because his victim signed and later repudiated a disclaimer clause. A party who made these representations and then claimed he did not assent voluntarily would be saying that had he only known he could not commit fraud and get away with it, he would never have assented. If he claimed that his assent was procured unfairly, he would be saying that he was duped into thinking he could get away with fraud.

Haas argued that not enforcing the disclaimer would be inefficient because it would increase transactions costs.¹⁷ The logic is that freedom of contract allows parties to freely allo-

16. *Id.* at 1057.

17. Haas, *supra* note 6, at 60.

cate the risk of the accuracy of information.¹⁸ It is impossible for the seller to monitor all of the communications from its employees and agents.¹⁹ Not allowing the freedom to contract around fraud would impose unlimited liability for every communication that is inaccurate.²⁰ Therefore, the seller would have an incentive to limit the flow of information.²¹ As a result, more due diligence would be needed to gather information and transaction costs would be increased.²²

Further, it would be costly for the seller to even attempt to monitor all communications from its employees and agents, but it may also be costly for the buyer to check their accuracy. Many representations play a greater or lesser role in the decision to contract. For parties to assume that everything that they have been told could be false and to check the authenticity of every word the other party has said would be impossibly costly. In any event, we are dealing with fraudulent misrepresentations. If the seller has to bear the cost of the harm done when his employees or agents lie, he has an incentive to monitor their behavior to see that they do not. He will do so efficiently: by spending the amount on monitoring that is reasonable given the harm that their lies may cause. He has no such incentive when he is protected by a disclaimer clause. Indeed, he profits when they lie, and so he has every incentive to overlook their misconduct, if not to encourage it. Indeed, sparing sophisticated parties from liabilities arising out of their fraud would encourage them to use integration clauses to contract out misrepresentations and get away with fraud.

II.

THE LAW IN DELAWARE

A. *Overview*

To establish a fraud claim under Delaware law:

[T]he plaintiff must plead facts supporting an inference that: (1) the defendant falsely represented or omitted facts that the defendant had a duty to disclose; (2) the defendant knew or believed that the

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

representation was false or made the representation with a reckless indifference to the truth; (3) the defendant intended to induce the plaintiff to act or refrain from acting; (4) the plaintiff acted in justifiable reliance on the representation; and (5) the plaintiff was injured by its reliance.²³

A survey of Delaware cases shows that in many cases in which the plaintiff's claim was dismissed, the plaintiff had failed to establish that they had, in fact, relied on the defendant's fraudulent misrepresentations. When the court actually barred an extra-contractual fraud claim, it acted as a factfinder to reach a determination that the party did not actually rely on the misrepresentation in light of the circumstances.²⁴ Courts assessed the facts and determined that the plaintiff did not actually fall for the lies based on a finding of fact that either (i) sophistication and experience prevented them from relying on the lies,²⁵ (ii) the ambiguity of the alleged oral promise could not have induced reliance,²⁶ (iii) the alleged misrepresentation was deemed too important to be left out of the written contract had it indeed been relied on,²⁷ or (iv) the opinion and prediction of the past results were not certain enough to form future promises.²⁸

It has mattered that the party raising a claim of fraud was sophisticated, that the contract was fully negotiated, and that it contained an unambiguous disclaimer and integration clause. It has mattered, though, because these circumstances helped to convince the courts that the party claiming fraud did not in fact rely on a misrepresentation or that his reliance was not reasonable. In other words, the courts were convinced that either there was no lie or the lie was not relied on by the sophis-

23. *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1050 (Del. Ch. 2006).

24. *See, e.g., Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35 (Del. Ch. 2015); *Black Horse Capital, LP v. Xstelos Holdings, Inc.*, No. 8642-VCP, 2014 WL 5025926 (Del. Ch. Sep. 30, 2014); *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129 (Del. Ch. 2003); *Progressive Int'l Corp. v. E.I. Du Pont de Nemours & Co.*, No. C.A. 19209, 2002 WL 1558382 (Del. Ch. Jul. 9, 2002); *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544 (Del. Ch. 2001).

25. *Great Lakes*, 788 A.2d at 555.

26. *Black Horse Capital*, 2014 WL 5025926, at *22.

27. *H-M Wexford*, 832 A.2d at 142.

28. *Great Lakes*, 788 A.2d at 554.

licated party. If, among sophisticated parties, an unambiguous disclaimer and integration clause was sufficient to bar a claim of fraud, whether fraud actually occurred would not matter. Neither would it matter whether there was reasonable reliance on the part of the victim. Yet, if the language of the integration clause itself is not a boilerplate and expressly disclaimed reliance on extra-contractual representations between sophisticated parties, the courts will find that the party must have not relied on the representation.²⁹

Conversely, courts have allowed claims for fraud by finding that the language of a disclaimer was insufficient. The courts do not have a clear rule about what kind of disclaimer would be sufficient to bar such a claim. The case law is so contradictory that the courts have been able to support just about any outcome by changing the standard for what constitutes an unambiguous disclaimer clause. They have done so by changing the standard for what constitutes clear anti-reliance language for purposes of overcoming a disclaimer which would seem to be unambiguous. In the earlier cases that dealt with contracting around fraud, the mere presence of a disclaimer in an agreement was said to be enough. Then, courts decided that boilerplate clauses do not bar fraud claims. In the 2006 case *ABRY*, the leading case on the effectiveness of such disclaimers, then-Vice Chancellor Strine stressed the importance of including a completely unambiguous disclaimer.³⁰ As required by the *ABRY* court, such a disclaimer must contain language that the party has contractually promised not to rely upon statements outside of the contract's four corners when entering into the contract.³¹ After *ABRY*, in *TrueBlue, Inc. v. Leeds Equity Partners IV, LP*³² and *Black Horse Captial, LP v.*

29. *E.g.*, *Monsanto Co. v. E.I. Dupont de Nemours & Co.*, No. 4:09CV00686 ERW, 2010 WL 3039210. *Cf. In re Medical Wind Down Holdings III, Inc.*, 332 B.R. 98 (2005) (finding that the integration clause in parties' agreement did not bar fraud in the inducement and negligent misrepresentation claims); *Kronenberg v. Katz*, 872 A.2d 568, 592–94 (Del. Ch. 2004) (permitting extra-contractual fraud claims when the integration clause was boilerplate).

30. *See generally* *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006).

31. *Id.* at 1057.

32. *TrueBlue, Inc. v. Leeds Equity Partners IV, LP*, No. CVN14C12112WCCCCLD, 2015 WL 5968726, at *8–9 (Del. Super. Ct. Sept. 25, 2015).

Xstelos Holdings, Inc.,³³ courts came to different conclusions about whether the reliance was disclaimed, although the language of the disclaimer clauses was virtually the same. One found justifiable reliance; the other did not, by taking into account other facts. In one of the two most recent cases, *Prairie Capital III, L.P. v. Double E Holding Corp.*, the court determined that there are no magic words or formula needed to effectively disclaim reliance.³⁴ The court then again came up with a new rule in *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*, that the language must affirmatively state what the parties are relying on in entering the contract and that they are not relying on any representations made outside the contract.³⁵

B. *The Misunderstood Delaware Case Law*

1. *The Pre-ABRY Case Law*

Traditionally, as held in *Norton v. Poplos*,³⁶ Delaware law prohibited the use of disclaimers to bar fraud claims. The rationale was to prevent sophisticated parties from exploiting unsophisticated parties through the use of boilerplate disclaimers that would bar fraud claims.³⁷ The court ruled that such boilerplate disclaimers did not bar fraud claims even when the representations were extra-contractual.³⁸

a. *Great Lakes Chem. Corp. v. Pharmacia Corp.*³⁹

The paradigm shifted in 2001, when the court barred claims of fraud for extra-contractual representations in *Great Lakes Chem. Corp. v. Pharmacia Corp.* The court held that the buyer's claim for fraud was barred by disclaimers in the agreement for the purchase of a business where the contract was entered into by sophisticated parties after extensive due diligence and negotiations.⁴⁰ The court argued that because the

33. *Black Horse Capital, LP v. Xstelos Holdings, Inc.*, No. 8642-VCP, 2014 WL 5025926, at *24 (Del. Ch. Sep. 30, 2014).

34. *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35, 50–51 (Del. Ch. 2015).

35. *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*, 131 A.3d 842, 860 (Del. Ch. 2016).

36. *Norton v. Poplos*, 443 A.2d 1, 6–7 (Del. 1982).

37. *Id.*

38. *Id.*

39. *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544 (2001).

40. *Id.* at 555.

parties were sophisticated, they did not require the same level of protection as that given to unsophisticated parties as in *Norton*:

[T]wo highly sophisticated parties, assisted by industry consultants and experienced legal counsel, entered into carefully negotiated disclaimer language after months of extensive due diligence. The parties explicitly allocated their risks and obligations in the Purchase Agreement. In these quite different circumstances, a party to such a contract who later claims fraud is not in the same position—and does not have the same need for protection—as unsophisticated parties who enter into residential real estate contracts having boilerplate disclaimers that were not negotiated.⁴¹

Nevertheless, a careful reading of the case tells a different story. The integration clause did not bar the fraud claim; rather, the lack of actionable fraud did.

The dispute centered around the sale of NSC, a business unit of Pharmacia. Great Lakes accused Pharmacia of misrepresentation and omission of material information, which resulted in the buyer overpaying for the business by 50 million dollars.⁴² It was alleged that Pharmacia intentionally hid the real reasons for the drop in NSC's sales, came up with future projections they knew to be too high, and assured the buyer that sales would later increase.⁴³ Great Lakes later discovered the true reason for the drop in NSC's sales:

[D]uring the negotiations, significant changes had occurred that affected NSC's business. Those changes resulted from price-cutting in the aspartame market, the failure of many smaller aspartame manufacturers, and the entry of new sellers of L-Phe into the pharmaceutical market. Those developments increased the number of NSC's competitors and affected NSC's customer base—changes that turned out to be permanent. Price competition in the aspartame market also reduced the price of L-Phe in the pharmaceutical market, which in turn drove

41. *Id.*

42. *Id.* at 551.

43. *Id.* at 547.

smaller producers of aspartame, (including NSC's sole sweetener customer, Enzymologa), out of the artificial sweetener market altogether.⁴⁴

The several disclaimers stated that (i) the seller did not assure the realization of the estimates, predictions, or forecasts, nor warrant the completeness and accuracy of the information provided, and that (ii) the buyer was taking full responsibility for making its own evaluation.⁴⁵ The disclaimers neither disclaimed responsibility for extra-contractual representations nor contained language in which the buyer promised not to rely on statements outside the contracts. Such language was later required by the *ABRY*, *Prairie*, and *FdG* courts.

Nonetheless, even if Pharmacia did in fact lie to induce Great Lakes to contract, the court did not think it mattered because it believed that reliance was not justified. Great Lakes had the resources available to ascertain the facts themselves without relying on the misrepresentation. Great Lakes retained industrial experts and top flight legal advisors who were capable of understanding and communicating to them how price-cutting in the aspartame market might be significant for NSC's future sale prospects.⁴⁶ The court further concluded that the representations were predictions and expressions of opinions about the future that did not give rise to actionable fraud.⁴⁷

44. *Id.* at 546.

45. *Id.* at 552–53. The several disclaimers at issue in the case stated as follows:

The Buyer acknowledges that there are uncertainties inherent in attempting to make such estimates, projections and other forecasts and plans, that the Buyer is familiar with such uncertainties, that the Buyer is taking full responsibility for making its own evaluation of the adequacy and accuracy of all estimates, projections and other forecasts Buyer has received no representation or warranty from either Seller with respect to such estimates, projections and other forecasts and plans [N]one of [the sellers] make any express or implied representation or warranty as to the accuracy or completeness of the information contained herein or made available in connection with any further investigation of the Company [A]ll projections of financial or operating results are based on estimates made by NSC and there can be no assurance that such results will be realize.

46. *Id.* at 554–55.

47. *Id.* at 554.

If the court's conclusion was that there was no valid claim for fraud because of the absence of justifiable reliance, the fraud claim would have been dismissed even without a disclaimer and integration clause.

b. *Progressive Int'l Corp. v. E.I. Du Pont de Nemours & Co.*⁴⁸

The position taken by the court in *Great Lakes* was reinforced in 2002 by then-Vice Chancellor Strine in *Progressive*. There, the contract in dispute was a license agreement that transferred the exclusive right to use Du Pont's Silver Stone kitchenware brand to Progressive. The fraud claim was based on Du Pont's alleged misrepresentation of the value, commercial viability, and profit margin of its Silver Stone brand, as well as its misrepresentation about its commitment to expand the brand. Progressive argued that they entered into the contract based on Du Pont's representations and promises. It turned out that Progressive overestimated the value of the brand and underestimated its production cost.⁴⁹ Moreover, Du Pont adopted a different marketing strategy and expanded the Teflon brand rather than Silver Stone.⁵⁰ The license agreement contained neither the representations nor the commitment, but did contain an integration clause.⁵¹ The integration clause was deemed sufficient to bar the claim for fraud.

Nevertheless, the language of the integration clause was not explicit enough to have met the standard later set by

48. No. C.A. 19209, 2002 WL 1558382 (Del. Ch. Jul. 9, 2002).

49. *Id.* at *6.

50. *Id.*

51. *Id.* The integration clause said:

Integration. This LICENSE and any attached schedules and exhibits, constitutes the entire agreement between the Parties pertaining to the subject matter contained herein and supercedes all prior and contemporaneous agreements, representations, and understandings of the Parties. Each of the Parties acknowledges that no other party, nor any agent or attorney of any other party, has made any promise, representation, or warranty whatsoever, express or implied, and not contained herein, concerning the subject matter hereof to induce the Party to execute or authorize the execution of this LICENSE, and acknowledges that the Party has not executed or authorized the execution of this instrument in reliance upon any such promise, representation, or warranty not contained herein

Strine in *ABRY*.⁵² It merely stated that the written contract and ancillary documents constituted the entire agreement, and that the parties had not made promises, representations, or warranties outside the written contract.⁵³ When the very same language was used in the integration clauses in *TrueBlue*⁵⁴ and *Anvil Holding Corp. v. Iron Acquisition Co.*,⁵⁵ however, the courts held them insufficient to constitute an explicit anti-reliance provision,⁵⁶ as they were merely stating that the parties were “not making any other express or implied representation or warranty”⁵⁷ Such a provision was said to lack “the specific anti-reliance language required as evidence that the parties intended for the clause to bar fraud claims.”⁵⁸ In contrast, in

52. Strine required integration clauses to contain “language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract’s four corners in deciding to sign the contract.” *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1059 (Del. Ch. 2006).

53. *Id.*

54. The provision states:

The Purchaser acknowledges that neither the Company, nor any of its Subsidiaries nor any seller nor any other Person . . . makes, or has made, any representation or warranty with respect to . . . information or documents made available to the Purchaser or its counsel, accountants or advisors with respect to the Company, its Subsidiaries or any of their respective businesses, assets, liabilities or operations The Purchaser acknowledges and agrees that the representations and warranties set forth in this Agreement (as qualified by the Schedules) supersede, replace and nullify in every respect the data set forth in any other document, material or statement, whether written or oral, made available to the Purchaser.

TrueBlue, Inc. v. Leeds Equity Partners IV, LP, C.A. No. N14C-12-112 WCC CCLD, 2015 WL 5968726, at *8 (Del. Super. Ct. Sept. 25, 2015).

55. C.A. Nos. 7975-VCP, N12C-11-053-DFP [CCLD], 2013 WL 2249655 (Del. Ch. May 17, 2013). The language of the contract in *Anvil* stated “neither the Company nor any Seller ‘makes any other express or implied representation or warranty with respect to the Company . . . or any Seller or the transactions contemplated by this Agreement’” and “[t]his Agreement . . . constitutes the entire Agreement among the Parties (and the Sellers’ Representatives) with respect to the subject matter of this Agreement and supersede[s] all other prior agreements and understandings, both written and oral, between the Parties with respect to the subject matter of this Agreement.” *Id.*, at *8-9.

56. *TrueBlue*, 2015 WL 5968726, at *9.

57. *Anvil*, 2013 WL 2249655, at *8.

58. *TEK Stainless Piping Products, Inc. v. Smith*, 2013 WL 5755468, at *4 (Del. Super. Ct. Oct. 14, 2013).

Progressive, the court concluded that the integration clause barred the fraud claim, and that sophisticated parties are bound by the unambiguous language of the contracts they sign.⁵⁹

Nevertheless, the court granted the motion to dismiss because it determined that any reliance would be unreasonable. The court repeatedly emphasized that *Progressive* had been in the industry since 1973 and had dealt with DuPont before.⁶⁰ Thus, it had sufficient experience to make an independent judgment on the commercial appeal of the brand and its profitability regardless of what DuPont represented to them.⁶¹ In addition, if they had relied on the representations to contract, such representations should have been scheduled as conditions and warranties in the contract.⁶²

Therefore, the court was convinced that *Progressive* had not been defrauded. The fraud claim was treated as an attempt to shirk a bargain that seemed bad in hindsight. Yet the court presented its decision to dismiss the claim of fraud as resting on the *disclaimer*, reasoning that:

[In] the unambiguous integration clause . . . *Progressive* explicitly disclaimed any reliance on representations that are not memorialized within the four corners of the Agreement The License Agreement was not a contract of adhesion *Progressive* had the freedom to walk away and not deal with DuPont, or to bargain for better terms, including the elimination of the integration clause [Therefore,] *Progressive* contractually agreed that it was not entering the License Agreement on the basis of extra-contractual representations by DuPont[]. . . . To enable *Progressive* to proceed with its rescission claims would allow *Progressive* to escape the plain language of the commercial contract it voluntarily chose to sign, and to renege on a contract promise it made to DuPont.⁶³

59. *Progressive Int'l Corp. v. E.I. Du Pont de Nemours & Co.*, 2002 WL 1558382, at *1 (Del. Ch. Jul. 9, 2002).

60. *Id.* at *2.

61. *Id.* at *8.

62. *Id.* at *9.

63. *Id.* at *1.

Progressive argued that for the disclaimer to be binding, it should have included a list of every representation and issue that the parties were not relying upon as a basis for contracting with each other.⁶⁴ Otherwise, Progressive could not know what representation or subjects it was not relying upon in executing the Agreement.⁶⁵ The court did not think that it would be commercially viable to require the listing of all material issues that are not the part of the foundation of their relationship.⁶⁶ But whatever the contract should or should not have listed ultimately would not have mattered. Progressive could not prove that it had been defrauded.

c. *H-M Wexford LLC v. Encorp, Inc.*⁶⁷

The pattern continued in *H-M Wexford* where the plaintiff, Wexford, accused the defendant, Encorp, of fraud related to a misleading unaudited financial statement made in a private-placement memorandum that was not integrated in a stock-purchase agreement.⁶⁸ The court granted the motion to dismiss the fraud claim based on the extra-contractual representation due to the anti-reliance language in the integration clause.⁶⁹ The court agreed with the defendant that the Purchase Agreement's integration clause had the effect of "exclud[ing] from the Purchase Agreement any representation or warranty not expressly set forth or referred to therein. The [private-placement memorandum] is not expressly referred to anywhere in the Purchase Agreement."⁷⁰

64. *Id.* at *10.

65. *Id.*

66. *Id.*

67. 832 A.2d 129 (Del. Ch. 2003).

68. *Id.* at 146.

69. *Id.* at 141. The integration clause reads:

This Agreement, including documents, Schedules, instruments and agreements referred to herein, and the agreements and documents executed contemporaneously herewith embody the entire agreement and understanding of the parties hereto in respect to the subject matter hereof. There are no restrictions, promises, representations, warranties, covenants, or undertakings, other than those expressly set forth or referred to herein or therein. This Agreement supersedes all prior agreements and understandings between the parties with respect to such subject matter.

70. *Id.*

Once again, this language would not have been deemed to contain the explicit anti-reliance language required in later cases.⁷¹ The Fraud claim would have been allowed by courts in *Blackhorse*, *FdG*, and *Trueblue*. Again, this case shows that the surrounding facts matter in deciding whether a fraud claim will be dismissed.

If the court had been convinced that an integration clause alone, if unambiguous, will bar a fraud claim despite the presence of fraud, it could have stopped there. Instead, the court went on to show that there was no justifiable reliance on the financial statements. The court reasoned that the purchase agreement warranted the accuracy of the audited financial statement until September 2000. Had the parties intended to warrant the accuracy of the unaudited statements until November 2000, they could easily have done so.⁷² Moreover, even though Wexford alleged that Encorp attempted to falsify the financial statement in the fourth quarter of 2000, the court concluded that Wexford should not have trusted the statement. The statement was merely a projection. Wexford was “an ‘accredited investor’ as defined by federal securities regulation. As such, it is presumed to have understood the ramifications of the integration clause in the purchase agreement and the disclaimer clause in the PPM.”⁷³ The court’s logic was apparently that even if Encorp lied, Wexford did not justifiably rely on that lie. “[I]f Wexford wanted to be able to rely upon the PPM or particular facts represented therein, it had an obligation to negotiate to have those matters included within the scope of the integration clause of the contract.”⁷⁴ The court therefore concluded that there was no justifiable reliance on Wexford’s part.⁷⁵ Justifiable reliance, however, is an essential element of a common law claim of fraud.⁷⁶ Again, we see the irony: since a claim of fraud was not established, the anti-reliance language in the integration clause should not have mattered.

71. *Id.* at 141.

72. *Id.* at 142.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

2. *ABRY Partners V, L.P. v. F&W Acquisition LLC*⁷⁷

As noted earlier, in this landmark case, then-Vice Chancellor Strine upheld a claim for fraud based on misrepresentations contained in a contract. He said that a “fraudulent inducement claim” could not be made for extra-contractual misrepresentations when the contract contained an effective disclaimer. He framed a rule as to what constitutes an effective disclaimer: there must be “language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract’s four corners in deciding to sign the contract.”⁷⁸ The effect of the decision, according to Haas, is that “while a party can totally immunize itself for intentional misrepresentations made outside of a contract, a party cannot limit its liability for intentional misrepresentations found within the contract itself.”⁷⁹

Nevertheless, none of Strine’s pronouncements on the effect of fraud in extra-contractual communications had anything to do with the case he was deciding. As he noted himself, the buyer did not base its claims for fraud on extra-contractual communications. “[T]he Buyer has premised its rescission claim solely on the falsity of representations and warranties contained within the Stock Purchase Agreement itself.”⁸⁰

The buyer, ABRY Partners, had contracted to buy the stock of a company, F&W Publications, from the seller, Providence Equity Partners. The buyer alleged that with the knowledge and connivance of Dominguez, a principal of the seller, F&W had misrepresented its condition in its financial statements. The financial statements were referenced by the Purchase Agreement. Another alleged misrepresentation concerned VISTA, which was F&W’s book ordering system. The buyer alleged that F&W represented that VISTA was “fully functioning and processing orders.”⁸¹ However, in fact, it was not functioning appropriately and orders had not been shipped for weeks, which had caused the loss of several key

77. 891 A.2d 1032 (Del. Ch. 2006).

78. *Id.* at 1059 (quoting *Kronenberg v. Katz*, 872 A.2d 568, 593 (2004)).

79. Haas, *supra* note 6, at 72.

80. *ABRY Partners V*, 891 A.2d at 1035.

81. *Id.* at 1039.

customers including Amazon.⁸² These facts were not disclosed.⁸³ This misrepresentation was made by F&W, and the buyer did not allege that it was made with the seller's knowledge and connivance. Yet, the buyer claimed that the change constituted a material adverse effect under the stock purchase agreement. The seller had certified in the purchase agreement that no material adverse effect had occurred since closing.

As Strine noted, the buyer was not making a claim for fraud arising from extra-contractual misrepresentations:

The present case is starker than the typical case. That reality is best illustrated by understanding the burden that the Buyer has voluntarily taken on, without raising a legal peep. The burden is that of demonstrating that its rescission claim is based on false representations of fact embodied within the four corners of the Stock Purchase Agreement itself.⁸⁴

Strine's conjecture was that the buyer did not do so because it "[r]ecogniz[ed] that the case law of this court gives effect to non-reliance provisions that disclaim reliance on extra-contractual representations."⁸⁵ That is conjecture. The reason the buyer did not claim that it had relied on fraudulent extra-contractual representations might be that it could not establish that such representations were made, or, if so, whether it had relied on them. The financial statements were not extra-contractual. They were referenced in the contract. The extra-contractual misstatements about the condition of VISTA were not made by the seller. The buyer did not allege, and may not have been able to prove, that they were made with the seller's knowledge or approval. One could not assume, as the court noted, that the seller would know what F&W knew:

The Seller did not manage the Company being sold directly. Most of the key representations of fact were made by the Company to the Buyer in the first instance, primarily through managers working directly for the Company who were not otherwise affiliated with the Seller. The Seller did not necessarily possess

82. *Id.*

83. *Id.* at 1040.

84. *Id.* at 1055–56.

85. *Id.* at 1035.

the same information as the managers of the Company.⁸⁶

Thus, Strine decided what the effect of extra-contractual fraud should be in a case in which extra-contractual fraud was not even alleged. Moreover, it is hard to see how he could reconcile what he said about such a case (which was not before him) with what he said in the case that was. Departing from his view about other cases, in this case he held that the integration and disclaimer clause would not protect the seller from a claim that, by including false information in the contract, the seller defrauded the buyer intentionally. As we have seen, his rationale for excluding a claim of extra-contractual fraud was that the victim himself lied by signing a contract with the disclaimer.⁸⁷

To fail to enforce non-reliance clauses is not to promote a public policy against lying. Rather, it is to excuse a lie made by one contracting party in writing—the lie that it was relying only on contractual representations and that no other representations had been made—to enable it to prove that another party lied orally or in a writing outside the contract's four corners. For the plaintiff in such a situation to prove its fraudulent inducement claim, it proves itself not only a liar, but a liar in the most inexcusable of commercial circumstances: in a freely negotiated written contract. Put colloquially, this is necessarily a 'Double Liar' scenario. To allow the buyer to prevail on its claim is to sanction its own fraudulent conduct.

Nevertheless, Strine held in the case before him:

[W]hen a seller intentionally misrepresents a fact embodied in a contract—that is, when a seller lies—public policy will not permit a contractual provision to limit the remedy of the buyer to a capped damage claim. Rather, the buyer is free to press a claim for rescission or for full compensatory damages . . . I dismiss the Buyer's claims except insofar as it can prove that the Seller intentionally misrepresented a fact within the Stock Purchase Agreement or knew that

86. *Id.* at 1062–63.

87. *Id.* at 1058.

the Company had misrepresented such a fact. In either situation, the Seller would have been responsible for the injury suffered by the Buyer in reliance upon a lie.⁸⁸

He gave two reasons why the disclaimer should not immunize the seller from an intentionally false misrepresentation. One is moral: “[T]here is a moral difference between a lie and an unintentional misrepresentation of fact [T]hus it is understandable that courts would find it distasteful to enforce contracts excusing liars for responsibility for the harm their lies caused.”⁸⁹ The other is practical:

There is also a practical difference between lies and unintentional misrepresentations. A seller can make a misrepresentation of fact because it was misinformed by someone else, was negligent, or even was reckless. All of those possibilities can be enhanced if the seller does little to investigate its own representations and compounded if the buyer does little independent due diligence of its own. The level of self-investigation expected from a seller, to me, seems to be a more legitimate subject for bargaining than whether the seller can insulate itself from liability for lies.⁹⁰

Why, then, should a party be able to immunize itself against a claim of an intentionally false extra-contractual communication? It would seem that the only relevant difference between the two is that when a representation is contained in the contract, it is *certain* a party made the representation and thus more likely that his victim relied upon it. And so we come back to this Article’s thesis: what should matter is whether one party lied and the other relied upon that lie to his detriment, which is a question of *fact*.

88. *Id.* at 1036.

89. *Id.* at 1062.

90. *Id.*

3. *The Post-ABRY Era*

a. *RAA Mgmt. v. Savage Sports Holdings, Inc.*⁹¹

In 2012, the Delaware Supreme Court barred a claim for fraud arising out of inaccurate and incomplete extra-contractual representations made during the due diligence process.⁹² After the negotiations broke down, RAA sued to recover the cost incurred during the due diligence process and the negotiations.⁹³ RAA argued that it would not have considered purchasing the company had it known about three facts that Savage misrepresented, but which were disclosed in due diligence.⁹⁴ The court dismissed the claim because the nondisclosure agreement expressly disclaimed the accuracy or completeness of evaluation material or of any other information provided.⁹⁵

This might be the only case so far where the court actually followed the rule it had laid out for itself since *Great Lakes*,⁹⁶ that an extra-contractual fraud claim is barred when the disclaimer is clear enough regardless of whether reliance could be found by looking at the facts. Nevertheless, the case can be explained under a different rationale.

RAA was not a case in which a disclaimer clause in a contract barred a claim for fraud. There *was* a disclaimer, but it was not contained in a contract. The liability here is not a contractual liability but a *pre*-contractual one. The alleged misrepresentations were made to induce the final sales agreement, not the nondisclosure agreement.

RAA, which had been interested in buying Savage Sports, sued for 1.2 million dollars that it had allegedly spent in due-diligence investigation and preliminary negotiations. It would never have incurred these costs, it claimed, except for three fraudulent misrepresentations made by Savage. The disclaimer said that “Savage was making no representations or warranties as to the accuracy or completeness of any information . . . be-

91. 45 A.3d 107 (Del. 2012).

92. *Id.* at 117.

93. *Id.* at 109.

94. *Id.* at 111.

95. *Id.* at 119.

96. *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544 (Del. Ch. 2001).

ing provided to RAA, and . . . Savage would have no liability to RAA resulting from RAA's reliance on such information."⁹⁷

RAA sued for fraud. The court dismissed its claim, invoking the rule of *ABRY* that the claim was barred by a disclaimer it had signed before incurring these costs. Nevertheless, this was not a case in which the buyer entered into a contract to purchase assets from a seller who had defrauded him. The parties never ended up contracting for the sale of Savage. It was not a case in which the parties entered into a preliminary agreement to bargain in good faith or reallocate the costs of investigation and negotiation. Along with the disclaimer, RAA had signed an acknowledgement that the parties had no contract: "You [RAA] understand and agree that no contract or agreement providing for a transaction between you and the Company [Savage] shall be deemed to exist between you and the Company unless and until a definitive Sale Agreement has been executed and delivered."⁹⁸

It was a case, then, in which one party who had spent money investigating and negotiating a deal—costs parties would normally bear themselves—wished to transfer these costs—which it would normally bear itself—to the other party, by raising a claim of fraud.

American courts traditionally recognize the freedom of negotiation but not *culpa in contrahendo*, the duty to negotiate in good faith under German law. As a result, it has been said that parties are relieved from any liability in the pre-contractual period.⁹⁹ If the court was of the same opinion, they could have dismissed the claim based on this reason alone regardless of the integration clause.

As E. Allen Farnsworth noted in his classic study, "courts have rarely applied the law of misrepresentation to failed negotiations."¹⁰⁰ These failed negotiations are different from a case in which a party was fraudulently induced to enter into a contract. One who has sold an asset through fraud has profited at the buyer's expense. One who has induced the other party to enter into negotiations that ultimately failed, normally

97. *RAA v. Savage*, 45 A.3d at 110.

98. *Id.* at 110–11.

99. E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreement: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 221 (1987).

100. *Id.* at 235.

has not. Farnsworth mentioned only two situations in which a claim of fraud has succeeded in failed negotiations: (i) when a party conceals the fact that he never intended to contract,¹⁰¹ or (ii) was secretly negotiating with someone else.¹⁰² In such cases, one party was trying to obtain some advantage at the expense of the other. Moreover, it would be dangerous to allow a party to shift the costs he incurred to the other party after negotiations have broken down by alleging that one or more of the many statements made to him was a misrepresentation on which he relied to start the negotiation.

The allegations of fraud in *RAA* illustrate just how dangerous it would be. Indeed, the allegations make it doubtful that *RAA* could have established the requisite elements of a fraud claim: intentional misrepresentation and justifiable reliance. The alleged misrepresentations concerned not existing problems, but events that might lead to problems in the future: an “ongoing investigation by the New York State Department of Environmental Conservation” into a site owned by a predecessor which, depending on the result, could lead to Superfund liability;¹⁰³ efforts by employees at the BowTech plant of a Savage subsidiary which, depending on the result, could lead to unionization;¹⁰⁴ and; a claim against BowTech that could lead to a lawsuit.¹⁰⁵ The misrepresentations *RAA* alleged were a denial that there was potential Superfund liability, a denial that there was a unionization effort at the BowTech plant, and nondisclosure of the possibility of litigation.¹⁰⁶ *RAA* would have needed to establish that these two denials amounted to fraudulent misrepresentations, rather than opinions as to whether there was a significant possibility of Superfund liability or unionization. Put simply, it would have needed to establish that the nondisclosure amounted to fraud. Moreover, it would have had to establish that it relied on these misrepresentations before due diligence even began, meaning it would have had to establish that the negotiation and due

101. *Id.* at 233–34 n.54 (citing RESTATEMENT (SECOND) OF TORTS §§ 525, 530 (AM. LAW INST. 1977)).

102. *Id.* at 234 n.55 (citing the “rare case” of *Markov v. ABC Transfer & Storage Co.*, 6 Wash. 2d 388, 457 P.2d 535 (1969)).

103. *RAA v. Savage*, 45 A.3d at 111.

104. *Id.*

105. *Id.*

106. *Id.*

diligence would not have taken place without such reliance and that the reliance was justifiable. It would be especially difficult to establish the case because: (i) Savage did not have the duty to disclose all pertinent information before a nondisclosure agreement was signed and the due diligence began, and (ii) the later-discovered events worthy of concern are the typical issues parties only find out through due diligence.

The court should have taken the opportunity to decide when, if ever, a party should be able to claim fraud in preliminary negotiations that never resulted in a contract. It could then, if necessary, have discussed the effect of a disclaimer in such a case, which may well be different from a case in which a contract had actually been made. Instead, the court took the easy way out and cited the rule in *ABRY*.¹⁰⁷

b. *TransDigm, Inc. v. Alcoa Global Fasteners, Inc.*¹⁰⁸

If Delaware law does allow a party to contract around fraud, the claim for fraudulent active concealment should have been dismissed in *TransDigm*. Instead, having determined that fraud was committed, the court allowed the fraud claim to proceed despite a clear disclaimer.¹⁰⁹ Alcoa claimed that TransDigm actively concealed material information that one key customer had expressed the intent to buy fifty percent less from TransDigm going forward and that the key customer was offered a five percent discount.¹¹⁰

The disclaimer clearly covered reliance on extra-contractual representations:

Buyer has undertaken such investigation and has been provided with and has evaluated such documents and information as it has deemed necessary to enable it to make an informed decision with respect to the execution, delivery and performance of this [a]greement and the transactions contemplated hereby. Buyer agrees to accept the [s]hares *without reliance upon any express or implied representations or warranties of any nature, whether in writing, orally or otherwise, made by or on behalf of or imputed to Trans-*

107. *Id.* at 117.

108. 2013 WL 2326881 (Del. Ch. May 29, 2013).

109. *Id.* at *7.

110. *Id.* at *6.

Digm or any of its [a]ffiliates, except as expressly set forth in this [a]greement.¹¹¹

TransDigm based its defense on *RAA*, where the court allowed the defendant to disclaim reliance on the completeness and accuracy of the information.¹¹² Here, the court distinguished the case from *RAA* on the grounds that (i) the disclaimer did not cover omissions, and (ii) there was reasonable reliance on the assumption that TransDigm did not actively conceal information.¹¹³

Such reasoning is hardly convincing. Under the law of fraud, the omissions due to “active concealment” are actionable because active concealment counts as a lie, just as an affirmative misrepresentation would. Moreover, it would be bizarre if one who tells an outright lie were better protected against a fraud claim than one who actively conceals a material fact.

If *ABRY* and the previous cases were right that extra-contractual fraud can be excused by a clear and unambiguous disclaimer, this disclaimer should have effectively barred these extra-contractual fraud claims. Following the logic in the previous cases, had Alcoa truly wanted to rely on the assumption that no material facts had been omitted, they could have written the assumption into the contract. Otherwise, any representations or warranties were disclaimed effectively.¹¹⁴

c. *Black Horse Capital, LP v. Xstelos Holdings, Inc.*¹¹⁵

In this 2014 case, it was alleged that the plaintiffs had agreed to make a ten-million-dollar bridge loan in exchange for the defendant’s transfer of a 60.5% interest in an asset referred to as “Serenity.”¹¹⁶ The Serenity agreement was an oral agreement not included in the written agreements. The integration clauses alone should have been sufficient to dismiss the fraud claim if a party was really allowed to contract around fraud.¹¹⁷ According to the court, they were. The court said,

111. *Id.* at *7.

112. *RAA v. Savage*, 45 A.3d, at 110.

113. *TransDigm Inc.*, 2013 WL 2326881, at *9.

114. *Id.* at *7.

115. 2014 WL 5025926 (Del. Ch. Sept. 30, 2014).

116. *Id.* at *5.

117. *Id.* at *24.

following *ABRY*, “a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a ‘but we did rely on those other representations’ fraudulent inducement claim.”¹¹⁸

In *Black Horse*, however, the plaintiff was suing for a breach of contract supposedly committed by the defendants when it refused to transfer Serenity. It argued that even if this claim failed because the contract was found to be unenforceable, it could recover for fraud because the defendants misrepresented their “state of mind” as to entering into the contract.¹¹⁹

The court held that “it is not reasonably conceivable that the Serenity Agreement is an enforceable contract between the parties.”¹²⁰ To do so, the defendants must have intended for the agreement to be binding. The court concluded, “it is not reasonably conceivable that plaintiffs could prove that the parties shared an intent to be bound by the Serenity Agreement.”¹²¹

One reason was that its terms were so indefinite that the alleged agreement would be unenforceable for that reason alone. The term “Serenity” was not defined and the assets to be transferred under the Serenity Agreement were not identified.¹²² Moreover, there was obvious ambiguity regarding what the alleged Serenity interest embodied.¹²³ It could have meant mere royalty rights or the additional residual proprietary interest, but no definitive answer was ascertainable.¹²⁴ The court found that “it is not reasonably conceivable that Plaintiffs could prove under Delaware law that the parties intended to be bound by the Serenity Agreement, in light of their execution only days or weeks later of these written agreements.”¹²⁵

The court then dismissed the plaintiff’s claim for fraud on the ground that “it is not reasonably conceivable that Plaintiffs

118. *Id.* (quoting *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1057 (Del. Ch. 2006)).

119. *Id.* at *24.

120. *Id.* at *11.

121. *Id.*

122. *Id.* at *18.

123. *Id.*

124. *Id.*

125. *Id.*

could prove the existence of a critical element of the applicable tests—namely, justifiable or reasonable reliance.”¹²⁶ The fraud claim was based on the defendant’s alleged “state of mind” in entering into the contract. It is hard indeed to imagine how that claim could succeed, given the court’s finding that “it is not reasonably conceivable that Plaintiffs could prove that the parties shared an intent to be bound by the Serenity Agreement.”¹²⁷ Once again, the plaintiff’s claim for fraud would have been dismissed regardless of the presence of the integration clause.

d. *TrueBlue, Inc. v. Leeds Equity Partners IV, LP*¹²⁸

This case was about a dispute regarding the parties’ claim to a six-million-dollar earn-out payment.¹²⁹ The parole evidence rule precludes introducing evidence outside the final written agreement when interpreting the contract.¹³⁰ The court therefore barred the breach of contract claim, blaming the plaintiff for its careless drafting of the contract, which did not include a provision as important as the earn-out clause.¹³¹ Therefore, the plaintiff only had the experts on whom it relied in drafting the agreement to blame.¹³² Yet, immediately after applying the technicalities of the parole evidence rule to refuse to enforce the provision, the court used another technicality in the language of integration clause to allow the fraud claim.

In accordance with *ABRY*,¹³³ the court found that the language in the integration clause (which provided that the final agreement would supersede all prior agreements and any representation or warranties outside the agreement) to be standard and “insufficient to create the kind of explicit and unam-

126. *Id.* at *21.

127. *Id.* at *12.

128. C.A. No. N14C-12-112 WCC CCLD, 2015 WL 5968726 (Del. Super. Ct. Sept. 25, 2015).

129. *Id.* at *1.

130. *Id.* at *4.

131. *Id.* at *3.

132. *Id.*

133. *Arby Partners V, L.P., v. F & W Acquisition LLC*, 891 A.2d 1032,1059 (Del. Ch. 2006) (following *Kronenberg v. Katz*, 872 A.2d 568, 593 (Del. Ch.2004), which held that “[b]ecause Delaware’s public policy is intolerant of fraud, the intent to preclude reliance on extra-contractual statements must emerge clearly and unambiguously from the contract.”).

biguous anti-reliance provisions that would preclude justifiable reliance on extra-contractual representations.”¹³⁴ Despite the court’s ruling, such language would have been sufficient to preclude the fraud claim in *Great Lakes* and *Progressive*.

In *Black Horse*, however, clear anti-reliance language was missing as well. In *Black Horse*, the court gave effect to the integration clause even though, as we have seen, the fraud claim would have been dismissed regardless. To distinguish the cases, the court in *TrueBlue* held that, even though the integration clauses were similar, the direct and complete contradiction between the Acquisition Agreement and the alleged oral agreement in *Black Horse* rendered the reliance unjustifiable.¹³⁵ In *TrueBlue*, the court found it plausible that TrueBlue would have relied on, and been induced to contract by, Leeds’ fraudulent promise to pay the earn-out despite an *entire agreement* clause.¹³⁶ Consequently, the alleged lie, according to the *TrueBlue* court, does not contradict the language of the stock purchase agreement so “directly and completely” as to justify dismissal of the fraud claim.¹³⁷

Supposedly, the court was interpreting the scope of the integration clause. Hidden behind the court’s skillful word play is the simple issue of whether one party justifiably relied on a lie told by the other. Unlike most opinions, the court in *TrueBlue* did recognize that justifiable reliance, or the reasonableness of one’s reliance on false information, is a question of fact.¹³⁸ Nevertheless, the court reframed the question as whether there are contractual provisions in which sophisticated parties disclaim reliance on extra-contractual representations.¹³⁹

The case law indicates that neither the technical rules regarding the language in the disclaimers nor the idea of freedom to contract around fraud means much to the courts. Whether extra-contractual fraud claims are allowed comes down to whether there is a justifiable reliance, and the justifi-

134. *TrueBlue, Inc. v. Leeds Equity Partners IV, LP*, C.A. No. N14C-12-112 WCC CCLD, 2015 WL 5968726, at *8 (Del. Super. Ct. Sept. 25, 2015).

135. *Id.* at *9.

136. *Id.*

137. *Id.*

138. *Id.* at *7 (quoting *Vague v. Bank One Corp.*, 2004 WL 1202043, at *1 (Del. May 20, 2004)).

139. *Id.* at *8.

ble reliance is a question of fact that has been determined by the court early on in pre-trial motions. When the courts are convinced that fraud was actually committed, they will allow the claim despite the technicalities on which they claim their decisions are based.

e. *Prairie Capital III, L.P. v. Double E Holding Corp.*¹⁴⁰

In this case, the seller of a company represented to the buyer that the company had met its sales target for March 2012.¹⁴¹ However, the sales figures had been doctored by changing the company's accounting method to include in accounts receivable the amounts due for the sale of products that were not yet shipped.¹⁴²

Applying *ABRY*, the court dismissed the buyer's claims for fraud contained in the extra-contractual representations on the grounds that the Stock Purchase Agreement contained a disclaimer and integration clause, but allowed the buyer's claims for fraudulent misrepresentations included in the agreement.¹⁴³ Again, the court's use of *ABRY* did not matter to the result. The extra-contractual misrepresentations were replicated by those in the agreement. Extra-contractually, the seller represented that it met its sales targets for March 2012, that it "recognize[d] revenues in its accounts receivable only upon the shipment of finished products, in conformance with GAAP" and that it presented financial statements "which included 'revenues' for the sale of products that were not yet sold or shipped to customers during the time-period at issue."¹⁴⁴ The representations included in the agreement were that the buyer had recognized as accounts receivable the sale of goods not yet shipped. Thereby, the buyer had "deviate[d] drastically and materially from its own ordinary course of business and internal accounting and other recordkeeping policies and procedures . . . include[d] in its accounts receivable revenues that were not collected or generated in the ordinary course of business" and had "falsif[ied] its own internal ac-

140. *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35 (Del. Ch. 2015).

141. *Id.* at 46.

142. *Id.* at 47.

143. *Id.* at 60–61, 66.

144. *Id.* at 49–50.

counting and other records to make it appear as though the Company's inclusion of false 'revenues' in its accounts receivable did not constitute a drastic alteration of the Company's internal practices and procedures."¹⁴⁵ Again, the case would have been resolved the same way even in the absence of the disclaimer and integration clause.

f. *FdG Logistics LLC v. A&R Logistics Holding, Inc.*¹⁴⁶

In this 2016 decision, the court allowed an extra-contractual fraud claim because the disclaimer language was not sufficient to disclaim reliance. The language clearly stated that the target company was not making any representations or warranties outside the written contract and there was an integration clause that excluded other understandings, representations, or agreements.¹⁴⁷ The court held, nevertheless, that the language was insufficient because it lacked any affirmative expression by the buyer "(1) of specifically what it was relying on when it decided to enter the [m]erger [a]greement or (2) that it is was not relying on any representations made outside of the [m]erger [a]greement."¹⁴⁸ The disclaimer by the seller only stated "what it was and was not representing and warranting."¹⁴⁹ Once again, a claim for fraud in extra-contractual representations prevailed despite *ABRY*. It did so although the same language would have been sufficient to disclaim reliance in pre-*ABRY* cases.

CONCLUSION

The law in Delaware is supposed to be settled. A party is entitled to lie provided he does so extra-contractually and then immunizes himself against a claim of fraud by using an integration and disclaimer clause. We have seen that, despite the language of their opinions, Delaware courts have not explicitly allowed parties to contract around extra-contractual fraud. In the cases in which the courts have supposedly done so, either the party seeking to uphold the contract did not make any

145. *Id.* at 56.

146. *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*, 131 A.3d 842 (Del. Ch. 2016).

147. *Id.* at 858.

148. *Id.* at 860.

149. *Id.*

fraudulent misrepresentations, the other party did not rely on them, or, for one reason or another, the rule that the court supposedly applied made no difference to the result.

As we have seen, that is as it should be. It is strange to think that one who signs a disclaimer clause drafted by lawyers stating that he has not heard the many statements which surely have been made to him, or did not rely on them when they were made, is held to be a liar. Further, it is strange to think that such a lie constitutes the sort of fraud that would exonerate the party who made the fraudulent misrepresentations, even if the clause led that party to believe that he could commit fraud and get away with it. Finally, it is strange to think that it is efficient for the victim to suffer from harm that the perpetrator can prevent. Fortunately, as is often said, the common law is made by what judges do and not by what they say.

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CURBING ARBITRAGE: THE CASE FOR
REAPPRAISAL OF DELAWARE'S
APPRAISAL RIGHTS

DESIREE M. BACA*

Touted as the new frontier in shareholder activism, appraisal arbitrage has increasingly found its way into corporate litigation. Arbitrageurs have created a burgeoning industry in which shareholders can profit by exercising their dissenters' rights in merger transactions. In response to the spike in appraisal activity in recent years, proposals have come before the Delaware legislature to amend its appraisal statute to curb strategic exercise of appraisal rights. While novel reforms may indeed deter arbitrage, other states have long had provisions on their books deterring this type of behavior. This Note examines how specific statutory mechanisms, most notably withdrawal rights, interest rate calculations, and after-acquired share provisions can either incentivize or deter appraisal arbitrage and how often these mechanisms are employed in jurisdictions other than Delaware. Even though Delaware is most often regarded as the "gold standard" of corporate law, these alternative jurisdictions can actually serve as a model for Delaware to improve its appraisal statute to reduce incentives for shareholders to engage in appraisal arbitrage.

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* Copyright © 2017 by Desiree M. Baca. J.D. Class of 2016, NYU School of Law; Lawrence Lederman Fellow for Law and Economics. Special thanks to Lawrence Lederman, William Allen, Emiliano Catan, Ryan Bubb, Florenzia Marotta-Wurgler, and my fellow Lederman Fellows and classmates in the NYU Law & Economics Colloquium and Corporate Litigation in the Delaware Chancery Court Seminar.

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INTRODUCTION

Corporate law grants minority shareholders particular rights.¹ One such right is the ability to dissent from certain merger transactions and to receive the judicially determined fair value of their shares in lieu of the merger consideration.² This mechanism allows majority rule to prevail in the determination of whether the merger should proceed, while simultaneously opening the door for minority rights by protecting minority shareholders from coercive transactions. It also paves the way for arbitrageurs to take advantage of those rights. From this minority right, a new style of shareholder activism has increasingly taken hold in the form of appraisal arbitrage.

Simply put, appraisal arbitrage occurs when shareholder activists and hedge funds acquire a target company's shares after a merger announcement (but before the merger is consummated) with the express intention of asserting appraisal

1. Certain transactions require approval of the majority of the minority, and minority shareholders have the right to bring derivative suits and exercise appraisal rights. See DEL. CODE ANN. tit. 8, § 262(d)(1) (2016); *In re Wheelabrator*, 663 A.2d 1194 (Del. Ch. 1995).

2. See DEL. CODE ANN. tit. 8, § 262(b)(2) (2016) (limiting appraisal rights to transactions where the consideration is anything but shares of stock in the surviving corporation, shares of stock in a third party firm, or cash for fractional shares only).

rights in order to profit.³ Originally, appraisal rights were designed to guard minority shareholders from the tyranny of the majority shareholders. Instead, professional arbitrageurs see appraisal actions as another form of investment.⁴

This creation of a new vehicle for short-term investors raises the significant question: is this activity socially beneficial or is it rent-seeking behavior with little or no economic value? It seems clear that the current Delaware appraisal mechanisms do not work especially well to curb this strategic behavior. The flexible timing in the statute, generous interest rate payouts, and a track record of rewarding higher appraisal share values all give arbitrageurs adequate incentives to profit in ways Delaware corporate law never intended. If appraisal arbitrage is not socially beneficial, the next question that arises is: how might it be contained or reduced?

Advocates of appraisal arbitrage argue that arbitrage serves a useful purpose. The ability of shareholders to engage in appraisal arbitrage may operate as an incentive for buyers to pay a fair price in mergers. This alone will not dissuade arbitrageurs from acting opportunistically, however. The high statutory interest rate on appraisal awards makes arbitrage a useful gamble even if the buyer and seller negotiate a fair price. Because courts are imperfect at determining “fair value,” arbitrageurs may take the chance that the court awards a higher value. If the court does not, then the interest rate gives some insurance against a bad result. Furthermore, risks of appraisal arbitrage may add to the transaction’s costs since the buyer does not know what it may have to pay for some part of the company’s shares. The buyer should also take the litigation costs of a potential appraisal action into account. At the margin, this appraisal tax might even decrease the number of deals that take place. Finally, when arbitrageurs get short-term gain from investing in the target company’s stock after a merger is announced, they take away from the returns of long-term investors of either the target or the acquiring company.

3. Appraisal arbitrageurs can turn a profit by strategically voting against a proposed transaction only to then litigate or settle for a premium over the deal price. See Abigail Pickering Bomba et al., *New Activist Weapon—A Look at Appraisal Arbitrage Cases*, LAW 360 (Aug. 7, 2014), <http://www.law360.com/articles/564814/new-activist-weapon-a-look-at-appraisal-arbitrage-cases>.

4. *Id.*

Thus, if one concludes that the appraisal arbitrage phenomenon is not beneficial to society or investors as a class, the question becomes: how may it be sensibly curtailed? In that inquiry it makes sense to look beyond the state of Delaware for possible ideas. Delaware is not alone in this problem. Generally, many states look to Delaware in matters of corporation law; it is seen as the gold standard.⁵ However, in the case of appraisal rights statutes, non-Delaware jurisdictions (“alternative jurisdictions”) may actually afford more protection to minority shareholders than Delaware, particularly in this relatively new age of appraisal arbitrage. By exploring how appraisal mechanisms compare across states and on which dimensions they differ, this Note contends that alternative jurisdictions can actually help Delaware improve its appraisal rights statute to deter incentives for appraisal arbitrage. Part I recounts appraisal arbitrage’s recent rise to prominence as a new frontier for shareholder activism. Part II sets out the various ways in which arbitrageurs can take advantage of appraisal rights under the traditional Delaware appraisal statute. Part III addresses whether this arbitrage is truly problematic, highlighting the tension between appraisal arbitrage being value reducing for merger transactions, while simultaneously serving as a corporate governance check to ensure the board of directors looks out for the interests of the minority shareholders. Part IV provides a comprehensive look at how specific mechanisms in alternative state regimes either incentivize or deter appraisal arbitrage. Part V highlights the implications and reforms to be implemented in Delaware.

I.

THE RISE OF APPRAISAL ARBITRAGE

Appraisal arbitrage has increasingly found its way into the minds of activists and academics alike. With the emergence of repeat players in the appraisal game and ever increasing appraisal actions (both in size and frequency) in the Delaware Chancery Court, appraisal arbitrage continues to garner acclaim in both the press and legal discourse.

5. *E.g.*, DEBORAH E. BOUCHOUX, FUNDAMENTALS OF BUSINESS ORGANIZATIONS FOR PARALEGALS 95 (3d ed. 2010) (claiming also that Delaware considers itself the “Incorporating Capital of the World”).

Repeat players, termed “bulge bracket” appraisal petitioners for their size and profitability, continue to bring appraisal cases to turn a profit. More than 80% of shareholders bringing appraisal actions have already filed previous claims, and three funds have already brought more than ten appraisal actions each.⁶ Most reputedly, Merion Capital has become one of the most active appraisal petitioners in terms of dollars at stake.⁷ As of 2013, it had raised \$1 billion for its fund to pursue appraisal claims.⁸ Some of its investments in target companies have been so large that they have triggered the SEC’s Schedule 13G requirements by crossing the 5% threshold.⁹ Merion serves as the paradigmatic hedge fund engaged in appraisal arbitrage, but others such as Verition Capital, Magnetar, and Merlin also take large dissenting positions in merger transactions, seemingly committed to appraisal as an investment strategy.¹⁰

As a result, appraisal litigation has surged in recent years. From 2004 to 2010, on average, appraisal actions occurred in nine transactions, in approximately 5% of all appraisal-eligible claims.¹¹ By 2013, the probability of an appraisal action tripled. Now, about twenty-two appraisal petitions are filed per year. Moreover, the value of these claims has increased tenfold: in 2013, the value of claims totaled \$1.5 billion.¹²

Despite the increase in appraisal activity, appraisal litigation remains focused on a small set of transactions. Out of the eighty-six transactions eligible for appraisal in 2014, petition-

6. Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1572 (2015).

7. Charles Korsmo & Minor Myers, *Reforming Modern Appraisal Litigation* 29 (Brooklyn Law Sch., Research Paper No. 431, 2016), https://www.lowenstein.com/files/upload/Appraisal%20Rights%20Litigation_.pdf.

8. Steven Davidoff Solomon, *New Form of Shareholder Activism Gains Momentum*, N.Y. TIMES, Mar. 5, 2014, at B5; see also Steven Epstein et al., *Delaware Appraisal: Practical Considerations*, BUS. LAW TODAY (Oct. 2014), http://www.americanbar.org/publications/blt/2014/10/keeping_current_epstein.html.

9. Korsmo & Myers, *supra* note 7 (stating that all Merion purchases of target stock disclosed on Form 13Gs after the announcement of the merger).

10. *Id.*

11. *Id.*

12. *Id.*

ers filed only thirteen (15.1%) in the Delaware courts.¹³ Of course there are more appraisal demands than appraisal litigation in a given year; according to some practitioners, as many as one in every four appraisal demands settles without a public filing.¹⁴ Shareholders still tend to focus on cases with abnormally low premiums where there is more reason to suspect opportunism. Insider buyouts are also twice as likely to have appraisal litigation, reflecting the increased probability that the minority shareholders may have been mistreated in the buyout.¹⁵

Media coverage has picked up on this phenomenon as well. Touted as a new form of the ever-evolving shareholder activism, appraisal arbitrage has found its way into mainstream business media.¹⁶ Famous (or perhaps infamous) shareholder activists such as Carl Icahn have publicly threatened to exercise appraisal rights, attracting the attention of news outlets such as *The New York Times*, *The Wall Street Journal*, and other publications.¹⁷ As proposals to curb this form of arbitrage continue to surface, appraisal arbitrage is likely to linger in the public's mind for some time to come.

II.

CREATING CONDITIONS FOR APPRAISAL ARBITRAGE

Appraisal arbitrage occurs for several reasons. First, the high statutory interest rate creates generous payouts that accumulate over the protracted time of appraisal litigation. Arbitrageurs also use time to their advantage because the Delaware appraisal statute allows for some flexibility as to when arbitrageurs can buy up shares, including after the merger has been announced. Under this regime, not only can shareholders continue to buy up shares in order to strategically dissent them, but the benefit of time gives the arbitrageur more information as to whether dissenting her shares will be a worthwhile investment in the first place. Lastly, the Delaware Chan-

13. *Id.* at 9.

14. *Id.*

15. *Id.*

16. See Liz Hoffman, *Wall Street Law Firms Challenge Hedge-Fund Deal Tactic*, WALL ST. J., Apr. 6, 2015; Steven Davidoff Solomon, *Delaware Courts Pause on the Deal Price Do-Over*, N.Y. TIMES, Feb. 19, 2015.

17. See, e.g., Ronald Barusch, *Dealpolitik: Is Dell Headed for Record-Breaking Delaware Appraisal Case?*, WALL ST. J., Feb. 11, 2013.

cery Court has a track record of rewarding higher appraisal share values, which may embolden shareholder activists and hedge funds to engage in this arbitrage strategy. Each of these will be discussed in turn.

A. Interest Rate

Perhaps the most obvious benefit of appraisal arbitrage is the added bonus of a high statutory interest rate. When dissenting shareholders successfully pursue appraisal litigation under Delaware law, the surviving company must pay the fair value of shares as of the effective date of the merger plus a statutory interest rate on the appraisal award. The statutory interest rate compensates the shareholders for the additional time in which they have not been employed during the course of the appraisal proceeding as the merger consideration to which they have been determined to be entitled.¹⁸ The statutory rate currently sits at the Federal Discount Rate plus 5%.¹⁹ This more than reimburses for the time value of the appraised shares alone.²⁰ Bear in mind that appraisal litigation can be protracted, with the average time to resolution in Delaware appraisal actions averaging 3.6 years, including a multi-day trial, extensive expert testimony, and post-trial briefing and arguments.²¹ Compounded quarterly, the time value of the award can generate significant revenues. In perhaps the most famous appraisal arbitrage case, *In re Appraisal of Transkaryotic Therapies, Inc.*, 11.3 million shares demanded appraisal, receiving interest of \$147.6 million, or \$13 per share in a settlement.²² In major cases such as this, the interest payout alone can be quite

18. Guarav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, 71 BUS. LAW 427 (2016).

19. DEL. CODE ANN. tit. 6, § 2301(a) (2016) (technically it is “5 percent over the Federal Reserve discount rate including any surcharge thereon or the contract rate, whichever is less.”). As the Federal Reserve recently increased interest rates, the rate on appraisal cases currently sits at 6%.

20. Hedge funds averaged about a 4.11% rate of return in 2015, much less than the Federal Discount Rate plus 5% (the Delaware statutory interest rate on appraisal actions). Julia La Roche, *Hedge Funds Are Getting Whacked Worse than at any Time Since the Financial Crisis*, BUS. INSIDER (Oct. 15, 2015), <http://www.businessinsider.com/hedge-funds-returns-in-2015-2015-10>.

21. Jetley & Ji, *supra* note 18, at 48.

22. George S. Geis, *An Appraisal Puzzle*, 105 NW. L. REV. 1635, 1639–40 (2011).

large, and generate further interest in the idea of appraisal arbitration as a viable option.

The interest rate may also overcompensate given the risk involved in appraisal actions. Studies have suggested that corporate bonds with comparable credit risk are lower than the statutory appraisal rate.²³ Higher interest rates on awards in an otherwise low-interest rate environment may only exacerbate arbitration opportunity.²⁴ The misalignment of risk and return in appraisal litigation can itself provide incentives large enough for shareholders to engage in arbitration.

This may not always be the case, however. Even if the interest rate provides more than adequate compensation for the risks involved in appraisal litigation, a broader view would show that other arbitration costs may counteract any financial benefit gained from interest payouts alone. For example, the arbitrator will incur costs of targeting a company ripe for an effective appraisal action, both in terms of research costs and costs of purchasing large blocks of shares in the target company. Beyond that, the arbitrator will face the usual costs of the litigation itself, often over the course of several years. Therefore, while the benefit of the statutory interest may not solely determine whether a shareholder decides to engage in arbitration, it may be one of several factors in combination that makes the arbitration profitable.

B. *The Ability to Delay Investment*

But if interest rates alone are not enough for a shareholder to engage in arbitration, another way arbitrators realize economic benefits is through their ability to delay investment in the target company's shares after the record date. Under the Delaware appraisal statute, shareholders may purchase shares after the announcement of the merger is made and must submit a written demand seeking appraisal before the shareholder vote is taken.²⁵

23. Jetley & Ji, *supra* note 18, at 48–50 (determining that a three-year period with credit ratings of BB or higher serve as comparison to the risk involved in appraisal actions).

24. See, e.g., Kirkland & Ellis, *Appraisal Rights – The Next Frontier in Deal Litigation?* (May 1, 2013), http://www.kirkland.com/siteFiles/Publications/MAUpdate_050113.pdf.

25. DEL. CODE ANN. tit. 8, § 262(d)(1) (2016).

Rather than acknowledge the benefit of delay, the Chancery Court has given more leeway to arbitrageurs waiting to buy up shares. For example, in the biggest appraisal action to date, *Transkaryotic*, hedge funds acquired nearly 10 million shares of the target company after the record date of the transaction.²⁶ In fact, by the end of the transaction, nearly one third of Transkaryotic's shareholders demanded appraisal rights.²⁷ Shire, the acquiring corporation, attempted to kick out some of these dissenting shares on the basis that they had been acquired too late. To qualify for appraisal, shares must not be voted in favor of the merger. But given the way shares are held today in common electronic pools, it is not possible to determine if any one share that is held in this common form (under Cede & Co.) was in fact voted for or against the merger. In *Transkaryotic*, it was held that shares could be eligible for appraisal so long as the total number of shares seeking appraisal was less than the total shares that voted against the merger or did not vote at all.²⁸ Although the hedge fund could not show that these newly acquired shares had been voted against or abstained from the merger vote,²⁹ the court held they would be entitled to appraisal.

In light of *Transkaryotic*, defense-side law firms heralded the decision as a "major new chapter in the appraisal rights remedy" and claimed that it could "potentially revolutionize the use of appraisal rights."³⁰ Academics found interesting implications as well. Some, like George Geis, have argued that the ability to acquire shares after the record date and still exercise appraisal rights has given rise to a short-term market for

26. *In re* Appraisal of Transkaryotic Therapies, Inc., C.A. No. 2776 (Del. Ch. 2008).

27. *Id.*

28. *Id.*

29. See Latham & Watkins LLP, "Empty Voting" and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds, M&A DEAL COMMENTARY (Apr. 2007), https://www.lw.com/upload/pubcontent/_pdf/pub1878_1.commentary.empty.voting.pdf. The hedge fund could not determine who voted which shares because of the phenomenon of empty voting, which gives the record shareholder the ability to hedge economic ownership while retaining voting rights. *Id.*

30. See Latham & Watkins LLP, *Appraisal Arbitrage: Will it Become a New Hedge Fund Strategy?*, M&A DEAL COMMENTARY (May 2007), <https://corpgov.law.harvard.edu/wp-content/uploads/2007/05/20070525%20Appraisal%20Arbitrage—A%20New%20Hedge%20Fund%20Strategy.pdf>.

appraisal claims.³¹ One could expect that after the record date but before the shareholder vote, target shares would trade equal to the expected value of an appraisal claim.³²

Transkaryotic also gives large shareholders the flexibility to calculate how many shares are necessary to push the deal through, while still maintaining a sizeable chunk of appraisal shares. In *Transkaryotic*, the record shareholder Cede held about 83% of *Transkaryotic*'s stock: it voted 12.9 million shares in favor of the merger, 9.9 million against, and withheld about 7 million votes.³³ Combined with minority shareholders' affirmative votes, the deal was approved by 52%, just enough for the deal to happen and allow for an appraisal action to follow.³⁴ With either plurality or majority shareholder voting, it may be relatively easy for a large shareholder to manipulate the outcome of a merger vote with an eye toward appraisal.

Subsequent case law has only reaffirmed the possibility of arbitrage. In *In re Appraisal of Ancestry.com*, Vice Chancellor Glasscock declined to adopt a proposed share-tracing requirement that would undo *Transkaryotic*.³⁵ On the same day, the Chancery Court held in *Merion Capital v. BMC Software* that nothing in the appraisal statute requires a shareholder to prove its specific shares seeking appraisal were not voted in favor of the merger,³⁶ while it remains open to the respondent company to prove that shares *were* voted in favor.³⁷ Given the way shares are held electronically today, this burden will often be untenable; acquirer companies like Shire in *Transkaryotic* will have no legal recourse against appraisal arbitrage.

The ability to purchase shares after the record date gives strategic investors better information (i.e. new information

31. Geis, *supra* note 22, at 1638.

32. Korsmo & Myers, *supra* note 6, at 1556.

33. *In re Appraisal of Transkaryotic Therapies*, C.A. No. 2776 at 1.

34. Geis, *supra* note 22, at 1636.

35. *See In re Appraisal of Ancestry.com*, Consol. C.A. No. 8173-VCG (Del. Ch. Jan. 5, 2015).

36. *See Merion Capital v. BMC Software*, C.A. No. 8900-VCG (Del. Ch. Jan. 5, 2015).

37. In *Merion* and its predecessors, the Chancery Court has left open the question of what would occur should the number of shares presented for appraisal actually outnumber the amount of dissenting shares. *See* Steven M. Hecht, *Delaware Chancery Reaffirms Appraisal Arbitrage Strategy*, APPRAISAL RTS. LITIG. BLOG (Jan. 7, 2015), <http://www.appraisalrightslitigation.com/2015/01/07/delaware-chancery-reaffirms-appraisal-arbitrage-strategy/>.

arising after the record date and closer to the day in which they must decide whether to exercise appraisal rights).³⁸ New information may be brought to light, either through investigations into the target company or through exogenous factors such as general market conditions or regulatory approvals. Even if no new developments occur during this time, investors will still have an incentive to wait to purchase shares until after the record date due to the information-rich proxy statement that will be delivered shortly thereafter. The proxy materials detail the ongoing transaction, including financial forecasts and valuations by the target's advisors.³⁹ Akin to a call option,⁴⁰ this better information can help investors more accurately determine the expected value of bringing an appraisal action.⁴¹

The "wait and see" approach also provides an opportunity for a signaling function. Because appraisal arbitrageurs are increasingly becoming repeat players specializing in this kind of scheme or investment, their reputation as bulge bracket appraisal petitioners makes the threat to go to trial more credible.⁴² If an experienced mutual fund dissents its shares, it may signal to other undecided shareholders that the deal price is undervalued, or at the very least, the expected gain from appraisal litigation is greater. It is questionable, however, how much this occurs in practice. Because arbitrageurs can wait up to sixty days after the deal closes to withdraw their appraisal under Delaware General Corporate Law (DGCL) section 262(k), they have an incentive to wait until the eleventh hour to decide whether to exercise their appraisal rights. Given the tight time frame between hearing of the hedge fund's decision to dissent and the shareholders' vote, it's unclear how many shareholders would take their votes into account.

38. Jetley & Ji, *supra* note 18, at 10 (finding on average that there are fifty-four days between public announcement of the transaction and the record date and thirty-two days between the record date and the shareholder's meeting to vote on the transaction).

39. See *Mergers*, U.S. SECURITIES AND EXCHANGE COMMISSION (Jan. 15, 2013), <https://www.sec.gov/answers/mergers.htm>.

40. For a more detailed exposition of how the ability to delay can be modeled as a call option, see AVINASH K. DIXIT & ROBERT S. PINDYCK, *INVESTMENT UNDER UNCERTAINTY* (1994).

41. Jetley & Ji, *supra* note 18, at 14–15.

42. Korsmo & Myers, *supra* note 7, at 29.

The signaling function may be more prevalent after the merger closes. Delaware's appraisal statute allows dissenting shareholders to decide whether to accept the deal price or exercise their appraisal rights up to sixty days after the deal closes.⁴³ Not only does this further extend the benefit of delay for dissenting shareholders, but it also provides them with a hindsight advantage by allowing them to exercise their appraisal rights and then opt out virtually cost-free if they determine that the deal price will be higher than the expected judicially-imposed fair value. Under Delaware law, dissenting shareholders have a right to demand a statement of the aggregate number of shares demanding appraisal.⁴⁴ Provided the shareholder has initially dissented from the merger, he or she may try to glean more information regarding which other shareholders have decided to forego the merger price. Practically speaking, the shareholder may wish to confirm the existence of other dissenting shareholders that can spread out the costs of litigating an appraisal claim. Of course, these evaluations would be discounted by the risk that the other dissenting shareholders will not exercise their right to accept the merger price.

On the same side of the coin, having up-to-date information can help minimize arbitrageurs' exposure to risk as well. Engaging in appraisal arbitrage is not risk-free. Arbitrageurs must factor in the costs of lengthy litigation and identifying an investment opportunity. There is also the possibility that the parties to the merger will fail to close the deal. As with any investment, arbitrageurs face the risk the appraisal action will not result in a higher price.⁴⁵ For example, Cypress Semiconductor acquired Ramtron International Corporation.⁴⁶ When deciding on a deal price, the parties factored in synergistic value from the transaction, yet under the Delaware Code, the statutory fair value is to be determined excluding these syner-

43. DEL. CODE ANN. tit. 8, § 262(e) (2016).

44. *Id.*

45. *See* Berger v. Pubco Corp., 976 A.2d 132, 141–42 (Del. 2009); Gilliland v. Motorola, Inc., 873 A.2d 305, 309 (Del. Ch. 2005).

46. Joint Press Release, Cypress Semiconductor Corp. & Ramtron Int'l Corp. (Sept. 19, 2012) (Cypress's Current Report on Form 8-K, filed Sept. 12, 2012), <https://www.sec.gov/Archives/edgar/data/849502/000119312512396132/d413527dex991.htm>.

gies.⁴⁷ Dissenting shareholders in the Ramtron acquisition brought an appraisal action, only for a judge to determine that they should receive \$3.07 as opposed to the deal price of \$3.10.⁴⁸ In a study cataloging appraisal actions from 2010 to 2013, the judge deemed that the fair market value was lower than the deal price in two out of nine cases.⁴⁹ While some of these risks cannot be assuaged by the additional time to buy target shares, most of them can be at least reduced with the input of additional, timely information.

C. *The Court's Computation of Fair Value*

The Delaware Chancery Court has gained a reputation for awarding appraisal values in excess of the deal price. The medium premium achieved in appraisal actions is not much below 100%,⁵⁰ although on occasion the Chancery Court has awarded a fair market value in excess of three or four times what the parties agreed to in the merger.⁵¹ Because of the flexible nature of determining fair value, commentators have likened the appraisal process to a lottery or casino-like process.⁵²

Some empirical studies find that the Delaware Chancery Court tends to award “fair market” values in excess of the transaction price.⁵³ One study showed that nearly 80% of appraisal actions that went to trial since 1993 resulted in higher prices for dissenting shareholders.⁵⁴ On average, appraisal actions have a little more than 10% premium over the merger

47. DEL. CODE ANN. tit. 8, § 262 (2016).

48. Liz Hoffman, *M&A Price Bump Lawsuit Backfires, Sounding Note of Caution*, WALL ST. J. (Jul. 1, 2015), <http://blogs.wsj.com/moneybeat/2015/07/01/ma-price-bump-lawsuit-backfires-sounding-note-of-caution/>.

49. Fried, Frank, Harris, Shriver & Jacobson LLP, *New Activist Weapon—The Rise of Delaware Appraisal Arbitrage: A Survey of Cases and Some Practical Implications 1* (June 18, 2014), <http://www.friedfrank.com/siteFiles/Publications/FINAL%20-%206182014%20TOC%20Memo%20-%20New%20Activist%20Weapon—%20The%20Rise%20of%20Delaware%20Appraisal%20Arbitrage.pdf>.

50. Kirkland & Ellis, *supra* note 24.

51. *See, e.g.*, *Borruso v. Comms. Telesystems Int'l*, 753 A.2d 451 (Del. Ch. 1999) (awarding a 302% premium to a dissenting shareholder).

52. Korsmo & Myers, *supra* note 7, at 1602.

53. Jetley & Ji, *supra* note 18, at 4–5.

54. Liz Hoffman, *Hedge Funds Wield Risky Legal Ploy To Milk Buyouts*, WALL ST. J. (Apr. 13, 2014), <http://www.wsj.com/articles/SB10001424052702303887804579500013770163966?cb=logged0.05828729015775025>.

price, with the median outcome a little less than 2% over the merger price.⁵⁵

Although these statistics indicating an appraisal premium may be accurate, appraisal actions are brought in the first place because dissenting shareholders feel the transaction price per share is too low. Shareholders (both genuine dissenters and arbitrageurs) must be convinced that the merger price is sufficiently low that they will be adequately compensated over the litigation expenses incurred. If the abnormally low-priced transactions are the ones ending up in appraisal litigation, it is no surprise that the court tends to award higher fair values than the merger price. Even if the Chancery Court does tend to award higher values, there appears to be a lurking selection bias, and it is unclear how much weight an investor would place on this uncertain information.

What explains this wide variance in fair market and deal valuations? First, courts are not exceptionally well-suited for sifting through financial analysis, nor do they care to assume that as their primary function.⁵⁶ One may wonder then, what makes courts better evaluators of a fair market price than those in the financial community who devote their careers to valuation of companies. In order to retain independent judgment and financial expertise, the court may appoint its own experts to aid in the valuation process.

Another partial explanation of this phenomenon is the false precision of the fair market value. The Delaware Chancery Court is statutorily required to pinpoint the “fair value” for the merger, a specific price.⁵⁷ In reality though, the value of the transaction likely falls within a range of viable prices, and the actual deal price within the range may depend on the negotiating ability of the parties.⁵⁸ If the actual deal price falls on the lower end, it may be that much easier for dissenting shareholders to show that the transaction necessitates a higher

55. Korsmo & Myers, *supra* note 7, at 1602.

56. *See, e.g., In re Ancestry*, No. 8173-VCG, 2015 Del. Ch. LEXIS 21 (Del. Ch. Jan. 30, 2015) (“I have commented elsewhere on the difficulties if not outright incongruities, of a law trained judge determining fair value of a company in light of an auction sale, aided by experts offering wildly different opinions on value.”).

57. DEL. CODE ANN. tit. 8, § 262 (2016).

58. *See* ROBERT H. MNOOKIN ET AL., *BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES* 17 (2000).

price, even if the actual initial price fell within the range of acceptable deal prices to both parties.

Compounding this issue, the method that the Chancery Court uses to determine the fair market value of dissenting shares in an appraisal action may also distort what is “fair value.” In appraisal litigation, the court must use “any legitimate valuation methodology used by the financial community.”⁵⁹ Because this is such a wide open standard, no party in an appraisal action can be fully sure which method the court will use. Generally, the Chancery judges tend to use the discounted cash flow method, as it is widely accepted in the financial industry.⁶⁰ The discounted cash flow method requires one to make certain assumptions and projections, which themselves can be highly uncertain, such as information as to how the company would have performed if the merger had not occurred.⁶¹ Moreover, the court, unlike the investment bankers advising M&A deals, tends to use the supply-side equity risk premium as an estimate of the company’s cost of equity in its discounted cash flow valuation.⁶² Supply-side equity risk premiums refer to stock market returns driven by factors linked to the productivity of firms. Investment bankers tend to use historical equity risk premiums, which generally result in lower valuations of fair value. The divergence in assumptions can lead to disparate valuations; experts’ valuation for respondents, on average, fell 22% below the merger price (with a median valuation 16% below the merger price).⁶³ Conversely, petitioners’ experts value dissenting shares 186% above the merger price on average (with a median of 78% above the merger price).⁶⁴ Academics such as Guarav Jetley and Xinyu Ji

59. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712–13 (Del. 1983) (doing away with the previous Delaware block valuation, which averaged together market value, asset value, and earnings value to determine the fair value of the equity of a company).

60. Mark E. Betzen & Matthew R. Shurte, *An Ounce of Prevention: Managing the Increased Threat of Appraisal Proceedings Under Delaware Law*, JONES DAY (2005), <http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=2716> (noting that an alternative valuation technique values a corporation’s stock on the basis of purportedly comparable companies and may be used with, or in lieu of, the discounted cash flow model).

61. See Epstein et al., *supra* note 8.

62. Jetley & Ji, *supra* note 18, at 8.

63. Korsmo & Myers, *supra* note 7, at 19–20.

64. *Id.*

argue that the difference in valuation methods may allow arbitrageurs to gain from the valuation gap created by this variance in methodology.⁶⁵

In at least five decisions, including some of the most recent appraisal opinions such as *CKx*, *Ancestry.com*, *Autoinfo*, and *MBC Software*, the Chancery Court has either awarded the deal price as the fair value of the dissenting shares or found it to be the most reliable indicator of fair value.⁶⁶ Fair value measured by the merger price, under the Merger Price Rule, intuitively makes sense in that the fair market value is equal to the amount a player in the market is willing to pay (pricing in all known risks). One must wonder then about what purpose appraisal actions serve at all. The newest research actually shows that not only is the merger price valuation the strategic equivalent of nullifying appraisal rights altogether, but that it can even undercompensate dissenting shareholders.⁶⁷

This trend of deferral to the price the parties negotiated may have a couple explanations. First, these may be weaker cases than their predecessors. All these Merger Price Rule cases took place during the rapid rise in appraisal litigation between 2011–2013 and were brought by repeat players to appraisal actions.⁶⁸ These repeat petitioners could have possibly been swept up in the new trend and pursued appraisal actions more aggressively than they had in the past. Alternatively, but not mutually exclusively, another explanation focuses on the disposition of the Chancery Court. In the midst of defense-side law firms decrying appraisal actions through corporate law panels, and blog postings advocating for reforms in Delaware before arbitration becomes too unwieldy, the court may be send-

65. Jetley & Ji, *supra* note 18, at 30.

66. See *LongPath Capital, LLC v. Ramtron Int'l Corp.*, No. 8094-VCP, 2015 WL 4540443, at *1 (Del. Ch. June 30, 2015) (calculating fair value at a small discount of the merger price); see also *Merion Capital LP v. BMC Software, Inc.*, No. 8900-VCG, 2015 WL 6164771, at *18 (Del. Ch. Oct. 21, 2015); *Merlin Partners LP v. AutoInfo, Inc.*, No. 8509-VCN, 2015 WL 2069417, at *18 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, No. 8173-VCG, 2015 WL 399726, at *2 (Del. Ch. Jan. 30, 2015); *Huff Fund Inv. P'ship v. CKx Inc.*, No. 6844-VCG, 2013 WL 5878807, at *15 (Del. Ch. Nov. 1, 2013).

67. Albert Choi & Eric Talley, *Appraising the 'Merger Price' Appraisal Rule 1* (Va. Law & Econ., Research Paper No. 2017-01, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2888420.

68. Korsmo & Myers, *supra* note 7, at 23.

ing a message, both to the critics of appraisal arbitration and the Delaware legislature, of its ability to “staunch a perceived gold rush” in appraisal arbitration without the need for legislative intervention.⁶⁹

The suggestion that the Chancery Court can moderate the amount of appraisal activity taking place in Delaware most closely aligns with the outcome of the most recent headliner appraisal arbitration case, *In re Appraisal of Dell Inc.*⁷⁰ In May 2016, Vice-Chancellor Laster held in an appraisal proceeding that the value of Dell was 28% higher than its negotiated merger price. The court cited, among others, the following reasons for the valuation gap: management buyouts such as Dell present different concerns than arms’ length transactions,⁷¹ the financial bidders only focused on the short-term internal rate of return (IRR) that is not as encompassing as section 262’s fair value, and the special committee negotiated the deal price based on the company’s stock and not its next best alternative to a negotiated acquisition.⁷² The novelty of the opinion, however, lies in the fact that Laster found no evidence of self-dealing on behalf of Dell.⁷³ Originally, appraisal rights were designed to protect minority shareholders from management’s self-dealing. Here, Dell made an effort to exact the highest bid for its shareholders (thereby surviving the enhanced scrutiny test⁷⁴), and yet, the highest bid was still not (nor even close) to the deemed “fair market value” in the appraisal action. The Vice Chancellor explained, “the concept of fair value under Delaware law is not equivalent to the economic concept of fair market value. Rather, the concept of fair value for purposes of Delaware’s appraisal statute is a largely judge-made creation, freighted with policy considerations.”⁷⁵

69. *Id.* at 24.

70. *In re Appraisal of Dell*, C.A. No. 9322-VCL (Del. Ch. Ct. May 31, 2016).

71. *Id.* at 60.

72. *Id.* at 75.

73. *Id.*

74. The enhanced scrutiny standard examines the “adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision” and “the reasonableness of the directors’ action in light of the circumstances” See *Paramount Comm’ns v. QVC Network*, 637 A.2d 34, 45 (Del. 1994).

75. *In re Appraisal of Dell*, C.A. No. 9322-VCL at 43 (citing *Finkelstein v. Liberty Digital, Inc.*, 2005 WL 1074364, at *12 (Del. Ch. Apr. 25, 2005)).

Thus, under *Dell*, the judge—not the market—has become the ultimate arbiter of a fair deal price, and the court is merely the next forum to negotiate a higher deal premium for activist shareholders.

III.

IS APPRAISAL ARBITRAGE REALLY A PROBLEM?

Before concerning oneself with ways that alternative statutory frameworks may curb appraisal arbitrage, it is first worth asking whether the practice of appraisal arbitrage is a legitimate investment strategy in the first place.

A. *Appraisal Arbitrage as Value Reducing*

Like any form of arbitrage, this practice undermines the statutory aim of appraisal. Originally adopted as a result of a compromise in the nineteenth century when corporate law moved from unanimous approval of mergers, appraisal statutes were enacted to protect minority shareholders.⁷⁶ Now, appraisal rights are used to quibble over the correct price. Not only does this depart from the original intention of appraisal rights, but it gives a remedy for an insufficient price that is not available in other corporate situations.⁷⁷ Likened to greenmail,⁷⁸ appraisal arbitrage has been seen as meritless strike suits that distort the merger process. After *Transkaryotic*, it is simply too easy for arbitrageurs to buy up chunks of stock and

76. Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Court Determine Fair Value*, 47 DUKE L.J. 613, 614–15 (1998) (stating that merger votes originally required unanimous consent and appraisal was provided as a remedy for the loss of the individual right of veto).

77. Most decisions are protected by the business judgment rule, which means that as long as the board of directors fulfills its duties of loyalty, care, and good faith, shareholders will not be able to second guess the merits of the decision. See, e.g., D. Gordon Smith, *The Modern Business Judgment Rule* (BYU Law, Research Paper Series No. 15-09, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2620536.

78. Abigail Pickering Bomba et al., *Shareholder Activism in M&A—Checklists . . . and the Future*, FRIED FRANK M&A BRIEFING (2014), <http://www.friedfrank.com/siteFiles/Publications/Final%20-%207-10-2014%20TOC%20Memo%20-%20Shareholder%20Activism%20in%20MA%20Checklists.pdf>. Greenmail is the practice of buying enough shares in a company to threaten a takeover, forcing the owners to buy them back at a higher price in order to retain control. See Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 1, 13 (1985).

claim that it was those shares that were not voted at the shareholders' meeting.

Critics also see arbitrage as value-reducing because it essentially imposes an appraisal tax on transactions.⁷⁹ Buyers may shun otherwise sensible deals if merger announcements routinely bring about appraisal costs, which will result in social welfare loss if buyers abandon synergistic mergers that, absent the risk of appraisal, would otherwise be a good deal. In fact, the tax may be more real than theoretical in scenarios where the firm simply decides to pay off investors to avoid the litigation expenses and negative reputational effects of a prolonged appraisal action.

One particular example of the appraisal tax occurred in Dell's going-private transaction in 2013. In this deal, Carl Icahn and others threatened to seek appraisal rights of shares that they acquired after the announcement of the merger and effectively blocked the deal from going through, leading to a \$400 million increase in the price of the merger itself.⁸⁰ Thus, a threat alone may induce companies to "pre-settle" with potential arbitrageurs to avoid the reputational harm and litigation costs of a protracted appraisal claim.

As a counterargument, some contend that if acquirers price the deal fairly then it is unlikely that shareholders will bring an appraisal suit in the first place.⁸¹ Yet, the problem with this argument is that reasonable merger prices lie along a spectrum of prices. Simply because a deal price is fairly priced, albeit on the lower end of reasonably acceptable market prices, does not mean arbitrageurs will not believe that they can persuade a court to award a higher fair market value of their shares.

The threat of an appraisal arbitrage tax also creates deal uncertainty. Parties must consider the probability that an appraisal action will occur, whether the cost of litigating the appraisal claims will exceed closing costs to complete the transaction, and the uncertainty as to how a court will determine fair market value of the shares. All of these risks will be priced into the transaction in the form of an appraisal tax.

79. Bomba et al., *supra* note 78.

80. See Epstein et al., *supra* note 8.

81. Korsmo & Myers, *supra* note 6, at 1600.

Nonetheless, parties can contract away the risk of appraisal arbitrage. They can rid themselves of the risk altogether by structuring the transaction in a way that does not allow for appraisal rights, such as an asset sale transaction or triangular merger.⁸² Yet corporate restructuring can be complex, and various tax, liability, shareholder, or other structural concerns may dictate that a statutory merger, aside from appraisal concerns, would otherwise work best. By avoiding appraisal rights, the risk of appraisal arbitrage further limits the possible deal structures available to the parties.

Another partial solution would be to include appraisal-closing conditions as a contractual countermeasure.⁸³ But even with this provision in place, appraisal arbitrage is arguably value-reducing. Creating appraisal-closing conditions may protect against litigation costs, but may also increase ex ante transaction costs by the need to draft around these contingencies. A typical appraisal-closing condition might say that the transaction can be abandoned if more than twenty percent of the shares demand appraisal.⁸⁴ However, the inclusion of an appraisal-closing condition may make the offer less attractive, and thus value-reducing, to the seller. With appraisal-closing conditions, deal uncertainty can actually increase because in the interim between signing and closing, neither party knows whether the appraisal closing condition will be triggered.⁸⁵ Thus, even if appraisal-closing conditions reallocate risk of appraisal from the buyer to the seller,⁸⁶ both parties still face the

82. See *Terry v. Penn Cent. Corp.*, 668 F.2d 188 (3d Cir. 1981); *Hairton v. Arco Elecs., Inc.*, 188 A.2d 123 (Del. 1963); see also Andrew Ross Sorkin, *Who Decides 'Fair Value?' in Dell's Case, a Judge*, N.Y. TIMES, June 7, 2016 (quoting Marty Lipton, "Private equity firms should be expected to ask whether they face routine appraisal exposure in Delaware, no matter how robust the auction, and therefore seek out alternative transaction structures to cap and price their risk (or exit the market entirely).").

83. See Andrew J. Noreuil, *Dissenting-Shareholders Clauses May Become More Common*, LAW 360 (Feb. 20, 2014), <http://www.law360.com/articles/510471/dissenting-shareholders-clauses-may-become-more-common>.

84. See Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV. 239, 242 (1999).

85. Victor Lewkow, *Negotiating Appraisal Conditions in Public M&A Transactions*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Nov. 23, 2016), <https://corpgov.law.harvard.edu/2016/11/23/negotiating-appraisal-conditions-in-public-ma-transactions/>.

86. Bomba et al., *supra* note 78, at 5.

possibility that the transaction will fail as a result of appraisal arbitrageurs.

B. *Appraisal Arbitrage as a Corporate Governance Check*

The arguments in favor of arbitration largely parallel those in favor of broader shareholder activism. Even if arbitration occurs, some contend that it can provide value to a transaction and at the very least serve as a check on poor corporate governance.⁸⁷

Ownership ambiguity and amplified appraisal activity might be seen as a protection against abusive freeze-out mergers because it gives investors the ability to band together to generate more meaningful appraisal claims.⁸⁸ *Weinberger v. UOP, Inc.* aimed to mitigate the coercive freeze-outs with appraisal rights. Moreover, if appraisal actions protect minority shareholders, they will be willing to pay more for the shares in the first place.

Appraisal activists may also be an effective corporate governance tool by serving as a monitoring function on controlling shareholders. When parties consummate a merger at a fair price, there may be little incentive for outside investors to buy into the target and bring an appraisal action. But if a controller tries to expropriate value from dissenting shareholders by offering a low price, then outside activist investors will have an incentive to purchase target shares and bring forth an appraisal claim. In fact, this was the case when Carl Icahn swooped in to purchase target shares in *Transkaryotic* after the record date but before the shareholder vote.⁸⁹ Much as in the market for corporate control, appraisal actions can function as a disciplinary check on managers when they engage in an underpriced freeze-out merger.⁹⁰ Moreover, appraisal actions can serve as a defense against “sloth, negligence, or otherwise unconscious bias in the sales process” of a third party transaction.⁹¹

87. Korsmo & Myers, *supra* note 7, at 42.

88. *See* Geis, *supra* note 22, at 1639.

89. David Benoit, *Carl Icahn's 'No Brainer' May Actually Require a Lot of Brains*, WALL ST. J. (Jul. 11, 2013), <http://blogs.wsj.com/moneybeat/2013/07/11/carl-icahns-no-brainer-may-actually-require-a-lot-of-brains/>.

90. Korsmo & Myers, *supra* note 7, at 43.

91. *Id.*

In order for appraisal actions to effectively serve the dual roles of monitoring controlling shareholders and being a check on negligence in the sale process, arbitrage, some argue, is necessary.⁹² Arbitrageurs can buy up large amounts of shares after the merger announcement and overcome the collective action problems that would otherwise accompany an appraisal case. Without these increasingly expert repeat players, dissenting shareholders are faced with the costs of litigation. Unlike a traditional class action, dissenters cannot just simply go along with the lead plaintiff, but rather they must individually assert appraisal rights.⁹³ In buying up a sizeable block of shares, arbitrageurs can spread the fixed costs of litigation across a broad base of shares, thereby decreasing the costs for smaller, individual shareholders as well.⁹⁴ Appraisal arbitrage can solve these issues without generating class action agency problems between attorneys and the dissenting shareholders in the process.⁹⁵

Moreover, the possibility of appraisal actions may in fact benefit the controlling shareholder in addition to minority investors. If a market for appraisal actions develops in the window between the record date and the shareholder vote, the ability to exercise appraisal rights (and arbitrage) creates value in the target shares. In the long run, the higher price of these shares would more accurately reflect the value of shares, and this increased value would increase the efficiency of the capital markets as a whole.

If appraisal arbitrage is indeed an effective corporate governance check, then the usefulness of appraisal statutes that deter arbitrage should be questioned. Perhaps most famously, Bayless Manning described appraisal statutes as “of virtually no economic advantage to the usual shareholder except in highly

92. *Id.* at 3.

93. Edward M. McNally, *Are Appraisal Cases Coming Back?*, MORRIS JAMES (July 17, 2013), <http://www.morrisjames.com/newsroom-articles-184.html>.

94. Korsmo & Myers, *supra* note 6, at 1599.

95. In class actions, attorney–client conflicts occur because the class representatives cannot monitor the attorney, thereby creating an agency problem. See John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency*, 54 U. CHI. L. REV. 877, 883 (1987) (“It’s no secret that substantial conflicts of interest between attorney and client can arise in class action litigation.”).

specialized situations.”⁹⁶ Modern commentary follows suit. Critics complain that it is easy to avoid appraisal rights⁹⁷ and that appraisal statutes are procedurally complex⁹⁸ and unnecessary now that that capital markets have developed since the inception of appraisal rights. Despite their faults, appraisal statutes may have finally found their usefulness, albeit as an unintended result.

While this Note does not aim to outline in detail the steps required to address the larger issue of shareholder activism, understanding the normative arguments surrounding appraisal arbitration sets the stage for what types of statutory mechanisms, as already implemented by other states, Delaware should ultimately adopt, if any.

IV.

ALTERNATIVE APPROACHES: MECHANISMS TO CURB ARBITRAGE

Most appraisal cases occur in Delaware, as it is the most influential corporate law jurisdiction and home to more than half of all publicly traded companies in the United States and more than two-thirds of the Fortune 500 companies.⁹⁹

Admittedly, appraisal cases in non-Delaware jurisdictions remain outliers, despite the overall increase in appraisal actions. Because of the scarcity of appraisal case law elsewhere, it is difficult to say with certainty that the alternative jurisdictions have directly led to less appraisal arbitration. Still, appraisal cases do occasionally crop up in alternative jurisdictions, permitting comparative analyses between the practical outcome in the alternative jurisdiction and the theoretical outcome in Delaware.¹⁰⁰

96. See Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 260 (1962).

97. *Id.*

98. See Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1004 (2006); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 798–99 (2003).

99. Laura Anthony, *Mergers and Acquisitions; Appraisal Rights*, LEGAL & COMPLIANCE LLC (Nov. 10, 2015), <http://securities-law-blog.com/2015/11/10/mergers-and-acquisitions-appraisal-rights/>.

100. Alison Frankel, *How To Squelch Appraisal Arbitrage, Minnesota Style*, REUTERS (Dec. 17, 2015), <http://blogs.reuters.com/alison-frankel/2015/12/17/how-to-squelch-appraisal-arbitrage-minnesota-style/> (projecting the

Moreover, despite the dearth of non-Delaware appraisal actions, all states retain appraisal statutes.¹⁰¹ Many of these are modeled after the Model Business Corporation Act (MBCA), which along with Delaware General Corporation Law (DGCL) serves as a template for legislators faced with drafting or revising appraisal statutes.¹⁰² Even though the vast majority of states either follow the Delaware or MBCA approach, it would be insufficient to merely compare the two of them. First, states may cherry-pick which provisions they desire from either the MBCA or DGCL, or both. Second, a binary comparison would only highlight the differences between two statutes. By tackling a state-by-state comparison, a more comprehensive view can be gleaned as to the prevalence of specific provisions that either deter or incentivize appraisal arbitrage and where Delaware fits along the spectrum of arbitrage-friendly or arbitrage-hostile statutes. Therefore, while an empirical study of the relationship between various states' appraisal statutes and their ability to curb arbitrage is impractical, an incentive analysis of six recurring statutory mechanisms—interest rates, withdrawal rights, information on other dissenters, the timing of payment for dissenters' shares, after-acquired shares, and litigation costs—shows that Delaware is not the gold standard for curbing appraisal arbitrage, should the state wish to be.

A. *Interest Rates (a Reprise)*

As previously mentioned, appraisal arbitrageurs can theoretically profit from appraisal litigation from the mere fact that the corporation will be required to pay the fair value of dissenting shares, plus accrued interest. When comparing Delaware's five percent premium over the Federal Discount Rate to interest rates of other states, Delaware actually seems to fall somewhere near the lower end of the spectrum in terms of the amount of interest rate owed to dissenting shareholders.¹⁰³

outcome of the Caribou Coffee acquisition had it been a Delaware corporation).

101. Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 4, 614 (1998).

102. In fact, drafters of the MBCA actually derided the Delaware statutes and asserted the superiority of their own work. See Jeffrey M. Gorris et al., *Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis*, 74 DUKE L.J. 107, 107–08 (2011).

103. See *infra* Appendix.

When examining the array of interest rates, states tend to fall within three categories. Like Delaware, some states use the statutory rate of interest employed by the state for a variety of issues, related and unrelated to appraisal rights.¹⁰⁴ Other states require the corporation to pay interest “at the average rate currently paid by the corporation on its principal bank loans.”¹⁰⁵ And yet other states grant broad latitude to courts in prescribing the interest rate, and simply provide that interest shall be paid “at a rate that is fair and equitable under the circumstances.”¹⁰⁶

Naturally, the higher rate of interest will appeal more to arbitrageurs because they can profit more from the time they exercise their appraisal rights to the time the corporation pays the dissenter. Beyond the value of the interest alone, arbitrageurs must factor in risk, including the risk of a low interest rate, into their calculations whether to pursue appraisal. Or, put another way, arbitrageurs will value the certainty of knowing the interest rate they can expect. This is particularly so because in arbitrage cases, the arbitrageur is not motivated solely by the fact that the deal price of the shares may be underpriced, but rather they are incentivized by making money off of the appraisal right.

Even within the states that use statutory rates, there is considerable variance. States’ interest can range anywhere from 400 basis points above the Federal Discount Rate¹⁰⁷ to twelve percent.¹⁰⁸ Nonetheless, a statutory rate provides dissenting shareholders (both genuine dissenters and arbitrageurs) more certainty of what interest rate they can expect from appraisal litigation.

Unlike the statutory interest rate schemes, interest rates based on the corporation’s principal bank loans will vary ac-

104. *See, e.g.*, CAL. CORP. CODE § 1303 (West 2013).

105. *E.g.*, MASS. GEN. LAWS ANN. ch. 156D, §§ 13.01, 46 (2016).

106. *E.g.*, N.Y. BUS. CORP. LAW § 623 (McKinney 2016) (“In determining the rate of interest, the court shall consider all relevant factors, including the rate of interest which the corporation would have had to pay to borrow money during the pendency of the proceeding. If the court finds that the refusal of any shareholder to accept the corporate offer of payment for his shares was arbitrary, vexatious or otherwise not in good faith, no interest shall be allowed to him.”).

107. FLA. STAT. §§ 55.03, 607.1301 (2017).

108. NEB. REV. STAT. § 45-104 (2017).

ording to the individual corporation. In order to discover what the appropriate interest rate will be in any one case, an arbitrageur must find out the principal on the corporation's bank loans, which requires greater investigative costs than knowing the statutory rate in a jurisdiction.

The least certain method, the "fair and equitable" method, gives dissenting shareholders little guidance as to what type of return they will receive from engaging in litigation. As with many other forms of litigation, arbitrageurs may look to prior case law to get a sense of what judges have awarded, but even this provides more uncertainty.

Indeed, higher but also more certain interest rates provide arbitrageurs with the greatest incentive to engage in arbitrage. Yet, simply moving to a more fluid standard may not be a solution either. By reducing certainty, genuine dissenters may be dissuaded from bringing meritorious appraisal claims. As long as the interest rate does not dip below the time value of money, a low interest should not deter genuine dissenters that sincerely want to cash out at the fair market value of their shares and nothing more. If legislators truly wish to curb frivolous suits, amending the appraisal statute to include a low, but statute-based interest rate would be most appropriate.

B. *Withdrawal Rights*

In Delaware, shareholders have the ability to withdraw their appraisal notices well after the deal takes place, even if they have perfected their appraisal rights up to that point.¹⁰⁹ These withdrawal rights give arbitrageurs a no-cost route to exert pressure against the company to obtain a higher deal price.¹¹⁰ Delaware is not alone in granting this right. Twenty-four states grant shareholders this ability.¹¹¹ In actuality, however, the Delaware statute may give a smaller time window in which appraisal-holding shareholding can choose to dissent. Shareholders in Delaware have the option to withdraw up to

109. DEL. CODE ANN. tit. 8, § 262 (2016).

110. Epstein et al., *supra* note 8.

111. *See, e.g.*, N.Y. BUS. CORP. L. § 623(e) (2016). Connecticut, Florida, Kansas, Louisiana, Maine, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas, Virginia, West Virginia, and Wyoming allow for withdrawal rights; *see also infra* Appendix.

sixty days after the deal.¹¹² In contrast, in alternative jurisdictions the timeline is more complicated and requires a more nuanced understanding of the technical details of the appraisal process.

As a general matter, the corporation must send an appraisal notice (often also referred to as a dissenters' notice) to all shareholders that may be eligible for appraisal rights no later than ten days after the merger occurs.¹¹³ The appraisal notice will state various items, among them notice that shareholders may exercise appraisal rights, the company's estimated value of the shares, how the corporation calculated the estimate, and various financial statements reaching back as early as sixteen months prior.¹¹⁴ This disclosure is intended to give investors requisite information to make an informed decision whether to exercise their appraisal rights. Appraisal notices also require the corporation to set a date by which shareholders must choose to dissent, falling between forty and sixty days¹¹⁵ from the time the appraisal notice is received.¹¹⁶ Shareholders must then adhere to the requirements for submitting their demand payment. After this back-and-forth process perfects the appraisal right for the shareholder, she can turn around and withdraw the demand, most often up until twenty days after the demand payment is due.¹¹⁷

Thus, in actuality, shareholders in alternative jurisdictions can have anywhere from fifty to ninety days after the deal to renege. In these jurisdictions, it is the corporation that sets the pace. By sending out the appraisal notice immediately after the deal happens and setting the date by which shareholders must submit demand payment, the corporation can cut in half the timeline for dissenting shareholders to ultimately withdraw. This may be a valuable tool for companies that are suspi-

112. DEL. CODE ANN. tit 8, § 262 (2016).

113. MODEL BUS. CORP. ACT § 13.20(b).

114. Georgia requires the maximum sixteen months prior of financial information. GA. CODE ANN. § 55-13-20(d)(1) (2017).

115. Some states, such as Alabama, Arkansas, Georgia, Hawaii, Illinois, Indiana, Kentucky, Michigan, Mississippi, Nebraska, New Jersey, Oregon, Rhode Island, Utah, Vermont, and Wisconsin do not follow MBCA's 40–60 day window for dissent, but rather have elongated the period to 30–60 days. *See, e.g.*, HAW. REV. STAT. § 414-353(b)(4) (2015).

116. MODEL BUS. CORP. ACT § 13.22(b)(2)(ii).

117. *Id.* § 13.22(b)(2)(v).

scious that some shareholders may attempt arbitrage, while allowing other companies the ability to prolong the appraisal period so as to give genuine shareholders more time to carefully consider whether they wish to cash out their shares.

C. *Right to Information on How Many Other Shareholders Dissent*

Relatedly, jurisdictions vary in how much information they provide to shareholders that are debating whether to dissent. The majority of disclosure is somewhat standardized, with only slight adjustments, such as how many months prior a corporation must provide its financials, small changes that are unlikely to truly persuade someone to commit arbitrage. Yet, one particular provision may help to tip the scales: in a handful of jurisdictions, shareholders can assert a right to receive a list of all other shareholders who have also submitted their demand payment.¹¹⁸

Information regarding other shareholders can be quite useful both by a genuine dissenting shareholder and an appraisal arbitrageur. A shareholder genuinely exercising appraisal rights faces a coordination problem. Appraisal actions do not contain a class action mechanism to help assuage coordination costs. Instead, appraisal-seeking shareholders must individually assert their claims. Depending on the jurisdiction, dissenting shareholders can join an ongoing appraisal claim, or in other statutes, all dissenting shareholders are automatically joined once a shareholder instigates appraisal litigation.¹¹⁹ This can be helpful to long-term shareholders because they can use cost-spreading amongst all (or many) dissenters to bring an action. It may also serve as a signaling function that because certain influential shareholders have dissented, it would be wise to follow suit.

118. Twelve states—Delaware, Louisiana, Maine, Massachusetts, Minnesota, New Hampshire, North Carolina, South Dakota, Tennessee, Virginia, West Virginia, and Wyoming—give shareholders the right to information regarding other shareholders. It comes as no surprise that these states also maintain withdrawal rights, which may suggest that some states intentionally wanted to provide more dissenter-friendly (and perhaps inadvertently more arbitrage-friendly) provisions as a whole. *See, e.g.*, ME. STAT. tit. 13C, § 1323(2)(B)(4), 1324(2).

119. *Cf.* DEL. CODE ANN. tit. 8, § 262 (2016), where shareholders must individually assert and perfect their appraisal rights independently in order to be eligible for a judicially imposed fair value of their shares.

But arbitrageurs will use this to their advantage. Arbitrageurs may dissent, regardless of whether they believe the dissenting shares' value has been fairly estimated, leading other less informed shareholders into a false sense that the case is genuinely worth litigating. This distortion could be prevented; by removing the right to receive information on other dissenting shareholders from the statute books, at least until the period for withdrawing perfected dissents has elapsed, legislators could remove the advantage of this information for arbitrageurs while still retaining some of the benefit of coordination for genuinely dissenting shareholders.

D. *Timing of Payment and Fair Value*

Fair value turns out not to be a particularly useful metric across states because it is so broadly defined. Most states¹²⁰ have adopted the language in *Weinberger*, where the Delaware Supreme Court opined that appraisal valuation could be based on “any techniques or methods . . . generally considered acceptable in the financial community.”¹²¹ And while this standard is fairly consistent across jurisdictions, its application is not. Courts disagree on a multitude of valuation techniques, such as whether to include a minority discount, factor in the deal price, or consider goodwill.¹²² Even within state jurisdictions, the courts do not apply fair value uniformly. Additionally, valuations of stock price may often turn on individualized facts of the case.¹²³ While this vast fluidity of fair value pricing could deter uncertain arbitrageurs on the whole, no particular

120. One exception to the Weinberger standard can be found in Ohio's appraisal statute, which requires fair value to be determined as “the amount that a willing seller who is under no compulsion to sell would be willing to accept and that a willing buyer who is under no compulsion to purchase would be willing to pay, but in no event shall the fair cash value of a share exceed the amount specified in the demand of the particular shareholder.” OHIO REV. CODE ANN. § 1701.85 (LexisNexis 2017).

121. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

122. Brian R. Potter, *Shareholder Disputes: What Is the Appropriate Standard of Fair Value?*, SRR (2011), <http://www.srr.com/article/shareholder-disputes-what-appropriate-standard-value>.

123. MINN. STAT. § 302A.471 (2017) No method is recommended because the different methods of measuring value (market, book, replacement, capitalization of earnings, etc.) are neither right nor wrong, but merely appropriate in different situations. *Id.*

state regime rises to the top as a particularly good regime for curbing strategic behavior.

Instead, it is more helpful to examine the fair value of shares in terms of *when* the corporation is required to pay the fair value of the shares because that timing affects the amount (and consequently the interest rate payout) to be litigated, thereby reducing incentives to arbitrage. Under this framework, states split along two lines. Those like Delaware require the corporation to pay the full fair value of the dissenting shares plus accrued interest at the end of the appraisal litigation.¹²⁴ The other line of states, and the MBCA, require the corporation to pay its estimate of the fair market value of shares up front, *before* appraisal litigation begins.¹²⁵ At the time of judgment, the corporation will only pay what the court determines to be the excess fair value over what the corporation estimated and already paid to the shareholders, plus accrued interest.

In the latter model, the contested amount is much smaller during the litigation stage. If the parties are only fighting over the differential in share value, it might not be worth it for an arbitrageur to bring a litigation claim. Plus, the accrued interest will be smaller, because it will only be interest accruing on the excess amount since the time the corporation paid its estimated fair value, as opposed to starting interest accrual from the effective date of the transaction. This statutory framework deters arbitrage by reducing incentives to bring appraisal litigation, unless the dissenting shareholder truly believes there is sufficient excess between the corporation's estimate of fair value and court's expected valuation.

Interestingly enough, this "fair value in excess" award only goes in one direction in some jurisdictions. These jurisdictions state that a dissenting shareholder will not be liable to the corporation for any excess the corporation has paid to the shareholder over what the court deems to be fair value.¹²⁶ In a Minnesota case, *Caribou Coffee Company, Inc., v. Richard Fearson*, the acquiring corporation, JAB Holding Company, actually

124. DEL. CODE ANN. tit. 8, § 262(h) (2016).

125. *E.g.*, MODEL BUS. CORP. ACT § 13.24.

126. MINN. STAT. § 302A.471 (2017).

overpaid the dissenting shareholder Fearson for his shares.¹²⁷ JAB offered to buy Caribou Coffee for \$16.00 a share, but when Fearson dissented, Caribou Coffee contended there were procedural problems with Fearson's dissent and only offered him \$15.03 per share. When the case came before the Minnesota court, the judge valued the shares at \$14.45.

Some argue that this statutory scheme dissuades arbitrageurs because it puts arbitrageurs on notice that they could lose money in an appraisal action.¹²⁸ Yet, it seems more likely that the opposite is true—that is, these statutory schemes incentivize arbitrageurs to strategically pursue appraisal. The concern that a court will value the shares lower than the value a shareholder could have received by approving the deal is no different from any other jurisdiction, *ceretis paribus*. But when the statute disallows payment by a shareholder to the corporation for an excess award, arbitrageurs can choose to pursue appraisal rights with little downside risk. At the very least, they have a particular price floor for their shares.

Admittedly, Minnesota cases like *Caribou Coffee* are not going to really affect professional appraisal arbitrageurs going after Delaware corporations. Appraisal cases like *Caribou Coffee* are outliers in non-Delaware states. Still, by understanding the incentive mechanisms behind the various alternative jurisdictions' statutes, Delaware can better reconstruct its own appraisal statute to deter arbitrage.

E. *After-Acquired Shares*

Unlike Delaware's section 262, the MBCA includes the concept of after-acquired shares, which provides perhaps the strongest deterrence of appraisal litigation and arbitrage.¹²⁹ In thirty states, shareholders must certify in their demand payment that they had purchased their shares prior to the announcement of the merger, either by way of a media announcement or announcement directly to the shareholders themselves.¹³⁰ If shareholders wishing to assert appraisal rights

127. Michael Greene, *Caribou Investors Get Less than Deal Price in Minn. Case*, BLOOMBERG BNA (Jan. 4, 2016), <http://www.bna.com/caribou-investors-less-n57982065675/>.

128. See Frankel, *supra* note 100, at 1.

129. See MODEL BUS. CORP. ACT § 13.25.

130. See, e.g., MISS. CODE ANN. § 79-4-1325 (2015); see also *infra* Appendix.

are unable to provide this certification, the corporation may limit their appraisal rights under the state's "after-acquired shares" provision.

After-acquired share provisions give the corporation an option to withhold payment for shares that investors have acquired after the announcement of the merger transaction.¹³¹ Shares acquired after that date may only receive an offer of payment that is conditioned on their full satisfaction of the claim. If the claim goes through litigation, after-acquired shareholders will be entitled to the entire fair value of their shares plus accrued interest (as compared to shareholders who held their shares prior to the merger announcement—they will be awarded the amount that the court finds to be the fair value in excess of the corporation's estimate, plus accrued interest).¹³²

Because of this difference in payment methods, it is not clear that this would reduce the incentive for arbitrage under the theory that more interest would accrue because the after-acquired shareholders will not have received any value until the court awards in their favor. At the same time, however, because they have held the shares for less time than their "before-acquired" shareholder counterparts, the interest will accrue over a shorter time horizon. The issue of whether this interest actually incentivizes after-acquired shareholders may come out as a wash, or at least insignificant enough for it to be a real factor in the calculus of whether to engage in arbitrage.

The rationale behind these after-acquired statutes is, after all, to reduce the incentives for arbitrage. As an example, the comments to Massachusetts's after-acquired shares statute explicitly address this concern:

If the right of unconditional immediate payment were granted as to all after-acquired shares, speculators and others might be tempted to buy shares merely for the purpose of demanding appraisal. Since the function of appraisal rights is to protect investors against unforeseen changes, there is no need to give equally favorable treatment to purchasers who

131. MODEL BUS. CORP. ACT § 13.25.

132. *Id.*

knew or should have known about the proposed changes.¹³³

Of course, corporations do not have to withhold payment of after-acquired shares; they merely have the option to do so. Similar to flexibility that the withdrawal rights time frame gives corporations, the ability to choose whether or not to withhold payment for after-acquired shares gives the corporation discretion depending on how skeptical it finds the dissenting shareholders' intentions. When the circumstances indicate an obstructionist maneuver by the dissenting shareholders, the corporation will be inclined to withhold immediate payment. In most cases, "consideration of simplicity and harmony will dictate immediate payment for after acquired as well as pre-acquired shares."¹³⁴

F. *Litigation Costs Assessed*

Different state regimes as to who should front the costs of appraisal litigation may factor into an arbitrageur's calculus to pursue appraisal rights. Under Delaware law, the costs of the litigation will be distributed as the court finds equitable.¹³⁵ In contrast, the MBCA, which forty states follow on this issue, places the costs of the litigation upon the corporation, unless the court finds that the dissenting shareholder acted arbitrarily, vexatiously, or not in good faith.¹³⁶ While these two standards sound similar, the fact that the MBCA formulation explicitly acknowledges the possibility of arbitrageurs taking advantage of the appraisal process may make those state courts more acutely aware of the possibility of arbitrage, while rendering the litigation itself more costly for arbitrageurs.

V.

IMPLICATIONS FOR LEADING CORPORATE LAW

Various mechanisms such as low interest rates, lack of withdrawal rights, and after-acquired share provisions in alternative jurisdictions provide better incentives to avoid appraisal arbitrage than the current Delaware statute. If the Delaware

133. MASS. GEN. LAWS ANN. ch. 156D, § 13.25 (2016).

134. Alfred F. Conrad, *Amendments of Model Business Corporation Act Affecting Dissenters' Rights (Sections 73, 74, 80, and 81)*, 33 BUS. LAW. 2587 (1978).

135. DEL. CODE ANN. tit. 8, § 262(j) (2016).

136. MODEL BUS. CORP. ACT § 13.31; *see also infra* Appendix.

Court of Chancery is unwilling to protect against appraisal arbitrageurs, it falls to the state legislature to amend the statute. The Delaware appraisal process has changed continuously over the years, the most recent being in 2009.¹³⁷ Since the recent uptick in appraisal arbitrage, several reforms to the Delaware appraisal statute have been proposed. These reforms tend to fall into three categories: the modest proposals to the Delaware legislature in the 2014–2015 and 2015–2016 sessions, more radical reforms recently proposed, particularly by corporate defense law firms (such as doing away with appraisal rights altogether), and those attempting to expand appraisal rights.

Proposals to curb appraisal arbitrage first made their way to the Delaware legislature in 2014. Some of these proposals are similar to already-enacted provisions in alternative jurisdictions, such as changes to the interest rate on appraisal claims. The Delaware State Bar Association Council of the Corporate Law Section recommended that respondents in an appraisal action be given “the option to cut off the accrual of interest by paying to the claimants a sum of money of the corporation’s choosing Interest would only accrue if the judicial award exceeded the amount paid, and then would accrue only on the excess.”¹³⁸ Although this pre-paying might encourage more arbitrage because it would pre-fund appraisal litigation for arbitrageurs, the overall payout would be less when taking interest into account, just as other states already have the corporation pay its estimate fair value upfront prior to appraisal litigation. Surprisingly, the Delaware legislature did not enact the Bar Association’s proposal because it found that arbitrage cases still represent a small portion of overall appraisal actions, and the effectiveness of appraisal rights would be curtailed in genuine circumstances if the appraisal statute were more limited.¹³⁹ In the aftermath of the broad exercise of judicial discretion in *Dell* in the summer of 2016, the Delaware legislature reversed course and amended section 262(h) to include this

137. See Geis, *supra* note 22. Delaware has amended its statute thirty-five times since its adoption in 1899. Korsmo & Myers, *supra* note 6, at 1645.

138. Lowenstein Sandler, *Section 262 Appraisal Amendments*, <https://www.lowenstein.com/files/upload/DGCL%20262%20Proposal%203-6-15%20Explanatory%20Paper.pdf>.

139. *Id.* (perhaps the reason why Delaware continues to retain a mix of both arbitration-friendly and arbitration-hostile provisions reflects a sense of ambiguity as to whether appraisal arbitrage is a desirable consequence).

reform, in a way responding to its judicial counterpart.¹⁴⁰ But again, this reform is only following in the established footsteps of the Model Business Corporations Act.

Adopting a de minimis requirement has also been considered and recently enacted. Both academics and the Delaware General Assembly set out proposed reforms to carve out appraisal rights for shareholders holding miniscule ownership in the target company. One such proposal states that a shareholder could only seek appraisal if “the total number of shares entitled to appraisal exceeded one percent of the outstanding shares that could have sought appraisal.”¹⁴¹ While rejected in the 2014–2015 legislative session, this precise amendment passed, effective August 1, 2016.¹⁴² Another type of de minimis reform limits appraisal actions to those in which the merger consideration for the total number of shares entitled to appraisal exceeds \$1 million.¹⁴³ De minimis reforms seek to deter nuisance claims, but they will not curb the concern that large hedge funds are enacting the most potent arbitrage.¹⁴⁴

A more extreme proposal would rid the DGCL of the appraisal right altogether. In a sense, the Delaware Chancery Court already flirts with this proposal by frequently using the Merger Price Rule. While there are certainly concerns with the valuation process, the statute by and large protects minority shareholders from being stuck holding undesirable shares of a new company. Because arbitrage is, for now, a small percentage of all appraisal cases and mostly limited to meagerly priced deals, getting rid of the appraisal right may severely harm the value of dissenters’ rights in corporate law.

This concern, however, is overblown. Legislatures first enacted appraisal rights at a time of illiquid capital markets. Now, if a shareholder dislikes holding shares of the new com-

140. DEL. CODE ANN. tit. 8, § 262(g) (2016).

141. *Id.*

142. *Id.* § 262(h); see also Alison L. Land & Lisa P. Ogust, *Amendments to DGCL Limit Appraisal Proceedings*, DEL. BUS. CT. INSIDER (Aug. 24, 2016), <http://www.delbizcourt.com/id=1202765835862/Amendments-to-DGCL-Limit-Appraisal-Proceedings?slreturn=20170025160452>.

143. DEL. CODE ANN. tit. 8, § 262(h) (2016); Land & Ogust, *supra* note 142.

144. See, e.g., JAMES D. COX ET AL., CORPORATIONS 595–96 (1997) (“[Appraisal] is rarely the remedy of other than the ‘wine and cheese’ crowd, for seldom is appraisal sought by investors whose holdings are less than \$100,000 . . .”).

pany after a merger, the shareholder need only follow the “Wall Street Rule” and sell his shares, in which he will receive the current fair market value of those shares. Appraisal rights, while a nicety, are not a necessity in the current capital markets. Yet practically speaking, it is unlikely that the entire appraisal right will be erased from the books, especially at a time in which appraisal activity is rapidly increasing.

As noble as these reforms sound, Delaware has no need to try to enact something extreme. Rather, practical reforms have been right in front of Delaware for years—many of the alternative jurisdictions have already long included mechanisms to deter appraisal arbitrage. By looking to modest proposals to decrease the interest rate, disallow withdrawal rates and information regarding other dissenters, and incorporate after-acquired share provisions, Delaware can realistically filter out appraisal arbitrage while still allowing credible appraisal cases to go forward.

CONCLUSION

Delaware corporate law often overshadows alternative jurisdictions, and rightly so. But even with its well-developed statutes and years of chancery expertise, Delaware corporate law is not perfect. Arbitrageurs have increasingly found their way between the rules embedded in DGCL section 262 to profit off dissenters’ rights. The flexibility in the Delaware statute, the interest rate that is not reflective of the amount of risk of an appraisal case, and the uncertainty surrounding courts’ valuation of dissenting shares all provide incentives for dissenters to profit off minority rights. And while academics and commentators have proposed various reforms in recent times to deter arbitrage, many states already have similar statutory mechanisms on their books. Despite their usual lack of prominence, non-Delaware states may be one step ahead than the leading body of corporate law in the area of appraisal arbitrage.

APPENDIX

Jurisdiction	Interest Rate	Withdrawal Rights	Other Dissenters' Information	Timing of Payment	After Acquired Shares	Litigation Costs (BF exception)
Delaware	1	Yes	Yes	Del.	No	No
MBCA	1	Yes	No	MBCA	Yes	Yes
Alabama	1	Yes*	No	Del.	No	Yes
Alaska	1	No	No	Del.	No	No
Arizona	1	No	No	MBCA	Yes	Yes
Arkansas	1	No	No	Del.	No	No
California	1	No	No	Del.	No	Yes
Colorado	2	No	No	Del.	Yes	Yes
Connecticut	1	Yes	No	MBCA	Yes	Yes
Florida	1	Yes	No	Del.	No	Yes
Georgia	3	No	No	Del.	No	Yes
Hawaii	2	No	No	MBCA	Yes	Yes
Idaho	1	Yes	No	MBCA	Yes	Yes
Illinois	2	No	No	MBCA	No	Yes
Indiana	2	No	No	MBCA	Yes	Yes
Iowa	1	No	No	MBCA	No	No
Kansas	3	Yes	No	Del.	No	No
Kentucky	2	No	No	MBCA	Yes	Yes
Louisiana	1	No	Yes	MBCA	Yes	Yes
Maine	1	Yes	Yes	MBCA	Yes	Yes
Maryland	3	Yes*	No	Del.	No	Yes
Massachusetts	2	Yes	Yes	MBCA	Yes	Yes
Michigan	2	No	No	MBCA	Yes	Yes
Minnesota	1	No	No	MBCA	Yes	Yes
Mississippi	1	Yes	No	MBCA	Yes	Yes
Missouri	1	No	No	Del.	No	No
Montana	2	No	No	MBCA	Yes	Yes
Nebraska	1	No	No	MBCA	Yes	Yes
Nevada	1	Yes	No	MBCA	Yes	Yes
New Hampshire	1	Yes	Yes	MBCA	Yes	Yes
New Jersey	3	Yes*	No	Del.	No	No
New Mexico	3	Yes*	No	Del.	No	Yes
New York	3	Yes*	Yes	Hybrid	No	No
North Carolina	1	Yes	Yes	MBCA	Yes	Yes
North Dakota	1	No	No	MBCA	No	Yes
Ohio	3	No	No	Del.	No	Yes

Jurisdiction	Interest Rate	Withdrawal Rights	Other Dissenters' Information	Timing of Payment	After Acquired Shares	Litigation Costs (BF exception)
Oklahoma	3	Yes	Yes	Del.	No	No
Oregon	2	No	No	MBCA	Yes	Yes
Pennsylvania	3	No	No	Del.	No	Yes
Rhode Island	1	Yes*	No	Del.	No	Yes
South Carolina	2	No	No	MBCA	Yes	Yes
South Dakota	1	Yes	Yes	MBCA	Yes	Yes
Tennessee	1	Yes*	Yes	MBCA	Yes	Yes
Texas	1	Yes*	No	Del.	No	No
Utah	1	No	No	MBCA	Yes	Yes
Vermont	2	No	No	MBCA	Yes	Yes
Virginia	2	Yes	Yes	MBCA	Yes	Yes
Washington	2	No	No	MBCA	Yes	Yes
West Virginia	1	Yes	Yes	MBCA	Yes	Yes
Wisconsin	2	No	No	MBCA	Yes	Yes
Wyoming	2	Yes	Yes	MBCA	Yes	Yes

1: Statutory Interest Rate

2: Interest rate equal to corporation's principal bank loans

3: Interest rate that is "fair and equitable"

* With consent of the corporation

Del: Payment of fair value at conclusion of appraisal litigation

MBCA: Payment of estimated fair value prior to start of appraisal litigation

Note: Each of these statutory mechanisms can be found within the state's dissenter's right chapter of their business code. Because states have multiple statutes within its dissenters' rights chapter addressing these mechanisms, the general chapter pertaining to dissenters' rights can be found here in the order that they appear in the Appendix: 8 DEL. CODE ANN. § 262; MODEL BUS. CORP. ACT § 13; ALA. CODE § 10A-2-13 (2016); ALASKA STAT. § 10.55.109 (2016); ARIZ. REV. STAT. §10-13 (2016); ARK. CODE § 4-27-13 (2015); CAL. CORP. CODE § 1300 (2016); COLO. REV. STAT. § 7-90-206 (2016); CONN. GEN. STAT. § 855-59 (2015); FLA. STAT. §607.1300 (2016); GA. CODE ANN. § 14-2-1300 (2015); HAW. REV. STAT. § 414-340 (2015); IDAHO CODE ANN. § 30-29-1301 (2016); 805 ILL. COMP. STAT. §5-11 (2016); IND. CODE. § 23-1-44 (2016); IOWA CODE § 490.1300(2016); KAN. STAT. ANN. § 17-78-109 (2015); KY. REV. STAT. ANN. § 13.13 (2015); LA. REV. STAT. § 12:1-1300 (2016); ME. REV. STAT. ANN. TIT. 13C, § 1300 (2016); MD. CORP. & ASSN. CODE § 3-201 (2015); MASS. GEN. LAWS CH. 156 § 46E (2016); MICH. COMP. LAWS § 450.1754-74 (2016); MINN STAT. §302A.471-73 (2016); MISS. CODE ANN. § 79-4-1300 (2015); MO. REV. STAT. § 351.455 (2016); MONT. CODE ANN. § 35-1-826-39 (2015); NEB. REV. STAT. § 21-2, 171-83 (2015); NEV. REV. STAT. § 78.3793 (2015); N.H. REV. STAT. § 293-A:13 (2016); N.J. REV. STAT. § 14A:11 (2016); N.M. STAT. § 53-15-3 (2016); N.Y. BUS. CORP. L. § 910 (2016); N.C. GEN. STAT. § 55-13 (2015); N.D. CENT. CODE § 10-19.1-87 (2016); OHIO REV. CODE § 1701.84-85

(2016); OKLA. STAT. TIT. 18 § 1155 (2016); OR. REV. STAT. § 60.551-94 (2015); 15 PA. CONS. STAT. § 317 (2016); 7 R. I. GEN. LAWS § 7-1.2-12 (2015); S.C. CODE ANN. § 33-13 (2016); S.D. CODIFIED LAWS § 47-1A-13 (2015); TENN. CODE ANN. § 48-23 (2015); TEX. BUS & COM. CODE § 21.460 (2015); UTAH CODE § 16-10A-13 (2016); VT. STAT. ANN. TIT. 11A, § 1300; VA. CODE ANN. § 13.1-729-41 (2016); WASH. REV. CODE § 23B.13 (2016); W. VA. CODE § 31D-13 (2016); WIS. STAT. § 180.1323 (2016); WYO. STAT. ANN. § 17-16-1300 (2015).

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ENHANCING SHAREHOLDER RIGHTS IN
INTERMEDIATED SECURITIES HOLDING
STRUCTURES ACROSS BORDERS

JESÚS GARCÍA APARICIO*

In today's interconnected capital markets, investors are no longer confined to national boundaries. On the contrary, domestic investors actively buy securities from companies incorporated in other jurisdictions. To connect companies with ultimate investors across borders, securities are allocated through multi-tier holding patterns formed by financial intermediaries. Each of the intermediaries in a chain holds investors' shares in securities accounts maintained with upper intermediaries located, on many occasions, in other jurisdictions. However, the flow of investors' rights along the holding chain may be interrupted for two major reasons. Local laws may ignore the cross-border financial reality: a particular domestic law may not recognize the interests of those ultimate investors located in another jurisdiction or prevent intermediaries from acting on behalf of those foreign inves-

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tors. Furthermore, securities holding chains suffer from structural deficiencies. The relationship between intermediaries across borders is governed by isolated contractual arrangements. As a result, the cross-border exercise of corporate rights is disrupted. Against this background, this Note proposes a combined solution that involves, first, increasing momentum for transnational harmonizing legal instruments, like the UNIDROIT Convention on Substantive Rules for Intermediated Securities and the E.U. Shareholder Rights Directive, and, second, giving a greater role to institutional investors to exercise their bargaining power in order to influence contractual relationships vis-à-vis financial intermediaries in securities holding chains that go beyond the current limitations set forth by domestic legal frameworks.

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INTRODUCTION

In the past decades, most of the corporate legal regimes in developed economies have been subjected to three major phenomena. First, shareholders and policy makers have pushed boards of directors and CEOs for greater democratic corporate governance.¹ Second, the internationalization of capital markets has stimulated the number of cross-border transactions of securities indirectly held by investors through

1. See MARTIN LIPTON, STEVEN A. ROSENBLUM & KARESSA L. CAIN, *THE FUTURE OF CORPORATE GOVERNANCE AND THE BOARD OF DIRECTORS* 1 (2010) (noting that it was precisely the enactment of pro-shareholder legislation that permitted the rapid development of a shareholder-centric model of corporate governance from which activists have largely benefited).

financial intermediaries.² Third, the rising number of institutional investors has modified the traditional ownership landscape in publicly listed companies.³ Since these three trends normally represent major competing interests, their interaction has proven to be a difficult territory where many complex legal issues have arisen.

Whereas recent reforms in corporate law seek to enhance shareholder democracy and participation as a sign of *good governance* in public corporations,⁴ capital markets regulations aim to foster greater efficiency in securities transactions.⁵ In other words, while the former purports to build a more transparent relationship between ultimate investors and the issuer,⁶ the latter requires a lengthy system of intermediaries capable

2. See Hideki Kanda, *Foreword*, in TRANSNATIONAL SECURITIES LAW V, V (Thomas Keijser ed., 2014); Thomas Keijser, *Preface*, in TRANSNATIONAL SECURITIES LAW VII, VII (Thomas Keijser ed., 2014); see also HIDEKI KANDA, LEGAL ASPECTS OF GLOBALIZATION, CONFLICTS OF LAWS, INTERNET, CAPITAL MARKETS AND INSOLVENCY IN A GLOBAL ECONOMY 69 (Jürgen Basedow & Toshiyuki Kono eds., 2000) (noting that many markets coexist in a multi-layered fashion and that financial transactions take place, and financial institutions act, across national borders in these multi-layered markets).

3. See Martin Lipton, Partner at Wachtell, Lipton, Rosen & Katz, *Activist Interventions and the Destruction of Long-Term Value*, Talk Before the Directors Forum (Jan. 26, 2015) (on file with author) (arguing that after the financial crisis of 2008 and 2009 the influence of institutional investors has significantly increased because corporate boards should consider a wider array of constituents when making decisions, including employees, communities, and customers).

4. See EUROPEAN COMMISSION, *Communication From the Commission to The European Parliament, The Council, The European Economic and Social Committee and the Committee of Regions, Action Plan: European company law and corporate governance—a modern legal framework for more engaged shareholders and sustainable companies*, COM (2012) 740 final, 2012 (COD) 14–15 (concluding that the proposed initiatives and reforms aim to increase the level of transparency between companies and their shareholders, and as regards company law, the initiatives proposed focus in particular on providing companies more legal certainty regarding cross-border operations).

5. See RÜDIGER VEIL, EUROPEAN CAPITAL MARKETS LAW 18–19 (Rüdiger Veil ed., 2013).

6. See Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSPECTIVES 117, 127–37 (2007) (explaining reforms made in France, Germany, and Italy in the last fifteen years to improve internal governance mechanisms, empower shareholders, enhance disclosure and strengthen public enforcement); see also EUROPEAN COMMISSION, *supra* note 4, at 5–8 (describing a number of initiatives to enhance transparency with regard to disclosure of board diversity policies and man-

of securing both the allocation and transfer of millions of securities worldwide at reasonable transaction costs.⁷ At this sensitive crossroads, the basic tenet is that what is good for the economic efficiency of capital markets is in many ways counterproductive for the vindication of legal interests of ultimate investors, the so-called beneficial owners, who face a number of obstacles to enforce their rights through transnational chains of financial intermediaries.⁸

Part I states the problem that is subject to analysis in this Note, and Part II expounds on its relevant consequences. The presence of intermediaries across borders seems necessary for reasons of efficiency, operational certainty, speed, and safety.⁹ However, even between two internally sound and reliable national systems, holding securities through a chain of intermediaries across borders usually causes a number of shortcomings.¹⁰ First, the legal frameworks in which each market

agement of non-financial risks, corporate reporting, and shareholder identification mechanisms).

7. See VEIL, *supra* note 5, at 87, 383 (noting that trading securities requires the intervention of financial intermediaries; as a result, only such intermediaries are authorized to conclude contracts for their own account or in their own name for the account of others); *see also Id.* at 211–12, (distinguishing three different goals in terms of efficiency in capital markets: allocational efficiency (matching investment opportunities to investable financial capital), institutional efficiency (referring to the availability of free market conditions), and operational efficiency (referring to speed and transactional costs)).

8. See Philipp Paech, *Capital Markets Union, Investment Securities and the Tradition of Casting Liquidity into the Law* (London Sch. of Econ., Law Dept., Working Paper No. 20/2015), at 5, <http://ssrn.com/abstract=2697718> (arguing that the concepts and mechanisms developed by securities law have proved unsuitable in the context of intermediation and centralised clearing and settlement, and that they are not compatible across jurisdictional borders).

9. See Luc Thévenoz, *The Geneva Securities Convention: Objectives, History, and Guiding Principles*, in INTERMEDIATED SECURITIES: THE IMPACT OF THE GENEVA SECURITIES CONVENTION AND THE FUTURE EUROPEAN LEGISLATION 7 (Pierre-Henri Conac et al. eds., 2013) (noting that the immobilization and dematerialization of securities create huge efficiencies, at the cost of relying almost exclusively on the operational safety and financial soundness of central securities depositories, banks, and other financial intermediaries).

10. See Luc Thévenoz, *Intermediated Securities, Legal Risk and the International Harmonization of Commercial Law*, 13 STAN. J.L. BUS. & FIN. 384, 398 (2008); *see also* UNIDROIT, *Legislative Guide on Intermediated Securities* (Revised Draft), Jan. 27, 2017, at 26, <http://www.unidroit.org/english/documents/2017/study78b/s-78b-cem04-02-e.pdf>.

participant (companies, intermediaries, or investors) operates are different.¹¹ This fact weakens both the legal compatibility among national jurisdictions and the effective exercise of investors' rights.¹² Second, some jurisdictions have legal frameworks in place based on traditional concepts of property law and capital markets.¹³ Traditional models, although rationally developed from a legal point of view, do not match the current standards required by increasingly intermediated and interconnected capital markets.¹⁴ Third, the process of determining the applicable law for each market participant is far from certain, so conflict-of-law issues arise among different legal regimes.¹⁵

In addition, those securities holding structures across borders are governed by contractual arrangements.¹⁶ It is the contract itself which defines the rights and obligations between the concerned parties. If the contract does not contemplate the obligation to pass the rights through the intermediaries to the final investors, the exercise of rights is disrupted.¹⁷ Against

11. See Thévenoz, *supra* note 10, at 399; see also UNIDROIT, *supra* note 10, at 26.

12. See Nora Rachman & Maria Vermaas, *Corporate Actions in the Intermediated System: Bridging the Gap Between Issuer and Investor*, in TRANSNATIONAL SECURITIES LAW 145, 146 (Thomas Keijser ed., 2014) (arguing that “[p]art of the problem is the reluctance of lawmakers and regulators to enable the ultimate account holder or beneficiary to avail itself of its direct income, voting, and information rights”); see also UNIDROIT, *supra* note 10, at 26.

13. See José Angelo Estrella Faria, *The UNIDROIT Convention on Substantive Rules Regarding Intermediated Securities: An Introduction*, 15 UNIFORM L. REV. 196, 198 (2010); see also Philipp Paech, *Harmonised Substantive Rules Regarding Intermediated Securities – Paris Seminar on the UNIDROIT Project*, 11 UNIFORM L. REV. 319, 321 (2006); UNIDROIT, *supra* note 10, at 26.

14. See Hideki Kanda, *Legal Rules on Indirectly Held Investment Securities: The Japanese Situation, Common Problems, and the UNIDROIT Approach*, 10 UNIFORM L. REV. 271, 274–76 (2005) (describing the legal system in major jurisdictions, such as the United States, France, Germany, the United Kingdom, and Japan); see also UNIDROIT, *supra* note 10, at 26.

15. See Francisco J. Garcimartín Alférez, *The Geneva Convention on Intermediated Securities: A Conflict-of-Laws Approach*, 15 UNIFORM L. REV. 751 (2010); see also UNIDROIT, *supra* note 10, at 26.

16. See Eva Micheler, *Custody Chains and Remoteness – Disconnecting Investors from Issuers 2* (London Sch. of Econ. Law Dep’t, Working Paper No. 14, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2413025.

17. *Id.* (noting that neither issuers nor investors are able to control the complexity of the chain or the content of the legal arrangements that govern the holding structure because intermediaries are connected through a

this background, investors need to know whether they are entitled to exercise their corporate rights, receive necessary information from companies, and give instructions to their relevant intermediaries in a reasonably simple and convenient way.

Part III develops a tentative solution to solve the problem at hand. First, states must foster core harmonization of intermediated securities regulation at the cross-border level. Although not in force yet, the major legal platform achieved thus far is the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the Geneva Securities Convention), which offers a set of essential harmonized material rules to develop internal soundness and cross-border compatibility of securities holding systems.¹⁸ More significant steps have been taken in this regard by the European Union, namely through the establishment of binding legal instruments such as the Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies (the Shareholder Rights Directive).¹⁹ Second, institutional investors have become prominent enough in some jurisdictions to play a key role in vindicating the rights of ultimate beneficial owners against cross-border financial intermediaries by altering the contractual terms. The sustained market power of intermediaries may be eroded by large institutional investors who are located downstream in the holding chain. As a result, institutional investors may be the missing piece of the puzzle needed to favor the ultimate shareholders.

Finally, this Note summarizes the conclusions of the legal analysis. The legislative and structural complexities of exercising corporate rights across borders by the ultimate beneficial owners of the shares can be minimized by non-mutually exclu-

series of bilateral legal relationships that are independent of each other and eventually erode the rights of investors); *see also* UNIDROIT, *supra* note 10, at 26.

18. *See* UNIDROIT, Convention on Substantive Rules for Intermediated Securities, Oct. 9, 2009, <http://www.unidroit.org/english/conventions/2009/intermediatedsecurities/convention.pdf>.

19. *See* Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies, 2007 O.J. (L 184) 17, amended by Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014, 2014 O.J. (L. 173) 190.

sive remedies: on the one hand, harmonized international legislation offers an effective platform to enhance investors' rights across diverse legal regimes; on the other hand, structural shortcomings along the chain of intermediaries can be fixed by giving an increased role to large institutional investors.

I.

THE PROBLEM: LEGISLATIVE AND STRUCTURAL COMPLEXITIES IN THE EXERCISE OF CORPORATE RIGHTS ACROSS BORDERS

Besides bonds, corporations traditionally use equity to raise capital for their business activities. Domestic corporate law grants equity holders, regardless of whether they are nationals or foreigners, a number of residual rights as the ultimate owners of the corporation. For instance, every shareholder usually has the right to vote on director elections at shareholder meetings. In addition, shareholders have the right to receive dividends and access certain corporate information. Furthermore, many jurisdictions acknowledge the shareholder right to vote on fundamental corporate changes, such as mergers or dissolutions. Finally, other matters, like the appointment of an independent auditor or the approval of management compensation, are also submitted for shareholder approval by the board of directors in many jurisdictions.²⁰

However, in today's capital markets, acquirers of stock are no longer confined to national boundaries.²¹ On the contrary, domestic shareholders actively buy shares from corporations incorporated in other jurisdictions. This trend has caused an increase in foreign ownership in publicly listed companies in

20. *See generally* ANDREAS CAHN & DAVID C. DONALD, *COMPARATIVE COMPANY LAW* 465–573 (making an overall comparative explanation of shareholder voting rights, shareholder information rights, and shareholder meetings among the jurisdictions of the United States, the United Kingdom, and Germany).

21. *See* PHILIPP PAECH, *CROSS-BORDER ISSUES OF SECURITIES LAW: EUROPEAN EFFORTS TO SUPPORT SECURITIES MARKETS WITH A COHERENT LEGAL FRAMEWORK* 8 (Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy, eds. 2011) (Briefing for the Economic and Monetary Affairs Committee of the European Parliament).

advanced capital markets, such as those in the United States²² and the Member States of the European Union.²³ For instance, the stock ownership structure in the European Union has changed substantially in the last decades.²⁴ In particular, shares in the hands of foreign investors have increased from ten percent in 1975 to forty-five percent in 2012.²⁵ The United States shows a similar trend. The foreign ownership of U.S. stock has steadily grown since the 1970s.²⁶ Whereas overseas investors owned less than five percent of the U.S. equity market in 1965, the most recent data shows a peak of over fifteen percent in 2015.²⁷ U.K. markets portray identical patterns;²⁸ more than half of the investors in U.K. equity come from outside the country.²⁹

These statistical figures demonstrate that exercising voting rights matters both across borders as well as domestically. Unfortunately, the increasing appetite of domestic investors to go overseas has not been matched by the establishment of an adequate legal and regulatory framework. Some studies portray an inverse relationship between voting turnouts at shareholder meetings and foreign ownership of domestic corpora-

22. See DINAH WALKER, COUNCIL OF FOREIGN RELATIONS, QUARTERLY UPDATE: FOREIGN OWNERSHIP OF U.S. ASSETS 4 (2015), <http://www.cfr.org/united-states/quarterly-update-foreign-ownership-us-assets/p25685>.

23. See EUROPEAN COMMISSION, *Proposal for a Directive of the European Parliament and of the Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement*, COM (2014) 213 final, 2014/0121 (COD) 3 (noting that the proposed E.U. action provides significant added value because non-national shareholders hold some forty-four percent of the shares listed in E.U. public corporations).

24. See OBSERVATOIRE DE L'EPARGNE EUROPEENE & OF INSEAD OEE DATA SERVICES, WHO OWNS THE EUROPEAN ECONOMY? EVOLUTION OF THE OWNERSHIP OF EU-LISTED COMPANIES BETWEEN 1970 AND 2012 (MARKT/2012/077/H) 5 (2013).

25. *Id.*

26. See WALKER, *supra* note 22.

27. *Id.*

28. See Paul L. Davies, *Shareholders in the United Kingdom* 21 (European Corp. Governance Inst., Working Paper No. 280, 2015), <http://ssrn.com/abstract=2557680>.

29. *Id.* at 4, 27. Table 1 of the Davies paper sets out the data produced by the Office of National Statistics' surveys on the beneficial ownership of listed U.K. equities since 1963, in particular the ownership held by "the rest of the world," which was 53.2% in 2012. *Id.* at 27.

tions.³⁰ Some commentators have suggested that this passivity of foreign investors may be linked to structural shortcomings in cross-border voting mechanisms.³¹ Exercising voting rights is already an uneasy task for investors in domestic jurisdictions; even more complexity exists in the international arena. Cross-border voting implies a number of hurdles for investors. This process is costly, time-consuming, and inefficient.³² First, each jurisdiction has its own set of rules to exercise voting rights at general shareholder meetings.³³ Second, the issuer (the public corporation) and the end-investor are separated by a chain of financial intermediaries that hold the shares indirectly on behalf of the end-investor.³⁴ Third, each jurisdiction has a different understanding of how capital markets and their corresponding interactions with property, securities, and corporate laws should be organized.³⁵

With the expansion of financial globalization, harmonization efforts in the area of capital markets law have not been accompanied by similar legal adjustments in the field of corporate law. Perhaps, the cause stems from the natural inclination of human beings to agree more easily on economics than politics, and the ownership and trading of domestic equity by foreign shareholders is an issue with deep socio-political impli-

30. See Dirk Zetzsche, *Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 8 J. CORP. L. STUD. 289, 290–95 (2008) (noting that there is no empirical evidence, but discussing data from several studies measuring voting turnout and concluding that the data suggests that the bulk of the passive shareholders constitute foreign investors).

31. *Id.* at 295.

32. See *Removing Obstacles to Cross Border Voting*, INT'L CORP. GOVERNANCE NETWORK: VIEWPOINTS (July 2014), <https://www.icgn.org/sites/default/files/Removing%20obstacles%20to%20cross%20border%20voting.pdf>.

33. See B. Espen Eckbo & Giulia Paone, *Reforming Share-Voting Systems: The Case of Italy* 5 (Tuck Sch. of Bus. at Dartmouth, Working Paper No. 93, 2011), <http://ssrn.com/abstract=1822287> (discussing the efforts to harmonize cross-border voting systems in the Member States of the European Union and particularly Italy).

34. See Eva Micheler, *Custody Chains and Assets Values, Why Crypto-Securities Are Worth Contemplating*, 73 CAMBRIDGE L.J. 2 (2015).

35. See Luc Thévenoz, *Who holds (Intermediated) Securities? Shareholders, Account Holders, and Nominees*, 15 UNIFORM L. REV. 845, 846, 849, 858 (2010) (arguing that we are in a diverse world of national policies, legal and regulatory provisions, and clearing and settlement arrangements).

cations³⁶ Whereas capital markets law seeks to enhance investors' ability to hold, dispose of, and pledge securities in a faster, cheaper, and safer way,³⁷ corporate governance aspires to strengthen owners' rights attached to their shares.³⁸ As a result, cost-efficient and more liquid transnational capital markets have been accomplished in many ways at the expense of less transparent cross-border corporate governance schemes.³⁹

Sometimes, holding chains are quite short.⁴⁰ A direct holding system is characterized by the lack of intermediaries between companies and investors.⁴¹ There are no intermediaries because companies offer the securities directly to end-investors.⁴² As a result, a mere agreement whereby the company agrees to issue securities in favor of investors is sufficient to create a legal relationship between the parties.⁴³ Both the issuance and the contractual privity between the company and the investors are usually governed by domestic corporate law, which determines the rights and obligations for both parties.⁴⁴ The advantage of direct holding is that the issuer is able

36. See Paech, *supra* note 8, at 2 (noting that the reform in the field of securities law has the caveat of being a political and complex area which makes it some kind of no-go area somewhere).

37. See VEIL, *supra* note 5, at 73–74 (making an overview to capital markets as trading venue where companies and business can raise equity or borrow capital and where these are publicly traded).

38. See GEOFFREY P. MILLER, *THE LAW OF GOVERNANCE, RISK MANAGEMENT AND COMPLIANCE* 17 (2014) (taking an excerpt from Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 883 (2005)). Professor Bebchuk argues that providing shareholders with more power would operate over time to improve all corporate governance arrangements.

39. See Paech, *supra* note 8, at 2. Paech argues that the reforms of capital markets aim to increase liquidity in the securities lending market, but that relevant reforms tend to trail behind in adjusting legal schemes to what is useful for the economy. *Id.* As a result, legal concepts and vested interests were given an intrinsic value in determining what was and was not good for efficiency and liquidity, thereby distorting the results. *Id.*

40. See PAECH, *supra* note 21, at 9 (referring to the case of the so-called transparent system); see also UNIDROIT, *supra* note 10, at 16–17.

41. See Thévenoz, *supra* note 35, at 850; see also Int'l Inst. for the Unification of Private Law, *Harmonised Substantive Rules Regarding Intermediated Securities—Two Seminars on the UNIDROIT Project*, 10 UNIFORM L. REV. 824, 824 (2005).

42. See Thévenoz, *supra* note 35, at 850.

43. See Michel Deschamps, *The Best Rules for Non-Intermediated Securities*, in *TRANSNATIONAL SECURITIES LAW* 1, 5 (Thomas Keijser ed., 2014).

44. See Garcimartín Alférez, *supra* note 15, at 757.

to identify the investor's identity and the occurrence of further transfer of securities.⁴⁵ In terms of scope, direct systems may encompass both bearer securities held physically⁴⁶ by the investor and securities directly registered with the company in the name of the investors.⁴⁷ The structure of a direct holding system would be as follows:

FIGURE 1



Other times, the situation is fairly complex.⁴⁸ Complications stem from the introduction of different financial intermediaries between companies and ultimate investors.⁴⁹ The process of intermediation was possible due to the adoption of the book-entry system in the recent years,⁵⁰ which does not use physical certificates.⁵¹ Instead, intangible securities are the result of a process of either dematerialization⁵² or immobilization.⁵³ Neither process requires actual delivery of tangible certificates; rather, a mere electronic debit-and-credit entry in the

45. See WENWEN LIANG, *TITLE AND TITLE CONFLICTS IN RESPECT OF INTERMEDIATED SECURITIES UNDER ENGLISH LAW 1-2* (2013).

46. *Id.* at 2-3, 152.

47. *See id.*

48. See Eva Micheler, *Transfer of Intermediated Securities and Legal Certainty*, in *TRANSNATIONAL SECURITIES LAW 117*, 118-22 (Thomas Keijser ed., 2014); see also UNIDROIT, *supra* note 10, at 16-17.

49. See Micheler, *supra* note 48, at 122.

50. See Luc Thévenoz, *Transfer of Intermediated Securities*, in *THE IMPACT OF THE GENEVA SECURITIES CONVENTION AND THE FUTURE EUROPEAN LEGISLATION 138* (Pierre-Henrik Conac et al. eds., 2013) (noting that the intermediated holding system developed in the 1960s and many statutes were enacted to reflect the change to the book-entry method).

51. *Id.* at 138-39.

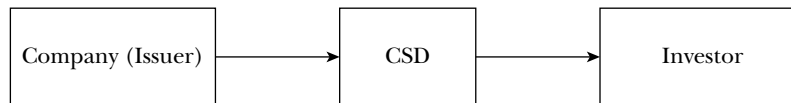
52. See LIANG, *supra* note 45, at 2-3.

53. See *id.* at 2 (noting that securities are instead immobilized when "all securities certificates or a global note representing the whole issue are deposited in a central securities depository which maintains securities accounts for direct participants and records their holding on their securities accounts, direct participants then maintain securities accounts for its clients and record their holding, from tier to tier, up to a final investor who holds securities for himself").

relevant investor account made by the relevant intermediary is enough to complete a transfer in favor of another person.⁵⁴

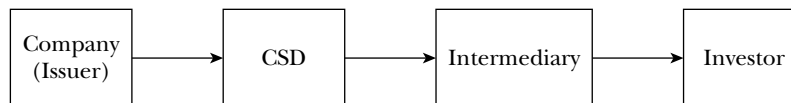
Intermediation takes place both domestically and across borders. On the one hand, domestic holding systems usually have a group of mechanisms to guarantee the internal soundness and compatibility of the complete chain of intermediaries.⁵⁵ The intermediaries may hold their securities according to different general patterns, which vary from jurisdiction to jurisdiction.⁵⁶ The simplest one is where a Central Securities Depository (CSD)⁵⁷ holds the securities in the name of the investor.⁵⁸

FIGURE 2



A further step consists of the existence of a top-tier intermediary, such as a CSD, holding the securities in the name of another intermediary, and the latter holds them in the name of the ultimate investor.⁵⁹

FIGURE 3



54. See *id.* at 3; see also Thévenoz, *supra* note 50, at 138–40.

55. See Int'l Inst. for the Unification of Private Law, *supra* note 41, at 829.

56. See Hideki Kanda, *The Law of Securities Trading in Emerging Markets: Book-Entry Operations and Property Law*, 16 UNIFORM L. REV. 13, 14–17 (2011).

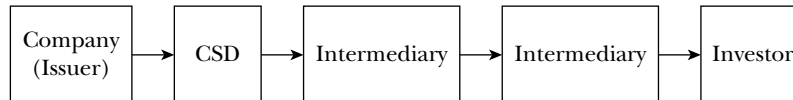
57. See PAECH, *supra* note 21, at 5, 19 (referring to the case of the so-called transparent systems and defining CSDs as “entities which keep securities centrally; usually they have a direct link with the issuer of the securities” (CPSS-IOSCO Glossary: “an institution for holding securities that enables securities transactions to be processed by means of book entries”).

58. See *id.* at 10–11; see also UNIDROIT, *supra* note 10, at 17.

59. See PAECH, *supra* note 21, at 10; see also UNIDROIT, *supra* note 10, at 18.

Naturally, the holding chain may become even more complex as the number of intermediaries increases at the level of the same jurisdiction.⁶⁰

FIGURE 4



On the other hand, cross-border holding structures cause additional shortcomings. Imagine the following example.⁶¹ Jean, a French retail investor, has his own securities investment strategy. In order to minimize risk, Jean decides to design a financial portfolio consisting of various types of assets from different capital markets around the world. Among the chosen assets, he holds bonds, stock, and other securities. Some of the stock is issued, for instance, by NewCo, a large U.S. multinational corporation incorporated in Delaware. However, under U.S. law, all stock issued by U.S. corporations must be held and registered in the name of Cede & Co., a subsidiary of the Depository Trust Company (DTC), which monopolizes the market for registering securities as the only CSD in the United States.⁶² Based on these circumstances, there are two major problems. Opening a securities holding account abroad is a complex and costly task for Jean. Also, raising equity finance directly in every single domestic capital market is a burdensome legal process for NewCo.

A fair solution consists of building a chain of financial intermediaries, such as banks, investment firms, or securities brokers, between Jean, the ultimate investor, and NewCo, the issuer.⁶³ These intermediaries enhance efficiency and liquidity

60. See PAECH, *supra* note 21, at 11, fig.1; see also UNIDROIT, *supra* note 10, at 18.

61. See, e.g., Thévenoz, *supra* note 10, at 398–99; see also Thévenoz, *supra* note 35, at 857–58; see generally PAECH, *supra* note 21, at 8; UNIDROIT, *supra* note 10, at 18–20.

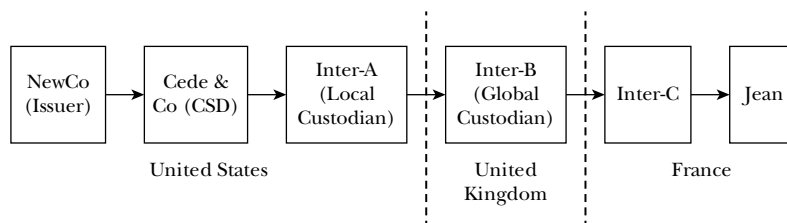
62. See Thévenoz, *supra* note 35, at 847 (noting that the DTC is at the top of the chain of intermediaries which create securities entitlements for their clients by setting a “credit” in the respective client’s account, so that the client becomes the beneficial owner of the acquired securities).

63. See *id.* at 850; see also UNIDROIT, *supra* note 10, at 19–20.

in cross-border securities transactions.⁶⁴ Despite this positive cost-benefit analysis, intermediaries are established in different jurisdictions and subject to various legal regimes. In the example, Cede & Co., the CSD under U.S. regulations, is at the beginning of the chain. At the other end of the spectrum, Jean opens a securities account to acquire his NewCo shares through Inter-C, a local intermediary bank subject to French legislation. Because these shares are intermediated securities, Inter-C holds the stock in the name of and for the account of Jean.

The web of relationships⁶⁵ becomes even more intricate when, as occurs in many instances, the local intermediary in France, Inter-C, does not have a securities account opened with Cede & Co. to get direct access to NewCo shares. On the contrary, in-between Inter-C and Cede & Co., there is normally a U.S. local custodian, like Inter-A, that opens an immediate account with Cede & Co. Once the shares are credited to its account, Inter-A allocates the NewCo shares overseas through an external network of financial intermediaries. One of them usually is a global custodian, like Inter-B, with its headquarters in London. Finally, Inter-B may outsource its custody activity in the Eurozone to local intermediaries, like Inter-C, which credit NewCo shares to eventually allocate them to their French clients.

FIGURE 5



64. See UNIDROIT, Convention on Substantive Rules for Intermediated Securities, *supra* note 18, at Preamble (“Conscious of the growth and development of global capital markets and recognising the benefits of holding securities, or interests in securities, through intermediaries in increasing the liquidity of modern securities markets.”).

65. For other similar examples of such webs of relationships, see Thévenoz, *supra* note 10, at 398–99, and Thévenoz, *supra* note 35, at 856–58. See generally PAECH, *supra* note 21, at 13–15; see also UNIDROIT, *supra* note 10, at 19–21.

An additional problem with the length of holding chains is the way in which intermediaries hold securities in the name of their clients, regardless of whether they are a lower intermediary or the indirect investor. Sometimes ultimate investors or intermediaries open individual separate accounts at a particular level of the holding chain, which makes it much easier to identify the actual holder of the securities; however, in other instances, cross-border intermediaries hold securities in pooled or omnibus accounts where the ultimate investor is not easily identifiable⁶⁶ since shares of numerous shareholders are commingled.⁶⁷ By consequence, the intermediary holder knows how many shares it holds on behalf of a plurality of investors, but it cannot exactly recognize the ultimate beneficial owner because it does not keep⁶⁸ separate accounts to register the shares held for each individual client.⁶⁹

II. THE CONSEQUENCES

In the described complicated cross-border scenario, if Jean wants to exercise his rights as NewCo's shareholder, he must cope with a number of challenging issues. First, vertically, four intermediaries separate him from NewCo. This long chain is comprised of the issuer (NewCo), the CSD (Cede & Co.), a U.S. local custodian (Inter-A), an English global custodian (Inter-B), the French intermediary (Inter-C), and the ultimate investor (Jean).⁷⁰ Second, relationships among intermediaries in the holding chain are governed by a series of bilateral contracts in a way that does not fully take into account the reality of the entire holding chain.⁷¹ That means

66. See Mirjana Radović, *Supranational Regulation of Exercising Shareholders' Rights in Indirect Holding Systems*, ANNALS FAC. L. BELGRADE L. REV. 170, 172 (2012).

67. See Louise Gullifer, *Ownership of Securities: The Problems Caused by Intermediation*, in INTERMEDIATED SECURITIES: LEGAL PROBLEMS AND PRACTICAL ISSUES 1, 12–16 (Louise Gullifer & Jennifer Payne eds., 2010).

68. See *id.* at 17.

69. See Kanda, *supra* note 56, at 15 (noting that it is impossible to tell what amount of intermediated securities belongs to which customer).

70. See Micheler, *supra* note 34, at 2 (referring to cross-border investments that usually look like the following holding chain: Investor – Custodian 1 – Custodian 2 – Custodian 3 – Central securities depositary – Issuer).

71. See Eva Micheler, *Intermediated Securities and Legal Certainty* 6 (London Sch. of Econ., Law Dept., Working Paper No. 3/2014), <http://ssrn.com/>

that Jean is in privity of contract only with Inter-C, but not with any other intermediary in the holding chain.⁷² Third, from a horizontal perspective, three different national laws are involved—those of the United States, the United Kingdom, and France—with different conceptions about corporate law, property, securities, and capital markets.⁷³ Therefore, under this full constellation of actors and legal systems, it is not unreasonable to believe that Jean, the ultimate investor and beneficial owner of his NewCo shares, may be dissuaded, or even prevented, from overcoming all these jurisdictional and contractual obstacles in order to be heard at shareholder meetings. Furthermore, the lineal structure described above can be extended to all international capital markets.⁷⁴

A. *A Constellation of Contractual Relationships*

Assuming that the relevant local legislation (in principle, the law of the issuer) entitles cross-border investors to exercise their voting rights against the issuer, a preliminary problem should be solved: the bridge between the issuer and the ultimate investor is formed by a long set of bilateral (and isolated) contractual relationships among intermediaries.⁷⁵ In the example, if Jean desires to exercise his rights at a NewCo shareholder meeting in Delaware, provided that he is entitled to do so according to U.S. law, he needs to move up the securities holding ladder until he reaches NewCo. However, as mentioned earlier, Jean, the French investor, cannot jump over all the cross-border intermediaries. Instead, he only has an immediate contractual relationship with his bank in France, Inter-C. In that sense, he is at the will of his bank regarding his voting rights. If the terms of the contract acknowledge such an obli-

abstract=2336889. Micheler notes that in an intermediation chain, there is a contract (Contract 1) between the Central Securities Depository (CSD) and the intermediary directly connected with the CSD (Intermediary 1). Intermediary 1 then has a contract (Contract 2) with Intermediary 2. Intermediary 2 has a contract (Contract 3) with Intermediary 3. Intermediary 3 has a contract (Contract 4) with Intermediary 4. Finally, Intermediary 4 has a contract (Contract 5) with the ultimate investor. *Id.*

72. *Id.*

73. See Kanda, *supra* note 14, at 274–76.

74. See PAECH, *supra* note 21, at 13.

75. See Micheler, *supra* note 71.

gation, Inter-C must exercise Jean's voting rights on his behalf.⁷⁶

The story is not over yet. Jean's efforts run the risk of being useless. Inter-C contractually depends on Inter-B, its upper intermediary, and Inter-B, in turn, depends on Inter-A to pass the voting rights up the holding chain. In a nutshell, Jean is held hostage by cross-border intermediaries in exercising his corporate voting rights. A single fault in the holding chain would derail the process of transferring the voting rights from NewCo to Jean and from Jean to NewCo. This could happen either because any of the bilateral contracts among the different intermediaries does not acknowledge the voting rights or because one of the different local legal systems (United States, United Kingdom, or France) does not recognize such intermediaries' obligations as mandatory.⁷⁷ To cope with this situation, Jean may agree with Inter-C to include a provision in their bilateral contract which obliges Inter-C to include in its bilateral contract with Inter-B a similar provision with the purpose to ensure the transfer of Jean's rights further up the securities holding chain. However, because Jean is contractually bound neither with Inter-B nor Inter-A, he may encounter serious hurdles in passing his corporate rights beyond Inter-B.⁷⁸

The web of relationships among cross-border intermediaries is mostly governed by contracts.⁷⁹ Their provisions are the result of the contractual freedom among the concerned parties. However, ultimate retail investors are faced with a variety of inconveniences. On one side, they have little market power to influence the contractual relationships between each financial intermediary.⁸⁰ Disseminated share-

76. *Id.* at 6–7 (noting that, if the end-investor is merely a retail customer without any bargaining power vis-à-vis his intermediary, he or she is inclined to accept the standard terms offered by the intermediary).

77. *See Micheler, supra* note 34, at 67; *see also UNIDROIT supra* note 10, at 20.

78. *See Micheler, supra* note 71, at 7 (noting that the process of drafting contractual documentation repeats the same terms and conditions at each level of the securities holding chain and explaining, “[e]ven if an ultimate investor is able to and interested in negotiating the terms of contract 5 which he enters into with Intermediary 4, he does not have the right to see contracts 1, 2, 3, or 4 or request amendments to these contracts”).

79. *Id.* at 6.

80. *See Michael C. Schouten, The Political Economy of Cross-Border Europe*, 16 COLUM. J. EUR. L. 1, 5, 35–36 (2010).

holder structures are unable to prevent large intermediaries from deviating from the investors' best interests. In these cases, ultimate investors do not have very compelling economic incentives to invest personal resources in improving their voting mechanisms along the holding chain.⁸¹ Because of the high degree of dissemination, retail investors need to find more effective solutions for the free rider problem. On the other side, intermediaries do not have sound economic grounds to exercise voting rights because all dividends are accrued to the ultimate investor.⁸²

B. *Shortcomings of the Different Domestic Legal Frameworks in Place*

A real example of how chains of intermediaries reduce legal certainty for end-investors can be drawn from a recent opinion in the United Kingdom.⁸³ In *Eckerle*, an English corporation was headquartered in Germany.⁸⁴ The English shares were also listed on the German stock market.⁸⁵ At the 2011 shareholder meeting, three minority shareholders, holding altogether around six percent of the equity, lost the proposal for dividend distribution against a coalition of majority shareholders.⁸⁶ One year later, the resulting board of directors, representing the interests of the majority shareholders, proposed to turn the corporation into a private, limited one.⁸⁷ The plan jeopardized the shares' marketability, causing them to lose much of their market value.⁸⁸ As a result, the minority shareholders filed a complaint before English courts, seeking pro-

81. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 66–67 (1st ed. 1991) (“When many are entitled to vote, none expects his votes to decide the contest. Consequently, none of the voters has the appropriate incentive to study the firm’s affairs and vote intelligently. If, for example, a given election could result in each voter gaining or losing \$1000, and if each is sure that the election will come out the same way whether or not he participates, then the voter’s optimal investment in information is zero.”).

82. See Radović, *supra* note 66, at 173.

83. *Eckerle v. Wickeder Westfalenstahl GmbH*, [2013] EWHC (Ch) 68; see also Micheler, *supra* note 48, at 120–21; Micheler, *supra* note 34, at 15–17.

84. See *Eckerle*, [2013] EWHC.

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

tection on the grounds that such a change triggered effects similar to a takeover action.⁸⁹ They argued that the court should force the majority shareholders to buy out the residual shares at the pre-existing market price.⁹⁰

Basically, *Eckerle* revolved around the issue of whether those minority shareholders had legal standing to file an action to set aside the corporate transformation approved by the majority of shareholders. According to the U.K. Companies Act, the plaintiff shareholders were required to hold at least five percent of the company's share capital measured in nominal terms in order to have standing.⁹¹ To resolve this matter, the court answered two essential questions. Firstly, which of the three plaintiffs could be strictly considered legal *holders* of the intermediated shares according to English law?⁹² Secondly, once the shareholders were identified, how could their shareholdings be computed for the five percent minimum stake to have standing before courts?⁹³

Eventually, the court ignored the cross-border reality of the intermediated shares. Because the corporation was incorporated in England, the court inspected the shareholders' register in that country.⁹⁴ The register contained only two references, one of an individual, the firm's CEO, holding one share, and one of a financial intermediary, the Bank of New York Depository Ltd (B.N.Y.D.), which held the remaining shares.⁹⁵ Unfortunately for the plaintiffs, there was no hint of the alleged shareholdings in the shareholders' register. B.N.Y.D. was a sub-intermediary that held the shares on trust for an upper-tier intermediary in Germany, Clearstream AG, the company in charge of securities trading in the German stock exchange.⁹⁶ Even more surprising in light of the court's ruling, the shares were only listed in that country.⁹⁷ Naturally,

89. *Id.* at 204–10; *see also* Micheler, *supra* note 48, at 120–21; Micheler, *supra* note 34, at 15–17.

90. *Id.* at 197.

91. *Id.* at 197.

92. *Id.* at 204–05 (discussing the differences in English law between allotment and registration).

93. *Id.* at 205.

94. *See* Micheler, *supra* note 48, at 119–20 (discussing the cross-border complexity of intermediated shares and the registration issue in *Eckerle*).

95. *Eckerle* [2013] EWCH, at 202–04.

96. *Id.* at 202–04.

97. *Id.* at 200.

like B.N.Y.D., all the Clearstream clients were required to be financial entities responsible for managing the electronic trading orders received from the ultimate investors, like the plaintiffs.⁹⁸ As a result, the plaintiff shareholders were not direct owners of the English corporation; instead, they held an indirect equity interest through a cross-border chain of custodians in Germany and the United Kingdom, which was subject to different corporate laws.⁹⁹

This real example shows why holding shares through cross-border intermediaries leads to numerous shortcomings for modern corporate law.¹⁰⁰ The court eventually denied the standing and dismissed the complaint based on a literal interpretation of the Companies Act that a *shareholder* or *the holder of a share* was only one whose name was formally registered in the shareholders' register.¹⁰¹ Therefore, investors who benefit from the ultimate economic interest in shares registered in the name of a third party cannot be formally deemed *shareholders*.¹⁰² In other words, the court set a maxim: One who is not in the issuer's books does not exist for the purposes of national corporate law.

If the conclusions from *Eckerle* were transposed to the complex scenario described for Jean above, he would be deprived of all enforceable rights against NewCo, the issuer of his shares, unless U.S. law provided for an appropriate legal solution. But again, the legal uncertainty persists because the solution is left in the hands of the relevant national legislature.

In *Eckerle*, the standard protection set by the English court for the holders of intermediated shares was very low. The court disregarded the underlying financial reality among the parties involved. Certainly, the plaintiffs were not registered as *formal shareholders* in the issuer's books in the United Kingdom. Nonetheless, it is hard to deny the fact that the ultimate investors are indeed the parties who bear the economic risk of their

98. *Id.* at 202–04.

99. *Id.* at 204–10; see Micheler *supra* note 48, at 120–21; see also Micheler, *supra* note 34, at 15–17.

100. See LOUIS GULLIVER & JENNIFER PAYNE, INTERMEDIATED SECURITIES: LEGAL PROBLEMS AND PRACTICAL ISSUES 87–208 (2010).

101. See *Eckerle* [2013] EWCH, at 204–05; see also Micheler, *supra* note 38, at 121.

102. See Micheler, *supra* note 48, at 121.

investment decisions.¹⁰³ In fact, the court itself indicated that the outcome achieved was not a particularly adequate one since the minority shareholders lost the kind of legal protection that every shareholder, foreign or national, would have expected to enjoy under the Companies Act.¹⁰⁴ However, the court believed that a different interpretation of the law would have involved “an impermissible form of judicial legislation.”¹⁰⁵ The judicial response in *Eckerle*, mainly due to an outdated legislative approach about modern international corporate and securities law,¹⁰⁶ could be viewed as not providing the level of legal hospitality that foreign investors might expect from the courts of the City of London, one of the largest financial centers in the world. Furthermore, the decision does not reflect the trends and practices in the international securities markets.¹⁰⁷ Who would be willing to acquire shares under foreign law when the Companies Act denies the basic rights for risk-bearers abroad? From the very beginning, German risk-bearers believed that they held U.K. shares, but they found out that English law did not recognize them as actual shareholders.¹⁰⁸ Consequently, in order to bring more legitimacy and transparency to the process of corporate voting across jurisdictions, securities issuers should gradually grant financial in-

103. See Schouten, *supra* note 80, at 4 (noting that one of the issues created by holding chains is that “the person who is legally entitled to vote might turn out to be a financial intermediary instead of the investor who bears the risk of the investment (the ‘ultimate investor’)”).

104. See *Eckerle* [2013] EWHC, at 209–10 (“I am conscious that my reading of the Act does deprive the claimants as indirect investors of the sort of protection which those who formulated the 2006 Act thought ought to be extended to minority shareholders. That is not a particularly comfortable conclusion at which to arrive[.]”).

105. *Id.*

106. See Paech, *supra* note 8, at 3 (noting that the practice in developed markets is governed by intermediation and the centralized clearing and settlement of securities, which enhances liquidity and reduces costs. However, jurisdictions have not even digested the emergence of all these aforementioned phenomena, consequently, laws have become complex and inconsistent with the underlying economic reality).

107. *Id.* (noting that legal certainty requires that the law be adapted to the new reality of intermediated systems in capital markets. This lack of adaptation causes, among other problems, the misattribution of rights by intermediaries, against which courts and legislatures have found complex or even mutually exclusive solutions).

108. See Micheler, *supra* note 48, at 120–21.

intermediaries major access to the identity of the ultimate account holders, and national legislatures should enact softer rules on end-investors disclosure and communication.

The fact that an intermediary, by merely being registered in the shareholders' book of a company, can be empowered with all the rights stemming from the shares creates a dangerous interpretation that jeopardizes the traditional doctrines of the principal-agent theory.¹⁰⁹ According to the principal-agent theory, shareholders, as the beneficial owners of the company, lack sufficient business expertise and specialized knowledge to deal with complex business situations.¹¹⁰ In order to overcome this deficiency, they appoint a group of people—a board of directors or a management team—as an agent to manage their assets on their behalf and for their best interests.¹¹¹ Despite this clear mandate, on occasion, the managers' self-interests deviate from those of their legitimate principals and, as a result, so-called "agency costs" emerge.¹¹² Jurisdictions with various distinct legal traditions and corporate governance systems have developed different devices to respond to the problem of separation of ownership and control, but shareholder voting has been the most important so far.

But what if the ultimate risk-bearers are not entitled to vote according to the law of the issuer? Or, perhaps, it is the law of the intermediary that impedes investor voting. How could they monitor and oversee the board of directors if they are deprived of the basic alignment mechanisms? How would risk-bearers implement incentives or measures against managers' potential egregious behavior when they are not even recognized as *owners* by a local court? How can they vindicate their rights arising out of their investment at the shareholder meeting?¹¹³ After all, they are the ones who bear the risk and have an economic incentive to do that. Is it fair to deprive ul-

109. See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

110. *Id.* at 308.

111. *Id.* at 311–12.

112. *Id.*

113. See Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227 (2008) (explaining the complexities of the U.S. corporate voting system and the underlying intermediated-ownership structure and how these problems create fundamental legal challenges for the shareholders' exercise of corporate rights).

mate investors of all their rights because a financial intermediary was registered instead in a shareholders' register?¹¹⁴ Does the relevant intermediary have an incentive to properly represent the interests of the end-investors at shareholder meetings? Part III presents answers to many of these questions.

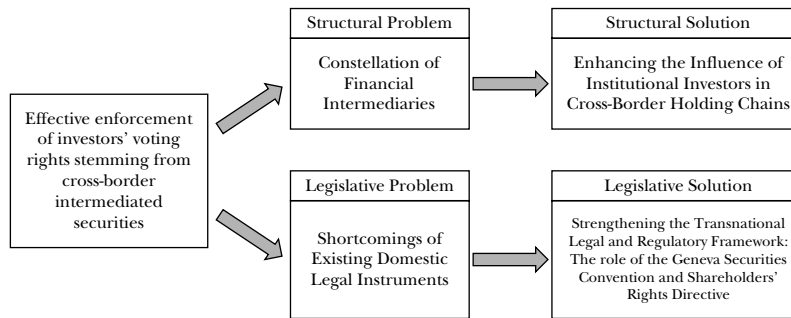
III. THE REMEDIES

Answering questions related to shareholders' rights within intermediated securities holding systems is certainly not a simple undertaking. To remedy the problems caused by the cross-border market infrastructure, ultimate investors may resort to different solutions. There could be room for more flexible alternatives, but each require the involvement, to a greater or lesser extent, of all the parties concerned: domestic legislatures, international organizations, corporations, financial regulators, intermediaries, and, of course, ultimate investors. The most satisfactory remedy should be the one where ultimate *actual* investors who hold intermediated securities are capable of exercising their corporate rights as if they were actually *formal* investors.

To achieve this goal, a combination of legislative and structural remedies would be necessary. If either is lacking, end-investors' rights are hardly exercisable through the cross-border holding chain against the companies, given the risks of malfunctioning. The solution therefore involves, first, giving a greater role to institutional investors to influence contractual relationships vis-à-vis intermediaries, and second, increasing momentum for transnational legal instruments, like the Geneva Securities Convention or the Shareholder Rights Directive, to counter the resistance and inflexibility of national legislation. The Chart below sheds light on the proposed strategy.

114. See Schouten, *supra* note 80.

FIGURE 6



A. *Structural Solution: Enhancing the Influence of Institutional Investors in Cross-Border Securities Holding Chains*

Results from the process of negotiation among the major interlocutors in holding chains have been relatively meager thus far. Some parties, particularly financial intermediaries, have a strong interest in preserving the cross-border complexity along the holding chain.¹¹⁵ On the one hand, if intermediaries are required (by law or by contract) to provide voting services, they would not miss the opportunity to charge high fees.¹¹⁶ On the other hand, if they are not required to provide that sort of services, they would not have any incentive to promote a change in the contractual conditions with ultimate investors because intermediaries are not the beneficial owners of such agency activity.¹¹⁷

In this context, institutional investors may be the missing piece of the puzzle. Rapid growth has rendered institutional investors well-prepared to vindicate voting rights on behalf of not only their clients but also all small retail shareholders. With their increasing weight in the shareholder base of publicly traded corporations, institutional investors enjoy favorable conditions of negotiation against financial intermediaries. This tilts the negotiating balance significantly in their favor, generating positive effects for all ultimate owners, regardless of whether they are represented by institutional shareholders or act in their own name.

115. *See id.*

116. *Id.* at 5.

117. *Id.* at 35.

As an example, this section will focus on the capital markets of major jurisdictions. Traditionally, most of the U.S. shareholder base has been defined by its large degree of dispersion.¹¹⁸ Similarly, the United Kingdom has traditionally been classified as a jurisdiction with a widely held ownership base in public corporations.¹¹⁹ However, both jurisdictions have progressively evolved to positions where most of the shares are held by a small number of institutional shareholders.¹²⁰ In contrast, jurisdictions that have been usually characterized by a highly concentrated domestic shareholder base, such as those of continental Europe, have gone through a process of shareholder dispersion due to the increasing receptiveness of domestic public corporations to international institutional investors.¹²¹ Within the European Union, most securities are held by institutional investors, especially with respect to cross-border relationships.¹²²

In the United Kingdom, in particular, institutional investors have become very powerful in recent years,¹²³ and the degree of share concentration by institutional investors has risen dramatically in the last decades.¹²⁴ Additionally, another collateral change in U.K. shareholder ownership comes from a shift in the nationality of investors who hold shares in public corporations.¹²⁵ Observing an average publicly traded company today, many of the institutional investors are from over-

118. See CHRISTIAN ANDRES ET AL., *CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE* 43 (H. Kent Baker & Ronald Anderson, eds. 2010).

119. See *id.* at 44.

120. See generally Paul Davies, *Shareholders in the United Kingdom* (Eur. Corp. Governance Inst., Working Paper No. 280/2015, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2557680 (explaining the grounds for the rise of institutional shareholders in the United Kingdom); see also Commission on Corporate Governance, *Report of the New York Stock Exchange*, 12 (Sept. 23, 2010) (commenting that institutional investors have dramatically increased their share ownership since the 1950s).

121. See Enriques & Volpin, *supra* note 6, at 128 (noting that the reforms in continental Europe with regard to corporate governance have been made with the purpose of increasing the attractiveness of national capital markets to international investors).

122. See OBSERVATOIRE DE L'ÉPARGNE EUROPEENNE, *supra* note 24.

123. See Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 9 (2011).

124. See Davies, *supra* note 120, at 3–4.

125. *Id.* at 21.

seas,¹²⁶ mainly the United States and continental Europe. This shift toward cross-border intermediated securities shows the increasing weight of international institutional investors. The rapid internationalization of British financial markets has altered the origin and the level of share concentration by institutional investors.¹²⁷ By way of contrast, in 1963, retail individuals owed 54% of all publicly traded shares in the United Kingdom as compared to the remaining 46%, owned generally by various sorts of institutional investors.¹²⁸ In 2012, 89.3% of the shareholder base was composed of institutional investors with 53.2% from overseas.¹²⁹

Similar conclusions can be drawn based on the U.S. market. The first decade of the twenty-first century witnessed tremendous changes in the composition and influence exerted by shareholders of publicly held corporations.¹³⁰ The current complexity of the U.S. shareholder reality can no longer be described in terms of individuals versus institutions. “[I]t’s all institutions now . . . [For] the average company, 75 percent of their shares are owned by institutions, answered a scholar to a qualitative research survey commissioned by the Aspen Business and Society Program in late 2013.”¹³¹ Therefore, only 25% of the corporate equity is owned by retail investors, an amount that is very far from the former 93% held sixty years ago.¹³² This data proves a clear shift away from a culture of

126. *Id.* at 6.

127. *Id.* at 3–4.

128. *Id.* at 3. In particular, insurance companies, 10%; pension funds, 6.4%; other financial institutions, 11.3%; unit and investment trusts, 1.3%; banks, 1.3%; and overseas institutional investors, 7%. *See id.* at 27. Table 1 sets out the data produced by the Office of National Statistics’ surveys of the beneficial ownership of listed U.K. equities since 1963. *Id.*

129. *Id.*

130. NYSE, REPORT OF THE NEW YORK STOCK EXCHANGE COMMISSION ON CORPORATE GOVERNANCE 12 (2010).

131. ASPEN INST. BUS. & SOC’Y PROGRAM, UNPACKING CORPORATE PURPOSE: A REPORT ON THE BELIEFS OF EXECUTIVES, INVESTORS AND SCHOLARS 28 (2014), <https://dorutodpt4twd.cloudfront.net/content/uploads/files/content/upload/Unpacking%20Corporate%20Purpose%20May%202014.pdf>.

132. ABA SECTION OF BUS. LAW CORP. GOVERNANCE COMM., REPORT OF THE TASK FORCE ON DELINEATION OF GOVERNANCE ROLES AND RESPONSIBILITIES 15 (2009); *see also* ASPEN INST. BUS. & SOC’Y PROGRAM, OVERCOMING SHORT-TERMISM 2 (2009), http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf (stating that one third of corporate equity is held by mutual and hedge funds in the United States.).

individual ownership toward one of institutional ownership, especially ownership in those companies with the largest market capitalization.¹³³

The information above demonstrates that the trend of share concentration by institutional investors is conclusive.¹³⁴ To provide an example, investment managers, like Blackrock or Fidelity, practically have a ubiquitous presence in corporate America.¹³⁵ Blackrock, in particular, manages around \$4 trillion in assets,¹³⁶ enabling it to be “the single largest shareholder in one of every five United States companies.”¹³⁷ For instance, Blackrock controls a large block of shares in key companies for the national economy, such as JPMorgan Chase, Wal-Mart, and Chevron, owning “5 percent or more of roughly 40 percent of all publicly traded companies in the country.”¹³⁸ These figures are indicative of the enormous impact that these asset managers can exert on cross-border securities intermediaries. Furthermore, in 2012, Blackrock cast votes on behalf of its clients on 129,814 proposals at 14,872 shareholder meetings around the world, 3800 of them for U.S. corporations.¹³⁹ With such large stakes and power to influence, if Blackrock decided that the applicable contractual terms were actually detrimental to their clients (the ultimate beneficial owners), the existing securities holding terms could be subject to a substantial review.

This Note has already argued that institutional investors have sufficient market power to affect intermediaries’ behavior. Despite this ability, such investors’ propensity to vote depends primarily on the procedural costs of voting, or the costs involved with the technical process of exercising the vote. Since these costs are particularly high in the present cross-border context, additional legal reforms and technological pro-

133. *Id.*

134. See Guangyao Zhu, *The Extinction of Widely Held Public Companies* 11–13, 40 (February 13, 2015) (unpublished manuscript), <https://www.dropbox.com/s/uw819g1tnphjnz/JMP-Guangyao-Zhu.pdf?dl=0>.

135. See David Yermack, *Private Benefits of Control—Restructuring Firms & Industries* 4 (Apr. 2015) (unpublished manuscript) (on file with author).

136. See Susanne Craig, *The Giant Shareholders, Quietly Stirring*, N.Y. TIMES (May 18, 2013), http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html?_r=0.

137. *Id.*

138. *Id.*

139. *Id.*

gress aimed at lowering these costs will encourage foreign institutional investors to vote.¹⁴⁰ The applicability of “*blockchain*” or “*distributed ledger*” technology could be a solution to increase speed and reduce costs in processing investors’ votes and other corporate actions in cross-border securities holding structures. Nonetheless, market regulators and national legislatures are still considering the potential benefits and drawbacks of these cutting-edge mechanisms.¹⁴¹

B. *Legislative Solution: Strengthening the Transnational Legal and Regulatory Framework*

Enhancing the role of institutional investors to influence the contractual terms along intermediated securities holding chains is a necessary but hardly sufficient ingredient for an effective collective response in favor of investors’ rights. The legal construction of traditional corporate law has been based on identifying the formally recorded holder of the shares.¹⁴² This issue is paramount to determining who can actually exercise the rights attached to the shares.¹⁴³ Nonetheless, domestic legislatures never thought about transferability in heavily interconnected capital markets or the resulting impact from ongoing financial globalization. They simply enacted rules based on thinking of domestic acquirers for domestic issuers. As a result, the applicable corporate law is still broadly national.¹⁴⁴ By contrast, modern capital markets have been characterized by a heavy internationalization due to electronic book-entry sys-

140. See Zetzsche, *supra* note 30, at 302–03.

141. See Nora Rachman & Maria Vermaas, *Corporate Actions in the Intermediated System: Bridging the Gap Between Issuer and Investor*, in *TRANSNATIONAL SECURITIES LAW* ¶ N-6-12 (Thomas Keijser ed., 2016) (Mar. 2016 online update to 2014 Edition from Oxford Legal Research Library).

142. See Thévenoz, *supra* note 35, at 846 (referring to the transparent systems in place in some jurisdictions where shareholders of a (domestic) company can be individually identified); see also Luca Enriques, Matteo Gargantini & Valerio Novembre, *Mandatory and Contract-based Shareholding Disclosure*, 15 *UNIF. L. REV.* 713, 718–724 (2010).

143. See Nora Rachman, *Securities Trading Meets Corporate Law: What Are “Securities” and Who Holds Them? Trends and Patterns in Brazilian Law*, 15 *UNIF. L. REV.* 833, 836 (2010).

144. See Philipp Paech, *Intermediated Securities and Conflict of Laws 1* (June 14, 2014) (conference on ‘Investing in Securities’ Harris Manchester College, University of Oxford, May 16, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2451030.

tems.¹⁴⁵ In such systems, securities are represented by credits made in the securities accounts kept by financial intermediaries at each link of the holding chain.¹⁴⁶ While purely domestic systems may be consistent and sound from the top intermediary to the ultimate investor, in today's capital markets, most cross-border securities transactions are completed with a network of financial intermediaries located in different jurisdictions that credit or debit the securities to the corresponding securities account.¹⁴⁷

As a consequence of this legislative isolation, various jurisdictions devised different approaches to modern securities and corporate law. *Eckerle* is only one of many examples of how national legislatures have set out their own particular vision about corporate concepts such as securities, issuers, shareholders, investors' rights, or intermediated holding chains.¹⁴⁸ In fact, some scholars distinguish five distinctive holding models with direct implications for the conceptions of property, securities, corporate governance, and capital markets: the trust system (found in the United Kingdom, Ireland, and most of the Commonwealth countries), the securities entitlement regime (with a presence in the United States and Canada), the pooled property or co-ownership model (in Germany, Austria, and Japan), the transparent model (in Spain, China, Poland, Brazil, and the Scandinavian countries), and the ownership scheme (found in France and other countries following the Napoleonic Code).¹⁴⁹ Against this background, if a securities holding chain begins or ends in another jurisdiction with a different characterization about the bundle of rights that ultimate investors may receive and enforce, a problem of legal uncertainty regarding investor protection may arise.

The fragmentation of legislation can be sustainably addressed only through international cooperation, by adopting

145. See Faria, *supra* note 13, at 200.

146. See Francisco J. Garcimartín Alférez, *Disposition and Acquisition of Intermediated Securities: The Geneva Convention and Traditional Property Law*, 15 UNIF. L. REV. 743 (2010).

147. See *Harmonised Substantive Rules Regarding Intermediated Securities—Two Seminars on the UNIDROIT Project*, 10 UNIF. L. REV. 824, 825 (2005).

148. See, e.g., Rachman, *supra* note 143, at 836–39 (comparing Brazilian corporate law to the Geneva Securities Convention).

149. See PAECH, *supra* note 21, at 14–19 (providing a full explanation and description of each securities holding scheme).

legal instruments with binding effects for the contracting states. Efficient cross-border holding chains are not especially useful if states do not assume the commitment to acknowledge corporate rights for intermediated ultimate investors vis-à-vis the issuer. The Geneva Securities Convention is the most important endeavor carried out by the international community to tackle the problem concerning the exercise of cross-border voting rights of intermediated securities. Within the European Union, the issue has been partially solved thanks to the Shareholder Rights Directive. Further improvements in the field have nonetheless been subjected to an intense debate with the purpose of facilitating the exercise of corporate rights in the area of E.U. securities law.¹⁵⁰

1. *The Geneva Securities Convention*

The 2009 Geneva Securities Convention, in particular, is currently the most ambitious transnational legal instrument. Although not yet entered into force, it seeks, in a cross-border scenario, the global compatibility and convergence of substantive legal frameworks and, at the national level, aims to ensure the internal soundness and well-functioning of the domestic holding structure.¹⁵¹

The Convention devotes specific provisions to the substantive regulation of the exercise of investors' rights, on the one hand, and the obligations of financial intermediaries, on the other hand.¹⁵² First, the Convention leaves intact the corporate rights conferred to investors by the relevant domestic

150. See EUR. COMM'N, SUMMARY OF THE SEVENTH MEETING OF THE MEMBER STATES WORKING GROUP ON SECURITIES LAW LEGISLATION (2013), http://ec.europa.eu/finance/financial-markets/docs/securities-law/130524_minutes_en.pdf (discussing the possible ways to improve legal certainty and client asset protection as well as facilitate the exercise of corporate rights in the area of securities law).

151. See ROY GOODE, HERBERT KRONKE & EWAN MCKENDRICK, *TRANSNATIONAL COMMERCIAL LAW* 433–34 (2d ed. 2015) (quoting and discussing the Preamble). See particularly the Second, Third, and Fourth items of the Preamble, emphasizing the protection of persons who acquire or hold intermediated securities, the reduction of legal and systemic risks in domestic and cross-border transactions, and the need to enhance the international compatibility of legal systems and the soundness of rules relating to intermediated securities.

152. For a full explanation and interpretation of the Geneva Securities Convention, see HIDEKI KANDA ET AL., *OFFICIAL COMMENTARY ON THE*

law.¹⁵³ Moreover, the Convention does not expressly set out who the corporation must recognize as the holder of securities (either the account holder, the intermediary, or a third party).¹⁵⁴

Article 9, titled “Intermediated Securities,” expressly states a list of core corporate rights attached to securities that investors must receive and be able to exercise, including dividend distributions and voting rights.¹⁵⁵ Together with this bundle of rights, the domestic (non-Convention) law may provide additional corporate rights to investors,¹⁵⁶ such as the right to access corporate information.¹⁵⁷ The breakthrough of this new approach provided by the Convention is not how corporate rights should come into existence or be regulated (since this aspect depends on the relevant domestic law) but rather how they should flow through the chain of intermediaries across borders.¹⁵⁸ For that reason, Article 10 of the Convention reinforces Article 9 with an essential provision requiring financial intermediaries to pass the voting rights attached to the securities down through the intermediary chain to whoever is entitled to receive and exercise them.¹⁵⁹ Article 10 states that “[a]n intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 9(1).”¹⁶⁰ Specifically, the intermediary must “give effect to any instructions given by the account holder or other authorized person, as provided by the non-Convention, the account agreement or the uniform rules of a securities settlement system”¹⁶¹ and “regularly pass on to account holders information relating to intermediated securities, including necessary for account holders to exercise rights, if provided by the

UNIDROIT CONVENTION ON SUBSTANTIVE RULES FOR INTERMEDIATED SECURITIES (2012).

153. See Thévenoz, *supra* note 35, at 848–49.

154. *Id.* at 849.

155. UNIDROIT, Convention on Substantive Rules for Intermediated Securities, *supra* note 18, at art. 9(1)(a)(i).

156. *Id.* at art. 9(1)(a)(ii) and 9(1)(d).

157. See GOODE, KRONKE & MCKENDRICK, *supra* note 151, at 435.

158. *Id.*

159. *Id.*; see also Thévenoz, *supra* note 35, at 848–49 n.8.

160. UNIDROIT, Convention on Substantive Rules for Intermediated Securities, *supra* note 19, at art. 10(1).

161. *Id.* at art. 10(2)(c).

non-Convention law, the account agreement or the uniform rules of a securities settlement system.”¹⁶²

In short, the Convention represents a major example of how international cooperation is absolutely critical to harmonize transnational rules in order to enhance legal certainty in the exercise of corporate rights arising out of securities held indirectly by investors.¹⁶³

2. *The Shareholder Rights Directive*

Although less geographically ambitious than the Geneva Securities Convention, the Shareholder Rights Directive has proven to be a more successful legal instrument in the process of harmonizing intermediated securities regimes, in particular with regard to the strengthening of voting rights by shareholders across the European Union.¹⁶⁴ In a wave of corporate governance reforms after the series of financial and accounting scandals that occurred at the start of the 2000s, the E.U. legislature deemed it urgent to give shareholders a greater voice in cross-border voting.¹⁶⁵ Both fragmented national regulation and multiple layers of financial intermediaries between securities issuers and end-investors across Member States were considered eminent obstacles that needed to be tackled through intensive legal harmonization.¹⁶⁶ The E.U. legislature became aware of the inverse relationship between complexity of intermediated holding structures, in addition to legal disorganization among Member States, and cross-border corporate voting efficiency. Since end-investors were frequently trapped by the lack of cooperation of financial intermediaries, who enjoyed no economic return when exercising corporate rights on be-

162. *Id.* at art. 10(2)(e).

163. See José Angelo Estrella Faria, *Sphere of Application of the UNIDROIT Convention on Substantive Rules for Intermediated Securities and Future Work by UNIDROIT on a Legislative Guide for Emerging Financial Markets*, 15 UNIF. L. REV. 357, 357 (2010) (asserting that the main purpose of the *Convention* is to offer harmonized transnational rules for the purpose of reducing the legal risk associated with the holding of securities through intermediaries).

164. See Shareholder Rights Directive 2007/36, 2007 O.J. (L 184) (EC), recital (2).

165. See *id.* recital (5) (considering that significant proportions of shares in listed companies are held by shareholders who do not reside in the Member State in which the company has its registered office).

166. See *id.* recitals (11), (14).

half of end-investors,¹⁶⁷ further substantive reforms were necessary.

Despite the good intentions of the E.U. legislature to provide increased legal certainty in casting corporate votes at shareholder meetings,¹⁶⁸ the Shareholder Rights Directive has suffered from a couple of substantial flaws since its inception. First, *shareholder* was defined as “the natural or legal person that is recognized as a shareholder under the applicable law.”¹⁶⁹ That definition, set forth in Article 2(b), was not the most suitable match for the current standards that cross-border intermediated securities holding chains demand. Instead of conceptualizing a binding, harmonized definition of *shareholder*—as the ultimate holder of corporate rights—across Member States, the E.U. legislature preferred to leave the final answer to each national legislature.¹⁷⁰ As *Eckerle* shows, the issue is that the legal concept of shareholder varies from jurisdiction to jurisdiction. For instance, in those jurisdictions where the formal definition of shareholders does not encompass the idea of actual ultimate beneficial owners or end-investors, the duality problem between risk-bearers and legal owners remains where transnational exercising of corporate rights takes place.¹⁷¹

Second, Article 13 of the Directive foresees the removal of certain impediments to the effective exercise of voting rights.¹⁷² As the only article of the Directive dealing with the cross-border exercise of corporate rights through financial intermediaries, it limitedly applies where such intermediaries or custodians, acting in the course of a business on behalf of a third party, the client, are formally recognized as formal *shareholders* by the applicable law.¹⁷³ In the way that Article 13 un-

167. See Radović, *supra* note 66, at 173.

168. See Shareholder Rights Directive 2007/36, 2007 O.J. (L 184) (EC), recital (6).

169. See *id.* art. 2(b).

170. See Radović, *supra* note 66, at 177.

171. See Anthony Hainsworth, *The Shareholder Rights Directive and the Challenge of Re-Enfranchising Beneficial Shareholders*, 1 LAW & FIN. MKT. REV. 11, 12, 17–18 (2007).

172. See Shareholder Rights Directive 2007/36, 2007 O.J. (L 184) (EC), art. 13.

173. See *id.*; see also Radović, *supra* note 66, at 180–82 (discussing the limitations of the achieved level of harmonization and, in particular, the limited scope of application of Article 13).

derstands corporate voting as attached to intermediated securities, the problem of corporate cross-border voting partially remains unresolved: it gives full effectiveness to voting only vis-à-vis intermediaries that are directly registered with the company in the name of the end-investors. Nonetheless, where the holding chain becomes more complex as the number of intermediaries increases, effectiveness is satisfactorily accomplished only in the first link.¹⁷⁴

As the legislation stood for the last few years, the E.U. legislature reacted by recommending changes to these rules. The Proposal for a Directive of the European Parliament and of the Council amending (a) the Directive 2007/36/EC on the Encouragement of Long-term Shareholder Engagement, and (b) the Directive 2013/34/EU on Certain Elements of the Corporate Governance Statement, seeks to solve the said malfunctioning in intermediated securities structures across borders by improving, among other aspects, the exercise of shareholder rights.¹⁷⁵ Specifically, Article 3c requires Member States to ensure that financial intermediaries facilitate the exercise of such rights along holding chains, including the right to participate and vote at shareholder meetings.¹⁷⁶

Taking a look at the proposed amendment, it seems that the E.U. legislature is basically content with a minimum agreement on basic principles and rules on exercising corporate rights across Member States. In this regard, the process of facilitation must cover *at least* either of the following: “the intermediary makes the necessary arrangements for the shareholder or a third person nominated by the shareholder to be able to exercise themselves the rights,”¹⁷⁷ or “the intermediary exercises the rights flowing from the shares upon the explicit authorization and instruction of the shareholder and for his

174. See Radović, *supra* note 66, at 180–82; see also Thomais Kotta Kyriakou, *The Harmonisation of Corporate Actions in the European Securities Markets 19–20* (Jan. 2016) (unpublished LL.M. thesis, International Hellenic University), https://repository.ihu.edu.gr/xmlui/bitstream/handle/11544/12453/Dissertation_ThomaisKottaKyriakou.pdf?sequence=3).

175. *Proposal for a Directive of the European Parliament and of Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-term Shareholder Engagement and Directive 2013/34/EU as regards Certain Elements of the Corporate Governance Statement*, at 2, COM (2014) 213 final (Apr. 9, 2014).

176. *Id.* at 18.

177. *Id.*

benefit.”¹⁷⁸ It is evident that the reform mostly focuses on one of the key elements of the issue: the complexity and cost of intermediated holding chains, particularly where many intermediaries exist.¹⁷⁹ The implementation of the proposed amendment aims to increase efficiency and transparency in the flow of corporate rights from investors up to the issuers.¹⁸⁰ However, a key matter is still pending, which affects harmonization: the concept of *shareholder* is still left to the applicable law of each jurisdiction. As a result, different understandings of securities, the right of property, and corporate law may diminish the legal certainty of the facilitation services carried out by intermediaries and discourage end-investors from actively participating in the corporate governance of the companies.

This line of thinking pursued by the E.U. legislature is aligned with the current Eurosystem initiatives with regard to reforms for intermediated securities and capital markets. The Eurosystem implemented the Target2-Securities (T2S) system, an integrated, single platform to provide CSDs with a cross-border, cost-efficient settlement mechanism for securities transactions within the European Union.¹⁸¹ The T2S therefore has more to do with speedy and cost-efficient securities transactions, rather than their underlying legal reality, because the formal exercise of voting rights from end-investors up to companies takes place completely outside this platform.¹⁸² As a result, the T2S has strongly harmonized the rules for securities settlements across E.U. capital markets but has broadly ignored further harmonization in the field of exercising corporate rights. Whereas payment of dividends is closely connected to the T2S since securities transactions are settled on the common platform, investors’ identification, voting process, and transfer of information still flow through traditional intermediated holding channels.¹⁸³

178. *Id.*

179. *Id.* at 5.

180. *Id.* at 6–7.

181. See *Target2-Securities*, BANCO DE ESPAÑA: EUROSISTEMA, http://www.bde.es/bde/en/areas/sispago/Sistemas_de_comp/TARGET2-Securiti/TARGET2-Securities.html.

182. See Rachman & Vermaas, *supra* note 141, ¶¶ N-6-9, N-6-10.

183. *Id.* ¶¶ N-6-8, N-6-9, N-6-10.

CONCLUSION

The effective exercise of investors' rights in cross-border securities holdings has been the subject of intense debate in many legal fora, domestically and internationally. However, past measures have only offered a partial, incomplete solution to the problem of, first, a constellation of contractual relationships through securities holding structures, and second, the presence of different domestic legal frameworks.

On the one hand, the good intentions of domestic legislatures unfortunately collide with the corporate reality beyond national borders. The reaction of the international community to overcome this political limitation has been to promote forward-looking transnational legislative instruments. However, multilateral negotiations brought to light countries' inability or unwillingness to agree on a comprehensive transnational legal framework. Once irreconcilable legal (or perhaps, political) differences were established, fears of a setback arose. Eventually, countries were content with a minimum agreement on basic principles and rules of substantive law. This was the situation at the regional level when the European Union took measures to address this issue with the Shareholder Rights Directive. At the global level, the UNIDROIT Convention on Substantive Rules for Intermediated Securities was the other major example of how the international community attempted to fill this gap within securities and corporate law.

The foregoing does not negate the merits of the Geneva Securities Convention or the Shareholder Rights Directive. First, the Convention has been the first of many necessary steps in the process of transnational legal harmonization in the field of intermediated securities. As financial globalization advances, so does the need for increasing legal certainty in the cross-border exercise of corporate rights attached to intermediated securities. Second, since the enactment of the Shareholder Rights Directive, the European Union has made steady progress toward harmonization of indirectly held securities. The proposed amendment to this Directive will further improve the current legal framework, in particular with regard to shareholders' identification, flow of communication, and the exercise of corporate rights.

Although highly positive for the construction of an adequate legal framework, current supranational legal instru-

ments do not offer, by themselves, an optimal solution to the problem of corporate rights in cross-border intermediated securities scenarios. Distinct understandings of property, corporate governance, securities, and capital markets remain insurmountable differences among jurisdictions. One thing is clear: if national legislatures disregard corporate rights for holders of intermediated securities, there is not much to be done in defining and protecting investors' corporate rights at the supranational level. Further legislative changes are inarguably a necessary, though not sufficient, condition to improve the legal enforcement of such rights. In the United Kingdom, *Eckerle* is a good example of how sound efforts by all the concerned parties—the issuer, intermediaries, and ultimate investor—were unsuccessful because of the inability of the national legislature to see the underlying financial truth behind the web of formal, legal relationships. Opinions like this are a case in point for why transnational binding substantive rules, such as the Geneva Securities Convention or the Shareholder Rights Directive, are needed and why they are crucial to achieve full legal harmonization.

An effective solution requires an extra layer, even within the context of forward-looking transnational legislation: structural changes in securities holding chains. Unfortunately, long chains of intermediaries still stand between companies and ultimate investors. Against this background, end-investors can do very little in cross-border settings. First, they cannot influence a foreign legislature to amend the rules of the jurisdiction in which they buy or sell securities. Second, with little market power against large multinational intermediaries, they are more likely to be the victims of disadvantageous contractual terms that set aside the responsible exercise of corporate rights through the holding chain.

Considering the current state of unfeasibility of reaching an extensive compromise at the international level that would satisfy all countries, and acknowledging the imbalance of powers between ultimate investors vis-à-vis financial intermediaries, further isolated mechanisms of legislative harmonization are likely ruled out. Utopian propositions, such as the instauration of a global transparent holding system without intermediaries, do not present much viability. Intermediaries will not be eliminated because they simply provide a necessary service in international capital markets. However, it is practically impossible

to demand an extensive international commitment from a majority of countries in order to establish an ambitious reform on substantive rules for intermediated securities. Each country has its legal idiosyncrasies, which will not be surrendered in the short run.

Given the circumstances, the question arises as to whether it is possible to introduce structural reforms in the holding chain that enhance legal certainty for investors' rights and simultaneously meet the expectations of all the parties involved: legislatures, companies, financial intermediaries, and end-investors. As discussed in this Note, there is little room for the structural modification of intermediated holding chains, but institutional investors may play a global leading role in this regard. The ownership of companies has become very concentrated in the last decades due to the intense business activity of institutional investors, such as fund managers, insurance companies, and pension plans. As a result, the success of this proposal stems from the ability of these institutional investors to mobilize the voting power of millions of end-investors to gain bargaining power and actively build favorable contractual relationships vis-à-vis the upper intermediaries in the securities holding chain that go beyond the ongoing limitations set forth by domestic legal frameworks. In this respect, the high concentration of shares held by institutional investors will provide a platform to push financial intermediaries to implement proper contractual schemes to make end-investors capable of exercising their corporate rights along the securities holding chain, even though the ongoing level of transnational harmonization is not optimal.

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THE DUAL CLASS VOTING STRUCTURE,
ASSOCIATED AGENCY ISSUES,
AND A PATH FORWARD

KISHORE EECHAMBADI*

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INTRODUCTION

Corporations have long since become the dominant form of business organization in the United States,¹ and the ensuing funding of these corporate entities with capital from the public has resulted in a general divergence of ownership from control. This divergence in turn has given rise to spirited debate about the existence and impact of various types of agency problems associated with corporate ownership structures.² Managers are not the residual claimants of the corporations that they control and oversee and, therefore, do not fully internalize the wealth effects of their decisions. Thus, there is a powerful incentive in place to take actions that lead to private extraction of benefits at the expense of the corporation's shareholders.

Broadly speaking, corporations have three different types of ownership structures: dispersed ownership (DO), controlled structures (CS), and controlling-minority structures (CMS). Dual class corporations, the subject of this Note, fall under the category of controlling-minority structures, where a shareholder or small group of shareholders exercises control while retaining only a minor percentage of the ownership equity.³ Dual class corporations, although in existence in the

1. See generally U.S. CENSUS BUREAU, Statistical Abstract of the United States: 2012 Section 15: Business Enterprise (2011), <https://www.census.gov/library/publications/2011/compendia/statab/131ed/business-enterprise.html>. Eighty-one percent of business receipts collected by the Census came from corporations, compared with fifteen percent from partnerships and only four percent from sole proprietorships. *Id.*

2. See generally Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

3. See Lucian Arye Bebchuck, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295, 295 (Randall K. Morck ed., 2000).

United States since the 1920s, came into vogue once again during the hostile takeover wave of the 1980s due to the defensive strength that they offer against hostile acquisitions.⁴ They continued to maintain prominence during the surge of high-profile technology initial public offerings over subsequent decades.⁵ Proponents of the dual class structure argue that it allows founders and management to focus on a long-term vision for the company and not be subject to the near-term vicissitudes of market and investor opinion. However, critics contend that it is simply an excuse for founders and management to entrench themselves in power and escape accountability to shareholders.⁶ Critics have also alleged that the dual class structure, by further decoupling economic ownership and voting control, diminishes investor monitoring effectiveness and further exacerbates the basic agency problems that exist in the publicly funded corporation business form.

This Note first seeks to review the basic monitoring and agency issues associated with the dual class form, deliver a recommendation on whether American stock exchanges or regulatory entities should ban dual class structures, and offer a path forward to decrease and minimize existing problems. In Part I, I discuss the corporation control structure. After considering agency issues associated with the public corporation business form generally in Section I.A, I introduce the three different types of corporate ownership forms and examine the basic kinds of agency problems and protections that arise in each in Section I.B. Part II delves into an analysis of dual class and other CMS structures. Section II.A provides an overview of the dual class structure, including a historical background and the basic characteristics of the dual class structures found in

4. Stephen I. Glover & Aarth S. Thamodaran, *Debating the Pros and Cons of Dual Class Capital Structures*, INSIGHTS: THE CORPORATE LAW & SECURITIES LAW ADVISOR, Mar. 2013, at 12.

5. Dual class companies accounted for 20 out of 170 initial public offerings between January 2010 and March 2012, many of which were technology start-ups, such as Zynga and LinkedIn. See Joe Mont, *Dual-Class Shares Get Double Teamed by Critics*, COMPLIANCE WEEK: THE FILING CABINET (Oct. 2, 2012), <https://www.complianceweek.com/blogs/the-filing-cabinet/dual-class-shares-get-double-teamed-by-critics#.VSQB9hPF-5I>.

6. Compare Google, Inc., Registration Statement (Form S-1) (Apr. 29, 2004), with Andrew Ross Sorkin, *Stock Split for Google That Cements Control at the Top*, N.Y. TIMES DEALBOOK (Apr. 16, 2012, 9:14 PM), <http://www.nytimes.com/pages/business/dealbook/index.html>.

the market today. Section II.B evaluates the arguments of proponents and critics of dual class structures and, in particular, focuses on the agency arguments that detractors have advanced against the dual class structure. Section II.C presents a survey of the empirical study literature surrounding dual class CMS structures. Section III.A offers a recommendation on the key question of whether dual class structures should be allowed on American stock exchanges, and in Section III.B, I advance several methods by which agency problems in dual class structures can be reduced and curtailed.

I.

THE CORPORATION CONTROL STRUCTURE AND BASIC AGENCY ISSUES

A. *The Corporate Ownership Form*

Corporations have become the dominant business entity structure in the United States. In 2008, they generated eighty-one percent of the business revenue in the country, as compared with partnerships at fifteen percent and sole proprietorships at four percent.⁷ Throughout history, sole proprietorships were the prevailing form of business enterprise until the modern era, when they were overtaken in popularity by the corporation.⁸ Corporations allow founders to scale their businesses to a size and complexity that is impossible with the sole proprietorship. In particular, the ability to raise capital through public stock markets is a unique feature of the modern corporation. As a result, the rise of corporations created new agency issues not previously seen in their sole proprietorship counterparts. As Eugene F. Fama and Michael C. Jensen describe in their seminal article, “Separation of Ownership and Control,” agency problems arise and need to be controlled “when the decision managers who initiate and imple-

7. U.S. CENSUS BUREAU, *supra* note 1, at 491.

8. It is important to note here that the *number* of sole proprietorships in the United States is still far greater than the number of C- or S-class corporations; as the Tax Foundation estimates, there are 23 million sole proprietorships as compared to 1.7 million C-corporations. See Scott Hodge, *The U.S. Has More Individually Owned Businesses Than Corporations*, THE TAX POLICY BLOG (Jan. 13, 2014), <http://taxfoundation.org/blog/us-has-more-individually-owned-businesses-corporations>. However, as shown by the 2012 Statistical Abstract, the revenue of each sole proprietorship is extremely small relative to what an average C-class corporation generates.

ment important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions.”⁹ Fama and Jensen believe that, in these types of organizations, decision management will be separated from decision control and all optimally performing companies—those companies that effectively manage agency costs—will have appropriate monitoring controls in place.¹⁰ It is worth noting, however, that it is not possible nor even desirable to attempt to eliminate agency costs altogether; eliminating public stock markets or management control would dramatically reduce agency costs, yet would also result in a significant loss of efficiency and wealth. Investors must accept that, as a result of separation of ownership and control, agency costs will exist. The successful players will be the ones that best monitor and manage these costs in the quest to optimize performance and wealth.¹¹

These types of corporations typically have different organizational checks and balances in place to make sure that agency costs are mitigated and lessened. For example, a formalized decision hierarchy allows for superiors to ratify and monitor the decisions of their subordinates.¹² At the top of the hierarchy, upper-level management will in turn be monitored and supervised by an experienced and knowledgeable board of directors, which oversees important decisions and actions with some members who are independent and external.¹³ In checking and aligning managers’ motivations with the interests of the corporation, the board of directors may create incentive compensation plans to reward managers based on positive company performance.

Furthermore, there are various market-imposed checks for publicly traded corporations. The stock market is one such monitoring mechanism. If shareholders are unhappy with the actions taken by management and believe that such actions are against their best interests, a stock sell-off serves as a strong

9. Fama & Jensen, *supra* note 2, at 304.

10. *Id.* at 323.

11. I am grateful to Professor William Allen of New York University School of Law for this insight.

12. Fama & Jensen, *supra* note 2, at 323.

13. *Id.*

indicator to management of shareholder disapproval.¹⁴ Naturally, if shareholders voice their disapproval by selling shares and the stock price drops significantly, the threat of a hostile takeover will become more significant and serve as a powerful incentive for management to correct its malfeasance.¹⁵

B. *The Dispersed Ownership, Controlled Structures, and Controlling-Minority Structures Corporate Ownership Forms*

There are three basic types of control dynamics that corporations exhibit: dispersed ownership (DO), controlled structures (CS), and controlling-minority structures (CMS).¹⁶ The typical publicly traded corporation operates under a DO structure, where the corporation's stock and voting control is dispersed among many thousands, if not millions, of shareholders, none of whom have enough shares to exert control over the affairs of the company. CS firms are firms in which one shareholder or an allied group of shareholders owns enough of the company's shares to exert influence and control over the corporation. Finally, CMS corporations are those in which a shareholder controls the firm while holding only a fraction of the equity. Dual class structure firms, which are the focus of this Note, fall under this third category.

Generally speaking, CMS firms do not have the same checks and balances to limit agency costs as DO and CS structures.¹⁷ Although the classic problem outlined in Fama and Jensen's article exists in DO structures—namely, that managers will not have to fully internalize the wealth effects of their decisions—managers have little voting control and can be easily displaced or challenged by the board of directors, proxy fights, activist investors, or hostile bidders. The controllers of CMS firms do not face this threat; due to the entrenching effects of the CMS structure, managers cannot be easily dis-

14. See, e.g., Martin Peers & Keach Hagey, *Fox Withdraws Time Warner Bid*, WALL ST. J. (Aug. 5, 2014) <http://www.wsj.com/articles/fox-withdraws-time-warner-bid-1407269617>. A potential blockbuster merger between 21st Century Fox and Time Warner was abandoned largely due to the precipitous price drop in Fox's stock, signaling strong shareholder disapproval of the combination.

15. Fama & Jensen, *supra* note 2, at 313.

16. See generally Bebhuck, Kraakman & Triantis, *supra* note 3.

17. *Id.* at 301.

placed (if at all).¹⁸ In CS organizations, despite the fact that the controller is entrenched and dictates the course of the company, it will largely internalize the wealth effects of its decisions due to its large economic stake. Presumably, this helps to restrain the holder of the control bloc from taking actions detrimental to shareholders' best interests.¹⁹ CMS controllers do not have this check either, as they have a similarly dominant level of voting control with comparatively low cash-flow rights.²⁰

We can see, therefore, an initial reason for alarm with CMS firms. The traditional methods that many corporations employ to reduce agency costs, such as board of director influence, market and hostile takeover checks, and shareholder activism, cannot be utilized very successfully in CMS corporations, theoretically paving the way for much higher levels of agency abuse. Indeed, one study has indicated that controlling and founding families often employ the CMS structure to entrench themselves and derive large private benefits.²¹ There are opposing views, of course,²² but for now it can be properly stated that the potential agency dynamics arising in CMS firms are at least significantly different from their DO and CS counterparts.

II.

THE CONTROLLING-MINORITY STRUCTURE AND DUAL CLASS STRUCTURE

A. Overview

Typically, shareholder voting rights and economic rights are perfectly aligned. One share of common stock normally entitles the shareholder to one share of the cash-flow and dividend rights, and one vote in the control of the corporation.

18. *Id.*

19. *Id.*

20. *Id.*

21. Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUANTITATIVE ANALYSIS 695, 714 (2003).

22. See, e.g., Armando Gomes, *Going Public Without Governance: Managerial Reputation Effects*, 55 J. FIN. 615 (2000) (asserting that a manager's reputation for proper shareholder treatment and the hope for higher stock prices can provide a powerful incentive, even in the complete absence of strong governance policies, for controllers in CMS firms to act in the best interests of minority shareholders).

Dual class structures decouple cash-flow and voting rights, allowing shareholders of the superior voting stock to hold several votes per share of stock as opposed to the traditional one vote, one share model.²³ Dual class structures first came into existence and use in the 1920s as a method for managers to raise capital from the public while maintaining strategic control of their firms.²⁴ The advent of the dual class structure sparked fierce debate about the impact it would have on shareholder rights, and criticism of the structure culminated in a ban on dual class structures by the New York Stock Exchange (NYSE) in 1940.²⁵

After a relatively quiet four decades following the NYSE ban, dual class voting structures came back into vogue during the hostile takeover battles of the 1980s.²⁶ Dual class voting structures offer a strong takeover defense since the superior voting class of stock is usually held by a single individual or a small group and not publicly traded. As a result, no matter how much of the publicly traded inferior voting stock a hostile raider might acquire, it will almost always be outvoted by the private holders of the superior voting stock. Thus, the hostile takeover is effectively thwarted before it even begins. Furthermore, many dual class corporations avoid the potential defector problem by declaring in the corporate charter that superior voting shares are automatically converted to inferior voting shares if transferred to another party, making it impossible for a hostile acquirer to woo superior voting shareholders

23. In the United States, dual class firms typically have two classes of stock, and the most common vote to share ratio seen in superior-voting shares is ten-to-one; this ratio is present in the superior-voting shares of companies such as Facebook and LinkedIn. See Myles Udland, *Facebook Has a New Class Structure and Mark Zuckerberg is Still in Control*, BUS. INSIDER (Apr. 27, 2016, 4:34 PM), <http://www.businessinsider.com/facebook-new-stock-structure-2016-4>; Steven Davidoff Solomon, *A Deeper Look at LinkedIn's Structure*, N.Y. TIMES (May 12, 2011, 4:01 PM), <http://dealbook.nytimes.com/2011/05/12/a-deeper-look-at-linkedins-structure/>. Many companies choose to deviate from this default, like Zynga, which has three classes of stock, one of which is reserved to the founder and carries a ratio of seventy-to-one votes per share. See Gary Rivlin, *Zynga's IPO Gives Founder Mark Pincus a Stock Class All His Own*, DAILY BEAST (Dec. 14, 2011, 6:18 PM), <http://www.thedailybeast.com/articles/2011/12/14/zynga-s-ipo-gives-founder-mark-pincus-a-stock-class-all-his-own.html>.

24. See Glover & Thamodaran, *supra* note 4, at 2.

25. *Id.*

26. *Id.*

with a premium offer.²⁷ Although the NYSE ban on dual class structures was still in effect at the beginning of the 1980s, companies seeking to implement the structure would simply list on the NASDAQ stock exchange instead, prompting the NYSE to eventually withdraw its ban in order to stay competitive.²⁸

The Securities and Exchange Commission (SEC), alarmed at the proliferation of dual class structures during the 1980s, promulgated Rule 19c-4 in 1988. In effect, Rule 19c-4 sought to prohibit the listing of a corporation's stock on a national security exchange if it had taken any action to nullify or restrict the voting rights of existing shareholders.²⁹ Although this was not a strict ban on dual class structures or a mandate for a universal one share, one vote policy, the rule sought to impose various restrictions on the issuance of dual class common stock. This regulation was extremely short-lived, however, and was struck down by the D.C. Circuit as an overreach of the SEC's rulemaking authority.³⁰ Thereafter, any restriction on dual class voting structures depended on the rulemaking power of the individual exchanges (although states do have the authority to regulate dual class structures, in almost all cases they have declined to do so).³¹ The exchanges implemented a compromise solution: IPOs for companies with existing dual class structures would be permitted, whereas companies that were already listed would be prohibited from restructuring the stock into a dual class system.³² This compromise remains in force today.³³

Presently, approximately five to ten percent of listed companies, as measured either by number of companies or market

27. See, e.g., UNITED PARCEL SERVICES, INC., RESTATED CERTIFICATE OF INCORPORATION 5 (2010) (holding that Class A shares will automatically convert to Class B shares if given to an individual who is not a "permitted transferee").

28. Glover & Thamodaran, *supra* note 4, at 2.

29. For a detailed discussion of Rule 19c-4, its fate in the D.C. Circuit Court, and subsequent regulation of dual class structures on the national security exchanges, see Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L. REV. 565 (1991).

30. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

31. Bainbridge, *supra* note 29, at 625.

32. Glover & Thamodaran, *supra* note 4, at 2.

33. *Id.*

capitalization, employ a dual class structure.³⁴ This number has been increasing steadily since the 1980s.³⁵ The most common arrangement in the United States among dual class corporations is a ten-to-one votes to share ratio for the superior voting stock, while the inferior class has one vote per share.³⁶ On average, this results in insiders controlling approximately sixty percent of the voting rights with only forty percent of the cash-flow rights.

Internationally, the use of dual class structures varies considerably. In Canada and the European Union, for instance, the percentage of firms employing a dual class structure is at or above 20%, considerably higher than the proportion on American exchanges.³⁷ In other areas, like Israel, Hong Kong, and Singapore, dual class structures are banned outright, although in Hong Kong regulators seem to be back-pedaling on this policy after several high-profile companies, including Alibaba, chose to list elsewhere due to their preference for the dual class structure.³⁸ Companies in international markets such as Hong Kong make ample use of alternative CMS structures (for example, pyramids and cross-holding), so the banning of dual class structures seems to only open the door for

34. Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies* 5 (Eur. Corp. Governance Inst., Working Paper No. 209, 2008), http://ssrn.com/abstract_id=1080361.

35. See Paul Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2007). Gompers et al. report that from 1994 to 2001, their sample size of dual class firms increased from 100 to 215, reflecting the popularity of the dual class structure among the technology firms of the late 1990s. A report by the Investor Responsibility Research Center and Institutional Shareholder Services found that from 2002 to 2012, the number of dual class firms in the S&P 1500 Composite Index rose from sixty-eight to seventy-nine, reflecting growth at a slower rate over the last decade, at least when looking at larger cap firms. IRRIC INST. & ISS, CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 3 (2012). In sum, Thomas Chemmanur and Yawen Jiao estimate that almost twice as many listed companies employ a dual class structure now than in the 1980s. Thomas J. Chemmanur & Yawen Jiao, *Dual Class IPOs: A Theoretical Analysis* 1 n.1 (Eur. Corp. Governance Inst., Working Paper No. 129, 2006), http://ssrn.com/abstract_id=925236.

36. Gompers, Ishii & Metrick, *supra* note 35, at 1053.

37. Chemmanur & Jiao, *supra* note 35, at 1 n.1.

38. See *Out of Control*, THE ECONOMIST (Sept. 20 2014), <http://www.economist.com/news/finance-and-economics/21618889-more-worlds-big-stock-markets-are-allowing-firms-alibaba-sideline>.

other more elaborate and unregulated mechanisms of maintaining family or founder control.³⁹ This may indicate that CMS structures are regarded as the most efficient corporate governance structure in at least some instances across various markets. Alternatively, if we adopt a darker view, the situation may demonstrate that if management wants to expropriate value from firms, it will find a way to do so despite the banning of dual class structures.

B. *Arguments For and Against the Dual Class Structure and Agency Issues Asserted by Critics*

The rationale for implementing a dual class structure is much the same today as it was in the 1920s: it is an excellent way to raise capital from the public while maintaining the long-term vision and control of the founder.⁴⁰ When one looks at the high-profile IPOs of recent years, a clear trend of high-growth technology start-ups with strong founder personalities is evident. Facebook with Mark Zuckerberg, Alibaba with Jack Ma, and LinkedIn with Reid Hoffman are just a few examples. There is certainly some *a priori* force to this argument; if a founder is not subject to the “fluctuating attitudes of the capital markets,” as Joseph Tsai of Alibaba labeled short-term market and investor pressure, she can focus more on long-term value maximization for shareholders.⁴¹ Particularly in technol-

39. Prominent examples of family pyramid structures in Asia include the Li Ka-Shing group in Hong Kong and the Gondrej family in India. See Bebchuk, Kraakman & Triantis, *supra* note 3, at 299.

40. See, e.g., Google, Inc., *supra* note 6, at iii. Larry Page candidly disclosed to potential investors that, “[i]n the transition to public ownership, we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. This [dual class] structure will also make it easier for our management team to follow the long-term, innovative approach emphasized earlier New investors will fully share in Google’s long-term growth but will have less influence over its strategic decisions than they would at most public companies.”

41. This quote comes from a blog post by Joe Tsai on Alizila, a news and commentary blog funded by the Alibaba Group. Joe Tsai, *Alibaba Offers an Alternative View of Good Corporate Governance*, ALIZILA (Sept. 26, 2013, 10:59 PM), <http://www2.alizila.com/alibaba-offers-alternative-view-good-corporate-governance>. Tsai’s post is a vigorous defense of Alibaba’s use of an elaborate type of dual class structure, and it was a direct criticism of the Hong Kong Exchange’s failure to allow Alibaba to list due to its ban on dual class structures. Tsai concludes the post by stating, “[w]e understand Hong Kong may not want to change its tradition for one company, but we firmly

ogy sector firms where the importance of innovation across product cycles is paramount, a myopic focus on next quarter's bottom line without proper investment in continuing projects could plausibly have deleterious consequences on long-term shareholder value and company health.⁴² Dual class structures exist in other, non-technology driven firms as well, one of the most historic cases being the New York Times, which is controlled by the Sulzberger family. Despite the punishing last two decades for all newspaper companies, the Sulzbergers have been able to fend off corporate raiders and hedge funds, and focus on long-term journalistic integrity over all else solely because they have been able to maintain control through the dual class structure of New York Times stock.⁴³ The example is particularly poignant given the sale of other prominent and historic newspapers during recent years, such as the Wall Street Journal and the Boston Globe. Finally, proponents of the dual class system point to instances like Berkshire Hathaway, which is often viewed as the gold standard in corporate governance and shareholder transparency, to argue that a multiclass share structure does not by itself lead to subpar corporate governance.⁴⁴

believe that Hong Kong must consider what is needed in order to adapt to future trends and changes. The question Hong Kong must address is whether it is ready to look forward as the rest of the world passes it by." *Id.*

42. Scott Kupor, *Sorry CalPERS, Dual Class Shares Are a Founder's Best Friend*, FORBES (May 14, 2013, 10:01 AM), <http://www.forbes.com/sites/ciocentral/2013/05/14/sorry-calpers-dual-class-shares-are-a-founders-best-friend> (writing that the ability to successfully navigate and innovate across longer-term product cycles determines the success or failure of technology companies, and that dual class share structures are well suited to this purpose).

43. See generally Joe Nocera, *How Punch Protected The Times*, N. Y. TIMES (Oct. 1, 2012), <http://www.nytimes.com/2012/10/02/opinion/nocera-how-punch-protected-the-times.html>. Upon the passing of Arthur Sulzberger, who listed the New York Times Company in 1969, long-time New York Times columnist Joe Nocera wrote an encomium praising Arthur's decision to list the newspaper company with a dual class structure. *Id.*

44. It is possible that advocates of Warren Buffet's management of Berkshire Hathaway are conflating superior financial performance with superior corporate governance, an assumption that does not necessarily hold true. There have also been complaints recently of increasing opacity at the conglomerate. Lynnley Browning, *Warren Buffet's Transparency Problem*, NEWSWEEK (Feb. 24, 2015), <http://www.newsweek.com/2015/03/06/berkshire-hathaways-transparency-problem-309127.html>.

Naturally, critics of the dual class structure vigorously contest the premise that founders need to maintain control in order to ensure long-term corporate success. To them, the idea of a founder entrenching herself in control in order to valiantly maintain a future vision for the company is a quixotic notion fed to public investors that allows an escape from shareholder accountability.⁴⁵ Of course, this principal argument has remained mostly intact from the 1920s, when the first critics of the newly introduced dual class structure emerged.⁴⁶ Detractors of the dual class structure counter such sterling examples of dual class governance, like Berkshire Hathaway, with more nefarious examples of managerial avarice enabled by entrenchment through the dual class system, like Lord Conrad Black, former CEO of Hollinger International, who served a felony sentence for fraud.⁴⁷ If the dual class structure does not lead to illegal extraction of benefits, as it did with Hollinger International, critics worry that it will cause stock underperformance, and point to recent listing examples such as Zynga.⁴⁸ As discussed in Section II.C, however, both advocates and critics seem to bring endlessly voluminous and contra-

45. See, e.g., Andrew Ross Sorkin, *Stock Split for Google That Cements Control at the Top*, N.Y. TIMES DEALBOOK (Apr. 16, 2012), <http://dealbook.nytimes.com/2012/04/16/stock-split-for-google-that-cements-control-at-the-top/>. Sorkin was highly critical of Google's issuance of a third class of stock in 2012 as a follow-up to its dual class listing in 2004. This piece in DealBook was particularly unforgiving towards the "visionary founder" argument, as Sorkin writes, "[j]ust think about other once highflying technology companies that turned sour. Yahoo. Or Research in Motion. Its founders were once lionized as visionaries—until they weren't. The problem is that Google will succeed until it doesn't. And when it falters, it won't have the kick in the pants that the prospect of pressure from shareholders can provide." *Id.*

46. The most prominent dual class critic in the 1920s was Harvard University Professor William Ripley, who was very likely the first individual to foresee and articulate the conflicts of interest and agency issues that were manifest in multiclass stock structures. Bainbridge, *supra* note 29, at 569. Professor Ripley asserted that the dual class structure was the "crowning infamy" of corporate regulation developments in the 1920s, which he viewed as empowering management at the expense of shareholder rights. See generally WILLIAM RIPLEY, MAIN STREET AND WALL STREET (1927).

47. Chemmanur & Jiao, *supra* note 35, at 2.

48. Since its initial public offering in December 2011, Zynga shares are down 71% as of March 1, 2017, compared with a 123% gain in the NASDAQ composite over the same period. This information may be found on Google Finance.

dicting empirical data to bear in order to advance their claims to no clear resolution.

The strongest arguments against the dual class structure invoke agency theory and the inherent conflict of interest that managers face with disproportionate voting right to ownership rights. As discussed in Section I.B, dual class and other CMS firms seem particularly susceptible to agency problems, more so than their DO and CS counterparts. Critics who allege heightened agency costs associated with dual class firms posit a two-part argument: first, there is decreased monitoring at these companies, and second, this decreased monitoring and oversight *a fortiori* signifies increasing agency problems and residual loss for shareholders.⁴⁹ I now examine each of these arguments in turn and conclude Section II.B with potential counterweights for the agency problems raised.

1. *Theories of Decreased Monitoring and Oversight*

A fall in share price and corresponding increase in the threat of a hostile takeover can serve as powerful motivators for corporate managers to change behavior that shareholders see as antithetical to their interests.⁵⁰ However, the controlling management in dual class firms will not face this pressure due to its entrenchment via control of the superior voting stock.⁵¹ Together with the ability to resist hostile bids, management will also be less receptive toward friendly offers than its counterparts at DO firms. Even if a favorable friendly offer is made, the majority of the gains would go to other shareholders, whereas entrenched management can extract one hundred

49. Jensen and Meckling put forward perhaps the most frequently cited definition of agency costs as the sum of: (1) monitoring expenditures by the principal, (2) bonding expenditures by the agent, and (3) residual loss, or the divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). This Note does not seek to explicitly discuss the potential higher agency costs of dual class structure firms under the agency costs = monitoring + bonding + residual loss equation, but briefly it can be mentioned that critics' agency arguments essentially imply that the *decreased* monitoring present in dual class firms is more than offset by the *increased* residual loss. As a result, overall agency costs will increase.

50. See Fama & Jensen, *supra* note 2, at 313.

51. See Bebchuck, Kraakman & Triantis, *supra* note 3, at 301.

percent of the private benefits of control should the status quo be maintained.⁵² Counterarguments have been advanced against this theory of decreased monitoring. Armando Gomes, for example, argues that controlling shareholders will work to increase their reputation for positive treatment of minority shareholders because, otherwise, upon going public, knowledgeable investors and analysts will discount the stock according to greater perceived extraction of private benefits.⁵³ Secondly, not all hostile takeovers or aggressive bidders are good for shareholders, whether they are controlling or minority shareholders. The management of a dual class firm may have implemented the structure to fend off these unwanted advantages rather than to ignore fruitful and beneficial takeover offers.⁵⁴ On balance, however, an explicit reason many founders have advanced to implement the dual class structure is the ability to ignore short-term market fluctuations, which is tantamount to founders asserting that they are throwing off the yolk of shareholder monitoring.

A stronger critique related to reduced monitoring at dual class firms alleges that board of director independence and supervision suffer at these companies.⁵⁵ For instance, one study found that approximately seventy percent of dual class firms had an independent board versus eighty percent for single class firms, where an independent board is defined as one

52. See Cronqvist & Nilsson, *supra* note 21, at 699. One may ask whether a controlling chief executive could in fact extract a larger piece of the pie by demanding a premium for his controlling shares. This may be possible absent minority shareholder protections in the corporate charter, but many dual class companies have provisions stating that there may be no premium for super-voting shares in a merger. See, e.g., Google, Inc., FOURTH AMENDED AND RESTATED CERTIFICATE OF INCORPORATION 3 (June 22, 2012). When dual class companies do have these anti-premium provisions, the Delaware Court of Chancery has stepped in to enforce them. *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012).

53. See Gomes, *supra* note 22, at 616.

54. See Cronqvist & Nilsson, *supra* note 21, at 700.

55. A counterargument to allegations of decreased board independence at dual class firms is that investors care about positive financial performance, not good governance. Despite the *ipse dixit* of dual class critics claiming that reduced board independence should concern investors, some studies have found no correlation between board independence and financial performance. See Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long Term Firm Performance*, 27 J. CORP. L. 231 (2001).

in which at least half of the directors are independent.⁵⁶ There is an excellent explanation for this disparity given current stock exchange rules. The NYSE and NASDAQ both contain controlled-company exemptions from many of their board independence requirements.⁵⁷ In both exchanges, controlled companies in which greater than fifty percent of the voting power is held by a single individual or group are exempt from the requirements of having a majority of independent directors on the board, maintaining an independent director nomination committee, and creating an independent compensation committee. The end result, critics allege, is a rubberstamp board that is beholden to the chief executive. One notable example is the unanimous board approval of Google's recent controversial decision to issue nonvoting shares through a stock split.⁵⁸ Google's situation is relatively innocuous, however, when compared to more egregious examples of founding families dominating the board through dual class entrenchment such as News Corp. In 2012 at the News Corp annual meeting, approximately two-thirds of independent investors voted to install an outside chairman; yet, the resolution still failed due to the Murdoch family's control of the superior voting stock.⁵⁹ As much as founders like Rupert Murdoch may insist that their interests are perfectly aligned with those of the shareholders, it can be hard for critics to take such claims seriously when corporations view corporate governance proposals with such disdain.

Finally, institutional investors exercise less oversight and ownership in companies with dual class structures, potentially

56. John S. Howe & Chris Tamm, *Corporate Governance of Dual-Class Firms*, in 14 INTERNATIONAL CORPORATE GOVERNANCE, ADVANCES IN FINANCIAL ECONOMICS, 1, 13 (Kose John & Anil K. Makhija eds., 2011). However, the authors note the interesting counterbalance statistic that dual class firms are more likely to have different individuals holding the CEO and Chairman of the Board titles than single class firms. *Id.*

57. See NEW YORK STOCK EXCHANGE, NYSE MANUAL 303A.00 1; NASDAQ, NASDAQ STOCK MARKET RULE 5615 1, 6.

58. See Sorkin, *supra* note 45. Sorkin continues to make the assertion that, "[t]he only likely alternative to voting 'yes' would have been to resign and explain why [they] voted 'no'."

59. Katherine Rushton & Richard Blackden, *Rupert Murdoch's Iron Grip on News Corp Dealt a Blow*, THE TELEGRAPH (Oct. 17, 2012), <http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/media/9613863/Rupert-Murdochs-iron-grip-on-News-Corp-dealt-a-blow.html>.

eliminating one of the most significant forms of monitoring to which most corporations are subjected. Institutional investors provide the best answer to the collective action problem that dispersed shareholders in most corporations face; by pooling their relatively larger holdings together and voting as a block, institutional investors play a very important role in overseeing management.⁶⁰ Research shows that higher institutional ownership levels also correlate positively with higher pay-for-performance sensitivity and negatively with the level of management compensation, therefore serving as an important check on a major corporate agency problem.⁶¹ Due to the lack of any real pressure that institutional investors can exert over the management of a dual class firm, critics allege that the percentage of shares owned by institutional investors in dual class firms has decreased. One study estimates institutional ownership of publicly traded dual class stock at 34.7% as compared to 37.5% of single class stock.⁶²

Institutional investors have not been silent about their alleged disenfranchisement. In 2012, amidst high-profile dual class IPOs such as Facebook and Manchester United, CalPERS, the largest public pension fund in the United States, launched a major publicity campaign to remove dual class structures and threatened to boycott any future dual class listings.⁶³ The Council of Institutional Investors (CII), an association that represents pension funds, endowments, and foundations with combined assets of \$3 trillion, consistently lobbies the NYSE, NASDAQ, and international stock exchanges to return to a one share, one vote model.⁶⁴ It is unclear, however, that such

60. Tian Wen, Comment, *You Can't Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges*, 162 U. PA. L. REV. 1495, 1504 (2014).

61. Jay Hartzell & Laura Starks, *Institutional Investors and Executive Compensation*, 6 J. FIN. 2351, 2351 (2003).

62. Howe & Tamm, *supra* note 56, at 13. The significance of this lowered ownership percentage is debatable; however, as even John S. Howe and Chris Tamm acknowledge, this decrease is only statistically significant at the ten percent level. *Id.*

63. Shanny Basar, *CalPERS Sets Sights on Dual-Class Stock Structures*, WALL ST. J.: MKTS. (Aug. 20, 2012, 12:16 PM), <http://www.wsj.com/articles/SB10000872396390443855804577601271252759472>.

64. *See, e.g.*, Letter from Jeff Mahoney, Gen. Counsel, Council of Inst. Inv., to John Carey, Vice President, NYSE (Mar. 27, 2014), http://www.cii.org/files/issues_vand_advocacy/correspondence/2014/03_27_14_CII_let

lobbying has had any effect, as the CII has sent several querulous letters over the past few years that have not seemed to yield any real results.⁶⁵ Institutional Shareholder Services (ISS), another corporate governance advocate for “asset owners, hedge funds, and asset service providers,”⁶⁶ also vigorously denounces dual class share structures and other management entrenchment mechanisms. For example, ISS labelled Facebook’s structure upon its IPO as “a governance profile with a defense against everything except hubris.”⁶⁷

Defenders of the dual class structure should raise an obvious question to these allegations of reduced institutional influence and presence: though they may help temper and reduce agency costs in theory, do institutional or activist investors actually drive up shareholder value at the firms that they seek to reform? In other words, we must ask whether shareholder activism is an efficient and effective form of monitoring in the first place. The answer is not simple, as studies tend to show conflicting or ambiguous results. This is particularly true of data regarding the so-called “CalPERS Effect,” the measured impact of prominent institutional investor CalPERS on the firms that it targets, which are known as the “Failing Fifty.”⁶⁸ One recent study finds that the companies pursued by CalPERS show an excess return of 2.9% per year for five years from the “initiative date,” or the date of CalPERS’ first letter, compared with an excess return of negative 30.9% per year for the five years prior.⁶⁹ However, these findings probably overstate the efficacy of CalPERS’ targeting for two main reasons.

ter_to_NYSE_one_share_one_vote.pdf. In this letter, the CII was strongly urging the NYSE to reject the listing of Alibaba, which opted to list on the NYSE due to its allowance of dual class structure listings.

65. *CII Correspondence & Testimony*, COUNCIL OF INST. INV., <http://www.cii.org/correspondence> (last updated Oct. 31, 2016).

66. *About ISS*, INST. SHAREHOLDER SERVICES, INC., <http://www.issgovernance.com/about/about-iss/>.

67. ISS, *THE TRAGEDY OF THE DUAL CLASS COMMONS 1* (Feb. 13, 2012). As noted previously, even if one could allege poor corporate governance at Facebook due to the dual class share structure, financial performance is perhaps uncorrelated. At the time of this writing, Facebook’s stock price is up over 200% from the time of its IPO, outperforming the NASDAQ handily.

68. Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227, 232 (1996).

69. Stephen L. Nesbitt, *The “CalPERS Effect” on Targeted Company Share Prices*, NACD DIRECTORSHIP, May 2001, at 1.

First, this study does not address the fact that much of the 2.9% average excess return is due to the stocks' performance from years three to five. If CalPERS were to actually account for the dramatic turnaround that the study's authors describe, one would expect the impact to occur much sooner. Secondly, for a span of five years, it is really quite difficult to say that a relatively low abnormal return is statistically significant since stock price fluctuation is a rather noisy statistical indicator and could reflect any variety of contributing factors of which the CalPERS Effect is just one.⁷⁰ Other studies conclude with similar unclear results; for example, Michael Smith finds an increase in shareholder wealth due to the CalPERS Effect but only when it is successful in its organizational change efforts.⁷¹ Additionally, this study found no statistically significant change in operating performance for targeted firms.⁷² Mixed results such as these certainly blunt the force of the argument that institutional investors have a reduced monitoring role at dual class firms.

Following analysis of the specific claims that the dual class structure results in weakened takeover and market checks, diminished board independence and effectiveness, and reduced institutional investor oversight, there does seem to be cause for concern about decreased monitoring and the board of directors' role in dual class corporations. Those boards have been shown to be statistically less independent and consequentially more deferential to management. Not as evident, however, is any connection or causation between reduced board independence and poor financial performance. Contentions about lack of a proper market check and decreased institutional investor oversight are still on less solid ground, and it is unclear what, if any, negative impact actually results from reduced monitoring through these avenues.

2. *Agency Costs and Extraction of Private Benefits*

Regarding agency problems and the residual loss that follows, several studies have alleged that minority shareholders in CMS and dual class firms endure a variety of agency costs, in-

70. Interview with Professor David Yermack of New York University Stern Business School.

71. Smith, *supra* note 68, at 243.

72. *Id.* at 248.

cluding poorer use of cash reserves, increased CEO compensation, questionable acquisition and project investment decisions, and a greater reluctance to allow a transfer of control.⁷³ Many of these agency issues are not unique to dual class firms of course; Jensen offers the hypothesis that, when confronted with free cash flow, management often makes poor acquisition decisions, grows firms beyond their optimal size, and invests in negative net present value projects.⁷⁴ More recently, other commentators have pushed the case that such agency problems are even greater at CMS and dual class firms than at their DO counterparts.⁷⁵

However, as I will argue in the next Section, despite such strong evidence suggesting that there is an expropriation of benefits from minority shareholders to the advantage of the controlling shareholders, these rationales may overstate the danger of agency problems in dual class firms, like founder reputation and future cost of raising capital.

3. *Counterweights to Offset Decreased Monitoring and Increased Agency Costs*⁷⁶

Critics asserting increased agency costs and wealth expropriation in dual class firms rely on an unstated assumption: the controlling shareholders in these firms do not own a significant percentage of the lower voting stock or a higher percentage of the stock than is necessary to maintain control. If this assumption were not true, controlling shareholders would be

73. See Cronqvist & Nilsson, *supra* note 21; Masulis, Wang & Xie, *supra* note 34. Both sources are well-written works that dive into the mathematical and statistical methods used to find the correlation between dual class or CMS structures and these agency costs. Perhaps two findings are most interesting. In the Masulis paper, the authors find that not only are agency costs positively correlated with the use of the dual class structure but they rise in step with the concentration of voting power in the founder's hands. In the Cronqvist article, the authors determine that, among the Swedish sample of firms studied, families are much more likely to employ CMS structures, and these family CMS firms are "associated with the largest discount on firm value."

74. See generally Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

75. See Cronqvist & Nilsson, *supra* note 21.

76. I am grateful to Professor William Allen of New York University School of Law for assistance with many of the concepts expounded in this Section.

expropriating a larger-than-required amount of wealth from themselves, and would be reducing the value of their shares, thus defeating the plausibility of increased agency costs and minority shareholder expropriation. This is because, in most cases, the value of the shares to the founder or controlling shareholder will be orders of magnitude greater than the value of any extraction, such as excess CEO pay, that the controller could procure. Furthermore, such malicious expropriation would likely be punished by the capital markets in future equity offerings, raising the future cost of equity and thereby further diminishing the value of the controlling shareholder's ownership.⁷⁷

Clas Bergström and Kristian Rydqvist challenge the assumption that controlling shareholders only own the superior voting stock necessary for control of the company, thus allowing them to extract private benefits of control at limited cost to themselves. Bergström and Rydqvist label this assumption the "expropriation hypothesis." Their findings show that, in most firms, the controlling shareholder owns more than the minimum fifty percent equity required for control. Additionally, the largest shareholder coalition frequently invests in significant amounts of inferior voting shares that, while adding little voting power, can appreciate in value over time given successful management of the firm.⁷⁸ By way of a more modern example, as of December 31, 2014, Mark Zuckerberg owned approximately four million class A shares in Facebook, which at the time had a market valuation just north of \$300 million.⁷⁹ Admittedly, this is a much smaller stake than represented by his superior voting Class B shares; however, it is nonetheless a significant amount of ownership in a class of stock that Zuckerberg did not need to own in order to maintain control of Facebook and extract private benefits.

Even if one accepts the cynical hypothesis that controlling shareholders only maintain ownership of the superior voting shares necessary in order to extract ownership benefits, there

77. Clas Bergström & Kristian Rydqvist, *Ownership of Equity in Dual-Class Firms*, 14 J. BANKING & FIN. 255, 258 (1990).

78. *Id.* at 267.

79. See Facebook, Inc., Schedule 13G (Dec. 31, 2014). As of the filing, Mark Zuckerberg owned 3,999,241 Class A shares valued at approximately \$305 million. In the Facebook corporate ownership structure, Class A shares are publicly traded and have inferior-voting rights to Class B shares.

are other pressures that may constrain them from minority shareholder exploitation. A founder's reputation for proper treatment of minority shareholders and the hope of higher stock prices can provide powerful incentives, despite the complete absence of strong governance policies, for controlling shareholders in dual class firms to act responsibly and not expropriate benefits.⁸⁰ Indeed, Jensen and William H. Meckling assert that minority shareholders are rational, and that they can anticipate such behavior and adjust the subscription or purchase price accordingly.⁸¹

One could also choose to take a more benign view of the reason for instituting a dual class structure in a firm. Perhaps, as Larry Page noted in the 2004 Google Registration Statement, the founders actually want to protect their long-term vision for the company and have no interest in attempting to expropriate shareholders.⁸² Of course, whether such intentions lead to strong long-term stock performance is another question, but adopting these sentiments at face value would at the very least rule out the possibility of malicious appropriation. Dual class structures may therefore be a legitimate way of giving founders the best of both worlds—capital from the public markets and the ability to focus on the future of a private company, allowing the business to excel more than if it were purely one or the other. Moreover, the dual class structure may even be necessary for societal wealth maximization; gifted entrepreneurs like Larry Page or Mark Zuckerberg, without the ability to implement a dual class governance structure, may prefer to restrict the growth of their firms rather than risk raising additional capital and face the possibility of losing control. Such an argument is not so far-fetched when one remembers the example of Steve Jobs, who was famously ousted at Apple soon after its IPO. Thus, the dual class structure can help resolve the “brilliant entrepreneur problem” and actually generate value for society by allowing innovative firms and their founders to scale up by tapping into public capital markets without risking ouster of the individuals who made them innovative in the first place. This could also provide a benign rationale for the restriction on transfer of high-voting shares men-

80. Gomes, *supra* note 22, at 616.

81. Jensen & Meckling, *supra* note 49, at 313.

82. See, e.g., Google, Inc., *supra* note 6, at i.

tioned in Section II.A. The market may recognize that high-voting shares serve the purpose of protecting visionary founders, but such shares no longer serve that purpose once transferred to another party.

Other counterweights to excessive founder overreach are the legal constraints imposed by courts. In general, controlling shareholders have a duty of loyalty to minority shareholders and cannot self-deal against the interest of the corporation.⁸³ Furthermore, there have been some cases where the Delaware courts have moved to protect the holders of inferior voting shares in dual class companies. In *In re Delphi Financial Group*, the Delaware Court of Chancery sided with minority shareholders and stated that the controlling shareholder in a dual class company breached his fiduciary duties by seeking and obtaining a control premium for his shares when the certificate of incorporation specifically stated that both classes of stock must be treated equally in a merger.⁸⁴ In *Levco Alternative Fund v. Reader's Digest*, Chancellor William B. Chandler III enjoined the recapitalization of the dual class company because the court found that the independent committee in charge of the recapitalization breached its fiduciary duties by not evaluating the fairness to non-voting shareholders of a payment to voting shareholders.⁸⁵ These legal protections could be labeled as fairly weak; in *In re Delphi*, shareholders only prevailed because there was a relevant protection included in the certificate of incorporation, and in *Levco*, Chancellor Chandler's ruling implies that, as long as a controlling shareholder passes the barrier of entire fairness, the action will not be struck down. However, the willingness that Delaware courts have shown to protect minority shareholders from gross overreach by the majority shareholder should come as a reassuring trend.

Finally, as the minority shareholders in *In re Delphi* successfully utilized to their advantage, investors can demand corporate charter protections from founders who decide to utilize

83. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 723 (Del. 1971) (finding that contracting overly favorably with another entity in which the controlling stock holder has an interest is self-dealing and an unfair transaction).

84. *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012).

85. *Levco Alternative Fund Ltd. v. Reader's Digest Ass'n., Inc.*, 803 A.2d 428 (Del. 2002).

the dual class structure. Mechanisms such as sunset provisions, bars on transfer of voting power, and restrictions on premiums for high-voting shares in the event of a change of control can all provide powerful checks on executive and founder power.⁸⁶ As I recommend in Section II.B, these voluntary provisions on the part of dual class firms can shore up confidence in the governance of such firms. Investors could then choose to invest in companies with strong self-governance mechanisms or penalize firms without such controls with a lower share valuation.

C. *Empirical Evidence on the Performance of Dual Class Firms*

To say that the evidence is conflicted on whether dual class firms outperform their single class counterparts is an understatement. A broad glance at high-profile technology IPOs of recent years such as Facebook, LinkedIn, and Zynga reveals large discrepancies in performance, from stellar returns beating the market by multiples (in the case of LinkedIn) to abysmal, company-threatening performance (in the case of Zynga). Due to such large differences in post-IPO performance and the general “noisiness” of using stock price as a reliable proxy for the evaluation of any one, isolated contributing variable, it is extremely difficult to generate a reliable conclusion or prediction of the impact of dual or single class structures on market performance. The literature and studies composed to date reflect this confusion and ambiguity.

A recent study conducted by the Investor Responsibility Research Center (IRRC) and ISS determined that the returns in multiclass companies behave precisely the opposite of how founders in these firms predict. Multiclass firms were found to outperform their single class peers over a one-year horizon, but underperform over a longer time period.⁸⁷ Moreover, the study found that the share price volatility of multiclass firms was much higher than for single class firms.⁸⁸ Unfortunately, this particular study likely suffers from some bias on the part

86. For examples of such provisions, see the charters of Facebook (sunset provisions), UPS (no transfer of superior-voting power), and Google (restriction against premium for sale of high-vote shares in a merger), available through Delaware’s Secretary of State.

87. See IRRC INST. & ISS, *supra* note 35, at 3.

88. *Id.*

of the authors; both the IRRC and ISS are prominent critics of the dual class structure and frequently lobby to have the NYSE and NASDAQ remove listings of dual class firms. Nonetheless, the groups are not alone in their findings, and there are multiple other studies that also arrive at the conclusion that dual class firms underperform in a variety of metrics.⁸⁹

However, for each study that seems to find that multiclass firms underperform, there is another study with the exact opposite conclusion. Ekkehart Bohmer, Gary C. Sanger, and Sanjay B. Varshney⁹⁰ ascertained that dual-class firm IPOs outperform single-class firm IPOs in stock market returns and accounting performance measures. Valentin Dimitrov and Prem C. Jain⁹¹ found that firms undergoing dual-class share recapitalizations exhibit long-term positive abnormal stock returns and operating performance. Thomas J. Chemmanur and Yawen Jiao⁹² concluded that, among firms with a high incumbent management reputation, an IPO with dual class structure and long-term focus will maximize shareholder value.

Hence, both proponents and critics of the dual class share system have studies and empirical data to support their positions, and both can justify their viewpoints depending on the study, methodology, and sample of companies that is selected. For a neutral observer, it is very difficult to draw any sort of conclusion about the impact of single or multiclass share structure on stock and operational performance of firms given the conflicting literature currently available. Furthermore, it is challenging to control for the impact that share structure has on these performance metrics against other variables since, as mentioned before, share price and financial performance can be noisy indicators. Every company, and every founder, is different, and where one multiclass company may succeed with a

89. See, e.g., Ashrafee Hossain, *Dual v. Single Class Firms: An Acquisition Perspective*, 14 J. ACCT. & FIN. 9 (2014) (finding that long-term post-acquisition operating performance of single class firms are significantly higher and experience higher abnormal returns around acquisition announcements).

90. Ekkehart Boehmer, Gary C. Sanger & Sanjay B. Varshney, *Managerial Bonding and Stock Liquidity: An Analysis of Dual-Class Firms*, 28 J. ECON. & FIN. 117, 117–18 (2004).

91. Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. CORP. FIN. 342 (2006).

92. Chemmanur & Jiao, *supra* note 35.

visionary founder, another may fail for reasons entirely unrelated to the multiple classes of stock. As it stands, we simply do not have sufficient information to posit a determinative answer to the question of whether and how multiclass governance structures systematically affect financial performance.

III.

A PATH FORWARD FOR DUAL CLASS STRUCTURES

A. *Recommendation on Inclusion of Multiclass Structures on American Stock Exchanges*

Given ambiguous evidence on the impact of multiclass share structures on the financial and operating performance of firms, American stock exchanges will, in all likelihood, continue allowing multiclass firms to publicly list their shares. There are multiple reasons for this conclusion, such as the strong trend towards use of the multiclass share structure domestically and abroad, the lack of enforceability for regulations on share structures, and adequate existing protections for investors who otherwise desire the ability to invest in multiclass firms.

As the ISS and IRRIC note, in recent years, there has been an increasing trend domestically toward use of a dual or multiclass share structure.⁹³ In particular, technology companies like Square, Alibaba, and Facebook have leveraged the use of the dual class share structure. It is doubtful that a restriction on the listing of multiple classes of shares would encourage such companies to adopt a single class structure; instead, similar to the flight away from the NYSE in 1940 after it banned the dual class structure, companies would simply list on other exchanges, even if they had to go abroad.⁹⁴ Manchester United, the quintessential British football club, opted to avoid listing on its natural home, the London Stock Exchange, due to such a prohibition.⁹⁵ Following grumbling about the loss of

93. See IRRIC INST. & ISS, *supra* note 35, at 3.

94. The recent case of Alibaba is instructive, as the company opted to list on the NYSE instead of the Hong Kong Stock Exchange due to Hong Kong's ban on multiclass structures. See THE ECONOMIST, *supra* note 38.

95. Manchester United proved to be extremely opportunistic in order to take advantage of disparities in listing regulations. After forgoing the London Stock Exchange due to its ban on dual class share structures and initially moving the IPO to Singapore, it also abandoned Singapore when it

massive amounts of business, some exchanges, including the Hong Kong Stock Exchange—albeit unsuccessfully— have shown signs of backtracking on the ban on dual class structures.⁹⁶ Therefore, banning dual class shares seems to amount to a collective action problem; even if the NYSE or NASDAQ would prefer to not list dual class shares, they will continue to do so as long as companies can simply list their dual class shares on another exchange. An effective ban would require all major international exchanges to come to an enforceable agreement to ban multiclass share firms. Given the amount of money that they have generated for exchanges like the NYSE, particularly through poaching dual class IPOs such as AliBaba and Manchester United, this is unlikely to happen.

The lack of regulatory methods to force American exchanges to ban dual class shares is also a critical reason why such a ban could not work. As previously noted, the SEC had attempted to regulate and discourage the listing of dual class shares through Rule 19c-4, promulgated in 1988. The D.C. Circuit invalidated this rule in 1990 and found that the SEC had exceeded the statutory authority delegated to it by Congress. Professor Stephen Bainbridge of the UCLA School of Law and other knowledgeable commentators have agreed with the decision, and there have been no significant efforts by the SEC to regulate dual class firm structures in the following years.⁹⁷ It seems that, for the time being, the only legal protections offered against dual class firms guard minority shareholders against founder overreach through cases such as *In re Delphi* and *Levco*.

Finally, asking the exchanges to ban dual class share structures to protect investors begs the question: do investors actually need additional protection? Although the ISS labels the

became clear that the country's regulators were dragging their feet to approve the IPO. Manchester United finally landed on the same safe ground for dual class listings that so many other companies have found, the New York Stock Exchange. See Steven Davidoff Solomon, *In Manchester United's I.P.O., a Preference for American Rules*, N.Y. TIMES DEALBOOK (Jul. 10, 2012, 2:32 PM), http://dealbook.nytimes.com/2012/07/10/in-manchester-united-i-p-o-a-preference-for-u-s-rules/?_r=0.

96. See Jennifer Hughes & Josh Noble, *Hong Kong Exchange Gives up on Dual-Class Share Plan*, FIN. TIMES (Oct. 5, 2015), <http://www.ft.com/intl/cms/s/0/0bc597ee-6b42-11e5-aca9-d87542bf8673.html#axzz47WfbHVJ0>.

97. See Bainbridge, *supra* note 29, at 567.

listing of dual class shares as a sort of Hobson's choice where investors must either accept governance structures which diminish shareholder rights or risk missing out on the hottest business models of the day, this argument is disingenuous.⁹⁸ Investors cannot liken missing out on a hot IPO to having a gun to their head forcing them to purchase shares; indeed, institutional and sophisticated investors like those that the ISS represents should be the very ones that do not buy into the mania and frenzy of high-profile IPOs if they judge something is amiss with the underlying company's governance model. Secondly, as this Note discusses in Section II.C, there is a wealth of data and studies available on the effects of a dual class structure on corporate governance and performance. Under an efficient markets hypothesis, all of this information should be accounted for when investors decide the price at which they seek to purchase a stock. If indeed a dual class structure is less desirable, that does not inevitably lead to the conclusion that we must ban the structure but rather that the stock price should receive a corresponding discount in the market. Finally, if an investor feels that management is extracting private benefits from its shares at the expense of holders of inferior voting shares, the ultimate market check is still available: it may sell their shares at any time.

B. *A Path Forward*

Given that it is both impractical and perhaps undesirable to attempt a ban on dual class shares, how can the exchanges and investors proceed in an optimal fashion? By revoking board independence exceptions, creating and enforcing corporate charter requirements, and continuing to ensure adequate information through disclosures, investors will feel protected and secure in the brave new world of dual class share listings.

The most obvious and commonsense reform that both the NYSE and NASDAQ can make in order to bolster corporate governance at dual class firms is to eliminate the controlled company exemptions that exist on both exchanges. On the NYSE, for example, a listed company where greater than fifty percent of the voting power is held by an individual is exempt from the requirements of an independent board, an

98. See ISS, *supra* note 67, at 1.

independent compensation committee, and any sort of nomination or corporate governance committee.⁹⁹ The NASDAQ joins the NYSE in all of these exemptions with the exception of waiving the need for a corporate governance committee.¹⁰⁰ It is difficult to fathom why controlled companies, which arguably would have the greatest need for independent board supervision in order to protect minority shareholders, are exempt from these requirements. No such explanation can be found in either the NYSE or NASDAQ rules. Eliminating these exemptions would go far in assuring investors that, once their capital has been invested in a CS firm, it will be protected by a board that is independent from the founders. As discussed by Sanjai Bhagat and Bernard Black,¹⁰¹ stronger independent board oversight may not lead directly to stronger financial performance, but it will in any case help counter the arguments of corporate governance critics.

The second recommendation of this Note is that the exchanges require basic protections be built into the charters of companies that choose to list with a dual class structure. As noted in Section II.B.3, many companies have voluntarily adopted measures such as sunset provisions that phase out dual class shares over time. These measures can lead to a more optimal balance between the need to protect a founder's long-term vision and the need to assure investors of proper long-term corporate governance. Advocates of the dual class structure may contend that a CMS structure is necessary to protect a founder's long-term focus, but that argument holds true mainly while the company in question is in a high-growth and more volatile stage. After ten or twenty years, if a company survives intact, it is likely to be a stable company that does not require protection for a founder's vision. The argument for dual class shares is significantly undermined when one considers a longer time horizon, and consequently sunset provisions are an excellent solution to balance the competing needs of

99. See NEW YORK STOCK EXCHANGE, NYSE MANUAL SECTION 3: CORPORATE RESPONSIBILITY. . The rules implicated here are 303A.01 (the exemption from needing a majority of independent directors), 303A.04 (exemption from needing a nominating and corporate governance committee), and 303A.05 (exemption from needing an independent compensation committee).

100. See NASDAQ, *supra* note 57.

101. See Bhagat & Black, *supra* note 55, at 233.

founders, who tend to think long-term, and investors, who generally want optimal short- and medium-term stock performance. By requiring this and other protections, such as restrictions on transfer of voting power and preventing premiums for the sale of high-voting shares, the NYSE and NASDAQ can go a long way toward keeping dual class shares but limiting the harm that investors fear, or keeping the baby while throwing out the bathwater.

One may rightly ask why exchanges should require even these relatively minimal protections: why not allow the markets to continue evolving such provisions organically and appropriately price the resulting governance structures? Although this is a compelling point that, at the very least, questions the validity of imposing uniform charter protections on a diverse array of companies, mandated basic charter protections serve two beneficial purposes. First, they would impose a uniformity that is currently lacking with the present patchwork of charter protections. It is much more difficult for investors to appropriately correct the market price of a particular structure when it is entirely unique with no analog for comparison. Instead, if a basic floor is set on all dual class listings, investors will have a more robust data set upon which to rely and a better chance of accurately pricing listings without having to compare the usefulness of, for example, a fifteen-year sunset provision with a high-voting share transfer restriction. Secondly, implementing this recommendation would also enable a discussion toward finding a reasonable baseline boundary of protection for minority voting shareholders. Dual class companies that choose to go above and beyond this baseline may be rewarded with a higher listing price should the market feel that it is warranted. Additionally, the feeling of having a Hobson's choice dilemma will be alleviated somewhat since investors will know that there is at least some sort of governance concession that dual class companies have agreed upon as useful to the investor and not harmful to the company or founder.

Finally, the efficient markets hypothesis and investor protection only work when the relevant information is disclosed and easy to find. Therefore, the exchanges and the SEC, to the extent they are able, should continue to make corporate governance structures easy to identify and evaluate. In fact, this is one area in which having dual class firms is actually significantly more desirable than other CMS types, such as pyramid

or cross-holding structures, which are infinitely more complicated and essentially impossible to fully comprehend due to their intricacies.¹⁰² Currently, the exchanges require that any firm relying on a controlled company exemption disclose this fact on its annual proxy statement, but the rules should require a clear disclosure of any firm utilizing a dual class structure whether or not it relies on this exemption. Although some firms like Google have laudably been crystal clear in their proxy statements about governance structure, such disclosure should be required of all CMS firms. If disclosure is adequate, proper protections are built into company charters, and board independence exemptions are eliminated, sophisticated investors and the public should be able to inform and protect themselves against any abuse or overreach from owners of superior voting shares.

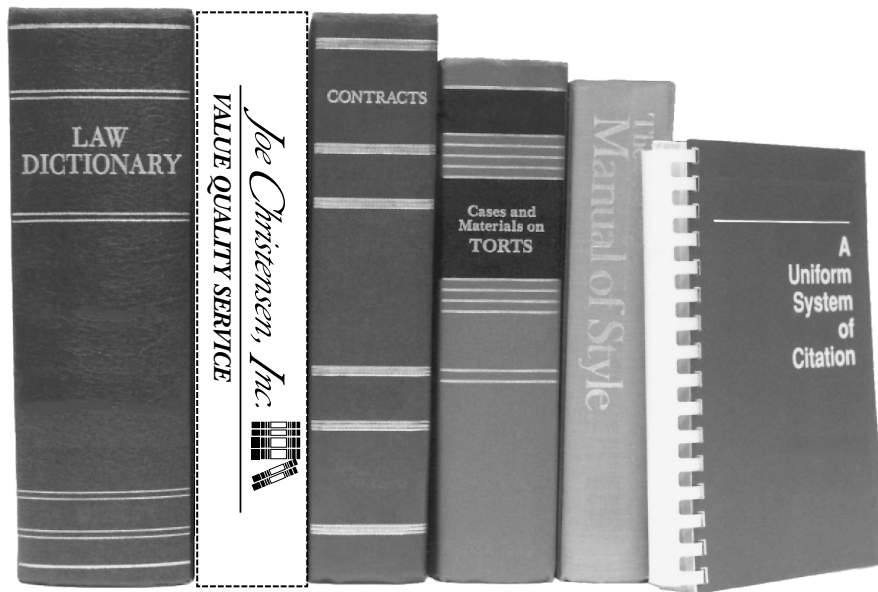
CONCLUSION

Banning dual class share structures from the NYSE and NASDAQ is even less practical now than it was when the NYSE first implemented its ill-advised prohibition in 1940. Where there is a will to implement a CMS governance structure, there is a way, whether by listing a dual class share structure in a foreign jurisdiction or creating elaborate pyramid and cross-holding structures. Even if it were a practical possibility, the evidence is conflicted as to whether or not dual class structures detrimentally impact corporate governance and, *a fortiori*, financial performance. Overly bleak and cynical views of the greedy controller expropriating shareholder value have also not generally been corroborated convincingly by the existing literature.

We must therefore come to terms with the brave new world of dual class structures since they are here to stay. Through increased independent board oversight, basic corporate charter protections, and adequate disclosures, investors

102. Telecom Italia is a prime example of a pyramid structure, whereas Samsung utilizes a cross-holding structure, both of which significantly obfuscate where the capital and power lies within each corporate structure. *See generally* Simon Mundy, *South Korea: Sparks Fly over the Chaebol*, FIN. TIMES (Nov. 2, 2014), <https://www.ft.com/content/9d84d488-5f90-11e4-8c27-00144feabdc0> (discussing the intricate and complicated structure of South Korea's chaebol business groups).

can feel sufficiently secure in their investments. We can make peace with a corporate governance structure that, when used properly, can reasonably contribute to an efficient and wealth-optimizing society.



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