DEAN GARY R. ROBERTS

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TRIBUTES

THE SPLENDID RUN OF DEAN GARY R. ROBERTS

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Among the most difficult assignments in the American legal profession is that of law school dean. Gary R. Roberts has proven an able master of the role, much to the benefit of the bench, the bar, and academy alike.

It takes a while to describe why the job of a law school dean is so challenging. The multiple constituencies with connections to a law school seek different things from their experiences with it. A school's students, for example, struggle to finish their legal studies and move on to careers made possible by their degrees. In the current environment, students lament the cost of their education and the diminished opportunities for law-related employment. Law faculties understand the challenges, but they experience the school in a different way. Faculties value their posts for the opportunity to teach and write, and hope that the school can increase in reputation, which in turn burnishes the faculty's own work. Graduates, like judges and practitioners, sometimes have diminished connections to a school after their departure, but they too see the institution through multiple prisms. They often relate to law schools as a source of young associates for their firms or institutions. And, more personally, they frequently associate their own standing in the legal community with the status of their alma mater. Finally, there are a host of other actors, like university administrators, donors, and legislators, who often pull at the school from rather different directions. All of the above look first to the dean, as the public face of the school, with the hope that the dean will respond favorably and successfully to their needs.

These multiple demands on a dean are the stuff of regular conversation in one or another of the profession's venues. I suggest here a different formulation of the dean's task that is less often identified: how does one build a solid base at home and still soar abroad?

The first of these two objectives is the one I have had the more direct chance to observe, knowing most about Dean Roberts' tenure from the point of view of the bench and bar. I record here with confidence that Gary has labored long and freely to achieve what practitioners hope a law school will mean for them. He honors the value of working lawyers and judges, commits hundreds of hours a year to reaching out to them, and relates to practitioners with confidence and

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directness.

Dean Roberts has taken this same approach to the Indiana University Robert H. McKinney School of Law's role in the life of Indiana. In some quarters, a school's dean might be reluctant to emphasize what the school contributes to the state in which it is located (indeed, some schools think of themselves as being *in* a state, but not *of* a state). They worry about seeming too "local." Gary Roberts has had no such reluctance. He proudly makes the point to all who will hear it that McKinney graduates presently serve as the Governor of Indiana, the Speaker of the Indiana House, a U.S. Senator, several members of the U.S. House of Representatives, and a majority of the Indiana Supreme Court.[1] "I have often argued that our law school is and has long been," he recently wrote, "the single most important educational asset in all of Indiana inasmuch as it produces most of the lawyers and judges for the state as well as much of the business and political leadership."[2]

Gary aims such messages at multiple constituencies. He has been right to remind the state's leadership of the School's value to Indiana's present and future. He also reiterates these achievements of McKinney alumni in order to help students understand what they themselves might become. His characteristic candor in such communications built a credibility about these messages. As my colleague, Zach Mulholland, explained to me: "When he communicated his vision about what we could be and what our school could be, I believed it because I could tell that he believed it."

Consistent with this pride of contribution to place, Gary has likewise gone out of his way to build a school that can add to the public life of Indiana. Undertakings like the School's Program on Law and State Government both lift up the caliber of public debate through symposia and similar events, and build beneficial arrangements through energetic, creative externship arrangements.

Dean Roberts embraces such opportunities and simultaneously works to enhance the reputation of the School in ways that fit the classic mold of a dean who aims for high-end capabilities and recruiting top-flight faculty members to burnish the School's standing.

The most illustrious of such spotlight moments have included visits by the likes of Chief Justice John G. Roberts, Jr., in 2010.[3] Justice Samuel Alito also spoke at the school during the Roberts years, as did the Chief Justice of Ireland,

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1. Robert H. McKinney School of Law graduates include the following: Indiana Governor Mike Pence, J.D., 1986; Speaker of the Indiana House Brian Bosma, J.D., 1984; Senator Dan Coats, J.D., 1972; Congresswoman Susan Brooks, J.D., 1985; Congressman Todd Rokita, J.D., 1995; Congressman Todd Young, J.D., 2006; Indiana Supreme Court Chief Justice Brent Dickson, J.D., 1968; Indiana Supreme Court Justice Steven David, J.D., 1982; and Indiana Supreme Court Justice Mark Massa, J.D., 1989.

2. Gary R. Roberts, *Message from the Dean,* ALUMNI MAG. & DEAN`S REP. (Ind. Univ. Robert H. McKinney Sch. of Law), Winter 2012, at i.

3. John G. Roberts, Jr., Chief Justice of the U.S. Sup. Ct., The James P. White Lecture on Legal Education at the Indiana University Robert H. McKinney School of Law (Apr. 7, 2010).

John L. Murray.[4]

Gary Roberts has always been game for activities that bring the School into the national spotlight. My most recent and personal experience was visiting to ask whether the Dean would support my bringing to McKinney the signature public event of the American Bar Association Task Force on the Future of Legal Education.[5] To make this happen, we needed space, staff support, and a modest financial contribution. Gary signed on without hesitation, and eventually committed a full day of his own time to the gathering. The result was an event of national interest, webcast in real time, as well as multiple stories in the country's legal press about this critical topic being examined at the McKinney School in Indianapolis.[6]

Of course, a law school's reputation cannot rest principally on adroit public relations. In this regard, Gary Roberts' talent for combining local and national ambition for the institution is visible in his description of the transformative gift from Mr. Robert H. McKinney, a commitment that will propel the School well into the national spotlight in fields yet to be imagined. All who believe in the rule of law will long be grateful for Bob McKinney's generosity. We will also be grateful to Gary Roberts for his seminal role in making the gift happen, strongly supported by people like Gene Temple, President of the Indiana University Foundation.

More than half of the gift, Gary is fond of pointing out, will go to help students meet the financial obligations necessary to gain a legal education in a tuition-and-debt environment that seems relentlessly headed in an adverse direction. The other half of the gift will endow five new faculty chairs to be filled by senior teacher-scholars of recognized national renown. Gary has called these additions an "unparalleled resource with which to realize the aspirations of our school—to become one of the finest public law schools in the nation."[7] These players-to-be-named-later will be great additions to the fifteen or so new faculty added to the team during the Roberts years.

Dean Roberts bolstered the School's financial health on two other less well-

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4. Samuel Alito, U.S. Sup. Ct. Justice, Keynote Address at the Indiana University Robert H. McKinney School of Law Conference on Relations Between Congress and the Federal Courts (Sept. 14, 2007); John L. Murray, Chief Justice of Ireland, The James P. White Lecture on Legal Education at the Indiana University Robert H. McKinney School of Law (Mar. 10, 2009). Fortunately for all, the Roberts and Murray visits were part of the continuing James P. White Lecture on Legal Education Series, from which the school may benefit in the future.

5. Held at the Indiana University Robert H. McKinney School of Law (Apr. 24, 2013).

6. *See e.g.*, *ABA Legal Education Task Force to Host Web Conference* (Apr. 19, 2013), http://www.americanbar.org/news/abanews/aba-news-archives/2013/08/aba_legal_education.html, *archived at* http://perma.cc/HVU9-5VYS. It is a happy fact that Gary's successor, Dean Andrew R. Klein, likewise readily lent support to this opportunity in his capacity as chief of staff to Chancellor Charles R. Bantz.

7. Scott Olson, *IU Law School in Indianapolis Gets $24M from McKinney*, INDIANAPOLIS BUS. J., Dec. 1, 2011, http://www.ibj.com/article/print?articleId=31085, *archived at* http://perma.cc/VU6B-DQJK.

publicized fronts. First, he managed to renegotiate the rate of the School's revenue annually contributed to central campus operations, effectively increasing the amount of tuition and other income that can be deployed in support of the School's budget. Second, he ably handled the last several years' budgets in ways that will help the School survive the present, prolonged downturn in student enrollment being experienced by virtually every law school in the country. His stellar performance on this front was rightly recognized in the most recent administrative review of his service by the Administrative Review Committee, a relatively tough crowd to please.[8]

Dean Roberts strives to elevate the School through scholarship and service in a field in which he is a legitimately international figure: the law of sports. Taking special advantage of the School's location near the headquarters of the National Collegiate Athletics Association and other national sports bodies, he has burnished the School's position in that field. The School's curriculum in the field is stronger than it has ever been, and the Sports and Entertainment Law Society sustains a robust set of opportunities. When the industry or its regulators need legal help, it is more likely that a McKinney lawyer will receive the tap.

Gary's mastery of the many topics that constitute sports law has placed him much in demand, for example, as on-air legal talent for the NFL Network.[9] When the long campaign reflecting Indianapolis's rising role in the world of sports reached its zenith with hosting Super Bowl XLVI in 2012, the national press was understandably on his door step. Gary has readily acknowledged that he responds to such requests partly because they are just plain fun, but he also knows that such activities serve another purpose. "It brings our institution into the public's consciousness," he told *The Indiana Lawyer*, "where good people are doing interesting things."[10]

Of course, as I have already said, such prominent publicity only works when it rests on high-caliber performance. Roberts has for some time been part of the body the International Olympic Committee (IOC) employed for one of its most ticklish tasks: the Court of Arbitration for Sport.[11] Most recently, he has received appointment for service in one of the IOC's premier events: the 2014 Olympic Winter Games in Sochi, Russia.[12]

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8. Memorandum from Charles R. Bantz, Chancellor, Indiana University Purdue University Indianapolis, to IUPUI Faculty Council (Jan. 31, 2013) (on file with author).

9. *Dean Gary Roberts Serves as NFL Network On-Air Legal Analyst*, IUPUI NEWS CENTER (Mar. 16, 2011), http://newscenter.iupui.edu/index.php?id=5072, *archived at* http://perma.cc/WKU9-KFKF.

10. Rebecca Berfanger, *Legal Analysts Use Media to Educate Public About Issues*, IND. LAW. (Mar. 30, 2011), http://www.theindianalawyer.com/legal-analysts-use-media-to-educate-public-about-issues/PARAMS/article/26028, *archived at* http://perma.cc/4NFH-HCYP.

11. *IU McKinney Dean Named to Court of Arbitration for Sport*, IND. LAW. (Apr. 6, 2012), http://www.theindianalawyer.com/article/print?articleId=28538, *archived at* http://perma.cc/3AMX-5HVF.

12. James Jewitt, *IU McKinney School Expert in Sports Law Heads Sochi Games*, IUPUI ARTS & HUMANITIES INSTITUTE (Feb. 3, 2014), http://www.iupui.edu/~iahi/?p=2307, *archived at*

Successful institutions have turning points in their histories that send them in a higher direction—people or events we readily recognize as marking moments when the enterprise made a turn for the better. For these, it may suffice to mention just a few words or an image, say, the Bepko years, or the day Justice Anthony Kennedy dedicated Inlow Hall, the house that Norman Lefstein built. Surely, the deanship years of Gary Roberts represent yet another such moment, one that can give us cause to face the future with optimism.

http://perma.cc/4WSL-J3DE.

GARY ROBERTS: AN APPRECIATION

PAUL N. COX*

INTRODUCTION

I was privileged to have served under Gary Roberts as his Vice Dean during most of the years of his deanship.

This was a period marked by significant changes in the law school. In part, these changes were fortuitous. For example, the faculty's composition changed radically in part due a tragic death and to many retirements and replacements (ultimately including my own). Its composition changed as well through Gary's leadership in expanding its size and in appointing many new and dynamic scholars. It was also through Gary's leadership that other significant changes occurred. The faculty adopted a strategic plan he initially drafted. At his urging, academic policies and procedures—particularly those governing examinations and grading—were re-examined and reformed. Academic programs and faculty research became better supported. The school's administration was reformed and strengthened. In particular, student affairs, external affairs, admissions and institutional development were greatly improved.

On all these counts, Gary's was a successful deanship. But it was more than this, as it not only changed but transformed the law school. He came to the school with a clearly stated diagnosis of the most significant challenge facing it. The school was doing a very good job of educating lawyers and had a solid academic reputation. It was enviably located in a thriving urban environment with immediate access to the courts and to the offices of federal and state government. Yet, the school was starved of the financial resources it needed to fulfill its great potential. Gary backed this diagnosis with grim statistics demonstrating that the school was greatly underfunded relative to both all other "Big Ten" law schools and, on an expenditure per student basis, relative to most law schools in the country. The solution was obviously to greatly increase financial resources.

I. STRATEGIES FOR INCREASING FINANCIAL RESOURCES

There were three strategies for pursing this solution. First, tuition could be raised. Gary did this, judiciously and reluctantly. It was, however, becoming increasingly clear that students could not sustain the student debt burden created by excessive tuition increases, so moderation was required, and tuition was not a panacea.

Second, overhead costs could be reduced, freeing resources for the school. Gary pursued an intense and ultimately successful campaign to reform the university's formulae for calculating overhead charges, reducing them significantly for the law school.

The third strategy is that for which Gary's leadership will no doubt be most remembered: increasing philanthropic support for the school. He pursued this

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with imagination, with great energy, and through an exhausting schedule of meetings, visits, conversations, luncheons, and dinners with alumni and others throughout the state of Indiana and, indeed, across the nation. At these he would with great persuasive force argue the case for the school. I observed these efforts, and was and remain enormously impressed by Gary's stamina, his intense devotion to the school's cause, and his ability to instill a significant measure of devotion in persons outside the walls of Inlow Hall.

II. Results

The efforts paid off. Alumni giving increased and a number of significant major gifts were made. The greatest success, of course, was the extraordinary naming gift made by Robert H. McKinney, transforming the school through support of student scholarships and faculty chairs, rendering it the Indiana University Robert H. McKinney School of Law.

I would be remiss, however, if I did not point out a further aspect of Gary's efforts, in part related to fundraising but also independently significant and largely pursued for independent reasons. Gary recognized, and never tired of reminding others, that the school has produced over its history an extraordinary number of political, judicial, business, and civic leaders both within Indiana and throughout the nation. This implied not only that the school was worthy of support, but also that these leaders, and, indeed, alumni generally, should be made a greater part of the life of the law school. Gary urged alumni to reconnect with the school, to participate in its programs and activities, and to become involved with its faculty and students. This, I believe, greatly strengthened the school, quite apart from the generous financial support offered by the alumni.

A further aspect of Gary's efforts, also of largely independent significance, was a general enhancement of the school's profile. It became better recognized and its reputation for excellence better acknowledged nationally through the publications of its enhanced external affairs office (which publications garnered several national awards), through Gary's presence and advocacy in national forums, and, with Gary's support, through faculty presentations and participation in national academic conferences and meetings. The school became better known and appreciated within the Indiana and Indianapolis communities through Gary's acceptance of leadership positions in civic organizations, his constant advocacy for the school, and his support of faculty initiatives connecting the school with local institutions.

Conclusion

In short, Gary Roberts, as dean, had a profoundly favorable impact on the law school. As the school now faces new challenges arising from a national decline in demand for legal education, it is a matter to be regretted that Indiana University's age limit for senior administrators compelled Gary to step down from the deanship. His leadership in a difficult time would have been invaluable. He is, however, an accomplished teacher and scholar, a very prominent figure in the field of sports law, and a continuing source of advice and counsel. He will no doubt continue to contribute greatly in his role as a member of the faculty.

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SYMPOSIUM

LEADING ACADEMIC, BUSINESS, AND GOVERNMENT FIGURES CONVENE TO EXAMINE LAW AND THE FINANCIAL CRISIS

ANDREA N. KOCHERT*
FRANK SULLIVAN, JR.**

"You never want a serious crisis to go to waste. . . . Things that we had postponed for too long, that were long-term, are now immediate and must be dealt with. This crisis provides the opportunity for us to do things that you could not do before."
— Rahm Emanuel, President Barack Obama's then-Chief of Staff[1]

INTRODUCTION

On April 4 and 5, 2013, more than 300 people gathered at the Robert H. McKinney School of Law for the *Indiana Law Review*'s "Symposium on Law and the Financial Crisis." The symposium brought together leading national figures from government, the private sector, and academia to pursue three inquiries: (1) law's role in instigating the financial crisis; (2) law's effectiveness in addressing the financial crisis; and (3) law's potential in preventing the next financial crisis. Over the course of the opening dinner and seminar, the speakers and attendees came away with a greater appreciation for the financial crisis the United States endured from 2007 to 2010 and efforts made by the government, the private sector, and academia not to let it "go to waste." The symposium agenda appears at the end of this article.

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1. Gerald F. Seib, *In Crisis, Opportunity for Obama*, WALL ST. J., Nov 21, 2008, http://online.wsj.com/article/SB122721278056345271.html, *archived at* http://perma.cc/J73W-4WL8 (statement of Rahm Emanuel, President Barack Obama's then-Chief of Staff, before a *Wall Street Journal* conference of top corporate chief executives in November 2008) (last visited May 20, 2014).

I. KEVIN KABAT, CEO, FIFTH THIRD BANCORP

The symposium began with a dinner on Thursday evening, April 4, with introductory remarks from David B. Meehan, Editor-in-Chief of the *Indiana Law Review*, and Andrew R. Klein, the newly-appointed dean of the Indiana University Robert H. McKinney School of Law.

The dinner's featured speaker was Kevin Kabat, Vice-Chairman and CEO of Fifth Third Bancorp,[2] who gave his perspective on the financial crisis—its principal events, its effect on Fifth Third's business, and the specific steps Fifth Third took in response.

Following Kabat's introduction by *Indiana Law Review* Symposium Editor Andrea N. Kochert, the audience warmly saluted Kabat in recognition of Fifth Third's recent $5 million donation to the Indianapolis Eskenazi Health Capital Campaign.[3]

Kabat assumed the role of Fifth Third's CEO in April 2007, the same month New Century Financial Corporation, a leading subprime mortgage lender, helped trigger the financial crisis by filing for Chapter 11 bankruptcy protection. His leadership of the "super-regional" bank holding company throughout the financial crisis has won him praise from the financial services industry and Fifth Third shareholders alike. During his presentation, Kabat explained how all players involved with the financial industry—the government, unregulated lenders, investment banks, regulators, borrowers, and traditional commercial banks like Fifth Third—had responsibility, admittedly some more than others, in causing and exacerbating the financial meltdown and subsequent recession. Kabat also described Fifth Third's quick and decisive actions that enabled it to survive and, in fact, grow from 2007 to 2013.

After his prepared remarks, Kabat was re-joined on the stage by Kochert. He candidly answered her questions, which addressed such matters as Fifth Third's decision to cut dividends and sell non-core banking assets in 2008 and the impact the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 on the

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2. Fifth Third Bancorp is a diversified financial services company headquartered in Cincinnati, Ohio. As of June 30, 2013, the company had $123 billion in assets and operated eighteen affiliates in twelve states, including Indiana. Fifth Third operates four main businesses: commercial banking, branch banking, consumer lending, and investment advisors. Fifth Third is among the largest money managers in the Midwest and, as of June 30, 2013, had $313 billion in assets under care, of which it managed $27 billion for individuals, corporations and not-for-profit organizations. *Investor Relations Home*, FIFTH THIRD BANK, http://phx.corporate-ir.net/phoenix.zhtml?c=72735&p=irol-IRHome, *archived at* http://perma.cc/5TQM-CQMM (last visited Aug. 30, 2013).

3. In October 2011, Fifth Third Bank and the Fifth Third Foundation donated five million dollars to the Eskenazi Health Foundation, the largest gift ever related to a financial institution in Indiana history. The gift supported construction of the new Sidney & Lois Eskenazi Hospital and Eskenazi Health campus. *Fifth Third Gift*, ESKENAZI HEALTH FOUNDATION, http://eskenazihealthfoundation.org/fifth-third-gift/, *archived at* http://perma.cc/P7XT-5DG4 (last visited May 20, 2014).

bank holding company.[4] The question-and-answer session ended with a focus on regional banking as the industry's new "sweet spot": large enough to bear regulatory burdens such as Dodd-Frank but nimble enough to provide excellent customer service.

II. Former U.S. Senator Evan Bayh

On Friday morning, April 5, the symposium resumed with the keynote address by former Senator Evan Bayh. Senator Bayh, as a senior member of the Senate Banking, Housing, and Urban Affairs Committee throughout the financial crisis, was at the center of the congressional response. He was among the key members of Congress to whom U.S. Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke described the state of the economy in the direst terms at an emergency meeting on September 18, 2009. His committee had jurisdiction over both the Emergency Economic Stabilization Act of 2008,[5] which established the $700 billion Troubled Asset Relief Program (TARP), and Dodd-Frank, which promotes financial stability in the United States through a variety of mechanisms. He was also among the Banking Committee members who conducted a dramatic hearing on November 18, 2008, during which executives of Ford, General Motors, and Chrysler requested access to the TARP for federal loans. Senator Bayh shared his candid observations on this period and its aftermath.

III. Law's Role in Instigating the Financial Crisis

Following Senator Bayh's remarks, the symposium turned to its first inquiry: the role that law may have played in causing the financial crisis. Antony Page, Vice Dean and Professor of Law at the Robert H. McKinney School of Law and himself an expert in corporate law, introduced this section of the program. Page noted the warning signs of the financial crisis even before the 2008 collapse of Bear Stearns Companies, Inc., and Lehman Brothers Holdings, Inc., including the April 2007 bankruptcy of New Century Financial Corporation referred to above and the July 2007 collapse of several Bear Stearns hedge funds, wiping out $1.6 billion in investments. However, Page emphasized that these events were only warning signs—in October 2007, for example, the U.S. stock market hit its all-time highs. Page observed that the financial losses and collapses, when mixed with other financial success in the market at the time, seemed tolerable and isolated. However, once the federal government failed to rescue Lehman Brothers, everything was thrown into turmoil.

Arthur E. Wilmarth, Jr., Professor and Executive Director of the Center for Law, Economics and Finance at The George Washington University Law School, followed Page's introduction with his new case study, *Citigroup: A Case Study in Managerial and Regulatory Failures*. Wilmarth traced the beginnings of the financial crisis back to the consolidation movement to large national banks in the

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4. Pub. L. No. 111-20, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301-5641 (2013)).
5. Pub. L. No. 110-343, 122 Stat. 3765 (2008) (codified at 12 U.S.C. § 5201-5261 (2013)).

early 1990s that magnified systemic risk,[6] as well as the passage in 1999 of the Gramm-Leach-Bliley Act.[7] (Gramm-Leach-Bliley partially repealed the Glass-Steagall Act of 1933 that had limited securities underwriting and dealing by banks and their affiliates, including bank holding companies.)

Wilmarth's presentation focused on the experience of Citigroup's creation in 1998 (a merger between Citicorp, then the largest bank holding company, and Travelers Salomon Smith Barney, then the largest insurance and securities holding company) and its near-collapse and repeated federal bailouts during the financial crisis of 2007 to 2009. Wilmarth argued that the creation of Citigroup, which he dubbed as the "poster child for the brave new world of financial conglomerates and diversified universal banking," helped hasten the repeal of Glass-Steagall because President Bill Clinton, the Secretary of the Treasury, and the Federal Reserve Board used it to pressure Congress to finally adopt Gramm-Leach-Bliley. In his analysis of Citigroup, Wilmarth drew parallels to the Great Depression of the 1930s and the notion of "too big to fail."

J. Robert Brown, Jr., Professor and Chauncey Wilson Memorial Research Chair at the Denver University Sturm College of Law, spoke next. In 1995, when the movement to repeal Glass-Steagall was gaining steam, Professor Brown wrote an article arguing against doing so.[8] At the symposium, he discussed the consequences of the deregulation he had opposed.

Professor Brown said the repeal of Glass-Steagall has permitted the largest commercial banks, fed by their new ability to engage in investment banking, to grow even larger while investment banks, unable to compete, have largely disappeared from the ranks of financial intermediaries.[9] One consequence of this new environment, Professor Brown contended, is that there is less capital available for start-up and small-to-medium-size businesses that do not satisfy traditional commercial loan underwriting standards. Companies without the requisite asset base or coverage ratios are simply not candidates for financing by commercial banks. But these were the kinds of risks that investment banks would underwrite; without investment banks, financing for this sector of the economy is not available.

A second consequence, Professor Brown maintained, is that the repeal of Glass-Steagall—called "deregulation"—has actually led to even more government regulation of commercial banks. This is because of the government's apprehension over the negative impact on the financial services market of a

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6. Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957 (1992).

7. Arthur E. Wilmarth, Jr., *How Should We Respond to the Growing Risks of Financial Conglomerates?*, BANKING LAW: FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 65 (Patricia A. McCoy ed., 2002).

8. J. Robert Brown, Jr., *The 'Great Fall': The Consequences of Repealing the Glass-Steagall Act*, 2 STAN. J.L. BUS. & FIN. 129 (1995).

9. According to Brown, there are now four megabanks (Bank of America, JPMorgan Chase & Co., Citibank, and Wells Fargo) and only two investment banks (Goldman Sachs and Morgan-Stanley).

possible commercial bank failure caused by ill-advised investment banking practices.

Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute, made the third presentation. Wallison has a lengthy record of service in both the Treasury Department and the White House during the Reagan Administration and was a member of the Financial Crisis Inquiry Commission.[10] The author of a major paper arguing that the repeal of Glass-Steagall by Gramm-Leach-Bliley in 1999 did not contribute to the financial crisis,[11] Wallison detailed the nature and effect of the provisions of Glass-Steagall that were repealed in 1999.

Carefully distinguishing among "banks,"[12] "bank holding companies,"[13] and "securities firms" (investment banks),[14] Wallison explained that under Glass-Steagall banks were not permitted to underwrite or deal in securities and that the repeal of Glass-Steagall did not change that. What Gramm-Leach-Bliley Act did authorize, Wallison explained, was for bank holding companies and their non-bank subsidiaries—but not banks themselves—to underwrite and deal in securities. This was sound policy, Wallison argued, because, given diminishing demand for conventional bank lending, bank holding companies under Glass-Steagall's restrictions were increasingly unable to compete with other financial intermediaries.

Wallison maintained that the repeal of Glass-Steagall could not have contributed to the financial crisis because there was nothing that the repeal permitted banks to do that they were not permitted to do prior to the repeal. What caused so many banks to fail or encounter financial difficulty during the financial crisis, he argued, was their dealing with subprime mortgages, either directly or as mortgage-backed securities, which was permitted by Glass-Steagall.[15]

Taken together, Brown and Wallison's analyses of the consequences of the repeal of Glass-Steagall were surprisingly consistent with each other in a number of important respects. Professor Brown made a sophisticated argument that reinstating pre-Gramm-Leach-Bliley limits on bank holding company securities underwriting and trading would permit securities firms to return to the marketplace, thereby increasing the availability of risk-based capital in the American economy and lessening the imperative for greater regulation of bank

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10. *See* FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 441 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, *archived at* http://perma.cc/YYD8-S4X3

11. Peter J. Wallison, *Did the 'Repeal' of Glass-Steagall Have Any Role in the Financial Crisis? Not Guilty; Not Even Close* (Networks Financial Institute 2009), http://ssrn.com/abstract=1507803 or http://dx.doi.org/10.2139/ssrn.1507803.

12. Entities chartered to accept demand deposits and permitted access to deposit insurance, the Federal Reserve's discount window, and the nation's payments system.

13. Non-bank entities that own one or more banks.

14. Entities that underwrite and deal in securities.

15. *See* THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 10, at 441 ("Dissenting Views of Peter J. Wallison").

holding companies.

And Wallison acknowledged Brown's argument that, to the extent one of the consequences of Gramm-Leach-Bliley was to shift the underwriting of securities from securities firms to bank holding companies, the availability of risk-based capital might well be diminished and government regulation increased. But Wallison maintained that while that was the best argument for reinstating Glass-Steagall, it was not a sufficient one. Rather, he contended, the risk-based capital necessary for economic growth would only be maximized where risk-taking and competition in the financial services industry includes bank holding companies, securities firms, and other financial intermediaries in direct competition with one another across the full range of financial products.

IV. LAW'S EFFECTIVENESS IN ADDRESSING THE FINANCIAL CRISIS

Following lunch, the symposium turned to its second inquiry: considering law's effectiveness in addressing the financial crisis. Tod Perry, Associate Professor of Finance at the Indiana University Kelley School of Business, introduced this section by identifying the ways in which the financial crisis has prompted changes in both regulation and enforcement. As to regulations, he noted that the very ambitiousness and complexity of Dodd-Frank makes them extremely difficult to implement. On the other hand, the legislation's "say-on-pay" provisions[16] have induced corporations to take action in response to shareholder advisory votes. In the end, what is important is analyzing the cost-benefit ratio of specific regulations.

As to enforcement, Perry observed that the SEC has made only limited use of new enforcement and penalty authority. Nor has the Department of Justice engaged in extensive prosecution of individuals for actions associated with the financial crisis. This record of limited enforcement, sometimes deemed "too big to jail," seems to be motivated, Perry said, by concerns over the collateral damage to the economy that might result from prosecution of executives at large financial institutions.

Washington University School of Law Professor Cheryl D. Block, made the first presentation of this session. Her expertise includes the study of "bailouts," and she spoke on the subject of Dodd-Frank. In her previous scholarship, Professor Block had identified what she terms "hidden" or "covert" bailouts—government activity designed to prevent economic failure that is disguised or otherwise not apparent on its face, for example, changes in tax law or tax policy not in any way announced as providing economic assistance to distressed businesses but being adopted for that express purpose.[17] She found this

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16. In general, "say-on-pay" is the practice of providing a firm's shareholders with an advisory vote on executive compensation. David C. Lee & Brian D. O'Neill, *Executive Compensation: Dodd-Frank's "Say-on-Pay" Provisions*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, http://gibsondunn.com/publications/Documents/Lee-ONeill-DoddFranksSayonPayProvisions.pdf, *archived at* http://perma.cc/FGX9-5UHL (last visited May 20, 2014).

17. *See* Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*,

history highly relevant to Dodd-Frank. Because the new law greatly restricts the flexibility of the government to respond to crises, reflecting dissatisfaction with the *ad hoc* nature of bailouts during the financial crisis, Professor Block anticipates that there will be an even greater incentive to use hidden or covert bailouts.

Following Block's presentation, Joe Hogsett, United States Attorney for the Southern District of Indiana, and Mark D. Stuaan, a partner in Barnes & Thornburg LLP who focuses his practice on white collar criminal defense, jointly addressed the role and effectiveness of criminal and civil enforcement actions in responding to the financial crisis.

Hogsett began by observing that the controversy regarding the prosecution of financial institutions and their officers ties directly to the larger, age-old questions of corporate liability and prosecutorial discretion. He then referred to United States Attorney General Eric Holder's remarks at a Senate Judiciary Committee hearing, in which Holder argued that there was "an inhibiting influence in the size of modern institutions." Hogsett defended Holder's position by reading corporate prosecution guidelines from the United States Attorney Manual (USAM), a guide for all federal prosecutors in their actions on behalf of the United States. In particular, Hogsett focused on USAM Title 9, Section 28.1000, "Collateral Consequences," and its comments to make clear that where collateral consequences for innocent third parties would be significant it *may* be appropriate to consider non-prosecution or deferred prosecution agreements. Hogsett then defended the use of non-prosecution agreements and deferred prosecution agreements as important tools for federal prosecutors when dealing with corporate criminal law.

Stuaan began his presentation with the premise that morally repugnant conduct such as greed is not necessarily a crime. He then defended the use of prosecutorial discretion in pursuing justice and determining whether the government had the evidence and resources to establish probable cause of a crime. Like Hogsett, Stuaan referred to the USAM in his analysis of law's effectiveness in addressing the financial crisis. Stuaan illustrated Hogsett's invocation of "collateral consequences" with the example of Arthur Anderson, a former "big five" accounting firm that was destroyed as a viable business due to the damage its reputation suffered when it was found guilty of criminal charges, even though the conviction was ultimately overturned by the United States Supreme Court.[18]

Stuaan then discussed another USAM provision: USAM Title 9, Section 28.1100, "Other Civil or Regulatory Alternatives," which specifies that a federal prosecutor should consider other alternative penalties to reach the same goal as a criminal prosecution. Stuaan defended the usage of non-prosecution agreements and deferred prosecution agreements as in the best interests of both defendants and federal prosecutors. He ended his presentation by arguing additional laws and steeper penalties were not necessary to combat financial

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67 IND. L.J. 951 (1992).

18. Arthur Andersen LLP v. United States 544 U.S. 696 (2005).

crimes.

V. LAW'S POTENTIAL IN PREVENTING THE NEXT FINANCIAL CRISIS

The symposium then turned to its third inquiry: evaluating law's potential for helping avert future financial crises. Valparaiso University School of Law Associate Professor David Herzig introduced this program by warning of a false sense of security that the problem of "too big to fail" that so contributed to the financial crisis was solved and gone. In his mind, the question was not whether another financial crisis would occur—but when. Herzig argued that the moral hazard of increased risk-taking encouraged by "too big to fail" was exacerbated by the institutional design of the financial market. In other words, economic models and government bailouts masked or eliminated the deterrence of taking excessive amounts of risk. To reduce systematic risk, Herzig raised four approaches that would be addressed by the third inquiry: (1) changing the scope of regulatory agencies, (2) creating a new agency to regulate the market, (3) establishing a new statute aimed at regulating the financial market, and (4) regulating the financial market from the bench.

M. Todd Henderson, Professor and Aaron Director Teaching Scholar at the University of Chicago Law School, followed Herzig's introduction with his explanation of why banking regulation failed and will continue to fail. Henderson began by noting that cycles of multiple bank failures have occurred in the United States about every twenty to thirty years. He then defended his thesis that "too big to fail" does not cause economic crises. What matters is the correlated risk in the economy that is generated by the banking sector, whether the banking sector has only a few or a great many entities. Henderson argued that the government would rescue *any* asset class with correlated risk if it materially threatened the economy generally, because the consequences would be the same regardless of size. After rejecting modes of regulation that operate before or after the fact like capital requirements, taxes, or the creation of a super-agency to regulate the banking sector, Henderson advocated an intermediate step using an economic model: the regulatory veto. Under this model, bank examiners would collect information about each bank's risk and shut down the banks when the risk became too large. Henderson then hypothesized that the effectiveness of bank examiners could be increased with incentive pay tied to whether an examiner's assigned bank did not fail and the internal auction of bank examination assignments.

University of Louisville Louis D. Brandeis School of Law Professor Lisa H. Nicholson was the final speaker. In addition to teaching securities regulation and corporate law, including the professional responsibility of lawyers in these settings, Professor Nicholson has securities and commercial litigation experience. She spoke on the subject of corporate governance and accountability, reviewing in some detail the provisions of Dodd-Frank regulating incentive compensation and comparing them to counterpart provisions in the Sarbanes-Oxley Act of

2002.[19] Using for illustration the trading losses suffered by JPMorgan Chase & Co. at the hands of the so-called "London Whale" in 2012,[20] Nicholson argued that compensation regulations such as those imposed by Dodd-Frank were likely to deter corporate misconduct more than enforcement of traditional corporate norms of fiduciary duty.

CONCLUSION

The *Indiana Law Review*'s 2013 Symposium on Law and the Financial Crisis successfully brought together leading figures from the worlds of business, government, and academia to share their respective experiences and viewpoints on the nation's greatest financial crisis since the Great Depression. The exhilarating mix of firsthand testimony from the eye of the storm to the sober and reflective analysis of noted law and business practitioners and professors made a marked contribution to understanding what occurred and preparing for the future. This volume sets forth much of that testimony and analysis.

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19. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 12 U.S.C. § 7201-7266 (2013)).

20. In 2012, a trader in JPMorgan and Chase Co.'s Chief Investment Office, nicknamed the London Whale, lost more than $6.2 billion based on a series of derivative transactions involving credit default swaps, reportedly as part of the bank's "hedging" strategy. These events raised the question whether banks were still addicted to risk and gave rise to a number of probes examining the firm's risk management and internal controls. Patricia Hurtado, *The London Whale*, QUICKTAKE BLOOMBERG, updated Oct. 17, 2013, http://www.bloomberg.com/quicktake/the-london-whale/, *archived at* http://perma.cc/UR4R-8H3A (last visited May 20, 2014); Dawn Kopecki, *JPMorgan Pays $920 Million to Settle London Whale Probes*, BLOOMBERG, Sept. 20, 2013, http://www.bloomberg.com/news/2013-09-19/jpmorgan-chase-agrees-to-pay-920-million-for-london-whale-loss.html, *archived at* http://perma.cc/95CZ-D5M2 (last visited May 20, 2014).

AGENDA

Opening Dinner – Thursday, April 4	
7:45 p.m.	**Welcome:** Ø David Meehan, Editor-in-Chief, *Indiana Law Review* Ø Andrew R. Klein, Paul E. Beam Professor of Law and Dean, Indiana University Robert H. McKinney School of Law Ø Andrea Kochert, Symposium Editor, *Indiana Law Review*
8:00 p.m.	**Perspectives on the Financial Crisis: Kevin T. Kabat**, Vice-chairman and Chief Executive Officer, Fifth Third Bancorp

Seminar – Friday, April 5	
8:00 a.m.	**Welcome:** Ø Andrea Kochert, Symposium Editor, *Indiana Law Review* Ø Dr. Charles Bantz, Executive Vice President, Indiana University, and Chancellor, Indiana University Purdue University Indianapolis
8:30 a.m.	**Keynote Address: Former U.S. Senator Evan Bayh** Former Chairman of the Subcommittee on Security and International Trade and Finance of the U.S. Senate Committee on Banking, Housing, and Urban Affairs
	Inquiry #1: Examining law's role in causing the financial crisis Did Law Cause the Financial Crisis?
9:15 a.m.	A Review of the Scholarship by the Moderator Ø Vice Dean Antony Page, Indiana University Robert H. McKinney School of Law
9:30 a.m.	"Citigroup: A Case Study in Managerial and Regulatory Failure" Ø Professor Arthur Wilmarth, Jr., Executive Director of the Center for Law, Economics and Finance at The George Washington University Law School
10:30 a.m.	Perspectives: The Gramm-Leach-Bliley Act and the Repeal of Glass-Steagall Act Ø Professor J. Robert Brown, Jr., Chauncey Wilson Memorial Research Chair at the University of Denver Sturm College of Law Ø Mr. Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute

	Inquiry #2: Considering law's effectiveness in addressing the crisis ***Did Law Solve the Financial Crisis?***
1:30 p.m.	A Review of the Scholarship by the Moderator Ø Professor Tod Perry, Indiana University Kelley School of Business
1:45 p.m.	The Dodd-Frank Act Ø Professor Cheryl Block, Washington University School of Law
2:30 p.m.	Criminal and Civil Enforcement Actions Ø Mr. Joe Hogsett, U.S. Attorney for the Southern District of Indiana Ø Mr. Mark Stuaan, Partner, Barnes & Thornburg LLP
	Inquiry #3: Evaluating law's potential to prevent the next financial crisis ***Will Law Prevent the Next Financial Crisis?***
3:45 p.m.	A Review of the Scholarship by the Moderator Ø Professor David Herzig, Valparaiso School of Law
4:00 p.m.	New Strategies for Regulation Ø Professor M. Todd Henderson, Aaron Director Teaching Scholar at the University of Chicago Law School
4:30 p.m.	Corporate Governance and Accountability Ø Professor Lisa Nicholson, University of Louisville Louis D. Brandeis School of Law

PERSPECTIVES ON THE FINANCIAL CRISIS[*]

KEVIN T. KABAT[**]

It's a pleasure for me to be here tonight. I spent many years in the great state of Indiana, first attending graduate school, and then actually starting my banking career at Merchants National Bank in Indianapolis. It's always good to be back.

Before I get started on my prepared remarks, I first want to thank Chancellor Bantz; professor and incoming dean of the school of law, Andy Klein; and Justice Sullivan for the invitation to speak. I also want to take a moment to thank Nancy Huber, our Central Indiana President, for accompanying me here this evening.

I've been asked to provide you with my perspectives on the financial crisis. And while I will try to paint an objective picture, I must be honest—I have more than a little bit of a regional bank bias, but I'll do my best to hide it.

First, let me give you a nugget of background, which will help you put the timing in perspective. I became CEO of Fifth Third Bank in April 2007. Some say the actual start of the crisis began a short ninety days later with the liquidation by Bear Stearns of two hedge funds that invested in various types of mortgage-backed securities. Timing is everything, I guess. It's been more than four years, and I still cringe when I remember those times.

Over the years, I've gotten the question many times "who's to blame for the financial meltdown and subsequent recession," and the best answer I can give is that everyone is to blame—government, unregulated lenders, investment banks, regulators, borrowers, and, yes, traditional commercial banks like Fifth Third all played a role—although some more so than others.

Shortly after the technology bubble and in the aftermath of 9/11, the Federal Reserve significantly reduced interest rates in order to mitigate the negative impact of recent events on the economy.[1] Low bond rates, low interest rates, and skepticism of the stock market significantly increased the attractiveness of real estate as an investment vehicle. This factor—coupled with government-sponsored enterprises that had a congressional mandate to increase home ownership—led to rapidly increasing real estate prices in many parts of the country.[2]

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* This is the text of the speech given to open the 2013 Indiana Law Review's national symposium, "Law and the Financial Crisis," delivered by Kevin T. Kabat on April 4, 2013 at the Indiana University Robert H. McKinney School of Law.

** Vice Chairman and CEO, Fifth Third Bancorp. Kevin previously served as Executive Vice President and led both retail and affiliate banking at Fifth Third, as president and CEO of Fifth Third Bank (Western Michigan), and as Vice Chairman and President of Old Kent Bank (which was acquired by Fifth Third Bancorp in 2001). Kevin received his bachelor's degree in Behavioral Science from Johns Hopkins University and a master's degree in Industrial/Organizational Psychology from Purdue University.

1. GAIL MAKINEN, CONG. RESEARCH SERV., RL 31617, THE ECONOMIC EFFECTS OF 9/11: A RETROSPECTIVE ASSESSMENT 15-16 (2002), *available at* http://www.fas.org/irp/crs/RL31617.pdf.

2. FIN. CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NAT'L COMM'N ON THE CAUSES OF THE FIN. AND ECON. CRISIS OF THE UNITED STATES 5-10 (2011) [hereinafter FIN. CRISIS INQUIRY COMM'N], *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

As property values rose, so did the availability of credit.[3] The "shadow banking" system that was comprised of unregulated lenders and securitization markets began to account for more and more lending activity—peaking at over seventy percent of all credit extended between 2003 and 2006.[4] This was further exacerbated by the emergence of new loan products that increased availability of credit, but were often done at teaser rates that would reset, required little money down, or completely circumvented most of the traditional underwriting process.[5] Pressure from the regulatory bodies responsible to Congress for the Community Reinvestment Act,[6] fair lending, and comparing "standard" lending practices to alternative lending offers only compounded the problem.[7]

The majority of toxic loan products, such as option-ARMs, subprime loans, and exotic mortgages, were created by lenders completely outside of the traditional regulatory authority of agencies like the Federal Reserve, FDIC, and the Office of the Comptroller of the Currency.[8] Investment banks with their exotic products, such as collateralized debt obligations, served to make matters worse.[9] I note that many traditional banks like Fifth Third did not originate these types of products, but we did continue to compete in more vanilla categories that were being underwritten based on grossly inflated property values. Don't misinterpret my message. Traditional banks played a role. Our risk management processes were not developed enough to help us avoid the forthcoming problems and the industry should have had a better understanding of the interconnectedness of our business to all that was to ensue.

The rest, as you know, is history. Teaser rates began to expire, property values began to decline, and we began to see more and more borrowers unable to pay their mortgages.[10] Given that consumer savings in America were at the lowest levels since the government began tracking the statistic in the 1950s, many people had little, if any, contingency funds to fall back on.[11] With the fall of large

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3. *Id*. at 83-84.

4. Saskia Sassen, *Expanding the Terrain for Global Capital: When Local Housing Becomes an Electronic Instrument*, *in* SUBPRIME CITIES: THE POLITICAL ECONOMY OF MORTGAGE MARKETS 80 (Manuel B. Aalbers ed., 2012).

5. FIN. CRISIS INQUIRY COMM'N, *supra* note 2, at 104-05.

6. Community Reinvestment Act of 1977, Pub. L. No. 95-128, tit. 8, § 802, 91 Stat. 1147 (1977).

7. U.S. DEP'T OF HOUSING & URBAN DEV., RECENT HOUSE PRICE TRENDS & HOMEOWNERSHIP AFFORDABILITY 85 (2005), *available at* http://www.huduser.org/Publications/pdf/RecentHousePrice.pdf.

8. *See Fair Lending*, U.S. DEP'T OF HOUSING & URBAN DEV., http://portal.hud.gov/hudportal/HUD?src=/topics/fair_lending (last visited Jan. 24, 2014) ("[S]ubprime lenders are largely unregulated by the federal government.").

9. FIN. CRISIS INQUIRY COMM'N, *supra* note 2, at 155.

10. *Id.* at 107-09.

11. *See* C. Alan Garner, *Should the Decline in the Personal Saving Rate be a Cause for Concern?*, FED. RES. BANK OF KANSAS CITY 8-9 (2006), *available at* http://www.kc.frb.org/publicat/econrev/PDF/2Q06garn.pdf.

banks, such as IndyMac and Lehman Brothers, liquidity dried up and panic ensued. Ultimately, lack of effective oversight of the shadow banking system and congressional meddling in housing policy played a large role in the crisis, but so too did banks continuing to compete for loans well past the point where it made economic sense.[12]

It's important to remember that, at this time, fear was rampant that the banking system would collapse and all banks would be nationalized. It seemed that the world was teetering on the brink of disaster. Even to me, it seems hard to believe the severity of the events and the negative sentiment that was pervasive at the time. But it was real—I know, I was there.

As a result of the impending crisis, the Bush Administration and Congress implemented the Emergency Economic Stabilization Act in early October 2008.[13] This bill was designed to restore liquidity and consumer confidence in the financial markets.[14] The most well-known component of this bill was the Troubled Asset Relief Program (TARP), which was designed to enable the U.S. Treasury to purchase preferred shares in healthy U.S. banks.[15]

While we at Fifth Third were initially relieved about our participation in the program, we soon learned TARP carried quite a stigma for the participating banks. It was common to hear the word "bailout" associated with the program.

Truth is, TARP was never a bailout. It was an investment made by the government in banks of all sizes to shore up their capital positions and encourage them to make loans to help spur the U.S. economy.[16]

Under TARP, the government invested $245 billion in banks, and, as of September 2012, banks repaid the government $267 billion through principal and interest.[17] That's a $21 billion profit to taxpayers. Specifically, Fifth Third Bank paid back more than $170 million per year—a total of $346 million in preferred dividends.[18]

In theory, the concept of TARP was a good one—it was all about restoring confidence in the system. In reality, it became, as one of my colleagues deemed it, a scarlet letter.

Was TARP necessary? I could make arguments on both sides. When the

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12. FIN. CRISIS INQUIRY COMM'N, *supra* note 2, at 444-45.

13. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

14. *Id*. § 2.

15. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, tit. 1, § 101, 122 Stat. 3765 (2008).

16. *Why TARP Was Necessary*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/about-tarp/Pages/Why-TARP-was-Necessary.aspx (last visited Jan. 24, 2014).

17. AGENCY FIN. REPORT, DEP'T OF THE TREASURY, OFFICE OF FIN. STABILITY—TROUBLED ASSET RELIEF PROGRAM, at viii (2012), *available at* http://www.treasury.gov/initiatives/financial-stability/reports/Documents/2012_OFS_AFR_Final_11-9-12.pdf.

18. ANNUAL REPORT 2011, FIFTH THIRD BANKCORP 17 (2011), *available at* http://ir.53.com/phoenix.zhtml?c=72735&p=quarterlyearnings.

goal of legislation and government intervention is to protect consumers or achieve a shared goal, we willingly accept certain limitations on our business model. However, there are situations when legislation is specifically designed to hamper efforts to provide the best service to our customers or in delivering value to our shareholders.

So how did Fifth Third survive the meltdown? I believe it's because we reacted quickly and decisively—well ahead of our peers. In the beginning we took some heat for those actions. We raised more than a billion dollars of capital. We sold non-core assets and cut our dividends. We refined our credit and oversight practices. We took these actions certainly not because they were the easy or popular things to do—far from it. We took these actions because they were the right things to do. And, as I said during the height of the crisis and I continued to say years later, making the decisions we did made Fifth Third a better, stronger, and smarter bank. And now we are seeing the financial benefits of those decisions.

In 2012, Fifth Third's net income was $1.6 billion, the second highest in the company's 155-year history. And earnings per share were up forty-one percent. The operating environment continues to be challenging, but if 2012 is any indication, there are many better days ahead.

As I wrap up my remarks, I would like to say in closing that the financial crisis of 2008 and 2009 was without a doubt the most challenging time in my career, and I hope, my lifetime. As hard as it was though, I am deeply proud of the outcome. We're looking forward to a bright future.

A SENATOR'S RECOLLECTION OF THE FINANCIAL CRISIS

EVAN BAYH*

I was privileged to serve as United States Senator from Indiana from 1999 to 2011. During those twelve years, our nation faced many challenges. Among the most severe was the financial crisis that began gathering force in 2007 and climaxed with the bankruptcy filing of the investment banking giant Lehman Brothers Holdings, Inc., on September 15, 2008.[1] As a senior member of the Senate Committee on Banking, Housing and Urban Affairs ("Banking Committee"), I was deeply involved in the policy debates and legislative response to the crisis.

In this Article, I set forth a few of my recollections on three aspects of the legislative response to the financial crisis: the Emergency Economic Stabilization Act; assistance for the American automobile industry; and the Dodd–Frank Wall Street Reform and Consumer Protection Act.

I. EMERGENCY ECONOMIC STABILIZATION ACT (TARP)

The reaction to the Lehman Brothers' bankruptcy filing on Monday, September 15, 2008, was swift and severe. The very next day, the Federal Reserve (with the full support of the Treasury Department) approved a loan of $85 billion to insurance giant American International Group (AIG) to prevent it from failing.[2] As the *Washington Post* reported at the time, a "massive disruption of the financial system" took place that day and the next:

> The AIG rescue hadn't calmed nerves. In fact, there appeared to be a run developing on money-market mutual funds, a $3.5 trillion pool of savings that was supposed to be nearly as safe as cash but lacks any government guarantee. If money-market funds failed, ordinary people stood to lose huge sums, stirring wider panic. Meanwhile, shares of Morgan Stanley and Goldman Sachs Group, the last two freestanding investment banks, sunk as investors bet they would collapse just as their rivals had. Commercial banks stopped lending to each other. The stock markets dove.[3]

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* United States Senator (1999-2011); Governor of Indiana (1989-1997); B.S., 1978, Indiana University Kelley School of Business; J.D., 1981, University of Virginia School of Law.

1. Press Release, Lehman Brothers, Lehman Brothers Holdings, Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition; No Other Lehman Brothers' U.S. Subsidiaries or Affiliates, Including Its Broker-Dealer and Investment Management Subsidiaries, Are Included in the Filing (Sept. 15, 2008), *available at* http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf.

2. Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Will Lend Up To $85 Billion To American International Group (AIG) (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.

3. Lori Montgomery et al., *A Joint Decision to Act: It Must Be Big and Fast*, WASH. POST, Sept. 20, 2008, http://www.washingtonpost.com/wpdyn/content/article/2008/09/19/AR2008091903996.html?sid=ST2008092001054.

On the evening of September 18, I was among a group of senior Senators from both parties who attended an emergency meeting at the Capitol with Treasury Secretary Henry M. Paulson, Jr., and Federal Reserve Chairman Ben S. Bernanke. The meeting was off-the-record and the discussion confidential but it has subsequently been publicly reported that Paulson and Bernanke said they would be proposing legislation to allow the government to buy "troubled assets" from financial institutions and urged its immediate passage.[4] "Unless you act, the financial system of this country and the world will melt down in a matter of days," Secretary Paulson was quoted as saying.[5] And Chairman Bernanke was quoted as saying, "If we don't do this tomorrow, we won't have an economy on Monday."[6]

This was the predicate for a dramatic meeting of the Banking Committee on September 23, 2008, when Secretary Paulson, Chairman Bernanke, Securities and Exchange Commission Chairman Christopher Cox, and Federal Housing Finance Agency Director James B. Lockhart III appeared to present the Bush Administration's request for authority to purchase troubled assets—to become known as "TARP"—for "Troubled Asset Relief Program."[7]

The sense of urgency was palpable. After all, Chairman Bernanke—a man who, it was safe to say, is not known for engaging in hyperbole—had just told us that we were perhaps only a matter of days from the beginning of a major economic collapse. He had warned of nothing less than the free fall of our financial markets and the beginnings of a severe and protracted recession that could put companies out of business and result in many jobs lost, savings wiped out, people losing their homes, and real distress for our country.

We needed to ask what alternatives had been considered. Why were we convinced that this was the right path? Were there no private sector solutions available that would perhaps lead to better outcomes than the ones that have been proposed? For me, the focus was on getting it right, and I wanted us to take the time to do just that.

Among my concerns were these. Several of my colleagues, including Senator Robert Menendez of New Jersey, had mentioned that our purpose should be to protect the taxpayers by buying the "troubled assets" from financial institutions at market prices. If that was to be the case, I needed to know how that would help solve the capitalization problem of these institutions.

On the other hand, if we were to pay above market prices, I needed to know what the taxpayers would receive in return. If equity was to be the answer to that

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4. *Frontline: Inside the Meltdown* (PBS television broadcast Feb. 17, 2009), *transcript available at* http://www.pbs.org/wgbh/pages/frontline/meltdown/etc/script.html.

5. *Id.*

6. *Id.*

7. *See* David M. Herszenhorn, *Administration Is Seeking $700 Billion for Wall Street*, N.Y. TIMES, Sept. 20, 2013, *available at* http://www.nytimes.com/2008/09/21/business/21cong.html; *see also Text of Draft Proposal for Bailout Plan*, N.Y. TIMES, Sept. 20, 2013, *available at* http://www.nytimes.com/2008/09/21/business/21draftcnd.html?_r=2&.

question, that would be one thing. But if not equity, I wanted to know why not. And I wanted to know why we encouraged (or at least permitted) sovereign wealth funds to invest in American companies and markets, but perhaps would not allow the American taxpayers to take a similar interest in our own companies and markets.

And it seemed to me that while we had to act, we also had to be willing to take the steps to make sure that this situation did not reoccur in the future. Underlying my concerns in this regard was the sense of outrage on the part of ordinary taxpayers. I was hearing from my constituents constantly. These were people who had behaved prudently, who had not taken inordinate risks, who had saved their money, who had not gotten in over their heads, who had not participated in highly leveraged instruments that had now come back to haunt them. We owed it to them to make sure that we learned the right lessons from this so that it would not happen again.

I was not cynical but skeptical about the way Washington can work in times like these. Congress will act in a moment of crisis, but once the crisis has abated, the sense of urgency will dissipate. The forces of reform would not have the energy that they had at the moment of crisis. All the interests opposing reform would then circle Washington like hungry birds looking at carrion in order to prevent us from taking the steps that were necessary. I was determined to try to prevent that from happening.

I recognized that Congress could not make the long-term reforms needed in the time frame that was at our disposal in September 2008, but I told my colleagues that I would be looking for some mechanism that would force us to revisit this issue. I firmly believed that absent long-term reform, a similar financial crisis would happen again, that history would judge us poorly, and our children and grandchildren would not forgive us.

The Emergency Economic Stabilization Act of 2008[8] containing TARP came before the Senate for a final vote on October 1. Viewing it as a distasteful but necessary step to protect millions of innocent people from the malfeasance of a few, I voted for the bill.

In doing so, I recognized that people were angry, and they had a right to be. I was, too. We should not have been in that mess, but we were. What were we going to do? After all, Chairman Bernanke, our nation's top economic expert, believed that if swift action was not taken to stabilize our financial system, Americans would face a deep and protracted recession, and millions will lose their jobs, life savings, and businesses. These were not just faceless statistics or big shots on Wall Street. Those who would pay the price for inaction were the workers at the cancelled construction project, small business owners who could no longer make payroll, students who would not be able to attend college because they could not get a loan, and senior citizens who could no longer make ends meet because their nest eggs had been devastated. All would suffer if we did not act.

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8. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (codified in 12 U.S.C. §§ 5201-5261 (2008)).

Could Chairman Bernanke have been wrong? Yes. Was ignoring his advice a risk worth running at that precarious time for our nation? I did not believe so. As distasteful as it was for Congress to pass the TARP legislation, doing nothing would likely have made things much worse. That was the choice before us as I saw it.

Although not a good option, I did think the final bill we were voting on was far better than the original proposal. Executives who had brought their companies to the brink of ruin and now sought public help would be prevented from profiting. There would be no golden parachutes or outrageous executive pay packages. There would be independent oversight to prevent conflicts of interest and outright corruption. The taxpayer would be protected by receiving an ownership interest in any company that received government assistance. If after five years the government had lost money, the financial industry would be required to pay it back.

I also thought the bill had been improved by including tax cuts to help middle class families. I calculated that more than 900,000 Hoosier homeowners would be eligible for a property tax cut. Tens of thousands of students would receive a $4000 college credit. Thousands of middle class Hoosier families would not see their taxes rise due to the Alternative Minimum Tax.

I remained firm in my resolve that, once we had dealt with the present crisis, we must channel our anger into making sure this never happened again. There were, of course, many culpable parties. Houses had been appraised at above market rates to make ill-advised loans possible. Loans had been given to individuals with no verification as to their ability to repay. These bad loans had been packaged into securities and sold to financial institutions, undermining their financial strength. Rating agencies had given their blessing, saying that these "junk" securities were "AAA" rated. Financial firms, seeking massive profits, had become highly leveraged, greatly exacerbating the harm of any potential mistake. Credit default swaps and other derivative products had proliferated in unregulated markets to such an extent that the entire financial system had been endangered. "Off-balance sheet accounting" had permitted companies to hide assets from public view. They were supposed to have been inconsequential. It turned out they were anything but. All of these items and countless others had contributed to the crisis that faced us on October 1, 2008. I was firmly convinced that all needed to be corrected.

The TARP legislation was no panacea. More difficult decisions lay ahead. But the TARP bill was better than doing nothing—and that was the alternative.

Two days later, on October 3, President Bush signed the Emergency Economic Stabilization Act into law, thereby establishing the $700 billion TARP program.[9] And ten days after that, on October 13, the Treasury Department announced that TARP would make $250 billion of capital available to U.S. financial institutions by purchasing preferred stock and that nine large institutions intended to participate.[10]

9. *Id.*

10. *See* Mark Landler, *U.S. Investing $250 Billion in Banks*, N.Y. TIMES, Oct. 14, 2008,

II. AUTO INDUSTRY ASSISTANCE

Of particular concern to me in this time period was the health of the American auto industry. For whatever problems American automakers had brought upon themselves, there was no denying that the financial crisis had caused a severe decline in consumer demand in general and drying up of consumer credit in particular. The resulting drop in consumer demand had materially adversely affected auto sales.[11]

On November 18 and 19, the leaders of Chrysler, Ford, and General Motors appeared on Capitol Hill to request emergency government financial assistance.[12] On November 19, they testified before the Banking Committee. At this hearing, I urged my colleagues to support action to help the struggling domestic American auto industry.

My analysis was grounded in the historic nature of the times. We faced, of course, what Chairman Bernanke had described as the greatest financial panic since the 1930s, a situation that had contributed, at least in part, to the greatest real downturn in the economy since at least the early 1980s. But more than that, this was the first significant economic downturn since the advent of globalization. Rather than having rapidly growing parts of the world serving as countervailing forces to weakness at home, now weakness in one part of the world begot further weakness. As such, we were running the risk of an accelerating economic decline around the world.

These unprecedented times had, as discussed above, led our government to intervene in the banking sector, taking significant equity stakes in the largest banks of our country, and in the insurance sector, virtually taking over one of the largest insurance companies in the world.

In addition, we had taken over Fannie Mae and Freddie Mac, turning government sponsored enterprises into government-run concerns. We had moved to stabilize the money market system. We were looking at the credit card

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http://www.nytimes.com/2008/10/14/business/economy/14treasury.html?pagewanted=print; *see also* Mark Landler & Eric Dash, *Drama Behind a Banking Deal*, N.Y. TIMES, Oct. 14, 2008; EDWARD NELSON, THE GREAT RECAPITALIZATION, ECONOMIC SYNOPSES, FEDERAL RESERVE BANK OF ST. LOUIS (No. 29 2008), *available at* http://research.stlouisfed.org/publications/es/08/ES0829.pdf.

11. The impact of the financial crisis on the entire auto industry was highlighted late in 2008 by Toyota's announcement of its first operating loss in seventy years. As the Wall Street Journal reported, "The recent pleas from the Big Three U.S. auto makers for a bailout from Washington have kept the spotlight on Detroit. But Toyota's forecast of an operating loss indicates auto makers of every stripe are facing extraordinary challenges." Yoshio Takahashi & Kate Linebaugh, *Toyota Sees First Loss in 70 Years: Global Plunge in Car Demand Creates an "Emergency That We've Never Experienced*,*"* WALL ST. J., Dec. 23, 2008, http://online.wsj.com/news/articles/SB122992788012825897.

12. Bill Vlasic & David M. Herszenhorn, *Detroit Chiefs Plead for Aid*, N.Y. TIMES, Nov. 18, 2008, http://www.nytimes.com/2008/11/19/business/19auto.html.

situation and student loans. And we were even debating whether entire states and municipalities may need financial assistance from our government to weather the unprecedented and unpredicted challenges of the times.

To permit the auto industry to fail would only add to the instability, fragility, and unpredictability of the economy that these steps reflected. In my view, if we allowed tens of thousands of ordinary people to lose their jobs, thousands of small businesses, suppliers, dealerships and others to be imperiled, three of the largest corporations in the country to run the risk of going down, it would have not only had those effects on the economy but unintended consequences as well, some of them quite possibly severe.

At the same time, I recognized that all of the major stakeholders needed to participate and make contributions if government assistance was to be forthcoming. Fortunately, there was a model to go by—the 1979 plan that had rescued the Chrysler Corporation. In that particular case, all the stakeholders did step up. The right decisions were made. And the net result was that the jobs were saved, the company was saved, and the taxpayers were repaid ahead of time and earned a profit. I was of the view that the current crisis, like the crisis of 1979, could be a win-win situation.

The requests of the auto executives on November 18 and 19 did not produce immediate positive results.[13] But discussions among the industry, Congressional leaders, and the Bush administration ultimately produced a plan, called the Auto Industry Financing and Restructuring Act, to provide up to $14 billion in emergency loans to General Motors and Chrysler.[14] The House of Representatives passed the bill on December 10 by a vote of 237 to 170.[15]
On the day of the House vote, I issued the following statement:

> We're faced with trying to choose the best among unpalatable alternatives. Nobody wanted to give money to the banks or to the insurance companies, and nobody wants to give money to the auto industry. I don't. But if the alternative is losing hundreds of thousands of jobs and having automakers, dealerships, part suppliers, and other retailers in local communities go down, we have to make a hard choice here.
>
> People think the economy is bad now, but if we let all these companies go belly up, and all those folks get laid off, I'm afraid it would be much worse.

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13. Bill Vlasic & David M. Herszenhorn, *Auto Chiefs Fail to Get Bailout Aid*, N.Y. TIMES, Nov. 19, 2008, http://www.nytimes.com/2008/11/20/business/20auto.html.

14. David M. Herszenhorn & David E. Sanger, *House Passes Auto Rescue Plan*, N.Y. TIMES, Dec. 10, 2008, http://www.nytimes.com/2008/12/11/business/11auto.html?pagewanted=all&gwh=AEEE7883B17F88E371594994C377946F&gwt=pay.

15. *Id.* The vote was mostly along party lines. Voting in favor were 205 Democrats and 32 Republicans. Voting against were 150 Republicans and 20 Democrats. *Id.*

> Indiana has a huge stake in this debate. If the big auto companies go down and thousands of jobs are lost, it's going to hit us a lot harder than almost any place else in the country.
> We are establishing strict criteria that the auto companies have to meet, and we are insisting that all of the different stakeholders make the sacrifices necessary for the long-term survival of the industry.[16]

The next day the Senate took up the Auto Industry Financing and Restructuring Act but the measure failed to garner the 60 votes necessary under the Senate rules to permit consideration.[17] My Indiana colleague, Senator Richard Lugar, and I both voted in favor of considering the bill.[18]

Following defeat of this legislation, the Bush administration immediately fashioned an emergency loan program for General Motors and Chrysler that it implemented without explicit authorizing legislation.[19] The Obama Administration, which took office the next month, later fashioned its own assistance program for General Motors and Chrysler.[20] Today, the American auto industry has been revitalized.

III. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

As discussed above, my vote for TARP was accompanied by a resolve to support additional legislation to prevent a reoccurrence of the financial crisis. Legislation to that end was enacted approximately two years later when President Barack Obama signed the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") into law on July 21, 2010.[21]

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16. Press Release, Office of Senator Evan Bayh, Statement from Senator Bayh on Auto Rescue Legislation (Dec. 10, 2008), *available at* http://www.insideindianabusiness.com/newsitem.asp?ID=32986.

17. David M. Herszenhorn, *Senate Abandons Auto Bailout Bid After G.O.P. Balks*, N.Y. TIMES, Dec. 12, 2008, http://query.nytimes.com/gst/fullpage.html?res=9500E7DE1F3EF931A25751C1A96E9C8B63.

18. The Senate voted 52 to 35 to reject a motion to invoke cloture on a motion to proceed to consider House Resolution 7321. *Id.*

19. *See* John D. McKinnon & John D. Stoll, *U.S. Throws Lifeline to Detroit*, WALL ST. J., Dec. 20, 2008, http://online.wsj.com/news/articles/SB122969367595121563; *see also* Jack Healy, *Stocks & Bonds; Shares End Mixed After Brief Bounce*, N.Y. TIMES, Dec. 20, 2008, http://query.nytimes.com/gst/fullpage.html?res=9904E4DB133EF933A15751C1A96E9C8B63 (discussing the affect of the Bush administration's action on the financial markets).

20. *See generally* STEVEN RATTNER, OVERHAUL: AN INSIDER'S ACCOUNT OF THE OBAMA ADMINISTRATION'S EMERGENCY RESCUE OF THE AUTO INDUSTRY (Houghton Mifflin Harcourt 2010) (recounting the Obama administration's actions to further assist the auto industry).

21. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat 1376 (2010); *see also* Helene Cooper, *Obama Signs a Contentious Overhaul of the U.S. Financial System*, N.Y. TIMES, July 22, 2010, http://query.nytimes.com/gst/fullpage.html?res=9E03EFD71331F931A15754C0A9669D8B63. My recollections on Dodd-Frank at the time of its passage set forth here are derived from comments I made on July 26, 2010, in an interview with

I voted for Dodd-Frank because I believed that it made it less likely in several ways that there would be a recurrence of the financial crisis.

First, when Lehman Brothers failed—which, as we have seen, was the domino that threatened to tip over all the other dominos in the economy—one of the problems was that there was no mechanism for the government to step in and seize that entity. The new law included a systemic risk council, where the government would monitor the level of risk that was being run by key financial institutions. If they threatened to get so big and take on such levels of risk that it threatened the national or global economy, the government would be in a position to do something about that.

And if these institutions began to fail, the government would now have resolution authority to step in and have an orderly unwinding of a business like Lehman Brothers rather than a chaotic one or one that took place over years. So there were mechanisms in Dodd-Frank that would help deal with the kind of panic that we had been through.

I think Dodd-Frank sent a number of messages. The hope was to make the financial markets more stable while minimizing the increased costs to both industry and, ultimately, to the consumer. However, Dodd-Frank was not going to prevent the recurrence of financial instability from time to time. No reform in the history of financial markets has ever accomplished that.
Although Dodd-Frank had these positive aspects, I nevertheless had concerns about the future.

My biggest concern was that we would continue to see an imbalance in consumption and savings in the global economy. Some economies—most notably China, Germany and some other parts of the developing world—were growing rapidly, saving large amounts of money, and basing their economies on exports.

The United States and a few other countries continued to consume more than we produced. So we were running fairly sizeable current account imbalances. As long as we had these imbalances that were unsustainable, they were going to manifest themselves in some way. It was a tech bubble back around 2000 that burst. It was a real estate bubble that burst in 2007 and 2008. When you have large disequilibrium, something bad is going to happen unless you move to correct it.

As mentioned above, I thought that the actions of Fannie Mae and Freddie Mac contributed to the financial crisis. I was in the small minority of the members of my political party who voted to include Fannie Mae and Freddie Mac reform in Dodd-Frank. They should have been included in the legislation, but they were not.

Another concern I had was that in the absence of global consensus and convergence on some of the standards in Dodd-Frank, its intent would be defeated, and Dodd-Frank could actually have some harmful effects on U.S.

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reporter Nin-Hai Tseng of CNN. Nin-Hai Tseng, *Bayh: How Financial Reform Could Impede Growth*, CNN MONEY, July 26, 2010, http://money.cnn.com/2010/07/26/news/economy/bayh_financial_reform.fortune/.

employment and growth in jobs and capital overseas. That would not be a good thing. So we would need to work with our allies to try and promote common standards in this regard.

Derivative trading was an example. We could do whatever we want regarding derivatives in this country, but if most other major economies did not have the same standards, the activity was still going to occur, it was just going to occur offshore. The risks would still be run, but the jobs and capital would no longer be here in our country. We needed to watch out for such unintended consequences.

As far as protecting consumers, the Consumer Financial Protection Bureau created by Dodd-Frank had real enforcement powers over consumer lending and so had great potential to safeguard consumers. But it also had the potential for abuse. I called for the Director of the Bureau to be very practical and understanding of the real world consequences of the decisions the Bureau would make.

More broadly, I was concerned that if Dodd-Frank was not enforced in the right way, it could impede economic growth. We did not want financial institutions to go back to reckless lending—lending that was not based on sound fundamentals. But we did want them to lend to credit-worthy businesses and individuals. That would be important to economic growth. If the new regulations made financial institutions so much less profitable that they did not have as much money to lend, or made financial institutions so gun-shy that they did not lend to even very credit-worthy customers, that would impact economic growth. That was something that would need to be corrected if it happened.

I thought the concern expressed by some that Dodd-Frank puts too much authority in the hands of regulators was a real risk and a legitimate criticism. But the alternative was to have legislators writing the rules with great specificity. These are people who are well-intended but they are not sufficiently familiar with these very complex issues. I thought that would have been a worse alternative.

We could also have done nothing, which given the panic we had been through was also not a satisfactory alternative. So I thought that what we had to do was be very vigilant over the regulators. If they started making ill-advised decisions, then elected officials needed to step in and say, "Wait a minute, that's not what we meant." Or to be honest and say, "We thought this was going to work well, but it didn't, and now some parts need to be substantially corrected."

CONCLUSION

The foregoing sets forth some of my recollections of efforts made in Congress to address the financial crisis that afflicted our country and the world at the end of the last decade. As a United States Senator from Indiana, it was a privilege and honor to represent the people of our great state in addressing these matters. Let me say in conclusion that in doing so, my focus was not only on the future of our country's financial institutions and manufacturing enterprises but even more on the innocent victims of the financial crisis whose homes, pensions, and livelihoods were jeopardized if not destroyed by the catastrophe.

REVISITING THE CAUSES OF THE FINANCIAL CRISIS

ANTONY PAGE*

ABSTRACT

Much has been written on the legal causes of the financial crisis and its aftermath, often referred to as the Great Recession. Presumably the debate will continue for many years to come, much as scholars continue to debate the causes of the Great Depression. Lost, however, in the descriptions of arcane laws and complex derivative financial products, is a relatively brief and straightforward account of the crisis and its most likely causes for interested lawyers, law students, or graduate students who are not specialists and do not want to become specialists. This Essay, based on a presentation at the Indiana Law Review's 2013 Symposium, Law and the Financial Crisis, aims to provide such an overview.

INTRODUCTION

Not surprisingly, an enormous amount has been written on the causes of the financial crisis from both academics[1] and others.[2] Even the federal government's

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1. Prominent professors writing on the crisis include GEORGE A. AKERLOF & ROBERT A. SHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM (2009); ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD (2013); ROSS GARNAUT & DAVID LLEWELLYN-SMITH, THE GREAT CRASH OF 2008 (2009); GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 (2010); SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010); RAGHURAM RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY (2010); CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009); NOURIEL ROUBINI & STEPHEN MIHM, CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE (2010); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED AND WHAT TO DO ABOUT IT (2008); JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY (2010); and JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED AND WORSENED THE FINANCIAL CRISIS (2009). If you were interested enough to read one book about the financial crisis, but only one, Alan Blinder's book would be an excellent choice.

2. Journalists on the financial crisis include: JOHN CASSIDY, HOW MARKETS FAIL: THE LOGIC OF ECONOMIC CALAMITIES (2009); WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET (2009); GREG FARRELL, CRASH OF THE TITANS:

principle analysis of the crisis has become a best seller.[3] Most of these publications, however, focus heavily on single causes, have political axes to grind, concentrate on personalities rather than policies, were published before enough of the facts became well-known, or assume a high-level of background knowledge and expertise. There is far less available material for educated and interested—but non-specialist—lawyers, law students, or graduate students that succinctly analyzes and explains potential causal legal factors. This short essay attempts to provide this analysis and explanation.[4]

At one level, the financial crisis was just like many others in U.S. history.[5] Too many creditors simultaneously sought the return of their assets. Two words, "bank run," get to the core of the financial crisis. [6] At another level, however, what made this crisis different was the focus on the "shadow banking system"—institutions and transactions outside the regular banking system.[7]

GREED, HUBRIS, THE FALL OF MERRILL LYNCH, AND THE NEAR-COLLAPSE OF BANK OF AMERICA (2010); MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010); ROGER LOWENSTEIN, THE END OF WALL STREET (2010); BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS (2010); GRETCHEN MORGENSON & JOSHUA ROSNER, RECKLESS ENDANGERMENT: HOW OUTSIZED AMBITION, GREED, AND CORRUPTION LED TO ECONOMIC ARMAGEDDON (2011); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES (2009).

3. THE FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011) [hereinafter FCIC REPORT], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf, *archived at* http://perma.cc/8FCS-8L5R; *Best Sellers: Paperback Nonfiction*, N.Y. TIMES, Feb. 20, 2011, www.nytimes.com/best-sellers-books/2011-02-20/paperback-nonfiction/list.html, *archived at* http://perma.cc/65TU-UFL8. It has proved particularly popular for legal scholars, having generated citations roughly equal to the contemporaneously published most cited law review article. Andrew W. Hartlage, *Book Notice: "Never Again," Again: A Functional Examination of the Financial Crisis Inquiry Commission*, 111 MICH. L. REV. 1183, 1193 (2013).

4. My aim here is simply to provide a general high-level overview, so in some places I will include some simplifications or oversimplifications.

5. Gary Gorton, *Banking Must Not be Left in the Shadows*, FIN. TIMES (Nov. 20, 2012), http://www.ft.com/intl/cms/s/0/48b78190-3278-11e2-916a-00144feabdc0.html#axzz2aSPOqWlQ (claiming that "[t]he financial crisis again showed that in market economies bank runs recur, over and over").

6. Mike Whitney, *A Beginners Guide to Shadow Banking*, CENTRE FOR RESEARCH ON GLOBALIZATION (June 12, 2011), http://www.globalresearch.ca/a-beginners-guide-to-shadow-banking/25246, *archived at* http://perma.cc/G96U-8MNS.

7. *See* GORTON. *supra* note 1, at 13-60. The Financial Stability Board's task force defined "shadow banking" as "credit intermediation involving entities and activities outside the regular banking system." Kelly Evans, *Bank-Run Risk in the Shadows*, WALL ST. J., Dec. 5, 2011, http://online.wsj.com/article/SB10001424052970204397704577074782946096256.html. Credit is intermediated "through a wide range of securitization and secured funding techniques." Zoltan

Meanwhile the general public did not understand or even notice these institutions and transactions. Notwithstanding the lack of attention, shadow banking had quietly become enormous.[8]

Most agree a credit crunch precipitated the crisis. A credit crunch occurs when enough parties simply refuse to lend to each other.[9] Overinvestment in housing led to a real estate bubble,[10] and this bubble's bursting created a domino effect, beginning with greatly increased defaults on subprime mortgages. The defaults were greatly amplified by collateralized debt obligations, credit default swaps, and other complex derivatives. Losses on these securities resulted initially in the fire sale of a big investment bank, Bear Stearns, and a few months later, a full blown banking crisis leading to the biggest bankruptcy in U.S. history, Lehman Brothers, and the collapse of several other financial giants.[11] The effect of the collapse spread around the world, leading to what is referred to as the Great Recession, which, in the view of many, continues to this day.[12]

There is far less agreement on the *causes* of this chain reaction. Nobel laureate economist Joseph Stiglitz attributed the crisis to "system failure," which is when not just a single decision, but a cascade of decisions, produces a tragic result.[13] Judge Richard Posner seems to blame the crisis on capitalism itself.[14]

Pozsar et al., *Shadow Banking*, Federal Reserve Bank of New York Staff Rep. No. 458 (July 2010, Rev. Feb. 2012), http://www.ny.frb.org/research/staff_reports/sr458.pdf, *archived at* http://perma.cc/RE2K-TFEL (defining shadow banks as "financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees"). They add, "what distinguishes shadow banks from traditional banks is their lack of access to public sources of liquidity such as the Federal Reserve's discount window, or public sources of insurance such as Federal Deposit Insurance." *Id.* at 2.

8. Pozsar et al., *supra* note 7, at 9 (noting, for example, that shadow banking liabilities exceeded traditional bank liabilities in June 2007, by $8 trillion, $22 trillion to $14 trillion, or 57%).

9. Paul Mizen, *The Credit Crunch of 2007 – 2008: A Discussion of the Background, Market Reactions, and Policy Responses*, FED. RES. BANK OF ST. LOUIS REV. 531, 531 (2008), *available at* http://research.stlouisfed.org/publications/review/08/09/Mizen.pdf, *archived at* http://perma.cc/87WE-XQ68.

10. *See* Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 7 (2009) (describing the continual rise in housing prices and the subsequent increase in purchases or mortgage-related assets).

11. *See* FCIC REPORT, *supra* note 3, at 354-62 (2011) (explaining the bankruptcy of Lehman Brothers following the burst of the real estate bubble).

12. According to Wikipedia, the Great Recession is also referred to as the "Lesser Depression" or the "Long Recession." *Great Recession*, WIKIPEDIA, http://en.wikipedia.org/wiki/Great_Recession *archived at* http://perma.cc/F9PQ-33LE (last visited Feb. 17, 2014). Officially, the recession ran from December 2007 to June 2009. *See US Business Cycles Expansions and Contractions*, NAT'L BUREAU OF ECON. RES. (Apr. 23, 2012), http://www.nber.org/cycles.html, *archived at* http://perma.cc/XG59-8J2R. Those still suffering from persistent unemployment, government austerity measures or the European sovereign debt problem might disagree.

13. Joseph E. Stiglitz, *Capitalist Fools*, VANITY FAIR (Jan. 2009), http://www.vanityfair.com/magazine/2009/01/stiglitz200901-2 (listing five key errors that led to the crisis, including

Others argue that it was private sector greed, pure and simple.[15] Washington Post columnist Robert Samuelson favors a "narrative rooted in mass and bipartisan delusion," what he refers to as a "long boom-bust" explanation.[16] He claims that "[w]hat ultimately explains the financial crisis and Great Recession is an old-fashioned boom and bust, of which the housing collapse was merely a part," where the boom lasted from 1983-2007.[17] Joe Nocera seems to agree, claiming that an analysis requires the skills of a psychologist, as it resulted from a "mass delusion" about housing prices, and is a "part of the human condition."[18] Put differently, people and their—our—fundamental human nature was the key cause.[19] Purported causes still make headlines, including a recent article asserting that cocaine use caused the crisis.[20]

This essay will briefly describe the crisis (what happened?) and then analyze various proposed causes (why it happened?). First, however, a disclaimer: while there is general agreement over what the crisis was, the causes remain contested and arguably unclear.[21] Moreover, although we now have the first drafts of

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appointing Alan Greenspan, an "anti-regulator" to serve as an "enforcer," and repealing the Glass Steagall Act).

14. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

15. Steve Denning, *Lest We Forget: Why We Had a Financial Crisis*, FORBES (Nov. 11, 2011), http://www.forbes.com/sites/stevedenning/2011/11/22/5086/, *archived at* http://perma.cc/K3RP-NZM6 ("It is clear to anyone who has studied the financial crisis of 2008 that the private sector's drive for short-term profit was behind it.").

16. Robert Samuelson, *Causes of the Crisis*, WASH. POST WRITER'S GROUP (Mar. 19, 2012), http://www.realclearpolitics.com/articles/2012/03/19/causes_of_the_crisis_113521.html, *archived at* http://perma.cc/MS4P-3DVV.

17. *Id*. More conventional explanations, he claims, result from other motivations. *Id.*

18. Joe Nocera, *Inquiry is Missing Bottom Line*, N.Y. TIMES, Jan. 28, 2011, http://www.nytimes.com/2011/01/29/business/29nocera.html?pagewanted=all, *archived at* http://perma.cc/QTG4-535S (concluding that the question is really when, not whether, a financial crisis will occur again).

19. Kevin Kabat, *Perspectives on the Financial Crisis*, 47 IND. L. REV. 23, 23 (2014) (from Kabat's Keynote Address at the Indiana Law Review Symposium: Law and the Financial Crisis (Apr. 5, 2013) (stating that "everyone" had caused the financial crisis)).

20. *See, e.g.*, Rob Williams, *Financial Meltdown Was Caused by Too Many Bankers Taking Cocaine, Says Former Government Drugs Tsar Prof David Nutt*, INDEPENDENT (Apr. 15, 2013), http://www.independent.co.uk/news/uk/home-news/financial-meltdown-was-caused-by-too-many-bankers-taking-cocaine-says-former-government-drugs-tsar-prof-david-nutt-8572948.html, *archived at* http://perma.cc/W54F-HTSK. The argument is perhaps not quite as silly as it sounds, in that cocaine may lead to overconfidence and, therefore, excessive risk-taking.

21. Robert Samuelson, the award winning economics journalist, observed, "[f]our years after the onset of the financial crisis . . . we still lack a clear understanding of the underlying causes." Robert Samuelson, *Long-term Understanding of the U.S. Economic Crisis*, WASH. POST, Mar. 18, 2012, http://articles.washingtonpost.com/2012-03-18/opinions/35449524_1_financial-crisis-real-estate-prices-booms, *archived at* http://perma.cc/W34B-8G52. Federal Reserve Chairman Ben

history, the second drafts are only just appearing, and there will undoubtedly be third and fourth drafts as well.[22]

I. The Crisis: Events

What do we really know about the financial crisis? Although it has been described as a "long and complicated story,"[23] at a high enough level of generality nearly everyone agrees. Risk, largely unobserved and linked to sub-prime mortgages and derivative securities that were based on them, built up in the financial system.[24] As the risks (and resultant losses) became apparent with the bursting of the housing bubble, concerns grew over borrowers' solvency. Lenders withdrew from the short-term debt market, resulting in a liquidity crisis, not just for the financial economy, but for what is sometimes referred to as the "real economy" as well.[25] Some financial institutions, notably Lehman Brothers, failed, whereas others were effectively taken over by governmental[26] or other institutions in shotgun marriages brokered by the government. [27] The U.S. government and others took unprecedented and decisive actions, and disaster—the risk of not having an economy within a few days[28]—was narrowly

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Bernanke has a somewhat different view: "[b]ecause the crisis was so complex, its lessons are many, and they are not always straightforward." Ben S. Bernanke, *Monetary Policy and the Housing Bubble*, Speech at the Annual Meeting of the Am. Econ. Ass'n (Jan. 3, 2010), http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm, *archived at* http://perma.cc/5FNA-S3G3.

22. *See* BLINDER, *supra* note 1, at 5 (claiming that his book, published in January 2013, should be considered a "second draft of history").

23. *Id.*

24. Michael Lewis describes some of those who observed and greatly profited from recognizing the buildup of risk. *See generally* LEWIS, *supra* note 2 (focusing on hedge fund managers, traders and analysts who invested against subprime mortgages well before the crisis).

25. The "real economy" can be defined as "the part of the economy that is concerned with actually producing goods and services, as opposed to the part of the economy that is concerned with buying and selling on the financial markets." FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=real-economy *archived at* http://perma.cc/Z8T7-FBCJ (last visited Oct. 1, 2013).

26. *See* Federal Reserve Bank of St. Louis, *The Financial Crisis: A Timeline of Events and Policy Actions,* available at http://timeline.stlouisfed.org/index.cfm?p=timeline# (Fannie Mae, Freddie Mac, AIG).

27. *Id.* (noting that Bank of America bought Merrill Lynch, Citigroup and then Wells Fargo bought Wachovia and JP Morgan Chase bought part of Washington Mutual.).

28. On Thursday, September 18, Federal Reserve Chairman Ben Bernanke told Congress that if the largest banks were not saved "we may not have an economy on Monday." Andrew Ross Sorkin et al., *As Credit Crisis Spiraled, Alarm Led to Action*, N.Y. TIMES, Oct. 1, 2008, http://www.nytimes.com/2008/10/02/business/02crisis.html?pagewanted=all&_r=0, *archived at* http://perma.cc/VY8J-LS9N. As Ben Bernanke said later "[w]e came very, very close to a global financial meltdown." BLINDER, *supra* note 1, at 3.

averted.[29] Even so, millions of people lost their homes,[30] jobs,[31] and much of their savings,[32] among other harms.[33]

These external contours of the crisis are well known, even if the reasons behind them are less well understood. Housing prices peaked in 2006 leading to early harbingers of the crisis. In April 2007, New Century Financial Corporation, a company that had specialized in loans to people with poor credit who were now defaulting in overwhelming numbers, declared bankruptcy.[34] Another warning came in July 2007 with the collapse of two Bear Stearns hedge funds capitalized at $1.6 billion dollars, due to their investment in collateralized debt obligations backed by subprime mortgage loans.[35] In March 2008, there was the government-brokered and supported—$30 billion in guarantees—forced-sale of Bear Stearns to JP Morgan Chase, at a final price of $10 per share, less than 10% of the stock's 52 week high.[36] On September 7, Fannie Mae and Freddie Mac, the government sponsored entities (GSEs) that owned or guaranteed roughly $6 trillion in U.S. mortgages,[37] were put in conservatorship.[38] Eight days later, after a round the

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29. Sorkin et al., *supra* note 28.

30. Jeff Cox, *US Housing Crisis is Now Worse than Great Depression*, CNBC (Jun. 14, 2011), http://www.cnbc.com/id/43395857 *archived at* http://perma.cc/N7NM-QJRP ("[T]he foreclosure problem is unlikely to get any better with 4.5 million households either three payments late or in foreclosure proceedings").

31. *See, e.g.*, BLINDER, *supra* note 1, at 12 (providing a graph showing declining employment after the crisis).

32. John H. Makin, *The Global Financial Crisis and American Wealth Accumulation: The Fed Needs a Bubble Watch*, AM. ENTER. INST. (Aug. 29, 2013), http://www.aei.org/outlook/economics/monetary-policy/the-global-financial-crisis-and-american-wealth-accumulation-the-fed-needs-a-bubble-watch/, *archived at* http://perma.cc/322W-9GRZ (providing one graph showing the decrease in the personal savings rate during the recession and another displaying the personal savings rate during the recession between December 2007 and June 2009 compared to the average personal savings rate of all Post-WWII recessions).

33. This account is similar to that presented by the FCIC report. FCIC REPORT, *supra* note 3, at 233-388. The FCIC report adds that the collapse was a global phenomenon, as investors around the word had exposure to U.S. mortgages through securities and derivative securities.

34. Julie Creswell, *Mortgage Lender New Century Financial Files for Bankruptcy*, N.Y. TIMES, Apr. 2, 2007, http://www.nytimes.com/2007/04/02/business/worldbusiness/02iht-loans.5.5118838.html?_r=0, *archived at* http://perma.cc/CPE6-DPAK.

35. Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, http://www.nytimes.com/2007/07/18/business/18bond.html, *archived at* http://perma.cc/6CL6-DQY4.

36. Andrew Ross Sorkin, *JP Morgan Raises Bid for Bear Stearns to $10 a Share*, N.Y. TIMES, Mar. 24, 2008, http://www.nytimes.com/2008/03/24/business/24deal-web.html, *archived at* http://perma.cc/4W88-BXS8.

37. Charles Duhigg, *Loan-Agency Woes Swell From a Trickle to a Torrent*, N.Y. TIMES, July 11, 2008, http://www.nytimes.com/2008/07/11/business/11ripple.html?pagewanted=all, *archived at* http://perma.cc/WVY5-6XXG.

38. Mark Jickling, Fannie Mae and Freddie Mac in Conservatorship 1 (2008), *available at*

clock rescue effort failed, Lehman Brothers Holding Inc., the fourth largest U.S. investment bank, filed for the largest ever bankruptcy.[39] The next day, AIG (the world's largest insurance company), on the hook for $441 billion in credit default swaps, was rescued by the U.S. Federal Reserve Bank.[40]

The bailout and other efforts, however, failed to end the crisis.[41] Investors panicked all over the world, trying to flee risky assets and not knowing what financial institutions were really at risk.[42] Nearly every asset class declined in value, except for U.S. government treasury obligations.[43] Over the next few weeks, more giant financial institutions were targeted (Morgan Stanley), others failed (Washington Mutual) or were purchased (Wachovia), and stock prices gyrated wildly.[44] The crisis also spread rapidly around the world, with the bailing-out or seizure of at least five European banks.[45] These events led President Bush to ask of Treasury Secretary Paulson: "How did we get here?"[46]

Clearly, the impact of the well-known decline in housing prices had been grossly underestimated. Early on, in July 2007, Federal Reserve Chairman Bernanke informed the U.S. Senate's Banking Committee that losses of up to $100 billion due to subprime mortgage[47] products were possible.[48] The U.S. stock indices, the Dow Jones Industrial Average, and the Standard & Poor's 500 each

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http://fpc.state.gov/documents/organization/110097.pdf, *archived at* http://perma.cc/AHM3-BJHT.

39. Sam Mamudi, *Lehman Folds with Record $613 Billion Debt*, MARKETWATCH (Sept. 15, 2008), http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss *archived at* http://perma.cc/82DP-QS4G. On the same day, Bank of America agreed to buy Merrill Lynch, but for reasons that are not entirely clear, Bank of America did not appear determined to bargain for a low price. *See* LEWIS, *supra* note 2, at 237.

40. LEWIS, *supra* note 2, at 237.

41. *Id.*

42. *Id.* at 238.

43. *Id.*

44. *Id.* at 240.

45. Mark Landler, *The U.S. Financial Crisis is Spreading to Europe*, N.Y. TIMES, Sept. 30, 1998, http://www.nytimes.com/2008/10/01/business/worldbusiness/01global.html?_r=0 (quoting a European economist stating that "a bank run spreads around the world, not around the block").

46. Jo Becker et al., *Bush Drive for Home Ownership Fueled Housing Bubble*, N.Y. TIMES, Dec. 21, 2008, http://www.nytimes.com/2008/12/21/business/worldbusiness/21iht-admin.3.18846524.html?pagewanted=all, *archived at* http://perma.cc/WN8S-FJBK.

47. "Subprime" is the term used for borrowers who were not eligible for (or sometimes were steered away from) mortgages at the "prime" rate. Such borrowers had lower credit ratings and thus were deemed to be less likely to repay their loans than the safest borrowers. To compensate lenders for the increased credit risk they charged a higher interest rate. Interestingly, (within the last twenty years), the term subprime had been used instead to refer to an interest rate that was below the prime rate, and thus only available to the highest-quality borrowers.

48. Staff and Wire Reports, *Bernanke: Subprime Could Top $100B*, CNN MONEY (July 19, 2007), http://money.cnn.com/2007/07/19/news/economy/bernanke/index.htm?postversion=2007071914 *archived at* http://perma.cc/WR7S-P6NZ.

hit all-time peaks in the fall of 2007 (a peak which was only passed in 2013).[49] And in what certainly with hindsight justifies being called "simply the worst deal in the history of the financial services industry,"[50] in January 2008, Bank of America agreed to buy Countrywide Financial, one of the most aggressive providers of subprime mortgages, for $4.1 billion.[51] At the time, however, some still believed it was a good deal.[52]

Beyond this barebones factual outline, there is much disagreement, not just among pundits, but among economists and policy analysts too.[53] To explain the financial collapse, consider how financial institutions are structured. Each has capital to keep it stable and earn profits from products such as loans, including mortgages.[54] The more capital a financial institution has relative to its loans, generally the more stable the financial institution. Making more and riskier loans with insufficient capital can result in the failure of the financial institution.

In the years leading up to September 2008, many of the financial institutions had not only issued and securitized mortgages, but also bought securities backed by the mortgages.[55] These were mortgage-backed securities (MBSs). They also bought collateralized debt obligations (CDOs), securities backed by the MBSs, which were one step further removed from the mortgages.[56] And one step even further along were synthetic CDOs, the value of which were based essentially on credit default swaps, which were a kind of insurance against other securities defaulting.[57]

Why did so many financial institutions buy so many of these securities?

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49. Charley Blaine, *Dow Nearly Tops 2007 Peak Before Stocks Sag,* MSN MONEY (Feb. 28, 2013), http://money.msn.com/top-stocks/post.aspx?post=efd08c31-1671-4d65-a5fc-8dc65ed5cb42 *archived at* http://perma.cc/Y245-CU24.

50. Jim Zarroli, *Looking Back on Bank of America's Countrywide Debacle*, NPR (Jan. 11, 2013), http://www.npr.org/2013/01/11/169108131/looking-back-on-bank-of-americas-countrywide-debacle *archived at* http://perma.cc/3C8P-UCKG.

51. *Id.*

52. *Id.* Bank of America has reportedly spent $40 billion to resolve litigation. *Id.* It has reportedly threatened to put Countrywide Financial into bankruptcy if various settlements in the works are not finalized. Matt Egan, *Could BofA Still Toss Countrywide into Bankruptcy?*, FOX BUS. (June 11, 2013), http://www.foxbusiness.com/industries/2013/06/11/could-bofa-still-toss-countrywide-into-bankruptcy/ *archived at* http://perma.cc/6W24-E2JX.

53. Mark Thoma, *What Caused the Financial Crisis? Don't Ask an Economist*, FISCAL TIMES (Aug. 30, 2011), http://www.thefiscaltimes.com/Columns/2011/08/30/What-Caused-the-Financial-Crisis-Dont-Ask-an-Economist, *archived at* http://perma.cc/V8FM-CSND.

54. Bank capital can perhaps best be analogized to the down payment on a house. *See* Matthew Yglesias, *What is Bank Capital? It's Not Reserves, It's Not a Cushion, and You Don't Hold It*, SLATE (July 10, 2013), http://www.slate.com/blogs/moneybox/2013/07/10/bank_capital_requirements_not_reserves_not_held.html *archived at* http://perma.cc/T9T3-2TW5. It can thus magnify both returns and losses.

55. *See* FCIC REPORT, *supra* note 3, at 256 (2011).

56. *Id.*

57. *Id.* at 236.

(Remember, for every security sold there also had to be a buyer.) For one reason, buyers often thought they were good deals, in the sense of a given return for the perceived risk.[58] Also, because of the triple A ratings many of these securities received from the ratings agencies, for some institutions they could be treated more favorably as capital,[59] and for others only such high rated securities were permissible investments.[60] Moreover, these securities were often seen as facilitating diversification, which would be good for the financial institution.[61]

Although it seems obvious now, all of these securities depended on the value of the underlying securities, which ultimately went back to the mortgages themselves—mainly subprime mortgages. When the underlying securities declined (home buyers defaulting on their mortgages, resulting in some MBSs, CDOs and synthetics losing value) the financial institutions must write down the value of the assets, thereby reducing their capital.[62]

Consider Lehman Brothers. Investment banks like Lehman Brothers typically rely on short-term funding.[63] Lehman was in fact "rolling over" $100 billion in short term financing every month, meaning that if it could not find lenders each month willing to lend them that much, it would be at risk of insolvency.[64] But with concerns regarding its stability (and in particular whether its capital remains sufficiently valuable) nobody will risk lending it money. Lehman is going to fail. The weekend before the September 15th, 2008 bankruptcy filing, the company was desperately looking for help.[65] Barclays and Bank of America, despite pressure from the federal government, would not buy Lehman (which would have required the buyers to guarantee their debts), so Lehman collapses.[66] This is terrible news, particularly for Lehman's creditors and

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58. *Id.* at 242. As Mclean and Nocera put it, buyers were "buying a [triple-A] rating and thought [they] couldn't lose money." MCLEAN & NOCERA, *supra* note 2 at 266.

59. *See, e.g.*, 17 C.F.R. § 240.15c3-1 (2008) (broker-dealers).

60. *Id.* at 8.

61. *Id*. at 55.

62. In *House of Cards: A Tale of Hubris and Wretched Excess on Wall Street*, William D. Cohan describes how a sharp decline in the reference value of mortgage securities led to the demise of the Bear Stearns' mortgage funds. Specifically, Goldman Sachs provided a value that dropped 43% in one month, resulting in a drop in the funds' asset values of 13%, and a restated earning release. *See* COHAN, *supra* note 2, at 399-402.

63. *FCIC Issues Preliminary Staff Report On Shadow Banking and the Financial Crisis*, Fed. Banking L. Rep. (CCH) P. 96-845, 2010 WL 7364426 (2010).

64. *See Diamond and Kashyap on the Recent Financial Upheavals*, FREAKONOMICS (Sept. 18, 2008), http://www.freakonomics.com/2008/09/18/diamond-and-kashyap-on-the-recent-financial-upheavals/, *archived at* http://perma.cc/NE8F-GNR7. Bear Stearns was borrowing up to $70 billion every day in late 2007. FCIC REPORT, *supra* note 3, at xx.

65. *See* Yalman Onaran & Christopher Scinta*, Lehman Files Biggest Bankruptcy Case as Suitors Balk*, BLOOMBERG (Sept. 15, 2008), http://www.bloomberg.com/apps/news?pid=news archive&sid=awh5hRyXkvs4, *archived at* http://perma.cc/Z6P7-9S5C (discussing Lehman Brothers' bankruptcy filing in September 2008).

66. *Id.*

employees, but this is one of the side effects of free-market capitalism.

However, these financial institutions are far from independent. It is as if they are all roped together. When a large institution like Lehman sinks, others become increasingly unstable and may actually be brought under as well. Globally, financial institutions were firmly and comprehensively intertwined—webbed together through their contractual obligations.[67] When Lehman goes down, some of its debt holders are not going to get paid, causing losses for them. Other debt-holders, however, have insured their debt—through credit default swaps—which means the counterparties, the sellers, companies like AIG, are on the hook.[68]

One very important way theses institutions are roped together is through CDSs.[69] Credit default swaps are guarantees or insurance policies, like home insurance.[70] You buy home insurance to protect your asset—if your house burns, the insurance company makes you whole. You have thus swapped the financial risk of your house being destroyed with the insurance company (in exchange for your premium payments). Likewise, with credit default swaps, one company swaps with another the risk of the borrower defaulting in exchange for a premium.[71] As part of this transaction, the company might be concerned that the issuer of the CDS might in turn default, so frequently the company would request collateral—collateral that might need to be supplemented.[72] An interesting feature of this is that a CDS can be very beneficial, much as buying home insurance reduces risk for homeowners.[73] But CDSs go one step further. They can act as though you bought home insurance on somebody else's house.[74] Instead of reducing risk, it is more like a bet. Financial institutions would buy CDSs on debt they did not hold.[75] In essence, they were predicting (hoping?) that the chance of default outweighed the premiums. At a minimum, the institutions

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67. *Id*.

68. AIG was of course on the hook for far more than just some of Lehman's obligations. They had also insured some of those securities, $57 billion worth, which were dependent on sub-prime mortgages.

69. Another way institutions were intertwined was through "cross buying." According to the SEC, "heading into 2007, there was a Streetwide gentleman's agreement: You buy my BBB tranches [low rated securities] and I'll buy yours." FCIC REPORT, *supra* note 3, at 203.

70. *See* Barry Ritholtz, *Credit Default Swaps Are Insurance Products. It's Time We Regulated Them as Such*, WASH. POST, http://www.washingtonpost.com/business/credit-default-swaps-are-insurance-products-its-time-we-regulated-them-as-such/2012/03/05/gIQAAUo83R_story.html, *archived at* http://perma.cc/EEA5-UYBQ (last visited June 28, 2014) (comparing CDOs to insurance products).

71. *See* Mary Elizabeth Desrosiers, *Prices of Credit Default Swaps and the Term Structure of Credit Risk*, Worcester Polytechnic Institute 1, 14-15 (May 2007), *available at* http://www.wpi.edu/Pubs/ETD/Available/etd-050107-220449/unrestricted/CDS-Default_Probability.pdf (discussing credit default swaps).

72. FCIC REPORT, *supra* note 3, at 50.

73. *Id.*

74. *Id.*

75. *Id.*

would also have an incentive not to help the borrower survive. By 2008, the value of CDSs greatly outweighed the underlying securities in valuation.[76] Therefore, when Lehman defaulted on its bonds, not only were bond-holders at risk, but also any institution that had issued CDSs on Lehman's bonds.

This interconnected web of roped-together institutions was at great risk of collapse.[77] Those institutions with more conservative financial structures, i.e., higher relative amounts of capital, or those who did not keep high values of MBSs and CDOs were somewhat safer, but the combined impact put nearly everyone at risk. All of the other institutions were desperately trying to untie the ropes that they had, not just with Lehman, but with the other less stable institutions as well.[78] The problem was, in part, asymmetric information, or what Nobel Prize winner George Akerloff called the "lemon problem."[79] None of the institutions could tell which were the good, solid institutions, and which were not, in part because of the difficulty in valuing an illiquid security that represents a little piece of perhaps 1000 to 10,000 mortgages. Thus, the institutions kept all high-quality liquid instruments, like cash and treasury bills, and nobody was willing to buy, or lend money based on, the mortgage-linked securities that had been exposed as risky.[80]

So, the financial institutions were trying to undo or reduce their ties to the other financial institutions. But everyone was doing the same thing at the same time and some were getting ever closer to failure. With the announcement of Merrill Lynch's sale to Bank of America,[81] and Lehman's bankruptcy filing, AIG was expected to be next.[82] These circumstances forced the government to rescue AIG the following day.[83] Over the next few weeks, Washington Mutual was

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76. *Id.*

77. *Id*. at 17.

78. *See id.* at 27 (discussing the interconnectivity of financial firms and its contribution to the financial crisis).

79. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 490 (1970) (discussing used car purchasers' reasonable fear that the car they are buying is a lemon because sellers know more about the car and are more likely to sell it if it is a lemon); *see also* Antony Page, *Taking Stock of the First Amendment's Application to Securities Regulation*, 58 S.C. LAW REV. 789, 814-16 (2007) (analogizing the used car "lemon problem" with securities).

80. *See id.* (discussing why asymmetrical information would discourage firms from purchasing risky securities).

81. Some have wondered why Bank of America paid $29 per share for Merrill Lynch when it appears highly probable the bank could have paid substantially less. *See, e.g.*, *Lewis Gets Faint Praise From Buffet,* N.Y. TIMES, Sept. 16, 2009 (quoting noted investor Warren Buffet asking "Why pay X for Merrill on Sunday when you could have had it for pennies on Monday?).

82. Carrick Mollenkamp et al., *Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash*, WALL ST. J., Sept. 16, 2008, http://online.wsj.com/article/SB122145492097035549.html, *archived at* http://perma.cc/Y7UQ-VVJ2.

83. Jody Shenn & Zachary Tracer, *Federal Reserve Says AIG, Bear Stearns Rescue Loans Paid*, BLOOMBERG (Jun 14, 2012), http://www.bloomberg.com/news/2012-06-14/new-york-fed-

about to fail and Federal regulators seized and sold it within hours.[84] Wachovia was in a similar state, and ended up being bought by Wells Fargo.[85]

Congress passed the rescue plan, the Emergency Economic Stabilization Act of 2008 (EESA), on October 3.[86] The EESA was originally designed to solve the problem of financial institutions owning too much risky or hard to value capital.[87] The government would buy the securities, the MBSs, CDOs, and their offshoots that nobody else wanted.[88] As financial institutions sold these toxic assets, their cash positions (capital) would increase, thereby making them more stable.[89] However, it quickly became clear that this response was inadequate.[90] Some institutions still lacked equity.[91] To address this issue, the United States Department of the Treasury ("Treasury") diverted some of the bailout funds, directly shoring capital.[92] The Treasury compelled the nine largest banks to sell equity, even the ones that did not want to,[93] using a total of $250 billion to this end.[94]

Citigroup went back to the well in late November, receiving a $20 billion capital infusion from the Treasury and guarantees of $306 billion in assets, which was described as an "undisguised gift."[95] In mid-January, 2009, Bank of America also received $20 billion and guarantees of $118 billion.[96]

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says-aig-bear-stearns-rescue-loans-fully-repaid.html, *archived at* http://perma.cc/MMA5-MZYY.

84. *See* Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, http://online.wsj.com/article/SB122238415586576687.html, *archived at* http://perma.cc/RG3D-JLXF.

85. *See* FCIC REPORT, *supra* note 3, at 368-69.

86. Pub. L. No. 110-343, 122 Stat. 3765 (2008).

87. *Id*.

88. *Breakdown of the Final Bailout Bill*, WASH. POST, Sept. 28, 2008, http://articles.washingtonpost.com/2008-09-28/news/36908549_1_treasury-secretary-troubled-assets-tarp, *archived at* http://perma.cc/QK3B-N3EP.

89. *Id*.

90. Dakin Campbell, *Treasuries Climb on Speculation Bank Bailout Plan to Fall Short*, BLOOMBERG (Feb. 10, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDkolK_d_T9w, *archived at* http://perma.cc/7L2L-DCD8.

91. Jane Sasseen & Theo Francis, *Paulson's $250 Billion Bank Buy*, BLOOMBERG BUS. WK. (Oct. 14, 2008), http://www.businessweek.com/stories/2008-10-14/paulsons-250-billion-bank-buybusinessweek-business-news-stock-market-and-financial-advice, *archived at* http://perma.cc/7L2L-DCD8.

92. *Id.*

93. *Id.* Why force all of the big financial institutions to take the investment? This prevented line-drawing between the "good" and "bad" banks. *Id.*

94. *Id.*

95. Michael Lewis & David Einhorn, *How to Repair a Broken Financial World*, N.Y. TIMES Jan. 3, 2009, http://www.nytimes.com/2009/01/04/opinion/04lewiseinhornb.html.

96. Phillip Inman & Julia Kollewe, *Financial Crisis: Bank of America Given $138bn Rescue Package,* GUARDIAN (Jan. 16, 2009), http://www.guardian.co.uk/business/2009/jan/16/ bank-of-america-20bn-rescue, *archived at* http://perma.cc/69LD-5SN7.

Overall, the Federal Reserve lent more than $1.2 trillion in 2008 in emergency loans to support financial institutions.[97] It ended up committing $7.77 trillion dollars by March 2009 to keep the financial system, and world economy, functioning.[98]

II. THE CRISIS: CAUSES

There are two main schools of thought regarding the causes of the financial crisis. One, from the right, asserts that government policies encouraging homeownership—particularly to lower income and minority buyers--led to the relaxation of underwriting standards, the housing bubble, and then ultimately its collapse.[99] The other, from the left, attributes the crisis to the private sector that took too many risks while the government failed to regulate, or even understand, derivative financial products and big financial institutions.[100] The first narrative claims the government did too much, whereas the second claims the government did not do enough.[101] The related claim is regarding "free" markets: they either would have worked to prevent the crisis but were not permitted to do so, or they themselves created the crisis and should not have been permitted to do so. Perhaps it is underappreciated that these two narratives are not necessarily inconsistent. Both could be at fault—government regulation could have encouraged the crisis and under-regulation could have failed to prevent it.

The causes of the crisis are something of a Rorschach test; experts can see in the causes what they want to see.[102] Better yet, perhaps the causes are like a thaumatrope; the image depends on which side of a card one looks, but when the toy is in motion, the images on both sides are combined.[103] The real question over the legal causes of the financial crisis, as Mark Calabria of the Cato Institute asserted, "is the quality and substance of [the] regulation" at issue.[104]

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97. *See* Bob Irvy et al., *Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress*, BLOOMBERG (Nov. 27, 2011), http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html, *archived at* http://perma.cc/CP9U-FV6J.

98. *Id.*

99. *See* FCIC REPORT, *supra* note 3, at 444.

100. Nick Ottens, *Democrats Blame Deregulation for Crisis*, ATL. SENTINEL (Jan. 28, 2011), http://atlanticsentinel.com/2011/01/democrats-blame-deregulation-for-crisis/, *archived at* http://perma.cc/LPH9-R95D.

101. *Id.*

102. Judge Richard Posner emphasizes this notion when he refers to ideology having led to blindness in the economics profession. *See* POSNER, *supra* note 14, at 328.

103. Chopsticks78, *Thaumatrope: Bird & Cage*, YOUTUBE (Jan. 23, 2009), http://www.youtube.com/watch?v=yD0ovANHdqQ (showing a video of the classic thaumatrope in which a bird on one side of a disc and a cage on the other is twirled so that the bird appears inside the cage).

104. Mark A. Calabria, *Did Deregulation Cause the Financial Crisis?*, Cato Policy Report 5 (July/August 2009), *available at* http://object.cato.org/sites/cato.org/files/serials/files/policy-report/2009/7/cpr31n4-1.pdf, *archived at* http://perma.cc/YLG-8V3K.

To fair-minded observers it is clear that there were several necessary—but insufficient—laws or policies that caused the crisis.[105] What were these failures of regulation and policy? An early but unselective account in the Declaration of the Summit on Financial Markets and the World Economy by the leaders of the Group of 20 stated:

> During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.[106]

The Financial Crisis Inquiry Commission (FCIC) implemented the most prominent and certainly the most extensive analysis of the crisis. Congress created the FCIC "to examine the causes, domestic and global, of the current financial and economic crisis in the United States."[107] The FCIC, spending nearly $10 million, took eighteen months, interviewed over 700 witnesses, reviewed millions of pages of documents, and held nineteen days of public hearings.[108] Its report made the New York Times' and Washington Post's *Best-Sellers* list,[109] with the New York Review of Books announcing it as "the definitive history of this period"[110] and "the most comprehensive indictment of the American financial failure that has yet been made."[111] The report was, "[b]y all accounts[,] . . . an

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105. TAYLOR, *supra* note 1, at xi ("What caused the financial crisis? . . . Rarely in economics is a single answer to such questions, but . . . specific government actions and interventions should be first on the list of answers"). The FCIC dissenters captured this notion, noting several factors "were essential contributors to the crisis" but each was "insufficient as a standalone explanation." *Id.*

106. *Declaration Summit on Financial Markets and the World Economy*, at 1 (Nov. 15, 2008), U.S. DEP'T OF THE TREASURY, *available at* http://www.treasury.gov/resource-center/international/g7-g20/Documents/Washington%20Nov%20Leaders%20Declaration.pdf, *archived at* http://perma.cc/VHY8-MRHM.

107. FCIC REPORT, *supra* note 3, at 416.

108. *Id.* at xi.

109. *Best Sellers: Paperback Nonfiction*, N.Y. TIMES, Feb. 20, 2011, http://www.nytimes.com/best-sellers-books/2011-02-20/paperback-nonfiction/list.html, *archived at* http://perma.cc/D5UJ-8PSX.

110. Jeff Madrick, *The Wall Street Leviathan*, N.Y. REV. BOOKS (Apr. 28, 2011), http://www.nybooks.com/articles/archives/2011/apr/28/wall-street-leviathan/?pagination=false, *archived at* http://perma.cc/EWE3-PRVS.

111. *Id.*

approachable and at times gripping account of the crisis."[112]

Although the style was generally praised, the substance faced far more criticism, including from the four dissenting members of the ten-member commission.[113] Three Republican members collaborated on a single dissent and a fourth, Peter Wallison from the American Enterprise Institute, a conservative think tank, issued a second dissent.[114] As the Republican dissenters noted, the report was "more an account of bad events than a focused explanation of what happened and why. When everything is important, nothing is."[115] The Economist newspaper sniffed, "[d]efinitive the report is not,"[116] whereas other reporters noted its "timidity."[117] Peter Wallison criticized not just the substance of the report, "a just so story about the financial crisis," but the process by which the FCIC majority created its report.[118] He charged that the report sought only "the facts that supported its initial assumptions—that the crisis was caused by 'deregulation' or lax regulation, greed and recklessness on Wall Street, predatory lending in the mortgage market, unregulated derivatives, and a financial system addicted to excessive risk-taking."[119]

The dueling narratives of the FCIC's majority and dissenting reports essentially follow the competing narratives of the left and right. The majority

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112. Hartlage, *supra* note 3, at 1184.

113. *Id.* at 1185.

114. *See* Peter Wallison, *Dissent from the Majority Report of the Financial Crisis Inquiry Commission*, American Enterprise Institute (Jan. 26, 2011), http://www.aei.org/papers/economics/fiscal-policy/dissent-from-the-majority-report-of-the-financial-crisis-inquiry-commission-paper/, *archived at* http://perma.cc/DZ6F-2V73 (discussing Peter Wallison's contribution as a panelist at the Indiana Law Review's symposium on *Law and the Financial Crisis* at the Indiana University Robert H. McKinney School of Law).

115. FCIC REPORT, *supra* note 3, at 414.

116. *The Official Verdict*, ECONOMIST (Feb. 3, 2011), http://www.economist.com/node/18060818?story_id=18060818, *archived at* http://perma.cc/QER8-SN9M.

117. Jesse Eisinger, *In Post Crisis Report a Weak Light on Complex Transactions,* N.Y. TIMES, Feb. 3, 2011, http://query.nytimes.com/gst/fullpage.html?res=9E0DE1D61F31F930A35751C0A9679D8B63, *archived at* http://perma.cc/5MBS-HHU7.

118. FCIC REPORT, *supra* note 3, at 444 (Wallison, dissenting).

119. *Id.* at 443. The report did not adequately explain why so many people did or failed to do so much before the crisis began. Although it serves as a thorough investigation, it fails to offer much explanation or adequate analysis. Notwithstanding its extensive nature, the investigation did not reveal much that was new. *See* Annie Lowrey, *The Financial Crisis Reading List: Do We Really Need an Official Government Report Telling Us How We Got into This Mess?*, SLATE (Dec. 16, 2010), http://www.slate.com/articles/business/moneybox/2010/12/the_financial_crisis_reading_list.single.html, *archived at* http://perma.cc/5XE5-HGMC (arguing that there was little in the report that was not already public and studied). Part of this was due to the statutory design that limited the FCIC's subpoena power. *See* Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(b)(1)(C)–(D), (b)(3)(B), (d)(2), 123 Stat. 1617, 1625-26, 1628-29 (2009) (specifying required FCIC votes for issuing a subpoena).

report's headline conclusion was that "the crisis was avoidable,"[120] adding (perhaps for English majors) that "the fault lies not in the stars, but in us."[121] Regulators were "sentries . . . not at their posts"[122] as they took "little meaningful action"[123] to address risks caused by increased subprime lending and unregulated derivatives. The poorly regulated marketplace led to the misfeasance and malfeasance of incompetent and unscrupulous executives and employees in the financial sector.[124] More recent books have reached similar conclusions.[125] In contrast, the minority commission voted that the report should not even include terms such as "deregulation," "Wall Street," and "shadow banking."[126] Their dissenting report did not include them.[127]

A. Inadequate Regulation of Subprime Mortgages

In and of themselves, it should be obvious that subprime mortgages are not necessarily bad. They allow people who are higher credit risks to buy homes and thereby participate in the American Dream. But they can be, and were abused. There was undoubtedly some predatory lending, in that lenders sold people mortgages that could only be paid back if housing prices continued to rise.[128]

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120. FCIC REPORT, *supra* note 3, at xvii.

121. *Id.*

122. *Id.* at xviii.

123. *Id.* at xvii.

124. *Id.* at xvii-xxv (asserting nine major conclusions about the financial crisis: 1) the financial crisis was avoidable; 2) widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets; 3) dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis; 4) a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis; 5) the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets; 6) there was a systemic breakdown in accountability and ethics; 7) collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis; 8) over-the-counter derivatives contributed significantly to this crisis; and 9) the failures of credit rating agencies were essential cogs in the wheel of financial destruction).

125. *See, e.g.*, BLINDER, *supra* note 1, at 27-28 (listing, as factors, the villains of inflated asset prices, particularly of housing and securities: excessive leveraging; lax financial regulation; disgraceful subprime and other mortgage banking practices; unregulated derivatives derived from mortgages; abysmal performance by the ratings agencies; and perverse compensation systems).

126. Paul Krugman, *Wall Street Whitewash*, N.Y. TIMES, Dec. 16, 2010, http://www.nytimes.com/2010/12/17/opinion/17krugman.html?_r=0, *archived at* http://perma.cc/ HD2J-F89M.

127. *Id.*

128. *See* Eli Lehrer, *Subprime Borrowers: Not Innocents*, BLOOMBERG BUS. WK., http://www.businessweek.com/debateroom/archives/2008/03/subprime_borrowers_not_innocents.html, *archived at* http://perma.cc/B2J9-3K3E (last visited Feb. 2, 2014) (discussing the sub-prime mortgage crisis).

Moreover, there were very weak underwriting standards.[129] Mortgage brokers who believed in the "four Cs of credit"—character, capacity, collateral, and capital—were left behind.[130] Originators of mortgages increased the number of low documentation, no documentation, and "no income, no job, no assets" (NINJA) mortgages.[131] Some called these "liar loans,"[132] although liar might refer to either the borrower or anyone involved in arranging the loan. The non-English speaking strawberry-picker, dubbed an "agricultural expert" or "field technician" on the loan documents, who earned $15,000 a year, but qualified for a $720,000 mortgage is illustrative.[133] Partly as a result of this kind of dubious lending, subprime mortgages increased dramatically from less than 7% of all mortgages in 2001 to 20% in 2005.[134] The value of these subprime mortgages in 2005 was $625 billion, with a total outstanding value of nearly $1.25 trillion.[135]

Sheila Bair, then Assistant Secretary of the Treasury, called for increased and improved regulation just before the explosion of subprime mortgages.[136] She wanted federal banking regulators to impose standards on banks and for non-regulated financial entities to commit to compliance with those standards.[137] All she was able to achieve, however, was an unenforceable industry code of best practices.[138]

Moreover, because the originators of these mortgages, such as Countrywide, were securitizing the loans—an originate-to-sell model rather than the traditional originate-to-hold model—they cared much less about whether the mortgages would be repaid.[139] The securitized loans, primarily residential MBSs, spawned

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129. *See* Rajdeep Sengupta & Bryan J. Noeth, *Underwriting on Subprime Mortgages: What Really Happened?*, FED. RES. BANK OF ST. LOUIS (Winter 2010), http://www.stlouisfed.org/publications/cb/articles/?id=2040, *archived at* http://perma.cc/BU8N-VDCK (discussing underwriting standards leading up to the sub-prime mortgage crisis).

130. *See* MCLEAN & NOCERA, *supra* note 2, at 23.

131. POSNER, *supra* note 14, at 23.

132. FCIC REPORT, *supra* note 3, at 9.

133. Carol Lloyd, *Minorities Are the Emerging Face of the Subprime Crisis*, SF GATE (Apr. 13, 2007), http://www.sfgate.com/entertainment/article/Minorities-are-the-emerging-face-of-the-subprime-2565428.php#page-3, *archived at* http://perma.cc/E8GS-DNZH; *see also* Paul Wagner, *Home, Sweet Hell*, METROACTIVE (Sept. 9, 2008) http://www.metroactive.com/metro-santa-cruz/09.03.08/cover-0836.html, *archived at* http://perma.cc/8U9P-2PZT.

134. CASSIDY, *supra* note 2, at 256.

135. Bob Ivry, *FHA Will Take on Subprime Loans Shunned by Lenders (Update2)*, BLOOMBERG (Oct. 6, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aougwNu_W.Zc; *Subprime mortgage crisis*, UNIV. N.C. 1, 13, *available at* www.stat.unc.edu/ (last visited Feb. 2, 2014).

136. Ryan Lizza, *The Contrarian*, NEW YORKER (July 6, 2009), http://www.newyorker.com/reporting/2009/07/06/090706fa_fact_lizza, *archived at* http://perma.cc/4VNC-EU97 (profiling Sheila Bair).

137. *Id*.

138. *Id.*

139. *See* William W. Lang & Julapa Jagtiani, *The Mortgage and Financial Crises: The Role

follow-on derivative securities such as CDOs. Any of the four governmental banking agencies (the Federal Reserve, Office of Thrift Supervision, FDIC, and OCC) could have significantly slowed the growth of subprime lending, but none of them did.[140] The Federal Reserve bears the most responsibility, as it "was really the only authority that could set lending standards across the board—banks, non-bank lenders, any mortgagor."[141]

B. Inadequate Regulation of Derivative Financial Products

Subprime mortgages flowed through the entire financial system as their availability and investor demand increased.[142] First, investment banks created MBSs.[143] To do this, the banks combined thousands of mortgages and then divided them into tranches that each had different risk/reward ratios and, thus, different credit ratings.[144] The banks then pooled the payments from the MBSs into CDOs, again with different risks and ratings.[145] The banks also used those CDOs to create synthetic CDOs, and so on, until there was an enormous amount of derivative securities that ultimately depended on subprime mortgages for their value.[146] Complex derivatives were what Warren Buffet in 2003 famously called "financial weapons of mass destruction, carrying dangers that . . . are potentially lethal,"[147] suggesting they might cause "serious systemic problems."[148]

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of Credit Risk Management and Corporate Governance, UNIV. OF PENN. 1, 2 (Feb. 9, 2010), *available at* http://fic.wharton.upenn.edu/fic/papers/10/10-12.pdf (discussing how "the 'originate-to-distribute' model distort[ed] incentives for risk taking, since lenders no longer had 'skin in the game').

140. As Alan Blinder asks, "[d]id the regulators really believe that subprime mortgage lending could expand that rapidly *without* deterioration of quality?" BLINDER, *supra* note 1, at 58. He later explains that the choice is either deterioration of quality or that a "huge number of creditworthy subprime borrowers suddenly appeared out of nowhere." *Id.* at 70.

141. *See* Lizza, *supra* note 136.

142. *See* Winston W. Change, *Financial Crisis of 2007-2010*, SUNY BUFFALO 1, 7 (Sept. 24, 2010) (discussing the high investor demand for subprime lending).

143. *See* Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper*, 8 J. BUS. INQUIRY 120, 122 (2009) (discussing mortgage-backed securities).

144. *Id*. at 125.

145. *See Collateralized Debt Obligation—CDO*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cdo.asp, *archived at* http://perma.cc/HB9J-WW9P (last visited June 28, 2014) (explaining collateralized debt obligations).

146. *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1020 (2006-2007) (discussing synthetic CDOs and the risks of credit derivatives).

147. BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 15 (2003), *available at* http://www.berkshirehathaway.com/2002ar/2002ar.pdf, *archived at* http://perma.cc/ETM9-QDXX.

148. *Id.* at 14. Indeed, before the crisis derivatives caused such high-profile collapses as Enron in 2001 and Long Term Capital Management in 1998. *See, e.g.*, Randall Dodd, *Derivatives*

Brooksley Born, then Chair of the Commodity Futures Trading Commission (CFTC) in 1998, proposed regulating what she called a "completely dark market"[149] of over-the-counter derivatives.[150] Robert Rubin and Larry Summers, among other members of the Clinton Administration, strongly criticized the concept paper.[151] A key idea was that derivatives should be traded on an exchange with a central counterparty, rather than as individual contracts between parties.[152] The central counterparty would guarantee the performance of the contract, thereby reducing the buyer's and seller's risk that the other would default.[153] As it was by accepting the seller's credit risk, credit default swap buyers did something akin to "buying insurance for the Titanic from someone on the Titanic."[154]

Congress, however, chose instead of regulation a laissez-faire approach, with the Commodity Futures Modernization Act of 2000 (CFMA).[155] Ironically, the CFMA expressly intended "to reduce systemic risk and provide greater stability to markets during times of market disorder."[156] This legislation ensured that nearly all over-the-counter derivatives traded between wealthy or sophisticated parties were not directly regulated.[157] As a result, derivatives reached an

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Markets: Sources of Vulnerability in U.S. Financial Markets, FIN. POLICY FORUM DERIVATIVE STUDY CTR. 2-3 (May 10, 2004), *available at* http://www.financialpolicy.org/fpfspr8.pdf, *archived at* http://perma.cc/V7V3-3ZRU.

149. *Frontline: Interview: Brooksley Born* (PBS television broadcast Aug. 28, 2009), *available at* http://www.pbs.org/wgbh/pages/frontline/warning/interviews/born.html *archived at* http://perma.cc/VY9Z-9NZY ("What was it that was in this [over the counter derivative] market that had to be hidden? Why did it have to be a completely dark market?").

150. *See* Over-the-Counter Derivatives, 63 Fed. Reg. 26114 (proposed May 12, 1998). ("[Over-the-Counter] derivatives are contracts executed outside of the regulated exchange environment whose value depends on (or derives from) the value of an underlying asset, reference rate, or index.").

151. *See* MCLEAN & NOCERA, *supra* note 2, at 105-09 (providing a detailed account of Born's failed attempt to regulate derivatives); *see also* Manuel Roig-Franzia, *Brooksley Born, the Cassandra of the Derivatives Crisis*, WASH. POST, May 26, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108.html, *archived at* http://perma.cc/JS8R-4JT3.

152. *Id*. at 5.

153. *See* Marcus Zickwolff, *The Role of Central Counterparties in Financial Crisis Recovery*, WORLD FEDERATION OF EXCHANGES, http://www.world-exchanges.org/insight/views/role-central-counterparties-financial-crisis-recovery *archived at* http://perma.cc/B5N4-HWRU (last visited Feb. 1, 2014) (discussing the role of Central Counterparties in derivatives trading).

154. Rana Foroohar, *Nassim Taleb on the Markets*, NEWSWEEK (Nov. 14, 2008), *available at* http://www.newsweek.com/nassim-taleb-markets-85443 (quoting investor Nassim Taleb, author of several best-selling books).

155. Commodity Futures Modernization Act § 1, 7 U.S.C. § 1 (2000).

156. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 2, 114 Stat. 2763, 2763 (2000).

157. The CFMA used the term "Eligible Contract Participants" which are defined in § 101.

estimated notional value of nearly $600 trillion by 2007.[158] One of Nobel Laureate Paul Krugman's favored explanations is that "[r]egulation didn't keep up with the system."[159] Likewise, Nobel Laureate Joseph Stiglitz said more cautiously, "it is absolutely clear to me that if we had restricted the derivatives, some of the major problems would have been avoided."[160] Current Federal Reserve Chairman Ben Bernanke seems to agree.[161] Most agree that the CFMA was a significant cause of the crisis.[162]

However, even if the CFMA helped magnify the crisis, part of the uncertainty concerns the counterfactual of what the alternative would have been. It does not appear likely that Congress would have permitted the CFTC to regulate derivatives even in the CFMAs absence. Great regulation, maybe even good regulation, could have prevented the growth of harmful derivatives. On the other hand, bad regulation, or even the CFTC's proposed regulation, might not have had the desired effect. A centralized exchange, for example, might simply increase the demand for derivatives and concentrate the credit risk.[163] It remains unknown what kinds of regulations would have been feasible, had they only been proposed in place of the CFMA.

C. Inadequate Regulation of the Rating Agencies

Credit ratings agencies—or more precisely the nationally recognized

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158. John Kiff et al., *Credit Derivatives: Systemic Risks and Policy Options* 3 (Int'l Monetary Fund, Working Paper No. 09/254, 2009), *available at* http://www.imf.org/external/pubs/ft/wp/2009/wp09254.pdf, *archived at* http://perma.cc/9GJ9-7FZ4. "Notional value" results in a somewhat inflated send of the overall value. A credit default swap, for example, that might have cost the buyer $10,000 could have a notional value of $1,000,000, i.e., the underlying insured amount.

159. *Nobelist Paul Krugman Explains the Financial Crisis,* NEWSWEEK (Oct. 17, 2008), http://www.newsweek.com/nobelist-paul-krugman-explains-financial-crisis-91869 (predicting that regulation would increase and securitization would be reduced, "and mortgages in south Florida won't be held in Norway.")

160. *Frontline: Interview: Joseph Stiglitz* (PBS television broadcast July 28, 2009), *available at* http://www.pbs.org/wgbh/pages/frontline/warning/interviews/stiglitz.html *archived at* http://perma.cc/W8G4-7HLV.

161. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve System, Testimony Before the Financial Crisis Inquiry Commission (Sept. 2, 2010), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm, *archived at* http://perma.cc/5E5F-7GXB.

162. *See, e.g.*, Lynn A. Stout, *Uncertainty, Dangerous Optimism, and Speculation: An Inquiry Into Some Limits of Democratic Governance*, 97 CORNELL L. REV. 1177, 1209 n.129 (2012) (providing sources). *See also* Graham Summers, *Why Derivatives Caused Financial Crisis,* SEEKING ALPHA (Apr. 12, 2010), http://seekingalpha.com/article/198197-why-derivatives-caused-financial-crisis, *archived at* http://perma.cc/S2TZ-5QTD ("[D]erivatives caused THE financial crisis") (emphasis in original).

163. *See, e.g.*, Calabria, *supra* note 104, at 7.

securities ratings organizations or NRSROs—are supposed to rate the riskiness of securities.[164] In 2003 there were only three agencies approved by the SEC as NRSOSs, Standard & Poor's (S&P), Fitch, and Moody's.[165] This privileged position allowed these agencies to grow quickly, doubling revenues from 2002 to 2006, with Moody's having "the highest profit margin of any company in the S&P 500 for five years in row."[166]

The ratings bestowed upon securities by the rating agencies were absolutely critical, because other regulations, like the SEC's "net capital rule," depended on them.[167] Some investors, for example, are only permitted to buy certain grades of investments.[168] As the SEC observed in 2003, "ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts." [169] The FCIC was thus able to conclude, "[t]he mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval."[170] Once the securities were sold, however, their value collapsed following homeowners' default on mortgages.[171] Rating agencies gave top triple A investment-ratings to securities that in fact were very risky.[172]

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164. *See Credit Rating Agencies and Nationally Recognized Statistical Rating Organizations (NRSROs)*, U.S. SEC. AND EXCH. COMM'N (last modified May 31, 2013), http://www.sec.gov/answers/nrsro.htm *archived at* http://perma.cc/D9RE-PWWJ (discussing the role of NRSROs in assessing the creditworthiness of an entity with respect to specific securities and money market instruments).

165. As of the end of 2013 there were ten Nationally Recognized Statistical Rating Organizations ("NRSROs"), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540557017#.U20CgDxdVAc (last visited April 2, 2014).

166. Dealbook, *Ratings Agencies Draw Fire on Capitol Hill*, N.Y. TIMES, Oct. 22, 2008, http://dealbook.nytimes.com/2008/10/22/rating-agencies-draw-fire-capitol-hill/, *archived at* http://perma.cc/V98Q-VH3A (quoting Henry Waxman, Chair of the House Committee on Oversight and Government Reform). Warren Buffet invested in Moody's due to its strong pricing power and because it was "a natural duopoly" (as Fitch was very small). FCIC REPORT, *supra* note 3, at 207 (quoting Warren Buffet).

167. *Examining the Role of Credit Rating Agencies in the Capital Markets: Hearing Before the H. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2005) (statement of Richard C. Shelby, Chairman of H. Comm. on Baking, Housing, and Urban Affairs).

168. *See* Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, YALE UNIV. 1, 1, http://www.law.yale.edu/documents/pdf/cbl/Partnoy_Overdependence_Credit.pdf, *archived at* http://perma.cc/P7C8-KYY7 (last visited Feb. 2, 2014) (discussing how overdependence on NRSRO credit ratings led to the 2008 financial crisis).

169. *Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*, Securities and Exchange Commission, Release Nos. 33-8236, http://www.sec.gov/rules/concept/33-8236.htm, *archived at* http://perma.cc/A3DN-TZWW.

170. FCIC REPORT, *supra* note 3, at xxv.

171. *See* Holt, *supra* note 143, at 120 (discussing the primary causes of the housing bubble and the resulting credit crisis).

172. *See* Matt Krantz, *2008 Crisis Still Hangs Over Credit-rating Firms*, USA TODAY, Sept.

Rating agencies looked at the combined payouts from low ranked tranches of the mortgage-backed securities into CDOs, and gave the new securities investment grade ratings.[173] Like when Rumpelstiltskin turned straw into gold, the rating agencies' ratings transformed junk securities into investment grade securities. Combining a large number of risky payments (the subprime mortgages combined into MBS) could theoretically create less risky security if the payments were sufficiently independent of each other.[174] The problem was not with the theory, it was that payments were not independent of each other.[175] The rating agencies' models apparently failed to include possibilities like a nationwide decline in the price of housing.[176] Standard & Poor's chief credit officer later admitted the model they used was barely better than flipping a coin.[177] With the benefit of hindsight, the optimistic rating of the securities built on subprime mortgages was perhaps the largest mispricing of risk ever.[178]

Why were the rating agencies' models and thus their ratings so colossally wrong? Some answers include conflicts of interest, related competitive pressures (or sometimes a lack of competition), incompetence,[179] or perhaps simply the problem of rating a very complicated security.[180] The most important factor may

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13, 2013, http://www.usatoday.com/story/money/business/2013/09/13/credit-rating-agencies-2008-financial-crisis-lehman/2759025/, *archived at* http://perma.cc/FMJ5-KSRH (discussing the role of credit-rating firms in the 2008 financial crisis).

173. *See id*. (discussing the role of credit-rating firms' ratings in marketing risky mortgage-backed securities, such as CDOs).

174. *See* Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008, http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html?pagewanted=all, *archived at* http://perma.cc/GU8Q-LKJU (discussing the bundling of sub-prime mortgages to create suitable investments); *see also* Stephen Hsu, *Central Limit Theorem and Securitization: How to Build a CDO*, INFORMATION PROCESSING (Nov. 16 2008), http://infoproc.blogspot.com/2008/11/central-limit-theorem-and_16.html *archived at* http://perma.cc/PLZ6-F3FA (explaining how CDOs can be made less risky if the individual default probabilities are independent of each other).

175. *See* Hsu, *supra* note 174 (discussing why CDOs are risky if the default probabilities are not independent of each other).

176. *See* Christopher Alessi et al., *The Credit Rating Controversy*, COUNCIL ON FOREIGN RELATIONS (Oct. 22, 2013), http://www.cfr.org/financial-crises/credit-rating-controversy/p22328, *archived at* http://perma.cc/PK37-GBZB (discussing how credit-rating firms failed to judge the likelihood of the decline in housing prices and their effect on loan defaults).

177. *See* Susan Beck, *The Treasure Buried in Financial Crisis Litigation*, AM. LAW., June 19, 2013 (quoting a deposition from Frank Parisi, S&P's chief credit officer for structured finance).

178. *See* Lang & Jagtiani, *supra* note 139; Aline Darbellay & Frank Partnoy, *Credit Rating Agencies Under the Dodd-Frank Act*, 30 BANKING & FINANCIAL SERVICES POLICY REPORT 1, 2 (2011) (noting, for example, that "[i]n 2006, 869 billion US dollars of mortgage-related securities were rated triple-A by Moody's and 83 percent went on to be downgraded within six months").

179. *See* LEWIS, *supra* note 2, at 156 (describing how the best analysts would leave for higher paying investment banking jobs).

180. *See, e.g.*, John B. Taylor, *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, http://online.wsj.com/article/SB123414310280561945.html, *archived at* http://perma.

well be the conflicts of interest.[181] Rating agencies are paid by the issuers of securities—the parties that most want the higher ratings.[182] The conflict of interest was obvious and transparent.[183] In one famous instant message conversation between Standard & Poor employees, the two analysts agreed that they should not be rating the security, and that their model definitely did not capture the risk involved.[184] One concluded that a deal "could be structured by cows and we would rate it."[185] Or as Mr. McDaniels of Moody agreed, at times "we drink the Kool-Aid."[186] The conflicts were exacerbated as the issuers could shop around between agencies for the rating they wanted,[187] and would not necessarily disclose all of the relevant characteristics of the assets that underlay the securities.[188]

The rating agencies' poor performance would not have brought about the financial crisis on its own.[189] But it is also fair to say that the financial crisis could not have occurred at anything like the scale at which it did without the rating agencies' failures.[190]

D. Leverage

Allowing self-regulation of leverage limits, resulting in excessive leverage, by investment banks was one of the reasons for the financial crisis.[191] In June

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cc/RV2G-QSUH. *See also* Beck, *supra* note 177 (quoting a ratings agency analyst's email stating "I had difficulties explaining 'HOW' we got to those numbers since there is no science behind it.").

181. A conflict of interest can lead to biased behavior without any conscious malfeasance. *See, e.g.*, Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 259.

182. Allana M. Grinshteyn, Note, *Horseshoes and Hand Grenades: The Dodd-Frank Act's (Almost) Attack On Credit Rating Agencies*, 39 HOFSTRA L. REV. 937, 944 (2011).

183. *Id.*

184. *Ratings Agencies Draw Fire on Capitol Hill*, N.Y. TIMES, Oct. 28, 2008, http://dealbook.nytimes.com/2008/10/22/rating-agencies-draw-fire-capitol-hill/, *archived at* http://perma.cc/6YAV-6ZL3.

185. *Id.*

186. Jesse Eisinger, *Vows of Change at Moody's, but Flaws Remain the Same*, N.Y. TIMES, Apr. 13, 2011, http://dealbook.nytimes.com/2011/04/13/vows-of-change-at-moodys-but-the-flaws-remain-the-same/, *archived at* http://perma.cc/HP78-UKKK.

187. *See, e.g.*, David McLaughlin, *S&P Analyst Joked of Bringing Down the House Before Crash*, BLOOMBERG (Feb. 6, 2013), http://www.bloomberg.com/news/2013-02-05/s-p-analyst-joked-of-bringing-down-the-house-ahead-of-collapse.html, *archived at* http://perma.cc/A7GN-CJ9J.

188. LEWIS, *supra* note 2, at 99-100.

189. FCIC REPORT, *supra* note 3, at xxv (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, *archived at* http://perma.cc/UDF9-FG64 (stating "[w]e conclude that failures of credit rating agencies were essential cogs in the wheel of financial destruction").

190. *Id.*

191. *Id.*

2004, the SEC allowed the large investment banks to regulate their own capital levels.[192] Leverage then increased.[193] Merrill's leverage doubled, for example.[194] Bear Stearns went to $33 of debt for every dollar of equity.[195] Of course this didn't last long, because all five investment banks stopped being investment banks—Lehman went bankrupt, Bear and Merrill were acquired, and Goldman and Morgan Stanley became banks.[196]

Leverage, understood as the ratio of assets to capital, was too high.[197] In essence, the higher the leverage, the greater the chance of a company failing.[198] Bear Stearns and Lehman Brothers both had leverage of over thirty (i.e., for every dollar of capital (equity) there was more than thirty dollars of assets.)[199] In contrast, a mortgage with the traditional 20% down payment would have a ratio of five, a slimmer 10% down payment would have ten, a 1% down payment would have one hundred, and if a buyer paid no down payment at all, the ratio would be infinite.[200]

While most parties agree that leverage before the crisis was too high, the cause of this is disputed.[201] At the time, and for at least a few years after the crisis, commentators claimed that the increase in leverage resulted from a 2004 change in SEC rules.[202] Respected economists such as Alan Blinder, for example,

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192. Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N. Y. TIMES, Oct. 2, 2008, *archived at* http://perma.cc/5Z88-3LBA.

193. U.S. Gov't Accountability Office, GAO-B-294184, SECURITIES AND EXCHANGE COMMISSION: ALTERNATIVE NET CAPITAL REQUIREMENTS FOR BROKER-DEALERS THAT ARE PART OF CONSOLIDATED SUPERVISED ENTITIES (2004).

194. Labaton, *supra* note 192.

195. *Id.*

196. *Id.*

197. Julie Satow, *Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers*, N.Y. SUN (Sept. 18, 2008), http://www.nysun.com/business/ex-sec-official-blames-agency-for-blow-up/86130/, *archived at* http://perma.cc/H9PP-683C.

198. FCIC REPORT, *supra* note 3, at 32 (2011) (stating "[w]e conclude that failures of credit rating agencies were essential cogs in the wheel of financial destruction").

199. *Id.*

200. FREDRICK S. WEAVER, ECONOMIC LITERACY: BASIC ECONOMICS WITH AN ATTITUDE 172 (3d ed. 2011).

201. Rolfe Winkler, *Leverage by the Numbers*, REUTERS (Nov. 24, 2008), http://blogs.reuters.com/rolfe-winkler/2008/11/24/leverage-by-the-numbers/ *archived at* http://perma.cc/ZR5X-XS7J.

202. Bethany McLean, *The Meltdown Explanation that Melts Away,* REUTERS (Mar. 19, 2012), http://blogs.reuters.com/bethany-mclean/2012/03/19/the-meltdown-explanation-that-melts-away/, *archived at* http://perma.cc/E8TP-BMUD (claiming this "fact" [SEC rule change resulted in dramatically increased leverage] became part of the conventional wisdom about the crisis); Barry Ritholtz, *What Caused the Financial Crisis? The Big Lie Goes Viral*, WASH. POST, Nov. 5, 2011, http://www.washingtonpost.com/business/what-caused-the-financial-crisis-the-big-lie-goes-viral/2011/10/31/gIQAXlSOqM_story_1.html, *archived at* http://perma.cc/PW42-4HGM (asserting that the SEC changed its rules in 2004 thereby allowing the five investment banks unlimited leverage instead of a maximum of twelve-to-one).

stated that leverage shot up from around twelve-to-one to thirty-three-to-one as a result of this change,[203] as did Kenneth Rogoff and others,[204] including noted law professor John C. Coffee.[205] Daniel Gross in *Slate Magazine* stated, "Perhaps the most disastrous decision of the past decade was the Securities and Exchange Commission's 2004 rule change allowing investment banks to increase the amount of debt they could take on their books."[206]

The rule at issue, SEC Rule 15c3-1, although complicated, did not significantly affect the relevant leverage.[207] In particular, the rule targeted leverage at the holding company level (which had been unaffected by the earlier version of Rule 15c3-1)[208] rather than at the broker dealer level.[209] Some of the companies that were later alleged to have increased their leverage ratios after 2004 had ratios of twenty-eight to one in 1998—higher than their ratios at the end of 2006.[210] For those who wanted to see a failure of (or permissive) regulation, this was a plausible story, [211] even though publicly available information would have readily disproved it.[212]

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203. Alan S. Blinder, *Six Errors on the Path to the Financial Crisis*, N.Y. TIMES, Jan. 24, 2009, http://www.nytimes.com/2009/01/25/business/economy/25view.html?_r=0, *archived at* http://perma.cc/H2AE-BT9Y (wondering "What were the S.E.C. and the heads of the firms thinking?").

204. REINHART & ROGOFF, *supra* note 1, at 214 (referring to the "2004 decision of the Securities and Exchange Commission to allow investment banks to triple their leverage ratios (that is, the ratio measuring the amount of risk to capital)" as a huge regulatory mistake); *see also* ROUBINI & MIHM, *supra* note 1, at 75; STIGLITZ, *supra* note 1, at 163.

205. John C. Coffee, *Analyzing the Credit Crisis: Was the SEC Missing in Action?*, N.Y. L.J., (2008). *See also* Robert J. Rhee, *The Decline of Investment Banking: Preliminary Thoughts on the Evolution of the Industry 1996-2008,* 5 J. BUS. & TECH. L. 75, 82-83 (2010.

206. Daniel Gross, *The Gang of Five and How They Nearly Ruined Us*, SLATE (Jan. 29, 2010), http://www.slate.com/articles/business/moneybox/2010/01/the_gang_of_five_and_how_they_nearly_ruined_us.html, *archived at* http://perma.cc/L68J-EMUP.

207. 17 C.F.R. § 240.15c3-1 (2005) (net capital requirements for brokers or dealers).

208. *Cf.* 17 C.F.R. § 240.15c3-1 (2003) and 17 C.F.R. § 240.15c3-1 (2005).

209. William D. Cohan, *How We Got the Crash Wrong*, ATLANTIC (May 21, 2012), http://www.theatlantic.com/magazine/archive/2012/06/how-we-got-the-crash-wrong/308984/, *archived at* http://perma.cc/G8LH-HNHK.

210. U.S. Gov't Accountability Office, Rep. No. GAO-09-739, at 40 (2009) (finding that "of four of the five broker-dealer holding companies that later [were covered by Rule 15c3-1] . . . three had ratios equal to or greater than 28-to-1 at fiscal year end 1998, which was higher than their ratios at fiscal year-end 2006 before the crisis began"), *available at* http://www.gao.gov/assets/300/292767.html; *see also* FCIC REPORT, *supra* note 3, at 153-54 (noting that although leverage at the investment banks increased in 2004-07, in most cases it had been higher in the late 1990s). Leverage in fact has fluctuated an enormous amount, ranging from below eight to one in the early 1970s to occasionally exceeding thirty-five to one in the 1950s. *See* Cohan, *supra* note 209.

211. *See* Andrew W. Lo & Mark T. Mueller, *Warning! Physics Envy May be Hazardous to Your Wealth*, 8 J. OF INV. MGMT. 13 (2010), *available at* http://arxiv.org/pdf/1003.2688.pdf.

212. *See* MCLEAN & NOCERA, *supra* note 2 (describing how a semi-retired lawyer and a

E. Low Interest Rates

Another area of dispute is the role of Greenspan's low-interest rate policy.[213] Alan Greenspan kept interest rates low, arguably too low, in the early 2000s. This could have contributed to the growth of the real estate bubble, as a would-be home buyer's monthly payments could support higher mortgages and thus higher prices.[214] More precisely, to form a bubble, housing prices would increase by more than they *should* increase, as standard economic theory "says that low interests rates *should* increase house values (or the value of any long-lived asset for that matter)."[215] Lower interest rates might also have contributed to the crash by encouraging greater demand for the higher-yielding derivative securities that magnified the crisis.[216] More indirectly, low interest rates can bring about reduced saving because saving becomes less attractive.

The dispute is not so much over interest rate's causal role, but rather over its extent. Professor John B. Taylor argues that unusually low interest rates, set in deviation from past practices and precedents, "should be first on the list of answers to the question of what went wrong."[217] Judge Richard Posner is in the same camp, asserting that low interest rates were one of two "dangerous developments" that resulted in the crisis.[218] John A. Allison, Chief Executive Officer of BB&T, a large financial service company, for nearly 20 years until

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retired investment banker identified the error).

213. *See, e.g.*, Alan Greenspan, *The Fed Didn't Cause the Housing Bubble*, WALL ST. J. Mar. 11, 2009, *available at* http://online.wsj.com/articles/SB123672965066989281 (arguing that Greenspan's monetary policy was not at fault). *See also* David Henderson & Gerald P. O'Driscoll Jr., *Did the Fed Cause the Housing Bubble?*, WALL ST. J. Mar. 27, 2009, *available at* http://online.wsj.com/news/articles/SB123811225716453243 (disputing the role of the low-interest rate policy).

214. By way of example, $100,000 borrowed on a thirty year mortgage at 5% interest requires a monthly payment of $537. The same monthly payment with a 10% interest rate only supports borrowing of $58,419. http://www.bankrate.com/calculators/mortgages/how-much-money-can-i-borrow.aspx.

215. Kenneth Kuttner, *Low Interest Rates and Housing Bubbles: Still No Smoking Gun,* at 160, *in* THE ROLE OF CENTRAL BANKS IN FINANCIAL STABILITY (Douglas Evanoff ed., 2013), (emphasis in original), *available at* http://web.williams.edu/Economics/wp/Kuttner-smoking-gun.pdf, *archived at* http://perma.cc/RRD6-FFDE; *see also id.* at 160-64 (explaining the impact of interest rates on housing prices). Kuttner goes on to argue that credit might have become looser due to lowered lending standards and increased securitization of loans. *Id.* at 181.

216. NPR, *Giant Pool of Money*, Sept. 5, 2008 (explaining how investors looked for higher yielding securities given the low US interest rates). *available at* http://www.thisamericanlife.org/radio-archives/episode/355/transcript

217. TAYLOR, *supra* note 1, at 61. John B. Taylor is a professor of economics at Stanford University, and is a former Under Secretary of the U.S. Treasury for International Affairs. He was also a member of the President's Council of Economics Advisors.

218. POSNER, *supra* note 14, at 315. The other development that led to the crisis according to Posner was deregulation. *Id.*

2008, claims it was the "primary cause."[219]

Most economists disagree.[220] In 2010, the *Wall Street Journal* provided a sampling of the views of economists who were part of the National Bureau of Economic Research's Monetary Policy Program posed with the question "whether low interest rates caused the housing bubble."[221] Without being too technical, economists disputed whether interest rates were that much lower in the relevant time period;[222] if they were, whether the impact was significant;[223] and whether the Federal Reserve itself could have done very much.[224] Those who agreed that low interest rates were a significant cause included it as one of several causes rather than a top or leading cause.[225]

The FCIC essentially gave Greenspan and interest rate policy a free pass, concluding that "excess liquidity did not need to cause a crisis,"[226] which is no doubt correct, if one accepts that there were no causes that were sufficient on their own. Easy credit, however, appears to be very important: "[i]n a modern

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219. *See* JOHN A. ALLISON, THE FINANCIAL CRISIS AND THE FREE MARKET CURE: WHY PURE CAPITALISM IS THE WORLD ECONOMY'S ONLY HOPE 17 (2012).

220. *See, e.g.*, *Economists' Views on Interest Rates, Housing Bubble*, WALL ST. J., Jan 12, 2010, http://blogs.wsj.com/economics/2010/01/12/economists-views-on-interest-rates-housing-bubble/, *archived at* http://perma.cc/BD8G-DX39 [hereinafter *Economists' Views*].

221. *Id.*

222. *Id.* (quoting Christopher House stating, "[w]hile the interest rate was below normal for some time it may not have been far below normal" and Kenneth Kuttner pointing out that "[t]he 'bubble' didn't really get going until 05-06, by which time the Fed had raised rates to more or less normal levels."). The article overall reminds one of the old line attributed to George Bernard Shaw, "if all economists were laid end to end they would not reach a conclusion." (*available at* http://www.quotationspage.com/quote/23681.html).

223. *Id.* (quoting Brad Delong, arguing that lower than usual interest rates would have led to only a 6% increase in prices); *see also* Kuttner, *supra* note 215, at 22 (arguing that "all available evidence . . . points to a rather small effect of interest rates on housing prices."); Peter Wallison, *Was The Financial Crisis Caused By Monetary Policy? Comments On A Speech By John B. Taylor* (Jan. 4, 2013), http://www.aei.org/speech/economics/financial-services/comments-on-a-speech-by-john-b-taylor/, *archived at* http://perma.cc/W8GW-3YE9 (presenting charts showing that much of the housing pricing boom occurred before the period of unusually low interest rates).

224. *Economists' Views*, *supra* note 220 (quoting Chris Sims saying, "[t]here may not have been a great deal that the Fed itself, without legislative cooperation, could have done about the situation as the housing bubble developed" and Jonathan Parker noting that "Fed did not have the legal authority to change or enforce regulations in most of the areas where these actions could have mitigated the crisis"). Alan Greenspan himself doubts whether there was much the Federal Reserve could have done. *See* Kristina Cooke, *Recession Will Be Worst Since 1930's: Greenspan*, REUTERS (Feb. 18, 2009), http://www.reuters.com/article/2009/02/18/us-usa-fed-greenspan-idUSTRE51H0OX20090218, *archived at* http://perma.cc/L58B-PF8J.

225. *Economists' Views*, *supra* note 220 (quoting Michael Bordo who stated there were several causes of the housing boom but low interest rates "provided much of the fuel").

226. FCIC Report, *supra* note 3, at xxvi. Low interest rates typically result increased liquidity. *See, e.g.*, RAJAN, *supra* note 1, at 168.

economy with a large financial sector, the combination of cheap money and lax oversight, if maintained for years on end, is sure to lead to trouble."[227] Likewise, an *Economist* article concluded, "[a]sk people in property what caused the crisis and the answer will invariably be the amount of liquidity in the system."[228]

F. Government Housing Policy

Perhaps the most heated dispute has been over the role of the government's housing policy in leading to the crisis. The federal government has long encouraged home-ownership—witness the mortgage deduction from income tax—and succeeding administrations have made it a priority.[229]

Of government policies, the Community Reinvestment Act's (CRA)[230] role in the crisis has been most controversial.[231] The CRA, passed in 1977, was primarily targeted at "redlining," the refusal to lend to some borrowers (typically minorities) and neighborhoods regardless of credit-worthiness.[232] A more loaded description is that the CRA's "real purpose was to force banks to make loans to low-income borrowers, especially minorities and particularly African-Americans."[233] It required federal regulators to evaluate banks' performance in lending to lower income borrowers and communities where banks have a presence, and consider these evaluations on banks' expansion plans.[234] The CRA did not, however, set minimum targets or quotas.[235]

The FCIC concluded it "was not a significant factor" in the financial crisis

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227. CASSIDY, *supra* note 2, at 233.

228. *The Official Verdict*, *supra* note 116. Some of that liquidity may also have been caused by an influx of foreign capital. *Id.*

229. A. Mechele Dickerson, *Public Interest, Public Choice, and the Cult of Homeownership,* 2 UC IRVINE L. REV. 843, 845 (2012) ("The United States has supported and subsidized homeownership for well over a century.").

230. Community Reinvestment Act of 1977, Pub. L. No. 95-128, 91 Stat. 1147 (codified as amended at 12 U.S.C. §§ 2901-2909 (2006)).

231. *Compare* Raymond H. Brescia, *The Cost of Inequality: Social Distance, Predatory Conduct, and the Financial Crisis*, 66 N.Y.U. ANN. SURV. AM. L. 641, 693-700 (2010) (concluding that the Community Reinvestment Act and government sponsored entities were not to blame for the crisis), *with* RAJAN, *supra* note 1, at 8-9 (arguing that politicians used easy credit policies to "mollify" the masses).

232. *See* Gustavo Gari, *Using Bazookas and Firewalls to Regulate Systematic Risk in the Financial Market: The Problems with Bailout and Bank Breakups and the Case for Network Interconnectivity*, 12 FLA. ST. U. BUS. REV. 155, 163 (2013).

233. *See* ALLISON, *supra* note 219, at 55.

234. *See* Gari, *supra* note 232, at 163.

235. Some have argued that although there are no explicit targets, "there are implied quotas for low-income minority loans (especially for African Americans." *See* ALLISON, *supra* note 219, at 55. He also claims that the Fair Housing Act (1968) and Equal Credit Opportunity Act (1979) were in practice "used to give banks incentives to make loans to low-income members of minority groups." *Id.*

based on their finding that "only 6% of high-cost loans—a proxy for subprime loans—had any connection to the law." [236] This is partially because the CRA only directly covers banking institutions, and not other mortgage originators such as credit unions.[237] Others have observed that because the crisis was primarily a result of defaults on mortgages originated between 2005 and 2007, any link for the CRA is attenuated given that there were no relevant substantive changes to the CRA after 1995.[238] The conclusion is bolstered by the finding that CRA-linked loans and similar loans that are unrelated to the CRA "perform comparably,"[239] although some have claimed that the default rates have been "extraordinarily high."[240]

The FCIC also concluded that with respect to the GSEs, their involvement was limited to following other lenders into the market rather than leading the charge.[241]

In his FCIC dissent, Peter Wallison claimed the "*sine qua non* of the financial crisis was U.S. government housing policy."[242] Wallison, among others, charged that it was U.S. government housing policy that encouraged home ownership among those with lower income.[243] This resulted in an overheated housing market and an increase in home ownership from the long-existing 64% in 1965 to nearly 70% by 2004.[244]

He notes that by 2007, half of U.S. mortgages (28 million) were subprime or weak, and of these, 74 percent "were on the books of government agencies or others subject to government requirements."[245] His report was dismissed as "a lonely, loony cri de coeur."[246]

Shifting ground somewhat, Allison argues that the legal responsibility to facilitate low-income home ownership became an ethical responsibility or duty,[247]

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236. FCIC REPORT, *supra* note 3, at xxvii; *see also* Neil Bhutta & Glenn B. Canner, *Community Dividend: Did the CRA Cause the Mortgage Market Meltdown?*, FED. RES. BANK OF MINNEAPOLIS (Mar. 1, 2009), *available at* phttp://www.minneapolisfed.org/publications_papers/ub_display.cfm?id=4136& (determining the 6% figure after carving out loans from lenders that were not regulated by the CRA and to borrowers who were no lower-income or in a CRA assessment area, and acknowledging possible inaccuracies in the figure).

237. *Id.*

238. *Id.*

239. *Id.*

240. ALLISON, *supra* note 219, at 56.

241. *See* FCIC REPORT, *supra* note 3, at xxvi.

242. *See id.* at 444 (Wallison, dissenting).

243. *See id.* (Wallison, dissenting).

244. *See id.* at 456 (Wallison, dissenting).

245. Wallison, *supra* note 114.

246. Joe Nocera, *Inquiry is Missing Bottom Line*, N.Y. TIMES, Jan. 28, 2011, http://www.nytimes.com/2011/01/29/business/29nocera.html?pagewanted=all, *archived at* http://perma.cc/E5V9-ETZG.

247. ALLISON, *supra* note 219, at 56.

and acknowledges the "ethical justification was more important."[248] It seems unlikely that this claim could be empirically proved (or disproved).

F. Repeal of Glass-Steagall

It is also worth mentioning one oft-cited cause that probably was not a cause at all: the repeal of the Glass-Steagall Act.[249] The Glass-Steagall Act, enacted in 1933 separated commercial banking from investment banking.[250] It was repealed by the Gramm-Leach-Bliley Act of 1999.[251] It is hard to see how this would be a plausible cause. Glass-Steagall never regulated the shadow-banking system, which is what caused the crisis.[252] Moreover, absent its repeal, JP Morgan would have been unable to buy Bear Stearns and the same for Bank of America's purchase of Merrill Lynch, which would have made the crisis far worse.[253] Glass-Steagall's repeal does, however, fit a narrative where rampant deregulation is the cause of the financial crisis.

CONCLUSION

There were plenty of necessary causes of the financial crisis, but no sufficient causes. With the benefit of hindsight, it is clear there were many parties who, had they acted differently, could have prevented the financial crisis, or at least mitigated its impact. Regulators failed to effectively regulate. The credit rating agencies used weak models, based on inadequate information, with an inherent conflict of interest. Buyers and sellers of securities did not adequately investigate the securities they were buying. Mortgage lenders and the support industry, such as appraisers, failed to behave ethically. And, of course, home buyers were perhaps too optimistic about their earnings prospects or the housing market, or

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248. *Id.* at 57.

249. *See, e.g.*, David Leonhardt, *Washington's Invisible Hand*, N.Y. TIMES, Sept. 26, 2008, http://www.nytimes.com/2008/09/28/magazine/28wwln-reconsider.html, *archived at* http://perma.cc/B5DS-A9M9 (noting that many cite the repeal of Glass-Steagall as a cause of the financial crisis, and that it is an easy scapegoat).

250. Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162.

251. *See* Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999) (repealing sections of the Glass-Steagall Act); Gari, *supra* note 232, at 161.

252. *See* Gari, *supra* note 232, at 163 ("Glass Steagall . . . firewalls could not stop the creation of a shadow banking system of derivatives, special purpose vehicles, and credit default swaps, all of which served the purpose of hedging and profiting from the risk of subprime loans").

253. *See* Andrew Ross Sorkin, *Reinstating an Old Rule Is Not a Cure for Crisis*, N.Y. TIMES DEAL BOOK (May 21, 2012), http://dealbook.nytimes.com/2012/05/21/reinstating-an-old-rule-is-not-a-cure-for-crisis/, *archived at* http://perma.cc/M7U3-RFZW.

sometimes just were misinformed or did not understand. The appropriate lesson is not a binary conflict between deregulation and regulation, but rather better and smarter regulation.[254] This also suggests that even though greed remains a fundamental aspect of human nature, an appropriate set of rules can greatly reduce, if not prevent, the chances of another such crisis.[255]

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254. Ben S. Bernanke, *Monetary Policy and the Housing Bubble* (Jan. 3, 2010), http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm, *archived at* http://perma.cc/ZQ5H-FTKK ("[T]he lesson I take from this experience is not that financial regulation and supervision are ineffective for controlling emerging risks, but that their execution must be better and smarter.").

255. As the FCIC noted "to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis." FCIC REPORT, *supra* note 3, at xxii-xxiii.

CITIGROUP: A CASE STUDY IN MANAGERIAL AND REGULATORY FAILURES

ARTHUR E. WILMARTH, JR.*

"I don't think [Citigroup is] too big to manage or govern at all . . . [W]hen you look at the results of what happened, you have to say it was a great success."

Sanford "Sandy" Weill, chairman of Citigroup, 1998-2006[1]

"Our job is to set a tone at the top to incent people to do the right thing and to set up safety nets to catch people who make mistakes or do the wrong thing and correct those as quickly as possible. And it is working. It is working."

Charles O. "Chuck" Prince III, CEO of Citigroup, 2003-2007[2]

"People know I was concerned about the markets. Clearly, there were things wrong. But I don't know of anyone who foresaw a perfect storm, and that's what we've had here."

Robert Rubin, chairman of Citigroup's executive committee, 1999-2009[3]

"I do not think we did enough as [regulators] with the authority we had to help contain the risks that ultimately emerged in [Citigroup]."

Timothy Geithner, President of the Federal Reserve Bank of New York, 2003-2009; Secretary of the Treasury, 2009-2013[4]

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1. Timothy L. O'Brien & Julie Creswell, *Laughing All the Way from the Bank*, N.Y. TIMES, Sept. 11, 2005, § 3, at 31 (quoting Mr. Weill, and noting that Mr. Weill served as CEO of Citigroup from 1998 to 2003).

2. Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1 (quoting a statement by Mr. Prince in 2006).

3. Nelson D. Schwartz & Eric Dash, *Where Was The Wise Man?*, N.Y. TIMES, Apr. 27, 2008, § BU, at 1 (quoting Mr. Rubin), *available at* http://www.nytimes.com/2008/04/27/business/27rubin.html?pagewanted=all, *archived at* http://perma.cc/ARZ3-CUC7.

4. THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT:

INTRODUCTION

Citigroup has served as the poster child for the elusive promises and manifold pitfalls of universal banking. When Citicorp merged with Travelers to form Citigroup in 1998, supporters of the merger hailed Citigroup as the first modern American "universal bank"—i.e., the first U.S. banking organization since 1933 that could offer comprehensive banking, securities and insurance services to its customers.[5] Citigroup's leaders asserted that the new financial conglomerate would offer unparalleled convenience to its customers through "one-stop shopping" for a broad range of banking, securities, and insurance services.[6] They also claimed that Citigroup would have a superior ability to withstand financial shocks due to its broadly diversified activities.[7] Supporters of the Travelers-Citicorp merger further argued that U.S. banks needed universal banking powers in order to compete with European and Asian banks that already possessed "the ability to offer an array of banking and insurance products under one corporate umbrella."[8] Travelers' chairman Sandy Weill declared, "We are creating the model financial institution of the future. . . . In a world that's changing very rapidly, we will be able to withstand the storms."[9]

By 2009, those bold predictions of Citigroup's success had turned to ashes.[10] Citigroup's high-risk, high-growth strategy proved to be disastrous.[11] As a result

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FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 303 (2011) [hereinafter FCIC REPORT] (quoting testimony of Mr. Geithner on May 6, 2010), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, *archived at* http://perma.cc/XVK2-L8FG.

5. Yvette D. Kantrow & Liz Moyer, *Citi, Travelers: A Global Leader Takes Shape*, AM. BANKER, Apr. 7, 1998, at 1, *available at* http://www.americanbanker.com/175/citi-travelers-a-global-leader-takes-shape-1041890-1.html, *archived at* http://perma.cc/U3PW-WDK2; Michael Siconolfi, *Big Umbrella: Travelers and Citicorp Agree to Join Forces in $83 Billion Merger*, WALL ST. J., Apr. 7, 1998, at A1.

6. Steven Lipin & Stephen E. Frank, *The Big Umbrella: Travelers/Citicorp Merger—One-Stop Shopping Is the Reason for Deal*, WALL ST. J., Apr. 7, 1998, at C14.

7. Siconolfi, *supra* note 5 (reporting that Citicorp CEO John Reed and Travelers CEO Sandy Weill "are betting that the broad services of the huge new firm could weather any future market swoons").

8. Timothy L. O'Brien & Joseph B. Treaster, *A $70 Billion Pact*, N.Y. TIMES, Apr. 7, 1998, at A1.

9. Kantrow & Moyer, *supra* note 5 (quoting Mr. Weill).

10. Bradley Keoun, *Citigroup Board Says Pandit Deserved Bonus for 2009 'Progress,'* BLOOMBERG.COM, Mar. 1, 2010, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aKWvUvCwZng0, *archived at* http://perma.cc/L8JT-VGDG (reporting that Citigroup incurred a net loss of $27.7 billion during 2008 and a further net loss of $1.6 billion during 2009).

11. Brian Collins & Terry Peters, *Citi Takes Huge Hit*, NAT'L MORTGAGE NEWS, Jan. 21, 2008, at 1 (reporting that Citigroup incurred a net loss of $9.8 billion during the fourth quarter of 2007).

of that strategy, the bank recorded more than $130 billion of write-downs on its loans and investments from the second half of 2007 through the end of 2009.[12] In order to prevent Citigroup's failure, the federal government injected $45 billion of new capital into the bank and provided the bank with $500 billion of additional help in the form of asset guarantees, debt guarantees, and liquidity assistance.[13] The federal government provided more financial assistance to Citigroup than to any other bank during the financial crisis.[14]

This Article describes Citigroup's rapid growth and sudden collapse during the decade following its creation. As explained below, Citigroup's managers and regulators repeatedly failed to prevent or respond effectively to legal violations, conflicts of interest, excessive risk-taking, and inadequate risk controls within the bank's complex, sprawling operations. Those repeated failures reflected a broader mindset—both on Wall Street and in Washington—that placed great faith in the ability of financial institutions and markets to discipline themselves while disdaining government regulation as misguided and counterproductive.

Citigroup was an arbitrage vehicle at its inception, because its founders (assisted by friendly government officials) exploited a statutory loophole to place great pressure on Congress to repeal the Glass-Steagall Act of 1933 and authorize universal banking.[15] Citigroup's key corporate predecessors—Citicorp and Salomon Brothers—had high-risk cultures, and both institutions flirted with failure during the decade preceding Citigroup's formation.[16] From 2000 to 2004, Citigroup was embroiled in a series of high-profile scandals, including tainted transactions with Enron and WorldCom, biased research advice, corrupt allocations of shares in initial public offerings (IPOs), predatory subprime lending, and market manipulation in foreign bond markets.[17] In 2005, Citigroup's bank regulators—the Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency (OCC)—imposed a moratorium on further large acquisitions until Citigroup improved its corporate compliance and risk management procedures.[18] That temporary moratorium appears to have been the only meaningful constraint imposed by regulators before Citigroup collapsed at the end of 2008.[19]

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12. *See infra* Part II.

13. *See infra* Part II.B.

14. *See infra* Part II.B; YALMAN ONARAN, ZOMBIE BANKS: HOW BROKEN BANKS AND DEBTOR NATIONS ARE CRIPPLING THE GLOBAL ECONOMY 83-87, 92-93 (1st ed. 2011) (explaining that Citigroup and Bank of America received the largest amounts of financial assistance from the federal government).

15. *See infra* Part I.A.

16. *See infra* Part I.A.

17. *See infra* Part I.B.

18. Citigroup Inc., Federal Reserve System (Mar. 16, 2005) (order), at 11 [hereinafter FRB Citigroup-FAB Order] (imposing moratorium as a condition to FRB's approval of Citigroup's acquisition of First American Bank in March, 2005), *available at* http://www.federalreserve.gov/boarddocs/press/orders/2005/20050316/attachment.pdf, *archived at* http://perma.cc/N2RZ-YBLV.

19. *See infra* Parts I.B.5; III.B.1.

Citigroup pursued an expansion strategy premised on internal "organic growth" until the FRB and OCC lifted their moratorium on large acquisitions in 2006.[20] Citigroup then made a series of rapid-fire purchases of foreign and domestic financial firms.[21] Citigroup also pursued a wide range of high-risk activities, including leveraged corporate lending, packaging toxic subprime loans into residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs), as well as dumping risky assets into off-balance-sheet conduits for which Citigroup had contractual and reputational exposures.[22] By the summer of 2007, Citigroup faced crippling losses from its aggressive risk-taking, and it was forced to accept multiple bailouts from the federal government to avoid failure.[23]

Post-mortem evaluations of Citigroup's near-collapse revealed that neither the bank's senior executives nor its regulators recognized the systemic risks embedded in the bank's far-flung operations.[24] Those findings strongly indicate that Citigroup was not only "too big to fail" (TBTF), but also too big and too complex to manage or regulate effectively. Citigroup's history raises deeply troubling questions about the ability of bank executives and regulators to supervise and control today's megabanks.[25]

I. CITIGROUP'S FORMATION AND TROUBLED HISTORY THROUGH 2004

A. Citigroup Was Created as an Arbitrage Play on Congress

Advocates of universal banking applauded the formation of Citigroup in 1998 as a bold maneuver to force Congress to repeal Sections 20 and 32 of the Glass-Steagall Act of 1933,[26] and to modify Section 4 of the Bank Holding Company Act of 1956 (BHC Act).[27] The Glass-Steagall and BHC Acts imposed substantial restrictions on the ability of banking organizations to engage in securities and insurance activities.[28] Big banks and their supporters had pushed bills to repeal

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20. *See infra* Parts II.A; III.B.1.
21. *See infra* Part III.B.1.
22. *See infra* Part II.A.
23. *See infra* Part II.B.
24. *See infra* Part III.
25. *See infra* Part III.
26. Pub. L. 73-66, 48 Stat.162 (1933).
27. 12 U.S.C. § 1843 (2012).
28. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 219-20, 225-27 [hereinafter Wilmarth, *Transformation*] (at 215, describing Sections 20 and 32 of the Banking Act of 1933, popularly known as the "Glass-Steagall Act," which prohibited banks from affiliating with securities firms; at 226-227, describing Section 4 of the BHC Act, which barred banks from affiliating with insurance underwriters and insurance agents; at 219-20, explaining that the Gramm-Leach-Bliley Act (GLBA) repealed the foregoing anti-affiliation provisions of the Glass-Steagall Act and the BHC Act).

the Glass-Steagall Act and amend the BHC Act since the early 1980s, but political divisions among large and small banks, securities broker-dealers, insurance underwriters, and insurance agents prevented the passage of such legislation.[29]

In the late 1990s, securities firms and insurance underwriters abandoned their longstanding opposition against efforts to repeal the Glass-Steagall Act and modify the BHC Act, and they joined forces with the big banks.[30] However, insurance agents and community banks continued to block passage of the legislation.[31] In the context of this continued stalemate, the Travelers-Citicorp merger was an audacious move that placed "tremendous pressure on Congress" to authorize universal banking.[32] The legality of the merger was premised on a temporary exemption in the BHC Act, which allowed newly formed bank holding companies to retain nonconforming assets for up to five years after their creation.[33] However, as a banking lawyer noted, "[t]he exemption was intended to provide an orderly mechanism for disposing of impermissible activities, not

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29. Sandra Suarez & Robin Kolodny, *Paving the Road to "Too Big to Fail": Business Interests and the Politics of Financial Deregulation in the U.S.* (June 15, 2010) (describing unsuccessful efforts to pass legislation to repeal the Glass-Steagall Act during the 1980s and 1990s), *available at* http://ssrn.com/abstract=1625289; Charles C.Y. Wang & Yi David Wang, *Explaining the Glass-Steagall Act's Long Life, and Rapid Eventual Demise* 26-34 (Dec. 8, 2010) (same), *available at* http://ssrn.com/abstract=1722373.

30. Suarez & Kolodny, *supra* note 29, at 29-33.

31. *Id.* (explaining that (i) by 1997, large banks had made significant inroads into the securities and insurance businesses by obtaining favorable rulings from the FRB and the OCC that exploited loopholes in the Glass-Steagall Act and other banking statutes; and (ii) after failing to overturn those rulings in the courts, securities firms and insurance underwriters decided to support universal banking legislation in order to secure reciprocal rights to enter the banking business, but community banks and insurance agents continued to oppose such legislation); Kathleen Day, *Reinventing the Bank: With Depression-Era Law About to Be Rewritten, the Future Remains Unclear*, WASH. POST, Oct. 31, 1999, at H1 (same); Daniel J. Parks & Lori Nitschke, *Banking: Financial Services Overhaul Sees Home Stretch at Last*, 57 CQ WKLY. 1645, June 10, 1999 (same). In addition, jurisdictional squabbles between the FRB and the Treasury Department over which agency (FRB or OCC) should exercise primary control over the proposed new financial conglomerates created another obstacle to passage in the late 1990s. Daniel J. Parks, *Banking: Senate Passes Banking Overhaul Bill Vulnerable to a Clinton Veto; House Version Divides Committees*, 57 CQ WKLY. 1081, May 8, 1999.

32. Richard W. Stevenson, *Financial Services Heavyweights Try Do-It-Yourself Deregulation*, N.Y. TIMES, Apr. 7, 1998, at A1 (quoting Peter Wallison), *available at* http://www.nytimes.com/1998/04/07/business/shaping-colossus-regulators-financial-services-heavyweights-try-it-yourself.html?pagewanted=all&src=pm, *archived at* http://perma.cc/U2ND-UUCZ; *see also* Edward J. Kane, *Implications of Superhero Metaphors for the Issue of Banking Powers*, 23 J. BANKING & FIN. 663, 666 (1999) (contending that Citigroup's leaders "boldly gambled that they [could] dragoon Congress . . . into legalizing their transformation").

33. *See* Wilmarth, *Transformation*, *supra* note 28, at 221 (discussing Section 4(a)(2) of the BHC Act).

warehousing them in hopes the law would change so you could keep them."[34]

In addition to the fact that the Travelers-Citicorp merger "challenge[d] both the statutory letter and regulatory spirit" of existing law,[35] the merger was extraordinary because of the advance clearance it received from regulatory and political leaders.[36] As I pointed out in a previous article, "Citicorp's and Travelers' chairmen consulted with, and received positive signals from FRB chairman Alan Greenspan, Treasury Secretary Robert Rubin, and President Clinton *before* the merger was publicly announced."[37] Greenspan, Rubin, and Clinton thereby indicated their approval for the companies' decision to confront Congress with a Hobson's choice: "either [to] end these [Glass-Steagall and BHC Act] restrictions, scuttle the [Citigroup] deal[,] or force the merged company to cut back on what it offers the customer."[38] As one congressman observed, Citicorp and Travelers were "essentially playing an expensive game of chicken with Congress," but they did so with the full support of top federal officials.[39]

The creation of Citigroup is widely viewed as a key factor that persuaded Congress to adopt the Gramm-Leach-Bliley Act (GLBA)[40] in November 1999.[41] GLBA repealed the anti-affiliation provisions of the Glass-Steagall Act and the BHC Act and authorized banks, securities firms, and insurance companies to join together by forming financial holding companies—thereby ratifying Citigroup's universal banking model.[42] Citigroup played a leading role in the financial industry's lobbying on behalf of GLBA, and then-Chairman Sandy Weill helped to arrange the final political compromise that secured GLBA's passage.[43]

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34. Barbara A. Rehm, *Megamerger Plan Hinges on Congress*, AM. BANKER, Apr. 7, 1998, at 1 (quoting an unnamed "banking lawyer").

35. Kane, *supra* note 32, at 666-67. The FRB approved the merger based on the exemption in Section 4(a)(2) of the BHC Act, and the D.C. Circuit upheld the FRB's decision. Indep. Cmty. Bankers of Am. v. Bd. of Governors, 195 F.3d 28, 31-32 (D.C. Cir. 1999) (holding that the merger's "literal compliance" with Section 4(a)(2) overcame any argument that the merger violated the "purposes" of the BHC Act).

36. Wilmarth, *Transformation*, *supra* note 28, at 306.

37. *Id.*

38. O'Brien & Treaster, *supra* note 8, at A1; Daniel Kadlec et al., *Bank on Change*, TIME, Nov. 8, 1999, at 50; Rehm, *supra* note 34 (Based on his discussions with regulators, Citicorp chairman John Reed stated that "there are all indications that (the merger) will be looked at favorably.").

39. Dean Anason, *Advocates, Skeptics Face Off on Megadeals*, AM. BANKER, Apr. 30, 1998, at 2 (quoting Rep. Maurice D. Hinchey (D-NY)).

40. 113 Stat. 1338 (Nov. 12, 1999).

41. Wilmarth, *Transformation*, *supra* note 28, at 219-21; Kadlec et al., supra note 38; *see also* Daniel J. Parks, *Banking: United at Last, Financial Industry Pressures Hill to Clear Overhaul*, 57 CQ WKLY. 2373, Oct. 9, 1999 ("The need for legislation was highlighted by the recent merger of the Travelers Group and Citicorp into the Citigroup financial conglomerate. . . . Citigroup must sell off its insurance activities within the next few years unless Congress approves an overhaul.").

42. Wilmarth, *Transformation*, *supra* note 28, at 219-21, 306-07.

43. *Id.* at 306-07 (citing news reports stating that "Senator Phil Gramm [R-TX] called on

Citigroup also hired former Treasury Secretary Robert Rubin as its new co-chairman during the final congressional deliberations over GLBA, thereby gaining "a highly visible public endorsement" for the repeal of the Glass-Steagall Act.[44]

Thus, Citigroup can reasonably be identified as the poster child for GLBA's new universal banking model. Indeed, advocates for GLBA essentially repeated the same arguments that supporters had presented in favor of Citicorp's merger with Travelers: namely, that universal banks (i) would provide "one-stop shopping" convenience, lower costs, and more credit for businesses and consumers, (ii) would be more profitable, more diversified and better able to withstand economic and financial shocks, and (iii) would ensure that U.S. financial institutions could compete on equal terms with large foreign universal banks from the U.K., Europe and Japan.[45]

Consumer groups largely dismissed claims that large universal banks would provide customers with greater convenience and lower-cost services.[46] GLBA's

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Citigroup co-chairman Sandy Weill to help broker a last-minute compromise between Republican congressional leaders and the Clinton administration, thereby ensuring [GLBA's] passage"); Jake Lewis, *Monster Banks: The Political and Economic Costs of Banking Consolidation*, MULTINATIONAL MONITOR, Jan./Feb. 2005, at 31, 33 (stating that John Reed of Citicorp and Sandy Weill of Travelers were "[a]t the forefront" of lobbying efforts for GLBA); Daniel J. Parks, *Banking: Financial Services Overhaul Bill Clears After Final Skirmishing Over Community Reinvestment*, 57 CQ WKLY. 2654, Nov. 6, 1999 (reporting that "key events in this year's overhaul efforts coincided with heavy political contributions by Citigroup").

44. Michael Hirsh, *In Bob We Trust*, NAT'L J., Jan. 19, 2013, at 12, 18; *see also* Parks "United at last," *supra* note 41 (reporting that Citigroup hired Rubin as its new co-chairman on Oct. 26, 1999); Lewis, *supra* note 43, at 32 (stating that Rubin "enthusiastically promoted the [GLBA] legislation" as Treasury Secretary); Robert Scheer, *Privacy Issue Bubbles Beneath the Photo Op*, L.A. TIMES, Nov. 16, 1999, at B9 (stating that "Rubin has become co-chairman of Citigroup, a conglomeration between Citibank and Travelers Insurance that immediately benefits from [GLBA], which was strongly backed by Rubin and his Treasury Department and for which he lobbied in the months following his resignation."); *Secretaries of the Treasury*, U.S. Dep't Treas., http://www.treasury.gov/about/history/Pages/edu_history_secretary_index.aspx *archived at* http://perma.cc/DG9A-YHLW (noting that Rubin served as Treasury Secretary from Jan. 10, 1995 to July 2, 1999).

45. S. REP. NO. 106-44, at 4-6 (1999); 145 CONG. REC. S13,783-84 (daily ed. Nov. 3, 1999) (remarks of Sen. Gramm); 145 CONG. REC. S13,880-81 (daily ed. Nov. 4, 1999) (remarks of Sen. Schumer); James R. Barth et al., *The Repeal of Glass-Steagall and the Advent of Broad Banking*, J. ECON. PERSPECTIVES, Spring 2000, at 191, 198-99; Joao Santos, *Commercial Banks in the Securities Business: A Review*, 14 J. FIN. SERVS. RESEARCH 35, 37-41 (1998); Day, *supra* note 31; Lori Nitschke, *Banking: GOP Touts 'One-Stop Shopping' as Key Benefit of Overhaul Bill*, 56 CQ WKLY. 728, Mar. 21, 1998; *see also supra* notes 6-9 and accompanying text (describing similar arguments advanced in support of Citicorp's merger with Travelers).

46. Day, *supra* note 31 (noting that consumer advocates did not believe such claims, particularly as larger banks typically charged higher service fees to consumers); Nitschke, *supra* note 45; *see also* Lewis, *supra* note 43, at 33 ("Proponents of financial modernization had the

opponents argued that financial conglomerates were likely to produce financial risks and speculative excesses similar to those that occurred when large U.S. banks operated securities affiliates in the 1920s.[47] Opponents also contended that GLBA would promote greater consolidation within the financial services industry and extend the federal safety net to embrace the securities and insurance sectors, thereby aggravating the TBTF problem.[48] Some critics warned that GLBA might create the conditions for a financial crisis similar to the Great Depression.[49]

In addition to general concerns about the potential risks of universal banking, there were more specific reasons to doubt whether Citigroup could fulfill its founders' bullish projections. Two of Citigroup's key predecessor organizations—Citibank and Salomon Brothers—had aggressive risk-taking cultures, and both organizations had narrowly avoided collapses in the past.[50] Citibank suffered heavy losses in the early 1930s after its disastrous forays into the securities markets under its hard-driving and controversial chairman, Charles "Sunshine Charley" Mitchell.[51] Citibank was forced to accept a large bailout from the Reconstruction Finance Corporation in 1933 to replenish its depleted capital.[52] From the 1970s to the early 1990s, Citibank again pursued speculative business strategies under the leadership of Walter Wriston and John Reed.[53] Citibank almost failed in the early 1990s due to massive losses from its loans to

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chutzpah to attempt to sell the legislation as a boon to consumers. . . . Through the years of hearings [on the bills that led to GLBA], no one ever produced the consumers who were supposedly yearning for one-stop money shops.").

47. For arguments presented by GLBA's critics, see, e.g., 145 CONG. REC. S13,871-74 (daily ed. Nov. 4, 1999) (remarks of Sen. Wellstone); *id.* S13,896-97 (remarks of Sen. Dorgan); 145 CONG. REC. H11,530-31, 11,542 (daily ed. Nov. 4, 1999) (remarks of Rep. Dingell); Kadlec, *supra* note 38 (describing views of bank analyst Lawrence Cohn and Ralph Nader); *see also* Wilmarth, *Transformation*, *supra* note 28, at 444-76 (warning of GLBA's risks, and stating that "the growth of large financial holding companies is likely to increase the risks of contagion within and among those conglomerates, thereby creating a more fragile financial system and intensifying pressures for TBTF bailouts during financial disruptions").

48. *Id.*

49. *Id.*

50. *See infra* notes 51-59 and accompanying text.

51. Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921-33? A Preliminary Assessment*, 4 CURRENT DEV. IN MONETARY & FIN. LAW 559, 575-80 (IMF, 2005) [hereinafter Wilmarth, *Universal Banks*], *available at* http://ssrn.com/abstract=838267; Binyamin Appelbaum, *Citi's Long History of Overreach, Then Rescue*, WASH. POST, Mar. 11, 2009, at D01, *available at* http://articles.washingtonpost.com/2009-03-11/business/36891255_1_vikram-pandit-citigroup-american-banks, *archived at* http://perma.cc/CQY8-28VA.

52. Wilmarth, *Universal Banks*, *supra* note 51, at 602-04, 607-11; Martin Hutchinson, *Citi at 200: With age, Foolishness*, GLOBE & MAIL (Canada), June 12, 2012, at B12, *available at* https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20120612/GIBREAKVIEWSCITIGROUP0612ATL, *archived at* http://perma.cc/V92S-XTKY.

53. Appelbaum, *supra* note 51.

developing countries, highly leveraged corporations, commercial real estate developers, and subprime consumers.[54] The bank survived after receiving extensive forbearance from federal regulators, a highly favorable interest rate policy engineered by FRB chairman Alan Greenspan, and a large investment from Saudi Prince Al-Waleed bin Talal.[55]

Salomon Brothers had an even more aggressive and legendary risk-taking culture.[56] Salomon nearly failed in 1991 after paying a $290 million penalty for illegally rigging Treasury bond auctions, and the bank was forced to turn to Warren Buffett for help.[57] Later, Salomon suffered large losses from speculative trading in mortgage-backed securities during 1994.[58] After incurring additional trading losses, Salomon agreed to sell itself to Travelers in 1997, a year before Travelers acquired Citicorp.[59] Sandy Weill's top lieutenant at Travelers, Jamie Dimon, tried to force Salomon to cut back on its risk-taking.[60] With Weill's approval, Dimon shut down Salomon's fixed-income arbitrage trading unit after that unit suffered heavy trading losses during the Russian debt default crisis in 1998.[61] However, Weill fired Dimon in late 1998, and Salomon's aggressive culture soon reasserted itself within the new Citigroup.[62]

B. A Series of Illuminating (But Largely Ignored) Lessons: Scandals at Citigroup from 2000 to 2004

Soon after its formation, Citigroup became embroiled in a series of scandals involving Enron, WorldCom, tainted research advice, predatory consumer lending, European trading abuses, and violations of Japanese private-banking

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54. Wilmarth, *Transformation*, *supra* note 28, at 304-05, 313-15, 401; CHARLES GASPARINO, THE SELLOUT: HOW THREE DECADES OF WALL STREET GREED AND GOVERNMENT MISMANAGEMENT DESTROYED THE GLOBAL FINANCIAL SYSTEM 49-50 (2009); ONARAN, *supra* note 14, at 83; Appelbaum, *supra* note 51; Anthony Bianco, *What Wriston Wrought*, BUS. WK., Feb. 7, 2005, at 36; Hutchinson, *supra* note 52; Andy Kessler, *The End of Citi's Financial Supermarket*, WALL ST. J., Jan. 16, 2009, at A11.

55. *Id*.

56. *See, e.g.,* GASPARINO, *supra* note 54, at 13-22, 28-37, 69-76, 83-84; FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 12-15, 84-111 (2003).

57. GASPARINO, *supra* note 54, at 83-84; PARTNOY, *supra* note 56, at 107-11.

58. RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 52-76 (2007); GASPARINO, *supra* note 54, at 136-40.

59. BOOKSTABER, *supra* note 58, at 52-76; GASPARINO, *supra* note 54, at 136-40.

60. BOOKSTABER, *supra* note 58, at 77-88, 91-93, 97-101, 125-34; GASPARINO, *supra* note 54, at 140-46.

61. BOOKSTABER, *supra* note 58, at 77-88, 91-93, 97-101, 125-34; GASPARINO, *supra* note 54, at 140-46.

62. BOOKSTABER, *supra* note 58, at 77-88, 91-93, 97-101, 125-34; GASPARINO, *supra* note 54, at 140-46.

rules.[63] Those scandals seriously damaged Citigroup's reputation and stock market price.[64] In view of the gravity of Citigroup's offenses, the regulatory responses were clearly inadequate. Agencies imposed corporate sanctions on Citigroup, but no top-level executives were punished.[65] The responses of Citigroup's management were equally ineffective. A widely-publicized campaign to transform Citigroup's culture proved to have little impact on the organization's actual behavior.[66]

1. Citigroup's Involvement with Enron and WorldCom.—Citigroup suffered extensive financial and reputational harm from aiding and abetting the fraudulent schemes of Enron and WorldCom.[67] Citigroup engineered three types of fraudulent transactions for Enron. First, Citigroup entered into prepaid commodity swaps ("prepays") that enabled Enron to obtain nearly $4 billion of disguised loans while reporting the proceeds of those transactions as cash flow from operating activities.[68] As a practical matter, "prepays enabled Enron to inflate its reported cash flow and to disguise its actual debt obligations."[69] Second, Citigroup arranged "Project Nahanni" and other "minority interest transactions," which provided additional disguised loans to Enron while allowing Enron to report the financing transactions as cash flow from "merchant investment" activities.[70] Third, Citigroup helped Enron to structure "Project Bacchus" and other fictitious "sales" of assets to special-purpose entities (SPEs) controlled by Enron.[71] Citigroup financed those asset "sales" by providing de

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63. Ryan Chittum, *200 Years of Citi*, COLUM. JOURNALISM REV. (Mar. 9, 2012), http://www.cjr.org/the_audit/an_alternate_history_of_citigr.php?page=all, *archived at* http://perma.cc/ANR9-Y724.

64. Bruce Mizrach & Susan Zhang Weerts, *Does the Stock Market Punish Corporate Malfeasance: A Case Study of Citigroup*, 3 CORP. OWNERSHIP & CONTROL No. 4 (Summer 2006), at 151; Peter Lee, *What Citigroup Needs to do Next*, EUROMONEY, July 1, 2005, at 64.

65. *See* Chittum, *supra* note 63 (summarizing Citigroup's misdeeds and corresponding regulatory responses, which did not include any penalties against Citigroup's management).

66. Mitchell Pacelle, *Moving the Market: Citigroup Works on Its Reputation*, WALL ST. J., Feb. 17, 2005, at C3 (describing Citigroup's implementation of ethics and code-of-conduct training program in 2005); *see infra* Part II.A (discussing Citigroup's continued pursuit of high risk strategies after 2005).

67. Arthur E. Wilmarth, Jr., *Conflicts of Interest and Corporate Governance Failures at Universal Banks During the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom* 4, 10, 24-25, 29, 42-44 (Geo. Wash. Univ. Law Sch. Pub. L. & Leg Theory, Working Paper No. 234, 2007) [hereinafter Wilmarth, *Conflicts of Interest*], *available at* http://ssrn.com/abstract=952486.

68. *Id.* at 12; *see also* In re Citigroup, SEC Admin. Proc. No. 3-11192 (July 28, 2003), at 15-21 [hereinafter SEC Citigroup-Enron Order], *available at* http://www.sec.gov/litigation/admin/34-48230.htm, *archived at* http://perma.cc/443K-CCDA. Citigroup also arranged similarly fraudulent prepays for Dynegy, another Texas energy company. *Id.* at 21-27.

69. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 12.

70. *Id.* at 12-13; SEC Citigroup-Enron Order, *supra* note 68, at 9-13.

71. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 13-14; SEC Citigroup-Enron Order,

facto loans to the SPEs, and Enron fraudulently reported the "sales" as operating earnings (while guaranteeing that the SPEs would repay their loans to Citigroup).[72]

Citigroup's officers recognized the fraudulent nature of the complex structured transactions that the bank arranged for Enron.[73] For example, Citibank's Capital Markets Approval Committee acknowledged that a prepay requested by Enron was "effectively a loan, [but] the form of the transaction would allow [Enron] to reflect it as 'liabilities from price risk management activity' on their [sic] balance sheet and also provide a favourable [sic] impact on reported cash flow from operations."[74] Citigroup's managers similarly described Project Nahanni as "year-end window dressing" and "an insurance policy for [year-end] balancing."[75] Another Citigroup officer explained that "Enron's motivation [in Project Bacchus] now appears to be writing up the asset in question from a basis of about $100MM to as high as $250MM, thereby creating earnings."[76]

David Bushnell, Citigroup's head of global risk management, objected to a transaction that was designed to refinance Project Nahanni because "[t]he GAAP accounting is aggressive and a franchise risk to us if there is publicity."[77] However, Citigroup went forward with the transaction because it wanted to maintain its lucrative relationship with Enron.[78] Citigroup received almost $200 million in fees from Enron and ranked Enron as "one of the highest revenue clients within Citigroup."[79] After Project Bacchus was completed, a Citigroup officer remarked, "Sounds like we made a lot of exceptions to our standard policies. I am sure we have gone out of our way to let them know that we are bending over backwards for them . . . let's remember to collect this iou when it really counts."[80]

Citigroup paid more than $100 million of civil penalties to settle allegations of securities law violations filed by the Securities and Exchange Commission

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supra note 68, at 13-15.

72. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 13-14; SEC Citigroup-Enron Order, *supra* note 68, at 13-15.

73. *See infra* notes 74-80 and accompanying text.

74. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 17-18 (quoting the Enron bankruptcy examiner's Third Report, which quoted the Citibank Committee's minutes of June 22, 1999).

75. *Id.* at 19 (quoting the Enron bankruptcy examiner's Third Report, which quoted from an undated "Citigroup Exposure Spreadsheet" and an email from James Reilly dated July 24, 2001).

76. *Id.* (quoting the Enron bankruptcy examiner's Third Report, which quoted emails from James Reilly dated Nov. 28 and Dec. 6, 2000).

77. *Id.* (quoting the Enron bankruptcy examiner's Third Report, which quoted an internal memorandum prepared by David Bushnell).

78. *Id.* at 20-21.

79. *Id.* (quoting Enron bankruptcy examiner's Third Report, which quoted a Citigroup interoffice memorandum of Sept. 24, 2001).

80. *Id.* at 20 (quoting Enron bankruptcy examiner's Third Report, which quoted an email from Steve Wagman dated Dec. 27, 2000).

("SEC") related to Citigroup's transactions with Enron.[81] Citigroup also entered into consent agreements with the Federal Reserve Bank of New York ("New York Fed") and the OCC, under which Citigroup agreed to take corrective measures designed to prevent similarly abusive structured financial transactions in the future.[82] However, the New York Fed, the OCC, and the SEC did not file Enron-related charges against any of Citigroup's officers or employees, and Citigroup neither admitted nor denied any of the agencies' charges.[83] Citigroup subsequently paid $3.7 billion to settle claims by Enron's investors and Enron's bankruptcy estate.[84]

Like Enron, WorldCom proved to be a very expensive client for Citigroup. Citigroup was a lead underwriter for several of WorldCom's public offerings of equity and debt securities.[85] For example, Citigroup acted as co-lead underwriter for an $11.9 billion public offering of bonds that WorldCom issued in May 2001, even though Citigroup and other lead underwriters had serious concerns about WorldCom's long-term viability.[86] Citigroup, together with its predecessors—Salomon Brothers and Salomon Smith Barney (collectively as "Salomon")—also provided extensive personal benefits to WorldCom's CEO, Bernie Ebbers, to solidify its status as WorldCom's most highly-paid bank.[87] From 1996 to 2002, Salomon and Citigroup received more than $140 million in fees from WorldCom.[88] During the same period, Salomon and Citigroup made preferential allocations of stock to Ebbers (a practice known as "spinning") in

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81. SEC Citigroup-Enron Order, *supra* note 68, at 28-30.

82. Citigroup Inc. & Fed. Res. Bank N.Y., Bd. of Governors of Fed. Res. Sys. (Jul. 28, 2003) [hereinafter New York Fed written agreement] (written agreement) (written agreement with the New York Fed that did not require Citigroup to pay any penalties), *available at* http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20030728/attachment.pdf, *archived at* http://perma.cc/WL5J-NMKV; Citibank, N.A. & Off. Comptroller of Currency, Dep't of Treas. Comptroller of Currency (July 28, 2003) [hereinafter OCC written agreement] (written agreement with the OCC that similarly did not require Citigroup to pay any penalties), *available at* http://www.occ.gov/static/enforcement-actions/ea2003-77.pdf, *archived at* http://perma.cc/A29R-HWY9.

83. New York Fed written agreement, *supra* note 82; OCC written agreement, *supra* note 82; SEC Citigroup-Enron Order, *supra* note 68, at 1-2.

84. Mitchell Pacelle & Robin Sidel, *Citigroup Accord to End Enron Suit May Pressure Others*, WALL ST. J., June 13, 2005, at C1 (reporting that Citigroup "agreed to pay $2 billion to settle a class-action lawsuit brought by investors in Enron"); Kristen Hays, *Citigroup settles in Enron case: Accord Results in Largest Total Recovered in Bankruptcy*, HOUS. CHRON., Mar. 27, 2008, 2008 WLNR 5799282 (reporting that Citigroup agreed to pay $1.7 billion to settle claims filed by Enron's bankruptcy estate).

85. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 30-31, 34-35.

86. *Id.* at 34-35; CHARLES GASPARINO, BLOOD ON THE STREET: THE SENSATIONAL INSIDE STORY OF HOW WALL STREET ANALYSTS DUPED A GENERATION OF INVESTORS 175-77 (2005) [hereinafter GASPARINO, BLOOD ON THE STREET].

87. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 32.

88. *Id.*

more than twenty initial public offerings (IPOs) and secondary offerings of stock by clients of Salomon and Citigroup.[89] Ebbers received almost $13 million of trading profits from those preferential stock allocations.[90] Citigroup also arranged more than $500 million of loans to Ebbers and one of his personally controlled companies.[91]

Citigroup cemented its strong relationship with WorldCom by encouraging Jack Grubman—Citigroup's top research analyst for telecommunications ("telecom") firms—to serve as an advisor to Ebbers and WorldCom's board while also touting WorldCom's stock in his research reports.[92] Grubman promoted WorldCom more aggressively than any other telecom firm, and he continued to maintain a "buy" rating on WorldCom's stock until a few months before WorldCom filed for bankruptcy in mid-2002.[93] Citigroup subsequently paid $2.6 billion to settle a class-action lawsuit filed by WorldCom investors.[94] In addition, as described in the following section, Citigroup paid $400 million to settle the SEC's allegations of securities law violations arising out of Citigroup's biased research advice and "spinning."[95]

2. Citigroup's Tainted Research Advice and "Spinning."—Citigroup promoted Enron, WorldCom, and other investment banking clients by pressuring its research analysts to issue bullish reports that urged investors to buy the stock of those clients.[96] In 1999 Citigroup fired Don Dufresne, a well-known research analyst, after he angered Enron's executives by publishing reports that criticized Enron.[97] In contrast, Citigroup paid more than $48 million to Grubman between 1999 and 2001 after he helped Citigroup to generate almost $800 million in fees from WorldCom and other telecom firms.[98]

Citigroup told its research analysts that they would be compensated based on their ability to help Citigroup's investment bankers attract business from existing and new clients.[99] Citigroup also told analysts that investment bankers would participate in determining whether the bank should pay bonuses to analysts for

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89. *Id.*

90. *Id.* at 32-33.

91. *Id.* at 33-34.

92. *Id.* at 39.

93. *Id.* at 36-41 (noting, inter alia, that Grubman urged investors to "load up the truck" with WorldCom stock in August 1999 and also encouraged investors to take advantage of WorldCom's "dirt cheap" stock price after WorldCom's market value declined sharply during 2000 and 2001); GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 73-75, 84-95, 173-85.

94. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 42-43.

95. *Id.* at 24.

96. *Id.* at 23.

97. *Id.* at 23, 50 n.85.

98. Complaint, ¶¶ 37-43, SEC v. Citigroup Global Markets, Inc., S.D.N.Y. Apr. 28, 2003, 03 Civ. 2945 (WHP) [hereinafter SEC-Citigroup Research Analyst Complaint], *available at* http://www.sec.gov/litigation/complaints/comp18111.htm, *archived at* http://perma.cc/8PRP-PYR8.

99. *Id.* ¶¶ 3, 18.

supporting the bank's securities activities.[100] Thus, Citigroup's compensation system exerted great pressure on research analysts to compromise their objectivity by issuing overly optimistic research reports that boosted Citigroup's clients.[101]

In a notable example of such pressure, Sandy Weill persuaded Jack Grubman to raise Grubman's rating for AT&T's stock from neutral to "buy" in November 1999.[102] Weill urged Grubman to upgrade AT&T in order to improve Citigroup's chances of winning a lucrative underwriting mandate for AT&T's $10.6 billion offering of wireless tracking stock.[103] Grubman's upgrade also helped Weill to convince AT&T's CEO—C. Martin Armstrong—who was also a director of Citigroup, to support Weill's ouster of John Reed as Citigroup's co-CEO in early 2000.[104] In return for Grubman's assistance, Weill facilitated the admission of Grubman's children into the highly selective 92nd Street Y preschool.[105] To ensure that outcome, Weill interceded on Grubman's behalf with a Y board member and also arranged for the Citigroup Foundation to make a $1 million donation to the Y.[106]

The SEC charged Citigroup with securities law violations for having pressured Grubman to boost AT&T's research rating.[107] The SEC also alleged that Grubman published fraudulent research reports in 2001 on two telecom firms (Focal Communications and Metromedia), and that Grubman refrained from downgrading Focal and five other telecom providers in April 2001 because of pressure from Citigroup's investment bankers.[108] The SEC's complaint quoted

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100. *Id.*

101. *Id.* ¶¶ 16-36. In January 2001, Citigroup's head of Global Equity Research attended an equities management meeting that reviewed stock recommendations by Citigroup's research analysts. His presentation at that meeting showed that, out of 1179 stock ratings, Citigroup's analysts had no "Sell" ratings and only one "Underperform" rating. In handwritten notes attached to the presentation, the officer described Citigroup's research ratings as "ridiculous on face" and observed that there was a "rising issue of research integrity" and a "basic inherent conflict between IB [investment banking] and retail [investment sales]." *Id.* ¶ 32. Notwithstanding that presentation and similar complaints voiced by the head of Citigroup's private client (retail) division, Citigroup's research analysts maintained no "Sell" ratings and only 15 "Underperform" ratings among their ratings for more than 1000 U.S. stocks at the end of 2001. *Id.* ¶¶ 33-34.

102. *Id.* ¶¶ 7-8.

103. *Id.* ¶¶ 7-8, 103-29 (noting that AT&T named Citigroup as the lead underwriter for AT&T's public offering of wireless tracking stock in early 2000 after Grubman raised his rating for AT&T).

104. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 168-69, 286-87; Charles Gasparino, *Grubman Boast: AT&T Upgrade Had an Altogether Different Goal*, WALL ST. J., Nov. 13, 2002, at A1.

105. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 154-60.

106. SEC-Citigroup Research Analyst Complaint, *supra* note 98, ¶¶ 123-25; GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 154-60.

107. SEC-Citigroup Research Analyst Complaint, *supra* note 98, ¶¶126-29.

108. *Id.* ¶¶ 63-102.

internal emails sent by Grubman to colleagues in which he called Focal a "pig" and acknowledged that "most of our banking clients are going to zero and you know I wanted to downgrade them months ago but got huge pushback from banking."[109]

From 1996 to 2002, due in large part to Grubman's bullish research reports, Citigroup earned $1.2 billion in fees from telecom firms and underwrote $190 billion of their debt and equity securities, representing a quarter of all telecom stocks and bonds issued during that period.[110] Grubman's view that customer demand for broadband capacity would continue to grow exponentially proved to be badly mistaken. The frenzied installation of broadband networks by Grubman's clients and their rivals produced a massive glut of transmission capacity by 2001.[111] By August 2002, when Grubman resigned from his position at Citigroup, WorldCom and several of his other major telecom clients—including Global Crossing, Metromedia Fiber Networks, Rhythms Netconnections, Winstar, and XO Communications—had all filed for bankruptcy.[112]

In addition to the SEC's allegations of biased research advice, the SEC charged Citigroup with unlawful "spinning" by making preferential allocations of shares in "hot" IPOs to Ebbers and other individuals affiliated with existing or potential clients of Citigroup.[113] The SEC alleged that Citigroup's spinning practices provided $40 million of trading profits to executives of WorldCom (including Ebbers) and four other telecom firms.[114]

In April 2003, Citigroup paid $400 million to settle the SEC's charges.[115] Grubman entered into a separate settlement with the SEC under which he paid a $15 million penalty and agreed to a lifetime ban from the securities industry.[116] Citigroup did not admit or deny the SEC's allegations, and the SEC did not file charges against Weill or any other top Citigroup executive.[117]

3. Citigroup's Subprime Lending Abuses during the Early 2000s.— Citigroup's origins and its subsequent expansion were closely linked to subprime lending. In 1986, Sandy Weill acquired Commercial Credit, a subprime

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109. *Id.* ¶¶ 61, 68.

110. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 38-39.

111. *Id.* at 39.

112. *Id.* at 38-39; Gretchen Morgenson, *Bullish Analyst of Tech Stocks Quits Salomon*, N.Y. TIMES, Aug. 16, 2002, at A1.

113. SEC-Citigroup Research Analyst Complaint, *supra* note 98, ¶¶ 142-58 (quote at ¶ 148).

114. *Id.*¶ 158.

115. Wilmarth, *Conflict of Interest*, *supra* note 67, at 24.

116. *Id.* at 42.

117. SEC Litigation Rel. No. 18111 (Apr. 18, 2003), *available at* www.sec.gov/litigation/litreleases/lr18111.htm, *archived at* http://perma.cc/NS3G-UDVH. The settlement required Weill to issue a public apology in which he stated, "certain of our activities did not reflect the way we believe business should be done. That should never have been the case, and I am sorry for that." Randall Smith & Susanne Craig, *Wall Street's Payout: Too Little and Late?*, WALL ST. J., Apr. 29, 2003, at C1.

consumer finance company.[118] Weill subsequently used Commercial Credit as the springboard to build his financial empire.[119] After Travelers acquired Citigroup, Citigroup established CitiFinancial as a separate subsidiary to conduct its subprime lending activities.[120] In 2000, Citigroup significantly expanded its subprime operations by acquiring Associates First Capital, a large subprime consumer finance company that was under investigation for predatory lending by federal and state agencies.[121] By 2002, CitiFinancial's activities (including Associates) accounted for 8% of Citigroup's total profits.[122]

When it acquired Associates, Citigroup promised to reform its subprime lending practices to avoid the abuses allegedly committed by Associates.[123] However, consumer advocates criticized Citigroup's promised reforms as "cosmetic" and inadequate.[124] The Federal Trade Commission ("FTC") and consumer plaintiffs subsequently filed lawsuits against Citigroup and Associates alleging predatory conduct.[125] Citigroup settled those suits in 2002 by paying $240 million in penalties and restitution.[126]

Citigroup's subprime problems did not end with its settlement of the claims against Associates. Federal investigators found evidence that Citigroup did not carry out the subprime lending reforms it had agreed to make in 2000 and 2001.[127] Citigroup promised to use "mystery shoppers" to monitor performance by CitiFinancial's employees, but Citigroup undermined the effectiveness of that monitoring by giving advance warning to CitiFinancial's regional managers about upcoming visits by "mystery shoppers."[128] In addition, despite its pledge to the contrary, CitiFinancial continued to include high-cost, single-premium credit insurance in the closing costs it charged to subprime borrowers.[129]

In 2004, the FRB issued a cease-and-desist order and imposed a $70 million

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118. Marc Hochstein, *Associates Deal Another Subprime Stroke for Citi*, AM. BANKER, Sept. 7, 2000, at 9.

119. *Id.*; Timothy L. O'Brien & Julie Creswell, *Laughing All the Way From the Bank*, N.Y. TIMES, Sept. 11, 2005, at 31; Richard A. Oppel Jr. & Patrick McGeehan, *Along With a Lender, Is Citigroup Buying Trouble?*, N.Y. TIMES, Oct. 22, 2000, at 31.

120. Hochstein, *supra* note 118.

121. *Id.*; Oppel & McGeehan, *supra* note 119.

122. Paul Beckett, *Efforts by Citigroup to Reform Subprime Unit Raise Questions*, WALL ST. J., July 18, 2002, at C1.

123. Richard A. Oppel Jr. & Patrick McGeehan, *Citigroup Revamps Lending Unit to Avoid Abusive Practices*, N.Y. TIMES, Nov. 8, 2000, at C1.

124. *Id.*

125. *See* Laura Mandaro, *In Focus: Citi Moving Fast to Put Associates Suits to Rest*, AM. BANKER, Dec. 13, 2002, at 1.

126. *Id.*; FCIC REPORT, *supra* note 4, at 92; Rob Blackwell, *Citi Exec on FTC Settlement: It's Not About Golden State*, AM. BANKER, Sept. 20, 2002, at 1.

127. Beckett, *supra* note 122.

128. *Id.*

129. *Id.*

civil penalty against Citigroup and CitiFinancial.[130] The FRB alleged that (i) CitiFinancial forced spouses or other persons to co-sign loans for which the applicants alone were qualified, because CitiFinancial wanted to sell credit insurance to multiple borrowers, (ii) CitiFinancial converted unsecured personal loans into home equity loans without adequately evaluating the borrowers' ability to repay those loans, and (iii) CitiFinancial's employees tried to mislead the FRB's examiners during their investigation of abusive practices.[131] Citigroup did not admit or deny the FRB's allegations, and the FRB did not take action against any of Citigroup's officers or employees.[132]

4. *Citigroup's Scandals Involving European Bond Trading and Japanese Private Banking*.—In 2004, Citigroup became embroiled in two additional scandals. On August 2, 2004, Citigroup's bond traders in London executed a bond-trading strategy called "Dr. Evil," in which they (i) made large sales of European government bonds, causing bond prices to fall, (ii) purchased bonds 30 minutes later, at substantially lower prices, and (iii) profited when prices returned to normal.[133] Citigroup sold more than 12.4 billion euros of bonds, bought back 3.8 billion euros of bonds, and reaped trading profits of more than $17 million.[134] Citigroup's bond traders concocted their trading scheme after "a senior Citigroup Inc. executive in London told traders on the European government-bond desk they weren't making enough money for the firm and ordered them to come up with new trading strategies."[135] Citigroup subsequently paid $25 million to settle allegations by the U.K. Financial Services Authority ("UKFSA") that Citigroup failed to supervise its traders and also failed to conduct its business with "due skill, care and diligence."[136]

In September 2004, the Japanese Financial Services Authority ("JFSA") ordered Citibank to shut down its private banking operations at four Japanese branches after finding numerous violations of Japanese law.[137] The JFSA's order

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130. Citigroup Inc., Bd. of Governors of Fed. Res. Sys. (May 27, 2004) (order), *available at* http://www.federalreserve.gov/boarddocs/press/enforcement/2004/20040527/attachment.pdf, *archived at* http://perma.cc/A7FW-U8JY.

131. *Id.*

132. *Id.*; Erick Bergquist, *Citi-Fed Pact On Subprime: Opening Act?*, AM. BANKER, May 28, 2004, at 1; Timothy L. O'Brien, *Fed Assesses Citigroup Unit $70 Million in Loan Abuse*, N.Y. TIMES, May 28, 2004, at C1.

133. Adam Bradbery, *Moving the Market: Citigroup Faces a Fine in Britain For Lapses Linked to Bond Trade*, WALL ST. J., May 31, 2005, at C3.

134. *Id.*; Eric J. Lyman, *Citigroup Bond Trades Probed by Italian, Other European Regulators*, 37 SEC. REGULATION & L. REPORT (BNA) 273 (Feb. 14, 2005).

135. Silvia Ascarelli, *Bond Trading Strategy Haunts Citigroup*, WALL ST. J., Feb. 3, 2005, at C1.

136. David Reilly, *Moving the Market: Citigroup to Take $25 Million Hit in 'Dr. Evil' Case*, WALL ST. J., June 29, 2005, at C3 (noting that the UKFSA decided not to charge Citigroup with "market manipulation, a more serious offense").

137. Toshio Aritake, *International Developments: Japan Orders Citibank to Close Private Banking Operations*, 36 SEC. REGULATION & L. REPORT (BNA) 1722 (Sept. 27, 2004).

represented "the most severe administrative punishment of a foreign financial institution" operating in Japan.[138] The JFSA alleged that Citibank (i) provided loans that were used by clients to manipulate stock prices, (ii) made a "bogus" one-day loan that enabled a customer to receive an improper government grant, (iii) allowed a client to engage in money laundering, (iv) failed to perform background checks on new clients to ensure that they were not criminals, (v) misrepresented the risks of complex structured investments sold to clients, (vi) overcharged clients for publicly-traded derivatives, and (vii) failed to safeguard the confidentiality of client information.[139] An internal investigation commissioned by Citigroup found that "many private bankers" in Citibank's Japanese offices were "not candid" with the JFSA during its probe of Citibank's operations.[140]

A senior JFSA official noted that "one of the main reasons" for Citibank's misconduct was that "salaries and performance evaluations were closely linked to sales targets" for Citibank's private banking employees in Japan.[141] Similarly, Citigroup's internal investigation found that senior Citibank officers set "successively higher net-income goals for the [Japanese private banking] unit," and the unit's managers "pressed to bring in more revenue."[142]

5. Inadequate Responses by Citigroup's Managers and Regulators to the Scandals Occurring from 2000 to 2004.—Citigroup's senior management and board of directors took a number of actions in response to the scandals that occurred between 2000 and 2004.[143] However, those measures failed to change Citigroup's entrenched culture of aggressive risk-taking.[144] Although Citigroup's executives repeatedly stated their intention to create a culture of compliance, those statements were undermined by management's primary focus on achieving rapid growth in Citigroup's revenues and profits.[145]

Sandy Weill faced increasing demands from investors, analysts, and

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138. *Id.*

139. *Id.*; *see also* Mayumi Negishi, *Citibank Japan Ordered to Close Four Offices over Legal Breaches*, JAPAN TIMES, Sept. 18, 2004 (available on Lexis); Mitchell Pacelle et al., *Mission Control: For Citigroup, Scandal in Japan Shows Dangers of Global Sprawl*, WALL ST. J., Dec. 22, 2004, at A1; Mikayo Takebe, *Moving the Market: Citigroup Unit Faces Discipline by Japanese Watchdog Agency*, WALL ST. J., Sept. 15, 2004, at C3; Todd Zaun, *Japan Shuts Unit of Citibank, Citing Violations*, N.Y. TIMES, Sept. 18, 2004, at C1.

140. Pacelle et al., *supra* note 139 (quoting findings from an internal investigation by Promontory Financial Group, led by former Comptroller of the Currency Eugene Ludwig).

141. Zaun, *supra* note 139 (quoting Toshihide Endo, director of JFSA's supervisory bureau).

142. Pacelle et al., *supra* note 139 (reporting on findings from Promontory's internal investigation).

143. Pacelle, *supra* note 66 (noting Citigroup's adoption of a "five-point" plan to "beef up the company's ethics").

144. *See infra* Part II.A (describing Citigroup's continued pursuit of high-risk strategies after 2005).

145. *See infra* Part II.A (describing Citigroup's continued pursuit of high-risk strategies after 2005).

Citigroup's directors to establish a succession plan following the Enron, WorldCom, and research analyst scandals.[146] He agreed to step down as CEO in 2003 but continued to serve as chairman of Citigroup until 2006.[147] Weill's successor as CEO was Charles "Chuck" Prince.[148] Prince had led Citigroup's efforts to resolve its legal problems in his prior roles as general counsel and head of Citigroup's corporate and investment bank.[149] In February 2005, following the additional scandals involving European bond trading and Japanese private banking, Prince "unveiled to [Citigroup's] employees a 'five-point plan' for beefing up the company's ethics," including annual "ethics and code-of-conduct [sic] training" programs for all employees as well as stronger internal controls and enhanced compliance training and review procedures for managers.[150] Prince continued to emphasize his compliance reform program throughout 2005.[151]

At the same time, Citigroup's senior management made clear that the new legal compliance program would not interfere with Citigroup's primary goal of achieving higher growth in its revenues and profits.[152] Prince assured investors (as he had done since late 2003) that he would produce "organic growth" by transforming Citigroup into a "distribution company" that would "push more

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146. Heather Timmons, *Citi: Time for a Succession Plan*, BUS. WK., Dec. 2, 2002, at 48.

147. Anthony Bianco et al., *Citi's New Act*, BUS. WK., July 28, 2003, at 31; *see also* GASPARINO, *supra* note 54, at 187-88 (reporting that New York Attorney General Eliot Spitzer may have secured Weill's agreement to step down as Citigroup's CEO in exchange for not naming Weill as a defendant in Spitzer's enforcement actions against Citigroup and Grubman for tainted research advice and IPO spinning). Weill retained substantial influence within Citigroup's senior management during the first year after he stepped down as CEO. However, by August 2005 Chuck Prince (Weill's successor as CEO) was firmly in control of Citigroup's management, and several senior executives who were close associates of Weill had left Citigroup. Todd Davenport, *Strategy and Tactics: The Book on a New Citi*, AM. BANKER, Aug. 26, 2005, at 1.

148. Monica Langley, *Course Correction—Behind Citigroup Departures: A Culture Shift by CEO Prince*, WALL ST. J., Aug. 24, 2005, at 1.

149. GASPARINO, *supra* note 54, at 187-89; Bianco et al., *supra* note 147; Langley, *supra* note 148.

150. Pacelle, *supra* note 66; *see also* Pacelle et al., *supra* note 139 (discussing Prince's decision to institute new compliance and training programs after the Japanese private banking scandal).

151. Davenport, *supra* note 147 (quoting Mr. Prince's statement that "there is no way given our size that we can really hope to have substantial growth if we basically have a tarnished reputation"); Langley, *supra* note 148 (quoting Mr. Prince's remark that "[y]ou can never sacrifice your long-term growth, your long-term reputation, to the short term").

152. Lee, *supra* note 64 (quoting comment by Robert Druskin, head of Citigroup's corporate and investment bank, that "[r]evenues have to grow . . . [w]e don't believe a greater focus on reputational risk issues should have any impact on revenues"); Todd Davenport, *Risk Concerns Dominate Citi Meeting*, AM. BANKER, May 27, 2005, at 20 (reporting on Mr. Druskin's statement that "concerns about reputation would not reduce [Citigroup's] revenue goals" or prevent Citigroup from being "willing, ready, and able to take intelligent risk").

financial products and advice" to customers within Citigroup's domestic and international consumer operations, as well as its global corporate and investment bank.[153] Prince's five-point compliance and ethics plan was also conveniently timed, since he issued his plan shortly before the FRB imposed a moratorium on further large acquisitions by Citigroup until the bank corrected its "deficiencies in compliance risk management."[154]

Until the financial crisis broke out in mid-2007, Prince continued to push "organic growth" in Citigroup's consumer, corporate, and investment banking operations as his primary strategy for producing higher revenues.[155] However, investors and analysts repeatedly criticized Prince's leadership between 2005 and 2007 because Citigroup's expenses grew at a faster rate than its revenues and Citigroup's stock price lagged behind the stock market values of its big-bank peers.[156] As a result, Prince and his management team were under intense pressure to generate significantly higher profits.[157] As discussed below, Prince and Rubin decided to produce higher profits by taking greater risks in Citigroup's consumer, corporate and investment banking operations.[158] Citigroup's pursuit of high-risk activities proved to be disastrous and led to Citigroup's collapse and

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153. Mara Der Hovanesian, *Rewiring Chuck Prince*, BUS. WK., Feb. 20, 2006, at 75, 78 [hereinafter "Rewiring Chuck Prince"]; *see also* Mara Der Hovanesian, *Chuck Prince's Citi Planning*, BUS. WK., Sept. 5, 2005, at 88; Lee, *supra* note 65; *infra* note 167 and accompanying text (discussing Prince's decision to adopt an "organic growth" strategy when he succeeded Weill as CEO in late 2003).

154. Prince announced his compliance and ethics plan in February 2005, and the FRB cited Citigroup's new plan when it issued its moratorium the following month. Pacelle, *supra* note 66; Lee, *supra* note 64 (quoting Citigroup Inc., FRB Citigroup-FAB Order, *supra* note 18, at 11; *see also* Lee, *supra* note 64, at 9-10 (noting that Citigroup "is in the process of implementing enhanced compliance policies and procedures" and "has introduced an enhanced corporate-wide ethics awareness program with an expanded orientation program and annual training sessions"); *see also infra* notes 408-11 and accompanying text (discussing the FRB's decision in April 2006 to lift its moratorium on additional large acquisitions by Citigroup).

155. *Rewiring Chuck Prince*, *supra* note 153; Tim Mazzucca, *Prince Puts 'Virtual' Growth on Citi Agenda: Post-deal Ban, CEO Still Emphasizing Organic Expansion*, AM. BANKER, Apr. 5, 2006, at 1; *see also* Mara Der Hovanesian, *Leadership: Cleaned Up but Falling Behind*, BUS. WK., Oct. 16, 2006, at 39 (reporting on Prince's desire to expand Citigroup's consumer banking operations); Clint Riley, *Citigroup to Focus on Investment Bank*, WALL ST. J., Jan. 20, 2007, at A2 (reporting on Prince's decision to invest additional resources in Citigroup's investment bank).

156. Todd Davenport, *Is Citi Rep-Damage Control Turning into a Distraction?*, AM. BANKER, July 19, 2005, at 2; Der Hovanesian, *supra* note 155; Clint Riley et al., *Shake-Up Puts Citigroup's CEO on the Hot Seat: Challenge for Prince is to Revitalize Big Bank*, WALL ST. J., Jan. 23, 2007, at A1; Robin Sidel & David Enrich, *For Citi, Cost-Cutting is only Half the Battle: Investors, Analysts Want Higher Rate of Revenue Growth*, WALL ST. J., Apr. 12, 2007, at C3.

157. *See* sources cited *supra* note 156; *see also* Clint Riley, *Citigroup Investors Agitate for Improvement*, WALL ST. J., Dec. 11, 2006, at C1.

158. *See infra* Part II.A.

multiple bailouts in 2008 and early 2009.[159]

Thus, Citigroup's managers failed to heed the lessons from the repeated mistakes and scandals that plagued the company from 2000 to 2004. A single-minded pursuit of higher earnings remained the overriding business strategy for Citigroup's leaders, regardless of the disasters that strategy had created in the past. The compliance and ethics training programs that Prince instituted in 2005 had no discernible impact on Citigroup's culture of aggressive risk-taking.[160] In response to pressure from financial industry analysts and Citigroup's investors, senior management kept pushing employees to find new ways to increase earnings without regard to the potential hazards of those methods.[161] As explained in Part II.B., the reckless actions of Citigroup's employees between 2004 and 2007 were similar to the conduct that damaged Citigroup and tarnished its reputation between 2000 and 2004.

Like Citigroup's management, the bank's regulators failed to respond adequately to Citigroup's repeated misconduct between 2000 and 2004. Regulators imposed about $800 million of penalties on Citigroup between 2002 and 2004 for its involvement in scandals related to Enron, WorldCom, tainted research analysis, IPO spinning, and predatory lending.[162] However, Jack Grubman was the only Citigroup employee who was the subject of an official enforcement action, and the regulatory penalties assessed against Citigroup paled in comparison to the $33 billion of profits that Citigroup amassed in 2002 and 2003.[163] In March 2005, as noted above, the FRB imposed a moratorium on further acquisitions until Citigroup improved its "deficiencies in compliance risk management."[164] However, the FRB removed that moratorium in April 2006, a misguided step that allowed Citigroup to expand its balance sheet and the magnitude of its risk-taking during the final and most frenzied period of the credit boom.[165]

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159. *See infra* Part II.B.

160. *See* authorities cited *supra* notes 150-55.

161. *See infra* Part II.A.

162. *See supra* notes 81, 95, 126, 130, 136 and accompanying text.

163. Bianco et al., *supra* note 147, at 31 (reporting that Citigroup earned $15.3 billion of profits in 2002); Robert Julavits & David Boraks, *Records at Citi, Wells; U.S. Bank Falls Short*, AM. BANKER, Jan. 21, 2004, at 2 (reporting that Citigroup had $17.85 billion of net income in 2003).

164. FRB Citigroup-FAB Order, *supra* note 18, at 11.

165. *See infra* notes 408-24 and accompanying text (discussing the impact of the FRB's lifting of its moratorium in April 2006).

II. CITIGROUP'S HIGH-RISK STRATEGY LED TO THE COMPANY'S COLLAPSE AND MULTIPLE BAILOUTS

A. Prince and Rubin Followed a Fatally Flawed Strategy That Sought to Generate Higher Profits by Assuming Greater Risks

In October 2003, when Chuck Prince succeeded Sandy Weill as CEO of Citigroup, Prince and his management team decided that Citigroup could no longer rely on large acquisitions to produce higher profits.[166] Instead, Prince adopted a new strategy of "growing organic revenues" by improving the efficiency and productivity of the universal banking "platform" that Weill had created.[167] Prince and Robert Rubin sought to increase Citigroup's earnings by expanding its involvement in "proprietary trading"— an area that Weill had sharply reduced after Salomon suffered large losses during the Russian debt default crisis in 1998.[168] Prince also enlarged Citigroup's subprime mortgage and home equity lending operations by purchasing Washington Mutual's consumer finance unit in November 2003.[169]

As discussed below, Citigroup pursued high-risk strategies in three major areas between 2003 and 2007—(i) originating and securitizing subprime loans, (ii) creating and marketing collateralized debt obligations (CDOs), and (iii) originating and securitizing leveraged corporate loans.[170] Citigroup's activities in all three areas produced huge losses that crippled Citigroup and forced it to accept a series of government bailouts in 2008 and 2009.[171]

1. Citigroup Pursued a Risky Strategy of Originating and Securitizing of Subprime Loans.—During the housing boom of the 2000s, Citigroup was a leading participant in the origination and securitization markets for subprime mortgages. CitiFinancial became a major subprime lender when it acquired Associates First Capital in 2000.[172] CitiFinancial ranked among the top twelve

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166. Robert Julavits, *Big Deals Out, Growing Organically In at Citi*, AM. BANKER, Nov. 5, 2003, at 2 (reporting that Prince replaced Weill as CEO in October 2003, and quoting Prince's statement that "[t]he era of the transformational merger . . . is over. . . . The platform we have is a terrific one, and we need to grow organic revenues off that platform.").

167. *Id.*

168. Jason Singer & Mitchell Pacelle, *Heard on the Street: Citigroup to Expand Its Trading*, WALL ST. J., Nov. 19, 2003, at C1; *see also supra* notes 60, 61 and accompanying text (discussing Weill's and Dimon's decision to shut down Salomon's bond arbitrage trading unit in 1998).

169. Mitchell Pacelle, *Citigroup Spends $1.25 Billion To Enlarge Subprime Presence*, WALL ST. J., Nov. 25, 2003, at C12 (reporting that the acquisition would "add 409 [storefront] locations in 25 states to the approximately 1,600 existing branches of CitiFinancial").

170. *See infra* Parts II.A.1., II.A.2., II.A.5.

171. *See infra* Part II.B.

172. KATHLEEN ENGEL & PATRICIA MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 202 (2011); *see also supra* notes 121, 122 and accompanying text (discussing Citigroup's acquisition of Associates).

subprime lenders in the U.S. from 2004 to 2007.[173] CitiFinancial pushed for even higher subprime lending volumes after 2006, when the FRB lifted the cease-and-desist order it had issued against CitiFinancial in 2004 for predatory lending abuses.[174] Citigroup nearly doubled the share of its mortgage business devoted to subprime loans from 10% in 2005 to 19% in 2007, and it also increased the percentage of subprime loans it originated with high-risk features such as low down payments, "piggyback" second mortgages, "stated income" mortgages with little or no documentation of the borrowers' income, and loans made to investors who intended to "flip" the houses they purchased.[175]

In addition to its origination business, Citigroup was deeply involved in the securitization market for subprime mortgages.[176] Citigroup provided warehouse lines of credit to leading nonbank subprime lenders, including Ameriquest and New Century.[177] Citigroup purchased large volumes of subprime and Alt-A loans originated by those and other nonbank lenders, and Citigroup packaged those loans into nonprime residential mortgage-backed securities ("RMBS") that were sold to investors.[178]

In September 2007, when the subprime mortgage market was already in turmoil, Citigroup decided to expand its subprime securitization business by purchasing the wholesale lending and servicing businesses of ACC Capital Holdings (Argent), the parent company of Ameriquest.[179] When the Argent deal was announced, a Citigroup executive declared, "We're big believers in the whole

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173. Paul Muolo, *Top Subprime Lenders & Their Owners*, NAT'L MORTGAGE NEWS, May 16, 2005, at 1 (table showing that CitiFinancial was the eighth-ranked subprime lender in 2004); Paul Muolo, *Top Subprime Lenders in 2005*, NAT'L MORTGAGE NEWS, May 15, 2006, at 1 (table showing that CitiFinancial was the twelfth-ranked subprime lender in 2005); ENGEL & MCCOY, *supra* note 172, at 202 (stating that CitiFinancial was "the eleventh largest subprime lender in 2006"); Paul Muolo, *Top Subprime Lenders in 2007*, NAT'L MORTGAGE NEWS, May 12, 2008, at 1 (table showing that CitFinancial was the seventh largest subprime lender in 2007).

174. ENGEL & MCCOY, *supra* note 172, at 202-03; *see also supra* notes 130-32 and accompanying text (discussing the 2004 order issued by the FRB against CitiFinancial).

175. ENGEL & MCCOY, *supra* note 172, at 203; FCIC REPORT, *supra* note 4, at 110-11; *see also 2ds Weaken at Citigroup*, NAT'L MORTGAGE NEWS, July 30, 2007, at 1 (reporting that "15% of [Citigroup's] $147 billion first mortgage portfolio consists of loans to borrowers with FICO scores below 620, and another 13% have scores between 620 and 660"; and also stating that Citigroup held $69 billion of second mortgages of which none were made to borrowers with FICO scores below 620); *see also infra* note 212 (stating that subprime borrowers typically had FICO scores below 640).

176. *See infra* notes 178-83 and accompanying text.

177. FCIC REPORT, *supra* note 4, at 113.

178. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 191-92; FCIC REPORT, *supra* note 4, at 113, 115, and 168; *see also* FCIC REPORT, *supra* note 4, at 71-72, 110-11 (describing an RMBS deal underwritten by Citigroup in 2006 that was backed by a pool of subprime mortgages of very poor quality, which Citigroup had purchased from New Century).

179. Harry Terris, *Citi-ACC: A Bet Vertical Integration Still Has Legs*, AM. BANKER, Sept. 13, 2007, at 1.

vertical integration of this part of the capital markets," and he emphasized that the deal would give Citigroup a new conduit for subprime securitization.[180] The deal soon proved to be disastrous, and Citigroup shut down the acquired unit in early 2008.[181]

In an interview with the Financial Crisis Inquiry Commission ("FCIC"), in March 2010, Prince admitted that the subprime securitization process "could be seen as a factory line," and he further acknowledged:

> As more and more of these subprime mortgages were created as raw material for the securitization process, not surprisingly in hindsight, more and more of it was of lower and lower quality. And at the end of that process, the raw material going into it was actually bad quality, it was toxic quality, and this is what ended up coming out the other end of the pipeline. Wall Street obviously participated in that flow of activity.[182]

Citigroup was a leading participant in the subprime securitization market during the mid-2000s.[183] Citigroup steadily lowered its standards for originating and purchasing subprime mortgages as the housing bubble stopped expanding in late 2005 and began to deflate soon thereafter.[184] The decline in Citigroup's underwriting standards was confirmed by its dealings with Clayton Holdings, a leading provider of third-party due diligence services to Wall Street firms that purchased subprime mortgages for securitization.[185] Clayton rejected 42% of the subprime mortgages that it reviewed for Citigroup between January 2006 and June 2007 because those loans did not meet Citigroup's underwriting guidelines.[186] However, Citigroup "waived in" nearly a third of the mortgages that Clayton had rejected.[187]

Richard Bowen was a senior CitiFinancial officer who was responsible for overseeing the reviews of mortgage loans that CitiFinancial purchased from third-

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180. *Id.* (quoting Jeffrey A. Perlowitz, head of global securitized markets in Citigroup's fixed-income, currencies and commodities unit); ENGEL & MCCOY, *supra* note 172, at 170.

181. ENGEL & MCCOY, *supra* note 172, at 170.

182. FCIC REPORT, *supra* note 4, at 102-03 (quoting interview with Mr. Prince on Mar. 17, 2010).

183. *Id.* at 71-72, 111, 113-18; Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 990 n.100 (2009) [hereinafter Wilmarth, *Dark Side*] (stating that Citigroup was one of the top twelve underwriters of private–label RMBS in 2007); *see also id.* at 1019 n.280 (reporting that Citigroup ranked among the top ten underwriters of RMBS in both 2003 and 2004).

184. FCIC REPORT, *supra* note 4, at 165-69, 172; *see also id.* at 111 (quoting testimony by Richard Bowen, a senior officer in CitiFinancial's consumer lending group, who said that Citigroup decided in 2005 that "[w]e're going to have to hold our nose and start buying the stated income [mortgage] product if we want to stay in business" in underwriting subprime RMBS).

185. *Id.* at 166.

186. *Id.* at 167.

187. *Id.*

party originators through its correspondent lending channel.[188] Bowen told the FCIC that he repeatedly warned senior management in 2006 and 2007 that CitiFinancial was ignoring Citigroup's stated criteria for buying subprime loans that would be packaged into RMBS.[189] Citigroup's chief risk officer for securitizations of mortgage loans overturned many of the decisions made by Bowen's team, and the same officer changed "large numbers of underwriting decisions on mortgage loans from 'turned down' to 'approved.'"[190]

Bowen also testified that most of the "prime" mortgages that CitiFinancial purchased from correspondent lenders and sold to Fannie Mae, Freddie Mac and other investors in 2006 and 2007 did not conform to the representations and warranties that Citigroup provided to those investors.[191] According to Bowen, Citigroup's management placed "significant corporate emphasis . . . upon the need for growth and market share" in originating, selling and securitizing mortgages.[192] Citigroup also "dramatically reduced the number of employees" who reviewed mortgages for conformity with quality standards.[193]

Bowen's supervisors disregarded his repeated warnings.[194] Finally, on November 3, 2007, Bowen sent an email to Robert Rubin, David Bushnell (Citigroup's chief risk officer), Gary Crittenden (Citigroup's chief financial officer) and Bonnie Howard (Citigroup's chief auditor).[195] Bowen warned the four senior executives about breakdowns in internal controls and "resulting significant but possibly unrecognized financial losses existing within Citigroup."[196] He provided a detailed description of Citigroup's systematic failures to follow its quality control standards while purchasing huge volumes of prime and subprime loans for sale to investors.[197] After Bowen sent his email, his responsibilities were reduced from supervising 220 employees to supervising only two, his bonus was cut, and he received a downgrade on his next

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188. *Id.* at 168.

189. *Id.* at 19.

190. *Hearing on Subprime Lending and Securitization and Government Sponsored Enterprises: Before Financial Crisis Inquiry Commission*, 111th Cong. (2010) (written testimony of Richard M. Bowen, III) [hereinafter Bowen Testimony], at 1-2, 4, 7-9, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-04-07%20Richard%20Bowen%20Written%20Testimony.pdf, *archived at* http://perma.cc/8EXG-67U8; *see also* FCIC REPORT, *supra* note 4, at 168 (citing Mr. Bowen's testimony).

191. Bowen Testimony, *supra* note 190, at 1-2, 7-8 (stating that "over 60%" of the "prime" mortgages purchased and sold by Citigroup in 2006 did not conform to Citigroup's representations and warranties to Fannie Mae, Freddie Mac and other investors, and the percentage of "defective mortgages" rose to "over 80%" in 2007).

192. *Id.* at 3.

193. *Id.*

194. *Id.* at 1-2, 7-8, 13-17.

195. *Id*. at 2.

196. *Id*. (quotation omitted).

197. *Id.* at 2, 13-14, 19-20 (Exhibit I) (text of email message).

performance review.[198] He left Citigroup in early 2009.[199]

Sherry Hunt was a member of Bowen's team, and she received comparable treatment when she raised similar warning flags.[200] Hunt supervised 65 mortgage underwriters at CitiMortgage's headquarters in Missouri.[201] Beginning in 2006, she told her supervisors that Citigroup was buying large volumes of defective mortgages from third-party lenders that included "doctored tax forms, phony appraisals and missing signatures."[202] Hunt eventually shared her concerns with Bowen, and Bowen relied in part on Hunt's information when he sent his email message to Rubin and the other senior Citigroup officers.[203] Citigroup's lawyers subsequently interviewed Hunt, but CitiMortgage did not change its business methods.[204] Instead, CitiMortgage removed Hunt as a supervisor and sent her to work as an ordinary employee in the "quality-control unit."[205]

In her new position, Hunt identified large numbers of defective mortgages "with issues such as obviously forged signatures, whited-out income lines on tax forms or misspelled bank names on borrower bank statements."[206] CitiMortgage responded by creating a team "whose mission was to challenge the findings of Hunt's quality-control group," and a CitiMortgage executive ordered Hunt's group to reduce its percentage of rejected loans "by brute force."[207] After another CitiMortgage executive threatened in early 2011 to fire Hunt and one of her colleagues if they did not reduce their rejection rates, Hunt filed a whistleblower lawsuit against Citigroup.[208] The federal government joined Hunt's suit, and Citigroup agreed in 2012 to pay $158 million to settle charges that it sold thousands of nonconforming mortgages to the Federal Housing Administration.[209]

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198. FCIC REPORT, *supra* note 4, at 19.

199. *Id.*

200. Bob Ivry, *Woman Who Couldn't Be Intimidated by Citigroup Wins $31 Million*, BLOOMBERG MARKETS MAG., May 31, 2012, *available at* http://www.bloomberg.com/news/2012-05-31/woman-who-couldn-t-be-intimidated-by-citigroup-wins-31-million.html, *archived at* http://perma.cc/V3MR-DGAU.

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.* (quoting email in November 2010 from Ross Leckie); *see also* Bob Ivry et al., *Citigroup Whistle-Blower Says Bank's 'Brute Force' Hid Bad Loans from U.S.*, BLOOMBERG, Feb. 16, 2012, http://www.bloomberg.com/news/2012-02-16/citigroup-whistle-blower-says-bank-s-brute-force-hid-bad-loans.html, *archived at* http://perma.cc/F5DE-XPT3 (reporting that CitiMortgage issued "Star Player Awards" in January 2011 to "workers who had successfully challenged negative reviews during meetings with quality-assurance workers and others").

208. Ivry et al., *supra* note 200.

209. *Id.* (reporting that Jeffery Polkinghorne allegedly told Hunt and her colleague in March 2011 that the number of loans they classified as defective must fall or it would be "your asses on the line"); Ivry et al., *supra* note 207 (reporting on Citigroup's agreement to settle lawsuit filed by

Citigroup subsequently agreed to pay more than $1.3 billion to settle similar claims that it sold 3.7 million defective mortgages to Fannie Mae and Freddie Mac between 2000 and 2012.[210]

Thus, Citigroup disregarded repeated warnings from both external and internal quality control monitors and continued to pursue unsound mortgage lending practices long after the financial crisis broke out in the summer of 2007. After suffering heavy losses in the second half of 2007, Citigroup reduced, but did not terminate, its involvement in making and securitizing subprime and Alt-A mortgages.[211] In early 2008, Citigroup stopped buying mortgages from brokers and also stopped funding the most risky types of subprime mortgages, including adjustable-rate mortgages (ARMs) with low introductory "teaser" rates.[212] Citigroup continued, however, to originate and securitize subprime mortgages for borrowers with FICO scores as low as 580.[213]

In 2008, Citigroup merged CitiFinancial into CitiMortgage, thereby consolidating its prime and nonprime operations.[214] The head of CitiMortgage explained that the new combined organization would work closely with Citigroup's investment bank to create "an end-to-end U.S. residential mortgage business that includes origination, servicing, and capital markets securitization."[215] In view of Citigroup's decision, in the midst of the mortgage crisis, to generate additional fee income by continuing to securitize risky mortgages, it is not surprising that Citigroup originated and sold many defective mortgages that did not meet its stated underwriting criteria.

2. Citigroup Recklessly Packaged and Marketed CDOs.—Along with Merrill Lynch ("Merrill"), Citigroup dominated the market for CDOs during the peak of

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Hunt and joined by the federal government).

210. Dakin Campbell, *Citigroup to Pay Freddie Mac $395 Million to End Mortgage Claims*, BLOOMBERG, Sept. 25, 2013, http://www.bloomberg.com/news/2013-09-25/citigroup-to-pay-freddie-mac-395-million-tied-to-mortgages-1-.html, *archived at* http://perma.cc/SQ8X-F6L8; Hugh Son & Donal Griffin, *Citigroup Will Pay Fannie Mae $968 Million on Faulty Loans*, BLOOMBERG, July 1, 2013, http://www.bloomberg.com/news/2013-07-01/citigroup-to-pay-968-million-to-fannie-mae-on-faulty-mortgages.html, *archived at* http://perma.cc/WM3M-2GBS.

211. Paul Muolo, *Citi Reducing Holdings 20%*, NAT'L MORTGAGE NEWS, Mar. 10, 2008, at 1.

212. *Id.* (reporting that Citigroup would continue making subprime loans with a "minimum FICO score" of 580, but would stop funding "higher-risk products" such as "2/28 and 3/27 ARMs" and "investor properties on three and four-unit rentals"); *see also* Wilmarth, *Dark Side*, *supra* note 183, at 1015-17, 1020-22 (describing subprime and Alt-A mortgages, noting that subprime borrowers typically had FICO scores below 640, and explaining the heightened risks of subprime ARMs with 2/28 and 3/27 amortization terms and low introductory "teaser" rates).

213. *Id.*

214. Matthias Ricker, *Citi Shift Means Less Capital for Mortgages: Slashing Origination Efforts to Primarily "What We Can Sell,"* AM. BANKER, Mar. 7, 2008, at 1.

215. *Id.* (quoting Bill Beckmann, President of CitiMortgage, and reporting that Citigroup planned to reduce its mortgage portfolio by $45 billion, or 20%, while keeping "just 10% of [mortgage] originations on its books, down from about 65%").

the subprime credit boom between 2005 and 2007.[216] CDOs played a crucial role in promoting higher volumes of subprime lending and securitization, because they served as the primary purchasers for the "mezzanine" tranches of subprime RMBS.[217] Institutional investors typically wanted to buy the "senior" tranches of subprime RMBS because they carried "AAA" credit ratings and paid higher yields than other types of AAA-rated securities.[218] The senior tranches usually accounted for the top 75-80% of the tranches in subprime RMBS deals.[219] Either Wall Street underwriters or hedge funds usually bought the unrated junior or "equity" tranches, which represented 5% or less of the tranches in typical subprime RMBS deals.[220] Relatively few investors wanted to buy the mezzanine tranches, which ranked below the senior tranches and carried relatively low credit ratings of "A" or "BBB."[221] Most investors did not view the yields of mezzanine tranches as being high enough to justify the additional risk.[222]

In response to the lack of investor demand for mezzanine tranches of RMBS, Citigroup and other Wall Street firms "created the investor" by constructing cash flow CDOs, also known as ABS CDOs.[223] Wall Street underwriters acquired large pools of unsold mezzanine tranches of subprime RMBS (and other debt instruments) and re-securitized those pools by creating ABS CDOs.[224] About 80% of the tranches of ABS CDOs were assigned "senior" status with AAA credit ratings.[225] ABS CDOs became the dominant buyers of mezzanine tranches of subprime RMBS after 2003 and thereby provided an essential source of demand for continued subprime lending and securitization.[226]

Thus, Wall Street firms used ABS CDOs to perform a kind of "alchemy" in which (i) pools of high-risk subprime mortgages were packaged into subprime RMBS, and (ii) the low-rated and unwanted mezzanine tranches of subprime RMBS were repackaged and transformed into senior AAA-rated tranches of

216. *See infra* notes 241-42, 245 and accompanying text.

217. FCIC REPORT, *supra* note 4, at 71-73, 115-17 (describing the structure of a typical subprime RMBS deal that Citigroup underwrote in 2006); Wilmarth, *Dark Side*, *supra* note 183, at 984-90 (describing the securitization process used by Wall Street firms to create subprime RMBS).

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.*

223. FCIC REPORT, *supra* note 4, at 130 (quoting statement by Credit Suisse banker Joe Donovan at a conference for securitization bankers in February 2002); *id.* at 127 n.* (explaining that ABS CDOs is a term used to describe "cash CDOs backed by asset-backed securities (such as mortgage-backed securities)"); Wilmarth, *Dark Side*, *supra* note 183, at 990 (providing a similar description of ABS CDOs).

224. FCIC REPORT, *supra* note 4, at 127.

225. *Id.* at 129-33.

226. *Id.* at 116, 117, 127-30, 132-33.

CDOs.[227] Two classes of institutions played essential roles in helping Wall Street to accomplish that alchemy. First, insurance companies, including American International Group (AIG), Ambac, and MBIA, issued credit default swaps (CDS) and other guarantees that protected the senior tranches of CDOs against losses.[228] Second, credit ratings agencies (CRAs) issued AAA ratings for those tranches in reliance on flawed financial models that overstated both (i) the diversification of risk within the underlying pools of mezzanine tranches of subprime RMBS and (ii) the value of protection provided by insurance company guarantees.[229] The financial models used by CRAs proved to be disastrously wrong in calculating the risks inherent in ABS CDOs.[230]

The generous fees paid by Wall Street underwriters to insurance companies and CRAs helped to persuade both classes of institutions to ignore any doubts those institutions might have had about participating in Wall Street's CDO alchemy.[231] A senior official of the Federal Reserve System (Fed) later concluded that "the whole concept of ABS CDOs had been an abomination" that helped to produce an unsustainable boom in subprime mortgages.[232]

As the subprime credit boom reached its peak, ABS CDOs became the leading buyers not only of mezzanine tranches of RMBS but also of mezzanine tranches of other CDOs.[233] The FCIC found that "[b]y 2005, CDO underwriters were selling most of the mezzanine tranches [of CDOs] . . . to other CDO managers, to be packaged into other CDOs."[234] An investigative report by Jake Bernstein and Jesse Eisinger similarly concluded that

> in the last years of the boom, CDOs had become the dominant purchaser of key, risky parts of other CDOs, largely replacing real investors like pension funds. By 2007, 67 percent of those slices were bought by CDOs, up from 36 percent just three years earlier. . . .
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> . . . .
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> . . . Crucially, such deals maintained the value of mortgage bonds at a

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227. *Id.* at 127-29, 148 (quoting Kyle Bass); *see also id.* at 193 (quoting analyst James Grant's description of the "mysterious alchemical processes" by which "Wall Street transforms BBB-minus-rated mortgages into AAA-rated tranches of mortgage securities" through the production of CDOs).

228. *Id.* at 132.

229. *Id.* at 127-29, 139-42, 146-50, 200-04, 206-12, 265-74, 276-78.

230. *Id.* at 127-29, 146-50, 206-12.

231. *Id.* at 139-42, 146-50, 200-02, 206-12; Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 967-71 (2011) [hereinafter Wilmarth, *Dodd-Frank*] (describing the "CRAs' pervasive conflicts of interest [that] encouraged them to issue credit ratings that either misperceived or misrepresented the true risks embedded in structured-finance securities").

232. FCIC REPORT, *supra* note 4, at 129 (quoting interview with Patrick Parkinson in March 2010).

233. *Id.* at 132.

234. *Id.*

time when the lack of buyers should have driven their prices down.[235]

Bernstein and Eisinger reported that Citigroup was one of the three most active banks (along with Merrill and UBS) in creating networks of CDOs that were used as dumping grounds for mezzanine tranches of other CDOs those banks sponsored.[236]

Citigroup also underwrote synthetic CDOs, which held portfolios of CDS that represented bets on the performance of designated tranches of subprime RMBS.[237] Citigroup frequently took "long" positions on those bets by retaining the "super senior" tranches of synthetic CDOs it underwrote, although it obtained protection from AIG and monoline insurance companies for some of those exposures.[238] Synthetic CDOs "multiplied the effects" of the collapse in the subprime mortgage market because they created additional bets on the performance of subprime RMBS and the underlying mortgages.[239]

When Prince became CEO of Citigroup in late 2003, he and Rubin pushed Tom Maheras (the head of Citigroup's fixed-income trading activities) to produce more trading profits and larger volumes of CDOs.[240] In 2004, Citigroup underwrote $7 billion of CDOs and ranked fifth among CDO underwriters.[241] That performance represented a significant rise from Citigroup's fourteenth-place ranking in 2003, but the bank's CDO production was still less than half of the amount generated by top-ranked Merrill.[242]

In early 2005, Prince and Rubin developed a new strategic plan for

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235. Jake Bernstein & Jesse Eisinger, *The Wall Street Money Machine: Banks' Self-Dealing Super-Charged Financial Crisis*, PROPUBLICA (Aug. 26, 2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis, *archived at* http://perma.cc/5USS-JLAW.

236. *Id.* (quoting a shareholder lawsuit alleging that "Citigroup's CDO operations during late 2006 and 2007 functioned largely to sell CDOs to yet newer CDOs created by Citi to house them," and also citing reciprocal purchases of CDO tranches that were made among three CDOs created by Citigroup—Octonion, Adams Square Funding II and Class V Funding III).

237. FCIC REPORT, *supra* note 4, at 142-46 (describing synthetic CDOs); *id.* at 190, 194-96 (describing Citigroup's significant role in underwriting synthetic CDOs and in retaining the "super senior" tranches of those CDOs).

238. *Id.*

239. *Id.* at 146 (quoting interview with Patrick Parkinson); *see also* Wilmarth, *Dodd-Frank*, *supra* note 231, at 965-67 (describing how synthetic CDOs and CDS enabled investors to place "multiple layers of financial bets" on the performance of subprime mortgages, thereby creating an "inverted pyramid of risk" that inflicted losses on investors that were much larger than the face amounts of the defaulted mortgages).

240. Schwartz & Dash, supra note 3.

241. Kevin Donovan, *Merrill's CDO Investment Pays Off with No. 1 Ranking*, ASSET SECURITIZATION REP., Jan. 10, 2005.

242. *Id.* (reporting that Merrill underwrote $15 billion of CDOs in 2004); *see also* FCIC REPORT, *supra* note 4, at 198 (stating that Citigroup ranked fourteenth among CDO underwriters in 2003).

Citigroup.[243] That plan called for generating higher profits by expanding Citigroup's fixed-income trading operations (including CDOs) and assuming greater risks in those operations.[244] Citigroup implemented the plan by ramping up its CDO production to $18.5 billion in 2005, $36.6 billion in 2006 and $35.7 billion in 2007, and its ranking as a CDO underwriter rose to third in 2005, second in 2006 and first in 2007.[245]

Citigroup earned large amounts of fees for creating and marketing CDOs.[246] In addition, the Citigroup executives responsible for CDO production received handsome rewards for their apparent success. In 2006, Tom Maheras (co-head of Citigroup's investment bank) earned $34 million in salary and bonus, while Randolph Barker (co-head of global fixed-income) was paid $21 million, and Nestor Dominguez and Janice Warne (co-heads of global CDOs) each received $7.4 million.[247]

3. Citigroup Used Off-Balance-Sheet Conduits as Dumping Grounds for Unsold CDO Tranches and Other Risky Securities.—Citigroup assumed ever-greater risks as it sought to become the top-ranked producer of CDOs. From 2003 to 2006, Citigroup sold $25 billion of "super senior" AAA-rated CDO tranches to off-balance-sheet conduits.[248] The conduits paid for the tranches by issuing short-term asset-backed commercial paper (ABCP) to investors.[249] Citibank provided "liquidity puts" to support Citigroup's sale of CDO tranches

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243. Schwartz & Dash, *supra* note 3 (noting that Rubin helped Prince to persuade Citigroup's board of directors to approve the plan).

244. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 190-92; Ken Brown & David Enrich, *Rubin, Under Fire, Defends His Role at Citi*, WALL ST. J., Nov. 29, 2008, at A1; Dash & Creswell, *supra* note 2; Schwartz & Dash, *supra* note 3; Notes on Senior Supervisors' Meetings with Firms: Confidential Supervisory Information: Citigroup, Office of Comptroller of Currency, Nov. 19, 2007, at 5 [hereinafter Senior Regulators 2007 Citigroup Meeting Notes] (confidential notes of meeting among representatives of Citigroup, New York Fed, FRB, OCC and SEC, which recorded that "Citigroup's Board of Directors approved the Management plan accepting Citigroup 'needed to take on more risk.'"), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2007-11-19_OCC_Notes_on_Senior_Supervisors_Meeting_with_Firms.pdf, *archived at* http://perma.cc/6WTR-9LWX.

245. Gabrielle Stein, *Market Sees Murky Outlook for U.S. CDOs in 2008*, ASSET SECURITIZATION REP., Jan. 7, 2008 (providing data for CDO underwriters in 2006 and 2007, and noting that Merrill ranked first in 2006 and second in 2007); Allison Pyburn, *U.S. CDO Market Posts Gains Through 2005*, ASSET SECURITIZATION REP., Jan. 9, 2006 (providing data for CDO underwriters in 2005, and noting that Merrill and Wachovia ranked first and second in that year).

246. FCIC REPORT, *supra* note 4, at 138 (stating that Citigroup's CDO desk typically earned a fee of about $10 million for each $1 billion CDO it created, and Citibank usually charged $1 to $2 million each year for providing "liquidity puts" to purchasers of AAA-rated tranches of CDOs); Dash & Creswell, *supra* note 2 (reporting that Citigroup earned $500 million from its CDO business in 2005).

247. FCIC REPORT, *supra* note 4, at 198.

248. *Id.* at 138-39.

249. *Id.*

to the conduits.[250] The liquidity puts guaranteed that Citibank would buy the ABCP if investors refused to roll over their holdings of the short-term paper.[251] In 2006, after Citibank's treasury department refused to allow any more liquidity puts, Citigroup's CDO trading desk began to retain large amounts of super senior CDO tranches that it could not sell to investors because of the relatively low yields on those tranches.[252] By September 2007, Citigroup's investment bank held $18 billion of unsold super senior tranches, thereby increasing its total super senior exposure to $43 billion.[253] In addition, Citigroup's investment bank held almost $12 billion of subprime mortgages and RMBS in its "warehouse" while waiting to package those instruments into new CDOs.[254] Thus, Citigroup had $55 billion of combined exposures to subprime CDO-related assets in the fall of 2007.[255]

Citigroup compounded its exposure to CDOs and other illiquid investments by creating structured investment vehicles (SIVs) as another type of off-balance-sheet dumping ground for those investments. SIVs were off-balance-sheet entities that purchased a variety of investments (including RMBS and CDOs) from their sponsoring banks and funded those purchases by issuing short-term ABCP and medium-term notes (MTNs).[256] SIVs were somewhat different from ABCP conduits because SIVs used a longer-term funding model and did not rely on liquidity puts from their sponsoring banks.[257] However, while SIVs did not have explicit liquidity support from their sponsoring banks, any default by an SIV would create significant reputational risks for its sponsor.[258]

Citigroup was the largest global sponsor of SIVs.[259] In December 2007,

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250. *Id.*

251. *Id.* at 137-39, 195-96; FED. RES. BANK OF N.Y., SUMMARY OF SUPERVISORY ACTIVITY AND FINDINGS: CITIGROUP, JAN. 1, 2007 – DEC. 31, 2007, at 3, 17 [hereinafter NEW YORK FED 2007 CITIGROUP EXAM REPORT].

252. FCIC REPORT, *supra* note 4, at 138-39, 196-97 (explaining that Citigroup had perverse incentives to provide liquidity puts and retain super senior tranches in order to complete CDO deals, because federal bank regulators had adopted capital rules that allowed banks to maintain very low levels of capital with respect to such commitments).

253. *Id.* at 196.

254. Carrick Mollenkamp & David Reilly, *Why Citi Struggles to Tally Losses*, WALL ST. J., Nov. 5, 2007, at C1.

255. *Id.*

256. FCIC REPORT, *supra* note 4, at 252-53 (explaining that MTNs were bonds maturing in one to five years).

257. *Id.*

258. *Id.*; VIRAL V. ACHARYA & PHILIPP SCHNABL, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 83, 86-94 (Viral V. Acharya & Matthew Richardson eds. 2009); *see also* Wilmarth, *Dark Side*, *supra* note 183, at 1033 (describing "reputation risk" faced by sponsors of SIVs despite the sponsors' lack of explicit contractual commitments to support their SIVs).

259. Shannon D. Harrington & Elizabeth Hester, *Citigroup Rescues SIVs With $58 Billion Debt Bailout (Update 5),* BLOOMBERG (Dec. 14, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&refer=home&sid=aS0Dm.iV5BCI, *archived at* http://perma.cc/PK8G-

Citigroup's seven SIVs collectively held about $50 billion of assets, including a substantial amount of subprime RMBS and CDOs.[260] Despite Citigroup's lack of any "contractual obligation" to support its SIVs, Citigroup felt compelled for reputational reasons to bring the assets of its SIVs back onto its balance sheet in order to prevent the SIVs from defaulting on $58 billion of debt securities the SIVs had issued.[261]

4. Citigroup's Executives Disregarded the Risks Created by Its Subprime RMBS and CDO Activities.—As Citigroup aggressively expanded its business of packaging RMBS and CDOs, Chuck Prince and Robert Rubin ignored the growing risks of that business and other aspects of Citigroup's capital markets operations.[262] Rubin was viewed as Citigroup's "resident sage" based on his experience as head of arbitrage trading and as chairman of Goldman Sachs before serving as Treasury Secretary during the Clinton Administration.[263] Rubin encouraged Prince and Citigroup's board of directors to assume more risk in order to keep up with Goldman Sachs and other key Wall Street competitors.[264] He especially "pushed to bulk up [Citigroup's] high-growth fixed-income trading, including the C.D.O. business."[265] A Citigroup banker described Rubin as "like the Wizard of Oz behind Citigroup . . . . He certainly was the guy deferred to on key strategic decisions and certain key business decisions vis-à-vis risk."[266]

Rubin "knew what a CDO was," but he claimed that he and Citigroup's board of directors properly relied on the bank's fixed-income executives and risk managers to oversee the CDO business.[267] Rubin and Prince told the FCIC that they did not know about Citigroup's $43 billion exposure to subprime CDOs (via

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SVFC (reporting that Citigroup's SIVs held about 13% of their assets in RMBS and CDOs).

260. *Id.* (reporting that Citigroup's SIVs held about 13% of their assets in RMBS and CDOs).

261. *Id.* (reporting that Citigroup was assuming responsibility to pay $10 billion of ABCP and $48 billion of MTNs issued by the SIVs.); Robin Sidel et al., *Citigroup Alters Course, Bails Out Affiliated Funds*, WALL ST. J., Dec. 14, 2007, at A1; *see also* NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 3, 17 (finding that Citigroup failed to consider "the potential impact of supporting Citi-advised [SIVs] for reputational reasons" until the SIVs were threatened with default).

262. *See supra* notes 216-17, 236-61 and accompanying text.

263. Dash & Creswell, *supra* note 2; *see also* GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 145-46, 190-91; Brown & Enrich, *supra* note 244. Weill, Prince and other Citigroup executives sought Rubin's advice on a regular basis. Raymond McGuire, a former co-head of global investment banking at Citigroup, described his meetings with Rubin as "a little like visiting Yoda . . . You go and get a dose of wisdom." Schwartz & Dash, *supra* note 3.

264. Dash & Creswell, *supra* note 2.

265. *Id.*; *see also* GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 145-46, 190-91; Brown & Enrich, *supra* note 244; Schwartz & Dash, *supra* note 3.

266. Schwartz & Dash, *supra* note 3 (quoting unnamed banker).

267. Brown & Enrich, *supra* note 244 (quoting Mr. Rubin); *see also* Schwartz & Dash, *supra* note 3 (quoting Mr. Rubin's statement that "[t]here is no way you would know what was going on with a risk book unless you're directly involved with the trading arena . . . . We had highly experienced, highly qualified people running the operation.").

liquidity puts and retained super senior tranches) until September 2007.[268] Prior to that time, they relied on assurances provided by Tom Maheras (co-head of Citigroup's investment bank) and David Bushnell (Citigroup's chief risk officer) that Citigroup did not have significant exposures to losses from subprime CDOs.[269] Maheras told Citigroup's senior management that "[w]e are never going to lose a penny on these super seniors," while Bushnell said that housing prices would have to fall 30% nationwide before Citigroup would have any "problems" with its CDO exposure.[270]

Prince and Rubin claimed that they acted reasonably in relying on Maheras and Bushnell as highly respected professionals.[271] However, their reliance was highly questionable in both cases. Many Citigroup employees knew that Maheras pursued extremely aggressive trading strategies with his own funds as well as Citigroup's money.[272] Some senior bond traders and salesmen questioned Maheras' high-risk strategies, but they eventually left Citigroup because senior management supported Maheras and eventually made him co-head of Citigroup's investment bank.[273]

Bushnell's reliability should also have been suspect. He was a longstanding friend of Maheras and Randy Barker, one of Maheras' top deputies.[274] Maheras and Barker frequently persuaded Bushnell to loosen or remove risk limits on Citigroup's trading operations.[275] Risk managers in Citigroup's fixed-income trading division reported to both Maheras and Bushnell, thereby undermining the independence of those managers.[276] Bushnell admitted to the FCIC that his risk management division "did approve higher risk limits when a business line was growing . . . [due to] a 'firm-wide initiative' to increase Citigroup's structured-products business."[277] According to some reports, the "close" friendship among

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268. FCIC REPORT, *supra* note 4, at 262-65.

269. *Id.*; Dash & Creswell, *supra* note 2.

270. FCIC REPORT, *supra* note 4, at 262 and 264 (quoting Mr. Prince's recollection of statements made by Maheras and Bushnell).

271. *Id.* at 261-64; GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 191, 282-83 (noting that in 2007 Maheras had "become the odds-on favorite to replace Prince" as CEO of Citigroup).

272. *See* GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 88, 137-38, 146-50, 238-39, 282-83, 305-06 (discussing Maheras' well-known reputation for speculative trading).

273. *Id.* at 142-43, 146-50, 282-82, 358 (stating that William Heinzerling, a senior bond trader, left Citigroup in 2005 and Citigroup's top three bond salesmen left between 2004 and 2007, due to their disagreements with Maheras' trading strategies).

274. Dash & Creswell, *supra* note 2.

275. GASPARINO, *supra* note 86, at 285, 305 ("Maheras had a built-in advantage when it came to risk-taking—his chief risk manager, Dave Bushnell, was a close friend, and his other close friend, Randy Baker, the co-head of all of fixed income, had consistently leaned on Bushnell to approve increasingly complex trades.").

276. Dash & Creswell, *supra* note 2.

277. FCIC REPORT, *supra* note 4, at 261 (summarizing and quoting from an interview with Mr. Bushnell, and also noting that Citigroup's risk officers increased the authority of the CDO desk to retain subprime RMBS and CDO tranches in the first half of 2007).

Maheras, Barker and Bushnell—and Bushnell's resulting lack of independence—was widely known within Citigroup.[278]

A careful analysis should have led Citigroup's management to question Bushnell's view that super senior tranches of CDOs were protected against any outcome less severe than a 30% drop in nationwide housing prices. Many CDO portfolios were stuffed with mezzanine tranches of subprime RMBS, and some analysts and investors had determined by 2006 that AAA-rated tranches in those CDOs would begin to suffer losses if national home prices fell by just 4%.[279] Nevertheless, Citigroup put "blind faith" in the seniority and AAA ratings of its super senior tranches and failed to perceive the risks embedded in the subprime collateral underlying the CDO tranches.[280]

In June 2007, Citigroup told SEC examiners that it was excluding the $43 billion of CDO liquidity puts and super senior tranches from its publicly disclosed subprime exposures because it viewed the "risk of default" on those AAA-rated obligations as "extremely unlikely."[281] Citigroup omitted the liquidity puts and super senior tranches from its disclosures of subprime holdings in several earnings reports and calls with investors between July and October 2007.[282] Citigroup finally disclosed its liquidity puts and super senior tranches to the public in November 2007.[283] The bank subsequently paid $665 million to settle an SEC enforcement action and a shareholder lawsuit alleging that Citigroup's

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278. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 285, 305 (indicating that Prince was aware of the "close" relationship among the three men); Dash & Creswell, *supra* note 2 (reporting that the friendship between Bushnell and Barker "raised eyebrows inside the company among those concerned about its [risk] controls," and quoting a former senior Citigroup executive who stated, "Because [Bushnell] has such trust and faith in [Maheras and Barker], he didn't ask the right questions").

279. FCIC REPORT, *supra* note 4, at 194-95 (quoting a newsletter article by James Grant in October 2006, and describing similar views held by several hedge fund managers). Mezzanine tranches of a subprime RMBS deal were exposed to losses after the junior or equity tranches (typically representing 3% or less of the total tranches) were wiped out. As a result, after defaults occurred on more than 3% of the pooled subprime mortgages in an RMBS deal, those losses were likely to impair the value of mezzanine tranches of the deal. As the value of mezzanine tranches of RBMS declined, so would the value of any CDOs that either held those tranches or contained CDS representing "long" positions on those tranches. *Id.* at 127-33, 193-95.

280. Dash & Creswell, *supra* note 2; *see also* FCIC REPORT, *supra* note 4, at 260 (noting that Mr. Prince cited the AAA ratings of CDO tranches as a reason for his initial lack of concern about Citigroup's exposure to those tranches); *id.* at 262 (quoting Citigroup risk officer Ellen Duke, who admitted that she was "seduced by structuring [that justified high credit ratings] and failed to look at the underlying collateral").

281. FCIC REPORT, *supra* note 4, at 262 (quoting Citigroup presentation to the SEC in June 2007, and noting that national housing prices had fallen by 4.5% and 16% of subprime ARMs were delinquent by that date); *see also* Dash & Creswell, *supra* note 2 (describing Citigroup's explanation to the SEC's examiners as to why the bank did not disclose its CDO positions).

282. FCIC REPORT, *supra* note 4, at 263.

283. *Id.* at 265.

failure to disclose the liquidity puts and super senior tranches violated federal securities laws.[284]

Citigroup's misplaced reliance on credit ratings gave the bank's traders a convenient rationale to keep running their CDO machine. Meanwhile, as indicated above, "Citigroup's risk models never accounted for the possibility of a national housing downturn."[285] Both mistakes seem glaring in retrospect, but the mistakes are more understandable when one considers the enormous financial incentives that spurred Citigroup's executives to continue creating CDOs and engaging in other high-risk capital markets activities.[286] As one banker explained, "senior managers got addicted to the revenues and arrogant about the risks they were running . . . . As long as you could grow revenues, you could keep your bonus growing."[287]

Prince and Rubin were also strongly inclined to overlook the risks incurred by Citigroup's capital markets activities because they relied so heavily on those operations to produce the earnings growth they kept promising to Wall Street.[288] For example, Citigroup's corporate and investment bank was praised as "the

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284. *Id.*; SEC Litigation Release No. 21605, July 29, 2010 (announcing that Citigroup had agreed to pay $75 million to settle the SEC's enforcement action, and alleging that Citigroup's "senior management" was aware of the liquidity puts and super senior tranches "as early as April 2007"), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21605.htm, *archived at* http://perma.cc/Q2MR-4LVA; Jessica Silver-Greenberg, *Citigroup in $590 Million Settlement of Subprime Lawsuit*, N.Y. TIMES, Aug. 30, 2012, at B4 (reporting on Citigroup's payment of $590 million to settle the shareholder lawsuit). Citigroup's chief financial officer, Gary Crittenden, and its head of investor relations, Arthur Tildesley, paid a total of $180,000 to settle SEC charges arising out of the same alleged disclosure violations. However, the SEC did not file charges against Prince, Rubin or other senior executives of Citigroup. SEC Administrative Release No. 34-62593, July 29, 2010 (announcing settlement of SEC charges against Crittenden and Tildesley), *available at* http://www.sec.gov/litigation/admin/2010/34-62593.pdf, *archived at* http://perma.cc/7PVM-94SA.

285. Dash & Creswell, *supra* note 2.

286. FCIC REPORT, *supra* note 4, at 138-39, 196-97.

287. *Id.*; Dash & Creswell, *supra* note 2 (quoting unnamed banker who with Citigroup's CDO group); *see also supra* note 247 and accompanying text (describing the very high compensation paid to Maheras, Barker and the co-heads of Citigroup's global CDO business); *infra* notes 382-83 and accompanying text (discussing the very high compensation received by Prince and Rubin).

288. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 190-91 (suggesting that Rubin saw risk-taking in Citigroup's capital markets operations as "Citi's sole savior" and "a tool to grow profits"); Riley, *supra* note 155, at A2 (reporting that Prince "expected to boost competitiveness at [Citigroup's] investment bank this year," and "[s]ince 2004, Citigroup's corporate and investment bank has served as a revenue growth engine for the company"); Der Hovanesian, *supra* note 155, at 41 (reporting on Prince's claim in October 2006 that "investments he made three years ago in Citi's capital markets business are now paying off nicely"); *see also supra* notes 152-53, 155-57 (discussing Prince's repeated pledges to produce larger earnings through "organic growth," especially in Citigroup's capital markets operations, to satisfy Wall Street's demands for higher profits).

company's main profit engine" in the second quarter of 2007, when the unit reported what appeared to be record results for revenues and net income.[289] Similarly, Citigroup's capital markets and investment banking operations reported strong revenues and earnings during the first quarter of 2007, and Prince publicly expressed his "thanks and gratitude" to Citigroup's traders.[290] Thus, Citigroup's top executives tolerated aggressive risk-taking by Maheras and his subordinates because they viewed the investment bank as "the key to Citigroup meeting Wall Street's quarterly profit expectations."[291]

5. Citigroup Assumed Major Risks in Syndicating Corporate Loans for Leveraged Buyouts.—Citigroup was a leading provider of loans for corporate leveraged buyouts (LBOs).[292] Large commercial and investment banks underwrote about $5 trillion of leveraged loans between 2003 and 2007, and many of those loans were used to help finance $1.8 trillion of LBOs that were completed in global markets between 2004 and 2007.[293] More than a tenth of those leveraged loans were pooled to create collateralized loan obligations (CLOs), which sold CLO securities to investors around the world.[294]

As the LBO boom reached its peak between 2004 and mid-2007, the quality of leveraged loans declined and their risks increased sharply.[295] Only 10% of leveraged loans that were issued between 2000 and 2003 carried the most risky credit rating ("CCC").[296] However, the percentage of CCC-rated leveraged loans rose above 40% in 2004 and reached 50% in 2006.[297] During the height of the LBO boom, Citigroup and other banks underwrote large amounts of leveraged loans that contained interest-only, "covenant lite," and "payment in kind" features, all of which imposed greater risks on the lenders.[298]

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289. David Enrich, *Citigroup Shows Its Strength: Investment Bank Powers 18% Jump in Earnings, Easing Pressure on CEO*, WALL ST. J., July 21, 2007, at A3.

290. Tim Mazzucca, *1Q Earnings: Upbeat Sign: Citi's Revenue Outgains Costs*, AM. BANKER, Apr. 17, 2007, at 19.

291. Robin Sidel & David Enrich, *Citigroup CEO Shakes Up Ranks: Prince Taps Pandit to Run Merged Investments Unit; Veteran Maheras Departs*, WALL ST. J., Oct. 12, 2007, at A3 (reporting on the departure of Thomas Maheras, co-head of the investment bank, after Citigroup reported significant trading losses, and noting that Maheras had "spearheaded Citigroup's push to trade a broader array of products" and "had been considered a potential successor to Mr. Prince").

292. DEALBOOK, *Citi Chief on Buyouts: 'We're Still Dancing,'* N.Y. TIMES (Jul. 10, 2007), http://dealbook.nytimes.com/2007/07/10/citi-chief-on-buyout-loans-were-still-dancing/, *archived at* http://perma.cc/USR4-92BS.

293. Wilmarth, *Dark Side*, *supra* note 183, at 1039-40.

294. *Id.* at 990-91 (describing CLOs as a type of CDO backed by syndicated leveraged corporate loans); *id.* at 1039 (stating that between $500 billion and $700 billion of leveraged loans were packaged into CLOs between 2002 and 2007).

295. FCIC REPORT, *supra* note 4, at 174-75.

296. Wilmarth, *Dark Side*, *supra* note 183, at 1040.

297. *Id.*

298. *Id.* at 1040-41 (explaining that (i) interest-only loans allowed borrowers to defer repayments of principal, (ii) "covenant-lite" loans exempted borrowers from standard covenants

As I noted in a previous article, "[t]he risky features of leveraged loans during the LBO boom resembled the interest-only, negative amortization and low- or no-documentation provisions of nonprime residential mortgages that [large financial institutions] issued during the simultaneous housing boom."[299] The "spread" between interest rates for leveraged loans and interest rates for low-risk debt like Treasury bonds or interbank loans fell to record low levels in early 2007, thereby indicating that lenders were underestimating the inherent risks of leveraged loans.[300]

Demand by investors for leveraged loans began to decline during the second quarter of 2007.[301] Citigroup and other major banks tried to offset weak investor demand by making "bridge loans" that provided "temporary financing for LBOs until investors could be found to purchase the requisite number of leveraged loans and junk bonds" to complete the deals.[302] Bridge loans helped Citigroup and other lenders to generate fees by completing additional LBO deals. However, bridge loans created the same type of retention risks that Citigroup assumed when it provided liquidity puts and kept super senior tranches on its balance sheet in order to complete CDO deals.[303]

Citigroup ranked third among underwriters of leveraged loans in 2007, a very significant rise from its thirteenth place ranking in 1999.[304] In early 2007, Citigroup's senior management decided to double the bank's portfolio limits for leveraged loans "in pursuit of earnings" and also to defend Citigroup's leading position in the leveraged-loan market.[305] Citigroup's regulators subsequently determined that "Citigroup's risk appetite was to maintain its 15-20% market share . . . As far as leveraged lending was concerned, Citigroup believed it had to be in all the roughly 6-7 mega deals that were put together in 2007, to maintain

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that typically would have limited the amount of their outstanding debt and mandated minimum levels of cash flow coverage and interest payment coverage, and (iii) payment-in-kind loans allowed borrowers to defer paying interest by issuing new debt to cover accrued interest).

299. *Id.* at 1041. Thus, "[a]s a practical matter, the LBO financing packages underwritten by [large financial institutions] represented the same kind of 'Ponzi finance' as nonprime residential mortgages, because many LBO firms and homeowners with nonprime mortgages could not satisfy their debts unless they were able to refinance those debts on more favorable terms." *Id.*

300. FCIC REPORT, *supra* note 4, at 174-75; Henny Sender & Serena Ng, *Market Pressures Test Resilience of Buyout Boom*, WALL ST. J., June 8, 2007, at A1.

301. Robin Sidel et al., *Banks on a Bridge Too Far? As Risk Rises in LBOs, Investors Start to Balk*, WALL ST. J., June 28, 2007, at C1; Sender & Ng, *supra* note 300.

302. Wilmarth, *Dark Side*, *supra* note 183, at 1042; Sidel et al., *supra* note 301.

303. Wilmarth, *Dark Side*, *supra* note 183, at 1042.

304. Bradley Keoun, *Citigroup Slips After 10 Years as Biggest U.S. Bank (Update 2)*, BLOOMBERG, Mar. 24, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a0w.04p3qtyY&refer=finance, *archived at* http://perma.cc/8ZGJ-HND2; *see also* Sidel et al., *supra* note 301 (reporting that JPMorgan Chase, Citigroup and Bank of America were "the biggest players in the leveraged-loan business").

305. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2, 4.

its market leadership."[306]

At the end of June 2007, the credit markets were unsettled by the threatened collapse of two hedge funds managed by Bear Stearns ("Bear").[307] Both hedge funds had invested heavily in subprime mortgage-related securities, including CDOs underwritten by Citigroup.[308] Analysts saw the problems at Bear's hedge funds as "emblematic of the widening fallout from the nation's housing downturn,"[309] and reporters noted that "investors were wondering how much longer the era of easy corporate credit can last."[310]

Notwithstanding growing concerns about the viability of LBO deals, Chuck Prince denied rumors that Citigroup was "pulling back" from those deals in an interview published in the *Financial Times* on July 9, 2007.[311] In that interview, Prince gave his now-famous explanation of why Citigroup remained fully committed to providing LBO loans: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."[312]

Prince also declared that "[t]he depth of the pools of liquidity is so much larger than it used to be that a disruptive event now needs to be much more disruptive than it used to be."[313] He pointed out that "big Wall Street banks" were acquiring "troubled subprime mortgage lenders," thereby providing "an example of how 'liquidity rushes in' to fill the gap as others spot a buying opportunity."[314] Prince's comments indicated that Citigroup viewed its continued commitment to leveraged lending as a risk-taking "opportunity" that was similar to Citigroup's misguided decision to acquire Argent (the parent company of subprime lender

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306. *Id.* at 6.

307. Michael Hudson, *Stock Market Quarterly Review: Is Corporate-Credit Party Almost Over?*, WALL ST. J., July 2, 2007, at C5, *available at* http://search.proquest.com/docview/399080199/C40C4FAA2BF942B3PQ/75?accountid=11243.

308. Kate Kelly et al., *Two Big Funds At Bear Stearns Face Shutdown: As Rescue Plan Falters Amid Subprime Woes, Merrill Asserts Claims*, WALL ST. J., June 20, 2007, at A1, *available at* http://search.proquest.com/docview/399090137/A53B6F6CEA1541C6PQ/9?accountid=11243.

309. *Id*.

310. Hudson, *supra* note 307.

311. Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-outs*, FT.COM, July 9, 2007.

312. *Id.*

313. *Id.* (reporting that Prince acknowledged that "[a]t some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go other way"; however, Prince added, "I don't think we're at that point.").

314. *Id.*; *see also* Wilmarth, *Dark Side*, *supra* note 183, at 1018, 1018 n.273 (describing how large commercial and investment banks purchased "nonbank subprime lenders in 2006 and 2007, as nonbank lenders encountered increasing problems with delinquencies and defaults," including Bear Stearns' acquisition of Encore Credit, Morgan Stanley's purchase of Saxon Mortgage, Deutsche Bank's acquisition of Mortgage IT, Merrill Lynch's purchase of First Franklin, and Citigroup's acquisition of Argent).

Ameriquest) in September 2007.[315]

Prince reaffirmed Citigroup's confidence and its commitment to leveraged lending in another interview published in the *New York Times* in early August.[316] Prince acknowledged that "[w]e see a lot of people on the Street who are scared," but he insisted, "We are not scared. We are not panicked. We are not rattled. Our team has been through this before."[317] Despite the "disruption" that many perceived in the credit markets, Prince maintained that "[w]hat we are seeing now is a pullback into a range of more normal kinds of credit experiences."[318] He added—in a comment that ranks alongside his "still dancing" statement of the previous month—"I think our performance is going to last much longer than the market turbulence does."[319]

At the time Prince made his bullish statements about leveraged lending, he recognized the dangers created by the overheated LBO market and declining standards for leveraged loans.[320] Prince attended a dinner with then-Treasury Secretary Hank Paulson on June 26, 2007.[321] Prince asked Paulson "whether given the competitive pressures there wasn't a role for regulators to tamp down some of the riskier practices," and "isn't there something you can do to order us not to take all these risks?"[322] Thus, Prince clearly understood the grave risks lurking in the LBO market, but Citigroup did not pull back from leveraged lending until the LBO market collapsed.[323]

Prince was not alone in having misgivings about leveraged lending or in failing to act on them. In a May 2007 speech, Bank of America ("BofA") CEO Kenneth Lewis admitted that "[w]e are close to a time when we'll look back and say we did some stupid things. . . . We need a little more sanity in a period in which everyone feels invincible and thinks this is different."[324] However, in the same speech Lewis boasted that BofA had participated in seven of the fifteen largest LBO deals during 2006, and he also declared, "There is tremendous value in being able to provide a strong balance sheet to arrange large, complex financial transactions."[325]

Thus, Prince and Lewis were both willing to keep dancing as long as the LBO band kept playing. Given their decisions to continue financing LBO deals despite

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315. *See supra* notes 179-81 and accompanying text (discussing Citigroup's disastrous acquisition of Argent).

316. Eric Dash, *Is the Dance Over? Citigroup Is Upbeat*, N.Y. TIMES, Aug. 3, 2007, at C1.

317. *Id.*

318. *Id.*

319. *Id.*

320. THOMAS G. STANTON, WHY SOME FIRMS THRIVE WHILE OTHERS FAIL: GOVERNANCE AND MANAGEMENT LESSONS FROM THE CRISIS 116 (2012).

321. *Id.*

322. *Id.* at 166 (quoting Mr. Prince).

323. *Id.*

324. Greg Ip, *Fed, Other Regulators Turn Attention to Risk in Banks' LBO Lending*, WALL ST. J., May 18, 2007, at C1.

325. *Id.*

their clear appreciation of the risks, it is not surprising that Citigroup and BofA were both forced to accept massive bailouts from the Troubled Asset Relief Program ("TARP"), and to rely on extensive liquidity support from the Federal Reserve.[326]

By September 2007, the markets for LBO funding had largely shut down.[327] At that point, Citigroup was left holding commitments to provide $69 billion of leveraged loans for LBO transactions.[328] Citigroup's LBO pledges represented a very significant share of the $300 to $400 billion in outstanding commitments by leveraged lenders in late 2007.[329] Through write-offs and sales to hedge funds and private equity funds, Citigroup reduced its leveraged-lending commitments to $43 billion at the end of 2007 and $26 billion at the end of April 2008.[330] Even so, as discussed below, Citigroup's leveraged-lending spree contributed to the

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326. *See infra* notes 336-49 and accompanying text (noting that Citigroup received $45 billion of TARP capital infusions and more than $300 billion of asset guarantees from the federal government); OFF. SPECIAL INSPECTOR GEN. TARP ("SIGTARP"), EMERGENCY CAPITAL INJECTIONS PROVIDED TO SUPPORT THE VIABILITY OF BANK OF AMERICA, OTHER MAJOR BANKS, AND THE U.S. FINANCIAL SYSTEM, SIGTARP-10-001 (Oct. 5, 2009) 1-2, 26-29 (explaining that BofA received $45 billion of TARP capital infusions, and federal regulators agreed to provide almost $120 billion in asset guarantees to BofA) [hereinafter "SIGTARP BofA Assistance Report"], *available at* http://www.sigtarp.gov/Audit%20Reports/Emergency_Capital_Injections_Provided_to_Support_the_Viability_of_Bank_of_America.pdf, *archived at* http://perma.cc/K82F-WN44. Citigroup and BofA also ranked second and third among financial institutions that received the largest amounts of emergency liquidity assistance from the Federal Reserve. Citigroup and BofA obtained $99.5 billion and $91.4 billion of emergency loans, respectively, and those amounts were exceeded only by the $107.3 billion that the Federal Reserve provided to Morgan Stanley. Bradley Keoun & Phil Kuntz, *Wall Street Aristocracy Got $1.2 Billion in Secret Fed Loans*, BLOOMBERG.COM, Aug. 22, 2011).

327. Dana Cimilluca & David Enrich, *Deal-Making Ties Unravel: Underwriters Retreating from Backing Buyouts*, WALL ST. J., Sept. 18, 2007, at C1; Dennis K. Berman, *Mood Swing: Deal Boom Fizzles as Cheap Credit Fades; Wall Street Mulls End of Golden M&A Era*, WALL ST. J., Sept. 6, 2007, at A1; Tom Lauricella, *Credit Crunch: Investors Flee Bank-Loan Funds*, WALL ST. J., Aug. 24, 2007, at C2; Shawn Tully, *Why the Private Equity Bubble Is Bursting*, FORTUNE, Aug. 20, 2007, at 30; *see also* FCIC REPORT, *supra* note 4, at 175 (explaining that the leveraged-lending market shut down soon after the subprime CDO market collapsed in the summer of 2007).

328. Pierre Paulden & Cecile Gutscher, *Pandit's "Closer to End" Means No Escaping LBO Loans (Update 4)*, BLOOMBERG.COM, Apr. 29, 2008 (providing figure for Citigroup in the fall of 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a73YZLrx84jQ&refer=bond, *archived at* http://perma.cc/7X9G-ZT63.

329. *Id.*; FCIC REPORT, *supra* note 4, at 175 (indicating that about $300 billion of commitments for LBO loans were outstanding in the fall of 2007); *compare* Wilmarth, *Dark Side*, *supra* note 183, at 1042 (stating that "nearly $400 billion of commitments to provide bridge financing for pending LBOs" were outstanding in the fall of 2007).

330. David Reilly, *Banks Use Quirk as Leverage Over Brokers in Loan Fallout*, WALL ST. J., Feb. 27, 2008, at C1 (providing figure for end of 2007); Paulden & Gutscher, *supra* note 328 (providing figure for end of April 2008).

very large losses that the bank reported between the fourth quarter of 2007 and the end of 2008.[331]

B. Prince's and Rubin's Aggressive Strategy Inflicted Huge Losses on Citigroup and Forced Citigroup to Accept Three Bailouts from the Federal Government

Citigroup's high-risk lending and capital markets activities produced massive losses between the summer of 2007 and the spring of 2010.[332] During that period, Citigroup recorded more than $130 billion in credit losses and write-downs on investments, a lamentable record that was exceeded only by Fannie Mae.[333] Chuck Prince resigned as CEO at the end of October 2007, after Citigroup publicly disclosed losses of about $10 billion on its subprime and CDO assets.[334] From the fourth quarter of 2007 through the end of 2009, Citigroup reported total net losses of almost $40 billion.[335]

Citigroup received its first government bailout on October 14, 2008.[336] On that date, the Treasury Department announced that it would buy $25 billion of Citigroup's preferred stock as part of Treasury's first round of TARP capital infusions into nine major banks.[337] Vikram Pandit, Citigroup's new CEO, eagerly welcomed Treasury's assistance because it provided "very cheap capital" to Citigroup.[338]

The federal government's first bailout was not sufficient to persuade the

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331. *See infra* notes 350-51 and accompanying text.

332. *See infra* Part II.A.

333. VIRAL V. ACHARYA ET AL., REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 147 (Tbl. 6.1) (Viral V. Acharya et al., eds. 2011) (showing that Citigroup recorded "Write-Downs and Credit Losses" of $130.4 billion between June 2007 and March 2010, a total that was exceeded only by Fannie Mae).

334. FCIC REPORT, *supra* note 4, at 265; Robin Sidel et al., *Two Weeks That Shook the Titans of Wall Street*, WALL ST. J., Nov. 9, 2007, at A1; Bradley Keoun & Edgar Ortega, *Weill's Profit Machine Breaks Down on Citi Writedowns (Update 6)*, BLOOMBERG.COM, Nov. 5, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ausU0j47QGsE&refer=home, *archived at* http://perma.cc/NEV8-XE8D.

335. Collins & Peters, *supra* note 11 (reporting that Citigroup incurred a net loss of $9.8 billion during the fourth quarter of 2007); Keoun, *supra* note 10 (reporting that Citigroup incurred a net loss of $27.7 billion during 2008 and a further net loss of $1.6 billion during 2009).

336. DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 236-40 (2009).

337. *Id.*; SIGTARP, EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC. 5 (2011) [hereinafter SIGTARP Citigroup Assistance Report], *available at* http://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf, *archived at* http://perma.cc/EFJ9-JHNY.

338. WESSEL, *supra* note 336, at 238-39 (quoting Mr. Pandit and noting that Treasury's terms for TARP preferred stock were "generous," including a dividend rate of only 5% for the first five years).

financial markets that Citigroup could survive the financial crisis.[339] On October 16, 2008, Citigroup reported a fourth consecutive net quarterly loss after incurring $13 billion of loan losses and write-downs on investments, bringing its total credit losses and write-downs to more than $70 billion since the summer of 2007.[340] In November 2008, Citigroup's stock price was undercut by significant short selling, and its "share price fell from around $13.99 at the market's close on November 3, 2008, to $3.05 per share on November 21, 2008, before closing that day at $3.77."[341] The cost of buying CDS protection against a default on Citigroup's outstanding debt rose sharply during the same period, indicating that "the market was increasingly concerned that Citigroup would not be able to make good on its debts."[342] In mid-November, depositors, investors, lenders, and other counterparties began to "'pull back from Citigroup' [sic] because of perceived decline in the bank's creditworthiness."[343]

From November 20 to 23, 2008, federal regulators reviewed Citigroup's rapidly deteriorating financial health.[344] Citigroup's management submitted a proposal for "additional Government assistance" on November 22.[345] The Fed, FDIC, and Treasury concluded that Citigroup would collapse without further help, and such a collapse would have "implications that reached beyond the bank itself, including serious adverse effects on domestic and international economic conditions and financial stability."[346] Based on those findings, Treasury Secretary Paulson issued a "Systemic Risk Determination,"[347] which authorized the federal government to provide extraordinary assistance to prevent Citigroup's failure and thereby protect all of its depositors and other creditors.[348]

The second bailout of Citigroup included (i) the Treasury's use of TARP funds to purchase an additional $20 billion of preferred stock from Citigroup and (ii) an agreement by the Treasury, FDIC, and New York Fed to protect Citigroup against catastrophic losses from a pool of more than $300 billion of the bank's troubled assets.[349] As originally proposed, Citigroup's troubled asset pool would

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339. *See infra* notes 340-43 and accompanying text.

340. Bradley Keoun & Josh Fineman, *Citigroup Posts Fourth Consecutive Loss on Writedowns (Update 2)*, BLOOMBERG.COM, Oct. 16, 2008.

341. SIGTARP Citigroup Assistance Report, *supra* note 337, at 8.

342. *Id.* at 9.

343. *Id.* at 11.

344. *Id.* at 13-14.

345. *Id.* at 13-16.

346. *Id.*

347. *Id.* at 15 (stating that Mr. Paulson consulted with President Bush before making his Systemic Risk Determination, and that Mr. Paulson concluded, "If Citi isn't systemic, I don't know what is.").

348. *Id.*; *see also* Wilmarth, *Dodd-Frank*, *supra* note 231, at 1001 (describing the "systemic risk exception" contained in 12 U.S.C. § 1823(c)(4)(G) (2012), under which "the Treasury Secretary can authorize the FDIC to provide full protection to uninsured creditors of a bank in order to avoid or mitigate 'serious effects on economic conditions or financial stability'.").

349. SIGTARP Citigroup Assistance Report, *supra* note 337, at 17-22 (explaining that

have included $85 billion of second-lien mortgages (including unfunded loan commitments), $57 billion of subprime and Alt-A mortgages held by Citigroup's retail mortgage business, $17.1 billion of subprime and Alt-A mortgages held in Citigroup's securitization warehouse, $12.2 billion of CDO assets, $8.6 billion of assets from SIVs, and $16.3 billion of leveraged loans.[350] Thus, Citigroup remained exposed in November 2008 to massive losses from its high-risk activities, including nonprime lending, CDOs, and leveraged lending, even though Citigroup had already recorded more than $70 billion of write-downs and losses on those assets.[351]

The second bailout of Citigroup also proved to be inadequate to stabilize the company. On January 16, 2009, Citigroup announced a fifth consecutive quarterly net loss after recording "a staggering $25.2 billion in write-offs and losses in both its consumer and investment bank."[352] The new write-offs and losses more than offset the $20 billion capital infusion that Citigroup received from Treasury in the second bailout. Citigroup's tangible common equity ("TCE") declined to 1.5% of its total assets, and its share price fell to a 16-year low of $3.50 per share as Citigroup's losses "wiped out any margin for error that

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Citigroup agreed to assume a "first loss position" of $39.5 billion on the $300 billion pool of troubled assets and "to absorb 10% of any losses in excess of $39.5 billion," while the Treasury, FDIC and New York Fed provided various protections to guarantee Citigroup against further losses on those assets); *see also* SHEILA BAIR, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 122-26 (2012) (describing the FDIC's participation in the second bailout of Citigroup).

350. As shown by the FDIC's summary of the original proposal for Citigroup's troubled asset pool, the subprime and Alt-A mortgages held as "mark-to-market" assets in Citigroup's securitization warehouse had been written down from their original value of $29.2 billion, while Citigroup's CDO assets, SIV assets and leveraged loans had been written down from their original values of $23.4 billion, $12.4 billion and $22.1 billion, respectively. In addition, the originally proposed troubled asset pool included $37 billion of commercial real estate loans, $29.1 billion of loans to the "Big 3" automakers, $19.7 billion of retail auto loans, $11 billion of "prime" mortgages for securitization, $9.5 billion of auction-rate securities, and $4.5 billion of exposures to monoline insurance companies. *See* Memorandum from James R. Wigand and Herbert J. Held to the FDIC Board of Directors regarding Citibank and Citigroup 3 ("Ring Fenced Portfolio" Tbl.) (Nov. 23, 2008) *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-11-23%20Memo%20to%20the%20FDIC%20Board%20fromJames%20R.%20Wigand%20and%20Herbert%20J.%20Held%20re%20recommendation%20for%20systemic%20risk%20determination%20for%20Citigroup.pdf, *archived at* http://perma.cc/FA5H-YX4S.

351. *See* Keoun & Fineman, *supra* note 340 and accompanying text (reporting that Citigroup incurred more than $70 billion of write-downs and loan losses between the summer of 2007 and October 2008). Federal regulators and Citigroup subsequently revised the composition of the troubled asset pool by eliminating CDOs, reducing the amount of commercial real estate loans and loans to automakers, and increasing the amount of residential mortgage loans. SIGTARP Citigroup Assistance Report*, supra* note 337, at 27-29.

352. Eric Dash, *Citigroup's Big Losses and Breakup Plan*, N.Y. TIMES, Jan. 16, 2009, at B8 (stating that Citigroup reported a net loss of $8.29 billion for the fourth quarter of 2008).

Citi might have to . . . weather the storm."[353]

Treasury announced in February 2009 that it would provide a third bailout to boost Citigroup's TCE and reassure investors.[354] In that transaction (which was completed in June 2009), the Treasury converted $25 billion of its preferred stock into common stock at a price of $3.25 per share, while other Citigroup shareholders converted $33 billion of their preferred stock into common stock on the same terms.[355] As a result, Citigroup's TCE increased significantly, and the federal government became the owner of 33.6% of Citigroup's common stock.[356]

Citigroup's condition stabilized after the third bailout, and it agreed with federal regulators on a two-part plan to remove the government's ownership stake in the bank.[357] First, in December 2009, Citigroup repurchased $20 billion of preferred stock held by the Treasury.[358] Second, from April through December 2010, the Treasury sold its holdings of Citigroup common stock in a series of transactions.[359]

In addition to its three TARP-financed bailouts, Citigroup received large amounts of additional help from the federal government. The Fed provided

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353. Bradley Keoun & Josh Fineman, *Citigroup's Pandit Tries to Save the Little That's Left to Lose*, BLOOMBERG.COM, Jan. 17, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aN81uQ4nU4e8, *archived at* http://perma.cc/TBR2-TCL7 (quoting James Ellman, president of money manager Seacliff Capital LLC).

354. SIGTARP Citigroup Assistance Report, *supra* note 337, at 30-31; SIGTARP, EXITING TARP: REPAYMENTS BY THE LARGEST FINANCIAL INSTITUTIONS 36-37 (2011) [hereinafter SIGTARP Exit Report], *available at* http://www.sigtarp.gov/Audit%20Reports/Exiting_TARP_Repayments_by_the_Largest_Financial_Institutions.pdf, *archived at* http://perma.cc/X76S-P4AC; David Enrich & Deborah Solomon, *Citi, U.S. Reach Accord on a Third Bailout—Government Puts Itself on Hook for More Losses*, WALL ST. J., Feb. 28, 2009, at B1; Bradley Keoun & Rebecca Christie, *Citi Gets Third Rescue as U.S. Plans to Raise Stake (Update 2)*, BLOOMBERG.COM, Feb. 27, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=as8R7HbWch.o&refer=home, *archived at* http://perma.cc/D53K-LM58.

355. SIGTARP Citigroup Assistance Report, *supra* note 337, at 30.

356. SIGTARP Exit Report, *supra* note 354, at 37; David Enrich et al., *Citi Deal Clears Way for Greater U.S. Sway*, WALL ST. J., June 10, 2009, at C1; Josh Fineman, *Asia Day Ahead: Citigroup Begins $58 Billion Share Conversion*, BLOOMBERG.COM, June 11, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aOe5cAa0zTGI, *archived at* http://perma.cc/J24B-Q3YV; *see also* BAIR, *supra* note 349, at 165-73 (describing the FDIC's involvement in negotiations for the third bailout of Citigroup).

357. SIGTARP Exit Report, *supra* note 354, at 34.

358. *Id.* at 37.

359. *Id.* at 42-43; Bradley Keoun, *Citigroup to Repay $20 Billion of Government Bailout (Update 2)*, BLOOMBERG.COM, Dec. 14, 2009, http://www.businessweek.com/bwdaily/dnflash/content/dec2009/db20091214_757347.htm, *archived at* http://perma.cc/54C-2FSY; Aaron Lorenzo, *Capital Purchase Program: Treasury Completes Common Citigroup Stock Divestiture; Bailout Profit Rises to $12 Billion*, 95 BANKING REP. (BNA) 1069 (2010); *see also* BAIR, *supra* note 349, at 205-06 (describing the FDIC's involvement in negotiations related to Citigroup's repurchase in December 2009 of $20 billion of preferred stock held by the Treasury).

emergency loans to Citigroup that peaked at $99.5 billion in January 2009 (an amount exceeded only by Morgan Stanley).[360] Citigroup also issued $64.6 billion of debt that was guaranteed by the FDIC under the Temporary Liquidity Guarantee Program ("TLGP").[361] Citigroup was the largest issuer of FDIC-guaranteed debt and therefore received the greatest subsidy under that program.[362] Moreover, Citigroup sold $32.7 billion of commercial paper (short-term debt) to the Fed's Commercial Paper Funding Facility ("CPFF"), which placed Citigroup among the top ten participants in the CPFF.[363] The fact that Citigroup was compelled to draw on such massive amounts of assistance from multiple federal programs demonstrated the drastic nature of Citigroup's predicament in 2008 and 2009.

III. CITIGROUP'S COLLAPSE REVEALED FAR-REACHING FAILURES BY ITS MANAGERS AND REGULATORS

A. Managerial Failures Were a Fundamental Cause of Citigroup's Devastating Problems

As described above, Citigroup experienced repeated problems and reported enormous losses during the first decade of its existence. Sandy Weill stepped down as CEO in 2003 after presiding over a long series of scandals that included Enron and WorldCom.[364] After taking the reins from Weill, Chuck Prince and Robert Rubin pursued a high-risk growth strategy that produced catastrophic losses and forced Citigroup to accept three bailouts from the federal government.[365] As shown below, federal regulators and outside analysts identified two major shortcomings by Citigroup's senior executives and business unit managers during the period leading up to the financial crisis: (1) a single-minded focus on revenue growth that ignored the risks created by Citigroup's aggressive expansion into speculative activities, and (2) a failure to establish and implement an effective risk management system.

1. Citigroup's Obsession with Revenue and Profit Growth.—As noted above, Prince and his management team were under constant pressure from Wall Street

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360. Keoun & Kuntz, *supra* note 326.

361. CONGRESSIONAL OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS 6-9, 35-39, 58-63, 74-75, 76 (Fig. 10) (2009), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT53348/pdf/CPRT-111JPRT53348.pdf, *archived at* http://perma.cc/X3D5-34U6 (describing the TLGP).

362. *Id.* at 76 (fig. 11) (showing that Citigroup issued the largest amount—$64.6 billion—of FDIC-guaranteed debt under the TLGP, followed by BofA with $44 billion of such debt).

363. Linus Wilson & Yan Wendy Wu, *Does Receiving TARP Funds Make it Easier to Roll Your Commercial Paper onto the Fed?*, J. ECON. LIT., Aug. 22, 2011, at 3-4, 29 (Tbl. 7, Panel A) (showing that Citigroup sold the tenth-largest amount of commercial paper to the Fed under the CPFF).

364. *See supra* Part I.B.

365. *See supra* Part II.

analysts and investors to produce consistent improvement in Citigroup's profitability.[366] In response to that pressure, Citigroup's executives gave top priority to increasing revenues and earnings and ignored the risks created by the bank's strategy of rapid growth.[367] The OCC determined that Citigroup's management "was focused on short-term performance and profitability along with achieving top industry rankings across many major products rather than on risk or potential loss."[368] In the OCC's view, Citigroup's CDO problems resulted from "a fundamental strong push for generating income. The apparent need to generate quarterly income triggered a ramping up in [CDO] risk exposure."[369] Similarly, the New York Fed observed that "[m]anagement's focus was primarily on revenue generation until it became clear that the credit market conditions had changed so significantly that the ability of the business to operate in a 'business as usual' mode was being seriously disrupted."[370] Thus, Citigroup's regulators agreed that the bank's senior management consciously adopted a policy of taking greater risks in order to produce "earnings growth."[371]

The Fed and the OCC determined that Citigroup's executives focused on expanding its leveraged lending and CDO businesses while overlooking the potential hazards of both activities. For example, Citigroup's managers approved increases in "pipeline limits" for leveraged loans (i.e., risk ceilings on loan commitments that Citigroup had not yet sold to investors) from $35 billion in June 2005 to $100 billion in March 2007.[372] Management allowed the leveraged

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366. *See supra* notes 152-53, 155-57 and accompanying text.

367. *See infra* Part II.A.

368. Letter from John C. Lyons, Examiner-in-Charge, to Vikram Pandit, Citigroup CEO, Comptroller of the Currency 2 (Feb. 14, 2008) [hereinafter OCC 2008 Citigroup Exam Report], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-02-14_OCC_Letter_from_John_C_Lyons_to_Vikram_Pandit_Serious_Problems_at_Citibank.pdf, *archived at* http://perma.cc/EPE8-D3FT.

369. Memorandum from Michael Sullivan and Ron Frake to John Lyons, OCC Examiner-in-Charge, *Subprime CDO Valuation and Oversight Review – Conclusion Memorandum* (Jan. 17, 2008) at 3 [hereinafter OCC 2008 Citigroup CDO Memo], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-01-17_OCC_Letter_from_Michael_Sullivan_and_Ron_Frake_to_John_Lyons_Re_Subprime_CDO_Valuation_and_Oversight_Review_Conculsion_Memorandum.pdf, *archived at* http://perma.cc/4WBJ-6B38.

370. NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 8; *see also* Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 7 (stating that "Citigroup focus had been on earnings growth and not balance sheet utilization. This focus on earnings growth was also not risk adjusted.").

371. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 5 ("Citigroup's Board of Directors approved the Management plan accepting [that] Citigroup 'needed to take on more risk.' . . . [M]anagement acknowledged that internal incentives focused too much on earnings growth and not enough on balance sheet usage."); *see also* BAIR, *supra* note 349, at 122 ("Citi had essentially bought into all the gimmicks to generate short-term profits: poorly underwritten loans, high-risk securities investments, and short-term, unstable liquidity.").

372. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2-3.

loan "pipeline" to grow rapidly in order "to maintain league leadership positions."[373] Meanwhile, "underwriting standards [for leveraged loans] were allowed to be diluted with senior management's acquiescence in an effort to remain a leader within the industry."[374]

Based on a similar desire to boost profits, Citigroup's executives decided to retain the "super senior" tranches of CDOs because these CDOs were "hard to sell in the primary issuance market[s] . . . and the bank was reluctant to give up some of the [deal] inception profits."[375] Regulators confirmed that Citigroup relied on an "originate to distribute" strategy for both CDO tranches and leveraged loans, and management ignored the risks that Citigroup would face if it could not sell its loan commitments or CDO tranches at prices close to their face values.[376] Regulators concluded that Citigroup "did not have meaningful hedges. Risk management believed that the leverage lending exposures would be syndicated and the CDO exposures would be sold."[377]

Citigroup's compensation policies encouraged excessive risk-taking by top executives, business unit managers, and traders.[378] In his testimony before the FCIC, Prince acknowledged that "[t]he compensation structure on Wall Street is one that many people have criticized over the years. It is for traders, for bankers and so forth, a compensation model that is based on revenue growth, not even profit growth."[379] Citigroup evidently followed a similar compensation model despite the flaws recognized by Prince. According to one news report, "[b]onuses doubled and tripled for CDO traders" as Citigroup's CDO business expanded, and one Citigroup banker said that "[a]s long as you could grow revenues, you could keep your bonus growing."[380]

Senior executives were the largest beneficiaries of Citigroup's policy of paying for growth. Sandy Weill received almost $1 billion in compensation from Travelers and Citigroup before he stepped down as Citigroup's chairman in April 2006.[381] Chuck Prince was awarded $158 million of cash and stock between 2003 and 2007, [382] while Robert Rubin received $126 million of cash and stock

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373. New York Fed 2007 Citigroup Exam Report, *supra* 251, at 6, 9.

374. *Id* at 3, 6.

375. OCC 2008 Citigroup CDO Memo, *supra* note 369, at 5; *see also* Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 6 ("[M]anagement found that it was unable to distribute the super-senior tranches at favorable prices. As management felt comfortable with the credit risk of these tranches, it began to retain large positions on balance sheet.").

376. NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 3, 6-7, 8-9.

377. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 4.

378. *See supra* notes 247, 286-87 and accompanying text.

379. STANTON, *supra* note 320, at 85 (quoting Prince's testimony on April 8, 2010).

380. Dash & Creswell, *supra* note 2.

381. Roddy Boyd, *Sandy's Goodbye: Praise and Poems at Citi Giant's Farewell*, N.Y. POST, Apr. 19, 2006, at 33; *see also* O'Brien & Creswell, *supra* note 1 (reporting in September 2005 that "[o]ver the last decade, [Weill] has hauled in $953 million in compensation from the companies he has run").

382. Eric Dash, *Fixing Citigroup Will Test Rubin*, N.Y. TIMES, Nov. 5, 2007, at A1.

between 1999 and 2009.[383]

Business unit managers prospered as well. In 2006, Tom Maheras and Randy Barker (senior executives in Citigroup's investment bank) received combined pay of $55 million, while Nestor Dominguez and Janice Warne (co-heads of Citigroup's CDO unit) received total compensation of almost $15 million.[384] Several scholars have concluded that the very large cash and stock awards given by Citigroup and other large financial firms during the 2000s encouraged senior executives to take aggressive risks without adequate concern for the long-term viability of their companies.[385] In addition, anthropologist Karen Ho has suggested that Wall Street executives and traders focused on short-term, high-risk, high-return activities to compensate for the likelihood that they might have relatively short tenures in their positions.[386]

2. Citigroup's Failures in Risk Management.—Regulators found that Citigroup's risk management system was inadequate and ineffective for three main reasons. First, risk management "had insufficient authority or failed to exercise its authority to constrain business activities."[387] Citigroup's individual business units "possessed too much power, and independent risk management

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383. Eric Dash & Louise Story, *Rubin Leaving Citigroup; Smith Barney for Sale*, N.Y. TIMES, Jan. 9, 2009, at B1.

384. *See supra* note 247 and accompanying text.

385. *See, e.g.,* STANTON, *supra* note 320, at 84-87; Lucian Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257, 259-61, 273-77 (2010) (finding that the bonuses and stock awards given to the top executives of Bear Stearns and Lehman Brothers between 2000 and 2008 encouraged them to take excessive risks, because they received $1.4 and $1 billion of such compensation, and those amounts substantially exceeded the $300 million and $600 million of company stock they already held in 2000); Sanjai Bhagat & Brian J. Bolton, Misaligned Bank Executive Incentive Compensation 1-4, 17-21 (June 11, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2277917 (similarly concluding that the bonuses and stock awards given to CEOs of Citigroup and 13 other very large U.S. financial institutions between 2000 and 2008 encouraged them to pursue high-risk strategies, and noting that those CEOs collectively received net cash flow benefits that were $650 million higher than the losses they incurred from stock price declines during 2008); *see also* FCIC REPORT, *supra* note 4, at xix ("Compensation systems—. . . too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. . . . This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.").

386. STANTON, *supra* note 320, at 87 (quoting analysis by Ms. Ho, who pointed to the "rampant insecurity" resulting from "Wall Street's pay-for-performance bonus system" and argued that "bonuses are also seen [by bankers and traders] as symbols of coming to terms with the riskiness of their jobs"); *see also* FCIC REPORT, *supra* note 4, at 8 ("On Wall Street, where many of these [subprime] loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, 'I'll be gone, you'll be gone.' It referred to deals that brought in big fees up front while risking large losses in the future.").

387. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2.

was marginalized."[388] As a result, "risk management played the role more of enabling management to incur what proved to be untenable risks for the sake of profitability."[389] Thus, a crucial flaw was that "Independent Risk Management did not have sufficient stature . . . to be an effective control mechanism in limiting risk taking by the business lines."[390] In fact, Citigroup's senior risk officer did not report directly to the CEO until *after* the bank publicly disclosed major losses in November 2007.[391]

Second, Citigroup's risk managers relied on highly optimistic assumptions that ignored "tail risks" (i.e., the likelihood of extremely adverse outcomes).[392] For example, Citigroup's managers placed great weight on the "AAA" credit ratings assigned to super senior tranches of CDOs, and they did not consider the possibility that Citigroup (i) might be unable to sell its CDO tranches or leveraged loan commitments to investors, or (ii) might be forced to honor its liquidity puts or to bring SIV-held assets back onto its balance sheet.[393] Citigroup's risk limits for individual business units "did not address extreme scenarios that hit the tails," and Citigroup's risk managers admitted that they needed a "better understanding of tail events."[394] Similarly, "Citigroup did not perform comprehensive, firm-wide consolidated stress tests" in order to evaluate the impact of extreme outcomes on the entire bank.[395] All of these shortcomings were consistent with the regulators' finding that risk managers repeatedly granted

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388. OCC 2008 Citigroup CDO Memo, *supra* note 369, at 3; *see also* OCC 2008 Citigroup Exam Report, *supra* note 368, at 4 (stating that "decisions on risk . . . routinely deferred to the senior business unit management's wishes" because risk management did not have "the same level of authority and influence as the business units").

389. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2; *see also id.* at 3 ("In none of the major problem areas (subprime, leveraged lending, trading) did independent risk management play a discernible role in tamping down risk appetite or risk levels.").

390. NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 7; *see also supra* notes 274-78 and accompanying text (discussing evidence that the independence of David Bushnell, Citigroup's chief risk officer, was compromised by his close friendship with Tom Maheras and Randy Barker, who were top executives in Citigroup's investment bank).

391. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 8 (noting that Citigroup's new senior risk officer "will report directly to the CEO. This is a higher stature than previously.").

392. *See infra* notes 393-95 and accompanying text.

393. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 6 ("Citigroup 'bought into the credit agency ratings'" and "saw holding Super Senior AAA tranches as remote disaster insurance"); *id.* at 4 ("Risk management believed that the leveraged lending exposures would be syndicated and CDO exposures would be sold"); *id.* at 10 ("management had no expectation that exposures could come back on balance sheet, nor was this captured in its funding or liquidity plans").

394. *Id.* at 13, 15. *See supra* notes 270, 279-80 and accompanying text (discussing chief risk officer David Bushnell's mistaken assumption that housing prices would have to fall by 30% nationwide before Citigroup would be exposed to losses on its super senior CDO tranches.).

395. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 14.

higher risk limits to accommodate the desire of senior executives and business unit managers for faster revenue growth.[396]

Third, due to Citigroup's highly fragmented structure, the bank "did not have an adequate, firm-wide consolidated understanding of its risk factor sensitivities."[397] By 2008, Citigroup was a sprawling financial conglomerate that held more than $2 trillion in assets, owned more than 2000 subsidiaries, operated in more than 100 countries, and employed more than 300,000 people.[398] Sandy Weill and Chuck Prince failed to integrate their many acquisitions into a coherent whole. Consequently, Citigroup's business units and foreign subsidiaries operated on a decentralized, quasi-independent basis, and those entities used multiple data processing systems that were not compatible and did not communicate with each other.[399] As banking analyst Meredith Whitney observed, "[Prince] inherited a gobbledygook of companies that were never integrated, and it was never a priority of the company to invest. The businesses didn't communicate with each other. There were dozens of technology systems and dozens of financial ledgers."[400]

Regulators found that the "decentralized nature of [Citigroup] created silos" and resulted in "[p]oor communication across businesses."[401] For example, the various business lines dealing with subprime mortgage-related assets–including consumer mortgage lending, securitization, CDO underwriting and CDO trading–did not share information effectively.[402] As a result, Prince and Rubin did not receive detailed information about Citigroup's total subprime-related exposures until September 2007.[403] Given those conditions, it was not surprising

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396. *Id.* at 2-6, 16; OCC 2008 Citigroup Exam Report, *supra* note 368, at 2-4.

397. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 3; *see also id.* at 7 ("Risk management did not adequately bring together total risk of [the] firm by risk factor.").

398. Josh Fineman, *Citigroup Falls to Lowest Since Bank Formed in 1998 (Update 1)*, BLOOMBERG.COM, July 15, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDV0R9M9Edu4, *archived at* http://perma.cc/FX9X-U6G8 (providing data regarding assets, employees and foreign operations in 2008); *see also* STANTON, *supra* note 320, at 126 (tbl. 6.2) (showing that Citigroup had more than 2,400 subsidiaries at the end of 2006).

399. STANTON, *supra* note 320, at 125, 127; Lisa Kassenaar, *Citi Unravels as Reed Regrets Universal Model (Update 2)*, BLOOMBERG.COM, (July 21, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVwxSMeM0MnA, *archived at* http://perma.cc/M4TM-32PP; Bradley Keoun & Lisa Kassenaar, *Pandit Dismantles Weill Empire to Salvage Citigroup*, BLOOMBERG.COM, Jan. 14, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPe0BmS_BI_w, *archived at* http://perma.cc/WAF3-BNME.

400. Dash & Creswell, *supra* note 2 (quoting Ms. Whitney); *see also* BAIR, *supra* note 349, at 124 (stating that, in November 2008, "Citigroup's management information systems were so poor that [the FDIC] really couldn't be certain which operations were in [Citibank], and thus subject to the FDIC's powers, and which were outside the bank, and thus beyond our reach.").

401. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2.

402. *Id.* at 2, 4.

403. FCIC REPORT, *supra* note 4, at 260-65; Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2-7, 17 (explaining that Citigroup "missed the "mortgage correlation"" among

that Citigroup lacked "a comprehensive view [of the] credit, market, liquidity and financial/accounting risks of its various businesses."[404]

B. Federal Regulators Failed to Stop Citigroup from Taking Excessive Risks

In previous articles, I have described numerous regulatory failures that contributed to the severity of the financial crisis and the resulting harm to the U.S. economy.[405] I will not repeat the findings of those articles here. However, I will comment on supervisory failures by Citigroup's three most important regulators—the Fed (including the FRB and the New York Fed), the OCC and the SEC—and suggest possible reasons for those failures.[406]

1. The Fed, OCC and SEC Failed to Restrain Excessive Risk-Taking by Citigroup Despite Their Awareness of the Bank's Rapid Growth and the Inadequacy of the Bank's Risk Management Systems.—In response to a series of scandals involving Citigroup between 2000 and 2004, federal regulators imposed relatively modest penalties and brought an enforcement action against only one Citigroup employee (Jack Grubman).[407] In March 2005, the Fed imposed a moratorium on Citigroup's ability to make additional large acquisitions.[408] However, the Fed lifted that moratorium only one year later.[409] In an internal memorandum recommending that action, Fed staff members stated that Citigroup had made "substantial improvements in its compliance and control infrastructure."[410] Because staff members believed that Citigroup had made

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its various business units that originated, securitized, and traded subprime assets and observing that the bank "historically ran its business on a decentralized basis" and there was no dialogue across businesses) (quotations at 7, 17).

404. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2.

405. *See, e.g.,* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Washington*, 81 U. CIN. L. REV. 1283, 1328-59 (2013) [hereinafter Wilmarth, *Blind Eye*]; Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. LAW 881, 926-40 (2012) [hereinafter Wilmarth, *Misguided Quest*]; Arthur E. Wilmarth, Jr., *The Dodd-Frank's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 897-919 (2011) [hereinafter Wilmarth, *Dodd-Frank's Expansion*].

406. *See* RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 60-61, 136, 600-01 (5th ed. 2013) (explaining that the OCC is the primary regulator for national banks, the Fed is the primary regulator for bank holding companies and financial holding companies, and the SEC is the primary regulator for securities broker-dealers, including those that are affiliates of banks); *see also* FCIC REPORT, *supra* note 4, at 198 (describing the same division of responsibilities among the OCC, the Fed, and the SEC with regard to their respective roles in supervising Citibank, Citigroup, and Citigroup Global Markets).

407. *See supra* notes 162-63 and accompanying text.

408. *See supra* note 164 and accompanying text.

409. FCIC REPORT, *supra* note 4, at 199 (discussing the lifting of the Fed's moratorium in April 2006); Mazzucca, *supra* note 155, at 1 (same).

410. Memorandum from the Bd. of Governors, Fed. Reserve Sys., Div. of Banking

"substantial progress in strengthening its internal control structure"—a view concurred in by the OCC's examiners—the Fed staff proposed that Citigroup should be "free to pursue expansionary activity in the normal course of business."[411]

The wisdom of the Fed staff's recommendation seems very doubtful, in view of Citigroup's repeated scandals between 2000 and 2004 and the staff's acknowledgment that "many aspects of [Citigroup's] compliance risk management processes are new and that it will take time to fully demonstrate their effectiveness."[412] The OCC's decision to concur with the Fed staff's recommendation was similarly questionable. In January 2005, the OCC reviewed Citigroup's CDO business and concluded that "[e]arnings and profitability growth have taken precedence over risk management and internal control."[413] Similarly, in December 2005—only two months before the Fed staff issued its recommendation to lift the moratorium—the OCC issued a report that sharply criticized Citigroup's "Credit Derivatives Trading" operation.[414] That report stated:

> The findings of this examination are disappointing, in that the business grew far in excess of management's underlying infrastructure and control processes. Furthering our concerns is that underlying management processes in the middle office were not capturing relevant metrics to determine whether the pace of growth was sustainable and sufficient. Additionally, control functions raised questions as to the business's capacity to accommodate future growth, but warnings went unheeded. . . . Management oversight is considered less than satisfactory.[415]

The OCC's reports in 2005 clearly identified both the aggressive growth and the inadequate risk controls that were primary causes of Citigroup's near-failure two years later.[416] Indeed, the December 2005 report warned that, "[g]iven [Citigroup's] oversight failure, we are considering options that would limit the bank's ability to perform future business."[417] However, the OCC did not take

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Supervision & Regulation, to Governor Susan Bies (Feb. 17, 2006), at 1, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2006-02-17_FRB_Memo_from_Division_of_Banking_Supervision_and_Regulation_to_Governor_Bies_Re_Upgrade_of_Citigroups_Risk_Management_Rating.pdf, *archived at* http://perma.cc/5NEN-2M42.

411. *Id.* at 2.

412. *Id.*

413. FCIC REPORT, *supra* note 4, at 199 (quoting OCC memorandum dated Jan. 13, 2005).

414. Letter from Ronald H. Frake, OCC Examiner, to Geoffrey O. Coley, co-head, Citigroup Global Fixed Income Div. (Dec. 22, 2005) [hereinafter OCC Frake 2005 Letter], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2005-12-22_OCC_Letter_from_Ronald_H_Frake_to_Geoffrey_O_Coley_Re_Citibank_Derivatives_Examination_Findings.pdf, *archived at* http://perma.cc/7574-W42M.

415. *Id.* at 1.

416. *See supra* notes 413-15 and accompanying text.

417. OCC Frake 2005 Letter, *supra* note 414, at 2.

effective action to restrain Citigroup's growth or to insist on meaningful improvements to Citigroup's risk management systems.[418] Instead, the OCC concurred with the Fed's decision to end the moratorium on large acquisitions by Citigroup.[419]

The OCC subsequently determined that the lifting of the moratorium in April 2006 contributed to Citigroup's collapse.[420] The OCC's 2008 examination report found that "after regulatory restraints against significant acquisitions were lifted, Citigroup embarked on an aggressive acquisition program. Additionally, with the removal of formal and informal agreements, the previous focus on risk and compliance gave way to business expansion and profits."[421] Even before the Fed lifted its moratorium, Citigroup was already generating "organic growth" by expanding its internal operations.[422] After the moratorium expired, Citigroup completed a rapid series of acquisitions, including purchases of several banks and securities firms in foreign countries as well as a U.S. electronic trading firm and a large hedge fund (Old Lane Partners).[423] As a result of Citigroup's accelerated growth strategy, "[i]n two and a half years, the bank's balance sheet ballooned by 58 percent to $2.36 trillion as of Sept. 30, 2007, just before Prince was fired."[424]

The Fed's and the OCC's willingness to tolerate Citigroup's breakneck growth was one of many regulatory shortcomings with regard to Citigroup. The FCIC determined that "the OCC assessed both the liquidity puts and the [CDO] super-senior tranches as part of its reviews of [Citigroup's] compliance with the post-Enron enforcement action, but it did not examine the risks of those exposures."[425] Instead, the OCC "relied on management's assurances in 2006 that the executives would strive to meet the OCC's goals for improving risk management."[426]

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418. FCIC REPORT, *supra* note 4, at 198-99, 303.

419. *Id.* at 199.

420. *Id.*

421. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2.

422. Mazzucca, *supra* note 155; *see also supra* notes 153, 155 and accompanying text (discussing Prince's adoption of an "organic growth" strategy in 2003).

423. Kate Linebaugh, *Citi's Asia Plan: Look Beyond the Elite*, WALL ST. J., Aug. 29, 2007, at C1; *Moving the Market: Citigroup to Buy Electronic Trader for $680 Million*, WALL ST. J., July 3, 2007, at C2; Aaron Lucchetti & Robin Sidel, *Moving the Market: Citigroup Is in Talks to Purchase Automated Trading Desk*, WALL ST. J., June 27, 2007, at C3; *see also* Mazzucca, *supra* note 290, at 19 ("Unleashed almost a year ago from a moratorium imposed by the Federal Reserve Board that barred major acquisitions, Citi made a number of deals in the first quarter that proved that it is once again willing to buy growth, particularly in its international businesses.").

424. Bradley Keoun & Donal Griffin, *Citigroup Ignored 2005 CDO Alarm After Shedding OCC 'Handcuffs,' FCIC Says*, BLOOMBERG.COM, Jan. 28, 2011, *available at* http://www.bloomberg.com/news/2011-01-28/citigroup-ignored-2005-bond-warning-after-shedding-handcuffs-.html, *archived at* http://perma.cc/SG72-9BJ4.

425. FCIC REPORT, *supra* note 4, at 303; *see also id.* at 263 (stating that the OCC "expressed no apprehensions about [Citigroup's] liquidity puts in 2003").

426. *Id.* at 303; *see also id.* at 198-99 (stating that the OCC had criticized Citigroup in January

Similarly, the FRB determined in December 2009 that the New York Fed's supervision of Citigroup was "less than effective" during the period leading up to the financial crisis.[427] The FRB's supervisory review found that the New York Fed "lacked the appropriate level of focus on [Citigroup's] risk oversight and internal audit functions" and also "lacked a disciplined and proactive approach in assessing and validating actions taken by the firm to address supervisory issues."[428] Timothy Geithner—who served as President of the New York Fed from 2004 to 2008 (before President Obama appointed him as Treasury Secretary)—acknowledged in testimony before the FCIC that "I do not think we did enough as an institution with the authority we had to help contain the risks that ultimately emerged in [Citigroup]."[429]

The SEC was the least active of Citigroup's regulators, as it examined Citigroup's securities broker-dealer subsidiary only once every three years, and its most recent examination prior to the financial crisis occurred in 2005.[430] At that time, the SEC's examiners saw nothing "earth shattering," but they did notice that Citigroup had "weaknesses in internal prices and valuation controls . . . and a willingness to allow traders to exceed their risk limits."[431] The SEC evidently did not take any action in response to those findings.

In June 2007, as described above, the SEC asked Citigroup to provide details about its subprime-related exposures.[432] In its response, Citigroup told the SEC that it was omitting $43 billion of liquidity puts and super-senior CDO tranches from its publicly disclosed subprime positions, because Citigroup viewed the "risk of default" on those instruments as "extremely unlikely."[433] The SEC did not order Citigroup to change its disclosures, and Citigroup did not publicly reveal until November 2007 that its total subprime exposures included those liquidity puts and CDO tranches.[434] The FCIC and other analysts have concluded that the SEC's supervision of large securities broker-dealers was generally ineffective during the period leading up to the financial crisis.[435]

2. Explaining the Fed's and the OCC's Regulatory Failures.—The SEC did

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2005 for weaknesses in "risk management and internal controls" in its CDO business).

427. FCIC REPORT, *supra* note 4, at 303 (quoting FEDERAL RESERVE BOARD, FRB NEW YORK 2009 OPERATIONS REVIEW: CLOSE OUT REPORT, at 3, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2009_FRBNY_Operations_Review_Report.pdf, *archived at* http://perma.cc/XHQ9-EE7J.

428. *Id.*

429. *Id.* (quoting Mr. Geithner's testimony on May 6, 2010).

430. *Id.* at 198.

431. *Id.* (summarizing and quoting from FCIC interview with SEC staff members on Feb. 9, 2010).

432. *Id.* at 262.

433. *Id.*; *see also supra* note 281 and accompanying text (discussing Citigroup's meeting with the SEC's examiners in June 2007).

434. *Id.* at 262-265.

435. ENGEL & MCCOY, *supra* note 172, at 208-18; STANTON, *supra* note 320, at 153-54; FCIC REPORT, *supra* note 4, at 149-54, 283.

not maintain a significant regulatory presence at Citigroup, since it examined Citigroup Global Markets only once every three years.[436] In contrast, the Fed and the OCC maintained continuous on-site teams of examiners at Citigroup.[437] As shown above, the Fed's and the OCC's examination reports from 2007 and 2008 provided a detailed and devastating critique of Citigroup's reckless growth, highly speculative activities, and shockingly inadequate risk controls.[438] Why did the Fed and the OCC fail to identify and act on any of those shortcomings *before* Citigroup disclosed its first set of large subprime losses in November 2007?[439] While a more complete discussion of regulatory errors is contained in my previous articles,[440] three factors appear particularly relevant to the Fed's and the OCC's dealings with Citigroup.

First, the OCC and the Fed have structural flaws that make them vulnerable to influence from Citigroup and other major banks.[441] The OCC's budget is funded primarily by assessments paid by the national banks it regulates, and the largest banks pay the highest assessments.[442] The OCC therefore has "powerful budgetary incentives" to please its regulated constituents.[443] The Fed is not subject to the same budgetary pressures as the OCC, because the Fed independently finances its operations by "drawing on earnings from [its] portfolio of Treasury securities and other debt instruments."[444] "However, the banking industry exerts significant influence over the Fed through the 'unique governance structure' of the Fed's twelve regional Federal Reserve Banks (Reserve Banks)."[445] As I observed in a recent article:

> Boards of directors of Reserve Banks have "typically been dominated by senior executives of major banks, large [nonbank] financial firms and leading nonfinancial corporations that are customers of the biggest banks." . . . For example, during the peak of the [financial] crisis between 2007 and 2009, the New York Fed's board of directors included

436. FCIC REPORT, *supra* note 4, at 198.

437. *Id.* at 198-99.

438. *See supra* Part III.B.1.

439. *See* FCIC REPORT, *supra* note 4, at 265, 302 (noting that Citigroup publicly disclosed $55 billion of subprime exposures and up to $11 billion of subprime-related losses on November 4, 2007, while the Fed and the OCC "finally downgraded the company and its main bank to "less than satisfactory" in April 2008 – five months after" Citigroup's public disclosures).

440. *See supra* note 405 (citing articles).

441. *See infra* notes 442-47 and accompanying text.

442. Wilmarth, *Dodd-Frank's Expansion*, *supra* note 405, at 915-16.

443. *Id.*; *see also* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 93-94 (2008) (discussing the OCC's "direct financial stake in keeping its bank clients happy").

444. Wilmarth, *Misguided Quest*, *supra* note 405, at 941.

445. Wilmarth, *Blind Eye*, *supra* note 405, at 1401 (explaining that "[m]ember banks in each Fed district elect six of the nine directors of that district's Reserve Bank, and three of those bank-elected directors vote (along with three additional directors appointed by the FRB) to select the Reserve Bank's president").

> JPMorgan chairman Jamie Dimon, Lehman chairman Richard Fuld, General Electric chairman Jeffrey Immelt, and Goldman director and former chairman Stephen Friedman.[446]

Financial journalists have described the New York Fed as an institution that "is, by custom and design, clubby and opaque," with "a board dominated by the chief executives of some [major] banks."[447] During his tenure as President of the New York Fed, Timothy Geithner frequently met with top executives of major New York financial institutions for professional and private discussions.[448] He was "particularly close to executives of Citigroup," including Robert Rubin, his former mentor at the Treasury Department, and Sanford Weill.[449] Weill tried to persuade Geithner to become Citigroup's new CEO when Chuck Prince stepped down in November 2007, but Geithner declined.[450]

Second, during the 1990s and 2000s, federal banking agencies adhered to a general philosophy that "regulators should seek to minimize any interference with innovation and competition in the financial markets . . . [because] market discipline and private risk management produced better results than government regulation over the longer term."[451] FRB chairman Alan Greenspan was the best-known advocate for that view,[452] but he was hardly alone. Treasury Secretary

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446. *Id.* at 1402 (quoting Wilmarth, *Misguided Quest*, *supra* note 405, at 943).

447. Jo Becker & Gretchen Morgenson, *Geithner, as Member and Overseer, Forged Ties to Finance Club*, N.Y. TIMES, Apr. 27, 2009, at A1 ("At the New York Fed, top executives of global financial giants fill many seats on the board.").

448. *Id.* According to one published report, Geithner frequently held "one-on-one meetings" with senior executives of Citigroup, JPMorgan and other banks regulated by the New York Fed. *Id.* A former New York Fed general counsel stated that such meetings were "not the general practice of Mr. Geithner's recent predecessors" and "[t]ypically, there would be senior staff there to protect against disputes in the future as to the nature of the conversations" involving the New York Fed's president. *Id.* (quoting Ernest T. Patrikis).

449. *Id.* (explaining that Rubin, as Treasury Secretary during the 1990s, "was Mr. Geithner's mentor from his years in the Clinton administration"); *see also* Wilmarth, *Blind Eye*, *supra* note 405, at 1410-11 (stating that Rubin helped to arrange Geithner's appointments as President of the New York Fed in 2003 and as Treasury Secretary in 2009).

450. Becker & Morgenson, *supra* note 447.

451. Wilmarth, *Dodd-Frank's Expansion*, *supra* note 405, at 903-04 (discussing views of FRB chairman Alan Greenspan).

452. *Id.*; *see, e.g.*, Alan Greenspan, FRB Chairman, Remarks at the Nat'l Ass'n of Bus. Econ. Ann. Mtg.: Economic Flexibility (Sept. 27, 2005) [hereinafter Greenspan 2005 Speech] (arguing that the "success of [deregulation] confirmed the earlier views that a loosening of regulatory restraint on business would improve the flexibility of our economy," and "[t]he impressive performance of the U.S. economy over the past couple of decades . . . offers the clearest evidence of the benefits of increased market flexibility"), *available at* http://www.federalreserve.gov/boarddocs/speeches/2005/20050927/default.htm, *archived at* http://perma.cc/95P-3JTP; *see also* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 100 (2009) (stating that there was "no truer believer in the ideology of free

Robert Rubin and his deputy and successor Lawrence Summers actively pursued a deregulatory agenda that included the enactment of GLBA (which ratified Citigroup's universal banking model) and the blocking of efforts by Commodity Futures Trading Commission chairman Brooksley Born to regulate over-the-counter derivatives.[453] Former Comptroller of the Currency Eugene Ludwig noted in 2010 that there was a "historic vision, historic approach, that a lighter hand at regulation was the appropriate way to regulate."[454]

Greenspan, Rubin, and Summers set the tone for a general regulatory "mindset" that favored deregulatory, "light touch" policies during the two decades leading up to the financial crisis.[455] As FRB General Counsel Scott Alvarez later acknowledged, "The mind-set was that there should be no regulation; that the market should take care of policing, unless there already is an identified problem."[456] Richard Spillenkothen, the FRB's Director of Bank Supervision from 1991 to 2006, agreed that regulators had "a high degree of faith that financial markets were largely efficient and self-correcting and, therefore, that counterparty and market discipline were generally more effective 'regulators' of risk-taking and improper practices than government rules and supervisors."[457]

A New York Fed self-study in 2009, which examined the reasons for supervisory failures during the period leading up to the financial crisis, concurred that regulators had placed too much faith in the assumption that "[m]arkets will always self-correct."[458] The New York Fed's self-study echoed a speech by

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markets, financial innovation, and deregulation" than Greenspan); ENGEL & MCCOY, *supra* note 172, at 192 (contending that "Greenspan made it his mission to minimize government oversight by outsourcing risk management to banks").

453. JOHNSON & KWAK, *supra* note 452, at 8-10, 98-100, 104, 133-37; Wilmarth, *Blind Eye*, *supra* note 405, at 1422.

454. STANTON, *supra* note 320, at 149-50 (quoting from an FCIC interview with Mr. Ludwig on Sept. 2, 2010).

455. FCIC REPORT, *supra* note 4, at 96, 170-73, 307-08; Wilmarth, *Blind Eye, supra* note 405, at 1421-26.

456. FCIC REPORT, *supra* note 4, at 96 (quoting from an FCIC interview with Mr. Alvarez).

457. Memorandum from Richard Spillenkothen, on the performance of prudential supervision in the years preceding the financial crisis by a former director of banking supervision and regulation at the Federal Reserve Board (1991 to 2006) (May 31, 2010), at 12 [hereinafter Spillenkothen FCIC Memo]; *see also id.* at 27 (stating that "the culture of the Federal Reserve—an agency dominated by professional economists whose mindset and intellectual biases were to enhance the workings of free markets, not to design regulations—was reinforced by a Chairman who had a strong, deep, and abiding philosophical belief that market and counterparty discipline were more effective in controlling risks than governmental regulation and oversight"), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-05-31%20FRB%20Richard%20Spillenkothen%20Paper-%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf, *archived at* http://perma.cc/9Y57-G22N.

458. FED. RES. BANK N.Y., REP. ON SYSTEMIC RISK & BANK SUPERVISION ("Discussion Draft" of Aug. 18, 2009) 2; *see also id.* at 6 (describing "the common expectation that market forces would efficiently price risks and prompt banks to control exposures in a more effective way than

Chairman Greenspan in September 2005, when he declared,

> We appear to be revisiting Adam Smith's notion that the more flexible an economy, the greater its ability to self-correct after inevitable, often unanticipated disturbances. That greater tendency toward self-correction has made the cyclical stability of the economy less dependent on the actions of macroeconomic policymakers, whose responses often have come too late or have been misguided.[459]

The prevailing deregulatory "mindset" encouraged regulators to view bankers as "customers" who were entitled to helpful and sympathetic "customer service."[460] For example, the New York Fed called its on-site examination teams "relationship management teams,"[461] a term that suggested a very close and symbiotic connection between on-site examiners and the large banks they regulated. Not surprisingly, the New York Fed's 2009 self-study concluded that on-site examiners frequently lacked sufficient independence from the banks they regulated.[462] The study found that "relationship managers were too deferential to bank management and too dependent on the bank's goodwill and [management information systems] to gain information."[463] Bank examiners described the importance of receiving "support from senior management [at the New York Fed] when banks complain about supervisory intrusion, and how demoralizing it can be when [examiners] perceive insufficient support," and one examiner added, "Within three weeks on the job, I saw the capture set in."[464]

Senior OCC officials expressed a similar attitude of deference to banks and the financial markets. For example, Acting Comptroller of the Currency Julie Williams assured a group of bankers in 2005 that (i) the OCC's supervisory approach provided "a spacious framework, designed to accommodate change,"

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regulators. . . . Regulators faced and often shared skepticism that regulators could push for more effective practices than those required by the market for controlling firm risk.") [hereinafter NEW YORK FED 2009 SELF-STUDY], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2009-09-10%20FRBNY%20Report%20on%20Systemic%20Risk%20and%20Bank%20Supervision%20draft.pdf, *archived at* http://perma.cc/CL6-8H27.

459. Greenspan 2005 Speech, *supra* note 452.

460. Wilmarth, *Blind Eye*, *supra* note 405, at 1419.

461. Caroline Salas & Bradley Keoun, *New York Fed's Dahlgren Overhauls Bank Supervision to Beef Up Oversight*, BLOOMBERG.COM, Mar. 21, 2011, http://www.bloomberg.com/news/2011-03-21/new-york-fed-s-dahlgren-overhauls-bank-supervision-to-beef-up-oversight.html, *archived at* http://perma.cc/BQ88-542U.

462. NEW YORK FED 2009 SELF-STUDY, *supra* note 458, at 8.

463. *Id.* at 19; *see also id.* at 8 ("Banks inherently have an information advantage over the supervisors. . . . Getting good, timely information is therefore dependent on the willingness and enthusiasm of bank staff in providing that information. Supervisors . . . believe that a non-confrontational style will enhance that process.").

464. *Id.* at 8, 8 n.2; *see also* STANTON, *supra* note 320, at 163 (observing that the New York Fed's 2009 self-study "found that supervisory staff often feared to speak up" and "were deferential to the banks they regulated").

and (ii) the agency's personnel were "advocates on the national stage [for] measures designed to make regulation more efficient, *and* less costly, less intrusive, less complex, and less demanding on [bankers] and [their] resources."[465] Comptroller of the Currency John Dugan testified at a congressional hearing in 2007 that the OCC strongly opposed any prohibitions against financial "innovations" because "there are many different kinds of innovations that have led to positive things and sorting out which ones are the most positive and somewhat less positive is generally not something that the Federal Government is good at doing."[466]

Timothy Geithner expressed a similar philosophy during his leadership of the New York Fed. During a meeting of the Federal Open Market Committee ("FOMC") in January 2006, he praised retiring Chairman Greenspan as "pretty terrific," and he added, "I think the risk that we decide in the future that you're even better than we think is higher than the alternative."[467] In a May 2007 speech, Geithner stated positions that were remarkably similar to those voiced by Greenspan two years earlier.[468] Like Greenspan, Geithner applauded "[c]hanges in financial markets . . . [that] have improved the efficiency of financial intermediation and improved our confidence in the ability of markets to absorb stress."[469] Geithner maintained that "[f]inancial innovation has improved the capacity to measure and manage risk" and to enable risk to be "spread more broadly across countries and institutions."[470] Geithner cautioned, as Greenspan

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465. Wilmarth, *Dodd-Frank's Expansion*, *supra* note 405, at 905 (quoting speech by Ms. Williams on May 27, 2005) (italics added).

466. ENGEL & MCCOY, *supra* note 172, at 173 (quoting Mr. Dugan's testimony in Sept. 2007).

467. Binyamin Appelbaum, *Inside the Fed in '06: Coming Crisis, and Banter*, N.Y. TIMES, Jan. 13, 2012), *available at* http://www.nytimes.com/2012/01/13/business/transcripts-show-an-unfazed-fed-in-2006.html?pagewanted=all&_r=0, *archived at* http://perma.cc/997Y-BBBK (quoting Mr. Geithner). At two FOMC meetings in late 2006, Geithner expressed little concern about emerging problems in the housing market and stated that the "fundamentals of the [economic] expansion going forward still look good." *Id.* (quoting Mr. Geithner's remarks in December 2006, and also quoting Mr. Geithner's comment in September 2006 that "[w]e just don't see troubling signs yet of collateral damage [from the housing market], and we are not expecting much").

468. *Compare* Timothy Geithner, Pres. Fed. Res. Bank N.Y., Remarks at the Fed. Res. Bank of Atlanta's 2007 Financial Markets Conference: Liquidity Risk and the Global Economy (May 15, 2007), *available at* http://www.newyorkfed.org/newsevents/speeches/2007/gei070515.html, *archived at* http://perma.cc/B9LM-FAAD [hereinafter Geithner 2007 Speech], *with* Greenspan 2005 Speech, *supra* note 452.

469. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan Speech, *supra* note 452 ("Deregulation and the newer information technologies have joined, in the United States and elsewhere, to advance flexibility in the financial sector" as well as "[f]inancial stability.").

470. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan 2005 Speech, *supra* note 452 (acclaiming "[c]onceptual advances in pricing options and other complex financial products" that "lowered the costs of, and expanded the opportunities for, hedging risks that were not readily deflected in earlier decades").

had in 2005, that financial markets remained vulnerable to unexpected "shocks," particularly after an extended period of low interest rates and comparative stability in the global economy.[471] However, Geithner, like Greenspan, remained optimistic about the strength and resilience of the banking system:

> The dramatic changes we've seen in the structure of financial markets over the past decade and more seem likely to have reduced this vulnerability [to financial shocks]. The larger global financial institutions are generally stronger in terms of capital relative to risk. Technology and innovation in financial institutions has made it easier to manage risk. Risk is less concentrated within the banking system.[472]

Geithner contended, as Greenspan had, that federal regulators "do not have the capacity to eliminate the risk of excess leverage or asset price misalignments, nor do we have the ability to act preemptively to defuse them."[473] Geithner also opposed, as did Greenspan, the use of strong regulatory measures to deal with the potential risks of financial shocks.[474] For example, Geithner saw "little prospect that supervision will have the capacity to identify and address potential concentrations in exposure to individual risk factors, whether through changes to capital charges or other means."[475] Geithner also argued that regulators "do not have the capacity to put in place a transparency regime over markets that would give people a real-time picture of the incidence and magnitude of potential risks."[476]

Instead, Geithner advocated market-friendly supervisory policies that would encourage financial institutions to maintain larger "financial cushions" and to

471. *Compare* Geithner 2007 Speech, *supra* note 468 ("Financial innovation and global financial integration do not offer the prospect of eliminating the risk of asset price and credit cycles, of manias and panics, or of shocks that could have systemic consequences."), *with* Greenspan 2005 Speech, *supra* note 452 ("History cautions that extended periods of low concern about credit risk have invariably been followed by reversal, with an attendant fall in the prices of risky assets," due to the "all-too-evident alternating and infectious bouts of human euphoria and distress and the instability they engender.").

472. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan 2005 Speech, *supra* note 452 ("New instruments of risk dispersal have enabled the largest and most sophisticated banks . . . to divest themselves of much credit risk" and have produced a "far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago.").

473. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan 2005 Speech, *supra* note 452 ("Relying on policymakers to perceive when asset bubbles have developed and then to implement timely policies to address successfully these misalignments in asset prices is simply not realistic.").

474. *See* Greenspan 2005 Speech, *supra* note 452 (advocating a reliance on "self-correction" by market forces and arguing that responses by financial policymakers to "unanticipated disturbances . . . often have come too late or have been misguided").

475. Geithner 2007 Speech, *supra* note 468.

476. *Id.* ("The pace of change is too rapid, the number of positions, funds, and institutions too great, and the analytical challenge too complex to offer the promise of that type of early warning system.").

adopt other "market-led initiatives" (such as improving industry standards for reporting derivatives trades and managing counterparty credit risk) that would be "reinforced rather than imposed by supervision."[477] Geithner's adherence to Greenspan's deregulatory philosophy and Geithner's emphasis on "market-led initiatives" help to explain why the New York Fed failed to take timely or effective action to prevent Citigroup's excessive risk-taking.

In sharp contrast to Geithner's distrust of the efficacy of preventive regulation, his aversion to vigorous government action disappeared when Citigroup and other major banks faced serious threats to their survival in 2008 and 2009.[478] Geithner became the earliest and the most outspoken advocate inside the federal government for aggressive bailouts of large banks.[479] He pushed hard to secure full protection for all of the creditors of Citigroup and other major banks.[480] He strongly—and largely successfully—opposed efforts by other regulators (including FDIC chairman Sheila Bair and TARP Special Inspector General Neil Barofsky) to attach strong conditions to those rescues.[481] A leading Wall Street lawyer described Geithner as "the federal regulator who was most willing to 'push the envelope'" to prevent major bank failures.[482]

The Greenspan-Rubin-Geithner consensus, which favored regulatory deference to internal risk management systems at big banks, contributed to a third major regulatory error. During the past three decades, federal regulators increasingly focused on evaluating the risk management policies and procedures of large banks as well as the banks' "internal models" and "credit risk metrics," and regulators stopped doing traditional "full scope" examinations for major banks.[483] Traditional examinations would have required "transaction testing," including "sufficiently robust testing to determine how well in reality [internal bank control] processes did work or would work in a prolonged period of high stress."[484]

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477. *Id.*; *see also* Becker & Morgenson, *supra* note 447 (reporting that Geithner "pushed the [financial] industry to keep better records of derivatives deals . . . . But he stopped short of pressing for comprehensive regulation and disclosure of derivatives trading and even publicly endorsed their potential to damp risk.").

478. Becker & Morgenson, *supra* note 447.

479. *Id*.

480. *Id.*

481. BAIR, *supra* note 349, at 99-100, 105, 117-19, 122-26, 165-73, 201-07; NEIL BAROFSKY, BAILOUT: AN INSIDE ACCOUNT OF HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET 71-78, 98-101, 151-57, 170-74, 192-200, 226-29 (2012); ONARAN, *supra* note 14, at 81-87, 105, 117-18 (explaining that "[t]he idea for a blanket guarantee [of bank liabilities] was first brought up by Timothy Geithner . . . during the summer of 2008," at 81, and contending that Geithner worked "to save the big banks at any cost," at 105); Becker & Morgenson, *supra* note 447 ("Mr. Geithner has been a leading architect of [bank] bailouts, the activist at the head of the pack.").

482. Becker & Morgenson, *supra* note 447 (quoting H. Rodgin Cohen).

483. Spillenkothen FCIC Memo, *supra* note 457, at 10-11.

484. *Id* at 11; *see also id.* at 12, 15-16 (contending that the Basel II capital accord encouraged

Fed chairman Greenspan addressed this issue at a congressional hearing in May 1997.[485] At that hearing, he declared that the Fed was seeking to avoid "unduly intrusive" supervision by focusing on "risk management and control systems" within bank holding companies.[486] Greenspan explained that the Fed had discarded its "traditional approach" for supervising bank holding companies and was instead following "a more risk-focused/less transaction-testing approach to inspections" that placed "greater reliance on internal and external auditors."[487]

In a November 2012 speech, FDIC Vice Chairman Thomas Hoenig questioned the wisdom of the current regulatory focus on internal risk management systems at major banks.[488] He criticized the fact that "full-scope examinations have been de-emphasized in favor of targeted reviews" and "model validations."[489] He argued that the current preference for limited-scope reviews is based on the mistaken assumption that the largest banks are "too large and complex for full scope examinations."[490] In Hoenig's view, "full exams are doable" for big banks, because regulators can use reliable statistical "sampling methodologies for auditing and examining large bank asset portfolios and other operations . . . at an affordable cost."[491] In a subsequent interview, Hoenig contended that bank examiners should "spend more time studying individual files to verify the quality of a bank's internal reports about its risk management capability."[492]

The "skeptical" views expressed by banking industry consultants in response to Hoenig's comments indicate that his proposal for renewed transaction testing would threaten the current ability of big banks to conduct "business as usual" without strong regulatory oversight.[493] In my opinion, to expect bank examiners to evaluate a major bank by checking the bank's internal risk models and procedures, but without testing reliable samples of the bank's actual transactions, is as futile as asking a car mechanic to check "the computer codes that run the car" without "looking at the tires or the fluid levels or the gaskets to see if they

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"an excessive faith in internal bank risk models [and] an infatuation with the specious accuracy of complex quantitative risk measurement techniques").

485. Statement by Fed. Res. Bd. Chairman Alan Greenspan before the House Comm. on Banking & Financial Services, 83 Fed. Res. Bulletin 578 (May 22, 1997).

486. *Id.* at 582.

487. *Id.*

488. Thomas M. Hoenig, FDIC Vice Chairman, Remarks at AICPA/SIFMA FSA Nat'l Conference: Financial Oversight: It's Time to Improve Outcomes (Nov. 20, 2012), *available at* http://www.fdic.gov/news/news/speeches/chairman/spnov3012.html, *archived at* http://perma.cc/7DGG-YHBA.

489. *Id*.

490. *Id.*

491. *Id.*

492. Joe Adler, *FDIC's Hoenig Proposes 'Full Scope' Big Bank Exams*, AM. BANKER, Feb. 12, 2013, at 1 (summarizing Mr. Hoenig's comments).

493. *Id.* (reporting that some "D.C. policy watchers" were "skeptical" about Hoenig's proposal for full-scope examinations for big banks).

were deteriorating."[494] It is difficult to believe that regulators would have failed to identify the enormous risks at Citigroup between 2004 and 2007 if regulators had rigorously analyzed and tested reliable samples of actual transactions within Citigroup's subprime mortgage origination and securitization units, its CDO trading unit, and its leveraged lending business.

CONCLUSION

Citigroup's tarnished history of repeated scandals and bailouts presents a serious challenge for those who continue to defend the virtues of universal banking. For example, supporters of big diversified banks have claimed that financial conglomerates weathered the crisis better than standalone investment banks like Bear Stearns, Lehman and Merrill.[495] In fact, however, the survival of Citigroup and BofA depended on the federal government's willingness to give them enormous bailout packages, which in turn reflected the broader policy decision that "no [financial] supermarket could possibly be allowed to fail."[496]

Citigroup's many missteps have inflicted heavy losses on its shareholders. Citigroup's stock price fell by 17% under Chuck Prince (who resigned in November 2007)[497] and by a further 89% under Vikram Pandit (who stepped down in October 2012).[498] Citigroup's board of directors appointed Michael

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494. *Id.* (quoting my comments in support of Hoenig's proposal).

495. *See, e.g.*, Donna Borak, *The Case Against Restoring Glass-Steagall*, AM. BANKER (Aug. 8, 2012), http://www.americanbanker.com/issues/177_152/the-case-against-restoring-glass-steagall-1051651-1.html, *archived at* http://perma.cc/F9BY-VU8L (citing arguments made by supporters of universal banks against reinstatement of Glass-Steagall-type barriers between commercial banks and securities firms).

496. John Authers, *Markets Make Best Case for Glass-Steagall*, FIN. TIMES (July 14, 2012), http://www.ft.com/cms/s/0/14e08822-eb04-11e2-9fcc-00144feabdc0.html#axzz2jyfEAidD, *archived at* http://perma.cc/H38Q-V6ST; *see also* Devin Leonard, *Company on Fire? Light a Cigar: Why Troubled Companies Like Citigroup Keep Hiring Dick Parsons*, BLOOMBERG BUS. WK., Mar. 28-Apr. 3, 2011, at 85, 90 (reporting that Treasury Secretary Timothy Geithner told Citigroup chairman Dick Parsons that Citigroup was "too important an institution to go down") (quoting Mr. Parsons); Matt Taibbi, *Ludicrous Times Op-Ed Forgets Entire Year of Wall Street History*, ROLLING STONE (Aug. 1, 2012), http://www.rollingstone.com/politics/blogs/taibblog/ludicrous-times-op-ed-forgets-entire-year-of-wall-street-history-20120801 *archived at* http://perma.cc/3J57-9G2H ("[T]he total [government] outlay for Citigroup was $476 billion in cash and guarantees—they were the biggest single bailout recipient, . . . [with] Bank of America [receiving] $336 billion in cash and guarantees.").

497. Rich Miller & Yalman Onaran, *Rubin to Draw on Crisis Management Experience at Citi (Update 2)*, BLOOMBERG, Nov. 5, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRqfhs4RlN1g, *archived at* http://perma.cc/8BMX-7RG9.

498. Suzanne Kapner et al., *Pandit Is Forced Out at Citi*, WALL ST. J., Oct. 17, 2012, at A1; *see also* Donal Griffin & Christine Harper, *Former Citigroup CEO Weill Says Banks Should Be Broken Up*, BLOOMBERG, July 25, 2012, http://www.businessweek.com/news/2012-07-25/weill-says-banks-should-be-broken-up, *archived at* http://perma.cc/TE9-WYDR ("Citigroup's shares,

Corbat to replace Pandit,[499] and Corbat declared, "We've got to get to a point where we stop destroying our shareholders' capital."[500] Mr. Corbat's blunt statement reflected the dismal fact that Citigroup's shares were trading at only 67% of the company's declared book value in January 2013.[501]

By the end of 2008, many financial analysts concluded that Citigroup and its universal banking peers were not only TBTF but also too big to manage or regulate, and that view has persisted.[502] Regulators pressured Citigroup's management to reduce the company's size by selling or spinning off "noncore"

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which traded as high as $564.10 at the end of 2006, when adjusted for a [10:1] reverse stock split, plummeted to $10.20 during March of 2009 . . . . They closed at $25.79 yesterday."); Matt Taibbi, *When Did Sandy Weill Change His Mind About Too Big to Fail? And Why?*, ROLLING STONE, Aug. 3, 2012, http://www.rollingstone.com/politics/blogs/taibblog/when-did-sandy-weill-change-his-mind-about-too-big-to-fail-and-why-20120803, *archived at* http://perma.cc/3W3D-8ZPA (discussing an assumed decline in value of Sandy Weill's Citigroup stock from about $792 million in 2003 to about $42 million in 2012, due in part to Citigroup's 10:1 reverse stock split in May 2012).

499. Kapner et al., *supra* note 498; *see also* Jessica Silver-Greenberg & Susanne Craig, *Citi Chairman Is Said to Have Planned Chief's Exit Over Months*, N.Y. TIMES, Oct. 26, 2012, at A1.

500. Donal Griffin, *Citigroup Goal Is to Stop Shareholder Capital Destruction*, BLOOMBERG (Jan. 17, 2013) http://www.bloomberg.com/news/2013-01-17/citi-ceo-says-goal-is-to-stop-destroying-shareholders-capital.html, *archived at* http://perma.cc/VYH-2Y4S (quoting Mr. Corbat).

501. *Id.* (also noting that "Citigroup's shares have declined 92 percent in the past six years").

502. *See, e.g.*, Authers, *supra* note 496 (stating that Citigroup and BofA "proved unmanageable because of their sheer complexity. This contributed to awful errors in risk management"); Simon Johnson, *Five Facts About the New Glass-Steagall*, BLOOMBERG, July 11, 2013, http://www.bloomberg.com/news/2013-07-11/five-facts-about-the-new-glass-steagall.html, *archived at* http://perma.cc/8MFH-L45Z ("The biggest U.S. banks have become too big to manage, too big to regulate, and too big to jail."); Jessica Silver-Greenberg & Susanne Craig, *Citigroup's Chief Resigns in Surprise Step*, N.Y. TIMES, Oct. 17, 2012, at A1 ("[Citigroup] is emblematic of financial institutions that are too large to manage because of labyrinthine bureaucracy and underperforming divisions."). For earlier statements of that perspective, see, e.g., *Breaking Up the Citi*, WALL ST. J., Jan. 14, 2009, at A12 (editorial) ("A bank that consistently has to be rescued by taxpayers lest it take down the entire financial system is too big to succeed. . . . Citi's repeated brushes with death prove that its management has never figured out how to run the business."); Kevin Dobbs & Paul Davis, *Citi Spinoff: Beginning of Its Endgame*, AM. BANKER, Jan. 13, 2009, at 1 (quoting analyst Karen Shaw Petrou's statement that "the strategic value of the oligarch bank model was never proven . . . . Under current market conditions, it clearly does not work."); Kevin Dobbs, *Even After Infusion Citi Seen Needing Fix*, AM. BANKER, Nov. 25, 2008, at 1 (reporting on analyst Christopher Whalen's view that the "global model" of Citigroup was "broken" because it was "too vast to manage all the various parts effectively, . . . forcing Citi in recent years to take big risks on exotic mortgages and securities to prop up its bottom line"); Annys Shin, *Citi's Relentless Quest for Growth*, WASH. POST, Nov. 25, 2008, at D01 (stating that "Citi was too big to manage well," and quoting legal scholar Jerry Markham's observation that Citigroup's "business model – a complete financial services firm – is nothing but trouble. . . . There's always some unit having a crisis.").

assets, and Citigroup adopted a plan that reduced its assets from $2.36 trillion in September 2007[503] to $1.94 trillion in September 2012.[504] Even so, Citigroup has retained a "core" group of universal banking operations, including trading in equity and debt securities, trading in foreign exchange, securities underwriting and other investment banking activities.[505] Thus, notwithstanding Citigroup's disastrous experience with capital markets activities, it seems unlikely that the company will choose voluntarily to divest those activities and return to Citicorp's former status as a commercial bank.

The co-founders of Citigroup have admitted that the company's universal banking model failed to achieve their bullish projections of success when Citigroup was formed in 1998.[506] Former co-CEO John Reed apologized in 2009 for his role in creating Citigroup and said that Congress made a mistake when it

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503. Keoun & Griffin, *supra* note 424.

504. Kapner et al., *supra* 498; *see also* Eric Dash, *Citigroup Plans to Split Itself Up Taking Apart the Financial Supermarket*, N.Y. TIMES, Jan. 14, 2009, at B1 ("Federal regulators pushed Mr. Pandit to move faster" in adopting "a strategy that now includes whittling Citigroup's financial supermarket into a core operation . . . and a group of noncore, loss-inducing business."); David Enrich, *Citigroup Takes First Step Toward Breakup*, WALL ST. J., Jan. 10, 2009, at A1 ("In December [2008], government officials started pressing Mr. Pandit and his deputies to devise and articulate a new strategy to slim down the financial colossus."); Monica Langley & David Enrich, *Citigroup Chafes Under U.S. Overseers*, WALL ST. J., Feb. 25, 2009, at A1 (reporting that the federal government's "ongoing pressure to slim down the company has forced Citigroup executives to consider a range of unwanted options," and Citigroup agreed to "split itself into two parts, with the goal of selling additional assets and businesses"); Heather Landy, *Weighing the Future of Citi 'Holding' Pen*, AM. BANKER, Sept. 21, 2009, at 1 (describing Citigroup's decision to move $649 billion of its "noncore" assets into a new "Citi Holdings" division for eventual sale or other disposition); Michael J. Moore et al., *Citigroup Productivity Worst of Big Banks Shows Challenge*, BLOOMBERG, Oct. 25, 2012, http://www.bloomberg.com/news/2012-10-25/citigroup-productivity-worst-of-big-banks-shows-challenge.html, *archived at* http://perma.cc/XY3B-TQUQ (reporting that Citi Holdings had reduced its assets to $174 billion).

505. Donal Griffin, *Citigroup Profit Beats Estimates as Stock Trading Gains*, BLOOMBERG, July 15, 2013, http://www.bloomberg.com/news/2013-07-15/citigroup-42-profit-rise-beats-estimates-as-stock-trading-gains.html, *archived at* http://perma.cc/M84Q-Z3Z6; David Henry, *Citigroup Profit Jumps 42 Percent on Stronger Markets*, REUTERS, July 16, 2013, http://www.reuters.com/article/2013/07/15/us-citigroup-results-idUSBRE96E0BZ20130715, *archived at* http://perma.cc/V9KU-CJ9V; *see also* Donal Griffin & Bradley Keoun, *Citigroup Earnings Miss Estimates as Stock and Bond and Bond Trading Revenue Slumps*, BLOOMBERG, Jan. 18, 2011, http://www.bloomberg.com/news/2011-01-18/citigroup-net-misses-estimates-on-charges-tied-to-tighter-credit-spreads.html, *archived at* http://perma.cc/EY4Y-L5Y7 (reporting that Citigroup produced more than $3 billion of quarterly revenue from "equity-trading" and "fixed-income" trading as well as its "investment-banking operation," and stating that "investment-banking" remained one of Citigroup's "core" businesses).

506. *See supra* notes 6-7, 9 and accompanying text (discussing the bold predictions for Citigroup's success made by John Reed and Sandy Weill in 1998).

repealed the Glass-Steagall Act in 1999.[507] Reed expanded on those views in 2013, explaining that "the greatest problem [Citigroup encountered] was of clashing cultures" between traders and commercial bankers.[508] As the trading culture grew within Citigroup, that culture became "infectious" and "a more dominant part of the organization."[509] In Mr. Reed's view, the increased emphasis on trading also undermined the effectiveness of Citigroup's risk management system.[510] Risk officers were reluctant to challenge high-risk capital markets transactions because the completion of those transactions was a leading metric for determining compensation.[511] Moreover, universal banking "turned out not to produce the hoped-for savings for the bank" because Citigroup needed to hire "highly-paid" investment bankers in order to sell "sophisticated products" to customers.[512] The complexity of Citigroup's widely dispersed operations also meant that the company "became harder to manage."[513]

At first, Sandy Weill defended Citigroup and the universal banking model against Reed's criticisms.[514] He acknowledged in January 2010 that he was mistaken in assuming that Citigroup was "impregnable," but he blamed Citigroup's collapse primarily on Chuck Prince's poor management.[515]

By mid-2012, Weill had evidently changed his mind. In an interview on CNBC, he said that policymakers should "split up investment banking from banking, have banks be deposit takers, have banks make commercial loans and real estate loans, have banks do something that's not going to risk the taxpayer dollars, that's not too big to fail."[516] He called for universal banks to "be broken

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507. Bob Ivry, *Reed Says 'I'm Sorry' for Role in Creating Citigroup (Update 1)*, BLOOMBERG, Nov. 6, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=albMYVE7D578, *archived at* http://perma.cc/6WM6-PJYX.

508. John Authers, *Culture Clash Means Banks Must Split, Says Former Citi Chief*, FIN. TIMES, Sept. 8, 2013, http://www.ft.com/intl/cms/s/0/2cfa6f18-1575-11e3-950a-00144feabdc0.html# axzz32qOGqcmh.

509. *Id.* (quoting and summarizing Mr. Reed's comments); *see also* FCIC REPORT, *supra* note 4, at 265 (quoting from interview with Mr. Reed on Mar. 24, 2010, in which he said that a "culture change" occurred after Salomon Brothers combined with Citibank as part of the formation of Citigroup in 1998. According to Mr. Reed, the Salomon executives "were used to taking big risks" and "had a history of . . . [of] making a lot of money . . . but then getting into trouble"); *see also supra* notes 56-59 and accompanying text (discussing Salomon's culture of aggressive risk-taking).

510. Authers, *supra* note 508 (summarizing Mr. Reed's comments).

511. *Id.* (quoting Mr. Reed).

512. *Id.*

513. *Id.*

514. Katrina Booker, *Citi's Creator, Alone with His Regrets*, N.Y. TIMES, Jan. 3, 2010, § BU, at 1 (reporting that Mr. Weill was proud of his role as "[t]he Shatterer of Glass-Steagall" and rejected Mr. Reed's criticism of the repeal of Glass-Steagall).

515. *Id.* (also describing Mr. Weill's regret that Citigroup had "hurt the dreams of so many people").

516. Kevin Wack, *Weill Puts Glass-Steagall Back on Washington's Agenda*, AM. BANKER, July 26, 2012 (available on Lexis) (quoting Mr. Weill's statements during the CNBC interview).

up so that the taxpayer will never be at risk, the depositors won't be at risk, the leverage of the [commercial] banks will be something reasonable," while standalone investment banks would be able to "make some mistakes" without threatening a systemic crisis.[517]

The statements of Reed and Weill are consistent with Citigroup's lamentable record of managerial and regulatory failures. Citigroup's history indicates that the universal banking model is deeply flawed by its excessive organizational complexity, its vulnerability to culture clashes and conflicts of interest, and its tendency to permit excessive risk-taking within far-flung, semi-autonomous units that lack adequate oversight from either senior management or regulatory agencies.

In contrast to Reed and Weill, Robert Rubin has maintained his longstanding support for the universal banking model. During interviews with journalists in 2008, Rubin blamed Citigroup's problems not on organizational or managerial shortcomings but instead on a rare confluence of economic events that had created a "perfect storm," which nobody had foreseen.[518] Rubin strongly reaffirmed his faith in the value of large universal banks in a subsequent interview with David Rothkopf.[519] When Rothkopf asked Rubin "whether the biggest and most influential financial organizations ought to be broken up, whether 'too big to fail' was a problem to be addressed," Rubin's emphatically disagreed:

> "'No,' [Rubin] said, 'don't you see? Too big to fail isn't a problem with the system. It *is* the system. You can't be a competitive global financial institution serving global corporations of scale without having a certain scale yourself. The bigger multinationals get, the bigger financial institutions will have to get.'"[520]

Lobbying organizations for large financial conglomerates have echoed Rubin's claim that the U.S. needs megabanks like Citigroup in order to serve global business corporations and to compete with foreign universal banks.[521]

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517. *Id.*

518. Schwartz & Dash, *supra* note 3; *see also* Brown & Enrich, *supra* note 244 (summarizing a November 2008 interview, in which Mr. Rubin stated that he had been "a very constructive part of the Citigroup environment." He also claimed that "what came together [in the financial crisis] was not only a cyclical undervaluing of risk [but also] a housing bubble, and triple-A ratings were misguided. . . . There was virtually nobody who saw that low-probability event as a possibility."); *see also* Wilmarth, *Blind Eye*, *supra* note 405, at 1293 (citing academic studies rejecting the claim that the financial crisis was a "perfect storm" that bankers and regulators could not have foreseen).

519. DAVID ROTHKOPF, POWER, INC.: THE EPIC RIVALRY BETWEEN BIG BUSINESS AND GOVERNMENT—AND THE RECKONING THAT LIES AHEAD 266 (2012) (quoting undated recent interview with Mr. Rubin).

520. *Id.*

521. *See, e.g.*, Rob Nichols, *U.S. Can't Afford to Break up Big Banks*, DALLAS MORNING NEWS, Jan. 28, 2013 (op-ed by President and CEO of the Financial Services Forum, contending that "large banking institutions provide unique and significant value that smaller banks simply cannot provide—in the sheer size of credits they can deliver, the wide array of products and services they

However, most big bank advocates do *not* acknowledge, as Rubin did, that the TBTF policy is the price that must be paid for the continued existence of global megabanks. In my view, that price is simply too great to accept in view of the massive governmental bailouts that were required to rescue Citigroup, BofA and other global megabanks during the financial crisis (e.g., ABN Amro, Commerzbank, Fortis, ING, Lloyds HBOS, Royal Bank of Scotland and UBS),[522] as well as the enormous economic costs inflicted by the crisis.[523] Moreover, it is highly doubtful whether the U.S., U.K., and European Union would have the necessary fiscal and monetary resources to finance similar bailouts of megabanks should another financial crisis occur during the coming decade.[524]

Because the price of the universal banking model is too costly to bear, I have advocated legal reforms that would remove government subsidies currently exploited by financial conglomerates.[525] Removing those subsidies would subject universal banks to market forces similar to those that forced the breakup of many commercial and industrial conglomerates during the 1980s and 1990s.[526] Other scholars and policymakers have advocated more far-reaching measures, including maximum size caps on financial institutions and a Glass-Steagall type of separation between banks and capital markets activities.[527] While the most promising reforms are still a matter of debate, it is abundantly clear, given the unfortunate history of Citigroup and many of its megabank peers, that we cannot afford to tolerate the status quo.

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offer, and in their geographic reach. . . . Breaking up large banking companies would only send the business of corporations like AT&T, Texas Instruments and Southwest Airlines overseas" to foreign universal banks), *available at* http://www.dallasnews.com/opinion/latest-columns/20130128-rob-nichols-u.s.-cant-afford-to-break-up-big-banks.ece, *archived at* http://perma.cc/5QP4-LB9Z; The Clearing House Ass'n, *Study Examines Large Banks' Contributions to the Economy* (Nov. 7, 2011) (announcing release of sponsored study concluding that the twenty-six largest U.S. banks provide significant benefits to "consumers, companies and governments . . . in the form of economics of scale, the broad scope of products and services that large banks provide, and the spread of banking innovation."), *available at* https://www.theclearinghouse.org/publications/2011/economics-of-large-banks, *archived at* http://perma. cc/G97K-W3JY.

522. Wilmarth, *Dodd-Frank*, *supra* note 231, at 958-59, 978-79; *see also* Wilmarth, *Blind Eye*, *supra* note 405, at 1312-14, 1345-47.

523. Wilmarth, *Blind Eye*, *supra* note 405, at 1314-17.

524. ONARAN, *supra* note 14, at 4-13, 147-56.

525. *See, e.g.*, Wilmarth, *Dodd-Frank*, *supra* note 231, at 1034-52, 1056-57.

526. *Id.* (describing my "narrow bank" proposal).

527. JOHNSON & KWAK, *supra* note 452, at 208-20 (advocating the imposition of maximum size caps); Jeff Bater, *Systemic Risk: McCain, Warren Push Glass-Steagall Bill to Reduce Risks from Megabanks*, 101 BNA'S BANKING REPORT 95 (July 16, 2013) (discussing the introduction of a proposed bill, the "21st Century Glass-Steagall Act," by Senators Elizabeth Warren (D-MA), John McCain (R-AZ) and Maria Cantwell (D-WA)).

REMARKS AT THE INDIANA LAW REVIEW SYMPOSIUM ON "LAW AND THE FINANCIAL CRISIS" APRIL 5, 2013*

PETER J. WALLISON**

INTRODUCTION

In 1981, under Secretary Donald Regan, the Treasury Department proposed a radical approach to bank deregulation.[1] The Glass-Steagall Act was in full effect at the time, and it prohibited banks from engaging in underwriting or dealing in corporate securities and from being affiliated with any firm that engaged in these activities.

The reasons for the 1981 Treasury plan were relatively simple. It was becoming clear even then that banks were losing their role as the primary sources of finance for the real economy. Increasingly, companies that had registered their securities with the SEC were going to the securities markets for financing, issuing bonds, notes, and commercial paper for their long, medium, and short-term financial needs.

Once companies began to report regularly to the SEC on their financial condition, investors were able to decide for themselves the risks associated with fixed income securities. The intermediation of banks—with their special knowledge of the financial condition of their borrowers—was no longer necessary. It was much cheaper for issuers of securities to pay underwriting fees than to negotiate loan agreements with banks and pay the higher interest costs banks required.[2]

Since the 1980s that trend has continued. The banking industry has provided about $1.5 trillion in financing to business borrowers, while the securities industry has provided about ten times as much, $15 trillion.[3] In 1965, bank lending to real estate was less than twenty-five percent; by 2008, over fifty-five percent of bank lending was to real estate, and continuing to rise. The reason, of

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1. Paul A. Samuelson, *Evaluating Reganomics*, 27 CHALLENGE 4, 8 (1984).
2. *Id.*
3. *Federal Reserve Statistical Release Z.1*, FINANCIAL ACCOUNTS OF THE UNITED STATES, http://www.federalreserve.gov/Releases/z1/Current/data.htm, *archived at* http://perma.cc/4X3H-V2NV (last updated Dec. 10, 2009).

course, is that real estate developers and small businesses seldom have access to securities market funding, so they have to borrow from banks. But lending to the volatile real estate business and the small business community is not going to sustain the U.S. banking system over the long term.

Under the Treasury plan, banks themselves would continue to be restricted by Glass-Steagall, but bank holding companies—ordinary corporations that control one or more banks—would be able to underwrite and deal in securities or control subsidiaries that did so. Then, as now, most banks, and all the large ones, were subsidiaries of holding companies.[4] To permit this structure to work, the sections of Glass-Steagall that prohibited affiliations between banks and securities firms had to be repealed. In other words, the Treasury's idea was to free bank holding companies—but not banks—from restrictions on the kinds of financial activities in which they could engage, allowing them to offer a variety of financial services as the market for these services developed.[5]

The key elements of the original Treasury plan were finally adopted in the Gramm-Leach-Bliley Act ("GLBA") of 1999, which repealed a portion—but not all—of Glass-Steagall. Its policy purpose was to allow bank holding companies to engage in other financial activities, such as underwriting insurance as well as underwriting and dealing in securities, though it retained the portion of Glass-Steagall that prohibits banks themselves from doing so.

With this background, there are two questions I would like to address today:

1. Did the partial repeal of Glass-Steagall have a role in the financial crisis?
2. Should Glass-Steagall be restored?

I. Glass-Steagall and the Financial Crisis

I will clarify the term "bank" because it is often misused. In the context of these remarks, a bank is a very specific type of entity, chartered by the federal government or a state, to take deposits that are withdrawable on demand—the hallmark of a bank—and make loans.

Only banks as I have just defined them are insured by the Federal Deposit Insurance Corporation ("FDIC"), have access to the Federal Reserve's ("Fed") discount window, and participate in the U.S. payment system. It is the presence of government insurance and those other functions that account for the special restrictions on bank activities. The theory is that banks, because of their deposit insurance and unique functions in the financial system, must be kept from taking risks.

Bank holding companies, on the other hand, are not insured, do not have access to the Fed's discount window, and do not participate in the nation's payment system. Accordingly, there is no sound policy reason for restricting their activities, as long as the risks taken by holding companies cannot affect the

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4. *Bank Holding Companies*, PARTNERSHIP FOR PROGRESS, http://www.fedpartnership.gov/bank-life-cycle/manage-transition/bank-holding-companies.cfm *archived at* http://perma.cc/GPF7-5BSA (last visited Feb. 12, 2014).

5. *Id.*

financial conditions of their subsidiary banks.

Part of the confusion about Glass-Steagall comes from the fact that there are entities called investment banks. These are firms that specialize in underwriting and dealing in securities. Investment banks are not banks in any strict sense; they are not long-term lenders, not backed by the government in any way, were never covered by Glass-Steagall, and—unlike true banks, generally called commercial banks—are intended to be risk-takers. In order to reduce the confusion caused by the similar use of the word "bank," I will refer to investment banks as securities firms.

The Glass-Steagall Act was designed to separate commercial banks from securities firms, and it did that simply by prohibiting affiliations between the two and by prohibiting banks from engaging in the business of underwriting and dealing in securities.[6] Much of U.S. banking law and regulation is designed to separate banks from the risks that might be created by the activities of their non-bank affiliates—particularly, its holding company or any holding company subsidiary. This separation is affected, as I'll discuss shortly, by severely restricting the transactions between banks and their holding company affiliates.

There are two principal reasons for these restrictions: (i) to ensure that the so-called bank "safety net"—deposit insurance and access to the discount window—is not extended beyond banks to their holding companies or their nonbank affiliates, and (ii) to protect the bank's financial position from exposure to the risks that are taken by its affiliates and securities subsidiaries. The idea is to allow a holding company—and even a bank securities affiliate—to fail without endangering the health of any related bank. That is the context in which the Glass-Steagall Act should be viewed.

Although Glass-Steagall prohibited banks from underwriting and dealing in securities, it did not prohibit banks from buying, selling, and holding loans and fixed income securities for investment, or trading the loans or securities in which they had invested. This is logical. Securities and loans are the stock in trade of banks, just as oil is the stock in trade of Exxon Mobil. So even under Glass-Steagall, banks could not only make loans, they could invest in loans and securities and buy and sell these assets as their businesses required.

Here, the difference between "buying and selling" and "underwriting and dealing" is crucial. As noted earlier, Glass-Steagall continues to prohibit banks from 'underwriting or dealing' in securities. "Underwriting" refers to the business of assuming the risk that an issue of securities will be fully sold to investors, while "dealing" refers to the business of holding an inventory of securities for the *purpose* of trading them.

Thus, a bank may purchase a security—say, a bond—and then decide to sell it when the bank needs cash or believes that the bond is no longer a good investment. Its *purpose* in buying the bond initially was not to trade it, so that activity would not be considered dealing in a security.

When securitization was developed, banks were permitted—even under Glass-Steagall—to securitize their loan assets and sell them in securitized form.

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6. *See* 12 U.S.C. § 378 (2012); *id.* § 24.

This was seen by regulators as simply another way to buy and sell loans, which was always permitted under Glass-Steagall.

From this analysis, it should be clear that the GLBA's repeal solely of the affiliation provisions of the Glass-Steagall Act did not permit banks to do anything that they were previously prohibited from doing. It certainly did not authorize banks for the first time to use insured funds to buy and sell securities, as some commentators have alleged.[7] As I've shown, banks were always able to do that under Glass-Steagall. It was simply part of the business of being a bank. To repeat, only underwriting and dealing in securities was forbidden to banks by Glass-Steagall. Accordingly, it is incorrect to suggest that Glass-Steagall's partial repeal had any affect whatsoever on the ability of banks to take any more risks than they had been taking while Glass-Steagall was fully in effect.

With this background, what banks did with mortgages and mortgage-backed securities ("MBS") before the financial crisis comes into focus. Before the GLBA, while Glass-Steagall was fully in effect, banks could invest in and buy and sell mortgages and mortgage-backed securities. These instruments were considered by bank regulators to be a securitized form of the whole mortgages that banks could always trade.

There is no evidence that trading—buying and selling—MBS caused any significant bank losses in the financial crisis. Those losses came almost entirely from investing in and holding privately-issued mortgage-backed securities, and to some extent whole mortgages. In other words, to the extent that banks suffered losses on MBS, collateralized debt obligations, or other instruments that were securitized versions of whole mortgages, their losses came from what turned out to be bad investments and not from trading—let alone underwriting and dealing—in these instruments.

It would be correct to say, therefore, that banks suffered losses on these securities by acting as banks—as lenders—and not as the securities traders that some commentators seem to imagine. Nevertheless, it is reasonable to ask whether the repeal of the affiliation provisions of Glass-Steagall could have caused banks to make these bad investments and thus suffer the losses that were a prominent feature of the financial crisis.

This could come about, for example, if the newly-permitted affiliations between banks and securities firms caused the banks to take greater risks. One way this might happen would be through banks making loans to their affiliated securities firms, or buying low quality MBS from their affiliates.

A. Bank Affiliations with Securities Firms

Banking law and regulations prevent the activities of a bank securities affiliate or subsidiary from adversely affecting the financial condition of a related bank. Sections 23A and 23B of the Federal Reserve Act, for example, limit the

7. Board of Governors of the Federal Reserve System U.S. Department of the Treasury, *Report to the Congress on Financial Holding Companies Under the Gramm-Leach-Bliley Act,* 28 (2003), www.federalreserve.gov/boarddocs/rptcongress/glbarptcongress.pdf.

financial and other transactions between a bank and its holding company or any holding company subsidiary.[8] For extensions of credit, the limit on a bank's exposure to its holding company or any such subsidiary is ten percent of the bank's capital and surplus for any one holding company affiliate and twenty percent for all affiliates in the aggregate.[9]

To put this in perspective, most banks have risk-based capital of roughly ten percent.[10] Thus, a loan to an affiliate cannot exceed one percent of the bank's assets, and loans to all affiliates as a group cannot exceed two percent. Moreover, all such lending or extensions of credit must be collateralized with U.S. government securities up to the value of the loan, and must be over-collateralized if other types of marketable securities are used as collateral.[11]
Under Section 371c of the Federal Reserve Act, all transactions between a bank and its affiliates are subject to the same standard of banking practices as the bank would offer to an unrelated party.[12] Other restrictions also apply, including prohibitions on the bank's purchase of a low quality asset from an affiliate,[13] or the bank's issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.[14]

All these restrictions are applied by bank regulators to a bank's relationship with its holding company, the holding company's subsidiaries, and in the rare case in which a bank itself—rather than its holding company—has a securities subsidiary.[15] In that case, incidentally, the bank's interest in its subsidiary must be subtracted from its assets when its capital position is computed.[16]

These restrictions effectively eliminate interconnections between a bank and its holding company affiliates and thus any substantial likelihood that the business of a securities affiliate or subsidiary will have an adverse effect on the bank. Accordingly, it is reasonably clear that GLBA's repeal of the affiliation provisions of the Glass-Steagall Act did not have and could not have had any adverse effect on the financial condition of any affiliated bank, thus not contributing to the weakening of banks in what we call the financial crisis.

B. Did the Securities Firms (Investment Banks) Get into Trouble Because of Their Affiliations with Banks?

There is still one other possibility—that GLBA's repeal of the affiliation provisions in Glass-Steagall enabled securities firms to establish relationships

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8. Federal Reserve Act, 12 U.S.C. §§ 371c-371c-1 (2012).

9. *Id.* § 371c(a)(1).

10. FDIC, *FDIC Community Banking Study*, 6-1 (2012), www.fdic.gov/regulations/resources/cbi/report/CBSI-6.pdf [hereinafter *Banking Study*].

11. 12 U.S.C. § 371c(c)(1) (2012).

12. *Id.* § 371c(a)(4).

13. *Id.* § 371c(a)(3).

14. *Id.* § 371c(c)(1).

15. 12 C.F.R. § 5.39 (h)(5) (2013).

16. *Id.*

with banks and that these relationships [somehow] caused the near-insolvency of the five large securities firms—Merrill Lynch, Goldman Sachs, Bear Stearns, and Morgan Stanley, and the bankruptcy of Lehman Brothers during the financial crisis.

First, it is important to note that, although affiliations between banks and securities firms were permissible after the adoption of the GLBA, no such relationship existed between the big U.S. banks and the five large securities firms that also had financial difficulties during the crisis.[17] Indeed, these large securities firms and the large Wall Street banks were fierce competitors.

To be sure, each of these securities firms had a subsidiary bank—something that would not have been possible before the repeal of the affiliation provisions of Glass-Steagall—but these bank subsidiaries were far too small to cause any serious losses to their massive parents. Merrill Lynch, for example, a securities firm with $670 billion in assets, had an affiliated bank with assets of $35 billion. Other large securities firms—Goldman, Sachs, Lehman Brothers, and Morgan Stanley had bank subsidiaries that were of roughly similar equivalent relative size.

Moreover, as in the case of the banks, the large securities firms got into trouble not from underwriting and dealing in securities—which they were permitted to do anyway because they were never subject to Glass-Steagall—but from buying and holding mortgage-backed securities for investment. When these securities declined in value during the financial crisis period, all of these firms were seriously weakened and Lehman Brothers failed.

In other words, the large securities firms and the large banks were both victims of the same activity—buying and holding for investment large amounts of mortgage-backed securities that fell significantly in value during what is known as the mortgage meltdown. Both were permitted to engage in this activity *before and after* the partial repeal of Glass-Steagall by the GLBA in 1999. Thus, it is possible to conclude without much question that GLBA's repeal of the affiliation provisions of the Glass-Steagall Act had no effect whatsoever on the financial crisis.

Indeed, if the GLBA had never been adopted, and Glass-Steagall had remained fully in effect, the financial crisis (except for the rescue of Bear Stearns) would have occurred exactly as it did. Let me correct that slightly. Without the amendment to Glass-Steagall, JP Morgan Chase could never have been able to acquire Bear Stearns in a Fed-finance, as the system was starting to unravel in March 2008. If you think that was a good thing, then you should be grateful for the repeal of the Glass-Steagall affiliation provisions. But if, as I do, you see that as the original sin—the reason for the chaos when Lehman was allowed to fail six months later—you might have a different view.

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17. Peter J. Wallison, *Five Myths About Glass-Steagall*, AMERICAN, Aug. 16, 2012, www.american.com/archive/2012/august/five-myths-about-glass-steagall.

II. SHOULD GLASS-STEAGALL BE RESTORED?

Although the partial repeal of Glass-Steagall had no role in causing the losses that gave rise to the financial crisis, there still might be reasons to restore it. All the major securities firms—Goldman, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns are now either gone (like Lehman), are subsidiaries of banks (like Bear and Merrill), or are bank holding companies regulated by the Fed (like Goldman and Morgan Stanley).[18] The likelihood is that they will no longer be the risk-takers they once were. Some may see this as good news, believing that risk-taking by large financial firms is what caused the financial crisis.

This, I think, is incorrect. The financial crisis was caused by U.S. government housing policy, implemented principally through the government-sponsored enterprises Fannie Mae and Freddie Mac, which forced the degrading of mortgage underwriting standards in order to spur home ownership by low and moderate income families.[19] "[B]y 2008, half of all mortgages in the United States—28 million loans—were subprime or otherwise weak."[20] Of this 28 million, "74 percent were on the books of government agencies" like Fannie and Freddie or Federal Housing Administration, showing incontrovertibly where the demand for these low quality loans originated.[21] When these mortgages began to default in unprecedented numbers, it weakened all financial institutions that held them and caused the financial crisis.[22]

Risk-taking is the father of innovation, competition, and change. That is as true in finance as it is in technology or pharmaceuticals. Bank holding companies, as regulated entities, are not risk-takers, so turning both securities and banking functions over to them—as has now happened—could slow economic growth. This is the most powerful argument for reinstating Glass-Steagall—not that it will prevent another crisis, but because separating securities firms from banks will encourage more risk-taking.

I don't believe that this is the right way to look at the issue. Deposit banking as a business is in trouble over the long term. It cannot compete with the securities markets in financing business corporations.

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18. Daniel Gross, *Morgan Stanley Retreats from Investment Banking and Trading*, DAILY BEAST (Jan. 11, 2013, 4:45 AM), http://www.thedailybeast.com/articles/2013/01/11/morgan-stanley-retreats-from-investment-banking-and-trading.html, *archived at* http://perma.cc/C7XS-CZAX.

19. *See* Peter J. Wallison, *Government Housing Policy and the Financial Crisis*, 30 CATO J. 397 (2010), object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/5/cj30n2-12.pdf.

20. Peter J. Wallison & Edward J. Pinto, *Wallison and Pinto: New Qualified Mortgage Rule Setting Us Up for Another Meltdown*, WASH. TIMES, Mar. 3, 2013, http://www.washingtontimes.com/news/2013/mar/3/wallison-and-pinto-new-qualified-mortgage-rule-set/?page=all, *archived at* http://perma.cc/V6QL-4JHG.

21. *Id.*

22. *Id.*

In 2012, JPMorgan Chase, the largest of the big Wall Street bank holding companies, earned only forty-six percent of its revenue from lending activities.[23] The balance, fifty-four percent, came from other businesses, including securities.[24] This disparity has been growing over time.[25]

The right policy, then, is the one originated by the Treasury in 1981 and adopted in the GLBA in 1999, to open up the range of permissible activity to bank holding companies, so they can follow the changes in a constantly changing market for financial services. Cutting them off from securities activity would have the opposite effect—isolating these large institutions as white elephants, consigned to a fringe area of the market, and gradually losing profitability as competitors innovate around them.

The question is whether bank holding companies, now active in the securities business, will come to dominate all of finance, especially after most of their competition has been either eliminated or fallen under the dead hand of the Fed.[26] This is a matter of serious concern.

However, I believe that among the thousands of securities firms that operate in today's market there are many that will grow to take the place of the large independent securities firms that were decimated by the 2008 financial panic. After all, the pattern we see repeated in our economy is a constant turnover in the firms that dominate a market.[27] Microsoft, for example, was once so dominant that there were calls for breaking it up.[28] Now, it is struggling to hold its position against competition from Apple and Google, which in turn are struggling to fend off competition from Samsung and Facebook.[29] This is how it will always be as long as we allow a free rein to competition and there are independent sources of equity finance always looking for profit.

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23. JPMORGAN CHASE & CO., ANNUAL REPORT 188-89 (2012).

24. *Id.*

25. *Id.*

26. *See* Donna Harris, *Ally's Chief Says Bank Holding Companies Will Dominate*, AUTOMOTIVE NEWS (Feb. 2, 2011, 12:23 PM), http://www.autonews.com/article/20110202/BLOG14/110209946/ally%E2%80%99s-chief-says-bank-holding-companies-will-dominate#axzz2g31ADVhT, *archived at* http://perma.cc/GSP3-FZ9P.

27. *Banking Study*, *supra* note 10, at 6-14.

28. Adam Hartung, *Microsoft Still Can't Find Its Future. Is It Too Late for the Company?*, FORBES (Jan. 20, 2013, 1:38 PM), http://www.forbes.com/sites/adamhartung/2013/01/20/sell-microsoft-now-game-over-ballmer-loses/, *archived at* http://perma.cc/QTC6-TFCY.

29. *Id.*

"GRADE INCOMPLETE": EXAMINING THE SECURITIES AND EXCHANGE COMMISSION'S ATTEMPT TO IMPLEMENT CREDIT RATING AND CERTAIN CORPORATE GOVERNANCE REFORMS OF DODD-FRANK

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ABSTRACT

Following the financial crisis of 2007-2009, Congress passed the Dodd-Frank Act with stated goals, among others, of creating a sound economic foundation and protecting consumers. The Dodd-Frank Act creates several new agencies and restructures the financial regulatory system, yet controversies remain on the promulgation of new rules and the overall effectiveness in accomplishing the stated goals of the Act.

This Article briefly discusses the status of rulemaking by newly created agencies and the restructured financial regulatory system mandated by the Dodd-Frank Act three years after its passage. Next, we focus on certain aspects of the SEC and its charge from Dodd-Frank to implement new agencies and regulations. Specifically, we examine the SEC efforts to establish the Office of Credit Ratings and its regulations and the SEC's efforts related to additional executive compensation disclosure regulations required by Dodd-Frank.

INTRODUCTION

Following the financial crisis of 2007-2009, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] a broadly-sweeping statute which increased regulatory influence on a large part of the U.S. economy. Congress passed Dodd-Frank with stated goals, among others, of creating a sound economic foundation and protecting consumers.[2] Dodd-Frank created several new agencies and restructured the financial regulatory system,[3] yet controversies remain on the promulgation of new rules and the overall effectiveness in accomplishing the goals of the Act. According to Paul Hastings, as of the third anniversary of Dodd-Frank on July 21, 2013, "only 40% of the

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2. S. COMM. ON BANKING, 111TH CONG., BRIEF SUMMARY ON THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 1, *available at* http://www.banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

3. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

approximately 400 required rules have been finalized."[4] On its website, the U.S. Securities and Exchange Commission (the "SEC") reports that Dodd-Frank "contains more than 90 provisions that require SEC rulemaking, and dozens of other provisions that give the SEC discretionary rulemaking authority."[5] In addition, the SEC claims that it proposed or adopted rules for more than 75% of the required provisions as of February 2014.[6] New regulations from the various entities are being proposed and adopted on a weekly basis, yet additional complications occur from both legislative actions to unwind parts of Dodd-Frank and court rulings discarding adopted or proposed regulations.[7]

The Dodd-Frank Act reorganized the U.S. Federal regulatory system of banking, finance, and securities to "strengthen oversight of insured depository institutions and nonbank financial companies"[8] and to establish a more efficient implementation of consumer protection system by consolidating responsibilities "that had been fragmented across multiple agencies."[9] Eleven federal agencies received new funding as part of the implementation of the Dodd-Frank Act. In addition, Dodd-Frank consolidated and reorganized the regulatory oversight of depository and nonbank financial companies through new offices or sections with three federal agencies: the Federal Reserve, the Department of the Treasury (the "Treasury"), and the SEC. Restructured or newly created agencies within the Federal Reserve and the Treasury include the Consumer Financial Protection Bureau (CFPB), an independent bureau within the Federal Reserve System, and three independent offices within the Treasury: the Office of Financial Research (OFR), the Financial Stability Oversight Council (FSOC), and the Federal Insurance Office (FIO). Dodd-Frank also abolished an office within the Treasury, the Office of Thrift Supervision (OTS). It merged OTS's responsibilities to regulate federally chartered and state chartered banks and savings and loan associations into the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, and the

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4. THE PAUL HASTINGS GLOBAL BANKING AND PAYMENT SYSTEMS GROUP, DODD-FRANK ACT THREE YEARS LATER . . . STILL A WORK IN PROGRESS 1 (2013), *available at* http://www.paulhastings.com/Resources/Upload/Publications/StayCurrent-Dodd-Frank-Act-Still-a-Work-in-Progress.pdf.

5. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank.shtml (last modified Feb. 13, 2014).

6. *Id.*

7. *See, e.g.*, Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695 (2013); Paul Rose & Christopher J. Walker, *Dodd-Frank Regulators, Cost-Benefit Analysis, and Agency Capture*, 66 STAN. L. REV. ONLINE 9 (2013), *available at* http://www.stanfordlawreview.org/sites/default/files/online/articles/DoddFrankFinal.pdf (discussing so-called "proxy access" rule and the subsequent legal response).

8. U.S. Gov't Accountability Office, GAO-11-808T, Dodd-Frank Act: Eleven Agencies' Estimates of Resources for Implementing Regulatory Reform 1 (2011), *available at* www.gao.gov/assets/90/82449.pdf.

9. *Id*.

CFPB.

This Article focuses on the impact of Dodd-Frank on the SEC more than three years after its passage and its increased and expanded role in the regulatory rulemaking process. Specifically, it provides a brief review and status of rulemaking and restructuring mandated by Dodd-Frank and then in greater detail analyzes: 1) the SEC's role in establishing the Office of Credit Ratings (OCR) and the accompanying regulatory structure designed to provide oversight to the rating agencies; and 2) the SEC's role in proposing and adopting regulations mandated by Dodd-Frank that intended to enhance disclosure of executive compensation to shareholders and other stakeholders. In the first case, Dodd-Frank affects a segment of the financial services sector by attempting to address problems with the economic model of the credit rating agencies and flawed incentives that resulted in ratings that did not appear to appropriately account for credit risk and have been blamed for exacerbating the financial crisis.[10] In the latter case, however, the corporate governance regulations adopted by the SEC affect all publicly-traded companies.[11] Therefore, the reach of Dodd-Frank and the costs it imposes on firms extends well beyond the financial sector. The Article will conclude with a discussion of the challenges ahead for the SEC related to its role in implementing Dodd-Frank.

I. RESTRUCTURING WITHIN THE SEC

Dodd-Frank required new offices within the SEC, which the Office of Investor Education and Advocacy (OIEA), the Office of Municipal Securities, the Office of Credit Ratings (OCR), and the Office of Whistleblower Protection.[12] Each office has autonomy from general overview of the SEC.

A. Office of Investor Education and Advocacy

The OIEA assists investors by functioning as a liaison between investors and the SEC.[13] It represents the interest of investors by providing feedback on proposed SEC rules and regulations, promoting regulations and rules that benefit investors, and analyzing investor problems with certain financial services and products.[14]

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10. THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, PROGRESS UPDATE ON MARCH POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 2 (2008), *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/q4progress%20update.pdf.

11. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last modified Jun. 10, 2013).

12. *Testimony on Oversight of the SEC: Hearing Before the H. Comm. on Fin. Services*, 113th Cong. (2013) (statement of Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n).

13. *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, *available at* http://www.sec.gov/about/whatwedo.shtml#org.

14. 15 U.S.C. § 78d(g)(4) (2011).

B. Office of Municipal Securities

The Office of Municipal Securities (OMS) establishes policies and administers rules to regulate the practices of municipal securities brokers and dealers, municipal securities advisors, municipal securities investors, and municipal securities issuers.[15] OMS works with the Municipal Securities Rulemaking Board (MSRB).[16] The MSRB is a self-regulated organization created by Congress in 1975 to create rules for the municipal securities market that protect investors, the public interest, and state and local government issuers; provide equal regulation of municipal securities dealers; establish guidelines for the dissemination of market information; and promote market leadership, outreach and education.[17] The OMS is the office within the SEC that enforces the MSRB rules.[18] In July 2012, OMS issued a comprehensive report with recommendations to improve the structure of the municipal securities market and to enhance disclosure to investors.[19]

C. Office of Credit Ratings

OCR is responsible for improving the accuracy of the credit rating agencies and the creation of procedures and processes to provide stability and control of the credit rating system.[20] The 2008 financial crisis put into question the ability of nationally recognized statistical rating organizations (NRSROs) to produce accurate credit ratings on debt securities.[21] This accuracy issue materialized at that time due to the widespread default of collateralized debt obligations and other asset-backed securities, including bundled subprime residential loan mortgages.[22] Congress believed that the inaccuracies of the credit rating system

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15. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 979, 124 Stat. 1376, 1926 (2010).

16. *See Office of Municipal Securities*, U.S. SEC. & EXCH. COMM'N, *available at* http://www.sec.gov/municipal#.U3TQMrfD_cs.

17. *See generally* MUNICIPAL SECURITIES RULEMAKING BOARD, http://www.msrb.org/ (last visited May 15, 2014).

18. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 979, 124 Stat. 1376, 1926 (2010).

19. U.S. SEC. & EXCH. COMM'N, REPORT ON MUNICIPAL SECURITIES MARKET (2012), *available at* http://www.sec.gov/news/studies/2012/munireport073112.pdf.

20. *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, www.sec.gov/about/whatwedo.shtml#org.

21. *See* JOSEPH R. MASON & JOSHUA ROSNER, WHERE DID THE RISK GO? HOW MISAPPLIED BOND RATINGS CAUSE MORTGAGE BACKED SECURITIES AND COLLATERALIZED DEBT OBLIGATION MARKET DISRUPTIONS 34-51 (2007), *available at* www.researchgate.net/.../32bfe5126a481bcd33.pdf.

22. *See generally* Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585 (2010) (describing the process of NRSROs rating the credit worthiness of subprime securities).

were a key element of the cause of the 2008 financial crisis.[23] Prior to the crisis, NRSROs were subject to oversight by the SEC through the Credit Rating Agency Reform Act.[24] However, the SEC's oversight was limited to establishing guidelines for the qualification of credit rating agencies as NRSROs, the regulation of the internal processes regarding record keeping, and the prevention of conflict of interests of NRSROs and the securities they rated.[25] The SEC was prohibited from having authority to regulate the credit rating methodologies of NRSROs.

Dodd-Frank attempted to address the accuracy of the NRSRO rating system by enhancing the authority of the SEC over NRSROs.[26] The powers of the SEC over the credit rating system were consolidated into the OCR, an independent office within the SEC.[27] The primary purpose of the OCR is to enhance the regulation, accountability, and transparency of NRSROs.[28] The OCR is charged with administering the rules of the SEC to encourage more competition for three of the largest NRSROs: Moody's Investor Service (Moody's),[29] Standard & Poor's (S&P),[30] and Fitch Ratings (Fitch).[31] The OCR also provides transparency of NRSROs to ensure credit ratings are not unduly influenced by conflicts of interest and ensures that firms provide greater disclosure to investors.[32] Dodd-Frank requires, without SEC rulemaking, that the OCR conducts annual reviews of each NRSRO and produces a public report assessing compliance with federal

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23. *See* 156 CONG. REC. S3977-79 (daily ed. May 19, 2010) (statement of Senator Christopher Dodd agreeing with other members of Congress that the erroneous credit ratings of asset-backed securities had a central role in the financial crisis).

24. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 4(a), 120 Stat. 1327 (2006).

25. *Id.*

26. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2013).

27. *Id.* §§ 931-939H.

28. *See About the Office of Credit Ratings*, SEC. & EXCH. COMM'N, http://www.sec.gov/about/offices/ocr.shtml (last visited May 15, 2014).

29. The predecessor of Moody's Investor Services was founded in 1900, and in 1909 began analysis of the stocks and bonds of America's railroads. *See Moody's History: A Century of Markey Leadership,* MOODY'S CORPORATION, http://v3.moodys.com/Pages/atc001.aspx (providing the history of Moody's Investor Services) (last visited May 15, 2014).

30. Standard & Poor's was created in 1868, providing a financial manual on America's railroads. *See A Short History of Standard & Poor's: Q & A*, TELEGRAPH, http://www.telegraph.co.uk/finance/financialcrisis/8937653/A-short-history-of-Standard-and-Poors-QandA.html (providing a brief history of Standard & Poor's) (last visited May 15, 2014).

31. Fitch Ratings was founded in 1913. *See About Us*, FITCH RATINGS, https://www.fitchratings.com/web/en/dynamic/about-us/about-us.jsp (providing the history of Fitch Ratings) (last visited May 15, 2014).

32. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 942, 124 Stat. 1376, 1896-97 (2010).

securities laws and SEC rules.[33] Each NRSRO is required to establish a board of directors, the majority of which is comprised of independent directors, to create more accountability.[34] Additional rules require disclosure of conflicts of interest with respect to sales and marketing practices, review of transactions involving former credit analysts that leave NRSROs, and assessment of fines and penalties on non-compliance by NRSROs.[35] The OCR's ability to require disclosure on credit rating methodologies of NRSROs is key to its authority.[36]

Recent litigation questions whether the SEC rules resulting from the 2006 Credit Agency Reform Act[37] have increased credit rating competition among NRSROs by reducing the control of the three largest NRSROs or created alternative methods of evaluating complex securities.[38] On February 4, 2013, the Department of Justice filed a lawsuit against S&P, and its parent company, McGraw-Hill Companies, Inc.[39] The lawsuit alleges S&P knowingly issued inflated credit ratings for certain collateralized debt obligations in 2006.[40] On July 8, 2013, during the first court hearing on the lawsuit, S&P countered the lawsuit with a motion to dismiss the case on grounds that reasonable investors would not rely on its generic statements about the credit rating systems.[41] The U.S. District Court for the Central District of California Southern Division Judge David O. Carter, denied S&P's motion to dismiss, questioning S&P's claim that

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33. *Id.* § 943.

34. *Id.* § 932(t).

35. *Id.* §§ 932(q), (s).

36. *Id.* § 932(p); *see also* U.S. SEC. & EXCH. COMM'N, OFFICE OF CREDIT RATINGS, http://www.sec.gov/about/offices/ocr.shtml (last visited May 15, 2014).

37. Credit Rating Agency Reform Act of 2006, 109 P.L. 291, 120 Stat. 1327 (The Act was enacted September 29, 2006 to improve credit rating quality to protect investors and increase competition for credit rating by reducing the influence of the big 3 NRSROs—S&P, Moody's, and Fitch—changing the NRSRO designation process to allow smaller credit rating companies to qualify as NRSROs).

38. *See* Daniel Fisher, *Suing S&P Won't Cure The Problem of Relying On Rating Agencies*, FORBES (Feb. 4, 2013, 4:09 PM), http://www.forbes.com/sites/danielfisher/2013/02/04/suing-sp-wont-cure-the-problem-of-relying-on-ratings-agencies/ (claiming the lawsuit will not resolve the conflict of interest between rating agencies and securities issuers).); Matt Robinson, *S&P Lawsuit Undermined by SEC Rules That Impede Competition,* BLOOMBERG (Feb. 6, 2013, 11:47 AM), http://www.bloomberg.com/news/2013-02-06/s-p-lawsuit-undermined-by-sec-rules-impeding-ratings-competition.html. (describing the lack of significant changes in the influence of the big 3 NRSROs—S&P, Moody's, and Fitch—and in the methodology of rating complex securities, after the implementation of new SEC rules resulting from Credit Rating Agency Reform Act).

39. United States District Court for the Central District of California, Southern Division, Filed Case No.: CV 13-0779 DOC (JCGx). *See* Department of Justice Complaint, http://www.ustice.gov/iso/opa/resources/849201325104924250796.PDF

40. *Id.*

41. Edvard Pettersson, S&P Raises Puffery Defense Against U.S. Ratings Case, BLOOMBERG (July 8, 2013, 4:15 PM), http://www.bloomberg.com/news/2013-07-08/s-p-to-argue-puffery-defense- n-first-courtroom-test.html..

its statements were not relied on by investors.[42] Since the court's decision on the motion to dismiss, there have been several status hearings on the progress of the suit and on April 14, 2014, the court ruled on motions by the defendant to split the suit into phases and to compel discovery and the plaintiff's cross motion to strike defendant's First Amendment retaliation defense.[43] The court denied the defendant's phased trial motion, partially granted the defendant's motion to compel discovery and denied the plaintiff's cross motion to strike defense.[44]

D. Enforcement and the Office of the Whistleblower

In addition to the extra regulatory framework for the SEC, Dodd-Frank also attempted to assist enforcement efforts with its mandate of the creation of the Office of the Whistleblower.[45] With a goal of encouraging individuals to report securities fraud and abuses within the financial markets, the Office of the Whistleblower provides monetary rewards to individuals who report information to the SEC that leads to SEC enforcement action resulting in sanctions over $1 million.[46] The range for awards is between 10% and 30% of the money collected.[47] Under Dodd-Frank, the Office of the Whistleblower also must report its activities to Congress annually, including the number of complaints and the number and magnitude of awards granted.[48]

According to the Fiscal Year 2013 Annual Report on the Dodd-Frank Whistleblower Program, the Office of the Whistleblower received just over 3,000 "Tips, Complaints, and Referrals" in its system during the 2012 Fiscal year, and 3,238 in the 2013 Fiscal year.[49] While only one payout of $50,000 occurred during 2012,[50] three additional payouts occurred in 2013, including an award of over $14 million announced on October 1.[51] In an SEC Press Release announcing the award, SEC Chair Mary Jo White stated, "Our whistleblower program already

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42. Order Denying Defense's Motion to Dismiss, U.S. v. McGraw Hill Co. et. al., CV 13-0779 (C.D. of Cal. S. Div. July 16, 2013), *available at* http://ia601505.us.archive.org/10/items/gov.scourts.cacd.553856/gov.uscourts.cacd.553856.34.0.pdf. Oral arguments on the motion to dismiss were held on July 8, 2013.

43. United States v. McGraw-Hill Cos., 2014 U.S. Dist. LEXIS 59408 (C.D. Cal. Apr. 15, 2014)

44. *Id.*

45. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841-49 (2010).

46. *Id.*

47. *Id.*

48. *Id.* § 924(d).

49. U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM 1 (2013), *available at* http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.

50. *Id.* at 8.

51. *Id.* at 15; *see also* Michael Calia, *Whistleblower Awarded More than $14 Million,* WALL STREET JOURNAL (Oct. 1, 2013, 2:52 PM), *available at* http://online.wsj.com/news/articles/B10001424052702303918804579109530867318834.

has had a big impact on our investigations by providing us with high quality, meaningful tips . . . [w]e hope an award like this encourages more individuals with information to come forward."[52]

The success of the overall enforcement program of the SEC related to the financial crisis has been subject to debate. As of December 12, 2013, the SEC indicated on its website its enforcement efforts to address "Misconduct that Led to or Arose From the Financial Crisis" had led to charges against 169 entities and individuals with total penalties, disgorgement, and other monetary relief of $3.02 Billion.[53] While the amounts may seem significant, the SEC has also received criticism for its reliance on no-admit settlements in many of these cases.[54] Apparently, due to this criticism, the SEC announced in the summer of 2013 that it would review its no-admit policy and be more active in requiring firms to accept responsibility, which will also impact the SEC enforcement efforts in the future.[55]

Going forward, the deterrent impact from reducing the number of no-admit settlements and the incentives to whistleblowers will become more evident.[56] Research by Professors Adam Pritchard of the University of Michigan Law School and Stephen Choi of New York University School of Law suggests that private enforcement of securities law violations through class actions may provide greater deterrence effects on firm behavior than SEC actions alone, and therefore this change in the settlement strategy of the SEC will likely impact the dynamic in private and public enforcement actions.[57] At the very least, observers should expect even more rewards as investigations prompted by these reports work through the investigative process and result in civil penalties against both individuals and firms.[58]

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52. Press Release, U.S. Sec. & Exch. Comm'n, SEC Awards More Than $14 Million to Whistleblower (Oct. 1, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258#.UlW7bRATW3p.

53. *SEC Enforcement Actions: Addressing Misconduct That Led to or Arose from the Financial Crisis*, U.S. SEC. & EXCH. COMM'N (Dec. 12, 2013), http://www.sec.gov/spotlight/enf-actions-fc.shtml.

54. *See* Edward Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt*, N.Y. TIMES, Jan. 6, 2012, http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html?_r=0 (discussing criticism leading to the eventual no-admit policy change).

55. Andrew Ackerman, *SEC Aims to Get Tougher on Fraud,* WALL ST. J. (Sept. 27, 2013, 5:50 PM), http://online.wsj.com/news/articles/SB10001424052702304526204579099092933019908.

56. Stephen J. Choi & Adam C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison,* U. MICH. LAW & ECON. RESEARCH PAPER NO. 12-022; N.Y.U. LAW & ECON. RESEARCH PAPER NO. 12-38 (Feb. 25, 2014), *available at* http://papers.ssrn.com/ol3/papers.cfm?abstract_id=2109739.

57. *Id.*

58. *Id.*

II. New Rules and Regulations from the SEC

A. OCR Rulemaking on NRSROs

On January 20, 2011, the SEC adopted rules that required NRSROs to disclose certain information to investors on representations and warranties on the rating of asset-backed securities.[59] The SEC has also proposed rules regarding the remaining requirements of Dodd-Frank on the regulation of NRSROs on May 18, 2011.[60] These proposed rules are "designed to improve the practices of credit rating agencies, including rules to limit the conflicts that may arise when NRSROs rely on client payments to drive profits and rules to monitor rating agency employees who move to new positions with rated entities."[61] On December 27, 2013, the SEC adopted final rules required by Dodd-Frank that removed references to credit ratings in certain financial regulations in the Securities Exchange Act of 1934[62] and under the Investment Company Act of 1940 and the Securities Act of 1933.[63] Although intended to protect investors from reliance on credit ratings of securities, these final rules do not address the conflict of interest issues addressed in the proposed rules issued May 18, 2011.[64] Also in December 2013, SEC staff issued an annual report on its findings of examinations of 10 NRSROs.[65]

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59. Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 17 C.F.R. §§ 229, 232, 240, 249 (2011).

60. 17 C.F.R. §§ 232, 240, 249, 249(b) (2011), *available at* http://www.sec.gov/rules/proposed/2011/34-64514.pdf.

61. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank.shtml (last modified Apr. 18, 2014).

62. *Available at* http://www.sec.gov/rules/final/2013/34-71194.pdf.

63. *Available at* http://www.sec.gov/rules/final/2013/33-9506.pdf.

64. *See supra* note 60 (Dodd-Frank requires rules on the regulation of NRSROs in the following areas: filing annual reports on internal controls; addressing conflicts of interest with respect to sales and marketing concerns; conducting "look-back" reviews of ratings in which former NRSRO employees participated to determine whether employment opportunities with a rated entity, issuer, underwriter, or sponsor influenced the rating; disclosing information relating to initial credit ratings and subsequent changes to credit ratings to track the performance of an NRSRO's credit ratings; requiring an NRSRO to have certain policies and procedures governing the way an NRSRO determines credit ratings; publishing a standard form with each credit rating disclosing, among other things, the assumptions underlying the methodology used to determine the credit rating; disclosing information concerning third party due diligence reports for asset-backed securities; establishing professional standards for training credit rating analysts; and requiring the consistent application of rating symbols and definitions).

65. *2013 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization*, *available at* http://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf?utm_source=page&utm_medium=/financial-reporting-network/insights/2014/sec-addresses-credit-ratings-nrsros.aspx&utm_campaign=download; (The

To receive public comments on various matters relating to credit ratings, the SEC created a Credit Ratings Roundtable.[66] The Roundtable has had three panels: one to examine issues on creating a credit rating assignment system, another to address the effectiveness of the SEC's current system for encouraging unsolicited ratings of asset-backed securities, and another to focus on potential alternatives to the current issuer pay business model.[67] The Roundtable discussion took place on May 14, 2013, and comments on issues addressed were accepted until June 3, 2013.[68] As of May 2014, the Roundtable has not held additional meetings, public panels, or solicited comments.[69]

Dodd-Frank's mandate on the OCR to solve perceived problems created by the "big three" credit rating agencies (Fitch, Moody's and S&P) has not been accomplished, as the SEC's proposed rules on regulation of NRSROs to prevent conflict of interest and undue influence on the financial markets have yet to be finalized.[70] In addition, credit rating industry thought leaders believe the OCR's proposed rules do not help NRSROs create transparency of credit rating methodologies, do not reduce the costs associated with becoming an NRSRO, and do not address the inherent conflict of interest existing in the current "issuer pay" model of the credit rating system.[71]

B. Corporate Governance and Compensation Disclosure Provisions

While Dodd-Frank primarily focuses on regulating financial services and markets, the scope of its corporate governance and compensation disclosure

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report reviewed 10 NRSROs, A.M. Best Company, Inc. ("AMB"), DBRS, Inc. ("DBRS"), Egan-Jones Ratings Company ("EJR"), Fitch Ratings, Inc. ("Fitch"), HR Ratings de México, S.A. de C.V. ("HR"), Japan Credit Rating Agency, Ltd. ("JCR"), Kroll Bond Rating Agency, Inc. ("KBRA"), Moody's Investors Service, Inc. ("Moody's"), Morningstar Credit Ratings, LLC ("Morningstar"), Standard & Poor's Ratings Services ("S&P") and states the finding and recommendations of staff in the areas Adherence to Policies, Procedures, and Methodologies; Management of Conflicts of Interest; Implementation of Ethics Policies; Internal Supervisory Controls, Governance, Designated Compliance Officer Activities, Complaints, and Post-Employment).

66. *Credit Ratings Roundtable,* U.S. SEC. & EXCH. COMM'N (Apr. 23, 2013), http://www.sec.gov/rules/other/2013/34-69433.pdf.

67. *Id.*

68. *Id.*

69. *Other Commission Orders, Notices, and Information*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/rules/other.shtml (last modified May 2, 2014).

70. *See* Jeffrey Manns, *Downgrading Rating Agency Reform*, 81 GEO. WASH. L. REV. 749 (2013) (describing the SEC's rulemaking challenges of resolving the conflict of interests problems in the present credit rating system and the failure to craft benchmarks for rating agency performance that hold them accountable).

71. *See* Robinson, *supra* note 38 (discussing the continued complications even after the formation of the Office of Credit Ratings).

provisions are much broader, affecting all publicly-traded firms.[72] In implementing Dodd-Frank, the SEC has adopted, proposed, or considered rules related to proxy access, "Say-on-Pay," relationship of pay and performance, management hedging policies, and compensation committee independence, including additional disclosures related to the compensation committee's use of compensation advisers and existing conflicts of interest.[73] Dodd-Frank continues the trend of regulatory bodies mandating additional disclosure in an attempt to "fix" perceived problems by ensuring transparency and providing additional information to users in order to assist the recipients in making better-informed decisions.[74] While some of the regulations have now been in place for a couple of years (e.g., Say-on-Pay),[75] others are still being proposed. In September 2013, the SEC proposed its most recent executive compensation disclosure rule mandated by Dodd-Frank which requires companies to disclose the ratio of total CEO compensation to the median of the annual total compensation of all employees of the firm except the CEO (the "Pay Ratio").[76]

We proceed by briefly describing the status of the Say-on-Pay and Pay Ratio executive compensation disclosures mandated by Dodd-Frank and proposed or adopted by the SEC. The experience of the SEC in proposing these regulations in the executive compensation area appear to be a microcosm of the overall experience of attempts to implement Dodd-Frank across the board, given the complexity of the legal and economic issues involved.

1. Say-on-Pay.—Under Section 951 of Dodd-Frank, public companies are required to offer shareholders the opportunity to have an advisory vote on executive compensation, along with an additional advisory vote on the frequency of the Say-on-Pay vote.[77] To implement the Dodd-Frank mandate, the SEC adopted final Say-on-Pay regulations in January 2011, requiring companies to include a resolution in its proxy statement asking shareholders to approve in a non-binding advisory vote the compensation of their executive officers disclosed in the proxy.[78] This concept was not a new one, as similar regulations had been in place in the United Kingdom since 2003 and many U.S. firms had been subject to shareholder proposals related to Say-on-Pay under the existing rules for shareholder proposals.[79] In addition, the SEC regulations also require a separate

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72. 12 U.S.C. § 5221 (2009).

73. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

74. *Id.*

75. *SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act,* U.S. SEC. & EXCH. COMM'N (Jan. 25, 2011), http://www.sec.gov/news/press/2011/2011-25.htm.

76. Pay Ratio Disclosure, 17 C.F.R. §§ 229, 249 (2013).

77. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010).

78. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 17 C.F.R. §§ 229, 240, 249 (2011).

79. *See generally* Randall S. Thomas et al., *Dodd-Frank's Say-on-Pay: Will It Lead to a*

resolution as to frequency of the Say-on-Pay resolution, which can range from between one and three years.[80]

According to the *Wall Street Journal*, most firms have elected to have annual Say-on- Pay votes, reporting over 80% of firms having annual votes.[81] Also, more than one-half of the companies that originally indicated that they would recommend holding votes every three years eventually elected to have annual votes.[82]

How have shareholders reacted to the Say-on-Pay disclosure, and in general do shareholders believe that CEOs are overpaid? According to Semler Brossy, an independent executive compensation consulting firm, over 90% of the companies reviewed from the Russell 3000[83] have had votes of more than 70% approving the CEO pay package, and 70% of the firms have had approval votes of greater than 90%.[84] In addition, just above 2% of the firms have failed to receive a majority of votes approving the pay package and these vote proportions have been consistent in each of the three years since Say-on-Pay went into effect.[85]

Thus, shareholders have overwhelmingly approved the Say-on-Pay resolutions, and yet it also appears that the regulation has had little impact on overall compensation levels, as average total compensation levels have continued to rise since 2010.[86] This is consistent with prior research on the Say-on-Pay regulation adopted in the United Kingdom in 2003 as to compensation levels, but Professors Fabrizio Ferri and David Maber find that pay-for-performance sensitivity has increased.[87]

While the regulations appear to have little effect on the majority of firms, the process has appeared at the very least to have opened up a dialogue about executive compensation between some firms and its investors. For example, Simon Property Group, a leading American commercial real estate company

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Greater Role for Shareholders in Corporate Governance?, 97 CORNELL L. REV. 1213 (2013).

80. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010).

81. Emily Chasan, *Most Companies Opt for Annual Say-On-Pay Votes*, WALL ST. J. (Apr. 9, 2013, 12:32 AM), http://blogs.wsj.com/cfo/2013/04/09/most-companies-opt-for-annual-say-on-pay-votes/ (citing a study by Towers Perrin).

82. *Id.*

83. A stock market index measuring the performance of 3000 U.S. publicly traded companies. *Russell 3000 Index*, RUSSELL INVESTMENTS, http://www.russell.com/indexes/data/fact_sheets/us/russell_3000_index.asp (last visited May 15, 2014).

84. Semler Brossy, *2013 Say on Pay Report*, SEMLER BROSSY (Sept. 21, 2013), http://www.semlerbrossy.com/sayonpay.

85. *Id.*

86. Jesse Eisinger, *In Shareholder Say on Pay Votes, More Whispers than Shouts,* DEALBOOK, N.Y. TIMES (June 26, 2013, 12:00 PM), http://dealbook.nytimes.com/2013/06/26/in-shareholder-say-on-pay-votes-more-whispers-than-shouts/.

87. Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 *REVIEW OF FINANCE 2 527-563 (2013)*.

headquartered in Indianapolis, Indiana, reduced its pay for its President following a negative vote and follow-up discussions with investors about the structure of the compensation.[88] Therefore, a primary benefit of the Say-on-Pay regulation may be the "improved relationships between boards and institutional investors, rather than improved economic decision-making."[89]

In evaluating the overall impact of Say-on-Pay, it appears that the required vote has been effective in enhancing the communication between investors and companies related to executive compensation.[90] Shareholders overwhelmingly approve all but a handful of proposals, and the overall levels of executive compensation have continued to grow after the initiation of Say-on-Pay in the U.S.[91] Professors Cotter, Palmitter, and Thomas state that while "the voting gesture mandated by law might have been mostly empty, placement of the issue on the company's ballot may have changed the dynamics of the shareholder–management dialogue. Shareholder votes focused negative attention on poorly performing firms with relatively high pay levels."[92]

2. Pay Ratio.—Unlike the Say-on-Pay regulation that was adopted in final form and went into effect soon after the passage of Dodd-Frank, the Pay Ratio disclosure has had a bumpier path. In September 2013, the SEC approved for comment new proposed rules for implementing Section 953(b) of Dodd-Frank which require: additional disclosures from the firm related to annual total CEO compensation, the median of the annual total compensation of all employees of the firm except the CEO, and the ratio of these two measures.[93] The SEC originally expected to finalize these regulations in 2011; however, the provision has been the subject of widespread discussion and debate, with the SEC receiving over 22,000 public comment letters prior to September 15, 2013.[94] In trying to satisfy the mandate of Dodd-Frank, requiring the specific disclosure while simultaneously fulfilling its mission of investor protection, the SEC states that "The proposed rules to implement Section 953(b) are designed to comply with the statutory mandate and to address commenters' concerns regarding the potential

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88. Kris Hudson & A.D. Pruitt, *Simon Property Changes CEO Pay Package After Criticism*, WALL ST. J. (Apr. 4, 2013, 7:00 PM), http://online.wsj.com/news/articles/SB10001424127887323916304578403040759610924.

89. David F. Larcker et al., *Ten Myths of "Say on Pay,"* ROCK CENT. FOR CORPORATE GOVERNANCE AT STAN. U. CLOSER LOOK SERIES: TOPICS, ISSUES, AND CONTROVERSIES IN CORPORATE GOVERNANCE NO. CGRP-26, 4 (June 28, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2094704.

90. *See* Thomas et al., *supra* note 79, at 1258-59 (discussing how "the new law has led many companies to increase their communication with shareholders and re-evaluate their compensation and corporate governance practices").

91. *Id*. at 1215.

92. *Id*. at 1265.

93. Pay Ratio Disclosure, Dodd-Frank Act Release (Sept. 18, 2013), *available at* http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

94. *Id.* at 6.

costs of complying with the disclosure requirement."[95] However, neither the statute nor the related legislative history "directly states the objectives or intended benefits of the provision."[96]

From one point of view, the pay ratio disclosure may appear to simply add to the transparency of executive compensation, given that firms already are required to disclose the total compensation of the CEO.[97] Proponents of the disclosure suggest that the information is important to investors seeking information related to executive pay relative to other employees, and the impact of pay structure on productivity and performance, which may in turn allow for more informed voting for directors and for say-on-pay resolutions.[98] In addition, the internal benchmarking of comparing CEO compensation to the median worker may offset some of the upward bias observed in CEO compensation levels from the practice of benchmarking against peer groups.[99]

However, the calculation of total compensation for the median employee increases the complexity and cost in complying with the regulation for the typical publicly-traded firm.[100] Most firms do not maintain information about each component of compensation for all employees, and it would be extremely costly to do so.[101] In the proposing release, the SEC acknowledges that the disclosure "requires registrants to disclose specific information about non-executive employee compensation that is not currently required for disclosure, accounting or tax purposes."[102] As a result, the SEC tries to accommodate these concerns by allowing some flexibility in determining both the median employee and total compensation.[103] Although all employees on the last day of the company's fiscal year must be considered, including part-time, seasonal, and non-US employees, the company is allowed some discretion in its approach to identifying the median

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95. *Id*. at 11.

96. *Id*.

97. Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes Rules for Pay Ratio Disclosure (Sept. 18, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895#.Un7mqflJMdU.

98. *See Overpaid? Or Worth Every Penny*, N.Y. TIMES, July 13, 2013, http://www.nytimes.com/2013/07/14/opinion/sunday/overpaid-or-worth-every-penny.html (discussing the potential uses of pay gap information).

99. *See* Luis A. Aguilar, *Providing Context for Executive Compensation Decisions*, U.S. SEC. & EXCH. COMM'N (Sept. 18, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539813937#.UnbeDvlJMdU (discussing the flawed practice of benchmarking against peer groups for determining executive compensation).

100. *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact On Executive Compensation* 4 (Dec. 2010), *available at* http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-executive-compensation.pdf; *see also* Ike Brannon, *The Egregious Costs of the SEC's Pay Ratio Disclosure* (May 2014), *available at* https://www.uschamber.com/sites/default/files/documents/files/Egregious-Cost-of-Pay-Ratio-5.14.pdf .

101. *Id*.

102. Pay Ratio Disclosure, *supra* note 93, at 10.

103. *Id*. at 12.

employee.[104] Also, the firm does not need to calculate the value of each of the components that comprise annual total compensation for every employee, but may identify the "median" employee using any compensation measure and then compute the annual total compensation for that employee.[105]

While the flexibility allowed by the proposed rule is an attempt by the SEC to make it less costly to implement for firms, the SEC acknowledges that the resulting outcome limits the comparability of the ratio across firms.[106] Thus, the usefulness of the ratio for investors is questionable because the discretion provided to firms prevents investors from making true relative comparisons.[107] The opponents generally have argued that the pay ratio disclosure would be costly, complicated, and potentially inaccurate while providing a disclosure that is immaterial to most investors.[108] In voting against adopting the provision, one of the five Commissioners of the SEC, Michael Piwowar, argued that the SEC should not be spending its efforts and resources on "any rulemaking that unambiguously harms investors, negatively affects competition, promotes inefficiencies, and restricts capital formation."[109] As to the potential benefits of the Pay Ratio, Commissioner Piwowar cited the release which "specifically warns that 'using the pay ratio to compare companies may not be relevant and could generate misleading interpretations or conclusions.'"[110] Another dissenting Commissioner, Daniel Gallagher, went further by stating that "There are no—count them, zero—benefits that our staff have been able to discern."[111] Continuing, he cited the proposal which states that "[T]he lack of a specific market failure identified as motivating the enactment of this provision poses significant challenges in quantifying potential economic benefits, if any, from the pay ratio disclosure."[112]

Potential legal challenges to the Pay Ratio and other new regulations

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104. *Id*. at 12-13.

105. *Id*. at 13.

106. The SEC argues the "precise comparability across companies may not be relevant and could generate potentially misleading interpretations or conclusions." *Id.* at 93. Also, "the potential value of this disclosure for assessing issues related to employee morale, productivity and investment in human capital may be diminished by the indirect costs of creating incentives for registrants to change their business structure." *Id.*

107. *Id.* at 71.

108. John Cavanagh, *Comment Letter on Pay Ratio Disclosure*, INST. FOR POL'Y STUD. (Oct. 30, 2013), *available at* http://www.sec.gov/comments/s7-07-13/s70713-278.pdf.

109. Michael S. Piwowar, *Statement at Open Meeting Regarding Municipal Advisors and Pay Ratio Disclosure*, U.S. SEC. & EXCH. COMM'N (Sept. 18, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539811778#.UnbiqflJMdU.

110. *Id*.

111. Daniel M. Gallagher, *Dissenting Statement of Commissioner Daniel M. Gallagher Concerning the Proposal of Rules to Implement the Section 953(b) Pay Ratio Disclosure Provision of the Dodd-Frank Act,* U.S. SEC. & EXCH. COMM'N (Sept. 18, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539815919#.UnbjOflJMdU.

112. *Id*. (quoting at Pay Ratio Disclosure, *supra* note 93, at 91).

mandated by Dodd-Frank and promulgated by the SEC are done with the backdrop of the SEC's experience with the so-called "proxy access" rule.[113] Although the SEC had announced its intent to propose a proxy access rule, allowing certain shareholders to include director nominees in the firm's proxy materials even before the passage of Dodd-Frank, Section 971 of Dodd-Frank gave the SEC the authority to adopt such a provision.[114] In 2009, the SEC proposed a revised Rule 14a-11, which permitted a shareholder or group of shareholders that had held 1% to 5% of the firm's shares for at least a year to nominate director candidates for up to 25% of the board.[115] Almost immediately, the rule was challenged in court, eventually leading to the D.C. Circuit Court striking down the regulation before it was ever officially in effect due in part to an insufficient cost benefit analysis.[116] Thus, the dissenting commissioner's concerns about potential costs and benefits of the Pay Ratio disclosure set the stage for another extended debate and potential challenges to the rule.[117]

CONCLUSION

Following the financial crisis of 2007-2009, Congress passed Dodd-Frank and greatly expanded the regulatory structure around the financial services sector. The SEC's role significantly increased, with requirements for additional agencies to be formed within the SEC along with provisions that mandate additional SEC rulemaking in many cases and that provide for discretionary rulemaking authority in others. In this Article, we discuss the SEC's progress and identify some of the problems associated with attempts to regulate perceived or real conflicts of interest by mandated rules or disclosure.

The challenges in drafting a rule that prevents the inherent conflict of interest associated with the current economic model of credit rating agencies is evident as Dodd-Frank's attempt to solve the problems with NRSRO's influence on the financial markets remains a work in progress. The SEC's proposed rules on regulation of NRSROs to prevent conflict of interest and undue influence have not been finalized and no further meetings of the Roundtable to receive public comments on improving the current credit rating systems has been scheduled since May 2013.

Alternatively, conflicts of interest may be managed if appropriate information is provided to interested parties. To promote transparency in the financial markets, the SEC has a long history of emphasizing disclosure with the goal of

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113. *See Facilitating Shareholder Director Nominations*, U.S. SEC. & EXCH. COMM'N (Aug. 25, 2010), *available at* http://www.sec.gov/rules/final/2010/33-9136.pdf) (discussing the SEC's proposed proxy access rule).

114. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010).

115. *See* Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 445 (2012) (describing the SEC's proxy access rule).

116. Bus. Roundtable v. Sec. & Exch. Comm'n, 647 F.3d 1144 (D.C. Cir. 2011).

117. Gallagher, *supra* note 111.

providing useful information to market participants.[118] While it appears straightforward that better and more information should lead to improved decision-making, disclosure as a mechanism for ensuring better decision-making has been questioned by a number of commentators. SEC Chair Mary Jo White recently commented in a speech that "[w]hen disclosure gets to be too much or strays from its core purposes, it can lead to 'information overload'a phenomenon in which ever-increasing amounts of disclosure make it difficult for investors to focus on the information that is material and most relevant to their decision-making as investors in our financial markets."[119] Specific to disclosure of executive compensation required by the SEC, Professors Steven Davidoff and Claire Hill argue that the enhanced disclosure related to executive compensation has had the unintended consequence of encouraging higher compensation levels for management.[120] Despite the theory that greater executive compensation disclosure would lead to action, due to real or anticipated shareholder outrage, "[t]he incremental information apparently has not prompted shareholder action, but appears to have prompted action by peer CEOs—to put pressure on their boards to raise their pay."[121] While the goals of Dodd-Frank are to address and prevent a similar financial crisis from occurring in the future, the use of the SEC's disclosure framework related to executive compensation appears to be inconsistent. Past attempts to use disclosure as a mechanism for reducing "excessive" executive compensation have not resulted in lower overall levels of executive compensation, which bolsters the arguments of commentators that suggest CEO pay is based on performance and may reflect market-based transactions.[122]

Given the SEC experience with the proxy access rule, the impact of Say-on-Pay and the discussion both in support of and dissenting from the Pay Ratio proposal is relevant. While questions may exist as to the magnitude of the benefits of the Say-on-Pay rule, it does appear that the introduction of the proposals has affected the dialogue between investors and firms and how firms motivate the levels of executive compensation.[123] However, given the advisory nature of the vote, it does not appear to be particularly costly to firms, other than from a reputational standpoint for a few outlier firms, as over 97% of firms have

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118. *See* Mary Jo White, *The Importance of Independence*, U.S. SEC. & EXCH. COMM'N (Oct. 3, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539864016#.UoOPk_lJMdU (discussing the history of disclosure practices at the SEC).

119. *Id*.

120. Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. Rev. 599, 626 (2013).

121. *Id*. at 604.

122. *Id*.; *see also* Steven Kaplan, *CEO Pay and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges*, 25 J. APPLIED CORP. FIN. 8, 25 (2013) (discussing how shareholder votes are more consistent with a market-based view of top executive pay as opposed to pay driven by managerial power).

123. *See* Thomas et al., *supra* note 79 (discussing how "say on pay" has created a broader dialogue on pay issues between management and shareholders).

received a positive confirmation from shareholders.[124]

Turning to the Pay Ratio, the split vote among SEC Commissioners in adopting the proposal demonstrates the varied and strong opinions on the potential costs and benefits.[125] SEC Chair White addressed the difficult position of the SEC given the Congressional mandates of Dodd-Frank in stating that "other mandates, which invoke the Commission's mandatory disclosure powers, seem more directed at exerting societal pressure on companies to change behavior, rather than to disclose financial information that primarily informs investment decisions . . . as the Chair of the SEC, I must question, as a policy matter, using the federal securities laws and the SEC's powers of mandatory disclosure to accomplish these goals."[126] Given the legislative mandate, however, the SEC must adopt the disclosure rule and attempt to limit or mitigate the costs.[127] As we move forward and the SEC promulgates additional regulations related to corporate governance and credit ratings, the debate will continue as to the costs and benefits associated with mitigating conflicts of interest and providing helpful disclosure to investors and other market participants.

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124. *See Homogenization of Executive Pay Plans: The Unintended Consequences of Say on Pay Votes*, Pay Governance, *available at* http://paygovernance.com/homogenization-of-executive-pay-plans-the-unintended-consequences-of-say-on-pay-votes-2/ (last visited May 15, 2014).

125. Jessica Holzer, *SEC, in Split Vote, Adopts 'Say on Pay' Rule*, WALL ST. J. (Jan. 25, 2011, 6:25 PM), *available at* http://online.wsj.com/news/articles/SB100014240527487046980045761 04071862597358.

126. White, *supra* note 118.

127. *Id*.

OPENING REMARKS

JOSEPH HOGSETT*

Good afternoon. I should begin my opening remarks by telling you that Tod Perry[1] and Mark Stuaan[2] have been great partners to work with in preparation for this afternoon. I hope that what we have to offer you is of value. I was comfortable at the end of yesterday afternoon believing I was reasonably well prepared. Thereafter, someone suggested that, before my presentation this afternoon, I would be well-served to review a recent episode of PBS *Frontline*, an episode called The Untouchables.[3] So I took the advice and reviewed it. In fact, I did so at about a quarter to one today. Having done so, I almost called in sick. For those of you who did not see it, I am sure it will become clear in our discussion today what the episode was all about.

To begin, I am proud to be here as the United States Attorney and, therefore, as an employee of the Department of Justice. But I would also suggest that I do not see my role on this panel as being a representative simply of the Department of Justice. I have no interest in sitting here this afternoon reading a list of approved talking points. Nor do I think you would have much interest in me reading such a list. With your agreement, I would like to instead try to address an overview of our discussion, the debate that surrounds criminal enforcement matters, including both the positions that have been taken by federal prosecutors who actually prosecute these types of cases and by many of the critics. And there are many. If you question the latter, watch the *Frontline* episode I mentioned.[4]

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1. Tod Perry is an Associate Professor of Finance at the Kelley School of Business, Indiana University. Prior to joining Indiana University, Professor Perry served on the faculty at Arizona State University and practiced law for Bell, Boyd, and Lloyd in Chicago (now K&L Gates), specializing in Corporate Finance and Securities. Professor Perry has a B.B.A. in Accountancy from Notre Dame, a J.D. from the University of Virginia, and a Ph.D. in Finance from the University of North Carolina.

2. Mark Stuaan is a partner in the litigation department at Barnes & Thornburg, LLP, focusing his practice in white collar crime. Before his time at Barnes & Thornburg, Mark was Assistant United States Attorney for the Southern District of Indiana and Assistant United States Attorney for the Central District of Illinois. He is a graduate of Wabash College and the Southern Illinois University School of Law, where he was the editor-in-chief of the law review. He is currently also an adjunct professor at the Indiana University Robert H. McKinney School of Law where he teaches white collar crime.

3. *Frontline: The Untouchables* (PBS television broadcast Jan. 22, 2013), *available at* http://www.pbs.org/wgbh/pages/frontline/untouchables/.

4. *Id*.

It strikes me as important to note that even as we sit in this room and discuss issues on the cutting edge of one particular area of the law, the focus of our attention rarely strays from questions that are not really new. In fact, the topic we will be discussing today—issues of corporate liability over and against prosecutorial discretion—is one which lawyers have struggled with for hundreds of years. The great Blackstone cited a case from 1612 where he summarized all of corporate law by saying "a corporation cannot commit treason or felony or other crime in its corporate capacity though its members may in their distinct individual capacities."[5] Those were simpler times. If you are interested, Blackstone also noted that corporations could not be ex-communicated because they do not possess a soul.[6] I believe this might lead some to suggest there are few areas of corporate liability that have never changed.

But change is upon us, and with the perilous rise of industry and corporate power, so too must the law rise up to meet the challenges of a new era. American law has struggled to keep up with the pace of economic progress from the basic theory of respondeat superior, all the way up to the New York Central Railroad case that created the foundation for modern corporate liability,[7] and most recently, as discussed today, passage of laws like the Sarbanes-Oxley Act[8] and the Dodd-Frank Act.[9] Although the law itself has evolved, all of these moments in time have come back to the same basic question that Blackstone sought to answer—how does one assign criminal blame to a fictional entity? As some scholars have more aptly put it, how do you punish a fictional entity in a legal system based on the intentional moral accountability of individuals? That is a complicated question.

This brings me to the recent testimony of Attorney General Eric Holder. I know that today's panel discussion is being videotaped so I want to disclose—he is my boss. Attorney General Holder's testimony has drawn some attention for comments that he made at a recent Senate Judiciary Committee meeting. The Attorney General was facing criticism from senators on the question as to whether prosecutors should appropriately take into consideration the size of a financial institution when making decisions as to whether criminal charges should be filed. For the record, here is what Attorney General Holder said.

> I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps

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5. 1 WILLIAM BLACKSTONE, COMMENTARIES *464 (referencing *Case of Sutton's Hospital*, 77 Eng. Rep. 960 (1612)).

6. *Id.* at *465.

7. N.Y. Cent. & Hudson River R.R. v. United States, 212 U.S. 481 (1909).

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of the 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

9. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.).

even the world economy.[10]

Attorney General Holder went on to say that he thought there was what he called an "inhibiting influence" in the size of modern institutions.[11]

The public reaction, as I am sure many of you are aware, was not particularly supportive of that observation. We will now get into some of the issues of financial institutions being too big to jail. As an introductory matter, it is important to provide some context to the remarks that were made by the Attorney General.

When you become a United States Attorney, two things happen. First, you spend a lot of time explaining to your family and friends exactly what a United States Attorney is. After that you are then handed a huge binder, known as the United States Attorney Manual (the "USAM").[12] The manual is supposed to be a guide for all federal prosecutors in their actions on behalf of the United States, including issues of prosecutorial discretion. In fact, there is an entire section devoted to corporate prosecution guidelines.[13] Those guidelines require federal prosecutors to consider many factors when deciding whether to file charges against any corporate entity and many of them were actually first developed in 1999 by then Deputy Attorney General Eric Holder.[14] He authored the Holder memo, which stated that prosecutors should consider (1) the nature and seriousness of the offense, (2) whether the offense was an isolated incident or a systemic pattern of behavior, (3) whether the corporation voluntarily disclosed the wrongdoing, and (4) what steps the corporation has taken to correct the conditions.[15] There are others, but these give you a feel for the wide scope of considerations that prosecutors may consider in exercising prosecutorial discretion.

The final factor I will mention is so important to this discussion this afternoon that I will even give you the citation: Title 9, Section 28.1000. The heading of this section is called "Collateral Consequences" and it reads "[p]rosecutors may consider the collateral consequences of a criminal conviction or indictment in determining whether to charge the corporation with a criminal offense and how to resolve corporate criminal cases."[16] The comments that follow in the USAM make clear that the main concerns here are the interests of innocent third parties.

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10. Evan Pérez, *First on CNN: Regulator Warned Against JPMorgan Charges*, CNN (Jan. 8, 2014), http://www.cnn.com/2014/01/07/politics/jpmorgan-chase-regulators-prosecutors/, *archived at* http://perma.cc/DC3J-XAQ6.

11. *Transcript: Attorney General Eric Holder on 'Too Big to Jail,'* AM. BANKER (Mar. 6, 2013), http://www.americanbanker.com/issues/178_45/transcript-attorney-general-eric-holder-on-too-big-to-jail-1057295-1.html, *archived at* http://perma.cc/Y82V-3346.

12. U.S. Dep't of Justice, United States Attorneys' Manual (1997), *available at* http://www.justice.gov/usao/eousa/foia_reading_room/usam/, *archived at* http:// perma. cc/WX6C-K2VG.

13. *Id.* at 9-28.000.

14. *Id.* at 9-28.300.

15. *Id.*

16. *Id.* at 9-28.1000.

Prosecutors are instructed that where those collateral consequences for innocent third parties would be significant it may, I underscore may, be appropriate to consider non-prosecution or deferred prosecution agreements.[17]

Now, Attorney General Holder received criticism for saying that prosecutors may find it difficult to prosecute corporations if they have information that indicates doing so would cause significant harm to the national or the global economy. I would suggest that while his choice of words may not have been ideal, what he was saying really was not new policy, or anything close to it. This particular section of the manual that I quoted, in its current form, was put in place in August 2008, during the administration of President Bush, specifically to address what was a very real threat at that time: that a full out scorched earth prosecution of the financial industry's alleged criminal acts could in effect cause the collapse of financial markets. As an aside, I would suggest at this point that prosecution, in my opinion, in real time through sophisticated investigative techniques, including wire taps and surveillance, is the most effective way to hold individuals accountable. But that was back in 2008, and we now find ourselves in 2013.

Whether you agree or disagree with the principles of Section 28.1000, Collateral Consequences,[18] those decisions at that time set in motion a series of decisions that have brought us to where we are today. The Department of Justice would have me say that we are in a period of unprecedented aggressiveness when it comes to federal prosecution of corporate and financial wrongdoing. Over the last three years the Justice Department has filed 10,000 financial fraud cases against 15,000 defendants. The Department has obtained guilty pleas from UBS and RBS subsidiaries for their role in a well-known manipulation scheme,[19] and there have also been indictments of individual traders in the UBS case.[20] Rajat Gupta, a former Goldman Sachs board member, has been prosecuted.[21] Alan Stanford was sentenced to 110 years in prison for his $7 billion fraud scheme.[22]

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17. *Id.*

18. *Id.*

19. Press Release, U.S. Dep't of Justice, UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-running Manipulation of LIBOR Benchmark Interest Rates (Dec. 19, 2012), http://www.stopfraud.gov/iso/opa/stopfraud/2012/12-ag-1522.html, *archived at* http://perma.cc/FG8J-WTHT; Press Release, U.S. Dep't of Justice, RBS Securities Japan Limited Agrees to Plead Guilty in connection with Long-running Manipulation of LIBOR Benchmark Interest Rates (Feb. 6, 2013), http://www.justice.gov/atr/public/press_releases/2013/292421.htm, *archived at* http://perma.cc/7MCN-JDX8.

20. Press Release, U.S. Dep't of Justice, ICAP Brokers Face Felony Charges for Alleged Long-Running Manipulation of LIBOR Interest Rates (Sep. 25, 2013), http://www.justice.gov/opa/pr/2013/September/13-opa-1064.html, *archived at* http://perma.cc/76ZK-EKK8.

21. Press Release, U.S. Dep't of Justice, Former Chairman of Consulting Firm and Board Director, Rajat Gupta, Sentenced in Manhattan Federal Court to Two Years in Prison for Insider Trading (Oct. 24, 2012), http://www.justice.gov/usao/nys/pressreleases/October12/GuptaSentencing.php, *archived at* http://perma.cc/UW27-93AW.

22. Press Release, U.S. Dep't of Justice, Allen Stanford Sentenced to 110 Years in Prison for

In fact, to bring it close to home, the United States Attorney's Office convicted financier Tim Durham and his two associates just this past summer. Mr. Durham, if his appeal is denied, will spend the rest of his life in prison. The Department would also underscore that it has sued or settled claims with banks relating to actions taken during the mortgage crisis to the tune of more than $2 billion, including settlements from Deutsche Bank, CitiMortgage, and Flagstar.[23]

But for our purposes here today, I think it is less helpful to focus on who has been prosecuted. Rather I presume much of our conversation will focus on who has not been prosecuted. And this is foreshadowed by the August 2008 additions to the USAM. The calling card of the post-crisis criminal enforcement action is not the indictment so much as it is twin alternatives—non-prosecution agreements (NPAs) and deferred prosecution agreements (DPAs).

Let me conclude by providing a general overview for those in our audience who may not be familiar with those new tools. Deferred and non-prosecution agreements are contracts between the government and a company accused of wrongdoing where, in return for not being prosecuted or for having charges deferred for a period of time, the corporation agrees to undertake specific actions. These terms usually require the payment of a fine, continued cooperation with any investigation or trial, and often require the creation of new and improved internal corporate policies. Much like any contract, the rules are simple: meet the conditions and the charges are dropped or never filed to begin with. If the corporation drops the ball, in the alternative, then the federal government drags the company into court. It has been these agreements that have dominated criminal law enforcement and its response by the Department of Justice in the aftermath of the financial crisis. In the past four years, the Department of Justice has entered into more than 250 of these agreements, extracting more than $32 billion in fines, penalties, forfeitures, and other settlements. The SEC has recently followed suit in embracing this new tool as the preferred method of enforcement.

I would like to add as a final observation that is critical to appreciate how significant the usage of non-prosecution agreements and deferred prosecution agreements have been to corporate criminal law. Until roughly twenty years ago, these tools simply did not exist for federal prosecutors. When confronted with any kind of criminal corporate wrongdoing there was a stark choice—indictment or declination. So many prosecutors walked away. Far too often, prosecutors decided to decline and allowed the corporations to walk away. The reasons are numerous. You are all probably familiar with the many reasons offered and why I believe that these non-prosecution agreements and deferred prosecution agreements have obtained such interest. It is that they provide more tools for the prosecutor to use to hold corporate wrongdoers to some level of accountability.

Orchestrating $7 Billion Investment Fraud Scheme (Jun. 14, 2012), http://www.justice.gov/opa/pr/2012/June/12-crm-756.html, *archived at* http://perma.cc/3WQC-FHTW.

23. Press Release, U.S. Dep't of Justice, Justice Department Recovers Nearly $5 Billion in False Claims Act Cases in Fiscal Year 2012 (Dec. 4, 2012), http://www.stopfraud.gov/iso/opa/stopfraud/2012/12-ag-1439.html, *archived at* http://perma.cc/9QA6-FKT5.

Just to give you a feel for how rare these agreements previously were, there were only 18 DPAs prior to 2007. Since then, there have been more than 150 signed agreements. Some people applaud this move; they see it as a natural next step in the evolution of corporate law. Others argue very vigorously that it represents a cop-out; a refusal to fully hold accountable those institutions most responsible for the conditions that led to the financial collapse.

So this is where we find ourselves today: in a period of uncertainty as to what the role of criminal prosecution is and what that role should be. The stakes are high, and, as Attorney General Eric Holder can attest, the emotions in this debate are high as well. But I welcome the discussion.

OPENING REMARKS

MARK D. STUAAN*

The question mentioned earlier this afternoon, "Did law solve the financial crisis?" is an interesting one in part, I suppose, because even if we debated it for far more time than we have allotted this afternoon, or even the more general question, "Does the law solve anything?" we would never reach a consensus. We all know that the law may prevent some people from acting in a particular way because they do not want to face the legal consequences of that action. And the law, as we all know, does provide for civil and criminal penalties if a person or a business violates the law, and that is what we will be discussing here in a few minutes. But I think what we ought to look at is the question, "Is the law solving the financial crisis?" and, from my perspective, the answer is yes. One portion of Joe Hogsett's remarks references the United States Attorney's Manual.[1] In addition to the section dealing with collateral consequences[2]—and as he mentioned, that has been on the books so to speak for many years, back when I started with the department—there is another provision. That other provision deals with whether the United States Attorney or the Assistant United States Attorney considering whether to charge a business should consider alternative remedies.[3] Are there other civil or regulatory remedies or penalties that, in a sense, may get you the end result that a criminal prosecution would? And some of my remarks are going to echo a little bit of what you heard earlier today, and that is that offensive, even repugnant, conduct is not necessarily criminal conduct. Thus, just because a person is behaving in a morally or ethically offensive or wrongful way does not mean that he or she is going to be charged with a crime or even a civil penalty. Now, such conduct is deserving of private and public criticism and in some instances may even justify some sort of law enforcement action. But acting badly does not necessarily mean you have committed a crime. I am not saying as the character portrayed (I think it was by Michael Douglas) in the movie Wall Street stated, that "greed is good,"[4] but to paraphrase, greed is not a crime. Greed is not a crime. We might be offended by it, we might find it repugnant, but being greedy is not criminal conduct. How one goes about feeding one's greedy appetite or fulfilling one's greedy needs—that is where, if you will, the rubber meets the road. That is where some people and some businesses cross the line from simply being greedy to committing a crime or violating some civil rule or regulation.

Now let us start with the fundamental premise, and I am going to disagree with Blackstone's somewhat dated comment; a corporation can be charged with

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1. U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL (1997), *available at* http://www.justice.gov/usao/eousa/foia_reading_room/usam/, *archived at* http://perma.cc/T6C7-YKBM.

2. *Id.* at 9-28.1000.

3. *See id.* at 5-11.115.

4. WALL STREET (20th Century Fox 1987).

a crime.[5] One of the novel aspects I still have trouble getting my head around is that a corporation can even be charged with committing or being involved in a conspiracy involving its own employees and others. But those are general premises. So the obstacle, if one sees it as one in terms of bringing charges against big banks or big financial institutions, is not that they cannot be charged to begin with. They can be. They can be charged with criminal conduct.[6] When there is probable cause to believe an individual has committed a crime, then that is deserving of reasoned consideration by a prosecutor or civil enforcement person. And the same is true for a business. When there is probable cause to believe a corporation has committed a crime, prosecution of that corporation is deserving of thoughtful consideration by the prosecutor. But as Joe mentioned, we entrust prosecutors, we entrust those responsible with civil enforcement, to exercise discretion. Now sometimes the result of that exercise of discretion leads to a decision not to charge a crime or to charge one crime and not another, or to seek a civil penalty or not to seek a civil penalty. As part of that penalty we do debar some, exclude some from serving on the board of directors of a bank for three years or five years, whatever the case may be.

I urge all of us to keep in mind that a prosecutor's job—and I am speaking broadly in terms of civil enforcers as well—is to seek justice. And of course that pursuit of justice, at times, means a criminal case is not going to be filed. Sometimes one is going to be filed. Now, when there are circumstances where the pursuit of justice means deciding not to file a criminal charge, sometimes the avenue to pursue is a civil or administrative penalty or sanction. And that is also part of what we will talk about this afternoon.

Now, a bit of a caveat if you will. Those of my brothers and sisters who are members of the defense bar, those of you who may aspire to the glorious position of being a criminal defense lawyer, will you take off your white hat and put on your black hat? I do not want to be misunderstood. Prosecution of criminal cases is good. At least it is good for the criminal defense business. It might not be good for XYZ Corporation or Bank One or whatever the case might be. So I do not want to be suggesting the opposite of that. Now I will offer a bit of an opinion and a word of advice which is not intended as a criticism of the media, but picking up somewhat on Joe's comments about the reactions to Attorney General Eric Holder's remarks: please, please do not decide whether someone should be prosecuted or whether someone should have been prosecuted based on what you hear or read in the media. Again I am not criticizing the media. I used to sit a desk not unlike Joe's—probably not as a big, probably not as fancy as his—but you would sit there as an Assistant United States Attorney and decide: "What is the right thing to do here? Is this probable cause? Yes, but can I prove the crime?" And what I want you to keep in mind if you have not been exposed to it before is that a prosecutor or someone responsible with enforcing civil rules and regulations knows a lot more of the back story than what you are going to get

5. *E.g.*, N.Y. Cent. & Hudson River R.R. v. United States, 212 U.S. 481 (1909).

6. *Bringing Criminal Charges Against Corporations*, U.S. Dep't of Justice (1999), http://www.justice.gov/criminal/fraud/documents/reports/1999/charging-corps.PDF.

in any news account, no matter how impartial that news account might be. The potential evidence, the possible evidentiary problems, the resources needed for a successful prosecution, the anticipated criminal penalties or alternatives to prosecution are often best known to prosecutors. Someone working in Joe's office today would say, "Well if I indict Bank X, what is going to happen?" Well the bank is not going to go to jail, but it may pay a fine of X amount of money. You can pretty well figure out what that penalty is going to be based upon the sentencing guidelines, or at least what the range is going to be. If you are thinking about charging a person, you can get a pretty good estimate of what jail time that person is looking at because of the sentencing guidelines. So the anticipated criminal penalties that would follow a criminal conviction are predictable. And, as we have talked a little bit about, there are other consequences beyond a prison sentence or a large fine. Does an indictment of this bank mean it is going to go out of business? Arthur Anderson was indicted, prosecuted, and the result was twenty-some thousand people out of work.[7] The Supreme Court reversed.[8] I am not saying that was a wrong decision or a bad decision, but that is part of what people who sit in Joe's seat have to consider. And it is an appropriate consideration. And Attorney General Holder was right on point.

Prosecutors and their civil and regulatory counterparts have more than enough tools in their respective toolboxes to enforce and punish or exercise deterrent signals, if you will, regarding the financial crisis. In my opinion there are enough statutes; there are enough rules; there are enough regulations on the books; there are enough tools in their toolbox. Now, people in Joe's position and other offices may want more resources, and I cannot speak to that. And they may want more agents to investigate, whatever the case may be. But this is not a resources question. This is, in a sense, a more fundamental question than that. But I do not think that more laws, more rules, more regulations, or increasing the maximum penalty for committing mail fraud or wire fraud, what have you, is the answer. More legislation may be appropriate in terms of reforming our financial industry, restructuring it, and preventing it from happening in the future, but I do not think we need it to go after those who committed crimes or crossed the line on the civil side.

One last thing: some of you may be sitting there thinking about the financial crisis. And some of you are probably young enough, and you are thinking, "Gosh, that is ancient history already," but if we think of it as 2008 and we are sitting here in 2013, and if you do any criminal work at all you may be thinking of the statute of limitations—what is going on there? Is the clock running out on pursuing some criminal cases? Probably not because there are specific statutes of limitations for certain crimes involving financial institutions, but even mail fraud and wire fraud, if it affects a financial institution, has a ten year statute of

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7. A.C. FERNANDO, CORPORATE GOVERNANCE PRINCIPLES, POLICIES AND PRACTICES 243 (Pearson 2006).

8. *Id.*

limitations.[9] So there is more than enough time if the facts and circumstances warrant it. So if you are sitting out there thinking, “Well this may be mildly interesting or very interesting, but these mortgage-backed problems happened in 2007 or 2008 and now it is 2013; has the shot clock not just about expired?” I wanted to mention that the answer to that is “no.”

9. 18 U.S.C. § 3293 (2006).

Q&A SESSION

JOSEPH HOGSETT*
MARK D. STUAAN**

MODERATOR: You both touched on this a little bit. This morning, your friend, former Governor and former Senator Evan Bayh, mentioned that, from his seat in the Senate, they were talking about stabilizing things now and were going to go after the bad guys later. I made a note to myself thinking about what we were going to be discussing this afternoon, and I think part of the obviously public dialogue is: will that happen? And I think you addressed some of this, but I guess the question is: is there a way to determine if these institutions are too big to jail or too big for trial? And how do you go about making determinations not necessarily on the criminal side and the legal side? Now you are making determinations in some respects that are getting into economic issues and collateral consequences about what is going to happen, and projecting out when you are sitting in their shoes.

HOGSETT: I think that is the wrong question to ask. Or I would at least rephrase it from "too big to jail or too big for trial." I think the appropriate question may be: are they too big to punish effectively? And my answer to that is no, on a case-by-case basis. Now, again in the interest of full disclosure, we do not see those types of cases and we do not make those kinds of decisions in the Southern District of Indiana with any frequency. So, let me put that limitation at the very forefront of my comments. I think one way to look at that question though is through the lens of two recent cases that were prosecuted by the Department of Justice, both of which I think were in December 2012. You may be familiar with them, so forgive me for repeating some of the background for your consideration. Banking giant HSBC admitted last December to violating the Bank Secrecy Act.[1] They apparently laundered billions of dollars through the United States financial system for the Mexican drug cartels and other countries subject to trade sanctions such as Iran, Burma, Sudan, Libya, and Cuba.[2] Rather than prosecute HSBC, the Department of Justice announced a settlement

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1. United States v. HSBC, No. 12-CR-763, 2013 WL 3306161, at 1 (E.D.N.Y. July 1, 2013).
2. *Id.* at 8-9.

including more than $1.9 billion in penalties.[3] Now, that settlement is far and away the largest forfeiture involving a bank, but the nearly $2 billion settlement pales in comparison to the $18 billion in profit that HSBC made in 2012.[4] But, more than just fines, the agreement also required a comprehensive corporate compliance policy that was required to be adopted, completely overhauling all of the internal controls at HSBC.[5] Now, contrast that settlement with the case involving UBS. Also last December, the Department of Justice announced the filing of criminal information against the Japanese subsidiary of UBS, the Swiss bank.[6] This time, the entire subsidiary was charged, and it ultimately entered a guilty plea.[7] The charges stemmed from a scheme to manipulate LIBOR, the London Interbank Offered Rate, a key benchmark for financial products and transactions around the world.[8] In pleading guilty to one count of wire fraud, the company faced over $1.5 billion in fines, and two individual UBS traders were criminally charged.[9] Now, in the end, what is the difference? In each case there was a significant financial impact and a large fine leveled against the companies, but beyond that there are few practical differences between the non-prosecution agreement reached in the HSBC case and the plea agreement reached in the UBS case. Because UBS, the parent company, did not lose its charter, the financial impact of the charges was minimal.[10] However, the UBS case was viewed by many commentators as a much stronger deterrent.[11] Many commentators said that is what we need to be doing—we need to be charging.[12] We need to be indicting and prosecuting instead of reaching these agreements. Yet, I would suggest that that may very well be a false distinction. Essentially, they are two different

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3. *HSBC Holding Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit $1.256 Billion in Deferred Prosecution Agreement*, U.S. DEP'T OF JUSTICE (Dec. 11, 2012), http://www.justice.gov/opa/pr/2012/December/12-crm-1478.html, *archived at* http://perma.cc/J49L-CSS2.

4. *HSBC Pays $4.2bn for Fines and Mis-Selling in 2012*, BBC (Mar. 4, 2013), http://www.bbc.co.uk/news/business-21653131, *archived at* http://perma.cc/49QJ-N6EJ.

5. *HSBC*, No. 12-CR-763, 2013 WL 3306161, at 10.

6. *UBS Securities Japan Co. Ltd. to Plea Guilty to Felony Wire Fraud for Long-running Manipulation of LIBOR Benchmark Interest Rates*, U.S. DEP'T OF JUSTICE (Dec. 19, 2012), http://www.justice.gov/opa/pr/2012/December/12-ag-1522.html, *archived at* http://perma.cc/N9TH-ETFZ.

7. *Id.*

8. *Id.*

9. *Id.*

10. Ben Protess, *Leniency Denied, UBS Unit Admits Guilt in Rate Case,* N.Y. TIMES, (Dec. 19, 2012), http://dealbook.nytimes.com/2012/12/19/leniency-denied-ubs-unit-admits-guilt-in-rate-case/?nl=todaysheadlines&emc=edit_ee_20121220, *archived at* http://perma.cc/QJ6D-Q7PC.

11. *See, e.g.*, Gabriel Markoff, *Arthur Andersen and the Myth of the Corporate Death Penalty: Corporate Criminal Convictions in the Twenty-First Century*, 15 U. PA. J. BUS. L. 797, 835 (2013) (discussing the need to shift towards increased prosecutions and away from deferred prosecution agreements).

12. *Id.*

tactics leading us to essentially the same outcome. Both are important. Both entities are held accountable in different ways. And yet, at least some of the public views it differently.

STUAAN: I would generally agree with Joe, and I like the notion of thinking of the question not in terms of "is a business too big to fail or too big to jail," but rather in terms of "is it too big to punish?" And the other part of what we are talking about this afternoon is not just whether the Southern District of Indiana U.S. Attorney's Office, the Southern District of New York, or the Eastern District of New York is more likely to bring charges against a business that is based on Wall Street or somebody that is on the board of some business on Wall Street. We have the civil part of it as well. As of October 2011, the Securities and Exchange Commission ("SEC") had charged 81 companies and individuals with some malfeasance within its rules and regulations.[13] As of February of this year, that number had gone up to 154.[14] 73 more individuals and companies had been taken to task by the SEC in roughly a sixteen-month period. It almost doubled from October 2011. And, one other item, in terms of those individuals who held the position of CEO or CFO, or held a senior management position in a bank or financial institution, as of October 2011, there were 39 that the SEC had charged.[15] As of February 2013, that number had gone up to 65, an increase of 26.[16] Not quite as dramatic, in terms of the companies indicted. But, still, if you think of someone who does not want to undergo the "perp walk,"—that is, being led out of your seventeenth floor office and down the elevator with your hands cuffed behind your back in your nice $400 or $500 Italian suit and your Italian loafers—it is the CEO or the CFO of a bank or a financial institution. Nobody likes it. Some folks at Joe's office deal with it and kind of come to expect it based on their lifestyle, but not those that are CEOs or CFOs. And, so, they are going to make those decisions pretty carefully. But, it is not just a criminal prosecution, it is the civil part of it, and that, I think, helps illustrate the notion: is a bank or an individual too big to punish? I would say the answer is no.

MODERATOR: You have both touched on this a little bit, but I wanted to give you an opportunity to expand on it. You have a continuum of things you can do across the criminal and civil enforcement regimes. But, in particular, as you mentioned, Joe, the accusation of a cop-out because of the prevalence of the deferred prosecution agreements today: do you care to expand on that and the kind of choices that you need to make within your role and, I guess, Mark, even from your role? Does this give you another option when you are on the other side of the table of possible outcomes? And how does that play a role in the process?

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13. U.S. Sec. & Exch. Comm'n, *FY 2011 Performance and Accountability Report* (2011), p. 2, 13, 189, *available at* http://www.sec.gov/about/secpar/secpar2011.pdf#2011review, *archived at* http://perma.cc/ULH8-FCHQ.

14. U.S. Sec. & Exch. Comm'n, *SEC Enforcement Actions: Key Statistics, (Updated through Sept. 1, 2013)*, http://www.sec.gov/spotlight/enf-actions-fc.shtml, *archived at* http://perma.cc/N6MJ-9EL4.

15. U.S. Sec. & Exch. Comm'n, *supra* note 13, at 189.

16. U.S. Sec. & Exch. Comm'n, *supra* note 14.

HOGSETT: Well, I think the collateral consequences component of the United States Attorneys' Manual guidelines is really just another step forward, in my opinion, in the process of accountability. I do not acknowledge nor do I accept that this is an attempt to let financial institutions off the hook once they reach a certain size. Rather, as a prosecutor making these types of decisions, I would hope that you would expect me to take all factors into consideration. On the *Frontline* program that I have referred to previously, I do not recall who was being interviewed, but they were absolutely vigorous in their belief that doing justice meant prosecuting.[17] And, that is it. That is the end of the inquiry—identify, investigate, and charge. That is, pure and simple, what it means to do justice. And that is what you are charged with the responsibility of doing, justice. I tend to think that is an overly simplistic view of the complexities of the decisions that we face, but I also acknowledge the complexities in the growth of the financial industry. I think that Mark's reference of Arthur Andersen is apt.[18] You know, the misdeeds in that case, if I remember, were largely constrained to the Houston offices in 2002. This was a company with thousands and thousands of people all over the world, and they all lost their jobs in the end. To pretend that these results should not be considered by prosecutors is just unrealistic. And the last thing I would say is it is important to remember that the collateral consequences component, and other issues that are part of prosecutorial discretion and the exercise thereof, are not rules. They are not binding principles. They are guidelines. If I choose to heed them or disregard them in my capacity as the United States Attorney, there is no or very little recourse against me. It is not Department of Justice policy so much as it is providing a United States Attorney who is looking at all the evidence that she has in front of her the information she needs to make informed decisions.

STUAAN: And you are right, Tod, from our perspective, the notion of a deferred prosecution or a non-prosecution agreement does give us an option. If I am going in to meet with Joe or one of the assistants in his office and my options are either talk him out of indicting or deal with an indictment, obviously there is not a whole lot to work with. But there is that third option, if you will, and that is if we can work out something where the government gets its pound of flesh, and yet we are not talking about an indictment where somebody has to go to trial, then that is great. If I represent an institution, that is going to be part of my pitch—"Come on, why is a deferred prosecution agreement not appropriate here?" I mean, and I am tickled that Joe did not quite quote *Pirates of the Caribbean*, they are more like guidelines, but that is what they are, they are guidelines; although Captain Jack Sparrow might take you to task if you do not follow those guidelines.[19] Just keep in mind, and I do not mean to suggest that the prosecutors are gun shy, but it is a reality. The Bear Stearns case in 2008—let

17. *Frontline: The Untouchables* (PBS television broadcast Jan. 22, 2013), *available at* http://www.pbs.org/wgbh/pages/frontline/untouchables/.

18. *See, e.g.*, Markoff, *supra* note 11, at 804-07.

19. *See* PIRATES OF THE CARIBBEAN: THE CURSE OF THE BLACK PEARL (Walt Disney Pictures & Jerry Bruckheimer Films 2003).

me take a step back. We have been talking about criminal and civil cases. They are not mutually exclusive. They happen a lot of times at the same time, and the Bear Stearns case is an example. Two of its senior asset managers, Ralph R. Cioffi and Matthew M. Tannin, were indicted in New York while also facing SEC charges.[20] As I recall, the SEC part of the case was put on hold, as is often the case. Civil proceedings are often put on hold when there is a criminal case going on because of the discovery discrepancies and so forth. These two gentlemen were indicted in 2008, went to trial, and the *New York Times* at the time said the prosecution viewed this as a clear case of Wall Street fraud.[21] And this is a crime, rather, these are crimes alleged to have come out of this financial crisis. This is not some separate insider trading case or what have you, it was viewed as a clear case of Wall Street fraud; a case of black and white lies by these defendants. The trial took three weeks.[22] The jury came back in about six hours.[23] A six-hour deliberation after a three-week trial from this side of the aisle is not encouraging for what is going to come out of the jury's mouth in terms of my client. For Joe's side it is a slam dunk. Three weeks—how do you consider three weeks of testimony in six hours? But, in any event, in six hours what did they decide? They acquitted both defendants of all charges.[24] Both defendants acquitted of all charges, and at the time, for example, the *New York Times* said you knew this verdict before it came out, but this verdict is expected to have wide ranging implications for how the government approaches similar white collar cases.[25] It is viewed "as a bellwether for other cases, both criminal and civil, involving the financial industry."[26] Now, again, I am not suggesting that because Cioffi and Tannin won acquittals that the Department of Justice has decided to back off. Because, frankly, I know enough prosecutors and was one myself, and if there is anything that whets your appetite more than, "Well, I am going to get the next conviction," then I do not know what does. So I do not want to suggest that they had backed off, but that is a reality. I tell folks that three things can happen when we go to trial, and two of them are not good. There is only one good thing that happens, and that is an acquittal. The second thing is a guilty verdict, and that is not good. The third thing is hung jury, and that is not good because the prosecution is likely to try it again. So, coming back, if I have the option of arguing with a United States Attorney about a deferred prosecution agreement as

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20. Indictment at 1, United States v. Cioffi, No. CR-08-415 (E.D.N.Y. Jun. 18, 2008); *SEC Charges Two Former Bear Stearns Hedge Fund Managers With Fraud*, U.S. SEC. & EXCH. COMM'N (Jun. 19, 2008), http://www.sec.gov/news/press/2008/2008-115.htm, *archived at* http://perma.cc/7P2B-VVQU.

21. Zachery Kouwe & Dan Slater, *2 Bear Stearns Fund Leaders Are Acquitted*, N.Y. TIMES, Nov. 10, 2009, http://www.nytimes.com/2009/11/11/business/11bear.html, *archived at* http://perma.cc/86D5-5QAL.

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

an option of whether to indict or not indict, then thank you, yes, I will take that option.

MODERATOR: This is my final question and then we will open it up. As we look forward, we talk about legislative and executive branch initiatives. Do you feel they should be aimed more at reform and prevention versus punishment and deterrents? And, I think that is one of the underlying themes of the frustration that sometimes comes out in the press, is that the lack of punishment for these perceived wrongdoers. And it also kind of runs through, I think, with some of the non-prosecution agreements, so again, as we look forward, where should we focus our efforts?

HOGSETT: I think one of the most compelling arguments in my thinking against the deterrence effect of death penalty type prosecution strategy, again, to return to Mark's example, is the Arthur Andersen case.[27] And the idea of weak laws versus weak enforcement, I have to wonder what did that really accomplish? Where was the deterrence? Here was a company that was completely abolished, essentially, and yet less than a decade later, the entire financial industry collapsed. That was an instance where the strongest enforcement of the laws produced very little effect. And at the end of the day, I think the answer would be similar in other areas of criminal prosecution. I do think that we have the tools available to us to adequately and fairly address these matters on a case-by-case basis. I do not think more legislative or executive branch efforts are necessary, I suppose, unless there are initiatives that I am not aware of that would be focused on more prevention and reform. I think Mark referred to that in his opening comments, the possibility of reform as opposed to punishment and deterrence. There is a regulatory role to play. There is a prosecutorial role to play. But I will end with this: it is like most every other criminal matter that comes before me. I do not think you can prosecute your way out of any problem. It takes a comprehensive, holistic effort that involves prevention, reform, and effective regulatory oversight. And, when appropriate, on a case-by-case basis, effective prosecution.

STUAAN: My notion is that there are enough rules, statutes, and regulations on the books now in terms of being able to enforce things, and it seems to me that legislative initiatives that we have heard a little bit about earlier today, those energies and focuses are better directed at reform and preventing things happening in the future as opposed to trying to undo what has happened in the past. So part of what this has to deal with is reforming or restructuring. And let me take a step back, in terms of the two gentlemen that I mentioned at Bear Stearns, although they were acquitted of their criminal charges, they both ended up settling the SEC charges.[28] Cioffi was barred from serving on any board or any bank for three years and had to pay an $800,000 fine in disgorgement.[29] Tannin was barred for two years and had to pay a $250,000 fine in

27. *See, e.g.*, Markoff, *supra* note 11, at 804-07.

28. Peter Lattman, *Bear Stearns Ex-Managers to Pay $1 Million to Settle Fraud Cause*, N.Y. TIMES, Feb. 27, 2012, http://dealbook.nytimes.com/2012/02/13/bear-stearns-ex-managers-to-pay-1-million-to-settle-s-e-c-case/?_r=0, *archived at* http://perma.cc/SE6Q-TMH8.

29. *Id.*

disgorgement.[30] I do not know their financial situation, but that seems to me to be a fairly decent penalty. But, as Joe mentioned, if you look at any of these settlement agreements with the SEC, it is rare that they do not require some internal changes or improvements. It may not be efficient on a case-by-case basis as opposed to across the industry, but sometimes that is what you are left with. That is, you have got to create an internal review process if you are going to stay in business. A lot of times these include a lot of factors and requirements beyond just how big the check is. And I think that is the more efficient and ultimately more productive way of trying to prevent this from happening in the future.

MODERATOR: We will open it up to the crowd for a few questions for our panelists.

AUDIENCE QUESTION: (inaudible)

HOGSETT: I think that is an excellent question. My response would be: it is one of the many things we take into consideration. It certainly is not determinative, ultimately, but to the extent that there may be a private right of action for individual victims to pursue is something that is considered. And this gives me the opportunity to underscore another point about deferred prosecution agreements and non-prosecution agreements. It seems to me that it is beyond important that there be a comprehensive reform of the governance and the structure. To be truly effective, I think there also needs to be an admission of wrongdoing, a clear and unequivocal admission of wrongdoing. Mark may disagree on that point, but the reason why it relates to your question is many private litigants are frustrated by deferred prosecution agreements and non-prosecution agreements that do not require an admission of wrongdoing. They see the government entering into these types of agreements where they do not hold, at least the institution, to that level of accountability, admission of wrongdoing, as harming their private right of action. So I want to qualify my support for the many different tools that I suggested today to add that caveat. It seems to me it is very important that people understand they are going to be given an opportunity to continue to live as an institution, but they have to admit their wrongdoing.

STUAAN: I respectfully disagree. I mean, at the risk of stating the obvious, if my client signs off on a plea agreement or even some sort of settlement that says, "Yes, we did bad, we did wrong, shame on us," I have handed a free ticket to plaintiffs out there to come after my client. I think that is part of the answer to that question. Sometimes it depends on which comes first. I mean, if a defendant is already in the midst of civil litigation and then the prosecutor starts rattling his saber about bring bringing a criminal case, then hopefully he will give me an opportunity to say, look, why not see what happens in the civil case because maybe that is the way, and you guys do not have very many resources anyway, you must fight terrorists and drug dealers and, Joe, you are busy. Let me save you the headache of going after my client and let us fight it out in the civil arena. And some prosecutors will consider that factor. If a plaintiff or group of plaintiffs has the financial wherewithal to come after a defendant, then that

30. *Id.*

sometimes is a factor for a prosecutor. Look, they are already in civil litigation. I have dope dealers, child pornographers, and so forth, so to some extent it depends on which opponent comes first. If a prosecutor is rattling his saber and then the civil folks, plaintiffs, raise their head, hopefully I will have a judge that will say "put the civil case on hold," and we will try to work things out in such a way that diminishes the pain that my client might feel, which is if I work a plea agreement with him, do it in such a way that it also addresses the civil suit as well. I have not been following them very closely, and there are a number of civil suits pending now arising out of the financial crisis. Some courts have issued some not very favorable rulings for plaintiffs, such as dismissing some antitrust charges and some other charges, but that is just a matter of a clever lawyer thinking of another theory and coming at it again. It will happen.

AUDIENCE QUESTION: (inaudible)

HOGSETT: That is a very interesting perspective. I do know that in the interviews that I have seen, particularly on these topics over the last year or so, the Department of Justice has underscored the difference in the burden of proof in that one has to show intent. And, to your point as to the amount of or the accuracy of disclosure in many cases, it is my understanding, and again I do not have personal experience, but it is my understanding that some cases have been declined because everyone fully disclosed everything, and nobody cared. Bank A said this was the due diligence and Bank B or Buyer B still invested even though he did not believe what Bank A was saying. Bank B or Buyer B did not care. For all of those reasons, I think the Department of Justice has taken the position that, back to Mark's point, using the regulatory environment where the burden of proof is preponderance of the evidence to extract some kind of accountability has been chosen because prosecutors have simply not found sufficient evidence to reach the beyond a reasonable doubt standard. I do not necessarily, again I am speaking as someone who does not make these decisions in this particular arena every day, but I do not see a need to change that. But, clearly, that has been the Department of Justice's position: that many of these cases have not been brought because of that high standard.

STUAAN: And the statute of limitations I was referring to was the criminal statute of limitations, and it is the same. The shot clock is a shot clock and that decision basically said when we say five years, we mean five years. Do not come and say, well, we have too much to do and that we need a little more time. That is a bad paraphrase, but I think that is what it is. But I do think part of what is going on in these financial crisis cases is, yes, people that bought homes are suffering because of what happened to their homes in terms of mortgage foreclosures and so forth, and that is wrong and bad. But with the people that were cutting the deals where the omissions were, there was full disclosure with pretty sophisticated folks. And I think to the extent that somebody sits back and says, well okay, these folks suffered and, yes, they did not tell everybody the whole deal or what have you, but this guy says he did not really believe them anyway, what prospective is going to say do not invest in this product? None. So I know there is going to be a certain amount of puffery or exaggeration. I am not an unsophisticated investor. I invest. I think there is some aspect of that at play. We are not talking about defrauding a farming couple in central Indiana out

of their life savings because you tell them you are going to double their money in twenty minutes. It is different. It is a different arena.

HOGSETT: Yes, and I would add just one last thought to that. And, I am sure you have probably discussed it already today, but let us not forget about the credit rating agencies. In many instances, when they were giving their stamp of approval, that made the prosecution of individuals in the corporate setting even more difficult. It is like somebody saying, well, I did what I did and you think it is wrong but it was on my lawyer's advice. So, let us not leave the credit rating agencies out of the equation either.

AUDIENCE QUESTION: (inaudible)

HOGSETT: That is a very good question, and it is a very difficult one to answer. But I will be as candid as I can. It would be my opinion that, as the United States Attorney, or any Assistant United States Attorney working in my office, we can never allow resources to be a reason for not prosecuting someone. My personal opinion would be that doing so would be inexcusable. Now, having said that, the reality is, after September 11, 2001, one-half of the FBI agents in the State of Indiana were no longer available. I mean, they were still here but the size of the FBI law enforcement partnership was cut in half over night because they were all dispatched to national security or counter-terrorism responsibilities. And, as everybody in this audience knows, a prosecutor relies on his law enforcement partners to work up cases. So we have not yet seen a substantial decrease in the amount of resources available to us as a result of sequestration, although my sense is only time will tell. But resources do play an important role in just how many cases we do pursue and accept, not in terms of the ultimate decision-making, but in our prioritization. I think that is the best way to answer it.

AUDIENCE QUESTION: (inaudible)

HOGSETT: Generally, that is driven by guidelines and it is not an arbitrary process. But, it is one that is imposed on us by people who are charged with the responsibility of having greater knowledge of those matters. It is not an "ouch" or a "wow" calculation, but it is obviously one that is born of not only guidelines, but negotiation. And, look, do I want to get the highest number that I possibly can? Yes. But Mark is going to argue vigorously against that, and there will be some area where we reach a compromise or an agreement.

STUAAN: Another thing to keep in mind: we have talked about these sentencing guidelines, and that does drive a lot of negotiations, but under federal law, at least, there are alternative fines available, and I am doing this from memory, but, for example, if a corporation is convicted of a felony, it carries a $500,000 fine. Or it can be twice the pecuniary gain to the defendant or twice the pecuniary loss to the victim, whichever is greater. I mean, I am oversimplifying. So if you have a $5 million loss, then the maximum fine that they could get, leaving the guidelines to the side, is $10 million, and that can be an "ouch." Keep in mind, it is not just "whatever the guidelines are," because it can end up twice what they got or twice what the victims lost. For a lot of folks that is a pretty good size check.

MODERATOR: Well, thank you very much. Thank you, gentlemen, for participating today and sharing your insights.

REVIEW OF CURRENT SCHOLARSHIP ON THE FISCAL CLIFF

DAVID J. HERZIG*

Most of the speakers at the Indiana Law Review Symposium: "Law and the Financial Crisis," held on April 5, 2013 at the Indiana University Robert H. McKinney School of Law, focused on the 2008 financial crisis, causes (including the law), and various concurrent responses. We sit here now thinking we have made it through the crisis and this will not happen again. Yet, the veneer of stability is probably just that. As recently as last week, Federal Reserve (the "Fed") chairman, Ben Bernanke, responded to an attempt at gutting Dodd-Frank by stating, "'[t]oo big to fail' is not solved and gone. . . . It's still here."[1] He went on to add that "'too big to fail' was a major source of the crisis, and we will not have successfully responded to the crisis if we do not address that successfully."[2] In fact, this narrative played out in a *Rolling Stone* article by Matt Taibbi, discussing Sen. Bernie Sanders' new bill in the spring of 2013.[3]

Many academic scholars seem to think that the question to ask is not whether another crisis like this will occur, but when.[4] Are we just over reacting? Is 2008

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1. James Downie, *The White House's Dangerous Stance on 'Too Big to Fail,'* WASH. POST (Mar. 27, 2013), http://www.washingtonpost.com/blogs/post-partisan/wp/2013/03/27/the-white-houses-dangerous-stance-on-too-big-to-fail/ *archived at* http://perma.cc/U9TM-9D2Q.

2. *Id.*

3. Matt Taibbi, *Growing Sentiment on the Hill for Ending 'Too Big to Fail,'* ROLLING STONE (Apr. 3, 2013), http://www.rollingstone.com/politics/blogs/taibblog/the-growing-sentiment-on-the-hill-for-ending-too-big-to-fail-20130403, *archived at* http://perma.cc/4YFD-5J4L.

4. Mehrsa Baradaran, *Banking and the Social Contract*, 89 NOTRE DAME L. REV. 1283, 1285-86, 1326-30 (2014); H. Rodgin Cohen, *Preventing the Fire Next Time: Too Big to Fail*, 90 TEX. L. REV. 1717, 1722 (2012); Simon Johnson, *Keynote Address: The Continuing Problem of "Too Big To Fail,"* 18 N.C. BANKING INST. 1 (2013); Roberta S. Karmel, *An Orderly Liquidation Authority Is Not the Solution to Too-Big-To-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 1, 44-45 (2011); Tom C.W. Lin, *The New Financial Industry*, 65 ALA. L. REV. 567, 585-89 (2014); Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 463-64 (2011); Steven L. Schwartz, *Ring Fencing*, 87 S. CAL. L. REV. 69 (2013); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951, 954 (2011); Jim Tankersley, *As Washington's Top Risk Seeker, Richard Berner Crunches Numbers to See Around Dark Corners In the Economy*, WASH. POST, Apr. 5, 2013, http://www.washingtonpost.com/business/wall-street-veteran-heads-new-federal-office-tasked-with-making-better-economic-forecasts/2013/04/05/bc9c912e-9ad6-11e2-9a79-eb5280c81c63_story.html, *archived at* http://perma.cc/TLE6-4DYW; *see also* Lawrence A. Cunningham, Symposium, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698 (2006); Mira Ganor, *Agency Costs in the Era of Economic Crisis: The Enhanced Connection Between CEO Compensation and Corporate Cash Holdings*, 55 ARIZ. L. REV. 105 (2013); M. Todd Henderson & Fredrick Tung, *Pay*

still close enough that we project our failings of 2008 on today's structures? Are we contrarians for the sake of being contrarians? Personally, I do not think so, and neither does Neil Barofsky, who served as Special Inspector General for the Trouble Asset Relief Program that bailed out the U.S. banking system in 2008.[5] He has stated that another financial crisis is inevitable and that the cost will be even higher than the 2008 financial crisis.[6] Why is this inevitable? We still have the primary problem with the current U.S. financial system having a few large institutions, or what have been called the "too big to fail banks," that are incentivized to take risks, and ensure that the executives will never be accountable for their actions.[7] As we can see from such recent actions as the London Whale problem (a mere $6 billion mistake),[8] and Barclay's rate manipulation,[9] among others, we are far from ending the risk taking of big banks.

The problem on a go-forward basis for dealing with another potential crisis is that the dynamic has now been shifted because the government introduced a safety net to the risk takers: bailouts.[10] Bailouts give bank executives an incentive to take short-term risks in order to maximize profits, because if the bank fails, the taxpayers will bear the burden of the bailout.[11] This is what is known in

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for Regulator Performance, 85 S. CAL. L. REV. 1003 (2012); M. Todd Henderson & Frederick Tung, *Reverse Regulatory Arbitrage: An Auction Approach to Regulatory Assignments*, 98 IOWA L. REV. 1895 (2013); Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262 (2013); Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575 (2013); David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437 (2013); Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 IND. L. J. 1405 (2013); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951 (2011) [hereinafter Wilmarth, *Dodd-Frank*]; Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street*, 81 U. CIN. L. REV. 1283 (2013) [hereinafter Wilmarth, *Blind Eye*].

5. NEIL BAROFSKY, BAILOUT: AN INSIDE ACCOUNT OF HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET 221-23, 225 (Free Press 2012).

6. *Id.* at 225.

7. *Id.* at 216-18.

8. Jessica Silver-Greenberg, *Withering Questions at Senate Hearings on JPMorgan Loss,* N.Y. TIMES, Mar. 15, 2013, http://dealbook.nytimes.com/2013/03/15/jpmorgan-executives-face-withering-questions-at-senate-hearing/, *archived at* http://perma.cc/WZ4E-9EPU; Wilmarth, *Blind Eye*, *supra* note 4, at 1429-37.

9. Mark Scott, *British Regulators Slow to Respond to Libor Scandal, Audit Says*, N.Y. TIMES, Mar. 5, 2013, http://dealbook.nytimes.com/2013/03/05/audit-faults-british-regulators-response-to-libor-scandal/, *archived at* http://perma.cc/K2JP-V5QD; Wilmarth, *Blind Eye*, *supra* note 4, at 1324; Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 190-93 (2013).

10. Verdier, *supra* note 4, at 1460-61.

11. Anat R. Admati et al., *Liability Holding Companies*, 59 UCLA L. REV. 852, 855-56 (2012); Andrea Freeman, *Payback: A Structural Analysis of the Credit Card Problem*, 55 ARIZ. L. REV. 151, 196-98 (2013); Stavros Gadinis, *From Independence to Politics in Financial Regulation*,

economic parlance as a "moral hazard." A moral hazard is where one party is responsible for the interests of another, but has an incentive to put his or her own interests first.[12] The standard example is a worker with an incentive to shirk on the job.[13]

Financial examples include the following: (1) I might sell you a financial product (e.g., a mortgage) knowing that it is not in your interests to buy it;[14] (2) I might pay myself excessive bonuses out of funds that I am managing on your behalf; or (3) I might take risks that you will have to bear. Moral hazards such as these are a pervasive and inevitable feature of the financial system and of the economy more generally.[15] Dealing with them—by which I mean, keeping them under reasonable control—is one of the principal tasks of institutional design to be discussed later.

This does not reflect the principles of a traditional free market because bailouts eliminate the deterrence of taking on an excessive amount of risk.[16] Because of the size of the financial institutions, the government is forced to bail them out or otherwise they will bring the entire financial system down with them.[17] Additionally, the U.S. government refuses to impose criminal sanctions on theses institutions or executives, because, again, their criminalization would collapse the entire financial market.[18] Thus, the main problems with the U.S.

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101 CAL. L. REV. 327, 387 (2013); Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 591, 598 (2013); Min, *supra* note 4, at 439-42; Erica A. Posner & E. Glen Weyl, *An FDA For Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets,* 107 NW. U. L. REV. 1307, 1345 (2013); Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO. L.J. 387, 441-42 (2013).

12. BLACK'S LAW DICTIONARY 786 (9th ed. 2009).

13. Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure and Relocation,* 136 U. PA. L. REV. 1349, 1384-85 (1988).

14. Mark Klock, *The Virtue of Home Ownership and the Vice of Poorly Secured Lending: The Great Financial Crisis of 2008 as an Unintended Consequence of Warm-Hearted and Bone-Headed Ideas*, 45 ARIZ. ST. L.J. 135, 163-64 (2013); Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63 (2012); *see generally* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 204-10 (2009) (describing when an actor does not bear all of the consequences of his action.).

15. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 254 (2010); Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951 (2012).

16. *See, e.g.*, Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 Fla. L. Rev. 1349, 1376-77 (2011); Simone M. Sepe, *Regulating Risk and Governance in Banks: A Contractarian Perspective*, 62 EMORY L.J. 327, 381 (2012).

17. Anat R. Admati et al., *Liability Holding Companies*, 59 U.C.L.A. L. REV. 852 , 896-97 (2012); Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1385-86 (2011).

18. *See, e.g.*, Samuel W. Buell, *Is the White Collar Offender Privileged?*, 63 DUKE L.J. 823,

financial market all stem from size of its financial institutions.

Further, the economic literature has supported that not only did we fail from a regulatory, law-making, and policy standpoint, but we failed with our modeling.[19] For example, in an ex poste examination of the 2008 crisis, Òscar Jordà, Moritz HP. Schularick, and Alan M. Taylor's recent working paper posits that excess credit is to blame.[20] They claim it was a historical mishap that, just as the largest credit boom in history engulfed Western economies, consideration of the influential of financial factors on the real economy had dwindled to the point where they no longer played a central role in macroeconomic thinking.[21] Standard models were ill equipped to handle financial factors, so the warning signs of increased leverage in the run-up to the crisis of 2008 were largely ignored.[22]

This all leads to the frame of this panel: is there really any way to regulate the financial market in order to prevent the next financial crisis? The post mortem has been undertaken by many. For example, Wladimir Kraus highlights that

> Judge Richard Posner bears the distinction of having published two books within little more than a year: *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009) and *The Crisis of Capitalist Democracy* (2010), both from Harvard University Press. The first and the shorter of the two, *A Failure of Capitalism*, introduces the reader, in fairly broad strokes, to Posner's overall understanding of the

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849 (2014) ("To 'hold Wall Street criminally responsible' for marketing derivative products that unleashed mayhem in 2007 and 2008 would require, at the least, two sharp departures from the traditions and architecture of Anglo-American criminal law."); Brandon L. Garrett, *Globalized Corporate Prosecutions*, 97 VA. L. REV. 1775, 1794-95 (2011) (discussing that deferred prosecution agreement is overly lenient to corporate crime); Gregory M. Gilchrist, *The Special Problem of Banks and Crime*, 85 U. COLO. L. REV. 1 (2014) (stating that regulators fail to use criminal tools which fails to introduce deterrence and expressive costs); Mary Kreiner Ramirez, *Criminal Affirmance: Going Beyond the Deterrence Paradigm to Examine the Social Meaning of Declining Prosecution of Elite Crime*, 45 CONN. L. REV. 865, 885 n.79 (2013) (arguing that failure to prosecute causes deadweight loss and perverse incentives); Scott A. Schumacher, *Magnifying Deterrence by Prosecuting Professionals*, 89 IND. L.J. 511 (2014) (discussing that an increase in the off-shore prosecutions has had a chilling effect on tax shelters); Rena Steinzor, *Introduction: Connecting the Dots Between Two Parallel Worlds*, 72 MD. L. REV. 1145, 1160 (2013) (stating that deterrence to corporate criminality is eliminated by the failure of routine criminal charges); Editorial, *Too Big to Indict*, N.Y. TIMES, Dec. 11, 2012, at A38, *available at* http://www.nytimes.com/2012/12/12/opinion/hsbc-too-big-to-indict.html?_r=0.

19. *See e.g.*, Òscar Jordà et al., *When Credit Bites Back: Leverage, Business Cycles, and Crisis* (Nat'l Bureau of Econ. Research, Working Paper No. 17621, 2011), http://www.bde.es/investigador/papers/sie1126.pdf, *archived at* http://perma.cc/W68A-47PS.

20. *Id.*

21. *Id.*

22. *Id.*

> manifold causes of the crisis and provides a critical assessment of intellectual and policy reactions to it. The second book, though in many respects a valuable stand-alone contribution, stays squarely within the analytical framework laid down in *A Failure of Capitalism* and constitutes largely an ''effort to deal in greater depth, and from a longer perspective, with a crisis that has continued to evolve, to elicit new response measures and new proposals for regulatory reform, to engender new concerns about the future and spawn new controversies about the past.''[23]

The normative target proposed by Posner, which I think is the theme of this panel, is systemic risk reduction.[24] After researching many scholarly writings on the subject, it appears that most proposals for this risk reduction fall under four categories: 1) changing the scope of the agencies regulating the financial market, e.g., granting more agency power; 2) creating a new agency to regulate the market; 3) establish a new statute aimed at regulating the financial market, like the Dodd-Frank Act; or 4) an approach that focuses more on judicial activism and the notion that courts should be more involved in the regulation of financial markets.

I. CATEGORY 1—AGENCY SCOPE

The first category involves changing the scope of the administrative agencies charged with regulating areas of the financial market.[25] Essentially, these proposals suggest that more power should be given to administrative agencies.[26]

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23. RICHARD A. POSNER, THE CRISIS OF CAPITALIST DEMOCRACY (Harvard Univ. Press, 2010); Wladimir Kraus, *The Financial Crisis: A Crisis, Too, For Law and Economics?*, CRITICAL REV. Vol. 23, Nos. 1-2, 147-48 (2011), *available at* http://wladimirkraus.net/resources/Kraus.pdf, *archived at* http://perma.cc/S7RQ-HRXK.

24. *Id.* at 148.

25. Colleen M. Baker, *Regulating the Invisible: The Case of Over-The-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287 (2010); Arthur W.S. Duff & David Zaring, *New Paradigms and Familiar Tools in the New Derivative Regulation*, 81 GEO. WASH. L. REV. 677 (2013); Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivative Clearinghouses*, 61 EMORY L.J. 1153 (2013); Richard E. Mendales, *Fitting an Old Tiger with New Teeth: Protecting Public Employee Funds Investing in Complex Financial Instruments*, 96 MARQ. L. REV. 241 (2012); Saule Omarova & Adam Feibelman, *Risks, Rules and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009); Omarova, *supra* note 4; Steven A. Ramirez, *Taking Economic Human Rights Seriously After the Debt Crisis*, 42 LOY. U. CHI. L.J. 713 (2011); Michael S. Solender, *How the Obama Administration Should Regulate the Financial Sector*, 26 YALE J. ON REG. 471 (2009); Manuel A. Utset, *Complex Financial Institutions and Systemic Risk*, 45 GA. L. REV. 779 (2011); Yesha Yadav, *Looking for the Silver Lining: Regulatory Reform After the "Credit Crunch,"* 15 STAN. J.L. BUS. & FIN. 314, 351-74 (2010).

26. *See, e.g.*, Utset, *supra* note 25, at 837-39 ("To effectively monitor the risk within particular institutions and the financial system, a regulator will need to deal with three levels of complexity: the institutional level, system level, and regulatory level. Identifying, on a timely basis,

By giving the agency more powers through access to the financial institutions and their information, the agency can manage the risk instead of the institution.[27] Thus, the agencies will have a better understanding on the amount of risk relative to the amount of capital that institutions are taking. Another popular broad suggestion is to increase the enforcement power of regulatory agencies so that institutions are more threatened from wrongdoing and excessive risk taking.[28]

A specific proposal by Yesha Yadav suggests that there should be a more multi-peaked rather than a unitary regulator in the mold of the Financial Services Authority (FSA).[29] She explains that this will enhance regulatory competition and create checks and balances within the oversight frame work.[30] One regulator can be prone to defending too many competing interests, such as confidentiality, clear regulatory objectives, and setting effective precedents.[31] Rather, she argues that having a small set of separate agencies managing different regulatory goals may help limit one dominating interests.[32] She breaks it down further by charging different regulation into three separate categories: 1) financial stability and monetary policy,[33] 2) market conduct,[34] and 3) consumer protection.[35] She then explains the scope of each agency, although she does not specifically designate a specific agency for categories two and three.[36]

Yadav charges the regulation of financial stability and monetary policy to the Fed.[37] She explains that because of the Fed's expertise on matters of prudential and risk regulation, that it would be perfect as regulator proscribing rules in respect of capital and liquidity requirements to manage externalities for the market.[38] These rules would assure the sufficiency of for all types of financial institutions that pose risks and be required to take steps to mitigate those risks through appropriate reserves of capital and available liquidity.[39] Market Conduct would be regulated by a completely new agency, which Yadav calls the Financial

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changes in the risk profile of a group of complex institutions interacting with each other along numerous dimensions creates much greater challenges for regulators than monitoring each of those institutions as single, isolated entities.").

27. *See, e.g.*, Omarova & Feibelman, *supra* note 25, at 483-91 ("The nature of the risk in the financial sector necessitates vigilant government oversight of the industry's self-regulatory process.").

28. *See, e.g.*, Mendales, *supra* note 25, at 296-311(arguing that regulatory "teeth" provide deterrence).

29. Yadav, *supra* note 25, at 351-74.

30. *Id.* at 373.

31. *Id.* at 367.

32. *Id.*

33. *Id.* at 368-69.

34. *Id.* at 369-70.

35. *Id.* at 370-71.

36. *Id.*

37. *Id.* at 368-69.

38. *Id.* at 368.

39. *Id.*

Services Regulator (the "FSR").[40] She emphasizes that the FSR be independent, with a mandate for creating and making rules to regulate and supervise firms, except for stability and monetary policy regulation.[41] The FSR would be more effective as it would involve less sector-based regulation and a greater focus on objectives-based approach to regulation, specifically evaluating firms' relationships with the market.[42] The FSR's responsibilities would include admitting firms into the financial market, oversee management structure, regulating conduct of business rules for the market, and oversee proper compliance of firms with customer-specific rules, disclosures, fraud, market manipulation, and insider trading.[43] Yadav proposes that the third category of consumer protection be regulated by a separate agency, which she refers to as the consumer protection agency.[44] She explained that this agency would be strictly focused on monitoring the proper application of and adherence to consumer protection standards.[45] It would "oversee consumer protection issues affecting the market as a whole, complementing the FSR."[46] She ensures that this will keep the FSR and Fed properly mindful of consumer interests against harmful behavior by financial institutions.[47]

Overall, Yadav asserts that by organizing agency regulation into this multi-peaked structure with proper interaction and contact between agencies, regulators would be better suited for each responsibility, and there would be a specialized degree of oversight without the serious structural impediments that keep these agencies from working together effectively.[48]

In their recent article, Saule Omarova and Adam Feibelman, discuss a "three-peak" structure changing the scope of regulators in the industry.[49] However, under this model, the agencies would not split up tasks vertically based on subject matter of regulation, as Yadav proposes.[50] Instead, the agencies' scope would be determined horizontally, based on different markets.[51] One agency would regulate and supervise the wide variety of retail financial service providers and markets.[52] A smaller, more nimble agency would regulate the wholesale financial services providers and markets in complex financial instruments.[53] These two agencies would aim at ensuring safety and soundness of financial institutions and

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40. *Id.* at 369.
41. *Id.*
42. *Id.* at 369-70.
43. *Id.* at 369.
44. *Id.* at 370.
45. *Id.*
46. *Id.*
47. *Id.* at 371.
48. *Id.*
49. Omarova & Feibelman, *supra* note 25.
50. *See* Yadav, *supra* note 25.
51. Omarova & Feibelman, *supra* note 25.
52. *Id.*
53. *Id.*

market conduct.[54] The third agency would then exercise general oversight aimed at preventing system-wide disruptions and ensuring regulatory consistency and general market integrity in both markets.[55] The third agency would also be responsible for regulating issuance of securities, operation of trading platforms, rating agencies, payment systems, and monitoring compliance with anti-money laundering laws.[56]

The authors also briefly mention other ways to shape the scope of regulators. The institutional or function approach would split up agencies to regulate based on the function of the institution, which is basically the current structure in the United States.[57] An integrated regulatory structure would give regulatory and supervisory power to one single super agency.[58] Lastly, a twin-peak approach would divide responsibilities between a prudential regulator of the safety and soundness of financial institutions, and a market conduct regulator.[59]

Omarova and Feibelman ultimately decide that regardless of the specific structure, first the government needs to decide what and whom should be regulated as well as why and how regulation should occur.[60] They argue that once this framework is decided, that the scope of the financial regulators will emerge logically.[61]

II. CATEGORY 2—NEW AGENCY

The second category focused primarily on establishing a new agency for regulation.[62] This was actually the most popular type of proposal by scholars. The argument is that currently, the United States does not have an agency that could effectively monitor financial markets, but, rather, financial regulation

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54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *See* Eric C. Chaffee, *Finishing the Race to the Bottom: An Argument for the Harmonization and Centralization of International Securities Law*, 40 SETON HALL L. REV. 1581 (2010); Kristin N. Johnson, *Macroprudential Regulation: A Sustainable Approach to Regulating Financial Markets*, 2013 U. ILL. L. REV. 881 [hereinafter Johnson, *Regulation*]; Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167 (2011); Roberta S. Karmel, *The Future of the Securities and Exchange as a Market Regulator*, 78 U. CIN. L. REV. 501 (2009); Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349 (2011); Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537 (2009); Steven L. Scharcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549 (2009); Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 IND. L.J. 213 (2013); Yadav, *supra* note 11.

consists of several dissimilar agencies with other primary objectives.[63] Thus, a completely new agency should be specifically designed to regulate the financial market.[64]

For example, Colleen Baker, in a recent article, suggested establishing a joint venture between the SEC and the Commodities Future Trading Commission, which she called the Derivatives Supervision Initiative (the "DSI").[65] The DSI would be designed to maximize regulatory strengths of both the SEC and CFTC.[66] The three objectives of the DSI would be "disclosure based regulation, market integrity and surveillance, and enforcement."[67] She argues that this will solve the problem with jurisdictional exemption of over-the-counter derivatives.[68]

Other authors have also lobbied for some sort of integration between the SEC and CFTC.[69] In his recent article, Robert S. Karmel proposed that doing so would have several advantages.[70] First, he argues, it would eliminate the jurisdictional squabbling in financial market regulation between these two agencies.[71] Second, it would operate as a bigger, more powerful agency, which would be better positioned to guard against agency capture.[72] Third, he recognizes the problems associated with putting all regulatory functions in one or two agencies; however he believes that some consolidation is necessary in order to hold certain regulators at fault who played a role in the financial crisis.[73] Fourth, the consolidation of the SEC and CFTC might lead to better coordination among regulators.[74]

On the other hand, Jeffrey Manns proposes to establish an independent agency called the Federal Government Investment Corporation (the "FGIC").[75] "The FGIC [would] serve as an investor of last resort, [and] would make bailout monies contingent on beneficiaries sharing both risks and long-term returns with

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63. *See generally* Karmel, *supra* note 62 (discussing that SEC could be a regulator of the market with more powers); Manns, *supra* note 62 (discussing establishment of an "independent agency, the Federal Government Investment Corporation (FGIC), to serve as an investor of last resort, which would make bailout monies contingent on beneficiaries sharing both risks and long-term returns with taxpayers.").

64. *See* Johnson, *Regulation*, *supra* note 62; Markham, *supra* note 62.

65. Baker, *supra* note 25, at 1338; *see also* U.S. SEC & EXCHANGE COMM'N & U.S. COMMODITY FUTURES TRADING COMM'N, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION (2009), http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf, *archived at* http://perma.cc/UAE2-SRF3.

66. Baker, *supra* note 25, at1345.

67. *Id*.

68. *Id*. at 1342-45.

69. *See* Karmel, *supra* note 62; Markham, *supra* note 62.

70. Karmel, *supra* note 62.

71. *Id*. at 533.

72. *Id*. at 533-34.

73. *Id.*

74. *See id*.

75. Manns, *supra* note 62.

taxpayers."[76] Essentially, it would be aimed at "handl[ing] bailouts in a structured way."[77] "The FGIC would establish express, ex ante conditions for providing aid that would temper corporate risk taking, protect taxpayers, and establish bounds to bailouts."[78] Overall, "the FGIC would provide taxpayers with long-term returns commensurate with the risks they assume in offering financing to [financial institutions crucial to the financial market] and to deter those companies from over-reliance on government aid in the process."[79] The key to deterrence is the reduction in stakes of shareholders and creditors as an exchange for government aid, so that shareholders do not have an interest of taking on too much risk without consequences.[80]

III. CATEGORY 3—STATUTORY APPROACH

This approach is focused on adding a statute that better regulates the financial market, like the Dodd Frank Act.[81] Advocates of this type of solution often state that it is more effective because it specifically addresses the conduct that the government wishes to prevent.[82] However, often times a statute like this is thousands of pages long, contains many loopholes, and is just patchwork on the top of other regulations.[83]

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76. *Id*. at 1349.

77. *Id*. at 1383.

78. *Id*. at 1349; *see generally* Louis Kaplow & Steven Shavelle, *Fairness Versus Welfare* 114 HARV. L. REV. 961 (2001).

79. Manns, *supra* note 62, at 1383-84.

80. *Id*. at 1388; *see* Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 57 (2004) (provides an example of deterrence in bail-out situations).

81. Eric C. Chaffee, *The Role of the Foreign Corrupt Practices Act and Other Transnational Anti-Corruption Laws in Preventing or Lessening Future Financial Crises*, 73 OHIO ST. L.J. 1283 (2012); John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795 (2011); Michael Faure & Klaus Heine, *Insurance Against Financial Crisis,* 8 N.Y.U. J. L. & BUS. 117 (2011); Macey & Holdcroft, *supra* note 17; Omarova, *supra* note 14; Wilmarth, *Dodd-Frank*, *supra* note 4.

82. *See* Chaffee, *supra* note 81; Macey & Holdcroft, *supra* note 17.

83. *See generally* Jan Bisset & Margi Heinen, *Are You Occupied by Dodd Frank*, 91 MICH. B.J. 50 (2012) (arguing that Dodd-Frank Act is unwieldy); Kathryn Reed Edge, *Only a Framework*, 46 TENN. B.J. 28 (2010) (arguing that Dodd-Frank's 2,139 pages are only a framework and more than 5,000 pages of regulations are needed); Steven A. Ramirez, *Dodd-Frank as Maginot Line*, 15 CHAP. L. REV. 109 (2011) (arguing that Dodd-Frank is not responsive and "encourages complacency, represents a massive diversion of resources and encourages bank managers to strategically flank its proscriptions"); David Enrich, *Banks Find Loophole on Capital Rule*, WALL ST. J. (Feb. 17, 2011), http://online.wsj.com/article/SB10001424052748704657704576150443241518166.html, *archived at* http://perma.cc/NS95-PRSJ (ruling making allows banks to plan round rules); Anna Timone, *Banks Find Comfort in Dodd-Frank Loopholes*, FOREXLIVE (Sept. 22, 2012, 2:46 PM), http://www.forexlive.com/blog/2012/09/22/banks-find-comfort-in-dodd-frank-

Todd Henderson has co-authored an article with Frederick Tung,[84] where they acknowledge the widespread concept "that executive compensation arrangements encouraged the excessive risk taking by banks that led to the recent Financial Crisis."[85] However, instead of calling for the reform on banker pay practices like most scholars, they "argue that regulator pay is to blame as well, and that fixing it may be easier and more effective than reforming banker pay."[86] They focus on the notion that there was a lack of similar incentives for bank regulators to prevent the risk the banks were engaging.[87] If a bank examiner is paid a flat wage at government wage rates, let's use $100,000, and their incentive is to follow protocol and not get fired, what incentive do they have for challenging the banks? Meanwhile, the bankers have huge incentive to take risk since their compensation is tied to the profitability. Therefore, they propose that regulators like "bank examiners, be compensated with a debt-heavy mix of phantom bank debt and equity, as well as a separate bonus linked to the timing of the decision to take over a bank."[88] By incentivizing the regulators to examine the risk by compensating them for uncovering bad deeds, they would prevent improper risk taking by the institution.[89] Specifically, the authors contend that the portfolio would provide a "variable compensation component based on the market value of a mix of the regulated bank's debt and equity-based securities."[90] The regulator would also become eligible for a "bonus [based] on the timing of the decision to take over a failing bank."[91] This would eliminate the current problem of regulators having too many incentives to wait too long before putting a failing bank into resolution.[92]

Jonathan R. Macey and James P. Holdcroft, Jr. suggest imposing a bright-line limit on the "too big to fail banks."[93] This "rule would limit the total liabilities

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loopholes/, *archived at* http://perma.cc/5JRC-HBNF (arguing that banks enjoy rules because they are easier to plan around); Karen Weise, *A $4 Trillion Dodd-Frank Loophole*, BLOOMBERG BUSINESSWEEK (Sept. 11, 2012), http://www.businessweek.com/articles/2012-09-11/a-4-trillion-dodd-frank-loophole, *archived at* http://perma.cc/AT4X-ZK8M (arguing that as rules are made, banks and investors move around rules).

84. Henderson & Tung, *supra* note 4.

85. *Id.* at 1003.

86. *Id.*

87. *Id.*; *see also* Ryan Grim, *Elizabeth Warren Embarrasses Hapless Bank Regulators at First Hearing*, HUFFPOLITICS BLOG (Feb. 14, 2013, 6:59 PM), http://www.huffingtonpost.com/2013/02/14/elizabeth-warren-bank-regulators_n_2688998.html *archived at* http://perma.cc/KKV5-4Q7J; David McMillin, *Bank Regulators Under Fire in DC*, BANKING BLOG (Feb. 20, 2013, 9:00 AM), http://www.bankrate.com/financing/banking/bank-regulators-under-fire-in-dc/ *archived at* http://perma.cc/F5MJ-H8V9.

88. Henderson & Tung, *supra* note 4, at 1003.

89. *Id*. at 1041.

90. *Id*.

91. *Id*. at 1050.

92. *Id*. at 1050-56.

93. Macey & Holdcroft, *supra* note 17.

of any [financial institution] to 5% of the targeted level of the FDIC's Deposit Insurance Fund for the current year as reported by the FDIC."[94] This way, liabilities would be limited to a metric based on the actual funds devoted to resolving failing banks.[95] This "approach does not require any restrictions on activities of banks or on the location of those activities of any kind," but focuses "on the size of financial institutions."[96] This rule would "require [institutions]. . . to comply with the size rule or [go through] a government-mandated breakup plan."[97] It does not rely on the notion of permitting large institutions to fail, but rather takes corrective action before the crises can occur.[98]

Another proposal of this type was again by Michael Faure and Klaus Heine.[99] Their proposal recognizes that one of the consequences of the 2008 crisis was that shareholders of the financial institutions receive additional protections of bailouts, without paying for them.[100] They propose a multi-layered statute that would require financial institutions to pay insurance premiums for the protection they receive.[101] Under the first layer, firms would be required to "hold enough equity to compensate temporary loses," which acts as the equivalent of a self-insurance requirement.[102] The second layer is that "private insurers offer risk-adjusted insurance contracts" to these financial institutions where they, the insurer, undertake investigations in order to calculate the risk-adjusted premiums.[103] The final layer is where the "public steps in as a re-insurer of last resort and may grant subsidies."[104] This "diversifies the third-layer risks over the entire population of firms and . . . future taxpayers."[105] The major advantage that the authors contend from this solution is that "insurance companies can monitor financial institutions" and "that the role of insurers in that respect [will] be far more promising than the [United States'] current practice of bailing out financial institutions."[106]

There has also been some focus among scholars to reenact the Glass-Steagall Act.[107] In, October 1929, the Glass-Steagall Act was enacted to stop banks from

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94. *Id*. at 1403-04.
95. *Id.* at 1404.
96. *Id.* at 1404.
97. *Id*. at 1372.
98. *Id.* at 1373.
99. Michael Faure & Klaus Heine, *Insurance Against Financial Crisis?*, 8 N.Y.U. J.L. & BUS. 117 (2011).
100. *Id*. at 136-37.
101. *Id*. at 137.
102. *Id*.
103. *Id.* at 137-39.
104. *Id*. at 139.
105. *Id*. at 140.
106. *Id*. at 150.
107. Connie Crawford, *The Repeal of The Glass-Steagall Act and the Current Financial Crisis*, 9 J. BUS. & ECON. RES. 127 (2011), http://www.unarts.org/H-II/ref/949-3747-1-PB-1.pdf, *archived at* http://perma.cc/N8QM-6CPK; Daniel K. Tarullo, Governor, Fed. Reserve System, Speech at the Brookings Institution Conference on Structuring the Financial Industry to Enhance

being involved in the trading and owning of speculative securities, which is what led to the Great Depression.[108] The Glass-Steagall Act prohibited commercial banks from engaging in investment banking activities and also made it illegal for a bank to be affiliated with an investment organization.[109] In the 1980s and 1990s, sections of the Glass-Steagall Act were reinterpreted to loosen its restrictions and it was officially repealed by the Gramm-Leach-Bliley Act in 1999.[110]

Since the most recent financial crisis, there has been much discussion of the reenactment of the Glass-Steagall Act.[111] Former Chairman of the Federal Reserve, Paul Volcker, has stated that he was in favor of restoring the Act.[112] Other scholars agree that this Act should have never been repealed.[113] The idea behind these proposals is that having a clear divide between banks and investment companies will prevent banks from becoming "too big to fail" because banks will no longer have the opportunity or incentive to engage in investment activities and take unjustified risks.[114]

IV. CATEGORY 4—JUDICIAL ACTIVISM

The last type of approach that seems popular among scholars is judicial activism, which focuses on courts having a bigger role in the regulation of financial markets.[115] Currently, the judiciary plays little to no role in regulating

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Economic Growth and Stability, Washington, D.C.: Industry Structure and Systemic Risk Regulation (Dec. 4, 2012) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.htm, *archived at* http://perma.cc/57GM-P9YS).

108. Crawford, *supra* note 107.

109. Roshni Banker, *Glass Steagall Through the Back Door: Creating a Divide in Bank Functions Through use of Corporate Living Wills*, 2010 COLUM. BUS. L. REV. 424, 429-30.

110. *Id*. at 432-36.

111. Thomas J. Schoenbaum, *Saving The Global Financial System: International Financial Reforms and United States Financial Reform, Will They Do The Job?*, 43 No. 1 UCC L.J. ART 3 (2010); R. Rex Chatterjee, *Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders it Ineffective and a New Solution is Needed to Adequately Regulate Proprietary Trading*, 8 B.Y.U. INT'L L. & MGMT. REV. 33 (2011).

112. Statement by Paul A. Volcker Before the Committee on Banking and Financial Services of the House of Representatives (Sept. 24, 2009) (transcript available at http://financialservices.house.gov/media/file/hearings/111/volcker9_24_2010.pdf, *archived at* http://perma.cc/9R-YTFH).

113. Filip C.J. Reinholdson & Henril S. Olsson, *The Separation of Commercial and Investment Banking: A Literature Review*, UNIV. GOTHENBERG SCH. BUS., ECON. & L. (2012), https://gupea.ub.gu.se/bitstream/2077/29503/1/gupea_2077_29503_1.pdf, *archived at* http://perma.cc/Z4W2-9JMR.

114. *Id*.

115. George M. Cohen, *The Financial Crisis and the Forgotten Law of Contracts*, 87 TUL. L. REV. 1 (2012); Diane Lourdes Dick, *Confronting the Certainty Imperative in Corporate Finance Jurisdiction*, 2011 UTAH L. REV. 1461 (2011); Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. CHI. L. REV. 1613 (2009); David A. Skeel, Jr., *Institutional Choice in an Economic Crisis*, 2013 WIS. L.

financial institutions, because of the general problem of trying to make shareholders liable for their excessive risk taking.

Eric Posner & Adrian Vermeule, propose that "judicial review of governmental action, in the name of the Constitution, should be relaxed or suspended during an emergency."[116] This argument relies on three major premises. First, an unavoidable tradeoff exists between security and liberty, since "[n]either good can simply be maximized without regard to the other." Second, the government is "not more likely" to engage in opportunism or oppress minorities "during emergencies than during normal times."[117] Third, "courts are less able to police such behavior during emergencies than during normal times."[118] The judiciary lacks the institutional competence to define the limits of executive power in national emergencies because judges are "generalists" and their "political insulation . . . deprives them of information," especially relating to "novel security threats."[119] Most importantly, Posner and Vermuele argue, "the expected costs of judicial review rise sharply in times of emergency" because judicial error "can produce large harms."[120] Meanwhile, the executive has the advantages of "relative decisiveness, secrecy, [and] centralization;" as a result, "political constraints on the executive are associated with increased terrorism[, so] shackling the executive has real security costs."[121]

In a recent article, Diane Dick, proposes two modifications to court methodologies.[122] "First, courts should consider the present-day economic substance of each party's claims. Second, courts should be empowered to allocate legal rights and remedies in a manner that is consistent with the actual economic arrangement of the parties."[123] Specifically, this article focuses on implementing a judicial decisional paradigm of legal certainty.[124] She asserts that "in the realm of [the financial industry]," stable financial markets are "best achieved when courts exercise considerable restraint, narrowly tailoring opinions to strict and construction and passive enforcement of contracts."[125] This advances the belief that "financial markets are vital to the national interests."[126]

Additionally, George Cohen proposes that courts should look to contract law doctrines to better put liability on institutions in the financial industry.[127] Many

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REV. 629.

116. ERIC A. POSNER & ADRIAN VERMUELE, TERROR IN THE BALANCE: SECURITY, LIBERTY, AND THE COURTS 5, 15-17 (2007).

117. *Id*. at 22.

118. *Id*. at 31.

119. *Id*.

120. *Id*. at 45.

121. *Id*. at 55.

122. Dick, *supra* note 115, at 1518.

123. *Id*.

124. *Id*. at 1465.

125. *Id*.

126. *Id*.

127. Cohen, *supra* note 115.

of the causes of the financial crisis are directly traceable to the actions of financial institutions and their poor management of financial risks.[128] By imposing contract law doctrines to the institutions, courts will "better able to control, prevent against, foresee, and mitigate these risks."[129]

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128. *Id*. at 19.
129. *Id.*

CORPORATE GOVERNANCE IN THE FINANCIAL SERVICES INDUSTRY: DODD-FRANK REFORMS TO BANKER COMPENSATION ARRANGEMENTS

LISA H. NICHOLSON*

INTRODUCTION

Dramatic failures of corporate governance and risk management at many systemically important financial institutions were cited as among the key causes of the 2008-2009 financial and economic crisis.[1] What resulted is the realization that neither the financial market should be self-regulated, nor that financial institutions should be trusted to police themselves. Too many bank and nonbank financial institutions recklessly took on too much risk with too little capital reserves while heavily dependent on the short-term funding for increasingly risky trading activities.[2] Moreover, compensation policies at many of the large financial institutions often rewarded short-term gains in an environment of intense competition for talented professionals and eager investors instead of consideration of the long-term consequences of the entities trading activities.[3] In 2009, the Obama Administration publicly called for heightened oversight of executive compensation at all banks amid increased public fury over the payment of executive bonuses by some firms who were viewed by the public as the

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1. There are a wealth of articles and reports on the various causes of the financial crisis by academics, Congressional committees, and various policy makers, federal regulators and financial industry professionals. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT, at xv-xxviii (2011) [hereinafter FCIC REPORT]. The Financial Crisis Inquiry Commission ("FCIC" or "Commission"), established as part of the Fraud Enforcement Recovery Act of 2009 (Pub. L. No. 111-21,123 Stat. 1617 (codified in scattered sections of 18 U.S.C.)), was created to examine the causes of the 2008-2009 U.S. financial and economic crisis. *See id.* at xi. The FCIC was a ten-member bipartisan commission charged with determining the causes of the financial crisis and issuing a report to the President by January 2011. *Id*. Consequently, the FCIC Report does not include any recommendations with regard to regulatory or policy reform. *See also* Brooksley Born, Former Comm'r, Fin. Crisis Inquiry Comm'n, Keynote Address: 2011 American University Business Law Review Symposium: Law, Finance and Legitimacy After Financial Reform "Financial Reform and the Causes of the Financial Crisis," *in* 1 AM. U. BUS. L. REV. 1 (2011-2012); SENIOR SUPERVISORS GRP., RISK MANAGEMENT LESSONS FROM THE GLOBAL BANKING CRISIS OF 2008 (2009) [hereinafter SSG REPORT], *available at* www.sec.gov/news/press/2009/report102109.pdf.

2. Born, *supra* note 1, at 3.

3. *Id.*; *see also* Lynne L. Dallas, *Short-Termism, The Financial Crisis, and Corporate Goverance*, 37 J. CORP. L. 265 (2012).

primary culprits of the crisis due to their unreasonably excessive risk-taking.[4]

Congress enacted and President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act")[5] in July 2010 to set forth corrective initiatives to deal with the apparent failures that led to the financial and economic crisis. The legislation, which focused primarily on regulations for financial institutions, was developed as a means to avert systemic failures in the future and its provisions are designed to improve transparency and accountability in the capital and financial markets going forward.[6] To that end, the Dodd-Frank Act (which takes up approximately 2,300 pages) reaches nearly every facet of the banking and financial services industry including reform of the regulations of mortgage origination and securitizations, derivatives trading, proprietary trading, credit rating agencies, corporate governance generally, and executive compensation in particular.[7] Since the legislation requires significant rule-making by various federal regulatory authorities—much of which has yet to be adopted, it is still too soon to tell conclusively how effective the Dodd-Frank Act will be in deterring future failures, and the ensuing harm to the nation's financial system.

Nevertheless, this Article attempts to prognosticate the effectiveness of the Act's corporate governance provisions as they relate to executive compensation—a small slice of the many financial regulatory reforms contained therein. More specifically, this Article addresses two areas relating to executive compensation: (i) enhancements to corporate claw-back policies and (ii) restrictions on incentive-based compensation for financial institutions. In Part I, corporate governance principles are discussed generally. Part II examines whether Sections 954 and 956 of the Dodd-Frank Act can help the financial industry change from the pre-financial crisis environment where many directors of systemically important financial institutions allowed managers free reign to engage in risky behavior without fear of being held accountable.

In drafting Sections 954 and 956, which purportedly impose restrictions on the compensation structures at financial institutions, Congress seemingly relied to some degree on the criminal law behavioral model to induce better corporate governance—through enhanced accountability—by the corporation and its executive officers. That criminal law model is premised on the notion that people either (i) will comply with the law out of an unconscious instinct to be law-abiding, or (ii) will comply with the law after a conscious evaluation of the risks

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4. *See* Stephen Labaton, *Administration Seeks Increase in Oversight of Executive Pay*, N.Y. TIMES, Mar. 22, 2009 (reporting that the Obama administration proposed greater requirements on the boards of all financial institutions "to tie executive compensation more closely to corporate performance and to take other steps to ensure that compensation was aligned with the financial interests of the company"); *see also* Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257 (2010).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.).

6. *Id.*

7. *See generally id.*

associated with disobeying the law.[8] The latter notion, itself, is the theory of deterrence which presupposes that a potential wrongdoer will engage in the necessary cost-benefits analysis that should lead him to avoid misconduct.[9]

Designed properly, the regulation of compensation policies can be a significant mechanism for enhancing corporate accountability. The Dodd-Frank Act's mandated executive compensation reform requiring, inter alia, structured compensation payouts over several years, with the possibility that some remuneration can be clawed back from executives under certain circumstances could have a deterrent impact. If employees know that their pay depended on profits that were sustainable, not the kind that could blow up twelve months or more down the road, they would have greater motivation to weigh the risks along with the rewards.[10] The proposed changes to the structure of executive compensation will help to ensure that the funds will be available if a claw back is required.

I. CORPORATE GOVERNANCE PRINCIPLES GENERALLY

Corporate governance involves the relationships and roles among and between a corporation's board of directors, its managers, its shareholders, and in some cases, its other stakeholders (e.g., employees, suppliers, customers and creditors). The term *corporate governance*, which has been around for decades, refers to the system of rules—typically state-sponsored—by which the corporation is both directed and controlled, with the intention of monitoring the actions of managers and mitigating instances of conflicts of interest between the owners and the operators of the corporation.[11]

The board of directors is expected to play a key role in corporate governance, having statutory authority to "manage [or direct the management of] the business and affairs" of the corporation.[12] In other words, the Board is charged with developing directional policy and organizational strategies; appointing, supervising and compensating senior executives who generally implement said polices and strategies; provide advice and counsel to those managers and make recommendations to shareholders where appropriate.[13] State corporate law

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8. *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 956 (2003).

9. *See* Lisa H. Nicholson, *Sarbanes-Oxley's Purported Over-Criminalization of Corporate Offenders*, 2 J. BUS. & TECH. L. 43, 51-52 (2007) [hereinafter Nicholson, *Sarbanes-Oxley's Purported Over Criminalization*].

10. *Accord* Andrew Ross Sorkin, *Where's the Plan, Wall Street*, N.Y. TIMES, Mar. 26, 2009.

11. *See* Committee on the Financial Aspects of Corporate Governance, Report of the Committee on the Financial Aspects of Corporate Governance § 2.5, at 14 (1992), *available at* http://www.ecgi.org/codes/documents/cadbury.pdf.

12. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (West 2013); MODEL BUS. CORP. ACT §§ 8.01(b) & 8.30(b) (1998)

13. *See generally* Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. LAW 257 (Supp. 2010).

imposes upon the Board a fiduciary duty in carrying out these responsibilities to ensure that the corporation is run in the long-term interests of the shareholders.[14]

The Board's fiduciary obligation necessarily includes authority to design and implement a compensation structure (including the form and amount) for its senior executives that will ensure that they conduct themselves in the best interest of the corporation. Executive compensation is a major issue for Boards given the separation of ownership from the control of the corporation. The Board is therefore required to examine whether the amounts paid are commensurate with the benefits received by the corporation. Best practices would require that a corporation's compensation policies align managerial incentives with those of shareholders.[15] The "pay-for-performance" movement took hold in the 1990s in the hope of meeting this end.[16]

The 2008-2009 financial and economic crisis, however, highlighted an environment in which directors gave managers free rein to engage in risky behavior without sufficient regard for the resulting impact on the corporation, its shareholders, or the economy. Executive compensation policies, which seemingly emboldened risk-takers at many bank and nonbank financial institutions, found their way into the public spotlight. Disgruntled shareholders and the general public began to express concern that executive pay and corporate performance continues to be misaligned since the top executives at many of the financial institutions made money despite the fact that their companies suffered huge losses.[17] They expressed concern that the current corporate compensation structures incentivized corporate managers to take unnecessary risks.[18]

Congress, in enacting Dodd-Frank's corporate governance provisions,[19] aimed specifically to address this concern by giving shareholders of publicly-held corporations a greater "say on pay" as well as better proxy access to nominate directors and encouraging greater accountability through the regulation of

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14. *See generally* Dodge v Ford, 170 N.W. 668 (1919).

15. *See, e.g.*, Charles M. Yablon, *Bonus Questions: Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271 (1999) (noting "the theory of pay for performance is that shareholders benefit when management compensation is significantly at risk, so that a high level of compensation is dependent on a high level of corporate performance").

16. *Id.* In the 1990s, performance-based compensation gained new support after a change in the tax laws, which prohibited corporations from deducting any compensation paid to a corporate officer in excess of $1 million unless the additional compensation was performance-based. *See* Section 162(m) of the Internal Revenue Code, adopted in 1993.

17. *See* Sorkin, *supra* note 10 (noting "Wall Street's pay structure has become the biggest occasion for national ridicule, and rage . . . In good years, tope employees share in huge riches. In truly dreadful years, like [2008] there are still bonuses across the firm—just smaller ones."); *see also* Ben W. Heineman, *Boards Fail—Again*, BUSINESSWEEK (Sept. 26, 2008), http://www.businessweek.com/stories/2008-09-26/boards-fail-againbusinessweek-business-news-stock-market-and-financial-advice.

18. *See* Lisa M. Fairfax, *Government Governance and the Need to Reconcile Governmental Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692, 1696 (May 2011).

19. *See* discussion *infra* Part II.

corporate compensation, including the establishment of guidelines for the composition of corporate compensation committees, and the disclosure and payout of incentive-based compensation. The legislation also provides for enhanced compensation oversight specifically for the financial industry. Fear of recoupment through claw backs or delayed payouts should force corporate executives to accept greater personal risks in the absence of better Board accountability. Opponents of the federalization of corporate compensation polices however argue that compensation is a matter that is best left to the markets—shareholders can vote with their feet and sell their shareholdings if they disagree with corporate payouts.[20]

This is the second time that the regulation of corporate governance practices, once the exclusive province of state corporate laws, was elevated to the federal level. The first occasion followed public revelations of the massive financial frauds at numerous public companies during 2001 and 2002.[21] Referencing the subsequent demise of many well-established public companies (including Enron, WorldCom and Arthur Anderson), federal legislation was adopted to ensure that more meaningful checks and balances of the chief executive and top management existed.[22] The Sarbanes-Oxley Act of 2002[23] ("S-Ox") set forth federally mandated corporate governance rules as a means to restore public confidence in the publicly-held corporation.

S-Ox addresses, inter alia, executive-level certifications of financial reports; requires real-time public disclosures of material events; prohibits corporation-to-employee loans; increases obligations for corporate legal counsels; and provides for better whistle-blower protections.[24] S-Ox corporate governance provisions

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20. *See, e.g.*, Squam Lake Working Group on Federal Regulation, Regulation of Executive Compensation in Financial Services (Council on Foreign Relations, Feb. 2010) (arguing that "governments should generally not regulate the level of executive compensation in financial institutions . . . society is better off if compensation levels are set by market forces."). The Squam Lake Working Group consists of academic economist, who first convened during fall 2008 as the financial and economic crisis was deepening, to "help guide reform of the capital markets." *Id.* at 1.

21. Accounting irregularities were unearthed at Enron Corporation, Kmart Corporation, Adelphia Communications Corp., WorldCom Inc., and Tyco International Ltd., to name a few. *See* Stephen Laboton, *Downturn and Shift in Population Feed Boom in White-Collar Crime*, N.Y. TIMES, June 2, 2002. For a more detailed discussion of the 2001-2002 corporate frauds, see Lisa H. Nicholson, *The Culture of Under-Enforcement: Buried Treasure, Sarbanes-Oxley and the Corporate Pirate*, 5 DEPAUL BUS. & COM. L.J. 321, 321-25 (2007) [hereinafter Nicholson, *The Culture of Under-Enforcement*].

22. *See* Elisabeth Bumiller, *Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002 (reporting on statements made by President George W. Bush during the signing of the Sarbanes-Oxley Act of 2002).

23. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

24. *See id.*; *see also* Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 503 n.119 (2006) ("Among

also set forth specific rules rather than discretionary principles, particularly with regard to the role, structure and composition of the Board and its committees.[25] The goal was strengthen the hands of corporate gatekeepers.[26] Arguably, Dodd-Frank Act's corporate governance provisions were enacted to fill the perceived gaps remaining after the 2002 enactment of S-Ox.

II. INCENTIVE-BASED COMPENSATION REFORMS UNDER THE DODD-FRANK ACT

Although 26.2 million Americans were out of work as of November 2010[27] and the U.S. unemployment rates reached a high of 10.1% in October 2009,[28] year-end bonuses that were paid to New York City securities professionals in 2009 totaled $20 billion, up 17% from the previous year, with "[a]verage compensation r[ising] by 27% to more than $340,000.[29] Following the ensuing government intervention to shore up the economy in 2008, commercial bank profits rose from $7.6 billion in the first quarter of 2009 to $18 billion by the first

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other provisions, the legislation toughened penalties for accounting fraud, established a five-person independent board to oversee the accounting industry, prohibited non-audit services to audit clients in most cases, mandated auditor rotation, and established employment restrictions on accountants who go to work for their former audit clients. Further, the law required company officials to certify periodic reports, subject to civil and criminal penalties; made it a crime for issuers to interfere with audits; prohibited corporate loans to company executives; and required enhanced financial disclosures. It also bolstered the budget of the SEC and made it a crime to retaliate against corporate whistleblowers.").

25. *See, e.g.*, Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1193-95 (2004) (noting that pre-S-Ox, corporate governance under state law was not regulatory in nature but relied on director and judicial discretionary interpretations). "Sarbanes-Oxley—housed in the federal securities law—not only represents a new federal presence in corporate governance, it adopts a wholly novel, rules-based approach to corporate governance." *Id.* at 1194-95; *see also* Burch, *supra* note 24, at 504-05 ("Several provisions in Sarbanes-Oxley, and the SEC and self-regulatory organization ("SRO") rules promulgated thereunder, deal directly with or will influence the scope of directors' fiduciary duties, including audit committee composition and board composition, nominating/ corporate governance committee composition and duties, oversight of public accountants by the audit committee of the board of directors and the functions and role of the audit committee with respect to independent audits of the corporation's financial controls and internal controls . . . .").

26. *See* Beverley Earle & Gerald A. Madek, *The New World of Risk for Corporate Attorneys and Their Boards Post-Sarbanes-Oxley: An Assessment of Impact and Prescription for Action*, 2 BERKLEY BUS. L.J. 185, 189-90 (2005).

27. *See* FCIC REPORT, *supra* note 1, at 391.

28. *See id.* at 389.

29. Press Release, Thomas P. DiNapoli, New York State Comptroller, Wall Street Bonuses Rose Sharply in 2009 (Feb. 23, 2010), *available at* http://www.osc.state.ny.us/press/releases/feb10/022310.htm. *See* Susanne Craig, *Wall Street Pay Rises, for Those Who Still Have a Job*, N.Y. TIMES, Feb. 26, 2013, at B1.

quarter of 2010.[30] Indeed, "[f]or banks with assets greater than $1 billion, profits more than doubled from $6.3 billion to $14.5 billion" during that period.[31] Reportedly, nearly half of the 2009 revenues of Wall Street firms were earmarked for compensation.[32] The public's notice of, and outrage about, the increased compensation rates for financial-industry personnel served as a backdrop to the legislators debating what would become the Dodd-Frank Act.

The compensation polices and practices of many systemically important financial institutions were believed to have played a role in fueling the financial crisis.[33] Risk-takers were seemingly favored by some financial institutions, whose compensation structures provided these employees with stature and influence which enabled them to skirt their firm's risk management and control functions.[34] Firm guidelines for granting incentive-based compensation awards typically did not reference the individual's risk management performance and generally failed to take into account the true economic profits that resulted from an employee's actions—adjusted for all costs and uncertainties.[35] Accordingly, some commentators noted that rule changes for incentive-based compensation in the

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30. *See* FCIC REPORT, *supra* note 1, at 401 (citing FDIC, *Quarterly Banking Profile: First Quarter 2009*, Mar. 2009, *available at* http://www2.fdic.gov/qbp/2009mar/qbp.pdf; and FDIC, *Quarterly Banking Profile: First Quarter 2010*, Mar. 2010, *available at* http://www2.fdic.gov/qbp/2010mar/qbp.pdf).

31. *See* FCIC REPORT, *supra* note 1, at 401.

32. Susanne Craig & Ben Protess, *A Bigger Paycheck on Wall Street*, N.Y. TIMES, Oct. 9, 2012, at B1.

33. BD. OF GOVERNORS OF THE FED. RESERVE SYS., INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING ORGANIZATIONS 1 (2011).

34. *Id. See* Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part i)*, 104 NW. U. L. REV. COLLOQUY 398, 406-07 (2010) ("Internal risk management at many financial market firms was not well-positioned to cope with the market volatility that came with the credit crisis. The ability of many firms to successfully endure such volatility has been hindered by a number of factors, including inadequate risk management, high leverage, and compensation structures that may have encouraged speculation and incentivized risky trading."); Marisa Anne Pagnattaro & Stephanie Greene, *"Say on Pay": The Movement to Reform Executive Compensation in the United States and European Union*, 31 NW. J. INT'L L. & BUS. 593, 600-01 (2011) ("As the financial markets collapsed in 2008, shareholders were outraged by what they perceived as excessive compensation for executives who profited even as shareholders suffered tremendous losses. . . . Treasury Secretary Geithner urged corporate boards in general, to 'pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm."); *see also* Terrance Gallogy, *Enforcing the Clawback Provision: Preventing the Evasion of Liability Under Section 954 of the Dodd-Frank Act*, 42 SETON HALL L. REV. 1229, 1233 n.23 (2012) ("the collapse of Lehman Brothers reflected larger problems in the financial system, including incentives for excess risk-taking and insufficient risk management") (citing *Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Financial Serv. Comm.*, 111th Cong. 179 (2010) (prepared statement of Mary Shapiro, Chairman, U.S. Sec. & Exch. Comm'n)).

35. BOARD OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 33, at 13.

financial industry and enhanced risk management oversight by the Board would be crucial to reining in risky behavior at the employee level and ensuring the financial stability of the capital markets.[36]

The Dodd-Frank Act's corporate governance provisions, in response, seek to give shareholders of publicly-held corporations a say on executive pay and create a basis for them to hold the Board and managers accountable to ensure that executive pay is performance-related.[37] Enhanced transparency is expected to enable shareholders to see at a glance the performance of their company and to decide whether the compensation awarded executives is justified. The Act's compensation reforms also seek to reduce excessive risk-taking, particularly with regard to financial institutions.

Sections 951-956 of the Dodd-Frank Act require shareholder *advisory* votes on both executive compensation and golden parachutes;[38] require disclosure about the role of, and potential conflicts from, compensation consultants to the Board;[39] require additional disclosures about pay-for-performance, including the ratio

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36. *See* FCIC REPORT, *supra* note 1, at 343 (noting "Lehman's failure resulted in part from significant problems in its corporate governance, including risk management, exacerbated by compensation to its executives and traders that was based predominately on short-term profits."); *see also id.* at 465 (where the Commission's majority noted other factors to explain the crisis included "Wall Street greed and compensation policies, systemic risk caused by credit default swaps, excessive liquidity and easy credit."); Eric D. Chason, *The Uneasy Case for Deferring Banker* Pay, 73 LA. L. REV. 923 (2013); Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575 (2013). This Author will address the boards' risk management oversight failures in a forthcoming article.

37. The SEC had already began taking action to enhance certain disclosure rules by providing investors with more information on the role of the board and the voting rights of brokers several years prior the enactment of the Dodd-Frank Act. For example, the SEC enhanced executive compensation disclosure rules (effective February 2010) by requiring proxy disclosures on (i) the relationship between compensation policies and practices and the associated risks (See SEC rule 14a-21(b) and Regulation S-K, item 402); (ii) the Board's role in risk oversight (See SEC rule 14a-3 and Regulation S-K, item 407(h)); and (iii) the background and qualifications of directors and nominees (See SEC rule 14a-8 and Regulation S-K, item 401(a-f)).

38. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). Publicly-held companies are required to provide shareholders with a non-binding vote to approve executive compensation once every three years, as well as a vote once every six years to determine whether this advisory vote on executive compensation should be held every one, two, or three years. Section 951 also requires institutional investment manages subject to Exchange Act Section 13(f) to report at least annually how they voted on these advisory shareholder votes.

39. *See id.* § 952. Section 952 sets forth rules intended to establish the independence of the Board's Compensation Committee, its consultants and any other advisors. To that end, Section 952 also requires the SEC to establish competitively neutral independence factors for all retained to advise the Board's compensation committee, as well as to direct the national exchanges to enact listing standards that include enhanced independence requirements for members of the Board's compensation committee.

between the CEO's total compensation and the median total compensation for all other company employees;[40] require additional disclosures about whether directors and employees are permitted to hedge any decrease in the market value of the company's stock;[41] require the SEC to direct national exchanges to prohibit securities listings by issuers who have not developed and implemented a compensation claw back policy;[42] and require prudential regulators to jointly promulgate rules prohibiting as an "unsafe and unsound compensation practice" any incentive-based compensation plan by covered financial institutions that provide to directors or executives excessive compensation fees and benefits or that could lead to material financial loss by the company.[43] As a result of these corporate governance provisions, many publicly-held corporations may have to redesign their compensation policies and alter the composition and operation of their compensation committees.

While the Dodd-Frank Act, as illustrated, contains a host of corporate governance provisions,[44] this Article addresses only two areas relating to executive compensation: (i) enhancements to corporate claw-back policies and (ii) restrictions on incentive-based compensation for financial institutions. To that end, I will examine whether the provisions of the Dodd-Frank Act governing compensation reform has the potential to reduce excessive risk-taking, or change compensation arrangements in the financial industry. First up: whether the enhanced claw-back policy at Section 954 is strict enough to have the desired deterrent impact. Thereafter, the Article's analysis will turn to Section 956's guidelines for the regulation of incentive-based compensation at financial

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40. *See id.* § 953. Section 953 provides that this information regarding executive compensation actually paid and the financial performance of the company must be disclosed in the company's proxy materials under Section 402 of Regulation S-K. *Id.*

41. *See id.* § 955. Section 955 provides that the new rules must require such disclosures in the company's proxy materials.

42. *See id.* § 954. Section 954 also requires that current or former "executive officers" repay to the issue any "incentive-based compensation (including stock options awardee as compensation)" received "during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement." *Id.* Presumably "executive officer" will have the meaning given the term by Rule 3b-7 of the Securities and Exchange Act of 1934. *See infra* note 135; *see also infra* Part II.A (discussing Dodd-Frank's claw back provision).

43. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). Covered financial institutions with less than $1 billion in assets are excluded from Section 956. *See also* discussion *infra* Part II.B.

44. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951-56, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). The Dodd-Frank Act also addressed the composition of the Board through new proxy access rules and a mandatory disclosure requirement that companies explain why they have selected joint chairman and chief executive officer positions. *See id.* §§ 971 and 972, respectively.

institutions.

When the issue of employee compensation was raised in 2012, James (Jamie) Dimon—chief executive officer of JPMorgan Chase & Co. ("JPMorgan") famously argued, "We are going to pay competitively" and that the firm "need[s] top talent, you cannot run this business with second-rate talent."[45] Notably, JPMorgan—the top U.S. bank holding company based on $2.3 trillion in consolidated assets[46]—made Dimon the highest paid among his cohorts in 2011;[47] paying him $23 million in salary and bonus compensation in 2011.[48] The firm reportedly also "paid the 25,999 employees in the Investment Bank unit an average of $341,552 in 2011—about 34 percent of the unit's revenue."[49]

Ironically, JPMorgan experienced a $6.2 billion trading loss in 2012 from a poorly monitored and ill-conceived employee-driven trading strategy in credit derivatives, at the hands of derivatives trader Bruno Iskil (the "London Whale") and manager Javier Martin-Artajo, among others.[50] Iksil entered into a series of

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45. David Benoit, *Jamie Dimon Wants to Make Sure Everyone Hears Him*, WALL ST. J. DEAL J. (Feb. 28, 2012, 4:42 PM), http://blogs.wsj.com/deals/2012/02/28/jamie-dimon-want-to-make-sure-everyone-hears-him/ (Dimon touched on several topics while speaking at JPMorgan's analyst day including employee compensation). *See* Dakin Campbell & Andrea Ludtke, *JPMorgan's Dimon Assails Newspaper Pay Levels in the Bank's Defense*, BLOOMBERG (Feb. 28, 2012), http://www.bloomberg.com/news/2012-02-28/jpmorgan-chief-dimon-assails-pay-practices-at-newspapers-in-bank-s-defense.html (JPMorgan reportedly posted $19 billion in profit in 2011) (reporting Dimon said "Obviously our business, in investment banking in particular, . . . have high capital and high human capital.").

46. JPMorgan is the largest bank holding company based on consolidated assets valued at $2,439,494,000 as of September 30, 2013. Fed. Fin. Insts. Examination Council, *Top 50 Holding Companies*, NAT'L INFO. CENTER www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx (last visited Jan. 8, 2014). Its principal bank subsidiary is JPMorgan Chase Bank, the largest U.S. Bank. U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES 18-19 (2013) [hereinafter SENATE REPORT].

47. Dimon's 2011compensation package dwarfed that of Bank of America CEO Brian Moynihan's $7 million and almost doubled Citigroup CEO Vikram Pandit's $14.9 million—the next largest bank holding companies. Dawn Kopecki, *JPMorgan Awards CEO Jamie Dimon $23 Million Pay Package*, BLOOMBERG (Apr. 4, 2012, 5:18 PM), http://www.bloomberg.com/news/2012-04-04/jpmorgan-awards-ceo-jamie-dimon-23-million-pay-package.html. Dimon's 2011 compensation package dwarfed that of Bank of America CEO Brian Moynihan's $7 million and almost doubled Citigroup CEO Vikram Pandit's $14.9 million—the next largest bank holding companies. *Id.*; *see also* JPMORGAN CHASE & CO., NOTICE OF 2011 ANNUAL MEETING OF SHAREHOLDERS AND PROXY STATEMENT 13-14 (2011) [hereinafter JPMORGAN 2011 PROXY STATEMENT], *available at* http://files.shareholder.com/downloads/ONE/2724945887x0x457330/25a50d66-47e7-442a-a74b-58fc43b40ade/Proxy2011-75BookMarked_for_web_post_April_7.pdf.

48. Dimon's $23 million compensation package included $12 million in restricted stock and options valued at $5 million for his performance in 2011. Kopecki, *supra* note 47.

49. Campbell & Ludtke, *supra* note 45. JPMorgan reportedly posted $19 billion in profits for that period. *See id.*

50. *See* Dan Fitzpatrick et al., *J.P. Morgan's $2 Billion Blunder*, WALL ST. J., May 11, 2012

complicated bets on credit derivatives on behalf of the firm while employed in JPMorgan's London unit of the Chief Investment Office ("CIO")[51] led by Ina Drew who, in 2011, received $14 million in compensation.[52] Both Iksil and Martin-Artajo were among the firm's best-paid traders and managers, receiving $7.3 million and $12.8 million for 2010, respectively.[53] Iksil's prior derivatives trading activity produced a $2.5 billion profit for JPMorgan during the five-year period that preceded the $6.2 billion loss.[54] In July 2012, JPMorgan was forced to restate its first-quarter earnings because "it was no longer confident that the company's traders [in the CIO unit] had fairly valued [their trading] positions."[55]

By summer's end, Iksil, Drew, Macris, Martin-Artajo, chief financial officer Doug Braunstein and several other JPMorgan executives were either fired, reassigned or asked to resign.[56] On July 13, 2012, the firm announced that it would withhold all severance payments and 2012 incentive compensation from all relevant parties and that it would "claw back compensation from each

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(according to Dimon, the trading strategy was "flawed, complex, poorly review, poorly executed and poorly monitored"); *see also* Jessica Silver-Greenberg, *JPMorgan Sues Boss of 'London Whale' in Trading Loss*, N.Y. TIMES, Oct. 31, 2012, *available at* http://dealbook.nytimes.com/2012/10/31/jpmorgan-sues-boss-of-london-whale/?_php=true&_type=blogs&_r=0 (last visited May 21, 2014). *Accord* SENATE REPORT, *supra* note 46.

51. The CIO, which "is located within JPMorgan's Corporate/Private Equity division, has a staff of about 425, including 140 traders, and maintains offices in several locations, including New York and London." SENATE REPORT, *supra* note 46, at 21; *see also* JPMORGAN CHASE & CO. MANAGEMENT TASK FORCE REGARDING 2012 CIO LOSSES 21 (2013) [hereinafter JPMORGAN TASK FORCE REPORT], *available at* http://files.shareholder.com/downloads/ONE/2272984969x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task_Force_Report.pdf. Its primary purpose is to maintain an investment portfolio to manage the bank's excess deposits. JPMORGAN TASK FORCE REPORT, *supra*, at 21. By 2012, the CIO was managing a portfolio of approximately $350 billion. SENATE REPORT, *supra* note 46, at 22.

52. *See* JPMORGAN 2011 PROXY STATEMENT, *supra* note 47, at 16. Achilles Macris, the International Chief Investment Officer, served as Drew's top deputy in the CIO's London office and oversaw the management of the credit derivatives trading portfolio. SENATE REPORT, *supra* note 46, at 24.

53. Dawn Kopecki et al., *London Whale Resurfaces in Potential U.S. JPMorgan Case*, BLOOMBERG (Aug. 13, 2013), *available at* http://www.bloomberg.com/news/2013-08-13/london-whale-resurfaces-in-potential-u-s-jpmorgan-case.html (last visited May 22, 2014). Reportedly, Macris was "paid $17.3 million—more than Drew, who received $15 million. Dimon . . . was paid $23 million for that year." *Id.*

54. *See* SENATE REPORT, *supra* note 46, at 56.

55. *See* Jessica Silver-Greenberg, *JPMorgan Says Trading Loss Tops $5.8 Billion; Profit for Quarter Falls 9%*, N.Y. TIMES (July 13, 2012, 10:10 AM), http://dealbook.nytimes.com/2012/07/13/jpmorgan-reports-second-quarter-profit-of-5-billion-down-9/?_r=0; *see also* SENATE REPORT, *supra* note 46.

56. *See* Floyd Norris, *Trading Loss at JPMorgan Will Result in Millions in Pay Givebacks*, N.Y. TIMES, July 13, 2012.

individual."[57] Drew and Iskil reportedly surrendered two years' and one year's pay, respectively; with Drew forfeiting approximately $21.5 million.[58] In all, using its existing internal discretionary *Bonus Recoupment Policy*,[59] JPMorgan clawed back more than $100 million in employee compensation.[60]

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57. SENATE REPORT, *supra* note 46, at 25. JPMorgan reportedly obtained the maximum recovery permitted under its employment policies from Drew, Marcis, Martin-Artajo, and Iksil through "a combination of canceling outstanding incentive awards and obtaining repayment of awards previously paid." *Id*.; *see also* JPMORGAN TASK FORCE REPORT, *supra* note 51, at 14.

58. SENATE REPORT, *supra* note 46, at 25; JPMORGAN TASK FORCE REPORT, *supra* note 51, at 14; *see also* Nelson D. Schwartz & Jessica Silver-Greenberg, *JPMorgan Chase Executive Resigns in Trading Debacle*, N.Y. TIMES, May 13, 2012, http://www.nytimes.com/2012/05/14/business/jpmorgan-chase-executive-to-resign-in-trading-debacle.html?pagewanted=&_r=0; Dawn Kopecki, *JPMorgan's Drew Forfeits 2 Year's Pay as Managers Ousted*, BLOOMBERG (July 13, 2012, 10:50 AM), http://www.bloomberg.com/news/2012-07-13/dimon-says-ina-drew-offered-to-return-2-years-of-compensation.html.

59. JPMorgan's *Bonus Recoupment Policy* is as follows:

> In the event of a material restatement of the Firm's financial results, the Board believes it would be appropriate to review the circumstances that caused the restatement and consider issues of accountability for those who bore responsibility for the events, including whether anyone responsible engaged in misconduct. As part of that review, consideration would also be given to any appropriate action regarding compensation that may have been awarded to such persons. In particular, it would be appropriate to consider whether any compensation was awarded on the basis of having achieved specified performance targets, whether an officer engaged in misconduct that contributed to the restatement and whether such compensation would have been reduced had the financial results been properly reported. *Misconduct includes violation of the Firm's Code of Conduct or policies or any act or failure to act that could reasonably be expected to cause financial or reputational harm to the Firm.*
>
> Depending on the outcome of that review, appropriate action could include actions such as termination, reducing compensation in the year the restatement was made, *seeking repayment of any bonus received for the period restated or any gains realized as a result of exercising an option awarded for the period restated, or canceling any unvested equity compensation awarded for the period restated.* Consideration may also be given to whether or not any one or more of such actions should be extended to employees who did not engage in misconduct that contributed to the restatement.

Corporate Governance Principles, *5.4 Bonus Recoupment Policy*, JPMORGANCHASE, http://www.jpmorganchase.com/corporate/About-JPMC/corporate-governance-principles.htm#recoupment (emphasis added) (last visited Feb. 12, 2014).

60. *See* 2013 JPMorgan Chase Proxy Statement at 7, *available at* http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=19617-13-305 (last visited May 22, 2014) ("The Board ensured that those directly responsible for the losses incurred over $100 million in compensation clawbacks, and are no longer with the Company."). For an additional discussion of JPMorgan's application of its claw back policy to those involved in the $6.2 billion trading debacle, see *infra* Part II.A.2.

A. The Dodd-Frank Act Claw Back Provision

The Dodd-Frank Act contains a significant claw back provision that removes the Board's discretion in that it *compels* publicly traded companies to recover erroneously paid executive compensation after an accounting restatement of any financial statement. Specifically, Section 954 adds Section 10D to the Securities Exchange Act of 1934 and requires the SEC to issue rules directing national exchanges to prohibit listings by any company that does not develop and implement policies to recover compensation from certain executive officers under particular circumstances.[61] The SEC also must adopt rules requiring every listed public company to: (1) discloses its policies on incentive-based compensation; and (2) develop and implement a policy that, in the event the company is required to restate its financials for material noncompliance with the federal securities laws, the *company will recoup* from current or former executive officers any incentive-based compensation, including stock option awards, that (i) were received within a 3-year period preceding the required restatement; (ii) are based on erroneous data; and (iii) are in excess of what otherwise would have been paid.[62] The SEC's current rulemaking schedule indicates that its regulations finally will be proposed by the end of October 2014.[63]

The genesis of Section 954 is Section 304 of S-Ox, the first initiative to codify the take back of compensation previously paid or owed to employees in certain situations. The S-Ox provision is referred to as a "claw back" because it authorizes a company to recover certain bonuses and stock profits from the company's chief executive officer and chief financial officer. Specifically, S-Ox Section 304 authorizes the forfeiture of bonuses, incentive or equity-based compensation, or trading profits from the sale of the issuers' securities during the first 12 months covered by an earnings restatement if the restatement was as a result of misconduct.[64] However, several issues remained more than ten years

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61. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(a)).

62. *See id.* (adding Exchange Act, Section 10D(b)).

63. The SEC has eliminated a specific rule-making schedule for Section 954 of Dodd-Frank Act, though it continues to list it as a pending matter. *See Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Pending Action*, SEC.gov, last modified June 6, 2014, http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml. Nevertheless, the SEC's rule-making agenda can be found in the Spring 2014 *Unified Agenda of Regulatory and Deregulatory Actions* which is published semi-annually by the Regulatory Information Service Center, *available at* http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201404&RIN=3235-AK99.

64. Section 304 of S-Ox provides: If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that

following enactment of S-Ox Section 304, including how this provision is to be enforced and what constituted the requisite "misconduct" trigger.[65] These issues may have affected use of the S-Ox claw back as a major enforcement tool to deter wrongdoing, and created a basis to retool the claw back weapon to enhance its deterrent effect.

1. Use of S-Ox Section 304 as an Enforcement Weapon.—"Section 304 create[d] a powerful incentive for CEOs and CFOs to take their corporate responsibilities very seriously."[66] Although it does not create any private right of action, it "establishe[d] that the SEC may sue the CEO and CFO of a company when that company has been required to restate its earnings due to noncompliance with securities laws."[67] Enforcement actions under S-Ox Section 304, however, have not been as plentiful—thus watering down its effectiveness as a deterrent measure. Even though the claw back remedy was enacted with an eye towards recouping both the CEO and CFO's bonus or trading profits, history has shown that claw backs of Wall Street CEO's compensation under Section 304 had been rare and inconsistent. Despite having authority to seek claw backs, the SEC has only pursued about a dozen of cases since 2002, and none before 2007.[68]

> person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and(2) any profits realized from the sale of securities of the issuer during that 12-month period.

15 U.S.C. § 7243(a) (2002).

65. *See* discussion *infra* Part II.B.

66. SEC v. Baker, Case No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012) (writing that Section 304 is an "enforcement mechanism that ensures the integrity of the financial markets"). "Imagine if someone told you that they would take away half of everything you earned this year if you did not catch the misconduct of one of your employees. You would most likely be highly motivated to catch the misconduct." *Id.* (quoting Cohen v. Viray, 622 F.3d 188, 195 (2010)).

67. Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust *ex rel.* Fed. Nat'l Mortg. Ass'n v. Raines, 534 F.3d 779,793 (D.C. Cir. 2008).

68. *See, e.g.*, SEC v. Mercury Interactive, LLC, Case No. 07-2822 (N.D. Cal. May 31, 2007) (where California-based software maker Mercury Interactive, LLC (formerly known as Mercury Interactive Corporation) and four former senior officers of Mercury—including former Chairman and CEO Amnon Landan and former CFO Sharlene Abrams were charged as wrongdoers based on allegations that the former senior officers perpetrated a fraudulent and deceptive scheme from 1997 to 2005 to award themselves and other employees undisclosed, secret compensation by backdating stock option grants and failing to record hundreds of millions of dollars of compensation expense. The SEC also alleged that during this period Mercury, through Landan and Abrams, made fraudulent disclosures concerning Mercury's "backlog" of sales revenues to manage its reported earnings, and structured fraudulent loans for option exercises by overseas employees to avoid recording expenses.). *Accord* SEC Litigation Release No. 20136 (May 31, 2007). *See also* SEC v. McGuire, Civil Action No. 07-CV-4779-JMR/FLN (D.Minn. 2007) and SEC Litigation Release No. 20387 (Dec. 6, 2007) (option backdating); SEC v. Brooks, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D.Fl. 2007) (fraud and misappropriation of corporate funds).

Moreover, while the SEC initially focused mostly on executives involved in the misconduct that led to the restatement,[69] it finally decided to take a more aggressive stance beginning in 2009 when it started targeting CEOs and CFOs who were not accused of misconduct in connection with the submitted noncompliant financial reports.[70] The SEC even acknowledged that its case, *SEC v. Jenkins*, was the first action to seek reimbursement under Section 304 where the individual sued was not alleged to have otherwise violated the securities laws.[71] According to the SEC, the claw back provision "deprives corporate executives of money that they earned while their companies were misleading investors, . . . Jenkins was captain of the ship and profited during the time that CSK was misleading investors about the company's financial health," and "[t]he law [and fairness] requires Jenkins to return those proceeds to CSK."[72]

In May 2010, the SEC's Division of Enforcement considered "working towards a policy that would have limited claw back actions to times when the executive is implicated in the violations," and not target those executives who were unwitting beneficiaries of the fraud.[73] SEC Commissioner Luis Aguilar reportedly objected at the time, however, arguing, "the plan would hinder the

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69. *See* sources cited *supra* note 68.

70. *See, e.g.*, SEC v. Jenkins, 718 F. Supp. 2d 1070 (D. Ariz. 2010) (where the SEC brought a claw back action under Section 304 in July 2009 against Maynard Jenkins, the former CEO of CSK Auto Corporation, seeking reimbursement of more than $4 million in bonuses and stock sale profits while CSK—and not Jenkins—was committing accounting fraud). Jenkins was subsequently ordered by the federal district court in Arizona through a consent decree to reimburse CSK's successor. SEC v. Jenkins, Final Judgment, Case No. 2:09-cv-01510-RJB (Nov. 16, 2011). *See also* SEC v. Walden O'Dell, Civil Action No. 1:10-CV-00909 (D.D.C.) (where the SEC brought a claw back action in June 2010, against Walden O'Dell, the former CEO of Diebold, Inc., seeking reimbursement of certain financial benefits while Diebold—and not O'Dell—was committing accounting fraud by engaging in fraudulent accounting transactions designed to improperly recognize revenues or otherwise inflate Diebold's financial performance). O'Dell consented to a final judgment ordering him to reimburse $470,016 in cash bonuses, 30,000 shares of Diebold stock, and stock options for 85,000 shares of Diebold shares. See SEC Litigation Release No. 21543 (June 2, 2010). The SEC also brought an administrative proceeding on August 5, 2010 against Navistar International over restated financial results, and announced that its CEO and former CFO would return over $2.3 million in bonues paid to them based on overstated earnings. *See In re* Navistar Internat'l Corp., Administrative Proceeding File No. 3-13994, SEC Release No. 33-9132, 34-62653 (Aug. 5, 2010).

71. *See* SEC Litigation Release No. 21149A (July 23, 2009); *see also* SEC v. Jenkins, Case 2:09-cv-01510-JWS (D. Ariz. July 23, 2009), *available at* http://sec.gov/litigation/complaints/2009/comp21149.pdf.

72. SEC Press Release, *SEC Seeks Return of $4 Million in Bonuses and Stock Sale Profits from Former CEO of CSK Auto Corp.* (July 22, 2009).

73. Jesse Westbrook, *SEC Rift on When to Claw Back Bonus May Leave Policy in Limbo*, BLOOMBERG NEWS (Aug. 6, 2010), *available at* http://www.bloomberg.com/news/2010-08-06/u-s-regulators-said-to-debate-when-it-s-appropriate-to-claw-back-bonuses.html.

SEC's ability to recoup pay based on inflated profits."[74] When the SEC used the law in the *Jenkins* case, it reportedly caused a split among the agency's commissioners along party lines; with former Commissioners Kathleen Casey and Troy Paredes opposing the case, arguing that "the SEC shouldn't go after bonuses when an executive didn't orchestrate a fraud and may not have known it was occurring."[75]

Despite the difference of opinions, the SEC has continued to bring enforcement actions under S-Ox Section 304 seeking reimbursement of bonuses and other compensation received during the period of the company's securities law violations against their CEO and CFO—even though these individuals are not alleged to have participated in the wrongdoing.[76] Where a recipient's bonus is premised on performance measures or targets that later turned out to be wrong because of fraud or other wrongdoing, such payments will result in an unjust enrichment to the recipient. Enforcement actions are necessary because the unwitting executives have no rightful claim to monies paid. A federal district court in Phoenix seemingly agreed when in June 2010 it upheld the SEC's right to seek a claw back of bonuses and other compensation in *Jenkins* absent allegations of wrongdoing by the executive [77]

Rather than settle with the SEC in July 2009, Jenkins argued unsuccessfully in his motion to dismiss that the SEC is trying to force a novel vicarious strict liability interpretation of Section 304 that "departs starkly" from the regulator's own repeated application of the statute.[78] Judge G. Murray Snow of the U.S.

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74. *Id.*

75. *Id.*

76. *See, e.g.*, SEC v. O'Leary, Case No. 1:11-cv-2901 (N.D. Ga.); Litigation Release No. 22074 (Aug. 30, 2011) (On August 30, 2011, the SEC announced a settlement with James O'Leary, the former CFO of Beazer Homes USA, to recover approximately $1.4 million in cash bonuses, incentive and equity-based compensation, and profits from his sale of Beazer stock during the period of time that the SEC alleged an individual at Beazer—but not O'Leary—was committing "accounting misconduct."); SEC v. McCarthy, Case No. 1:11-CV-667-CAP (N.D. Ga.); Litigation Release No. 21873 (Mar. 4, 2011) (The SEC filed an action on March 3, 2011, against Ian J. McCarthy, the President and CEO of Beazer Homes USA, Inc., seeking to recover bonuses and other incentive-based and equity-based compensation and stock sale profits received after Beazer was required to prepare accounting restatements for the fiscal year ended September 30, 2006 and the first three quarters of fiscal 2006 due to its manipulation of Beazer's land development and house cost-to-complete accounts to increase income, and the improper recording of certain model home financing transactions as sales, again to increase Beazer's income. McCarthy was not charged with the underlying misconduct or alleged to have otherwise violated the federal securities laws.)

77. *See* SEC v. Jenkins, 718 F. Supp. 2d 1070 (D. Ariz. 2010).

78. *See id.*; *see also Securities and Exchange Commission v. Maynard Jenkins, Notice of Motion and Motion by Defendant Maynard L. Jenkins To Dismiss the Complaint; Memorandum of Points and Authorities In Support Thereof*, United States District Court for the District of Arizona, Case No. CV-09-01510-PHX-GMS, at 1 (Sept. 15, 2009), *available at* https://www.complianceweek.com/s/documents/MotiontoDismiss.pdf, last accessed May 22, 2014 (where

District Court for the District of Arizona rebuffed Jenkins' efforts in 2010 after reviewing the text of the statute and its legislative history. [79] The court held that while Section 304's meaning was unambiguous,[80] it found that the legislative history supported a congressional intent to punish even innocent executives for corporate wrongdoing; [81] writing that it is not irrational for Congress to require that such additional compensation amounts be repaid to the issuer, considering that "when a CEO either sells stock or receives a bonus in a period of financial noncompliance, the CEO may *unfairly benefit* from a misperception of the financial position of the issuer that results from those misstated financials, even if the CEO was unaware of the misconduct leading to misstated financials." [82] And further still that "Section 304 provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring that they reimburse additional compensation received during periods of corporate noncompliance regardless of whether or not they were aware of the misconduct giving rise to the misstated financials." [83] In the end, Jenkins agreed to settle with the SEC on November 16, 2011, agreeing to pay CSK $2,796,467 in damages.[84] The *Jenkins* settlement left unsolved some of the potential constitutional challenges to Section 304.[85]

A Texas federal court followed the *Jenkins* analysis in part, more than a year later, when it also upheld the SEC's authority to bring a stand-alone claw back action absent allegations that the defendant also engaged in wrongdoing. In the case *SEC v. Baker*, the court similarly rejects the defendants' arguments, inter alia, that the language of Section 304 required the misconduct of the officer from whom the reimbursement was sought, and that the statute was unconstitutional.[86]

Jenkins argued, "This truculent construction of section 304 is not only unprecedented, it departs starkly from the SEC's own repeated interpretation and application of the statute since its enactment seven years ago.").

79. *See Jenkins*, 718 F. Supp. 2d 1070.

80. *See id.* at 1074-75 (noting that "the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO. According to the court, it is the issuer's misconduct that triggers the CEO and CFO's reimbursement obligation as Section 304 specifies that the reimbursement obligation is triggered if an issuer has to prepare an accounting restatement 'due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws.'"). *Id.* (citing 15 U.S.C. § 7243(a)).

81. *See id.*

82. *See id.* at 1070.

83. *See id.*

84. Final Judgment as to Defendant Maynard Jenkins, CV-09-01510-PHX-RJB (Nov. 16, 2011).

85. *Id.* (The court also denied the defendant's motion to dismiss the SEC's complaint based on the argument that section 304 was unconstitutionally punitive. The court held that the nature of the relief requested was a factual issue that could not be resolved on a motion to dismiss.)

86. SEC v. Baker, Case No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012).

Defendants Michael A. Baker and Michael T. Gluk were CEO and CFO, respectively, of Arthrocare, which previously restated its financials due to alleged fraud by two senior vice presidents.[87] The defendants were not alleged to have committed any conscious wrongdoing in connection with the fraud. In denying the defendants' motion to dismiss the SEC's case against them, U.S. District Judge Sam Sparks of the Western District of Texas, wrote:

> Apologists for the extraordinarily high compensation given to corporate officers have long justified such pay by asserting CEOs take 'great risks,' and so deserve great rewards. For years, this has been a vacuous saw, because corporate law, and private measures such as wide-spread indemnification of officers by their employers, and the provision of Directors & Officers insurance, have ensured any 'risks' taken by these fearless captains of industry almost never impact their personal finances. In enacting Section 304 of Sarbanes-Oxley, Congress determined to put a modest measure of real risk back into the equation."[88]

Quickly noting that Section 304 contains no scienter or personal wrongdoing requirement,[89] this court then turn[ed] to a further analysis of Section 304's legislative history. Finding that a requirement of wrongdoing by executives would render Section 304 meaningless because the SEC already had the power to seek disgorgement of profits earned through wrongdoing pre-dating Sarbanes-Oxley, the court stated, "for [Section] 304 to have any meaning beyond mere exhortatory rhetoric, the Court must give effect to the statute as written, and as argued by the SEC: reimbursement is required without any showing of wrongdoing by the CEO or CFO, and the amount or reimbursement is not limited to income attributable to the wrongdoing of others."[90]

Further still, reading Section 304 in context with other provisions of the Act, including Section 302 (which requires CEOs and CFOs to certify issuers' financial statements), the *Baker* court stated that Congress clearly intends to increase CEOs and CFOs accountability throughout the statute.[91] Specifically, Section 304 "ensures corporate officers cannot simply keep their own hands clean, but must instead be vigilant in ensuring there are adequate controls to prevent misdeeds by underlings."[92] Declining to follow the Ninth Circuit opinion in SEC v. Jasper, which held that Section 304 required equitable disgorgement,[93] the *Baker* court also rejected the defendants' argument that Section 304 established an equitable remedy similar to disgorgement, and as such, required a finding of misconduct by the defendants.[94] In so doing, the *Baker* court found

87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. 678 F.3d 1116 (9th Cir. 2012).
94. *See Baker*, 2012 WL 5499497 (citations omitted).

instead that Section 304 was a penalty that could be imposed regardless of fault.[95] The court in Baker similarly rejected the defendants' constitutional arguments that Section 304 was void for vagueness because the statutory reference to misconduct did not specify to whom the term should apply.[96] The *Baker* court wrote that the reference to issuer misconduct clearly referred to the issuer and its agents acting within the scope of their employment.[97]

Victories in the *Jenkins* and *Baker* cases, as well as the other settlements of SEC's recent enforcement actions under Section 304, may represent significant victories for the agency (issuers and derivatively, the shareholders), thereby making implementation of Dodd-Frank Section 954 unnecessary. However, the long-term significance of these decisions remains unclear. The enforcement requirements of S-Ox Section 304 are far from a settled area of law. Case law in this area remains sparse and, in some cases, conflicting.[98] This view is supported particularly in the Ninth Circuit,[99] where courts have ruled that section 304 is an equitable remedy, thus enabling defendants to argue that compensation being clawed back must be linked to the misconduct, and not to other unrelated goals. It is also too soon to determine whether the SEC will continue on this path or retreat from wielding Section 304 as aggressively. To date, the SEC has been inconsistent in its enforcement of Section 304—sparing some executives while clawing back compensation from others—all the while providing no real guidance to the public.[100] Only time will tell. In the meantime, given the uncertainties associated with Section 304, rulemaking under Dodd-Frank Section 954 must move forward.

2. How Dodd-Frank Section 954 Enhances S-Ox Section 304 Claw back Weapon.—The Act attempts to respond to those enforcement issues left unresolved by S-Ox Section 304 as Dodd-Frank Section 954 substantially broadens the S-Ox claw back rule primarily by (i) removing the "misconduct" requirement as a trigger for the claw back; (ii) increasing the recovery period; (iii) expanding the parties subject to the claw back beyond the CEO and CFO; and (vi) expanding who can enforce the claw back mandate.[101] However, as will be

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95. *See id. Accord* S.E.C. v. Microtune, 783 F. Supp. 2d 867, 886-87 (2011); Cohen v. Viray, 622 F.3d 188, 195 (2010)).

96. *See Baker*, 2012 WL 5499497 (citations omitted).

97. *See id.*

98. *Cf.* Sec v. Jasper, 678 F.3d 1116 (9th Cir. 2012).

99. *See id.* at 1130 (relying on *In re* Digimarc, 549 F. 3d. 1223,1232-33 (9th Cir. 2008)).

100. For further analysis of the interpretation issues regarding Section 304 of S-Ox and the potential shortcomings of the SEC's enforcement action prior to 2009 that might bind the Agency going forward, see Allison List, *The Lax Enforcement of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct?*, 70 OHIO ST. L.J. 195 (2009).

101. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). (adding Exchange Act, Section 10D(b)). *Cf.* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

illustrated in the next part of the Article, Section 954 also narrows the amount and nature of assets that could have been reached pursuant to the S-Ox claw back rule.

The forfeiture authority under the pre-existing S-Ox claw back rule is triggered only when the required accounting restatement results from misconduct. In contrast, the recovery right under Section 954 occurs whenever the company is required to prepare any accounting restatement due to the material noncompliance with a financial reporting requirement—without regard to whether the noncompliance was due to misconduct. Personal fault of the target of the recovery is no longer at issue; thus avoiding the litigations that plagued the S-Ox claw back remedy.

While the authorized recovery period to claw back compensation under S-Ox is limited to the 12 month period *following* the first public issuance or filing of the misstated financials where that unearned compensation was received, Section 954 expands the recovery period to a three-year timeframe *preceding* the date on which the issuer is required to prepare an accounting restatement.[102] Taken together with the deleted "misconduct" trigger, the expanded claw-back recovery period makes for a more impactful deterrent effect. Financial industry personnel now will have exposure to real downside risks—true compensation forfeiture; exposure for a greater period of time—if they are compensated for events that fail to occur or other instances where they receive compensation that is essentially unearned had the financial results been properly recorded.[103] In accord with the recent holdings in *Jenkins* and *Baker*, executive officers will be held to account under Dodd-Frank Section 954 for monies paid or due while the company was misleading shareholders through noncompliant public filings.[104] Such personnel implicitly will be required to ensure that their cohorts and underlings are not acting in ways that might contribute to the restatement as well as to provide oversight and vigilance for a greater period of time. The expanded recovery period to three-years also would cover those instances where the employee might consider a delayed disclosure to protect his compensation payout during the current year.[105] Moreover, corporate internal controls should ferret out wrongdoing or fraud during this time, and unearth any basis to cause a material restatement of a corporation's financials. Once discovered, it is highly unlikely that a corporation would willfully refrain from restating its financials for three years to avoid the claw back mandate in order to protect an executive officer's compensation.

Section 954 also expands the reach of the S-Ox claw back remedy beyond

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102. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)). *Cf.* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

103. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)).

104. *See generally id.* (adding Exchange Act, Section 10D(b)).

105. *See generally id.* (adding Exchange Act, Section 10D(b)).

CEOs and CFOs who are the sole targets of the S-Ox claw back rule to now reach all current and former *executive officers*.[106] The S-Ox claw back remedy, which sought compensation recoupment from only the CEO and CFO, left so many other employees with similar policy-making authority unjustly enriched as they were allowed to benefit despite the falsehood in the issuer's filings. Although the expansion of potential targets under Dodd-Frank Section 954 is significant, that provision continues to leave many other potential targets free from the recoupment threat. As JPMorgan recently illustrated, many financial institutions employ highly compensated, non-executive individuals who also have the capacity to harm the corporation through errant performance, excessive risk-taking or conduct that lacks integrity.[107] These employees also should be covered by the rules to be promulgated by the SEC.

A final distinction between the two provisions relates to the enforceability of, and penalties for, violating the claw back provision. Pursuant to Section 954, corporations must police their executives and have little discretion about whether to recover unearned compensation.[108] Noncompliant companies now will be required to be delisted by the national exchange or NASDAQ if they do not develop and implement policies to recover certain unearned compensation awards.[109] This mandate, which requires greater vigilance on the part of the company's Board in reviewing the compensation awards for *all* executive employees, differs from the approach under Section 304 of S-Ox that gave the SEC discretion to bring an enforcement action if there is a violation and the CEO or CFO did not voluntarily agree to reimburse the corporation. While some may criticize Section 954 for removing discretion from the Board since recovery must be sought if the publicly-held corporation has material financial restatements, the provision is a powerful mechanism for assisting the Board in meeting its fiduciary obligations to shareholders—Section 954 holds them accountable to shareholders who want the Board to balance proper risk management with high performance when authorizing compensation awards.

Unfortunately, the SEC has yet to propose rules to affect Dodd-Frank Section 954's mandated recovery. Indeed, the Commission has removed its rule-making timeline from its website.[110] Their tardy rulemaking on the claw back remedy greatly impacts the national securities exchanges' ability to move forward as well. While it is too soon to determine whether the new rules will provide a narrower interpretation of both the amount and nature of compensation that is subject to recovery, or who, and on what basis would that person be subject to the claw

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106. *See id.* (adding Exchange Act, Section 10D(b)). *Cf.* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

107. *See infra* Part II (discussing JPMorgan's $6.2 billion trading debacle).

108. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)).

109. *See generally id.* (adding Exchange Act, Section 10D(a)).

110. *See supra* note 64.

back remedy, there is a great danger that the SEC will do too little rather than too much.

In fact, Commissioner Troy Paredes took aim at the Dodd-Frank claw back provision when he delivered a speech on July 13, 2012.[111] He expressed concern that the new regulatory regime "will prove to be excessive, unduly burdening and restricting [on] our financial system . . . suppressing private sector innovation, entrepreneurism and competition at the expense of [the] country's economic growth and global competitiveness."[112] Commissioner Paredes stated that he understood why some found the "no-fault nature" of Section 954 "troubling,"[113] seemingly a repeat of his 2010 fairness argument. He offered the example of "an executive who has worked diligently and honestly at a company that has robust financial controls and top notched procedures and systems" but who "may nevertheless have to pay back a considerable portion of his or her compensation if the company has to restate because of an accounting error." [114] Commissioner Paredes' argument misses the point that this executive had been compensated on the basis of a mistake, albeit honest on his part, that if left uncorrected would leave that executive with a benefit that he did not earn.

Commissioner Paredes, in criticizing Dodd-Frank's compensation rules, also raised application issues including whether: (i) companies would restructure their compensation arrangements to minimize the size of the incentive pay in favor of a larger discretionary bonus not specifically linked to a financial or performance target; (ii) executives will press for a higher base pay to compensate them upfront for the risk associated with future forfeited incentive pay; (iii) this compensation policy shift will impact an executive's incentives; and (iv) companies will avoid or be discouraged from restating financials to avoid triggering the Section 954 claw back.[115] In regard to the latter argument, it is unreasonable to believe that a corporation would willfully refrain from restating its financials for up to three years simply to avoid Section 954's claw back mandate. The Commissioner's remaining arguments will be addressed below in the discussion of Dodd-Frank Section 956.

Most interestingly, an increasing number of companies have already begun describing their claw back policies within their proxy statements over the last two years rather than wait for the SEC's rulemaking.[116] Like JPMorgan, more and

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111. Commissioner Troy A. Paredes, Remarks at Society of Corporate Secretaries & Governance Professionals, 66th National Conference on "The Shape of Things to Come," SEC Speech (July 13, 2012).

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. The vast majority of the "Top 25 U.S. Bank Holding Companies" have adopted some form of a claw back policy. The list of the 25 "United States' Largest Banks" as of December 31, 2012 was sourced from the Federal Reserve System, National Information Center, and is *available at* http://www.infoplease.com/ipa/A0763206.html. The supporting documents and citations for all, except USAA, HSBC, TD Holdings and RBS Citizens Financials, are on file with the Author.

more financial institutions are going further with their claw back provision than was envisioned by Congress—even invoking their policies in response to adverse business results.[117] Several other big Wall Street banks (including Citigroup, Morgan Stanley, and Goldman Sachs) also have announced new claw back policies in recent years that target the pay of their employees who put the banks in big financial or legal trouble.[118] For example, according to Dimon, JPMorgan's claw back policy targets all senior employees and also can be invoked for "bad judgment."[119] A 2012 study conducted by Equilar found that 86% of Fortune 100 companies have publicly disclosed their claw back policies; 49% of their claw back triggers relate to both financial restatements and ethical misconduct; and 67% target key executives.[120] The SEC's regulations should meet (if not surpass) the standards currently adopted by these companies to avoid any retrenchment on their part.

3. What Is Lacking in Dodd-Frank's Claw-back Reform Effort?—While Section 954 is a very good start towards enhancing the accountability net at publicly-held corporations by removing the motivation to engage in behavior that may lead to the restatement of noncompliant financials, the provision as written unnecessarily narrows both the amount and nature of recovery by the corporation, and derivatively by the shareholders. Section 954 limits recovery to only "incentive-based compensation, including stock option awards," and then only that amount that was paid "in excess of what would have been paid" under the restated financials.[121] Section 304 of S-Ox, in contrast, is more expansive; authorizing the recovery of "any bonus or other incentive-based or equity-based compensation received on the basis of the fraudulent financial statement" as well as "any profits realized from the sale of securities" during the twelve-month recovery period.[122]

The S-Ox claw back recovery is a penalty that, as noted by the court in *Jenkins*, punishes even innocent executives for corporate wrongdoing.[123] It also

117. *See, e.g.*, *id.*

118. *See, e.g.*, *id.*

119. *See supra* note 60; *see also* Ben Protess, *JPMorgan's Chief Says Clawback Efforts Are 'Likely*,*'* N.Y. TIMES, June 13, 2012 (according to Dimon, JPMorgan "has broad authority to recoup pay" and that the bank "can claw back compensation for 'bad judgment' and other missteps."). Donal Griffin & Dawn Kopecki, *Dimon Says Clawback Likely for Executives Tied to Loss*, BLOOMBERG (June 13, 2012), *available at* http://www.bloomberg.com/news/2012-06-13/dimon-says-clawbacks-likely-for-executives-tied-to-trading-loss.html, last accessed May 22, 2014.

120. *See* EQUILAR, 2012 CLAWBACK POLICY REPORT (2012), *available at* http://www.equilar.com/knowledge-network/research-reports/2012-research-reports/2012-Clawback-Policy-Report.php.

121. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)).

122. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

123. *See* SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074-75 (D. Ariz. 2010). In *Jenkins*, the court

prevents unjust enrichment from those who received compensation that is essentially unearned. Like the S-Ox claw back, the Dodd-Frank claw back recovery should be deemed a penalty. To that end, Dodd-Frank's claw back provision should reach all incentive-based compensation paid *and* all ill-gotten gains realized from the sale of the securities during the relevant recovery period, not just the "erroneous" and "excess" compensation paid the executive officers. Moreover, the theory underlying deterrent-based punishment, as previously noted, is that people with comply with the law after a conscious evaluation of the risks associated with disobeying the law.[124] Applying this theory, potential targets of the claw back recovery purportedly will engage in the necessary cost-benefits analysis to find that the rewards gained from noncompliant financial statements may be recovered at a later date, which should lead him to be more "vigilant in ensuring that there are adequate controls to prevent misdeeds by underlings.[125] To be effective, the claw back penalty must remove all economic incentives that may result from either the misconduct or the failure to be vigilant. Accordingly, the SEC should promulgate rules affecting Section 954 that expansively define "incentive-based compensation[126]—to go beyond annual and long-term, incentive-based compensation—to ensure that companies do not skirt the application of their recoupment mandate.

Section 954 also suffers another shortcoming. Its requirement that the company parse recovery amounts will create unnecessary confusion in fully implementing and enforcing the claw back remedy. It is not hyperbole to argue that it will be a nightmare for corporations—particularly financial institutions—to be able to easily calculate what part of the incentive-based compensation award is tied to the employee's performance related to the noncomplying financial report given the various formulas applicable to the types of compensation packages awarded.[127] Few financial institutions have a bright-line process by which bonuses are calculated or paid.[128] JPMorgan's response to the $6.2 billion loss in 2012 is instructive.

Following the discovery of JPMorgan's massive trading debacle that resulted in losses to the firm totally $6.2 billion by year-end 2012 and the ensuing internal investigation into the actions of employees in the CIO unit, JPMorgan was

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was interpreting the application of S-Ox Section 304's claw back remedy. *See id.*

124. *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 956 (2003); *see also* Nicholson, *Sarbanes-Oxley's Purported Over Criminalization*, *supra* note 9, at 51-53; Nicholson, *The Culture of Under-Enforcement*, *supra* note 21, at 372-78.

125. SEC v. Baker, Case No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012).

126. Incentive-based compensation is not defined in Section 954 apart from the inclusion of stock options. The new rules should explicitly state that the claw back should reach both variable cash and equity earned during a particular period as well as long-term incentive and deferred compensation.

127. *See, e.g.*, *supra* note 116.

128. *Id.*

required to restate its earnings in the first quarter 2012 filings believing employees had sought to hide the extent of trading losses.[129] Relying instead on the firm's compensation policy[130] and not on the federal claw back provision of S-Ox Section 304, JPMorgan subsequently clawed back almost $100 million in compensation,[131] consisting of forfeited severance payments and salaries and bonuses undoubtedly due to the difficulty in parsing earned versus unearned compensation awards. The firm also decided to apply a blanket 50% cut to the 2012 compensation awarded Dimon; resulting in a an amount of $11.5 million notwithstanding the $18.7 million compensation the firm disclosed for Dimon in its 2013 proxy filing with the SEC since it included a bonus awarded in 2011 but paid out in 2012.[132] JPMorgan reportedly "invoked comprehensive claw backs of previously granted outstanding awards and/or repayment of previously vested awards subject to claw."[133]

Apart from creating an issue with regard to the *amount* and nature of compensation awards subject to recovery, the language of the statute also raises numerous additional questions relating to the definition of *executive officer of the issuer*, and what constitutes *material noncompliance*. As a result, the SEC will be forced to decide whether to rely either on precedents (e.g., previous definitions of executive officer under the federal section laws or the basis for prior S-Ox Section 304 enforcement actions), or to draft new rules to interpret Section 954.

Addressing the latter concern first, it remains to be seen whether the SEC will determine that noncompliance goes beyond financial statements that do not comply with generally accepted accounting principles since misconduct in connection with the financial restatement is no longer required. Many publicly-held companies, who have existing claw back policies, also allow recovery beyond the malfeasance trigger where there has been an ethical violation or where there has been an erroneous calculation of the incentive compensation, though not

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129. *See* Silver-Greenberg, *supra* note 55; *see also* JPMorgan Chase Form 8-K (July 13, 2012) (disclosing that "the Firm had reached a determination to restate the Firm's previously-filed interim financial statements for the first quarter of 2012," that the "restatement will have the effect of reducing the Firm's reported net income for the 2012 first quarter by $459 million (after-tax)" and that "recently discovered information raises questions about the integrity of the trader marks [suggesting] that certain individuals may have been seeking to avoid showing the full amount of the losses being incurred in the portfolio during the first quarter.").

130. *See supra* note 60 ("JPMorgan's *Bonus Recoupment Policy*").

131. *See* Matthias Rieker, *J.P. Morgan's Dimon Total 2012 Compensation $18.7 Million; Whale Claw backs Top $100 Million*, WALL S. J., Mar. 22, 2013; *see also* JPMorgan 2013 Proxy Statement at 7.

132. *See id.*; *see also* JPMorgan 2013 Proxy Statement at 7; Dawn Kopecki, *JPMorgan Claws Back $100 Million, Pays Zames More Than Dimon*, BLOOMBERG (Mar. 23, 2013) (reporting that the "board cited the debacle while cutting Dimon's 2012 compensation to $11.5 million from $23 million the previous year").

133. Steve Dickson, *JPMorgan Clawed Back More Than $100 Million Tied to CIO Loss*, BLOOMBERG (Mar. 22, 2013, 3:24 PM), http://www.bloomberg.com/news/2013-03-22/jpmorgan-clawed-back-more-than-100-million-tied-to-cio-loss.html.

where the financials restatement is required due to a change in the applicable reporting standard.[134] The SEC also should follow suit, rather than take a very narrow view of what constitutes "material noncompliance."

The SEC has more choices when it comes to defining "executive officer" as it is reasonable to presume that the SEC would look to the other definitions under federal securities laws. For example, pursuant to Rule 3b-7 of the Securities Exchange Act of 1934, the term executive officer includes: the company president, its vice presidents of business unit, division or function, and others who perform similar policy-making functions, including executives of subsidiaries who perform policy-making functions.[135] A narrower grouping would be captured if the SEC instead relies on the definition at Item 402 of Regulation S-K, which only includes the principal executive officer, the principal financial officer and the company's three most highly compensated executive officers other than the aforementioned two employees.[136]

Nevertheless, even using the expansive definition of Rules 3b-7, many non-executive employees will be left out of the corporation's efforts to deter risk-taking and enhance accountability by use of the claw back punishment. Trading personnel at financial institutions, for example, are just as likely as executive officers to engage in conduct that might lead to restated financials, as illustrated by JPMorgan's derivatives trader Iksil and his fellow traders in the London office of the CIO.[137] Accordingly, the SEC also must develop a new definition of to capture these other employees, and to meet both the spirit of the Dodd-Frank Act's corporate governance provisions and the public shareholders' expectations for good corporate governance. In so doing, the new regulation reasonably could define executive officer to include both traditional executive officers, as well as key, highly compensated employees who have the capacity to harm, or have a material adverse effect on, the company through their performance or nonperformance.

Finally, when promulgating the new rules effecting Section 954, the SEC should consider another path taken by those publicly-held corporations that have already incorporated claw back policies into their compensation program. The malfeasance that triggers the claw back should go beyond a material misstatement of financials to also include reckless behavior and ethical misconduct as well as those instances where the executive terminates employment shortly after exercising their stock options to fully plug the loophole seemingly left open by Dodd-Frank Section 954.

B. Incentive-Based Compensation Arrangements

The financial industry itself, which played a key role in the 2008-2009

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134. *See e.g.*, *supra* note 116.

135. *See* 17 C.F.R. § 240.3b-7 (2013) (defining "executive officer").

136. *See id*. § 229.402(a)(3) (Item 402) (executive compensation).

137. *See supra* notes 51, 52, and 55 (discussing JPMorgan's $6.2 billion dollar trading loss at the hands handsomely paid traders).

financed crisis, also played a key role in weakening regulatory constraints on institutions, markets, and products, reportedly spending $2.7 billion in lobbying expenses between 1999 and 2008.[138] In this environment of light regulation, compensation arrangements were designed to focus on short-term rewards rather than long-term consequences.[139] These arrangements also favored risk takers at the expense of independent risk managers and control personnel.[140]

In 2009, the Group of Twenty (the "G-20"), which serves as the economic council for wealthy nations including the United States,[141] noted that incentive-based compensation engendered the excessive risk-taking that fueled the global economic crisis.[142] The G-20 called for the reform of compensation policies as an essential part of enhancing capital market stability.[143] Specifically, it endorsed

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138. FCIC REPORT, *supra* note 1, at xviii.

139. *Id.* at xix.

140. SSG REPORT, *supra* note 1, at 4. The Senior Supervisors Group ("SSG") is a group of senior financial supervisors from the United States, Canada, France, Germany, Japan, Switzerland, and United Kingdom, who reviewed funding and liquidity risks at a sample of global financial institutions during the 2008-2009 crisis and found extensive deficiencies in the financial institutions' corporate governance and risk management practices that may have contributed to the industry's distress. The United States sent representatives from the SEC, Office of the Comptroller of Currency, Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System. *See id*. at Transmittal Letter.

141. *About G20*, G20, https://www.g20.org/about_G20 (last visited Feb. 12, 2014). The G20 brings together finance ministers and central bank governors from 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States of America plus the European Union, which is represented by the President of the European Council and by Head of the European Central Bank. The objectives of the G20 include: "[1] policy coordination between its members in order to achieve global economic stability, sustainable growth; [2] promoting financial regulations that reduces risks and prevent future financial crises; and [3] modernizing international financial architecture." *What Is the G20*, G20, http://en.g20russia.ru/docs/about/about_G20-print.html.

142. *See* U.S. Department of State, *The Pittsburgh Summit: Key Accomplishments* (Sept. 25, 2009), *available at* http://www.state.gov/e/eb/ecosum/pittsburgh2009/resources/165061.htm ("the G-20 agreed to strong international standards for bank capital … and also agreed to strong international standards for compensation aimed at ending practices that lead to excessive risk-taking. . . . These rules will result in a financial system that looks far different from the one that led to this financial crisis, with more capacity to absorb losses and new incentives to avoid a return to past excesses."); *see also* Christine Harper, *G-20 Leaders Vow to 'Raise Standards' on Financial Regulation*, BLOOMBERG (Sept. 26, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aF5cR_E70CtU.

143. *See* G-20, *G-20 Leaders Statement after Talks in Pittsburgh (Full Text)* ¶ 13, BLOOMBERG (Sept. 25, 2009), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=auIe3UTJncpY (last visited May 22, 2014) (noting "Excessive compensation in the financial sector has both reflected and encouraged excessive risk taking. Reforming compensation policies and practices is an essential part of our effort to increase financial stability. We fully endorse the

aligning banker compensation with long-term value creation and provided that a significant portion of incentive-based compensation be structured as variable, deferred and tied to long-term performance subject to appropriate claw backs.[144] The new structure would ensure that trading risks be personally borne by the bankers whose compensation would be subject to claw backs when their trades did not work out. The G-20 also recommended more transparency and disclosures of compensation calculations.[145]

The G-20 proposals were supported by a 2009 study of 20 global financial institutions by a group of senior financial supervisors from seven countries including the United States (the "SSG"), which found that "historical compensation arrangements evidenced both an insensitivity to risk and the skewed incentives to maximize revenues."[146] The SSG also found that these compensation "schemes for measuring individual performance also often failed to take into account [either the units' or the firms'] true economic profits, adjusted for all costs and uncertainty."[147] If the JPMorgan trading debacle is indicative, compensation arrangements following the financial crisis continue to be misaligned with the firm's risk appetite. JPMorgan's 2012 compensation policy, for example, was found by the Senate Sub-committee investigating the London Whale trades to be premised on rewarding employees for financial gains and risk-taking more than effective risk management.[148] Indeed, CIO unit managers Macris and Martin-Artajo reportedly received incentive pay worth millions of dollars each year; rates which moved in tandem with the CIO's credit derivatives' trading profits.[149]

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implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by (i) avoiding multi-year guaranteed bonuses; (ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; (iii) ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure align with performance and risk; (iv) making firms' compensation policies and structures transparent through disclosure requirements; (v) limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and (vi) ensuring that compensation committees overseeing compensation policies are able to act independently.").

144. *Id.*

145. *See* G-20, *supra* note 143, ¶ 13 ("If we all act together, financial institutions will have stricter rules for risk-taking, governance that aligns compensation with long-term performance, and greater transparency in their operations. All firms whose failure could pose a risk to financial stability must be subject to consistent, consolidated supervision and regulation with high standards. Our reform is multi-faceted but at its core must be stronger capital standards, complemented by clear incentives to mitigate excessive risk-taking practices.").

146. SSG REPORT, *supra* note 1, at 4.

147. *Id.*

148. SENATE REPORT, *supra* note 46, at 57-60.

149. *Id.* at 59.

Many firms will likely respond to criticism of their compensation arrangements by arguing, as did JPMorgan in Dimon's February 2012 remark, that "We are going to pay competitively,"[150] that their compensation arrangements were and continue to be driven by competition and the need to attract and retain talented staff, and that this race to retain people led to some inconsistencies in their incentive-based compensation arrangements. Some of these firms also may believe that they are protected from undesirable financial or business results that may result from their employees' acts because the firms have adopted claw back policies.[151] However, such policies are only as good as the firm's ability to recover the unearned funds. Once compensation awards have been made to errant personnel, the difficulty of recovery of unearned amounts is greatly amplified. The funds simply may be unavailable.

Of course, best practices would be to structure incentive-based compensation arrangements in a manner to prevent excessive risk-taking in the first place; but where that does not occur, consideration also must be given to the firm's ability to recover the unearned awards. As a result, incentive-based compensation arrangements that are structured in a manner that would allow the firms to offer deferred payments that have both longer vesting periods as well as longer distribution periods would also serve the firm's latter concern. Such a structure would enable the firm (and its shareholders) to be self-protected from any resulting tail risks.

Section 956 of the Dodd-Frank Act, which requires joint action by the appropriate federal regulators, mandates disclosure obligations and guidelines for structuring all incentive-based compensation arrangements offered by covered financial institutions in order to limit excessive risk-taking by industry personnel.[152] Congress further requires both the new disclosure standards and the new incentive-based compensation rules be modeled against the FDIC safety and soundness standards for insured depository institutions.[153] Some may question the paternalistic nature of Section 956(a)'s reporting obligation, but enhanced prudential regulation is one of the hallmarks of the Dodd-Frank legislation.[154]

1. The Dodd-Frank Act Reform of Incentive-based Compensation Arrangements.—The required disclosures under Dodd-Frank Section 956(a) must allow for a determination by the appropriate federal regulator that the firm's compensation structure does not either: (i) provide an executive officer,

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150. *See* discussion *infra* Part II.A.

151. *See* discussion *infra* Part II.A.

152. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956, 124 Stat. 1376, 1905 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.)

153. *Id.* § 956(c).

154. *See* G-20, *supra* note 143 (noting "Reforming compensation policies and practices is an essential part of our effort to increase financial stability. We fully endorse the implementation standards . . . aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by . . . (iv) making firms' compensation policies and structures transparent through disclosure requirements; . . . .").

employee, director or principal shareholder with excessive compensation, fees, or benefits; or (ii) lead to a material financial loss to that firm.[155] Section 956(b) further directs federal regulators to adopt joint regulations that will prohibit incentive-based compensation arrangements that these regulators deem will encourage inappropriate risks by covered financial institutions.[156] The ensuing joint regulations, therefore, must restrict those incentive-based compensation plans that either: (i) provide an executive officer, employee, director or principal shareholder with excessive compensation, fees, or benefits; or (ii) could lead to a material financial loss to that firm.[157]

On February 7, 2011, the seven federal regulatory authorities (including the SEC)[158] issued the proposed rules to implement Section 956.[159] Though it has been more than three years since these agencies first published their proposed rule in the Federal Register,[160] the public is still awaiting final rules.[161] Nevertheless, the regulators have provided the public with an insight into their views on the best manner to meet the challenges of excessive risk-taking by financial institutions. The proposed rules are broad in scope, and lack specificity in how certain terms should be applied. Yet, they show that the federal regulators are finally moving in the right direction to reform executive compensation arrangements.

In general, the proposed rules prohibits regulated entities with consolidated assets of $1 billion or more ("covered financial institutions")[162] from maintaining incentive-based compensation arrangements for covered persons[163] that encourage "inappropriate risks" that could lead to "material financial loss" at such institutions, or encourage "inappropriate risks" by providing "excessive

155. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956(a), 124 Stat. 1376, 1905 (2010).

156. *Id.*

157. *Id.* § 956(b).

158. Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170-01 (proposed Apr. 14, 2011). The other federal agencies include the Federal Deposit Insurance Corporation, Office of the Comptroller of Currency, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, National Credit Union Administration, and Federal Housing Finance Agency. *Id*.

159. *Id.* at 21,170.

160. *Id.*

161. The proposed rule was posted in the Federal Register in April 2011. The original comment period ended May 31, 2011, and the terms of the final rules were expected to become effective six months from the publication of the final rule in the Federal Register. *See id.* at 21,170-01.

162. *Id.* at 21,174. The "covered financial institutions" include banking organizations (e.g., national or state-chartered depository institutions, bank holding companies), registered brokers or dealers, investment advisors, Fannie Mae and Freddie Mac, and any other financial institution that the appropriate federal regulators jointly by rule determine should be treated as such. *Id.*

163. *Id*. at 21,175. The term "covered persons" includes any of the institution's "executive officers," non-executive officers, "directors," and "principal shareholders." *Id.*

compensation."[164] The proposed rules also require "large covered financial institutions"—those with assets of $50 billion or more—to defer at least 50% of the incentive-based compensation paid to executive officers for a period of at least three years.[165] The firms are also required to ensure that those deferred compensation amounts are subject to adjustments for the actual losses of the covered financial intuition, or based on other measures of performance.[166] Incentive-based compensation is broadly defined to include any variable compensation that serves as an incentive for performance.[167]

The proposed rules also direct the actions of Boards of the larger covered financial institutions; requiring directors to review and approve all incentive-based arrangements for certain designated employees ("non-executive officers") who the boards determine have "the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance."[168] The boards, in awarding approval, must determine that the compensation arrangements effectively balances the financial rewards to the individual with the range and time horizons of risks associated with the individual's activities.[169] The boards, however, may use various methods in reaching this determination, including deferrals, risk-weighting and longer performance periods.[170]

Finally, all covered financial institutions are required to provide an annual report within 90 days of the end of the fiscal year to the appropriate federal regulator for its determination of the firms' compliance with the rules' requirements.[171] This annual report must detail the key components of the respective firm's incentive-based composition arrangements, set forth the firm's policies and procedures governing its plans, along with any changes in policies or procedures since its latest filing; and provide the specific rationale for the firm's determination that its compensation arrangements neither are excessive, nor provide incentive to engage in actions that would lead to a material financial loss.[172] The required institutional report need not, however include the actual compensation received by the individuals within those plans.[173]

2. The Proposed Rules Implementing Section 956 Should Withstand the Criticisms Raised.—In order to effectively rein in the size of executive compensation and its role in incentivizing short-term risk-taking at financial

164. *Id.* at 21,172.

165. *Id.* at 21,194.

166. *Id.* at 21,180.

167. *Id.* at 21,175. Incentive-based compensation is any variable compensation whether cash, equity award or other property. The broad definition is intended to provide some flexibility as forms of compensation evolve.

168. *Id.* at 21,177.

169. *Id.* at 21,181.

170. *Id.* at 21,173.

171. *Id.* at 21,174.

172. *Id.* at 21,176-77.

173. *Id.* at 21,213, 21,218.

institutions, the compensation structure must be designed to (i) tie both the bonus accrual and unit performance measurements to the firm's economic profits[174]—adjusted for costs and uncertainty; (ii) integrate firm risk controls into individual performance evaluations through a "bottom-line return on risk" at the unit level, rather than "top-line return on investment at the firm-wide level;[175] (iii) extend vesting and distribution periods for deferred compensation plans to allow for negative tail risk events; and (iv) involve the unit chief risk officer directly in business-line compensation decisions. The proposed rules, though stuck in limbo, will allow the Board leeway to so structure the firm's incentive-based compensation plans to take into account each of these points.

Perhaps the delay in adopting final rules is due to the alarmingly high number of comments on, and criticisms of, the proposed rules directed to the federal regulators. The criticisms generally target (i) the lack of definiteness of the proposed rules; (ii) the unintended consequences that may arise from the implementation of the proposed rules—including the increased use, and over-inflation, of the fixed compensation component; and (iii) the adverse impact on covered financial institutions in the global competition for talented employees and clients.[176]

A key criticism appears to be that the proposed rules do not provide tangible benchmarks to determine when compensation is in fact *excessive*. However, it would be impossible for the regulators to create a one-size-fits-all, bright-line benchmark of what definitively is "excessive compensation" given the various types of financial institutions at issue as well as the various positions held by their personnel. Moreover, a bright-line rule would be too easy to avoid if the financial institutions wanted to continue along their historic compensation paths. In any event, the proposed rules do provide factors to be considered by the Boards of the covered financial institutions that should enable them to make the determination of what is "excessive" compensation, including: (i) the combined value of all cash and non-cash benefits provided the covered person; (ii) historical compensation of the covered person in comparison to other individuals with comparable expertise at the covered financial institution; (iii) the institution's financial condition; (iv) comparable compensation practices at comparable institutions;[177] (v) projected total cost and benefit of post-employment benefits; (vi) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse; and (vii) any other

174. *See* SSG REPORT*, supra* note 1, at 4-5.

175. *See id.* at 5.

176. *See* Public Comments on the Agencies' respective websites to their Joint Proposed Rules on Incentive-Based Compensation, which were published in the Federal Register on April 14, 2011, *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-04-14/pdf/2011-7937.pdf. These concerns will be addressed in this Section.

177. When comparing financial institutions, the covered financial institution should take into consider factors such as asset size, geographic location, complexity of operations and assets. *See* Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,218 (proposed Apr. 14, 2011)

factors the federal agencies determine relevant.[178]

Arguably any limitation on incentive-based compensation awards can be avoided by any financial institution's decision to increase the base salaries of certain employees in order to retain top talent. However, that strategy will eventually undermine the purpose of providing the bonus in the first place. Incentive-based compensation is supposed to motivate employees to go beyond what is expected of them throughout the performance-review period. If financial services personnel are paid most of their compensation as salary, the motivation to exceed expectations sharply declines. Indeed, a guaranteed upfront payment, which delinks compensation from the employee-driven transactions' risk profile, also will make it harder for the financial institution to renege on the paycheck as punishment for the employee's gross negligence or other misconduct as set forth in the company's internal claw back policy. The up-front payments also do little to curtail excessive employee risk-taking—an unspoken interest of most corporations.

Opponents of executive compensation reform also continually argue that any limitation on banker compensation will force many talented and highly skilled individuals and financial institutions to move jobs overseas where the compensation rules are less restrictive.[179] A multinational approach to executive compensation reform would narrow the places where financial institutions could relocate to avoid new rules as governments worldwide understand (as evidenced by the statements from the G-20 leaders during the 2009 Pittsburgh Summit) the unwanted repercussions if financial instability returns to their capital markets simply because they were bullied away from meaningful reform. There remains some reputational and tax benefits to doing business in a well-regulated market.

Moreover, as the recent crisis illustrated, the global nature of risk contagion has caused other nations to re-consider a "hands-off" approach to executive compensation reform. Indeed, European lawmakers already have moved ahead on proposed rules that would limit bonuses of European bankers in hopes of curtailing the type of risky behavior that played a role in the global economic crisis.[180] In early March 2013, for example, the citizens of Switzerland voted to impose the strictest restriction on executive compensation—the Swiss voted

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178. *See id*

179. *See, e.g.*, Squam Lake Working Group on Federal Regulation, *Regulation of Executive Compensation in Financial Services* (Council on Foreign Relations, Feb. 2010) (arguing that "Broader limits on the compensation of financial executives may even drive parts of this highly mobile industry to more receptive countries.").

180. The European Parliament approved restrictions on bonus payments by financial institutions on April 16, 2013 as part of the Capital Requirements Directive ("CRD") IV in order to amend the rules on capital requirements for credit institutions (i.e., banks) and investment firms. *See* Capital Requirements Directive IV. *See also Capital Requirements—CRD IV/CRR—Frequently Asked Questions*, European Commission—MEMO /13/690 (16/07/2013) ¶ 12 ("Remuneration"), *available at* http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en. The bonus restriction applies to both employees of EU-based financial institutions and foreign employees of financial institutions of EU-based financial institutions. *See id.*

overwhelmingly to give shareholders of companies listed in Switzerland "a binding say on the overall compensation package of their executives and directors."[181] Pension fund shareholder voting also is mandatory.[182] Due to the firestorm of criticism that resulted from Novartis' payment of $78 million severance payout to its departing chairman, the new law also restricts Swiss companies from offering bonuses to either incoming or outgoing executives, or to executives in corporate acquisitions.[183] There are mandatory fines (up to six year's salary) and prison time (up to three years) for violation of any of these provisions.[184]

Similarly, in February 2013 the European Parliament and European Commission struck a provisional agreement to limit bonuses to 100 percent of bankers' salaries and require a majority-shareholders' vote to allow affected banks to increase the bonuses to twice the bankers' salaries in an effort to curb risky behavior that poses a systemic risk.[185] Still further, where the bonus exceeds the bankers' annual salaries, a quarter of the additional compensation must be deferred for at least five years under the initial proposal.[186] By mid-April 2013, the European Parliament had finalized the plan to cap bankers' compensation arrangements and defer part of the variable payments largely as proposed.[187] The Capital Requirements Directive (CRD IV), which entered into force on July 17, 2013, is applicable to employee performance from January 1, 2014 onward.[188] Surpassing the United States, the European Commission already has adopted the standards or technical rules for the implementation of the

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181. Raphael Minder, *Swiss Voters Approve a Plan to Severely Limit Executive Compensation*, N.Y. TIMES, Mar. 3, 2013, http://www.nytimes.com/2013/03/04/business/global/swiss-voters-tighten-countrys-limits-on-executive-pay.html?_r=0 ("Almost 68 percent of Swiss voters backed" the proposals to limit executive compensation).

182. *Id.*

183. *Id.*

184. *Id.*

185. *See* Michael J. De La Merced & Peter Eavis, *Bonus Rules May Just Reinforce, Not Overhaul, Pay Practices*, N.Y. TIMES, Feb. 28, 2013, *available at* http://dealbook.nytimes.com/2013/02/28/bonus-rules-may-just-reinforce-existing-pay-practices-rather-than-overhaul/?_php=true&_type=blogs&_r=0.

186. *Id.*; *see also* James Kanter & David Jolly, *European Union Agrees on Plan to Limit Bankers' Bonuses*, N.Y. TIMES, Feb. 28, 2013, *available at* http://www.nytimes.com/2013/03/01/business/global/european-union-agrees-on-plan-to-cap-banker-bonuses.html?pagewanted=all (last visited May 22, 2014.)

187. *See* Aaron Lucchetti & Julie Steinberg, *Regulators Get Banks to Rein in Bonus Pay*, WALL ST. J., Apr. 23, 2013, *available at* http://online.wsj.com/news/articles/SB1000142412 7887323551004578439242195663044; Juergen Baetz, *EU Lawmakers Vote for Banker Bonus*, ASSOCIATED PRESS (Apr. 16, 2013), *available at* http://bigstory.ap.org/article/eu-lawmakers-vote-banker-bonus-cap.

188. *See Capital Requirements—CRD IV/CRR—Frequently Asked Questions*, European Commission—MEMO/13/690 (16/07/2013) ¶ 12 ("Remuneration"), *available at* http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en.

restrictions on compensation arrangements in March 2014.[189] From the beginning, Britain has voiced opposition to the EU's restrictions on executive compensation arrangements for the financial industry, raising the same "competition" arguments as have many in the United States—that their industry would be disadvantaged because such rules would drive up fixed salaries; others would find a way to evade the restrictions; and both individual talent and businesses would be driven away to less restrictive regions like New York and Hong Kong.[190] Nevertheless, both caps on compensation levels and structural changes are now the law of the European Union. Given that the United States is also dealing with these issues, the competition-relocation argument must be viewed as a bit of a red herring—there are not as many viable jurisdictions for relocating a global financial capital like New York and London.[191] The time has come for the United States to hold fast to the statements made at the 2009 G-20 Pittsburgh Summit.

CONCLUSION

Risk-taking is an essential part of the financial services industry, and as such must be managed. Where the consequences of excessive risk taking affect the stability of the financial markets, governments must act to deter behavior that self-regulation cannot contain. Though it does little to enhance directors risk management oversight, Sections 954 and 956 of the Dodd-Frank Act will have a deterrent effect on certain employees in certain financial institutions if the rules promulgated thereunder hold fast to the spirit of the legislation. Restricting incentive-based compensation arrangements and recovering unjustly earned payouts serves to hold certain financial industry personnel accountable for the consequences that arise from taking outsized risks—accountability that shareholders deserve.

Unfortunately, we are more than three years out from the enactment of the

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189. *See Commission Adopts New Standards to Increase Transparency Over Bankers' Pay and Risk Profiles, European Commission*—IP/14/210 (04/03/2014), *available at* http://europa.eu/rapid/press-release_IP-14-210_en.htm?locale=en.

190. De La Merced & Eavis, *supra* note 185 (also arguing that any bonus cap would drive up fixed salaries to compensate for the shortcoming).

191. "A strong institutional framework that protects investors' and creditors' rights includes adequate mechanisms to enforce contracts and the rule of law. . . . this requires: (i) a capable and independent judicial system, free of political pressures; (ii) legal process that support the prompt implementation of regulations; (iii) transparency in government policies; and (iv) an adequate bankruptcy law." Liliana Rojas-Suarez, Center for Global Development, *Towards Strong and Stable Capital Markets in emerging Market Economies*, BIS Papers No. 75, *available at* www.bis.org/publ/bppdf/bispap75c.pdf. Very few jurisdictions will meet the criteria for having in place such an institutional framework. *See* Liliana Rojas-Suarez, Global Development: Views from the Center, *Strengthening Capital Markets in Emerging Economies: Two Key Issues that the G20 Should Not Miss* (Feb. 21, 2014), *available at* http://www.cgdev.org/blog/strengthening-capital-markets-emerging-economies-two-key-issues-g20-should-not-miss.

Dodd-Frank Act, and we are still without final compensation policy rules. Without the need of a crystal ball, we can see the concerted effort now in effect to prevent the full implementation and enforcement of the financial regulatory reforms contained in the Dodd-Frank Act.[192] Large financial institutions, trade associations and their lobbyists have already begun to wage a full out assault to have Congress repeal or weaken the Act. Much money and effort already has been spent to persuade the regulatory authorities to water down any regulation authorized pursuant to the Dodd-Frank Act. If there is no political will to resist the political power of the financial industry, the financial crisis of 2008-2009 that gripped the nation and the world will happen again.

192. *See, e.g.*, Ben Protess, *A Year Later, Dodd-Frank Delays Are Piling Up*, N.Y. TIMES, July 22, 2011, *available at* http://dealbook.nytimes.com/2011/07/22/a-year-later-dodd-frank-delays-pile-up/ (last visited May 22, 2014) ("'They are trying to stall,' Representative Barney Frank, the Massachusetts Democrat who was a co-author the Dodd-Frank law, said of the Republicans. 'Their plan,' he said in a recent interview, is to 'hope that they will win the 2012 election with the support of the financial people.' Once in control of Washington, he said, Republicans would 'then undo what we were able to do, and then, yes, the system would be at risk.'"); Ben Protess, *Regulator Approves New Exchange Rules, but Delays Others*, N.Y. TIMES, May 10, 2012, *available at* http://dealbook.nytimes.com/2012/05/10/c-f-t-c-approves-new-exchange-rules-but-delays-others/ (last visited May 22, 2014) ("The agency also clarified on Thursday that it would further delay a flood of other new Dodd-Frank regulations, indicating it would not wrap up rule-writing until the end of 2012. The announcement codified the latest setback for Dodd-Frank, which initially set a deadline of July 2011.").

SEPARATION ANXIETY: A CAUTIOUS ENDORSEMENT OF THE INDEPENDENT BOARD CHAIR

LISA M. FAIRFAX*

INTRODUCTION

In 2013, for the second consecutive year, major shareholders at JP Morgan Chase & Co. ("JPMorgan") strenuously urged JPMorgan to appoint an independent director as chair of its board of directors, and thus to separate the roles of CEO and board chair.[1] While JPMorgan indicated that separating the roles of CEO and board chair could cause "uncertainty, confusion, and inefficiency in board and management function and relations,"[2] shareholder advocates insisted that combining such roles creates a conflict of interest that weakens the board's ability to engage in effective oversight, undermining strong corporate governance and corporate performance.[3] In 2012, JPMorgan shareholders relied on federal and state investigations aimed at JPMorgan in the wake of the financial crisis to support their call for an independent board chair.[4] In 2013, JPMorgan shareholders renewed their calls for independent board leadership, pinpointing the "'London Whale' trading fiasco, in which [JPMorgan] recorded $5.8 billion of principal transactions losses."[5] In both years, JPMorgan shareholders argued that separating the roles of CEO and board chair not only would improve directors' ability to perform their oversight responsibilities, but also could provide independent board leadership necessary to curtail the kind of risky and inappropriate managerial behavior that had contributed to the company's financial woes.[6]

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1. *See 2013 Notice of Annual Meeting of Shareholders and Proxy Statement*, JPMORGAN CHASE & CO., Apr. 20, 2013, at 44, *available at* http://files.shareholder.com/downloads/ONE/2493146808x0x652544/b2a9705c-e6d5-4060-aaf2-418933ed0001/JPMC_2013_Definitive_Proxy_Statement_r65_web_post_.pdf *archived at* http://perma.cc/9552-EE5Q [hereinafter JP Morgan 2013 Proxy Statement]; *2012 Notice of Annual Meeting of Shareholders and Proxy Statement*, JPMORGAN CHASE & CO., Apr. 4, 2012, at 38, *available at* http://files.shareholder.com/downloads/ONE/2493146808x0xS19617-12-185/19617/filing.pdf, *archived at* http://perma.cc/GW97-FBNP [hereinafter JPMorgan 2012 Proxy Statement].

This Article uses the term "independent chair" or "independent board chair" to refer to a board chair who does not concurrently serve as the CEO.

2. JPMorgan 2012 Proxy Statement, *supra* note 1, at 40.
3. *Id*. at 38-39.
4. *Id*. at 39.
5. JPMorgan 2013 Proxy Statement, *supra* note 1, at 44.
6. *Id.* (noting that an independent board chair would be "particularly constructive" because the London Whale scandal had tainted the CEO's reputation as a risk manager and raised questions

Although the effort to separate the CEO and board chair positions failed at JP Morgan in both years,[7] it reflects part of a growing movement by shareholders and others in support of independent board chairs; a movement that has grown in intensity since the financial crisis.[8] Indeed, as the authors of one recent study note, when, as a result of a financial crisis, public corporations and their boards come under fire for a lack of accountability and appropriate oversight, the issue of separating the CEO and board chair roles "is often front and center."[9] Activist shareholders, institutional investors, and regulators alike, believe that separating such roles increases the board's independence from management, thereby enhancing the board's monitoring and oversight functions while simultaneously reducing the potential for managerial misconduct.[10]

Propelled by these sentiments, the percentage of companies that have separated the CEO and board chair roles has steadily climbed since the financial crisis.[11] In 2007, 65% of board chairs at S&P 500 companies also held the office

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about the board's oversight); JPMorgan 2012 Proxy Statement, *supra* note 1, at 39 (noting that an independent board chair would be "particularly constructive" in light of federal and state investigations aimed at JPMorgan).

7. The vote only received 32.2% shareholder approval in 2013. *See* Barry B. Burr, *Shareholders Fall Short on J.P. Morgan Chase Independent Chair Vote*, PENSIONS & INVESTMENTS (May 21, 2013), http://www.pionline.com/article/20130521/DAILYREG/130529981, *archived at* http://perma.cc/4BK9-E4QR. The 2012 vote received 40% shareholder approval. *See* Jessica Silver-Greenberg & Susanne Craig, *Stockholder Power Faces Test at JPMorgan*, N.Y. TIMES, May 19, 2013, http://mobile.nytimes.com/blogs/dealbook/2013/05/19/jpmorgan-chase-vote-tests-stockholders-power/ *archived at* http://perma.cc/4WBX-DKAW.

8. DELOITTE DEVELOPMENT LLC, HOT TOPICS: 2012 PROXY SEASON: LOOKING AHEAD TO 2013, at 2 (2012) [hereinafter HOT TOPICS], *available at* http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/USEng/Documents/Deloitte%20Periodicals/Hot%20Topics/December%202012%20Hot%20Topics_Deloitte_2012%20Proxy%20Season_Looking%20Ahead%20to%202013_Final.pdf, *archived at* http://perma.cc/V93V-AQN6; William Kelly & Mutya Harsch, *Director Notes: Directors' Duties Under the New SEC Rules Disclosure Enhancement*, THE CONFERENCE BOARD, Feb. 2010, at 7, *available at* http://www.davispolk.com/files/Publication/7d3ff413-0d1c-411f-b499-01223e870d4c/Presentation/PublicationAttachment/4807ffe7-2ecf-477f-8072-09333153775a/DN-005-10.pdf, *archived at* http://perma.cc/U2DM-4FWP (noting that the number of proposals in this area has increased in recent proxy seasons).

9. Richard Leblanc & Katharina Pick, *Director Notes: Separation of Chair and CEO Roles*, THE CONFERENCE BOARD, Aug. 2011, at 1, *available at* http://www.yorku.ca/rleblanc/publish/Aug2011_Leblanc_TCB.pdf, *archived at* http://perma.cc/533A-DUCQ; *see* HOT TOPICS, *supra* note 8, at 3 (noting heightened focus on board leadership structure and accountability by shareholders).

10. Leblanc & Pick, *supra* note 9 at 1112.

11. SPENCER STUART, 2012 SPENCER STUART BOARD INDEX 12 (2012) [hereinafter 2012 SPENCER STUART BOARD INDEX], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf, *archived at* http://perma.cc/5WLU-AE34.

of CEO.[12] By 2012, that number had declined to 57%.[13] Thus, 43% of S&P 500 boards currently have separated the roles of CEO and board chair.[14] Moreover, in the five years from 2007-2012, the number of companies with truly independent board chairs (i.e., board chairs who are not current or former executives of the companies at which they currently serve as chair) had nearly doubled, going from 13% to 23%.[15]

Like the shareholders at JPMorgan, advocates insist that separating the roles of CEO and board chair will improve board oversight, leading to better corporate governance and improved corporate performance.[16] In their view, such separation negates the concentration of power and conflicts of interests inherent in a board leadership structure that combines the two roles.[17] Thus, the separation facilitates the checks and balances necessary for appropriate managerial accountability that enables the board to effectively carry out its responsibilities.[18]

Of course, boards and other commentators disagree about the benefits associated with splitting the CEO and board chair roles. Opponents of such a split insist that the separation not only ignores the benefits of CEO duality (a board structure that combines the two roles), but also ignores the costs associated with a board leadership structure that relies on an independent board chair.[19] These concerns appear to be reflected in the kind of support shareholder proposals seeking a split of the CEO and board chair roles have received from the broader shareholder class and proxy advisory firms. Unlike other corporate governance proposals that have witnessed average shareholder supports of 50% or more in recent years,[20] shareholder proposals calling for a split of the CEO and board roles have received more modest levels of shareholder support that, on average, fall short of a majority.[21] Then too, proxy advisory firms have been equivocal in their support for the independent board chair, suggesting that other board leadership models may be as appropriate depending on the company and company specific needs.[22]

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12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. Leblanc & Pick, *supra* note 9, at 2; Thuy-Hga T. Vo, *To Be or Not to Be Both CEO and Board Chair*, 76 BROOK. L. REV. 65, 84 (2010).

17. Leblanc & Pick, *supra* note 9, at 2; Vo, *supra* note 16, at 84.

18. Paul Hodgson & Greg Ruel, *The Costs of a Combined Chair/CEO*, GMIRATINGS, June 2012, at 1, *available at* http://info.gmiratings.com/Portals/30022/docs/gmiratings_ceochaircomp_062012.pdf, *archived at* http://perma.cc/5YDC-76JA; Oded Palmon & John Wald, *Are Two Heads Better than One? The Impact of Changes in Management Structure on Performance by Firm Size*, 8 J. CORP. FIN. 213, 224-25 (2002).

19. James A. Brickley et al., *Leadership Structure: Separating the CEO and Chairman of the Board*, 3 J. CORP. FIN. 189, 192-96 (1997); Vo, *supra* note 16, at 78.

20. *See infra* note 41.

21. *See infra* notes 44-45.

22. *See infra* notes 126-27 and accompanying text.

This Article critically examines the competing arguments related to splitting the roles of CEO and board chair. Although the campaign for independent board chairs has received increased attention from shareholders and regulators,[23] there has been very little academic analysis of such campaign.[24] This Article seeks to fill this void not only by examining the campaign, but also by assessing its implications in light of the available empirical evidence and normative claims. Based on this assessment, this Article offers two conclusions. First, while there appear to be costs associated with splitting the roles of CEO and board chair, those costs likely have been overstated. Second, there are clear benefits associated with having an independent board chair. However, whether a corporation can take advantage of those benefits may depend upon various factors and circumstances, some of which may be difficult to achieve. Whether corporations can realize the benefits of separating the board and CEO roles may depend on whether corporations have truly independent board chairs, and many corporations do not. It also may depend on corporate size as well as the extent to which corporations have in place structures and processes ensuring that their outside board chairs have access to appropriate and diverse information sources so that they need not rely solely on their inside CEOs and thus can be effective monitors and leaders. Hence, this Article offers conditional support for splitting the roles of CEO and board chair. As a result, this Article argues that efforts to mandate such a split at all public companies could be counterproductive because such efforts may not appropriately consider the costs of such a split; and those efforts may not appropriately consider that while there are clear benefits to such a split, whether those benefits can be realized may depend on several variables that may not be present at every company. In this regard, when considering whether to split the roles of CEO and board chair, caution is warranted.

Part I of this Article demonstrates the manner in which the corporate governance landscape has shifted toward a board- leadership structure that embraces the independent board chair. Part II discusses the empirical evidence associated with the costs and benefits of that embrace as it relates to financial performance, and will then draw important conclusions based on that evidence. Part II also pinpoints the limitations associated with the admittedly large body of empirical evidence in this area. Part III examines the normative case related to the independent board chair. Part IV offers a conclusion.

I. A GRADUAL SHIFT TOWARDS THE INDEPENDENT CHAIR

Although the issue regarding whether to separate the CEO and board chair

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23. *See infra* notes 28, 29.

24. To be sure, there is a significant body of empirical literature aimed at assessing the financial impact of splitting the roles of CEO and board chair. *See infra* Part II. However, my research unearthed only two comprehensive scholarly discussions on the issue. *See* Constance Bagley & Richard Koppes, *Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure*, 34 SAN DIEGO L. REV. 149, 152 (1997) (discussing the merits of independent board leadership in the context of a proposal for same); Vo, *supra* note 16, at 118.

roles has been debated for years,[25] the financial crisis and other governance failures have thrust it into the spotlight as advocates insist that such a separation can help improve board oversight and thus prevent corporate wrongdoing.[26] Governance experts insist that separation of the CEO and board chair roles represents the most optimal board structure.[27] Shareholder advocates echo this sentiment. In its 2010 policy survey, the proxy advisory firm Institutional Shareholder Services ("ISS") found that a substantial majority of investors believed that the CEO should not concurrently hold the role of board chair.[28]

On the heels of the financial crisis, regulators took up the calls for an independent board chair. In response to that crisis, legislators in both the Senate and House introduced bills that would have required public companies to have an independent board chair.[29] In December 2009, the Securities and Exchange Commission (the "SEC") approved new rules requiring a company to disclose (a) whether and why the company has chosen to combine or separate the principal executive officer and board chair positions, and (b) why the company believed that its leadership structure is the most appropriate.[30] The SEC stated that the new rules were "not intended to influence a company's decisions regarding its board

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25. Leblanc & Pick, *supra* note 9, at 1 (noting that since the early 1980s the "combination (or separation) of the chair and CEO roles" has been among "the most hotly debated structural feature").

26. *Id*. at 2; *see also* HOT TOPICS, *supra* note 8, at 3.

27. Leblanc & Pick, *supra* note 9, at 1.

28. *See* INSTITUTIONAL SHAREHOLDER SERVICES, INC., 2010-2011, POLICY SURVEY SUMMARY OF RESULTS 9 (2010), *available at* http://www.issgovernance.com/files/ISS2010-2011_PolicySurveyResults.pdf, *archived at* http://perma.cc/SRM3-ULEY (finding that 76% of investors and 41% of issuers believe that the chair and CEO roles should be separate); *see also* INSTITUTIONAL SHAREHOLDER SERVICES, INC., 2011-2012, POLICY SURVEY SUMMARY OF RESULTS 16 (2011), *available at* http://www.issgovernance.com/files/PolicySurveyResults2011.pdf, *archived at* http://perma.cc/T5N3-9P65 (revealing that 70% of investors believe that a company should commit itself to adopting an independent chair model after the current combined CEO/chair leaves; only 11% of issuers held such a belief).

29. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. 8-9 (2009), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111s1074is/pdf/BILLS-111s1074is.pdf; Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. 5-7 (2009), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111hr2861ih/pdf/BILLS-111hr2861ih.pdf (requiring that the chairman of the board of directors of a public company be an independent director who has not previously served as an executive officer).

30. Proxy Disclosure Enhancements, SEC Release No. 33-9089, at 43 [hereinafter SEC Release No. 33-9089], *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf, *archived at* http://perma.cc/4YYJ-SJDB (for companies that combine the roles of CEO and chair, and rely on a lead independent director, the new rules require disclosure regarding why the company has a lead independent director and the specific role the lead independent director plays in the leadership of the company). *See* Bagley & Koppes, *supra* note 24, at 152 (As early as 1997, two professors recommended that listing agencies adopt a similar disclosure policy regarding board leadership.).

leadership."[31] However, the new rules were part of a host of rules aimed at responding to the financial crisis by enhancing corporate governance and board accountability.[32] Given that context, such rules may be viewed as playing a role in facilitating, if not supporting the general push for the separation of the CEO and board chair roles. Importantly, the pressure for additional regulation remains. For example, in 2010, the United States Congress introduced three proposals calling for the separation of the CEO and board chair functions.[33]

In addition to agitating for regulatory reform, shareholder advocates have focused their sights on altering the board structures at major companies, particularly those embroiled in corporate scandal. The fight to separate the CEO and chair position at JPMorgan received significant attention given the prominence of the company and the significance of its financial woes. And the fight was part of a larger effort in this area. The 2012 proxy season witnessed a record number of proposals calling for the separation of the CEO and board chair roles.[34] Shareholders submitted thirty eight such proposals in 2012, as compared to twenty-five in 2011.[35] In 2012 and 2013, proposals to split the CEO and board roles were the second most prevalent shareholder proposal type—second only to proposals related to political spending.[36] As of May 2013, eighteen Fortune 250 companies had faced or were being faced with proposals to split the CEO and board chair roles.[37]

Shareholder support for such proposals can best be described as strong but cautious. As noted in the introduction, both proposals failed at JPMorgan.[38] Moreover, a relatively small number of proposals have garnered majority support. Only three such proposals passed in 2011,[39] while only two passed in 2012.[40]

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31. SEC Release No. 33-9089, *supra* note 30, at 43.

32. Press Release, Sec. Exch. Comm., SEC Approves Enhanced Disclosure About Risk, Compensation and Corporate Governance (Dec. 16, 2009), *available at* http://www.sec.gov/news/press/2009/2009-268.htm, *archived at* http://perma.cc/NL95-LGYW.

33. Tina Yang & Shan Zhao, CEO Duality, Competition, and Firm Performance, at 3-4 (2012) *available at* http://www.lehigh.edu/~jms408/yang_2012.pdf, *archived at* http://perma.cc/3SGX-FR3W.

34. HOT TOPICS, *supra* note 8 at 3; SULLIVAN & CROMWELL LLP, 2012 PROXY SEASON REVIEW 1 (2012) [hereinafter SULLIVAN REVIEW], *available at* http://www.sullcrom.com/files/Publication/fdd28332-7b79-4d37-9ada-89da9bc111a9/Presentation/PublicationAttachment/d546858a-ee4a-43af-b379-170d4995e41c/2012_Proxy_Season_Review-7-20-2012.pdf, *archived at* http://perma.cc/SQY9-86RD**.**

35. SULLIVAN REVIEW, *supra* note 34, at 1.

36. Press Release, Proxy Monitor, 2013 Season Under Way, *available at* http://proxymonitor.org/Forms/2013Finding2.aspx, *archived at* http://perma.cc/Q9V6-DCSE [hereinafter Proxy Monitor 2013 Season]

37. *Id*.

38. Burr, *supra* note 7 (the failure of the proposition in 2013); Silver-Greenberg & Craig, *supra* note 7 (the failure of the proposition in 2012).

39. The companies were Aetna, Moody's, and Vornado Realty. Ted Allen et al., *2011 U.S. Postseason Report*, INSTITUTIONAL SHAREHOLDERS SERVICES INC., Sep. 29, 2011, at 24, *available*

Then too, the average level of shareholder support falls short of the level of shareholder support for other governance proposals in the wake of the financial crisis and corporate governance scandals, such as majority voting or board declassification[41] where the average support has been 50% or higher for several years.[42] Nonetheless, shareholder support can still be considered relatively strong. In 2012, such proposals averaged 35% of the votes cast,[43] with a similar level of support for 2011.[44] As of May 2013, although the average support for the separation of CEO and chair roles among Fortune 250 companies was down to 27%,[45] shareholder proposals at three companies in the Fortune 250 received over 40% shareholder support.[46]

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at http://www.issgovernance.com/files/private/2011_US_PostSeason_Report_0929.pdf, *archived at* http://perma.cc/HS5U-EB64. A proposal at Cedar Fair, a non-Russell 3000 company, also won majority support. *Id.* As a result of the votes, Aetna expanded the duties of its presiding director, Cedar Fair appointed an independent chair, and Moody's agreed to appoint an independent chair in 2012. *See* Shirley Westcott, *2012 Proxy Season Review: Shareholder Proposals*, ALLIANCE ADVISORS, Sep. 2012, at 5 n.12, *available at* http://allianceadvisorsllc.com/dimages/file_49.pdf, *archived at* http://perma.cc/Q4CQ-ZQ4P.

40. HOT TOPICS, *supra* note 8, at 3 (citation omitted).

41. *See* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO STATE L.J. 53, 66-67, 70-71 (2008) [hereinafter Fairfax, *Making the Corporation Safe*].

42. *Id. See* RISKMETRICS GROUP, RISKMETRICS GROUP POSTSEASON REPORT: A NEW VOICE IN GOVERNANCE: GLOBAL POLICYMAKERS SHAPE THE ROAD TO REFORM 5 (2009) (The average shareholder support for majority voting proposals was 56% in 2009 and 50% in 2008 and 2007. In 2009, the average shareholder support for board declassification was 63%, compared to 67% in 2008 and 6363636463% in 2007. In 2011, the average shareholder support for majority voting was 56.6%, while the average shareholder support for board declassification was 70%.), *available at* https://www.governanceexchange.com/repository/KnowledgeGateway/pubs/2009_PSR_Public_final.PDF, *archived at* http://perma.cc/B9Z3-UBRW; *see also* INSTITUTIONAL SHAREHOLDER SERVICES, 2011 U.S. PROXY SEASON SCORECARD (2011), *available at* http://www.issgovernance.com/files/private/2011ProxySeasonScorecard_20110606.pdf, *archived at* http://perma.cc/XH5V-MDEP.

43. *See* SULLIVAN REVIEW, *supra* note 34, at 1 (such proposals received an average of 34% support at Fortune 200 companies in 2012); James R. Copland et al., *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism*, PROXY MONITOR, Fall 2012, at 18, *available at* http://www.proxymonitor.org/pdf/pmr_04.pdf, *archived at* http://perma.cc/D4LJ-MF2H; ERNST & YOUNG LLP, FOUR KEY TRENDS OF THE 2012 PROXY SEASON: ENGAGEMENT DRIVES CHANGE 5 (2012) (average support at Russell 3000 companies was as high as 37%), *available at* http://www.ey.com/Publication/vwLUAssets/Four_key_trends_of_the_2012_proxy_season/$FILE/1207-1372854_ProxyGovernance_CF0035_071612.pdf, *archived at* http://perma.cc/W3CB-6QU4.

44. *See* SULLIVAN REVIEW, *supra* note 34, at 1 (revealing average support of 34%); Allen et al., *supra* note 39, at 24 (revealing that proposals earned 32.8% average support at Russell 3000 companies).

45. Proxy Monitor 2013 Season, *supra* note 36.

46. *Id*. (those companies included Honeywell, Boeing and IBM).

Irrespective of whether these proposals have received widespread shareholder support, the push to separate the roles of CEO and board chair has prompted many corporations to voluntarily change their board leadership structure. In 2002, only 25% of S&P 500 companies maintained boards with separate roles for CEO and board chair.[47] By 2007, that number had increased to 35%.[48] By 2012, 43% of S&P 500 companies had adopted a leadership structure comprising separate roles for the board chair and CEO.[49] Many prominent companies across industries have separated their CEO and board chair positions, including Proctor & Gamble, Visa, Starbucks, and FedEx.[50]

Importantly, the percentage of corporations with truly independent board chairs has nearly doubled in five years. A truly independent board chair is someone who has no significant relationship with the corporation outside of being a board member and is neither a current executive nor a former CEO or executive of the company for which she is currently serving as board chair.[51] In 2007, 13% of board chairs were truly independent.[52] That number had increased to 23% in 2012.[53] Thus, the percentage of both independent board chairs and truly independent chairs has increased since the financial crisis.

To be sure, the shift in board leadership structure is not necessarily permanent. A 2012 survey revealed that "[o]nly eighteen companies . . . report[ed] having a formal policy requiring the separation of the CEO and chair roles."[54] The lack of such a policy means that corporations are free to alter their board leadership structure whenever they choose. Corporations have taken advantage of this freedom. For example, Disney separated the roles of CEO and board chair in 2005 and then restored them in 2012.[55] Similarly, the CEO of Dell relinquished his chair position in 2004, only to step back into that role three years later.[56] Consistent with this anecdotal evidence, in 2012, eight companies that had separated the CEO and board chair roles had returned to combining them.[57] Nonetheless, the overall empirical evidence reflects a growing trend towards independent board chairs.

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47. *See* 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 10.

48. *See id.*

49. *Id*.

50. Elizabeth Olson, *Why the CEO-Chair Split Matters*, CNN MONEY (Mar. 12, 2013), http://management.fortune.cnn.com/2013/03/12/ceo-chair-split/, *archived at* http://perma.cc/UAK6-CGWC.

51. *See* Hodgson & Ruel, *supra* note 18, at 2 (describing characteristics of a non-independent board chair).

52. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 10.

53. *Id.*

54. *Id*. at 23.

55. *See* Olson, *supra* note 50.

56. Nell Minow, *Independent Chairmen Are Smart Investments*, BLOOMBERG (Jul. 17, 2012), http://www.bloomberg.com/news/2012-07-17/independent-chairmen-are-smart-investments-nell-minow.html, *archived at* http://perma.cc/HX3S-XXP3.

57. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 23.

This trend is consistent with the broader shift towards greater independence on the board as a whole. Indeed, as a result of federal regulations and a growing consensus related to best practices,[58] "[t]he percentage of independent directors on S&P 500 boards has increased from 79% in 2002 to 84% in 2012."[59] Today, almost every corporation has fewer than two non-independent directors on their board.[60]

As a result, the CEO increasingly represents the only non-independent director on the board. In 2002, the CEO was the only non-independent director on 31% of S&P 500 boards.[61] By 2012, that number had risen to 59%.[62] As these statistics reveal, this number has nearly doubled in the past decade. This data suggests that if shareholder advocates are successful in their efforts to create more independent board chairs, a sizeable majority of boards will be composed solely of independent directors. The remainder of this Article weighs the costs and benefits of this phenomenon.

II. ASSESSING THE FINANCIAL PERFORMANCE DATA

Grappling with the empirical evidence on the impact of independent board chairs on financial performance represents a daunting task.[63] There is a significant body of empirical literature focused on this issue, comprising more than 30 empirical studies and meta-analyses.[64] Several commentators have

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58. *See generally* Lisa Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 136-37 (2010) [hereinafter Fairfax, *The Uneasy Case*].

59. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 6.

60. *See* Fairfax, *The Uneasy Case*, *supra* note 58, at 136 (noting that 91% of companies had two or fewer inside directors in 2004).

61. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 15.

62. *Id.* (In 2007, CEOs comprised the only non-independent directors at 43% of S&P 500 boards.).

63. This Article does not seek to separately evaluate the quality of the empirical studies themselves, but rather evaluates them based on their own stated conclusions and limitations.

64. *See Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Hearing Before the Subcomm.* on *Sec., Ins., and Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 7 (2009) [hereinafter Coates Testimony] (statement of Prof. John C. Coates IV), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=c754606c-0b95-4139-a38a-63e63b4b3fa9&Witness_ID=49f23bdb-ae69-42a8-a6d5-82d7fb82502a, *archived at* http://perma.cc/XF7D-ZJDX. The analysis in this section is limited to those studies that focus on financial performance. There is also empirical evidence on the impact of separating the roles of CEO and board chair in the context of other issues (*e.g.*, there is some empirical support for the proposition that independent board chairs can help curb corporate misconduct). *See* Hodgson & Ruel, *supra* note 18, at 4. The Hodgson and Ruel study suggest that combining the roles of CEO and board chair creates a greater potential for governance and management failures. Companies in the study that combined the roles faired far worse in ratings that tested for fraud and financial restatements. The study did include some companies that had split the roles, but they also fared poorly on such ratings. However, on average,

characterized the empirical evidence regarding the impact of separating the CEO and board chair roles as mixed or weak.[65] By contrast, at least one commentator has described the overall set of empirical evidence related to independent board chairs as providing strong support in favor of such separation.[66] This Article argues that an overall assessment of the available data supports at least three conclusions. First, there may be costs associated with separating the two roles, but many of those costs have been exaggerated and outweighed by the benefits of such separation, particularly for long-term shareholders and at larger corporations. Second, there are clear benefits associated with separating the two roles, though the strengths of those benefits and whether they can be realized vary. Third, truly independent board chairs impact financial performance, but that impact also varies.

A. Evidence of Impact on Financial Performance

Available research only revealed one study that appeared to unequivocally support the view that CEO duality positively correlates with firm performance. The 1991 study found that CEO duality was associated with higher levels of average return on equity.[67] However, the authors were careful about drawing any broad conclusions, and qualified their results by suggesting that combining the roles of CEO and board chair does not produce adverse consequences for corporate performance, and actually could produce benefits.[68]

While a few other studies identified a positive connection between CEO duality and firm performance, all of those studies included important limitations or countervailing evidence. One study examined a period between 1979 and 1998, and found that companies with CEO duality outperformed those companies with separate roles in environments where there is increased competition.[69] This was primarily because firms with CEO duality can access information more quickly, which is an important benefit when competition intensifies.[70] However, the positive effects of CEO duality disappeared once the study controlled for other governance mechanisms.[71] Moreover, the study did not distinguish between non-CEO board chairs and those chairs who also serve as a former or present

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companies with an independent board chair scored better on metrics aimed at identifying items that might signal potential fraudulent accounting statements

65. *See* Leblanc & Pick, *supra* note 9, at 2 (describing the evidence as "not definitive"); Coates Testimony, *supra* note 64, at 7 (describing the evidence as "more mixed" than research on other board proposals).

66. *See* Vo, *supra* note 16, at 118.

67. Lex Donaldson & James H. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUSTL. J. MGMT. 49, 56 (1991).

68. *Id*. at 61.

69. Yang & Zhao, *supra* note 33, at 1-2, 22, 31.

70. *Id.*

71. *Id.* at 31.

employee of the firm.[72] These limitations could undermine the saliency of the study's findings because the latter chairs may not be viewed as truly independent. Along similar lines, after assessing over 600 firms, a 1997 study concluded that firms that split the CEO and board chair roles "do not necessarily have lower accounting returns" than firms that combined the roles.[73] The study's authors warned that their results "should be interpreted with caution," because their tests "do not control for other potential determinants of firm performance."[74]

Three other studies revealed both positive and negative connections between firm performance and CEO duality. A 1995 study found support for both CEO duality and separating the CEO and board chair functions.[75] Similarly, a 2002 study of 157 announcements of board changes from 1986 to 1999 found that small firms experienced negative abnormal returns when changing from a combined board leadership model to a split model, while large firms experienced positive abnormal returns.[76] Along these same lines, a 2012 study found that "[i]n the short term, companies with combined chair and CEO roles fared much better than those companies with a separate CEO and chair" roles.[77] However, over a longer period, companies with separate CEO and board chair roles had shareholder returns nearly 28% higher than those with the combined roles.[78]

At least one broader assessment of available empirical data suggests that there is no connection between board leadership structure and company performance. Thus, a 2007 meta-analysis of the empirical literature found no evidence to support the connection between corporate performance and leadership structure.[79]

By comparison, several studies have reflected a weak connection between board leadership structure and performance. A 1998 meta-analysis of thirty-one studies concluded that there was relatively little evidence of a systemic relationship between financial performance and board leadership structure.[80] Similarly, a 1996 study found only weak evidence that combining the roles of CEO and board chair negatively impacts long-term performance (performance over a five year period from 1986-1991), after controlling for other factors that

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72. *Id.* at 32.

73. Brickley et al., *supra* note 19, at 211 (finding mixed evidence on the impact of CEO duality on firm performance).

74. *Id.*

75. Brian K. Boyd, *CEO Duality and Firm Performance: A Contingency Model*, 16 STRATEGIC MGMT. J. 301, 309 (1995).

76. Palmon & Wald, *supra* note 18, at 216, 222.

77. *See* Hodgson & Ruel, *supra* note 18, at 4.

78. *Id.* (study was over five years).

79. Dan Dalton et al., *The Fundamental Agency Problem and Its Mitigation: Independence, Equity, and the Market for Corporate Control*, THE ACADEMY OF MANAGEMENT ANNALS, 1, 13 (Royston Greenwood ed., 2007) ("[t]here is no evidence of substantive, systematic relationships between corporate financial performance and board leadership structure").

80. Dan Dalton et al., *Meta-Analytical Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 278 (1998).

might impact performance.[81]

In contrast, several studies reveal a strong link between financial performance and an independent board chair. A 1978 study, one of the earliest, found that Fortune 200 companies that combined the CEO and board chair roles had significantly lower stock price appreciation and return on equity than companies that separated such roles.[82] A 1991 study found that during 1978 and 1983, companies that separated the board chair and CEO positions had significantly higher returns on investment, average returns on equity, and average profit margins than companies with combined positions.[83] A 1993 study found that, on average, between 1988 and 1990, companies in the banking industry that had separated the roles consistently outperformed those with CEO duality.[84] A 2001 meta-analysis of twenty-two samples across 5,751 companies concluded that independent board leadership has a significant influence on performance, though the correlation varies by context.[85] In support of their argument that an independent board chair has been found to improve financial performance, sponsors of the JPMorgan shareholder proposal pinpointed a 2007 Booz Allen Hamilton & Co. study which found that, "[i]n 2006, *all* of the underperforming North American CEOs with long tenure had either held the additional title of company chairman or served under a chairman who was the former CEO."[86] The Booz Allen Hamilton study indicated that investors enjoy higher returns over the long run when the chair is independent of the CEO.[87] A 2010 meta-analysis of over fifteen studies, including several other meta-analyses, concluded that the empirical evidence provides "a convincing case that separating the CEO and Chair positions has a positive impact on corporate performance from both financial and nonfinancial perspectives."[88]

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81. B. Ram Baliga et al., *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT. J. 41, 41 (1996).

82. Sanford V. Berg & Stanley K. Smith, *CEO and Board Chairman: A Quantitative Study of Dual vs. Unitary Board Leadership*, 3 DIRECTORS AND BOARDS 34, 35 (1978).

83. Paula L. Rechner & Dan R. Dalton, *CEO Duality and Organizational Performance: A Longitudinal Analysis*, 12 STRATEGIC MGMT. J. 155, 158-59 (1991).

84. Lynn Pi & Stephen Timme, *Corporate Control and Bank Efficiency*, 17 J. BANKING & FIN. 515, 529 (1993).

85. Dawna L. Rhoades et al., *A Meta-analysis of Board Leadership Structure and Financial Performance: Are "Two Heads Better than One"?*, 9 CORP. GOVERNANCE: AN INT'L REV. 311, 311 (2001).

86. *See* Chuck Lucier et al., *The Era of the Inclusive Leader*, 47 Strategy+Business, BOOZ & CO. 2, 4 (2007), *available at* http://www.strategy-business.com/media/file/sb47_07205.pdf, *archived at* http://perma.cc/D9VY-7VA7; JPMorgan 2013 Proxy Statement, *supra* note 1, at 44 (citing study); JPMorgan 2012 Proxy Statement, *supra* note 1, at 39 (same).

87. *See* Lucier et al., *supra* note 86, at 6.

88. Vo, *supra* note 16, at 118.

B. Concluding Assessments and Limitations of the Data

First, while there is some support for the proposition that splitting the roles of the CEO and board chair can be costly, that support is relatively weak and tentative, suggesting that the costs of such a split—at least in terms of financial performance—may have been exaggerated.[89] Indeed, in light of the wealth of empirical evidence on this issue, it is worth noting that there is only one study that appears to unequivocally find a positive association between CEO duality and firm performance.[90] Importantly, the authors of that study seem less than confident in their conclusions, suggesting that the case for a positive correlation is tentative at best.[91] Moreover, the remaining studies that demonstrate positive connections between combining the CEO and board chair roles and corporations' financial performance do so only in the context of pinpointing countervailing negative results. Taken together, this data suggests that while there may be costs associated with splitting the roles of CEO and board chair, it is not clear how significant those costs are, and such costs must be weighed against the benefits, particularly benefits that flow to larger shareholders and those that flow over the long run when the CEO and board chair positions are split.[92]

Second, the empirical evidence provides ample support for arguments in favor of splitting the CEO and board chair roles. While the bulk of the empirical evidence admittedly falls along a spectrum, on balance such evidence does appear to tilt in favor of supporting the proposition that independent board chairs can enhance financial performance.[93] There are certainly several studies as well as meta-analyses indicating little to no connection between board leadership structure and financial performance.[94] Such findings suggest little reason to prefer one board structure over another, at least with respect to the potential for such a structure to enhance corporate performance.[95] Moreover, they suggest that it is appropriate for boards to determine their leadership structure on a case-by-case basis. On the other hand, many more studies reflect a positive connection between firm performance and splitting the CEO and board functions.[96] Thus, the case for splitting the roles of the CEO and board chair is much stronger than the case against such a split, supporting the proposition that there are important benefits to be gained from such a split.

Third, and consistent with the first two conclusions, the empirical evidence suggests that whether splitting the roles of CEO and board chair produces positive benefits may depend on the context and circumstances. At least two studies

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89. *See supra* notes 67-74 and accompanying text.

90. *See* Donaldson & Davis, *supra* note 67, at 56.

91. *Id.*

92. *See* Hodgson & Ruel, *supra* note 18, at 4; Palmon & Wald, *supra* note 18, at 216.

93. *See infra* Part II.A.

94. *See supra* notes 77-79 and accompanying text.

95. *See* Leblanc & Pick, *supra* note 9, at 3 (noting that "[n]o structural attribute of boards has ever been linked consistently to company financial performance").

96. *See supra* notes 82-88 and accompanying text.

revealed that the benefits of such a split are more pronounced in the long run.[97] Those studies suggest that splitting the roles of CEOs and board chairs in larger companies may be more optimal, because larger more complex companies benefit from a structure that facilitates more effective checks and balances.[98] The authors of a 2012 study, finding that companies with separate CEO and board chair roles fared significantly better in the long term, concluded: "Strong shareholder returns and sustainability extend beyond separating the role of CEO and chair, however, the decision to have the roles separate is likely to set off a chain reaction of decisions at the company that are made with the proper checks and balances in place."[99] Confronted with this kind of evidence, even an opponent to mandating the separation of the CEO and board chair roles conceded that the empirical evidence indicated that the split might be a good idea for larger companies.[100]

Fourth, the evidence suggests that truly independent board chairs impact performance, but that impact may vary. The one study (a 2013 study) that focuses specifically on truly independent board chairs found a much stronger connection between such board chairs and corporate performance.[101] Importantly, that study found that there was virtually no impact on firm performance when the CEO and board chair roles were split, but the board chair had some connection to the corporation, thereby making him non-independent.[102] However, a significant connection emerged for board chairs who were truly independent.[103] The authors of the study concluded that separating the CEO and board chair positions can be beneficial when there is true independence of the board chair, but they also emphasized that even with a truly independent board chair, the benefits could be realized only under the right circumstances.[104]

With respect to this data on truly independent board chairs, it is important to point out that, outside of this study, none of the empirical evidence seeks to distinguish between the impact of non-independent board chairs and truly independent chairs. Indeed, the number of truly independent board chairs has been relatively low throughout many of the periods focused on in the available empirical research. In 1988, almost no major firm in the United States had an independent outsider as board chair.[105] Instead, in almost all cases, the chair was the former CEO or a person with ties to the firm.[106] As recently as 2007, only

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97. *See* Hodgson & Ruel, *supra* note 18, at 4; *see also* Palmon & Wald, *supra* note 18, at 216.

98. Palmon & Wald, *supra* note 18, at 223.

99. Hodgson & Ruel, *supra* note 18, at 4.

100. Coates Testimony, *supra* note 64, at 77.

101. Ryan Krause & Matthew Semadeni, *Director Notes: CEO-Board Chair Separation—If It Ain't Broke, Don't Fix It*, THE CONFERENCE BOARD, Jun. 2013, at 2-3, *available at* http://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V5N11-13.pdf&type=subsite.

102. *Id*.

103. *Id*.

104. *Id*.

105. Brickley et al., *supra* note 19, at 218.

106. *Id*.

13% of directors were truly independent.[107] In 2005, only 9% of directors were truly independent.[108] In light of those small numbers, one study acknowledged the difficulties of pinpointing truly independent board chairs, but also acknowledged that the failure to tease out the impact of truly independent board chairs on firm performance could limit the saliency of the study.[109] Other studies do not appear to recognize that this distinction that could impact their data. The fact that there may be considerable differences in corporate performance associated with truly independent board chairs as compared to board chairs that have some connection to the corporation, and that almost no study accounted for these differences, raises questions about the strength of the available empirical evidence as a whole.

To summarize, the literature points to the conclusion that separating the CEO and board chair roles can yield positive financial results. However, (1) those results may depend on the context, (2) those results must be weighed against the admittedly tentative evidence on the costs of such separation, and (3) those results likely depend significantly on whether the board chair can be classified as truly independent.

III. THE NORMATIVE CASE FOR THE INDEPENDENT BOARD CHAIR

While the governance community insists that splitting the roles of CEO and board chair represents the most optimal board leadership structure, its opponents contend that such a split can be costly. This section reveals that while there may be costs associated with splitting the roles, such costs may have been overstated, and such costs may be outweighed by the benefits that flow from an independent board chair. In this regard, this assessment is consistent with the conclusions drawn from the empirical data on financial performance.

A. The Perils of the CEO/Board Split

1. The Merits of Unity.—Those who oppose efforts to mandate independent board chairs contend that there are important benefits associated with combining the roles of CEO and board chair. As an initial matter, some wonder whether the appointment of an independent board chair raises additional agency costs because there may be no one to monitor such a chair.[110] More importantly, separating the two roles creates possible confusion both within and outside of the corporation.[111] In contrast, CEO duality creates clear and unambiguous lines of authority and accountability, which is essential to effective management and leadership.[112] At least one study of boards in the United States and the United Kingdom revealed

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107. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 10.

108. SPENCER STUART, 2010 SPENCER STUART BOARD INDEX 8 (2010), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/ssbi2010.pdf.

109. Yang & Zhao, *supra* note 33, at 32.

110. Brickley et al., *supra* note 19, at 194.

111. *Id*. at 195.

112. Leblanc & Pick, *supra* note 9, at 2.

that separating the roles of CEO and board chair paves the way for confusion that leads to struggles over power, territory, and accountability.[113] Consistent with this study, some point to the public disagreement between GM's chair and CEO as an example of the pitfalls associated with separating such roles.[114]

Of course, this anecdotal and empirical evidence does not necessarily condemn separation, but rather suggests that when companies separate such roles, it is also imperative to clearly define the roles and lines of authority associated with each position. Indeed, the same study that pinpointed concerns about confusion stemming from splitting the roles of CEO and board chair not only revealed that too often there was no clear and defined job description for those who served as an independent chair, but also that there was a wide range of roles and activities that fell under the purview of board chairs at different companies.[115] This suggests that the confusion associated with separation is not endemic to the separation itself, but instead may stem from the failure to clearly pinpoint the roles and responsibilities of the two positions.

Then too, separating the roles also can lead to better clarity for those who occupy the positions. The board chair is the leader of the board and its team of monitors. By contrast, the CEO is head of the corporate managerial team. Combining the roles serves to blur the distinction between these two functions.[116] Recent years have ushered in an increased expectation that the board would take its monitoring role seriously, as shareholders and others increasingly look to the board to engage in active monitoring over corporate affairs. As the pressure increases on directors to take their monitoring obligations more seriously, pressure mounts to more clearly define directors' monitoring obligations and distinguish them from the managerial role.[117] Creating clear lines of power and authority may be especially important for CEOs because it may encourage them to recognize and pay heed to the boundaries of their authority.[118]

Additionally, studies revealing the benefits associated with a combined board leadership structure must be weighed against the drawbacks, and the drawbacks appear to be more acute at larger companies and over the long term. Thus, studies reveal that there are distinct benefits to having an independent board

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113. *Id.*; Jay Lorsch & Andy Zelleke, *Should the CEO be the Chairman?*, 2 MIT SLOAN MGMT. REV. 46, 70-74 (2005).

114. Amy Goodman et al., *Considerations for Public Company Directors in the 2012 Proxy Season*, GIBSON, DUNN & CRUTCHER LLP, Jan. 3, 2012, *available at* http://www.gibsondunn.com/publications/pages/ConsiderationsforPublicCompanyDirectors-2012ProxySeason.aspx, *archived at* http://perma.cc/T7NX-DNYM.

115. Leblanc & Pick, *supra* note 9, at 2 (citing Lorsch & Zelleke, *supra* note 113, at 70-74).

116. *See* Olson, *supra* note 50 (noting that "[c]ombining the two roles often seems a default for companies despite studies showing that the arrangement muddies clear lines of authority").

117. *Id.*

118. *See* Bagley & Koppes, *supra* note 24, at 158 (noting that "the existence of a separate chair serves as a reminder to the CEO that he or she reports to, and serves at the pleasure of, the company's board of directors").

chair, including their ability to monitor more effectively.[119] Moreover, studies suggest that because there is a greater potential for abuse in larger firms, these monitoring benefits outweigh the costs associated with separating the roles of CEO and board chair for larger firms.[120] In light of these benefits, even those who oppose legislation that would mandate splitting the two positions concede the appropriateness of such legislation for larger companies.[121]

2. Independent Leadership by Any Other Name?—Most public companies do not dispute the need for independent board leadership; instead they insist that their current leadership structure provides such independence. There appears to be an emerging consensus about the need for independent board leadership.[122] The disagreement lies in whether there is an optimal board structure for obtaining such independent leadership. Shareholder advocates favor separating the board chair and CEO roles; many companies insist that independent leadership can be obtained even when the CEO and board chair roles are combined. In its statement against the shareholder proposal for separating the roles of board and chair, JPMorgan insisted that such separation was unnecessary because its leadership structure "already provid[ed]" independent leadership and oversight.[123] JPMorgan pointed out that all but one of its directors was independent as defined by the NYSE listing requirements.[124] Most importantly, JPMorgan emphasized that it had appointed a presiding director to further provide independent leadership on the board.[125] Among other things, the presiding director (1) was appointed by the independent directors, (2) presided over executive sessions and meetings at which the chair was not present, (3) had the authority to call meetings of independent directors, (4) approved board meeting agendas and schedules for each board meeting, and had the authority to add agenda items, (5) approved board meeting materials for distribution to and consideration by the Board, and (6) facilitated communication between the chair, CEO, and independent directors.[126] JPMorgan argued that this structure was sufficient to ensure independent board leadership even without separating the roles of CEO and board chair.

Empirical evidence reveals a significant trend in favor of lead or presiding directors. The duties of a lead or presiding director may vary by company, but as a general matter, a lead or presiding director is an independent director who, among other things, presides over executive sessions of the board—sessions comprised solely of independent directors. Thus, the lead director can provide a source of independent leadership even when non-independent directors, such

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119. *Id*. at 152.

120. Palmon & Wald, *supra* note 18, at 223.

121. Coates Testimony, *supra* note 64, at 7.

122. Goodman et al., *supra* note 114.

123. JPMorgan 2012 Proxy Statement, *supra* note 1, at 39.

124. *Id*.

125. *Id*.; JPMorgan 2013 Proxy Statement, *supra* note 1, at 44.

126. JPMorgan 2012 Proxy Statement, *supra* note 1, at 39; JPMorgan 2013 Proxy Statement, *supra* note 1, at 44.

as the CEO, serve on the board. This Article will refer to such a director as a lead director. The number of companies with lead directors has more than doubled in the last decade.[127] In 2012, 92% of S&P 500 boards reported having a lead director.[128] This is a dramatic change from 1996 when only 27% of companies that had combined the CEO and board chair roles had a lead director.[129]

There also is a growing consensus among directors that appointing a lead director is a good corporate governance practice. In 2003, 72% of directors believed it was the right thing to do.[130] In 2007, 85% of directors agreed that it was appropriate to appoint a lead director.[131]

ISS has suggested that a board structure that includes a lead director may be an appropriate substitute for separating the CEO and board chair roles. In their guidance, ISS indicated that one of the most critical issues it would consider when deciding whether to recommend a vote in favor of proposals for calling the separation of the CEO and board chair roles was whether the company targeted by the proposal had a lead director with specified duties.[132] According to ISS, the lead director's role should include, among other things, (1) presiding over executive sessions and meetings at which the chair is not present, (2) serving as a liaison between the chair and independent directors, (3) approving information sent to the board, meeting schedules, and meeting agendas for the board, and (4) having the authority to call meetings of the independent directors.[133] These duties appear consistent with those identified by JPMorgan. In this regard, ISS has suggested that a board structure that includes a lead director could provide the independent board leadership necessary to promote effective board oversight and good corporate governance.

However, it is clear that a lead director is not the same as an independent chair. A board chair has authority that a lead director does not, including the ability to more proactively influence the meeting agenda, and to chair regular board meetings.[134] Commentators insist that agenda control is a critical source of power.[135] While the lead director has input in the board agenda, evidence suggests that such a director plays less of a role in developing the agenda or

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127. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 25 (noting the changes from 2004).

128. *Id*.

129. Bagley & Koppes, *supra* note 24, at 159 n.42 (citing KORN/FERRY INTERNATIONAL, 23RD ANNUAL BOARD OF DIRECTORS STUDY 23 (1996)).

130. KORN/FERRY INSTITUTE, 34TH ANNUAL BOARD OF DIRECTORS STUDY 7 (2008).

131. *Id*.

132. INSTITUTIONAL SHAREHOLDER SERVICES, 2012 U.S. PROXY VOTING SUMMARY GUIDELINES 19-20 (2011), *available at* http://www.issgovernance.com/files/2012USSummaryGuidelines.pdf, *archived at* http://perma.cc/4EKE-QPHG. ISS also indicated that a company's problematic governance and management issues would factor into ISS's recommendation regarding whether to vote in favor of a proposal for splitting the board chair and CEO roles. *See id*.

133. *Id*. at 20.

134. Leblanc & Pick, *supra* note 9, at 10.

135. Bagley & Koppes, *supra* note 24, at 157 n.35.

otherwise ensuring that critical issues are included on the agenda.[136] In this respect, it seems relatively clear that a board chair has more agenda setting power than a lead director. Moreover, because the board chair presides over all normal board sessions, the board chair, rather than the lead director, continues to be the primary source of leadership on the board. Importantly, empirical evidence suggests that the power and influence associated with the board chair means that any negative effects of combining the board chair and CEO functions cannot be entirely offset by installing a lead director.[137]

The differences between the roles of board chair and lead director mean that the presence of a lead director is not the only factor ISS will consider when making a recommendation regarding shareholder proposals for splitting the CEO and board chair positions. First, ISS recently has altered its policy, indicating that it would look more closely at the distinction between the lead director's ability to "consult" or "review" materials as opposed to approve, which suggests concerns that a lead director may not have a sufficiently active role on the board to serve as a suitable replacement for an independent board chair.[138] Second, ISS has indicated that, even when a company has a lead director with comprehensive duties, ISS would assess a company's financial performance as well as the extent to which the company has problematic performance or management issues before recommending against a proposal to split the CEO and board chair roles.[139] Indeed, ISS recommended a vote in favor of splitting the CEO and board chair positions at JPMorgan despite the fact that JPMorgan's lead director had duties consistent with those outlined by ISS, based on the belief that the presence of such a director had been insufficient to provide an optimal level of board oversight.[140] These nuances in the ISS policy reflect its concern that the lead director may have shortcomings that make splitting the roles of CEO and board chair the most optimal board structure.

In fact, ISS considered changing its policy so that it would only recommend against proposals for splitting the CEO and board chair functions when a company has a compelling company-specific reason against such a split, even if the company has a lead director with appropriately defined duties.[141] ISS indicated that the intent of such a change would be to encourage companies to

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136. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 27 (revealing that the lead director has less responsibility for such role than the combined CEO/Chair).

137. Vo, *supra* note 16, at 120.

138. SULLIVAN REVIEW, *supra* note 34, at 2.

139. INSTITUTIONAL SHAREHOLDER SERVICES, 2013 U.S. PROXY VOTING SUMMARY GUIDELINES 19-20 (2013), *available at* http://www.issgovernance.com/files/2013ISSUSSummary Guidelines1312013.pdf, *archived at* http://perma.cc/S2W9-4B8H.

140. Dawn Kopecki, *JPMorgan Investors Urged to Split Chairman Role, Oust Directors*, BLOOMBERG (May 5, 2013), http://www.bloomberg.com/news/2013-05-04/jpmorgan-should-name-chairman-to-watch-ceo-iss-tells-investors.html, *archived at* http://perma.cc/CXN9-SKAJ.

141. *Independent Chair Shareholder Proposals (US)*, INSTITUTIONAL SHAREHOLDER SERVICES (2011), http://www.issgovernance.com/policy/2011comment/IndepChair, *archived at* http://perma.cc/S56C-73JS.

explain why the role of board chair could not be filled by an independent director.[142] Although ISS does not appear to have adopted such a change, its consideration of the change suggests a growing belief that the lead director may be suboptimal, and thus, that an independent board chair represented the most appropriate board leadership structure.

Overall, this assessment reveals that the costs connected to splitting the CEO and board chair functions may have been overstated. This is because in many cases, not only can those costs be mitigated with appropriate planning, but also those costs may be offset by benefits, particularly those that flow to larger companies. Moreover, the assessment of lead directors reveals that companies with such directors may not necessarily be able to capture the benefits associated with independent board chairs.

B. The Benefits of Separating the CEO and Board Chair Roles

1. The Corrupting Potential of Absolute Power.—Advocates for separation of the roles of CEO and board chair argue that such separation protects against potential abuse associated with over-concentration of power. The two most authoritative positions in the corporation and its boardroom are the CEO and the board chair.[143] Combining the two positions concentrates the power of such offices within the hands of one individual, which creates the potential for abuse.[144]

However, concerns about over-concentration of power may be overstated in light of the fact that the power associated with the CEO and board chair roles has been diminished in recent years. In their paper, *Embattled CEOs*, Professors Marcel Kahan and Ed Rock argue that power has shifted away from the CEO as a result of two key phenomena: changes in the compensation and characteristics of the board, and increased shareholder power.[145] The shift in power away from the CEO not only may represent an important accountability check for CEOs, particularly those who serve concurrently as board chair, but also may mitigate concerns regarding over-concentration of power.

Both CEO and board chair power have been reduced in recent years by changes in board composition and authority, including the increased independence of the board and the enhanced authority of board committees.[146] As a result of perceived best practices, as well as soft rules and regulations at the state and federal level,[147] the audit committee, nominating committee, and

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142. *Id*.

143. Hodgson & Ruel, *supra* note 18, at 1.

144. *Id*.

145. *See* Marcel Kahan & Edward Rock, *Embattled CEOs,* 88 TEX. L. REV. 987, 989 (2010) (noting that the loss of power "represents a significant move away from the imperial CEO who was surrounded by a hand-picked board and lethargic shareholders").

146. *Id*. at 1007-11 (noting the impact of the decline in staggered boards and the rise of majority voting for directors).

147. Fairfax, *Making the Corporation Safe*, *supra* note 41, at 136-37, 139-45.

compensation committee of the board not only are comprised solely of independent directors,[148] but also have increasingly more critical roles. Indeed, such committees not only have primary responsibility for key board functions such as oversight of financial reporting, director nominations, and executive compensation, but these committees also have been empowered with the ability to hire their own counsel and advisors.[149] The augmentation of board committee power has shifted power away from the CEO, greatly undermining the CEO's decision-making power.[150] It also has shifted power away from the board as a whole, and thus away from the board chair, particularly if that chair is an inside director such as the CEO.

Several key indicators underscore CEO's diminished power. First, a key indicator of committees' increased power is the number of times they meet.[151] That number has not only grown over the years, but remained steady in recent years.[152] Second, Kahan and Rock noted that when boards spend more time monitoring the CEO, the CEO is likely to have less power.[153] The average number of hours board members work has increased through the years and Kahan and Rock indicate that these changes reflect that the boards are increasingly engaged in monitoring.[154] Third, "the percentage of boards with a formal process for evaluating CEOs increased from the high in the sixties in 1997 and 2001 to around 92% in 2007."[155] This suggest a change in boardroom dynamics pursuant to which boards more actively assess CEOs, and thus supports Kahan and Rock's thesis that CEOs have less power. Consistent with this concept, studies reveal that boards are becoming less tolerant of under-performing CEOs.[156] Instead, boards are far more likely to challenge and terminate CEOs for poor performance.[157] A Booz Allen Hamilton study revealed

> Annual turnover of CEOs across the globe increased by 59%between 1995 and 2006. In those same years, performance-related turnover—cases in which CEOs were fired or pushed out—increased by

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148. Kahan & Rock, *supra* note 145, at 1022-23; *see* 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 11 (citing a growth in committee independence over five and ten year periods).

149. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (empowering compensation committee to hire its own independent counsel and compensation consultant).

150. *See* Kahan & Rock, *supra* note 145, at 1039 (stating that much of a CEO's power has been delegated to the board committees of audit, compensation and nomination).

151. *Id*. at 1027-28.

152. *Id*.

153. *Id*. at 1025.

154. *Id*. at 1029.

155. *Id*.

156. Lucier et al., *supra* note 86, at 6 (finding that between 1995 and 2006, CEOs that delivered above-average returns to investors were more than twice as likely to stay in their position for more than seven years than CEOs who delivered subpar returns).

157. *Id.*

> 318%. In 1995, only one in eight departing CEOs was forced from office. In 2006, nearly one in three left involuntarily.[158]

Increased CEO turnover, and board's willingness to effect such turnover, is yet another indicator of the board's enhanced independent oversight, as well as the diminished power of the CEO position.[159] All of these indicators reflect reduced power of the CEO and board chair, and therefore may alleviate concerns that combining the CEO and board chair roles represents an unacceptable concentration of power.

In recent years, the corporate governance landscape also has shifted so that shareholders have increasingly gained more power and authority over corporate affairs.[160] Professors Kahan and Rock argue that increased shareholder power further reflects an erosion of CEO power. In their view, shareholder activism is a key source of the loss of CEO power.[161] As shareholders have played a more active role in the shareholder proposal arena, the CEO has lost his or her agenda setting control to shareholders.[162] This loss of control undermines CEO's decision-making power. Shareholders' ability to influence critical decisions within the corporation further erodes CEO's power. Thus, shareholders not only play an increasingly greater role in the director nomination and director election process, but also have increasingly greater influence over compensation decisions.[163] This enhanced shareholder power lessens the power held by both the CEO and the board chair, thereby potentially weakening the claim that combining these roles reflect an over-concentration of power.

These observations, however, do not mean that over-concentration should not remain a concern. To be sure, one factor contributing to Professors Kahan and Rock's assessment that CEOs are becoming less powerful is the erosion in the practice of having the CEO serve as board chair.[164] Moreover, Professors Kahan and Rock argue that changes in boardroom structure, particularly those that focus on enhanced director independence, serve to undercut CEO power and dominance.[165] This suggests that separating those roles may still be relevant. Two authors have theorized that increased independence on the board may prove inefficient unless it is coupled with splitting the roles of the CEO and board chair.[166] From this perspective, separating the roles of CEO and board chair may continue to be necessary to avoid over-concentration.

Increased shareholder power coupled with the increased power of

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158. *Id*. at 3.

159. Kahan & Rock, *supra* note 145, at 1031-32.

160. Fairfax, *Making the Corporation Safe*, *supra* note 41, at 55.

161. Kahan & Rock, *supra* note 145, at 1000 (noting that activism by hedge funds has become a "prime irritant for CEOs").

162. *Id*. at 1038-39.

163. *Id*. at 1039-40; *see* Fairfax, *Making the Corporation Safe*, *supra* note 41, at 61-79.

164. Kahan & Rock, *supra* note 145, at 1030.

165. *Id*. at 1042.

166. Bagley & Koppes, *supra* note 24, at 163-66.

independent directors and board committees may provide some check on the concentrated power stemming from combining the CEO and board roles. However, those increases in power do not eradicate the latter concerns, and thus, the combination of such roles may still prove problematic.

2. *Conflicts of Interest*.—Advocates also insist that separating the CEO and board chair roles helps avoid the inherent conflict of interests associated with combining such roles, leading to better and more effective monitoring and oversight. As one former board chair queried: "Is a company a sandbox for the CEO, or is the CEO an employee? If he's an employee, he needs a boss and that boss is the board. The Chairman runs the board."[167] Monitoring the CEO and top management is perhaps the most fundamental function of the board. As the above quote suggests, when the CEO concurrently serves as the board chair, that structure creates concern regarding how the board can properly perform that function. Such concurrence suggests that the CEO is essentially charged with monitoring himself or herself.[168] In other words, such a structure means that the CEO essentially acts as his or her own boss, creating an obvious conflict of interest that undermines effective oversight of the CEO and his or her decision-making.

On the one hand, evidence suggests that combining the CEO and board chair positions does not necessarily undermine the board's ability to evaluate, and in fact, terminate CEOs. As noted above, boards have an increased ability and willingness to actively monitor CEOs and to terminate those CEOs for poor performance.[169] Evidence suggests that this increase may be connected to an increase in overall board independence, without regard to the independence of the board chair. Studies also find that companies with outside dominated directors are significantly more likely to remove CEOs on the basis of performance, as opposed to companies with insider dominated boards.[170] These studies, however, do not take into account board leadership structure. All of this evidence supports the proposition that boards can effectively monitor CEOs irrespective of board leadership structure.

On the other hand, there is clear and convincing evidence that combining the roles of CEO and board chair has a negative impact on the board's ability to monitor the CEO. A recent study found that board leadership structure has a significant impact on the effectiveness of board's oversight. That study revealed that CEOs generally have incentives to direct board attention away from active and robust monitoring.[171] That study also revealed that boards' ability to attend to all of the responsibilities associated with carrying out their duties is necessarily

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167. Olson, *supra* note 50 (quoting the former chair of Intel, Andrew Grove).

168. Hodgson & Ruel, *supra* note 18, at 1.

169. *See supra* notes 151, 153.

170. *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON., 431, 432 (1988).

171. Christopher Tuggle et al., *Commanding Board of Director Attention: Investigating How Organizational Performance and CEO Duality Affect Board Members' Attention to Monitoring*, 31 STRATEGIC MGMT. J. 946, 951 (2010).

limited.[172] As a result, boards do not consistently engage in monitoring, but instead selectively attend to that function.[173] Whether and under what circumstances boards focus on monitoring is impacted by whether a corporation combines the roles of CEO and board chair.[174] The study revealed that the combining the roles of CEO and board chair gives the CEO the perfect platform to divert the board from monitoring the CEO and top management.[175]

Thus, the combination of those roles leads to the board allocating lower attention to monitoring.[176] First, the power associated with combining the positions of CEO and chair may enable the person holding the position to "create norms in which it is inappropriate to question management's effectiveness," thereby reducing the board's ability to monitor.[177] Second, the CEO-chair's control of the agenda has an appreciable impact on boards' attention to monitoring not only by focusing attention away from such monitoring, but also by making it difficult to engage in effective CEO evaluation and succession planning.[178] Third, the CEO-chair may institute unacceptably low levels of board attention to monitoring during periods of positive performance. This may be done not only because there is a general tendency to focus board's attention away from monitoring, but also because during periods of positive performance, there are less likely to be compelling reasons for the board to focus on monitoring.[179] This is particularly troublesome when issues involving long-term planning are discussed because boards may not give due attention on those issues. Further, boards may not be able to effectively engage in proactive monitoring, which could have negative long term implications on company performance.[180]

These problems are exacerbated during times of poor performance or managerial misconduct. As one shareholder representative noted: "It is impossible to imagine how board oversight of the company's affairs will be strengthened while [the CEO] leads the very board that is charged with overseeing his own shortcomings."[181] Combining the CEO and board chair roles "tilts the balance of power in favor of the CEO such that even as firm performance deteriorates, board monitoring can be impeded."[182] As the authors

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172. *Id*. at 947.
173. *Id*.
174. *Id*.
175. *Id.* at 951.
176. *Id*. at 951, 960.
177. *Id*. at 951.
178. *Id*. at 960.
179. *Id*.
180. *Id*.
181. Press Release, Am. Fed'n of State, Cnty. & Mun. Employees, Major Investors Call on JPMorgan Chase to Name Independent Board Chair (Feb. 20, 2103), *available at* http://www.afscme.org/news/press-room/press-releases/2013/major-investors-call-on-jpmorgan-chase-to-name-independent-board-chair, *archived at* http://perma.cc/4EJE-Y6QN (citing Connecticut Treasurer Denise L. Nappier).
182. Tuggle et al., *supra* note 171, at 952.

of a study point out, when performance is poor, CEOs are more likely to use their influence to impact board's monitoring in ways that protect the CEOs jobs.[183] Importantly, while poor performance generally enhances all boards' attention to their monitoring responsibilities, the study found that CEO-chairs disrupt this phenomenon.[184] Thus, their evidence suggests that when faced with the threat of poor performance, CEO-chairs "utilize their power to combat the natural tendency of boards to increase attention to monitoring."[185] Another study found that the existence of a predecessor CEO as board chair dampens the ability of the new CEO to deliver performance that deviates from pre-succession levels or otherwise make strategic changes.[186]

Importantly, it is not clear that a lead director overcomes this problem. This is because the lead director only acts as chair when the board chair is not available. Hence, in most settings the lead director is not able to take the lead in setting the agenda on these critical issues, or otherwise appropriately focus the board's attention on monitoring.

However, merely separating the CEO and board chair may be insufficient to truly reduce the conflict of interest, unless companies also commit to ensuring that the board chair is truly independent. Financial performance data confirms that truly independent board chairs matter. Krause and Semadeni found that a CEO-chair separation without true independence of the board chair has virtually no impact on firm performance other than what one would expect from any CEO succession.[187] The Booz Allen Hamilton study similarly reveals that separation without true independence of the board chair is not likely to have an impact on undermining conflicts of interest, and thus ensuring the kind of independent leadership that will enhance the board's overall monitoring capabilities.[188] The study found that "most chairmen who were CEO protect their protégés, reducing the likelihood that the new CEO will be fired for poor performance."[189] In the alternative, former CEOs who were not ready to relinquish their role seek to use their position as chair to interfere with the new CEO or otherwise find faults with the CEO at the first sign of trouble.[190] Other studies also reveal that separation without true independence may not remedy the conflicts of interest that impede effective board oversight. As Professor Fred Tung noted, new studies support the proposition that social ties impact directors' performance of their duties.[191] At

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183. *Id*.

184. *Id.* at 952.

185. *Id*. at 960.

186. *See* Timothy Quigley & Donald Hambrick, *When the Former CEO Stays on as Board Chair: Effects on Successor Discretion, Strategic Change, and Performance*, 33 STRATEGIC MGMT. J. 834, 834 (2012) (arguing that retaining a CEO on a board restricts the CEO's predecessor's discretion).

187. *See* Krause & Semadeni, *supra* note 101.

188. Lucier et al., *supra*, note 86, at 7.

189. *Id*.

190. *Id.* at 7-8.

191. Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV.

least one study reveals that even soft social ties such as "mutual alma mater, military service, regional origin, academic discipline and industry" between the CEO and outside directors had significant effects on firm performance, CEO compensation and CEO turnover.[192] The fact that separating the CEO and board chair roles does not necessarily correlate with true independence undermines the extent to which such separation will generate its promised benefits.[193]

3. Undue Influence.—Advocates for separation of the CEO and board chair functions also argue that such separation will reduce the ability of the CEO to unduly influence and control the board of directors.[194] The power and expertise inherent in the CEO role inevitably prompts increased reliance on the part of the board. This reliance is augmented by recent shifts in the corporate governance landscape related to boards. Since the CEO is often the only insider/employee on the board, the CEO may have greater company-specific knowledge, prompting boards to rely more significantly on the CEO's perspective. Further, the CEO may have more industry-specific knowledge, which increases the likelihood that board members will unduly rely on the CEO. While such reliance is expected, and some reliance in fact may be appropriate, the danger is that boards will rely too heavily on the CEO, effectively rubber-stamping his or her decisions without any critical examination of those decisions. Such behavior, in turn, renders the boards ineffective as monitors. Separating the roles of CEO and board chair is designed to undermine this instinctive reliance, prompting boards to engage in more objective analysis of managerial programs, and thus improving their monitoring of CEOs and those programs.[195]

Unfortunately, it is not clear that corporations can counter inappropriate reliance merely by removing CEOs from the board rooms.[196] In the compensation context, evidence suggests that the compensation committee continues to unduly rely on the CEO despite the fact that the CEO is not a member of that committee. A similar phenomenon has developed in the director nomination process, where the CEO continues to wield authority despite not being a formal member of the nomination committee.

Empirical evidence confirms these trends. The evidence reveals that even when the CEO and board chair roles are separated, the board continues to rely on the CEO not only to keep them apprised of developments between board meetings, but also as the primary source for determining the quality, quantity and

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1175, 1179-85 (2011).

192. *Id*. at 1181.

193. *See* Leblanc & Pick, *supra* note 9, at 2-3.

194. *See* Bagley & Koppes, *supra* note 24, at 157.

195. Nicola Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 290-91 (2012) [hereinafter Sharpe, *Process Over Structure*].

196. *See* Nicola Sharpe, *Questioning Authority*: *The Critical Link Between Board Power and Process*, 38 J. CORP. L. 1, 36, 46-47 (2012) [hereinafter Sharpe, *Questioning Authority*] (describing information asymmetries between managers and independent directors).

timeliness of information received from management.[197] Directors rely almost exclusively on the CEO and management for information, and directors' information channels are limited to information filtered through the CEO and the management team the CEO oversees, which undermines the board's ability to be effective.[198] This reliance undermines the board's ability to monitor the CEO because it limits the extent directors receive and assess unbiased and objective information.[199] Even if a CEO is not actively seeking to distort information, studies suggest that the CEO filters and organizes information in ways that are biased towards the CEO's perspective and aimed at supporting the CEO's agenda.[200] As a result, even when there is a separation of the roles of CEO and board chair, the fact that directors continue to rely almost exclusively on CEOs and information filtered through CEOs means that such separation may not have an impact on inappropriate reliance. Thus, the separation may not yield the positive results that its advocates have promised.[201]

4. Salary Distortions.—Another benefit of separating the CEO and board functions is to combat excessive executive compensation, an issue that has risen to prominence since the financial crisis.[202] Studies reveal that executives who serve jointly as CEO and board chair cost more than when the CEO and board chair positions are separated.[203] A 2012 study assessed 180 North American companies with a market capitalization of $20 billion or more to gain a better understanding of how leadership structure impacted large complex corporations.[204] The study found that executives with combined CEO and board chair roles received a median compensation of just over $16 million.[205] In contrast, companies with a CEO and a separate board chair each paid a combined $11 million in compensation, while companies with a CEO and a separate independent chair each paid a combined $9.3 million in compensation.[206] Other studies confirm that CEO pay tends to be higher when the CEO also chairs the board.[207]

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197. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 27 (revealing that most survey respondents rely on the CEO for these information gaps).

198. Sharpe, *Questioning Authority*, *supra* note 196, at 13, 44.

199. *Id*.

200. *Id*. at 243; *see* Sharpe, *Process Over Structure*, *supra* note 195, at 308.

201. Sharpe, *Process Over Structure*, *supra* note 195, at 308.

202. *See* Ben Protess, *S.E.C. Plans Crackdown on Bonuses*, N.Y. TIMES, Mar. 3, 2011, http://query.nytimes.com/gst/fullpage.html?res=9F02EFDE1F3EF930A35750C0A9679D8B63&ref=executivepay, *archived at* http://perma.cc/WX35-7BQ3; RICHARD FERLAUTO, THE CONFERENCE BOARD TASK FORCE ON EXECUTIVE COMPENSATION 7 (2009) (noting that the economic crisis "has intensified public anger over executive compensation").

203. Hodgson & Ruel, *supra* note 18, at 1.

204. *Id*.

205. *Id*.

206. *Id*.

207. Tuggle et al., *supra* note 171, at 951. *See generally* Charles O'Reilly & Brian Main, *Economic and Psychological Perspectives on CEO Compensation: A Review and Synthesis*, 19

Advocates for separating the CEO and board chair functions not only insist that these increased salaries result from the excessive influence and conflict of interest inherent in having the CEO serve as board chair, but also that separation can overcome such salary distortions. To be sure, the authors of the 2012 study pointed out that one would expect a premium to exist for executives who hold the positions of CEO and board chair.[208] However, they expressed concern regarding the size of that premium in light of the fact that employing two different individuals to serve in the two roles only accounted for 75% of the costs of the combined position.[209] The authors also noted that the size of the premium for the combined role was particularly problematic because the factors that typically account for variations in compensation were moot.[210] In this regard, they concluded that the increased costs is not based on merit, but rather results from the dangers inherent in combining the two positions.[211]

Notably, the 2012 study found that non-independent chairs earn far more than their independent colleagues.[212] The authors stated that while there may be some expectation that CEOs would receive a premium for serving in dual capacity, "there is little or no reason for non-executive positions to earn more."[213] As a result, the inevitable conclusion is that such non-independent chairs earn more because of conflicts of interests associated with their connections to the CEOs. This conclusion not only provides another reason for separating the CEO and board functions, but also underscores the argument that such separation will achieve the most optimal results when the board chair is truly independent.[214]

The fact that shareholders increasingly have played a role in the context of executive compensation may mitigate some of the concerns about excessive compensation because shareholders may be able to help check any tendencies to award excessive pay packages.[215] Shareholders now have a say on pay—a non-binding vote on the compensation packages of executive officers,[216] and the available empirical evidence reveals that shareholders' say on pay vote can impact a corporation's compensation practices.[217] It is possible, therefore, that

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INDUS. & CORP. CHANGE 675, 686-87 (2010) (discussing CEO's level of influence on board and the effect of the influence on CEO compensation).

208. Hodgson & Ruel, *supra* note 18, at 1-2.

209. *Id*. at 2.

210. *Id*.

211. *Id*. at 4-5.

212. *Id*. The study found that independent chairs are paid less than non-independent chairs.. The median compensation of independent chairs was $417,910 while the median compensation for non-independent chairs was $630,930.

213. *Id*.

214. *See id.* at 1-3.

215. *See* FERLAUTO, *supra* note 202, at 27 (discussing shareholder advisory votes on questions of executive compensation).

216. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 951, 124 Stat. 1376, 1899 (2010).

217. *See generally* Fabrizio Ferri & David Maber, *Say on Pay Votes and CEO Compensation:*

compensation practices will achieve optimal levels without regard to board leadership structure. To be sure, however, studies about say on pay reveal that while say on pay has had some impact on disciplining pay practices at poorly performing firms, it has had no impact on firms that do well.[218] One recent study focused on the impact of say on pay in the United States failed to find any major change in the level or structure of CEO compensation based on say on pay votes.[219] At the very least, this suggests that in those cases, there will continue to be pay distortions, which may be more problematic in companies that do not separate the CEO and chair positions.

This section suggests that there are real benefits to be gained from separating the CEO and board chair roles, including those related to curtailing excessive compensation, preventing undue reliance on executives, and reducing conflicts of interests. All of these benefits, if realized, enhance boards' ability to effectively monitor the CEO and the corporation enterprise more broadly. However, this section also reveals that there may be factors that undermine corporations' ability to realize those benefits, raising questions regarding whether separating the CEO and board chair functions promises rewards that it cannot deliver. The next section seeks to respond to those questions.

C. Beyond Separation

Both the empirical and analytical evidence suggests that whether boards can obtain the benefits of separating the roles of CEO and board chair may depend on various factors. This section focuses on two of those factors: independence and board processes.

1. The Elusive Quest for Independence.—As discussed above, mere separation of the CEO and board chair functions does not guarantee independent board leadership because it does not ensure that the board chair will be truly independent, and thus, free from conflicts and biases that undermine his or her ability to perform the oversight role effectively. Unfortunately, there does not appear to be a clear path towards overcoming this obstacle for at least three reasons. First, the current governance landscape does not include many truly independent CEOs. Indeed, as of 2012, only 23% of chairs of S&P 500 companies could be classified as truly independent, as opposed to the 20% of independent chairs that are, in large part, former company CEOs or current

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Evidence from the UK, REV. FIN., Feb. 13, 2013, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394l (discussing the view that shareholder pay votes add value to an organization); Vicente Cuñat et al., *Say Pays! Shareholder Voice and Firm Performance*, Feb. 2012, at 7, *available at* http://www.oecd.org/els/SayonPaySept72012Complete.pdf, *archived at* http://perma.cc/9LL8-KE2H (noting that the U.K. say on pay votes appear to curb the "pay for failure" scenario).

218. Cuñat et al., *supra* note 217, at 7; Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 119 (2010-2011).

219. *See generally* Cuñat et al., *supra* note 217, at 3 (noting limited effect of say on pay votes on executive compensation in the United States).

executives.[220] At least one recent study confirms that the most prevalent CEO-Board chair separation involves the former CEO retaining the board leadership position.[221] This means that when companies separate the roles of chair and CEO, it is most often that the chair is a former CEO, former executive, or other individual who has a significant business relationship with the company other than board service.[222] As one recent study noted, "the separation of the two posts in American firms often signifies that the chair is the former CEO—hardly a dispassionate supervisor, and . . . possibl[y] a major obstacle to change."[223] The current status quo raises questions regarding whether it is possible for corporations to have board chairs that are truly independent.

Second, evidence suggests that many companies are reluctant to adopt a separation model disallowing the former CEO to serve as board chair because that model is preferred by CEOs, and hence eliminating or restricting the model could entail costs.[224] Commentators explain that a common CEO succession process is "passing the baton," pursuant to which the CEO relinquishes her title but remains in the role of board chair for some period.[225] Efforts to install truly independent board chairs run counter to this process. CEOs often bargain for the right to be promoted to board chair after their employment term ends,[226] and removing that right may impact the bargaining process in ways that make corporations reluctant to embrace a model of truly independent board chairs, including increasing the costs of such process or otherwise undermining the corporation's ability to attract top talent.[227] This reduces the possibility that such a model will be the norm, and thus, reduces the extent to which we can expect separation of the roles to achieve the true independence necessary to ensure that companies can take full advantage of that separation.[228]

Finally, the fact that definitions of independence do not take into account social ties may undermine true independence of board chairs.[229] As one expert noted, there is a longstanding tradition "that the chairman and the CEO usually come from the same group of people, the circle of friends and acquaintances where people know each other."[230] While this may create an ease of

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220. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 23.

221. Krause & Semadeni, *supra* note 101, at 2.

222. *See* Hodgson & Ruel, *supra* note 18, at 2 (describing characteristics of a non-independent board chair).

223. Quigley & Hambrick, *supra* note 186, at 836.

224. Brickley et al., *supra* note 19, at 192.

225. *Id*. at 194.

226. *See id.* at 195.

227. *Id*. at 194-95.

228. *See* Quigley & Hambrick, *supra* note 186, at 834-85 (describing the advantages of retaining a former CEO as a board chair).

229. *See* O'Reilly & Main, *supra* note 207, at 686 (noting the social influence of the CEO over the board).

230. Olson, *supra* note 50.

communication,[231] it also may undermine the objectivity needed to be deemed truly independent. Directors often share thick social ties with the CEO that may undermine their ability to be objective, and hence impede their ability to effectively monitor CEO behavior.[232] As an initial matter, ensuring that directors do not share bias-producing social ties with the CEO may not be possible given the pool from which directors are selected, as well as the social ties that are formed with the management team once directors serve on the board.[233] Regulators and judges have essentially refused to include, in any meaningful way, considerations of social or professional ties in the determination of director independence,[234] and there is no indication that the courts will reverse course with respect to that refusal.[235] This creates additional uncertainty regarding whether separating the roles will translate into true independent leadership, which impacts the extent to which the benefits of separation can be realized.[236]

2. The Importance of Board Process.—Several commentators have noted that the focus on independence and other structural reforms related to the board is too narrow, and therefore, incomplete.[237] Thus, in addition to embracing enhanced independence, boards also must consider the processes necessary to ensure that such independence will translate into effective oversight. Behavioral theories buttress the notion that board process is critical to ensuring that boards can successfully perform their responsibilities.[238] Thus, merely seeking independence without regard to the processes that are necessary to ensure that such independence translates into effective monitoring is a mistake.[239]

One important process relates to information. Ensuring that the board, and particularly, an independent board chair, have access to unbiased information, and multiple information gathering channels that do not rely on management, is important for board independence.[240] How directors obtain information and who provides the information is critical to an effective decision-making process.[241] This is because information that stems from limited and potentially biased

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231. *Id*.

232. Tung, *supra* note 191, at 1177, 1179-80.

233. Fairfax, *The Uneasy Case*, *supra* note 58, at 153; *see generally* Tung, *supra* note 191, at 1185 (describing social ties between boards and managers).

234. *See* Fairfax, *The Uneasy Case*, *supra* note 58, at 146-48.

235. *See id.* at 151-52.

236. *See* Tung, *supra* note 191, at 1185 (noting the difficulties with creating a workable definition of independence that captures all of the social experiences that may undermine monitoring incentives, and noting that those difficulties may cause the acknowledgement that there could be limits on the ability to "operationalize independence").

237. *See* Sharpe, *Process Over Structure, supra* note 195, at 264; Leblanc & Pick, *supra* note 9, at 3.

238. Sharpe, *Process Over Structure, supra* note 195, at 264; Leblanc & Pick, *supra* note 9, at 3.

239. Sharpe, *Process Over Structure*, *supra* note 195, at 265.

240. Sharpe, *Questioning Authority*, *supra* note 196, at 26-27, 36.

241. *Id*. at 36.

channels, reduces the full range of information available to the board, and thus necessarily undermines the board's ability to assess a broad range of available alternatives.[242] Without an appreciation for that range of alternatives, directors are hampered in their ability to adequately oversee the choices made by the CEO and management.[243]

The very independence of independent board chairs hinders their access to information. Consequently, in these boards, a focus on board process is critical to ensuring that such chairs can be effective monitors. An independent board chair by definition serves on a part-time basis. This creates time constraints that may undermine the chair's ability to effectively absorb information.[244] Further, a truly independent board chair by definition has no employment relationship with the company whose board she chairs.[245] This makes it more difficult for such chairs to access information, increasing the potential that they will exclusively utilize one mode of information-gathering: reliance on the CEO and management.[246]

At least one study suggests that a way to enhance the effectiveness of the board chair's information gathering process is to ensure that the board chair has appropriate industry experience.[247] Industry knowledge furthers at least two goals critical to information gathering and effective decision-making processes. First, it generates respect for the chair and her experience, which leads to more efficient and constructive dialogue in the boardroom.[248] The study revealed that such industry knowledge provided board chairs with the cloak of respectability that enabled them to lead discussions effectively.[249] The industry experience also provided the chairs with a level of in-depth knowledge and sophistication that allowed the chairs to frame critical issues, and provide important insights.[250] By contrast, independent board chairs' lack of industry knowledge "made it difficult for [the] separate chair to establish legitimacy with the directors and management team in a way that allowed him or her to meaningfully shape the board discussion."[251] Second, a board chair's industry knowledge and experience not only augments her access to information, but also increases the likelihood that she will have ready access to information gathering channels independent of management. As a result, such background provides an important source of objective information upon which the board chair can rely to better process and understand other information being provided to the board, and to more

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242. *Id*.

243. *Id*.

244. Sharpe, *Process Over Structure, supra* note 195, at 290.

245. *See id*. (describing the difficulty with which part-time and independent board members learn about a company).

246. Sharpe, *Questioning Authority*, *supra* note 196, at 26-27.

247. Leblanc & Pick, *supra* note 9, at 8.

248. *Id*.

249. *Id*.

250. *Id*.

251. *Id*.

appropriately monitor management.[252] This suggests that industry experience may play an important role in buttressing board process, and thus ensuring that separate board leadership can prove beneficial.

However, retaining board chairs with industry experience may prove challenging. Indeed, the pressure to populate the board with independent directors undermines the ability to recruit directors with company and industry specific ties because there is an increased likelihood that directors with such ties will not be independent.[253] Further, restrictions on corporate directorships have become increasingly more common as corporations recognize that effective board service requires increased time commitment.[254] Seventy-four percent of S&P 500 companies limit corporate directorship for their board members, as compared to 55% five years ago.[255] While this limitation may be appropriate for effective board governance, it limits the pool of available candidates with the industry experience necessary to serve in the board chair role. Reflective of this limit, corporations have expressed frustration with their inability to find enough board members with industry experience who can serve on their boards.[256]

CONCLUSION

Boards are facing significant pressure to engage in more effective monitoring. The financial crisis raised concerns regarding whether boards had paid sufficient attention to their monitoring function, and the crisis spurred reforms aimed at improving such function.

One such reform is the separation of the board and CEO functions. The hope is that such separation will reduce conflicts of interest and other factors that impede the board's ability to objectively oversee the corporation and its operations. The hope is also that such separation will better equip boards to monitor the actions of the CEO and top management team, including the prevention of excessive compensation packages.

This Article contends that splitting the board and CEO roles can positively impact the board's monitoring function. However, it identifies important caveats to that contention. First, it acknowledges that there may be costs associated with that split, some of which may have been overstated, but nevertheless, are worthy of consideration when determining the appropriate board leadership structure. Second, it recognizes that whether separating the roles of CEO and board chair can prove beneficial may depend on several variables including the size of the firm, the relative independence of the chair, and the types of processes—particularly information processes—that are available to the independent board chair. With respect to the latter two variables, achieving them may prove

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252. *See id*. at 8-9 (noting that an experienced board chair can operate independently from management, which helps the chair monitor and oversee the actions of the company).

253. Fairfax, *The Uneasy Case*, *supra* note 58, at 166, 167.

254. 2012 SPENCER STUART BOARD INDEX, *supra* note 11, at 16.

255. *Id*.

256. *Id*

challenging for corporations. This undermines the extent to which the independent board chair can deliver its promised benefits. As a result, this Article only gives conditional support for the separation of the CEO and board chair roles.

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SPRING 2013 JAMES P. WHITE LECTURE ON LEGAL EDUCATION

RECALIBRATING THE FUTURE OF HIGHER EDUCATION

GORDON GEE*

I want to thank Dean Roberts for the introduction. Dean Roberts, I read recently that you will be stepping down as dean in July. I wish you some rare moments of respite, which you surely deserve. I also must express my utmost gratitude to Jim White for this opportunity. First of all, Jim has been a longtime friend of mine. More importantly, he has been an iconic leader of legal education. Perhaps no one has had more of an impact on the modern American law school than Jim White. He has been a valiant solider, a hard-nosed advocate for envisioning legal education in the future, and someone who is not intimidated by the large or small, rich or mighty. Jim is someone who has been willing to champion change when necessary, and he has been a friend to those in need when one needed a friend indeed. There were a number of occasions as a young law school dean when I needed guidance, and there have been a number of occasions since I have been a university president when I have looked to Jim for wisdom. In short, I stand here in the shadow of someone I greatly admire. So, I thank him and all of you for this opportunity.

I have been a college president for the past thirty-three years. Therefore, it has been thirty-three years since I have had the opportunity to be fully engaged in legal education. That said, I remain a law professor at heart, and on the faculty of the law schools that I have served. I have continued to publish in the field of law and higher education. I recently co-authored a casebook, *Law, Policy, and Higher Education*. In this book, my co-authors and I developed a policy approach to address major concerns in higher education, such as government regulation, academic integrity, discrimination of freedoms, and, what has become my favorite topic, innovative ways of financing public higher education. Indeed, my law degree remains the most important arrow in my quiver.

This goes to prove that you can do anything with a law degree—even become

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a university president. To be sure, law schools remain very much in my heart. Law schools represent the opportunity to knit together the intellectual life of the university with the fabric of the community through the kinds of clinical and practical work that they do. I also believe that amid the barrage of changes of the twenty-first century, law schools, like universities, are being challenged to reinterpret their founding principles for the contemporary context. This is not a matter of legal education; this is a matter of higher education in a most ornery moment in history. Think of it, ours is an institution with origins in eleventh century Bologna, in the early Middle Ages when Dante and Chaucer were among the modern writers. No wonder we are resistant to change, slouching toward realization, looking over our shoulder for reassurance, rather than looking ahead.

As I was preparing to come here today, I read about one of Indianapolis's own sons, John Green, author of the novel *The Fault in Our Stars*. For those of you unfamiliar with the work, it is described as "exploring the funny, thrilling, and tragic business of being alive and in love."[1] I must say, if only my remarks today were about that topic, we would all be wholly entertained.

Alas, they are not. That allusion to Shakespeare which gives the novel its title, albeit turned on its head, is a good starting point for my remarks today. In the play "Julius Caesar," Cassius, he of a "lean and hungry look" (kind of like a young lawyer), tries to convince Brutus to join the Ides of March murder plot against Caesar.[2] He says "the fault, dear Brutus, is not in our stars,/But in ourselves, that we are underlings."[3] I have spent so much of these past several years pondering the slings and arrows of higher education, so pardon my mixed Shakespearian metaphors.

For so long, the American system of higher education has been the envy of the world. Our colleges are economic engines, generators of insights and breakthroughs, knowledge cities, and cultural communities. That magnificent system is in jeopardy. We can no longer ignore a vexing constellation of issues that now confront us, such as the rising cost of college tuition, enrolled students who never graduate, diminishing state and federal funds, new expectations by nontraditional students, and on and on. I propose to you that if we are not the *architects* of our future, we will be the victims of our destiny. Indeed, the fault is *not* in the stars, in a star-crossed destiny, but in us, and higher education as a whole if we cannot pull ourselves up by our bootstraps, briefcases, iPads, and Blackberries, and adapt to an ever changing and ever more demanding world.

The fault is in ourselves, if we succumb to complacency, fear, and stasis. When all is said and done, I see this as a binary between complacency and curiosity. We can succumb to complacency, hide our heads in the sand, and ignore the luminous possibilities of the future, or we can take this occasion to reconfigure, recalibrate, rethink, and redefine what higher education will look like in the twenty-first century. In order to do this we need to challenge traditional

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1. Amazon, http://www.amazon.com/The-Fault-Stars-John-Green/dp/0525478817 (last visited May 20, 2014).

2. WILLIAM SHAKESPEARE, JULIUS CAESAR, act 1, sc. 2.

3. *Id.*

assumptions, drive creativity, foster greater innovation, and renew our own personal commitment to the large public ideals that underpin all of our efforts.

First of all, I wholly believe we must innovate from the inside out, rather than be forced into change by external forces. Kierkegaard once declared that a man's greatest fear is learning what he is truly capable of doing and becoming.[4] Granted, Kierkegaard is known as the father of "angst" and "existential despair." So I offer the words of yet another philosopher, pop artist Andy Warhol, who said "They always say that time changes things, but you actually have to change them yourself."[5] Last year, for the first time ever, representatives from all six national higher education associations met in Washington, D.C. for a series of unique conversations.[6] Leaders from all sectors of higher education were at the table—from community colleges to small, private universities, to large, public universities.[7] This National Commission on Higher Education Attainment became a forum for leaders to voice ideas, take stock of how our colleges are helping students, and offer suggestions to improve these efforts. In late January, this Commission issued an emphatic call to our colleagues and to the public that we must make college completion a national priority.[8]

Last year, a record 21.6 million students enrolled in American universities, yet nearly two in five will never don a cap and gown.[9] This is an unacceptable loss of human potential with major implications. Students who do not graduate face diminished career prospects and a stack of student loans with little hope of paying them back. I offer our commission work as one example of how higher education must control its own destiny, how we must do more than just gaze at the landscape speeding by. We must take the wheel.

As you know, higher education in the United States has been facing tremendous headwinds. The financial crisis has been deep and pervasive, and recovery is slow. Many public universities have been on life-support for

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4. LARRY CHANG, WISDOM FOR THE SOUL: FIVE MILLENNIA OF PRESCRIPTIONS FOR SPIRITUAL HEALING (2006).

5. ANDY WARHOL, THE PHILOSOPHY OF ANDY WARHOL (FROM A TO B AND BACK AGAIN) 111 (First Harvest ed. 1977).

6. The National Commission on Higher Education Attainment was convened in October, 2011. The six participating associations were the American Council on Education (ACE), the American Association of Community Colleges (AACC), the American Association of State Colleges and Universities (AASCU), the Association of American Universities (AAU), the Association of Public and Land-grant Universities (A P L U), and the National Association of Independent Colleges and Universities (NAICU). *National Commission on Higher Education Attainment*, AM. COUNCIL ON EDUC., http://www.acenet.edu/news-room/Pages/National-Commission-on-Higher-Education-Attainment.aspx (last visited June 28, 2014).

7. *Id.*

8. *An Open Letter to College and University Leaders: College Completion Must Be Our Priority*, NAT'L COMM'N ON HIGHER EDUC. ATTAINMENT (Jan. 2014), *available at* http://www.acenet.edu/news-room/Documents/An-Open-Letter-to-College-and-University-Leaders.pdf.

9. *Projections of Education Statistics to 2021, 40th ed.*, NAT'L CENTER FOR EDUC. STATS. (Jan. 2014), *available at* http://nces.ed.gov/pubs2013/2013008.pdf.

months.[10] The threat of sequestration has become a stark reality for our research universities across the country. And, for my part, I will say that this is a time in which the heads of university presidents rest lightly upon their shoulders. Even before the recession struck, it was evident that higher education needed to become ever more innovative.

The entire funding model for public universities is in fast-forward decline. Gone are the days when we can hold our palms outright and hope for the best. We know we can no longer depend on federal and state funds to support our aspirations. In the past, I have reiterated the litany of woes of universities around the country. These include layoffs, astronomical tuition hikes, larger class sizes, and fewer services. You have no doubt heard the horror stories. Thus far, Ohio has fared better than most. However, I will tell you that current analyses of funding scenarios based on state and federal budgets in the near term do not look promising. To be frank, early indications suggest even more perilous challenges ahead for higher education. At times, it seems the overwhelming response is one of hanging on and surviving.

I do not subscribe to that philosophy. I believe we must face these unprecedented challenges by being more agile, less bureaucratic, and infinitely more inventive. Indeed, we have undertaken a series of innovative financing strategies at Ohio State that show promise and potential.[11] Ohio State recently agreed to lease its campus parking operations for $483 million, thus boosting our endowment by twenty percent overnight.[12] And, in 2011, we became the nation's first public university to issue $500 million dollars in century bonds, which will help fund capital projects, such as our $1.1 billion dollar Wexner Medical Center expansion.[13] We will continue to look for new ways to reconfigure Ohio State for the future, as an institution that can endure any number of storms, any financial upheaval, and transitory questioning about the value of higher education. I want to make the point that everything we are doing is in service of building our academic core, so that bright young people are prepared for the twenty-first century.

Our colleges and universities spring from a rich and wonderful past. While traditions are important, the past cannot serve as our compass for the future. By all indications, the higher education institution of the future is going to be vastly different from the university of today. The modes of learning are evolving. The

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10. Jeffrey J. Selingo, *Colleges Struggling to Stay Afloat*, N.Y. TIMES, Apr. 12, 2013, http://www.nytimes.com/2013/04/14/education/edlife/many-colleges-and-universities-face-financial-problems.html?_r=0.

11. *See Strategic Plan 2013-2017*, *Office of Business and Finance at the Ohio State University*, OSU.EDU (Nov. 2012), *available at*, http://oaa.osu.edu/assets/files/strategicPlanning/2012-Strategic-Plans/Support%20Unit/BusinessFinance.pdf.

12. *Ohio State Makes Final Recommendation on Leasing Parking Operations,* OSU.EDU (June 8, 2012), http://www.osu.edu/news/newsitem3437.

13. Bill Bush, *Ohio State Sells $500M in Bonds for Construction*, COLUMBUS DISPATCH, Oct. 23, 2011, http://www.dispatch.com/content/stories/local/2011/10/23/ohio-state-sells-500m-in-bonds-for-construction.html.

funding model is devolving. Technology is revolutionizing our lives and integrating the global landscape. More and more universities are joining the online education revolution by developing massive open online courses to facilitate learning in today's fully wired and global world.[14] This is happening all across the country, including at Indiana University.[15]

I will offer a few examples from my own university to illustrate that point. This spring, 26,000 students registered for one of our online calculus courses. And one of our instructors, who features the "flipped classroom" approach, has now reached 100,000 students through his online general chemistry class.[16] Clearly, today's students will continue to dictate the high-speed cadence of our world, on and off campus. They are the most tech-savvy, global-minded, and collaborative students in history.

In order to remain relevant, we must step outside of the comfort zone of the past century and match their pace. We must move boldly forward, holding fast to the enduring principles of the past, the art of the possible, and the shining promise of the future. Now, how does this translate to legal education?

From the distance of thirty-three years and from the distance of the president's chair, I am not going to suggest *how* legal education should be reformed; I am going to suggest that it *should be* reformed. I believe these times require us to ask fundamental questions about all aspects of the educational system. Clearly, legal education, like all of higher education, is facing a torrent of challenges and is, in many ways, under a barrage of criticism from all sides, including from within. Young lawyers are having a difficult time finding positions.[17] Law school applications are down almost fifty percent over the last three years.[18] And, like other college graduates, law school graduates are shouldering far too much debt. These sharp realities give us the opportunity to ask some tough questions. I am not advocating any of these questions, but I am saying that these are the kinds of questions we need to be asking.

In order to move forward, we must decide the following things: How do we reward and recognize our faculty? How do we provide more partnerships and training with the legal community? What are the possibilities of degrees beyond the Juris Doctor, such as executive education for business or a master's degree in

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14. Tyler Kingkade, *MOOC Skepticism Persists Among University Presidents, Despite Rapid Growth Of Online Courses In 2012*, HUFFINGTON POST, Nov. 26, 2012, http://www.huffingtonpost.com/2012/11/26/moocs-skepticism_n_2191314.html.

15. *Id.*

16. Liv Gjestvang, *Ohio State Chemistry Flips the Classroom*, DIGITAL FIRST.OSU (May 21, 2012), http://digitalfirst.osu.edu/news/75.

17. Susan Adams, *The Best Law Schools for Career Prospects 2013*, FORBES, Oct. 8, 2013, http://www.forbes.com/sites/susanadams/2013/10/08/the-best-law-schools-for-career-prospects-2013/ (stating that the American Bar Association unemployment statistic for 2012 law school graduates is 10.6%).

18. Staci Zaretsky, *Law School Applications Plummet*, ABOVE THE LAW (Aug. 20, 2013), http://abovethelaw.com/2013/08/law-school-applications-continue-to-tumble/ (noting law school applications down thirty-eight percent).

legal studies? Is it true that we scare our law students to death the first year, work them to death the second year, and bore them to death the third year? The dean of Moritz College of Law at Ohio State says *that* is definitely not true, by the way.[19] But we *are* looking carefully at these questions and others.

As the economic pressures continue, we are looking for additional ways to provide pathways from school to practice. One such example at Ohio State is our Corporate Fellowship Program, which I believe is the first of its kind in the country. This program allows our new graduates to spend a year inside the General Counsel's Offices of major corporations, which are normally staffed exclusively by lawyers with many years of practice. The program allows our graduates a unique "inside look" at how corporations use legal services, while launching them into practice, shoulder-to-shoulder with experienced lawyers. Like a medical residency, the program provides elite, post-graduate training. And, I am told, that the companies love this too. They have been deeply impressed by what our hard-working, young graduates can do for them at a reasonable cost, and are pleased by the opportunity to join in training the next generation.

We are also starting to look at other changes, such as how to incorporate technology into the classroom. We are not incorporating technology as a replacement for our small and intimate class discussions, but rather as a way to complement those discussions and continue to explore ways to expand resources for our students. Just this month, our law school decided to move forward with a synchronized online education program with the University of Iowa. Because we have the leading election law program in the country, students from Iowa will take one of our election law classes online, alongside our students in the classroom. And our students will participate in an antitrust law class at Iowa which is taught by one of their superstars. It is a win-win for everyone, and it is a clear example of how we must continue to innovate and hone our curriculum in order to better prepare our students for the twenty-first century legal stratosphere.

To be honest, I am not one to dwell on the negative, but I will tell you this very clearly—the greatest impediment I can imagine is a culture that is rooted in balkanization, lacking in curiosity, and mired in complacency. In other words, a culture that is unable or unwilling to scan the horizon for brighter prospects. To fulfill our shared promise we must pursue our goals with both a heightened concentration and an inclination for the long view. We cannot contemplate our future through the rear-view mirror. We must keep our eyes trained on the skyline ahead, and on the luminous possibilities that are ours for the taking.

Indeed, I believe that this time of uncertainty and challenge is precisely what American education has needed to loosen us from our moorings. As we consider new directions together, I caution against the natural impulse to see challenges and changes as obstacles, and to seek comfort by sounding the retreat. I firmly believe that every challenge we face is also an opportunity to charge ahead, to

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19. Alan C. Michaels, J.D. is the Dean of the Moritz College of Law at the Ohio State University. *The Moritz College of Law: Administration*, OSU.EDU, http://moritzlaw.osu.edu/about/administration/ (last visited May 20, 2014).

think differently, to collaborate more fully, and reconfigure ourselves for the long-term benefit of our students and our nation. Author Nassim Nicholas Taleb, you may have read about some of his volatility theories, proposes that we have most to gain when we have most to lose, when we are forced to view turmoil and challenge square in the eye, when necessity *demands* innovation.[20] In Taleb's view, the institutions that continue to adapt—especially in moments of crisis—will flourish in the long haul.[21] Indeed, Taleb describes these moments of crisis as Black Swans, rare and unpredictable events that impact "almost everything in our world, from the success of ideas and religions, to the dynamics of historical events, to elements of our own personal lives."[22]

Black Swans from recent history would include September 11, the rise of the Internet, the fall of the Soviet Union, and the recent global financial crisis, which really had a tsunami effecton the funding of public higher education. Taleb suggests that, in order not just to survive but to thrive in a volatile world, we must be robust enough to "gain from disorder," a state of resiliency and adaptability that he calls being "antifragile."[23] I find his theories fascinating, but also daunting.

I have often said that my university, as one of the largest, most comprehensive university in the country,[24] is something of an elephant, powerful and unwieldy. We have to be ever-more nimble and agile, like a ballerina, to adapt more gracefully to the future.

Ladies and gentlemen, 150 years ago, President Lincoln had the wisdom and foresight to invest in young people and re-chart American higher education when he signed the Morrill Act.[25] Without knowing what the future held, our forefathers determined that the path forward was paved with education. What Lincoln did was thoroughly radical, and he undertook this act in a moment of great peril and challenge for our country.

We, too, are at a pivotal moment in our country's history. What hangs in the balance is nothing less than the future of public education and our ability to sustain democracy through an educated citizenry. I often ponder the questions about higher education in the twenty-first century from my office in the heart of the Ohio State campus. Quite prominently, amid all the wonderful memorabilia and reams of paperwork, is a quote that lies at the heart of how I approach leading Ohio's flagship university. The quote is not from Plato, Abraham Lincoln, or

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20. NICHOLAS NASSIM TALEB, ANTIFRAGILE: THINGS THAT GAIN FROM DISORDER 41-42 (2012).

21. *Id.* at 3-4.

22. NICHOLAS NASSIM TALEB, THE BLACK SWAN, at xviii (2d ed. 2010).

23. TALEB, *supra* note 20.

24. The U.S. Department of Education ranks Ohio State as the ninth largest university in the country with an undergraduate enrollment of 56,867. U.S. DEPT. OF EDUC., NAT'L CENTER FOR EDUC. STATS. (2012), http://nces.ed.gov/fastfacts/display.asp?id=74.

25. The Morrill Act was signed into law by President Lincoln in 1862 and provided 30,000 acres of federal land to each state which was then sold by the states in order to fund public colleges. *Primary Documents in American History*, LIBRARY OF CONGRESS, http://www.loc.gov/rr/program/bib/ourdocs/Morrill.html (last visited May 20, 2014).

Thomas Aquinas. There on an easel, looming over the conference table, inserting itself in the proceedings every day, are the words of General Eric Shinseki. "If you don't like change," the General said, "you're going to like irrelevance even less."[26]

Ladies and gentlemen, the crux of my argument is simply this: the case for reconceptualizing the American university, and our law schools as part of the university, is the case for the future. The animating principle that has carried millions of Americans to universities, that moved previous generations to build those universities, was a relentless belief in the future. No one would pursue the American dream, much less live it, nor even dream it, without a fundamental belief in what is yet to come, without the belief that what is in the stars for generations of young people—what *must* be our destiny, theirs and ours—is that higher education will continue to shine brightly enough to light the way for the future.

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26. James Dao & Thom Shanker, *No Longer a Soldier, Shinseki Has a New Mission*, N.Y. TIMES, Nov. 10, 2009, http://www.nytimes.com/2009/11/11/us/politics/11vets.html?pagewanted=all&_r=0.

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NOTES

CONFUSION OR MERE DIVERSION? *ROSETTA STONE V. GOOGLE*'S IMPACT ON EXPANDING INITIAL INTEREST CONFUSION TO TRADEMARK USE IN SEARCH ENGINE SPONSORED ADS

ALEASHA J. BOLING*

INTRODUCTION

On April 9, 2012, the Fourth Circuit Court of Appeals issued an opinion that could limit one of the most profitable tools search engines use: keyword advertising.[1] Specifically, the Fourth Circuit's *Rosetta Stone Ltd. v. Google, Inc.* (*Rosetta Stone II*) opinion opened the door wider for trademark owners to hold search engines liable under a direct trademark infringement theory.[2] According to this position, search engines are responsible for the use of owners' trademarks by third parties taking advantage of search engines' lucrative keyword advertising programs.[3] In contrast to other federal court decisions,[4] including that of the United States District Court for the Eastern District of Virginia from which *Rosetta Stone I* was appealed,[5] the Fourth Circuit held search engines could be liable for direct trademark infringement based on the likelihood of consumer confusion[6]—a cornerstone of trademark law.[7]

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1. Anindya Ghose & Sha Yang, *Analyzing Search Engine Advertising: Firm Behavior and Cross-Selling in Electronic Markets*, REFEREED TRACK: INTERNET MONETIZATION—SPONSORED SEARCH 219 (2008), *available at* http://www.wwwconference.org/www2008/papers/pdf/p219-ghose.pdf, *archived at* http://perma.cc/H9NJ-J3WE.
2. Rosetta Stone Ltd. v. Google, Inc. (*Rosetta Stone II*), 676 F.3d 144, 152 (4th Cir. 2012).
3. *Id.*
4. *See* Tiffany, Inc. v. eBay, Inc., 600 F.3d 93 (2d Cir. 2010) (finding no liability for search engines because plaintiffs could not prove a likelihood of consumer confusion or that the search engines made "use" of the trademarks as required elements of infringement); 1-800 Contacts, Inc. v. WhenU.com, Inc., 414 F.3d 400 (2d Cir. 2005).
5. Rosetta Stone Ltd. v. Google, Inc. (*Rosetta Stone I*), 730 F. Supp. 2d 531 (E.D. Va. 2010).
6. *Rosetta Stone II*, 676 F.3d at 152.
7. Lanham Act, ch. 540, tit. VIII, § 43, 60 Stat. 441 (1946) (codified as amended at 15

According to the Fourth Circuit, when searches for a particular product or company online present consumers with paid advertisements from third parties that used the trademarks of that particular product or company, the consumers are likely confused about the source or sponsorship of the advertisement for only a brief moment.[8] They then click on the ad and quickly realize it is not associated with their intended inquiry.[9] This brief uncertainty about the source or affiliation of a product is a type of consumer confusion dubbed "initial interest confusion."[10] Many courts have found the concept of initial interest confusion valid in trademark infringement cases, both online and offline.[11] The Fourth Circuit reviewed crucial evidence of initial interest confusion in reasoning why the district court should not have granted summary judgment to Google.[12] Although the initial interest confusion doctrine has been developing over time, the Fourth Circuit's *Rosetta Stone II* decision made clear the concept applies in cases of trademark infringement by search engines promoting their ad programs.[13]

The purpose of this Note is to explore the initial interest confusion doctrine and investigate how it relates to a growing amount of litigation between trademark owners and search engines. This litigation focuses on search engines' selling rights to third parties to use the owner's trademarks both in the text of their paid advertisements and as part of the algorithm used to trigger the appearance of such ads on search engines' results pages. This Note also argues that the Fourth Circuit's consumer confusion analysis in *Rosetta Stone II* is correct and should begin to reverse the trend finding search engines not liable for trademark infringement.[14]

Part I of this Note summarizes the current state of trademark law as it relates to both Internet and non-Internet applications and explains search engines'

U.S.C. § 1125 (2006)) (explaining that liability can attach to any entity using another person's intellectual property in a way that "is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person . . . .").

8. *Rosetta Stone II*, 676 F.3d at 157-59.

9. *Id.*

10. Brookfield Commc'ns, Inc. v. W. Coast Entm't Corp., 174 F.3d 1036, 1062 (9th Cir. 1999).

11. *See* Australian Gold, Inc.. v. Hatfield, 436 F.3d 1228, 1239 (10th Cir. 2006); Promatek Indus., Ltd. v. Equitrac Corp., 300 F.3d 808, 813 (7th Cir. 2002); *Brookfield*, 174 F.3d at 1062 (holding defendants liable for trademark infringement on an initial interest confusion theory).

12. *Rosetta Stone II*, 676 F.3d at 157-60.

13. *Id.*

14. On October 31, 2012, Rosetta Stone and Google agreed to settle all claims and dismiss the suit after its remand to the U.S. District Court for the Eastern District of Virginia. The Fourth Circuit's holdings in the case, however, remain valid. Terry Baynes, *Rosetta Stone and Google Settle Trademark Lawsuit*, REUTERS (Oct. 31, 2012, 5:26 PM), http://www.reuters.com/article/2012/10/31/us-usa-court-rosettastone-google-idUSBRE89U1GE20121031, *archived at* http://perma.cc/S8XD-RD74.

keyword advertising programs, such as Google's AdWords. Part II discusses the historical treatment of trademark owners' rights in keyword advertising or metatag cases, including how courts have treated owners' rights in suing both the search engines and the advertisers. Part III discusses the history and development of the initial interest confusion doctrine and how courts have applied it in both Internet and non-Internet contexts. Part IV analyzes the traditional elements of trademark law as applied to *Rosetta Stone II* and suggests "likelihood of confusion" is the controlling element. It also argues that the initial interest confusion doctrine can and should compensate for previous cases which note that the period for confusion is too brief to constitute infringement.

I. STATE OF TRADEMARK LAW AND KEYWORD ADVERTISING PROGRAMS

Keyword advertising on the web is immensely popular. Advertisers spent $18.7 billion on paid search ads in 2011, and ninety-two percent of web searchers click on paid search ads.[15] Advertisers benefit from bidding on trademark owners' intellectual property to use in metatags[16] causing their websites to appear in paid search results and in the actual copy of their ads, a phenomenon known as "paid search conquesting."[17] The benefits come from the advertiser's ability to associate themselves with the goodwill of another brand.[18]

The mechanics of keyword advertising programs start with the website's metatags, which describe the contents of the website.[19] Description metatags describe the site, and keyword metatags contain keywords related to the contents of the site.[20] The more often a term appears in a site's metatags, the more likely it will appear in paid search results when a user searches for that term.[21]

Search engines use keywords by processing them through their index of websites and using proprietary algorithms to sort the search results by relevancy.[22] To determine relevancy, search engines look at domain names, text, and metatags.[23]

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15. Daniel Malachowski, *Search Engine Trade-Marketing: Why Trademark Owners Cannot Monopolize Use of Their Marks in Paid Search*, 22 DEPAUL J. ART TECH. & INTELL. PROP. L. 369, 371 (2012).

16. A metatag is an HTML tag used in the coding of a website containing descriptive information about the website that does not appear when the website is displayed. THE AMERICAN HERITAGE SCIENCE DICTIONARY (Houghton Mifflin 2002), *available at* http://dictionary.reference.com/browse/metatag.

17. *Id.* at 374-75.

18. *Id.*

19. Brookfield Commc'ns, Inc. v. W. Coast Entm't Corp., 174 F.3d 1036, 1045 (9th Cir. 1999).

20. Promatek Indus., Ltd. v. Equitrac Corp., 300 F.3d 808, 811 (7th Cir. 2002).

21. *Id.*

22. *Brookfield*, 174 F.3d at 1045.

23. *Id.*

A. Google's AdWords Program

Google's keyword advertising program, AdWords, allows advertisers to purchase keywords for their website's metatags and their Google advertisements, which Google's algorithm will then recognize when a searcher types the relevant keyword(s).[24] This is like buying the right to have the advertiser's ad appear with the search results for a certain keyword(s).[25] Advertisers make these purchases by auction.[26] Because searchers are more likely to click on ads higher up on the search results page,[27] Google maximizes the frequency of searchers clicking on these ads by placing the most relevant ads higher up on the page.[28] This is how advertisers' (and consequently Google's) revenues increase.[29] Thus, the more relevant a website is to the keyword searched, the higher the website will appear in the results list.[30]

Google has long had policies governing its AdWords program to prevent "illegal or fraudulent business practice."[31] Prior to 2004, Google's policy prohibited use of trademarks as keywords except upon request of the trademark owner.[32] In 2004, Google began to allow third parties to purchase trademarks as keywords and invented a trademark keyword tool that would suggest relevant trademarks on which third parties could bid.[33] Google continued to block third parties' use of keywords in the actual text of the ads, however, due to internal studies suggesting such practice might confuse searchers.[34] This policy change appears to be financially motivated—seven percent of Google's revenue was from trademarked keywords.[35] At this time, Google expected an increase in lawsuits from trademark owners.[36] After all, its own studies showed significant source confusion when trademarks were included in the ad copy.[37]

In 2009, Google allowed use of trademarks in third parties' ad text in four

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24. *Rosetta Stone II*, 676 F.3d 144, 151 (4th Cir. 2012). Although Google has the most prominent keyword advertising program, and it is the one analyzed in *Rosetta Stone I* and *II*, other search engines have similar programs. Malachowski, *supra* note 15, at 371 ("Marketers spent most [of the money spent on paid ads] on Google, which held a 66.4 percent search market share as of February 2012."). For example, Microsoft's Bing and Yahoo! search engines also allow advertisers to bid on others' trademarks and use them in their ad copy. *Id.* at 374.
25. *Rosetta Stone II*, 676 F.3d at 151.
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.* at 156.
36. *Id.*
37. *Id.*

situations: 1) the sponsor was a reseller of the genuine trademarked product, 2) the sponsor made or sold parts for the product, 3) the sponsor offered goods compatible with the product, or 4) the sponsor provided information about or reviewed the product.[38] Google expected a substantial increase in revenue from this policy change, as well as an increase in litigation.[39] Google's revenue expectations were met in 2011, when it generated $36.5 billion in advertising revenue, most of which came through its AdWords program.[40]

B. Application of Traditional Trademark Law to Keyword Advertising Cases

Although many Internet trademark applications are relatively new, including keyword advertising, traditional trademark law can still be applied to these cases to achieve a just outcome.[41] One purpose of trademark law is to reduce the consumer's costs of shopping and making purchasing decisions by clarifying that the item comes from a particular producer.[42] Additionally, trademark law assures producers they will receive the benefits associated with producing the product, such as goodwill and increased revenue.[43]

In the context of counterfeit goods, which are often advertised using the genuine products' trademarks as keywords, consumer interests are especially endangered.[44] "Although these websites may have low prices, what they do not tell consumers is that the true costs to our nation and consumers include lost jobs, stolen business profits, threats to our national security, and a serious risk of injury to consumers."[45] Agencies "follow the money" when investigating counterfeit goods.[46] This tactic often leads to search engines that profit from selling ads to counterfeiters.[47] This presents a host of problems for trademark owners different than those experienced when stores sell counterfeit goods.[48] Counterfeit goods

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38. *Id.* at 151-52.

39. *Id.* at 156.

40. Malachowski, *supra* note 15, at 371.

41. Lauren Troxclair, *Search Engines and Internet Advertisers: Just One Click Away From Trademark Infringement?*, WASH. & LEE L. REV. 1365, 1367-68 (2005).

42. Brookfield Commc'ns, Inc. v. W. Coast Entm't Corp., 174 F.3d 1036, 1053 (9th Cir. 1999).

43. *Id.*

44. Rebecca Dunlevy, *Internet Immunity: The Limits of Contributory Trademark Infringement Against Online Service Providers*, 22 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 927, 929 (2012).

45. *Id.*

46. *Id.* at 929-30.

47. *Id.*

48. *Id.* at 930 ("The issues confronting trademark right holders in the Internet marketplace for counterfeit goods are unique because the relationships between purveyors of counterfeit goods and those providing necessary support services are less transparent and less personal. . . . The problems trademark right holders must confront in the Internet marketplace are what strategies will best protect their intellectual property and how to deter infringers in a cost efficient way. The

also harm consumers because they do not correspond with consumer expectations about goods or services.[49] They harm trademark owners because they take away the owner's lawful monopoly over their reputation and trademarks.[50]
To establish a case of trademark infringement under the Lanham Act, a plaintiff must prove:

> (1) that it owns a valid mark; (2) that the defendant used the mark "in commerce" and without plaintiff's authorization; (3) that the defendant used the mark (or an imitation of it) "in connection with the sale, offering for sale, distribution, or advertising" of goods or services; and (4) that the defendant's use of the mark is likely to confuse consumers.[51]

The first three elements are not at issue in *Rosetta Stone II*.[52]

The only issue in *Rosetta Stone II*, and the one addressed in this Note, is whether a search engine's use of trademarks in its keyword advertising program is likely to cause consumer confusion. To prove consumer confusion, a plaintiff must establish that defendant's use of the trademark is likely to cause consumers to believe either that the plaintiff is the source of the defendant's goods or services or that the defendant is the source of the plaintiff's goods or services.[53] Factors relevant to determining likelihood of confusion include: 1) strength of plaintiff's mark as used in the marketplace; 2) similarity of the marks; 3) similarity of the goods or services identified by the marks; 4) similarities of the facilities used by the mark holders; 5) similarity of advertising used by the mark holders; 6) defendant's intent; 7) actual confusion; 8) quality of defendant's product; and 9) sophistication of consumers.[54]

Even fleeting confusion can constitute the consumer confusion necessary to establish a claim of trademark infringement.[55] This doctrine is known as initial interest confusion and is particularly helpful in keyword advertising cases where consumers might be confused as to the ad's sponsorship only momentarily until they click on the ad and are taken to a website that obviously is not the trademark owner's.[56] When a consumer stays with the competitor even after realizing the competitor's products are not the trademark owner's products, the competitor

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answer in the brick-and-mortar world was the judicially-created doctrine of contributory trademark infringement. In the online world, however, the application of the contributory liability doctrine to OSPs presents new challenges for trademark holders and the courts."). *Id.*

49. *Id.* at 933.

50. *Id.*

51. Lanham Act, ch. 540, tit. VIII, § 43, 60 Stat. 441 (1946) (codified as amended at 15 U.S.C. § 1125 (2006)); *Rosetta Stone II*, 676 F.3d 144, 152 (4th Cir. 2012).

52. *Rosetta Stone II*, 676 F.3d at 152-53. Courts have already established that Google's auctioning of trademarks qualifies as "use in commerce." Rescuecom Corp. v. Google, Inc., 562 F.3d 123, 129-31 (2d Cir. 2009).

53. Australian Gold, Inc. v. Hatfield, 436 F.3d 1228, 1238 (10th Cir. 2006).

54. *Rosetta Stone II*, 676 F.3d at 153.

55. *Australian Gold*, 436 F.3d at 1239.

56. *Id.* at 1238.

captures the trademark owner's potential customer.[57] This situation can result in damage to the owner's trademark in three ways: 1) the original diversion of the consumer to a source that he believes is authorized; 2) the consequent effect of the diversion on the consumer's ultimate decision whether to purchase; and 3) the credibility the consumer might give to the infringing product that would have been ill-gotten through the goodwill and reputation of the protected mark.[58]

II. TRADEMARK OWNERS' RIGHTS IN INTERNET KEYWORD CASES

The Internet context in general, and the Internet paid advertisement context in particular, present special problems for trademark owners. The Internet has given rise to an "exponential number of legal struggles."[59] In trademark law, as in other areas, the overarching question is whether existing historic concepts and rules are equally as effective in the Internet context as in more traditional cases.[60]

One issue that might concern trademark owners in keyword advertising cases is that, in addition to the normal expenses of policing and litigating infringement of their marks, they often must bid on their *own* marks in search engine keyword auctions to prevent competitors and counterfeiters from appearing higher than their unpaid search result.[61] Search engines benefit from a competitive search market for keywords.[62] In *Rosetta Stone I* and *II*, the court explained how Google collects revenues on Rosetta Stone's trademark from Rosetta Stone's competitors, counterfeiters, and even Rosetta Stone itself.[63] Many trademark owners would not bid on their own marks if competitors and others were not allowed to do so.[64]

Although search engines often do not allow counterfeiters and competitors to purchase trademarks in their keyword ad program policies, these policies are not always enforced.[65] This harms the trademark owner for the period between the appearance of the ad and the search engine's successful removal of it.[66]

Two main lines of keyword advertising cases have developed pertaining to trademark owners' litigation against those allegedly infringing their trademarks: suits against the advertisers themselves and suits against the search engines that profit from keyword advertising programs.[67]

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57. *Id.* at 1238-39.

58. *Id.* at 1239.

59. Big Star Entm't, Inc. v. Next Big Star, Inc., 105 F. Supp. 2d 185, 189 (S.D.N.Y. 2000).

60. *Id.*

61. Malachowski, *supra* note 15, at 376.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 377.

66. *Id.*

67. *See, e.g.*, Playboy Enters. v. Netscape Commc'ns Corp., 354 F.3d 1020, 1023 (9th Cir. 2004) (discussing plaintiff's suit against search engine); Brookfield Commc'ns, Inc. v. W. Coast Entm't Corp., 174 F.3d 1036, 1053 (9th Cir. 1999) (discussing plaintiff's suit against advertiser).

A. Cases Against Advertisers

In one line of cases, trademark owners have sued the advertisers who purchase the owners' trademarked terms for use in their own ads. In *Brookfield Communications Inc. v. West Coast Entertainment Corp.*, the court granted a preliminary injunction to a communications company that ran an entertainment industry-related searchable database and had registered trademarks for it under the name MOVIEBUFF against a video rental store that ran another searchable database on its domain name (www.moviebuff.com).[68] The court found a likelihood of success on the merits for trademark infringement in both the context of the store's domain name and its use of "MovieBuff" in its website metatags. The court found the communications company was the senior user of the term; "MovieBuff" and "moviebuff.com" were, for all intents and purposes, identical in sight, sound and meaning; both companies featured searchable databases and used the Internet for marketing; many forms of confusion could result from the store's use, including initial interest confusion in the metatags use; and the store's use of "MovieBuff" was not fair use.[69]

In *Promatek Industries Ltd. v. Equitrac Corp.*, a competitor of the owner of the trademark COPITRAK used "Copitrack" as a metatag in its website because it provided maintenance to Copitrak equipment.[70] The court upheld a preliminary injunction against the competitor because the marks were similar (with one intentionally referencing the other), the companies were direct competitors and the degree of care exercised by consumers in searching "Copitrack" would result in a likelihood of initial interest confusion that would harm the trademark owner.[71]

In *Nissan Motor Co. v. Nissan Computer Corp.*, the carmaker sued the registrant of Nissan.com and Nissan.net, claiming the domain names were trademark infringements.[72] Although Nissan was the alleged infringer's last name, the court found for Nissan Motor Co. because the websites advertised auto-related products.[73] The court held initial interest confusion existed as a matter of law because Nissan.com and Nissan.net captured the attention of consumers shopping for cars.[74] The court further noted that any consumer looking for information on a Nissan car would likely enter "Nissan.com" into their web browser and, in fact, there had been evidence of actual consumer confusion in the case.[75]

In *Australian Gold, Inc. v. Hatfield*, the court held defendants liable for infringement after they resold and advertised trademarked items on their websites

68. *Brookfield*, 174 F.3d at 1036.
69. *Id.* at 1049, 1055, 1056-57, 1062, 1066.
70. Promatek Indus., Ltd. v. Equitrac Corp., 300 F.3d 808, 810-11 (7th Cir. 2002).
71. *Id.* at 812.
72. Nissan Motor Co. v. Nissan Computer Corp., 378 F.3d 1002, 1006 (9th Cir. 2004).
73. *Id.* at 1019.
74. *Id.* at 1007.
75. *Id.* at 1019.

and in the metatags of the sites and paid a search engine to have the trademarked terms trigger a high placement of defendants' ads in search results.[76] In determining the likelihood of confusion related to the websites and metatags, the court analyzed the initial interest confusion doctrine and found defendants' actions to be attempts to divert traffic to their websites and use plaintiffs' goodwill to lure consumers.[77] Similarity of the marks, products and marketing channels, the infringer's intent, consumer sophistication, and strength of the mark all weighed in plaintiffs' favor.[78]

In *Network Automation, Inc. v. Advanced Systems Concepts, Inc.*, the Ninth Circuit took a step back from *Brookfield* by holding a competitor's use of the trademark ACTIVEBATCH in the metatags of its website did not constitute initial interest confusion.[79] The court noted the *Brookfield* decision related mostly to domain names, not metatags, and the three most important likelihood-of-confusion factors in *Brookfield* did not fit all Internet cases.[80] The court also analyzed initial interest confusion more strictly, stating the use must demonstrate likely confusion, not mere diversion.[81] In this case, the court found the most important factors to be: 1) strength of the mark, 2) evidence of actual confusion, 3) type of goods and degree of care likely to be exercised by consumers, and 4) the labeling and appearance of ads and their context on search results pages.[82]

B. Cases Against Search Engines

In another set of cases, trademark owners sued the search engines that had developed and profited from the keyword advertising programs that allowed third parties to purchase others' trademarks as keywords. In *Playboy Enterprises, Inc. v. Netscape Communications Corp.*, the owner of the PLAYBOY and PLAYMATE trademarks sued the search engine Netscape for using the trademarked terms in a list of terms third-party advertisers of adult entertainment must use as keywords to trigger their Netscape banner ads.[83] The court found a genuine issue of material fact existed as to the likelihood of consumer confusion based on initial interest confusion, so the claim withstood summary judgment.[84] The court concluded consumers would reach third-party advertisers' sites because of Netscape's use of Playboy's trademarks, and such use was actionable.[85] Other factors pointing to a likelihood of confusion included actual confusion, strength

76. Australian Gold, Inc. v. Hatfield, 436 F.3d 1228, 1233 (10th Cir. 2006).

77. *Id.* at 1239.

78. *Id.* at 1240.

79. Network Automation, Inc. v. Advanced Sys. Concepts, Inc., 638 F.3d 1137, 1148 (9th Cir. 2011).

80. *Id.*

81. *Id.* at 1149.

82. *Id.* at 1154.

83. Playboy Enters. v. Netscape Commc'ns Corp., 354 F.3d 1020, 1023 (9th Cir. 2004).

84. *Id.* at 1024.

85. *Id.* at 1026.

of the mark, proximity of the goods, similarity of the goods, type of goods, consumer care expected, and defendant's intent.[86]

In *1-800 Contacts, Inc. v. WhenU.com, Inc.*, a trademark owner sued an Internet marketing company that was using its trademarks in a private list used to trigger pop-up ads on computer users' screens.[87] The court held there was no trademark infringement because the defendant did not "use" plaintiff's trademarks as contemplated by the Lanham Act on its private list or on its pop-up ads, so it did not get to the question of consumer confusion.[88]

In *Rescuecom Corp. v. Google, Inc.*, the Second Circuit distinguished Google's use of plaintiff's trademarks in its keyword advertising program from the marketing company's use in *1-800 Contacts*, holding Google's use constituted "use" as required by the Lanham Act.[89] The court noted *Rescuecom* contrasted sharply with *1-800 Contacts* in two ways: 1) in *Rescuecom*, Google was selling plaintiff's actual trademark to third parties for use as a keyword as opposed to placing its domain name on a private list, and 2) Google displayed, offered, and sold trademarks to third parties, even going so far as to suggest them through its Keyword Suggestion Tool.[90]

A high-end jewelry company sued eBay for both direct and contributory trademark infringement in *Tiffany, Inc. v. eBay, Inc.*[91] The court found eBay not liable on either theory.[92] The court found eBay had taken substantial steps to prevent counterfeiters from selling counterfeit Tiffany merchandise on its site and that eBay had good reason to prevent such action: to preserve the integrity of its site.[93] eBay's use of Tiffany's marks was considered nominative fair use as its goal was to inform consumers it was selling genuine Tiffany merchandise, and the use did not imply false affiliation or endorsement.[94]

Rosetta Stone I held Google was not liable for direct trademark infringement in using trademarks as keyword triggers for paid ads or within the text of the ads.[95] The court granted summary judgment in favor of Google based on its holding that Google's use of plaintiff's trademarks did not constitute a likelihood of consumer confusion.[96] Its decision was based on three important factors: defendant's intent, actual confusion, and consumers' sophistication.[97] The court found that the relevant intent is the intent to confuse, not Google's intent to

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86. *Id.* at 1026-28.
87. 1-800 Contacts, Inc. v. WhenU.com, Inc., 414 F.3d 400, 402 (2d Cir. 2005).
88. *Id.* at 403, 406.
89. Rescuecom Corp. v. Google, Inc., 562 F.3d 123, 127-28 (2d Cir. 2009).
90. *Id.* at 129.
91. Tiffany, Inc. v. eBay, Inc., 600 F.3d 93, 96 (2d Cir. 2010).
92. *Id.*
93. *Id.* at 98.
94. *Id.* at 102-03.
95. *Rosetta Stone I*, 730 F. Supp. 2d 531, 534 (E.D. Va. 2010).
96. *Id.* at 534-35.
97. *Id.* at 541.

profit.[98] Additionally, it found Google could not have intended to pass off its products as Rosetta Stone's because Google does not offer physical products.[99] With respect to the actual confusion factor, the court found Rosetta Stone's evidence of actual confusion de minimis, and those who claimed to be confused were confused about whether their products were real or counterfeit, not about the sponsorship of the products.[100] It also noted confusion over endorsement of a product is not the same as confusion over the source of a product.[101] Finally, the court noted those seeking Rosetta Stone software would be highly sophisticated and unlikely to be confused.[102]

III. VALIDITY OF INITIAL INTEREST CONFUSION DOCTRINE

As trademark cases involving the Internet have developed, they have often relied on the concept of initial interest confusion to find defendants liable for trademark infringement.[103] However, courts have different stances on whether initial interest confusion is a valid doctrine.[104] The Supreme Court has not spoken on the subject of initial interest confusion, particularly as it relates to the Internet, having recently denied certiorari in two cases involving the doctrine.[105]

A. Application of Initial Interest Confusion Doctrine Valid

One line of federal circuit initial interest confusion cases dealing with metatags finds the doctrine can be applied to constitute a likelihood of consumer confusion. In *Brookfield Communications, Inc. v. West Coast Entertainment Corp.*, the court said the likelihood of confusion of source is not as great in metatags cases as it might be in domain name cases because once a consumer has created a website, it is usually clear who operates it.[106] However, initial interest confusion still occurs when consumers are confused as to the sponsorship of the link that first brought them to the website.[107] By using trademarks in metatags to divert consumers to a different website, a defendant is capitalizing on another's

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98. *Id.*

99. *Id.*

100. *Id.* at 543-44.

101. *Id.* at 544.

102. *Id.* at 545.

103. *See, e.g.*, Brookfield Commc'ns, Inc. v. W. Coast Entm't Corp., 174 F.3d 1036, 1063-64 (9th Cir. 1999) (finding the Lanham Act protects against initial interest confusion).

104. *See, e.g.*, Promatek Indus., Ltd. v. Equitrac Corp., 300 F.3d 808, 812-13 (7th Cir. 2002) (finding application of initial interest confusion doctrine valid). *But see, e.g.*, Designer Skin, LLC v. S&L Vitamins, Inc., 560 F. Supp. 2d 811, 820 (D. Ariz. 2008) (finding application of initial interest confusion doctrine invalid).

105. M2 Software, Inc. v. M2 Commc'ns, Inc., 450 F.3d 1378 (Fed. Cir.), *cert. denied*, 549 U.S. 1096 (2006); Gibson Guitar Corp. v. Paul Reed Smith Guitars, LP, 423 F.3d 539 (6th Cir. 2005), *cert. denied*, 547 U.S. 1179 (2006).

106. *Brookfield*, 174 F.3d at 1062.

107. *Id.*

goodwill achieved through development of a mark.[108] The harm is done even if no actual sale was made as a result of the confusion.[109]

The *Brookfield* court based its support of initial interest confusion on several other cases that have found the Lanham Act protects against initial interest confusion.[110] The court also provided an analogy to a more concrete example of initial interest confusion.[111] It compared initial interest confusion on the Internet to a billboard along the interstate directing drivers to a certain video store at the next exit.[112] Although drivers actually find a competing video store at that exit, they are satisfied with it and make their purchases there.[113] Even though they were not confused as to the source of the products when they made their purchases, their initial interest confusion is what diverted them to the competing store in the first place.[114]

The *Brookfield* court recognized fair use as a defense to trademark infringement in initial interest confusion cases.[115] However, in *Brookfield*, the defendant used the plaintiff's marks to attract people to its own website, not to describe plaintiff's products, so fair use did not apply.[116]

In *Promatek Industries, Ltd. v. Equitrac Corp.*, the court defined initial interest confusion as "when a customer is lured to a product by the similarity of the mark, even if the customer realizes the true source of the goods before the sale is consummated."[117] It also noted that initial interest confusion is a function of consumers' degree of care.[118] The important question, the court noted, was not how long the consumer was confused (even if it was for only a second) but the misappropriation of plaintiff's goodwill.[119] The court also recognized the danger of initial interest confusion: Consumers are more likely to mill about the first website they reach (even if in error) before starting another search for the website they initially sought.[120]

The court in *Australian Gold, Inc. v. Hatfield* laid out three ways initial interest confusion could harm a plaintiff: 1) the original diversion to a source the

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108. *Id.*

109. *Id.*

110. *Id.* at 1063-64 (citing Forum Corp. of North Am. v. Forum, Ltd., 903 F.2d 434, 442 (7th Cir. 1990); Securacomm Consulting, Inc. v. Securacom Inc., 984 F. Supp. 286, 298 (D.N.J. 1997); Blockbuster Entm't Group v. Laylco, Inc., 869 F. Supp. 505, 513 (E.D. Mich. 1994); Jordache Enters., Inc. v. Levi Strauss & Co., 841 F. Supp. 506, 514-15 (S.D.N.Y. 1993); Television Enter. Network, Inc. v. Entm't Network, Inc., 630 F. Supp. 244, 247 (D.N.J. 1986)).

111. *Id.* at 1064.

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* at 1065-66.

116. *Id.*

117. Promatek Indus., Ltd. v. Equitrac Corp., 300 F.3d 808, 812 (7th Cir. 2002).

118. *Id.*

119. *Id.* at 812-13.

120. *Id.* at 813.

consumer believes at first is authorized, 2) the effect of that diversion on the consumer's choice to purchase what he thinks is an authorized or related product, and 3) the initial credibility the consumer would attach to the infringer, even if it were based on the plaintiff's goodwill.[121] Additionally, the court noted that "initial interest confusion in the [I]nternet context derives from the unauthorized use of trademarks to divert [I]nternet traffic, thereby capitalizing on a trademark holder's goodwill,"[122] and that initial interest confusion was to be evaluated based on the same factor test (which varies from circuit to circuit) as traditional likelihood of confusion.[123]

Finally, the court noted that some forms of injunctive relief available for traditional trademark infringement, like requiring a statement on defendant's website disclaiming any relation to the plaintiff, would not remedy initial interest confusion.[124] This is because initial interest confusion will already have occurred and the damage will already have been done by the time the consumer reaches defendant's website.[125]

B. Application of Initial Interest Confusion Doctrine Invalid

Another line of federal cases finds that initial interest confusion cannot be applied to constitute likelihood of confusion in trademark infringement cases. In *Trans Union, LLC v. Credit Research, Inc.*, the court disposed of the potential metatags infringement by relying on the fair use doctrine without considering the initial interest confusion doctrine's effects on metatags.[126] This case demonstrates the line of authority that says the fair use doctrine applies when defendant uses another's trademark simply to describe the content of his website.[127] In this case, defendant's use of plaintiff's trademark was considered fair as it described defendant's contractual relationship with plaintiff by stating defendant was "affiliated with" plaintiff.[128]

The *Trans Union* court did, however, approve of the concept of initial interest confusion in reference to domain names and website content.[129] It said consumers looking for plaintiff's services might be drawn to defendant's website because of use of plaintiff's logo and similar domain name.[130] This risk of initial interest confusion tipped the "actual confusion" factor in favor of plaintiff.[131]

In another Internet trademark infringement case brought by Playboy, the

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121. Australian Gold, Inc. v. Hatfield, 436 F.3d 1228, 1239 (10th Cir. 2006).
122. *Id.*
123. *Id.* at 1239-40.
124. *Id.* at 1240.
125. *Id.*
126. Trans Union, LLC v. Credit Research, Inc., 142 F. Supp. 2d 1029, 1039 (N.D. Ill. 2001).
127. *Id.*
128. *Id.* at 1040.
129. *Id.* at 1043-44.
130. *Id.*
131. *Id.*

Southern District of California found defendant's use of plaintiff's trademarks amounted to fair use, but there could be no fair use if there was a likelihood of confusion.[132] Thus, it found there was no likelihood of confusion under plaintiff's initial interest confusion theory.[133] The *Playboy* court distinguished *Brookfield*, saying neither *Brookfield* nor any cases it cited involved the fair use defense or use of trademarks in metatags that fairly describe the content of the site, and *Brookfield* expressly left open the fair use defense.[134]

In *Playboy*, the court also cited *Brookfield*'s discussion of the special nature of confusion in metatags cases and how the traditional eight-factor confusion test would not suffice because it could not be said that consumers would necessarily be confused as to the source of the product at the time of purchase.[135] Thus, the court deemed the relevant factors in initial interest confusion cases to include 1) the confusion is "damaging and wrongful," 2) the confusion would lead to consumer's interest in defendant that he would not have had otherwise, and 3) the confusion offers an opportunity for sale for the defendant that would not otherwise be available.[136] After outlining the important factors, the court concluded that none of them were relevant in *Playboy*.[137]

The court in *Designer Skin, LLC v. S&L Vitamins, Inc.*, negatively cited *Australian Gold* on facts that were nearly identical, saying:

> In this court's view, there is a meaningful distinction between (1) using a mark to attract potential customers to a website that only offers products of the mark holder's competitors and (2) using a mark to attract potential customers to a website that offers the mark holder's genuine products as well as the products of competitors. . . . [I]n the latter situation no "bait and switch" occurs.[138]

The Fourth Circuit, which decided *Rosetta Stone I*, does not have a history of analysis for initial interest confusion in the metatags context; however, it has decided cases involving initial interest confusion in the contexts of domain names and physical products.[139]

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132. Playboy Enters., Inc. v. Terri Welles, Inc., 78 F. Supp. 2d 1066, 1074 (S.D. Cal. 1999).

133. *Id.*

134. *Id.* at 1092-93.

135. *Id.* at 1093-94.

136. *Id.* at 1094.

137. *Id.* at 1095.

138. Designer Skin, LLC v. S&L Vitamins, Inc., 560 F. Supp. 2d 811, 820 (D. Ariz. 2008).

139. *See* Lamparello v. Falwell & Jerry Falwell Ministries, 420 F.3d 309 (4th Cir. 2005) (finding no initial interest confusion in domain name context); PETA v. Doughney, 263 F.3d 359 (4th Cir. 2001) (finding initial interest confusion in domain name context); Sara Lee Corp. v. Kayser-Roth Corp., Civ. No. 6:92CV00460, 1992 WL 436279 (M.D.N.C. Dec. 1, 1992) (finding initial interest confusion in context of actual product).

C. Policy Justifications for Initial Interest Confusion

Although an initial interest confusion analysis differs somewhat from a traditional analysis of the likelihood of consumer confusion, it still is a useful and sometimes necessary tool for promoting the goals of trademark law and ensuring that those who violate it are held liable. Even though the first cases analyzing the validity of initial interest confusion on the Internet did so in the context of website metatags, search engines like Google have evolved since then to use paid keyword advertisements and proprietary algorithms, rather than metatags, to deliver search results to consumers.[140] Still, the metatag analysis is sufficient to cover the keyword ad cases that have become more prevalent. The purpose of both metatags and keyword advertising is to cause a certain link to appear in a particular set of search results, such as the results from searching for a competitor's trademark.[141] "[B]ecause metatags were once used to get a website listed on a search engine, and now companies have circumvented that system by purchasing keyed advertising, the intent of alleged trademark infringers is 'sufficiently analogous' for courts to apply the initial interest confusion doctrine from *Brookfield*."[142]

To understand the validity of the initial interest confusion doctrine, it is helpful to acknowledge its statutory basis. Initial interest confusion is not mentioned in the Lanham Act; however, amendments to the act in 1962 triggered courts' subsequent acceptance of the doctrine.[143] In that year, Congress removed the reference to "purchasers" in the act, which previously had required that "purchasers" be deceived or confused about the origin of a product or service before trademark infringement would be found.[144] According to the Senate report on the amendments, the act applies to potential purchasers as well as to actual purchasers.[145] "Courts properly interpreted the change in the Lanham Act as broadening the concept of trademark infringement to include consideration not only of confusion at the time of sale, but also of confusion that exists prior to the time of sale, and that which emerges after a sale is completed."[146] Thus, in many circuits, a trademark infringement claim can be based on initial interest confusion, even if the confusion is eventually dispelled or no actual sale occurred.[147]

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140. Gregory R. Shoemaker, *Don't Blame Google: Allowing Trademark Infringement Actions Against Competitors Who Purchase Sponsored Links on Internet Search Engines Under the Initial Interest Confusion Doctrine*, 58 CATH. U. L. REV. 535, 563 (2009).

141. *Id.* at 562.

142. *Id.* at 563 (quoting Picture It Sold, Inc. v. iSOLD It, LLC, 199 F. App'x 631, 634 (9th Cir. 2006)).

143. Jennifer E. Rothman, *Initial Interest Confusion: Standing at the Crossroads of Trademark Law*, 27 CARDOZO L. REV. 105, 160 (2005).

144. *Id.*

145. *Id.*

146. *Id.*

147. Note, *Confusion in Cyberspace: Defending and Recalibrating the Initial Interest Confusion Doctrine*, 117 HARV. L. REV. 2387, 2392 (2004) [hereinafter *Confusion in Cyberspace*].

Although the initial interest confusion doctrine originally developed to address alleged infringement offline, different views exist on whether the concept is more or less important in the online context.[148] Many Internet users realize sponsored ads on search engines are not part of their organic search results because these ads are often distinguished on the page.[149] Though courts have assumed confusion is more likely on the Internet because of the speed of linking from one website to another, Internet users' confusion can also be quickly corrected.[150]

> [T]he time and effort it takes to get back into the car, drive back to the freeway and drive around looking for the store they originally intended to go to is far greater than the little time and effort it takes to click on the 'back' button when browsing the web. In other words, the initial interest confusion doctrine makes more sense when applied in a brick-and-mortar case . . . .[151]

These are rational arguments; however, the more convincing view is based on what is perhaps a more subtle difference between trademark infringement online and offline: the origin of the harm to the trademark holder.[152] In offline cases, the competitor gains the consumer's interest that would have gone to the trademark owner because these cases do not involve an active search for a particular trademarked term on the part of the consumer.[153] In online search engine cases that involve a consumer's active search for a trademarked term, the competitor takes from the trademark owner the consumer's interest that the trademark owner already had earned by virtue of the search.[154] This subtle difference in the harm to the trademark owner justifies expanded trademark protection online in the form of the initial interest confusion doctrine. Additionally, the online context provides unique opportunities to competitors to lure consumers to their goods because it is easier to draw consumers away from a trademark owner's website than to physically lure them away from a brick-and-mortar store. Property rights give trademark owners more options in ejecting competitors from their stores, and confusing uses of trademarks online are less likely to cause consumer backlash than confusing uses offline.[155]

A major argument against application of the initial interest confusion doctrine is that it essentially serves as a substitute for the "likelihood of consumer confusion" analysis required by the Lanham Act, allowing trademark owners to

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148. *See generally id.* (arguing initial interest confusion is more important online); Rothman, *supra* note 143 (arguing initial interest confusion is less important online).

149. Rothman, *supra* note 143, at 134.

150. *Id.* at 169.

151. Niki R. Woods, *Initial Interest Confusion In Metatag Cases: The Move from Confusion to Diversion*, 22 BERKELEY TECH. L.J. 393, 401 (2007).

152. *Confusion in Cyberspace*, *supra* note 147, at 2396.

153. *Id*.

154. *Id.*

155. *Id.* at 2396-97.

circumvent the in-depth confusion analysis by simply proving diversion and making it easier on them to prove trademark infringement.[156] Proponents of this view cite two ways courts misapply initial interest confusion: 1) by considering initial interest confusion a presumption in favor of trademark infringement, thus substituting it for consumer confusion, and 2) by allowing initial interest confusion to substitute for evidence of actual confusion, weakening the traditional confusion analysis.[157] Essentially, these courts have lowered the standard for trademark infringement from confusion to mere diversion.[158] While this analysis might have merit in some cases, it does not apply in *Rosetta Stone II*. Congressional reports indicate the purpose of the Lanham Act is to protect the public from confusion *and deception*.[159] While mere diversion might normally be well within a competitor's rights, particularly for the sake of fair competition, diversion through deceit and misrepresentation violates the Act.[160] In *Rosetta Stone II*, the plaintiff's primary concern was Google's allowance of the use of its trademarks by *counterfeiters* trying to pass off their own products as genuine Rosetta Stone products.[161] This use rises beyond fair competition to deceit.

> Baiting and switching is a legitimate concern. If consumers are misled into believing that a product is made by one company when in truth it is not and as a result expend significant time and effort to purchase the deceptive product, then it matters little that the confusion is ultimately cleared up prior to the time of purchase.[162]

The initial interest confusion doctrine comports with the goals of trademark law, namely, to reduce consumers' search costs and protect trademark owners' goodwill.[163] The doctrine can promote these ends while refraining from limiting fair competition and giving trademark owners a monopoly over their marks. One way to understand initial interest confusion's impact on consumers is to conduct a cost-benefit analysis.[164] A trademark owner's incentive to provide online services or information on a website for consumers to access is diminished when a portion of those consumers are being diverted to a competitor's website.[165] Whether the diversion is lawful or not, the trademark owner likely will either shift resources from its online operations that are no longer as profitable because of the diversion, or he will shift more resources to the promotional aspects of his website in order to combat the diversion, leaving fewer resources for the

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156. Woods, *supra* note 151, at 393.
157. *Id.* at 405.
158. *Id.* at 407.
159. Rothman, *supra* note 143, at 123-24.
160. *Id.* at 124.
161. *Rosetta Stone II*, 676 F.3d 144, 152 (4th Cir. 2012).
162. Rothman, *supra* note 143, at 161-62.
163. *Confusion in Cyberspace*, *supra* note 147, at 2400-05.
164. *Id.*
165. *Id.* at 2401.

functional aspects of his website.[166] Either way, the consumer loses out on online content. The costs to consumers outweigh the benefits competitors receive by using others' trademarks.

Initial interest confusion also increases consumers' search costs.[167] By performing an online search for a trademark rather than a generic term, a consumer is choosing to limit results to one specific producer. Although the consumer probably will eventually reach the website for which he was looking, he first must dig through the results by competitors for which he was not looking, increasing the time and effort needed to complete his task.[168]

Opponents of initial interest confusion argue that the threat of trademark infringement based on the doctrine would chill competitive Internet activity, leaving consumers with less information overall.[169] These opponents argue that those who type a particular trademark into a search engine might be looking for a list of similar products.[170] However, in most cases a consumer looking for a product without regard for its brand would search in generic terms that would not include a trademark. Although the trademark owner's website might be among the search results—and likely will be the first result if the consumer searched for the trademarked term—sponsored ads that are not clearly marked as such still will make it difficult for consumers to find the trademark owner's site.

Another goal of trademark law is to protect the goodwill a business has built in association with its trademarks.[171] Although fair competition is desirable, competition achieved through deceit, as in *Rosetta Stone II*, is barred by the Lanham Act.[172] The initial interest confusion doctrine helps trademark owners pursue claims against those who would deceitfully harm their goodwill.[173] "Trademark law requires a balancing not just of consumer confusion and protection of a trademark holder's goodwill, but also consideration of the legitimate interests of competing businesses."[174] It is this idea that refuses to give trademark owners monopolies over their marks; trademarks are not property themselves, as are copyrighted or patented works, but rather give to their holders limited rights.[175] One of those rights encompasses protection of goodwill from competitors who would deceitfully harm it, as did the counterfeiters in *Rosetta Stone II*.

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166. *Id.* at 2402.
167. *Id.* at 2406.
168. *Id.* at 2406-07.
169. Woods, *supra* note 151, at 416.
170. *Id.*
171. *Confusion in Cyberspace*, *supra* note 147, at 2400-05.
172. Rothman, *supra* note 143, at 164.
173. *Id.*
174. *Id.*
175. *Id.* at 166.

IV. APPLICATION OF INITIAL INTEREST CONFUSION TO *ROSETTA STONE II* ANALYSIS

In *Rosetta Stone II*, one of the first cases involving alleged trademark infringement by a search engine in its ad program keywords, the Fourth Circuit correctly decided there was a likelihood of confusion based on initial interest confusion.[176]

In the case, Rosetta Stone, maker of language learning software, sued Google, a search engine, for allowing advertisers to use Rosetta Stone's trademarks as keywords to trigger their own paid advertisements and in the text of those ads.[177] Rosetta Stone contended that after Google changed its policy to allow this, it had been plagued with counterfeiters (reporting 190 instances between September 2009 and March 2010) who were able to market their counterfeit goods by taking advantage of Google's new policy.[178] The district court granted summary judgment to Google on the issue of direct infringement.[179] The Fourth Circuit vacated this judgment, finding that a reasonable trier of fact could find a genuine issue of material fact as to whether there was a likelihood of confusion.[180]

A. Fourth Circuit Reliance on Initial Interest Confusion

Although not mentioning the doctrine by name, the Fourth Circuit's argument for a likelihood of confusion centers on initial interest confusion.[181] According to the court, it could be found that Google intended to cause confusion based on the studies it conducted prior to changing its AdWords policy that showed significant source confusion when trademarks were included in the title or body of the ad.[182] Google changed its policy anyway based on projected increased revenue.[183]

The court also found evidence of actual confusion sufficient to withstand summary judgment based on buyer testimony, Google studies, and an expert report.[184] Five consumers allowed to testify bought counterfeit Rosetta Stone software after seeing a Google ad and later called Rosetta Stone directly to complain that the software did not work.[185] Although the district court dismissed this evidence because the buyers knew before they purchased the software that they were not purchasing it from Rosetta Stone directly, the Fourth Circuit said source confusion is not the only concern; sponsorship, affiliation, and connection

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176. *Rosetta Stone II*, 676 F.3d 144, 160 (4th Cir. 2012).
177. *Id*. at 151-52.
178. *Id.* at 152.
179. *Rosetta Stone I*, 730 F. Supp. 2d 531, 535 (E.D. Va. 2010).
180. *Rosetta Stone II*, 676 F.3d at 149-50.
181. *Id.* at 155-60.
182. *Id.* at 156.
183. *Id.*
184. *Id.* at 156-59.
185. *Id.* at 156.

confusion is also relevant.[186] The court also noted that Google's policy against advertising counterfeit goods was not relevant in the case because consumers are not privy to the policy; the issue is whether they are actually confused.[187] In its final word on actual confusion, the court said five confused consumers was not de minimis when only five were allowed to testify.[188] Rosetta Stone presented evidence of 123 complaints from buyers of counterfeit software from April 2009 through December 2009 and 139 complaints from December 2009 through March 2010.[189]

In addition to consumer testimony, Google's own studies and testimony showed actual confusion.[190] One study recommended the only effective policy would be to allow trademark usage for keywords but not in the ad copy.[191] Additionally, Google's own trademark lawyers testified that they were unable to determine without more research which links were to actual Rosetta Stone products when shown a page of search results for "Rosetta Stone."[192] The court said mere uncertainty of the origin of a product is quintessential evidence of actual confusion.[193]

Finally, Rosetta Stone presented an expert report showing a significant number of purchasers were likely to be confused and about seventeen percent actually were confused.[194] Additional evidence presented showed that even well-educated, sophisticated consumers were confused by the nature of Google's sponsored ads and sometimes did not even realize they were ads.[195]

Although many federal cases considering the validity of the initial interest confusion doctrine in Internet contexts have decided in favor of defendants under the fair use doctrine, the Fourth Circuit in *Rosetta Stone II* did not discuss the viability of a fair use defense or whether that would alter the likelihood of confusion test.[196] The court did, however, suggest that Google's use of the Rosetta Stone marks might be nominative in nature.[197]

B. Rosetta Stone II *Distinguished from Cases Against Initial Interest Confusion's Validity*

Rosetta Stone II can be distinguished from cases arguing against initial interest confusion as a basis for likelihood of confusion. In *Trans Union*, the

186. *Id.* at 157.
187. *Id.*
188. *Id.* at 158.
189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.* at 158-59.
193. *Id.*
194. *Id.* at 159.
195. *Id.* at 160.
196. *Id.* at 155.
197. *Id.*

court did not consider the impact of initial interest confusion on metatags because it said defendant's use was fair use based on its contractual relationship with the plaintiff.[198] No such relationship existed in *Rosetta Stone II*.[199] As far as domain names and logos, the *Trans Union* court found that initial interest confusion *does* tip the scale toward likelihood of confusion.[200]

Playboy also involved a fair use defense that was not considered in *Rosetta Stone II*.[201] However, the facts of *Rosetta Stone II* comport with the *Playboy* court's analysis of the most important factors in finding initial interest confusion: 1) the confusion was "damaging and wrongful" as evidenced by the discussion of Google's intent, 2) the confusion created an interest in the counterfeiters that consumers would not have had but for seeing the Google ads, and 3) the confusion ultimately led to opportunities for the counterfeiters to sell their goods, as evidenced by the fact that Rosetta Stone was inundated with counterfeit complaints once Google changed its policy.[202]

Finally, *Rosetta Stone* falls under the first instance in the critical difference articulated in *Designer Skin*'s "bait and switch" analysis: The counterfeiters using Google's ad services used Rosetta Stone's mark to attract potential customers to websites offering only counterfeit products.[203]

CONCLUSION

Rosetta Stone II correctly emphasized the importance of initial interest confusion despite other courts' failure to find evidence of it or diminishing its importance in trademark infringement cases, particularly in the context of domain names. This emphasis likely is what will make *Rosetta Stone II* the case that opens the door for more litigation in this new context and should serve as guidance in future cases.

Courts have long recognized the concept of initial interest confusion, and many have approved it in the context of domain names and metatags. It is a natural extension to include in this context advertising keywords, which have quickly become the foundation on which profitable search engines are built. The dangers of deceitfully capturing another's goodwill in the keyword advertising context are high, as consumers can be quickly and easily diverted from one search result or web page to another. The Internet's far-reaching influence on business and consumer strategies and behavior makes it even more profitable for would-be infringers to trade in on a competitor's goodwill and makes it more possible for consumers, whether sophisticated or not, to become confused by deceitful practices online.

If courts do not arrive at the correct decisions in this new and complex

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198. Trans Union, LLC v. Credit Research, Inc., 142 F. Supp. 2d 1029, 1039 (N.D. Ill. 2001).

199. *Rosetta Stone II*, 676 F.3d 144.

200. *Trans Union*, 142 F. Supp. 2d at 1043-44.

201. Playboy Enters., Inc. v. Terri Welles, Inc., 78 F. Supp. 2d 1066, 1092 (S.D. Cal. 1999).

202. *Id.* at 1094-95.

203. Designer Skin, LLC v. S&L Vitamins, Inc., 560 F. Supp. 2d 811, 820 (D. Ariz. 2008).

context, the ramifications could be felt throughout the business sector. Consumers will spend more time searching online for what once would have been an easy find, and businesses will hesitate to offer comprehensive online services for fear that they will be taken advantage of by their competitors. At the end of the day, it will stall progress and growth in the way consumers and businesses interact.

Perhaps even more importantly, *Rosetta Stone II* and future cases that rely on its reasoning will ensure that the dual goals of trademark law continue to be met: to reduce consumers' search costs and protect trademark owners' goodwill. While healthy competition among businesses is desirable, achieving competitiveness through deceitful practices harms both consumers and businesses and goes against the longstanding function of trademark law.

NO GOOD DEED: THE IMPROPRIETY OF THE RELIGIOUS ACCOMMODATION OF CONTRACEPTIVE COVERAGE REQUIREMENTS IN THE PATIENT PROTECTION AND AFFORDABLE CARE ACT

ROSE SHINGLEDECKER*

INTRODUCTION

On March 23, 2010, the 111th Congress enacted the Patient Protection and Affordable Care Act (PPACA),[1] dramatically expanding Americans' access to health insurance coverage. Along with other provisions, the PPACA requires employers with fifty or more employees to provide health insurance benefits to their employees.[2] Under the Women's Health Amendment (WHA),[3] these group health plans must provide a minimal level of coverage, including certain "preventive care and screenings" for women.[4] The covered preventive care services are delineated in comprehensive guidelines promulgated by the Health Resources and Services Administration.[5] These guidelines include well-woman visits, screening for gestational diabetes, breastfeeding support and counseling, and screening and counseling for interpersonal and domestic violence.[6]

More controversially, plans must include coverage for all Food and Drug Administration-approved contraceptive methods, sterilization procedures, and associated counseling.[7] In response to public outcry from groups that oppose contraceptive and sterilization services for religious reasons, the Department of

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1. Pub. L. No. 111-148, 124 Stat. 119 (2010).
2. 26 U.S.C. § 4980H(c)(2)(A) (Supp. 2011).
3. 42 U.S.C. § 300gg-13(a) (Supp. 2011).
4. *Id.* § 300gg-13(a)(4). More comprehensively, regarding preventive care, § 300gg-13(a) provides:

> "[a] group health plan and a health insurance issuer offering group or individual health insurance coverage shall, at a minimum provide coverage for and shall not impose any cost sharing requirements for—
> (1) evidence-based items or services that have in effect a rating of "A" or "B" in the current recommendations of the United States Preventive Services Task Force; . . .
> (4) with respect to women, such additional preventive care and screenings not described in paragraph (1) as provided for in comprehensive guidelines supported by the Health Resources and Services Administration for purposes of this paragraph."

5. *Id.*
6. *Affordable Care Act Rules on Expanding Access to Preventive Services for Women*, U.S. DEP'T OF HEALTH & HUMAN SERV. (Aug. 1, 2011), http://www.hhs.gov/healthcare/facts/factsheets/2011/08/womensprevention08012011a.html [hereinafter *Affordable Care Act Rules*].
7. *Id.*

Health and Human Services (HHS) adopted a narrow religious exemption to the contraceptive services coverage provision.[8] However, numerous non-exempt religious employers have challenged the HHS rule requiring coverage of contraception in employer group health plans on the grounds that the regulation violates the First Amendment and the Religious Freedom and Restoration Act by requiring employers to violate their religious beliefs.[9]

This Note argues that HHS's religious exemption was unnecessary and misguided. First, the broad requirement that all employers provide health insurance benefits that include contraception services in the minimum level of coverage does not violate the Free Exercise clause of the First Amendment or the Religious Freedom and Restoration Act. Second, the exemption makes the regulation vulnerable to the very First Amendment challenges it seeks to avoid. As the saying goes, no good deed goes unpunished.

I. BACKGROUND: THE RELIGIOUS EXEMPTION, CONCEPTION TO BIRTH

A. The Women's Health Amendment

On December 3, 2009, the U.S. Senate passed by a 61-39 vote Senator Barbara Mikulski's (D-Md.) Women's Health Amendment (WHA),[10] which expanded the PPACA's minimum insurance coverage requirements.[11] The WHA requires an employer's group health plan to provide a minimal level of coverage—without any cost-sharing—for women's preventive care and screenings.[12] The WHA does not specify which preventive care and screenings are covered.[13] Rather, it designates the Health Resources and Services Administration (HRSA), an HHS agency, to identify the covered preventive services.[14] Senators debating the WHA expressly contemplated including contraception and family planning among the covered services.[15] However, the

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8. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(4) (2012). (The language referenced in this citation has since been amended, but it is still accessible at http://www.law.cornell.edu/cfr/text/45/147.130.)

9. *See* Laurie Goodstein, *Bishops Sue Over Contraception Mandate*, N.Y. TIMES, May 22, 2012, at A17.

10. Press Release, Senator Barbara A. Mikulski, Senate Approves Mikulski Amendment Making Women's Preventive Care Affordable and Accessible (Dec. 3, 2009), http://www.mikulski.senate.gov/media/pressrelease/12-03-2009.cfm.

11. *See* Chad Brooker, Comment, *Making Contraception Easier to Swallow: Background and Religious Challenges to the HHS Rule Mandating Coverage of Contraceptives*, 12 U. MD. L.J. RACE, RELIGION, GENDER & CLASS 169, 184 (2012).

12. 42 U.S.C. § 300gg-13(a)(4) (Supp. 2011).

13. *Id.*

14. *Id.* (stating that additional preventive care and screenings are "provided for in comprehensive guidelines supported by the Health Resources and Services Administration").

15. Brooker, *supra* note 11, at 186-88.

extent of the covered services remained unclear for nearly twenty months.[16]

B. The Department of Health & Human Services Rule

On July 19, 2010, HHS issued an interim final rule (IFR),[17] which stated that guidelines for required women's preventive services would be issued by August 1, 2011.[18] For input on additional preventive services for women, the HRSA turned to the Institute of Medicine (IOM).[19] IOM is an independent, nonprofit organization founded in 1970 to advise Congress, federal agencies, and other organizations on medical issues.[20] In a July 2011 report, IOM issued recommendations that HHS should include, among other services, the "full range of Food and Drug Administration-approved contraceptive methods, sterilization procedures, and patient education and counseling for women with reproductive capacity."[21] HHS adopted IOM's recommendations, including the contraception recommendations, on August 1, 2011.[22]

C. The Religious Exemption

When HHS adopted IOM's recommendations, HHS also amended the IFR to provide a narrow religious exemption to the contraception coverage requirements.[23] The amended regulations created an automatic exemption for certain categories of employers with religious objections to contraceptive use.[24] A qualifying employer:

> (1) has the inculcation of religious values as its purpose;
> (2) primarily employs persons who share its religious tenets;
> (3) primarily serves persons who share its religious tenets; and
> (4) is a non-profit organization under section 6033(a)(1) and section

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16. *See infra* Part I.B.

17. *See* Interim Final Rules for Group Health Plans and Health Insurance Issuers Relating to Coverage of Preventive Services Under the Patient Protection and Affordable Care Act, 75 Fed. Reg. 41,726 (July 19, 2010). The proposed rule was issued by HHS, in conjunction with the departments of the Treasury and Labor. For simplicity, this Note refers to the rules as originating from HHS.

18. *Id.* at 41728.

19. *Affordable Care Act Rules*, *supra* note 6.

20. *About the IOM*, INST. OF MED., http://www.iom.edu/About-IOM.aspx (last updated Nov. 4, 2013).

21. *Recommendations for Preventive Services for Women that Should be Considered by HHS*, INST. OF MED. (July 19, 2011), http://www.iom.edu/Reports/2011/Clinical-Preventive-Services-for-Women-Closing-the-Gaps/Recommendations.aspx.

22. *Affordable Care Act Rules*, *supra* note 6.

23. Group Health Plans and Health Insurance Issuers Relating to Coverage of Preventive Services Under the Patient Protection and Affordable Care Act, 76 Fed. Reg. 46,621 (Aug. 3, 2011) [hereinafter Interim Final Rules].

24. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(4) (2012).

6033(a)(3)(A)(i) or (iii) of the Code.[25]

Section 6033(a)(3)(A)(i) and (iii) refer to churches, their integrated auxiliaries, and conventions or associations of churches, as well as to the exclusively religious activities of any religious order.[26]

In adopting the religious employer definition, HHS's stated goal was "to reasonably balance the extension of any coverage of contraceptive services . . . to as many women as possible, while respecting the unique relationship between certain religious employers and their employees in certain religious positions."[27] Moreover, HHS explicitly modeled this definition of religious employer on existing state laws that require employer-sponsored health plans to cover contraceptive services.[28] Although the IFR fails to specify which states provided the model, the highest courts in New York and California have upheld the constitutionality of nearly identical exemptions to contraceptive coverage laws in their respective states.[29] Comments regarding the amendment were accepted through September 30, 2011.[30]

D. Response & Criticism

HHS received more than 200,000 responses to the request for comments on the interim regulations.[31] The narrowness of the exemption drew criticism from a variety of groups, particularly organizations that, although affiliated with a church or other religious sect, would not likely be considered a religious organization under the rule.[32] One commentator speculated that "Catholic

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25. *Id.*

26. 26 U.S.C. §§ 6033(a)(3)(A)(i), (iii) (2006); *see also* Interim Final Rules, *supra* note 23, at 46,623.

27. Interim Final Rules, *supra* note 23, at 46623.

28. *Id*. ("The definition of religious employer, as set forth in the amended regulations, is based on existing definitions used by most States that exempt certain religious employers from having to comply with State law requirements to cover contraceptive services.").

29. *See* Catholic Charities of the Diocese of Albany v. Serio, 7 N.Y.3d 510, 521 (2006) (holding that the religious freedoms of plaintiffs of eight Catholic and two Baptist organizations that did not qualify for a narrow religious exemption from a New York law requiring employers to provide insurance coverage for contraception, were not violated); Catholic Charities of Sacramento, Inc. v. Super. Ct., 10 Cal. Rptr. 3d 283, 290 (2004) (holding that a California law requiring employer-sponsored health plans to cover contraceptive services did not violate the religious freedoms of a large Catholic employer that did not qualify for a narrow religious exemption).

30. Interim Final Rules, *supra* note 23, at 46,621.

31. Group Health Plans and Health Insurance Issuers Relating to Coverage of Preventive Services Under the Patient Protection and Affordable Care Act, 77 Fed. Reg. 8725, 8726 (Feb. 15, 2012) [hereinafter Final Rule].

32. *See, e.g.*, Press Release, Rev. Larry Snyder, President, Catholic Charities USA (Jan. 20, 2012), http://www.scribd.com/doc/111046521/Statement-From-CCUSA-on-Health-Care-Contraception-1-20-12 ("With the existing restrictive definition in this mandate, the ministry of

hospitals, food banks, homeless shelters, most Catholic schools, and . . . Catholic business owners" (as well as non-Catholic but similar organizations associated with a religious group) likely would not qualify for the exemption.[33] Specifically, large religious non-profit hospitals, though religious in ownership or management, do not qualify as "churches, their integrated auxiliaries, and conventions or associations of churches," thus violating section four.[34]

E. The Final Rule

In February 2012, HHS adopted the IFR without change to the religious exemption criteria, effective for all non-grandfathered plans on August 1, 2012.[35] HHS noted that it "carefully considered whether to eliminate the religious employer exemption or to adopt an alternative definition of religious employer," but decided to retain the four-pronged religious employer definition from the August 2011 ruling.[36]

However, despite HHS's claims that the February regulations "finalize, without change, [the] interim final regulations,"[37] HHS simultaneously created a temporary safe harbor for certain non-exempt employers.[38] The safe harbor extends the compliance deadline to August 1, 2013, for those non-exempted, non-profit employers that object for religious reasons to contraceptive services but do not meet the religious employer definition.[39] During this time, HHS pledged to "work with stakeholders to develop alternative ways of providing contraceptive coverage without cost sharing. "[40] HSS's expressed goals for the safe harbor period were two-fold: "providing contraceptive coverage without cost-sharing to individuals who want it and accommodating non-exempted, non-profit organizations' religious objections to covering contraceptive services."[41]

Jesus Christ himself would not be considered a religious entity.").

33. Edward Whelan, *The HHS Contraception Mandate vs. the Religious Freedom Restoration Act*, 87 NOTRE DAME L. REV. 2179, 2180 (2012).

34. 26 U.S.C. § 6033(a)(3)(A)(i) (2006); 45 C.F.R. § 147.130(a)(1)(iv)(B)(4) (2012).

35. Final Rule, *supra* note 31, at 8725.

36. *Id.* at 8727.

37. *Id.*, at 8725.

38. *Id.* at 8727.

39. Bulletin, Dep't Health & Human Serv., Guidance on the Temporary Enforcement Safe Harbor for Certain Employers, Group Health Plans and Group Health Insurance Issuers with Respect to the Requirement to Cover Contraceptive Services Without Cost Sharing Under Section 2713 of the Public Health Service Act, Section 715(a)(1) of the Employee Retirement Income Security Act, and Section 9815(a)(1) of the Internal Revenue Code (June 28, 2013), http://www.cms.gov/CCIIO/Resources/Regulations-and-Guidance/Downloads/preventive-services-guidance-6-28-2013.pdf.

40. Final Rule, *supra* note 31, at 8728.

41. *Id.* at 8727.

F. Proposed Accommodation

On March 21, 2012, HHS issued an advance notice of proposed rulemaking (ANPRM) and requested comment until June 19, 2012.[42] In the ANPRM, HHS delineated an accommodation designed to maintain employees' access to contraception while protecting religious organizations "from having to contract, arrange, or pay for contraceptive coverage."[43] The compromise permits the issuer of a non-exempt religious employer's insurance plan (i.e. the employer's insurance company) to exclude contraception from covered services.[44] The issuer would then issue directly to the employee, without additional cost, a separate plan to cover contraceptive services.[45] As the proposal explains:

> This means that contraceptive coverage would not be included in the plan document, contract, or premium charged to the religious organization. Instead, the issuer would be required to provide participants and beneficiaries covered under the plan separate coverage for contraceptive services, potentially as excepted benefits, without cost sharing, and notify plan participants and beneficiaries of its availability. The issuer could not charge a premium to the religious organization or plan participants or beneficiaries for the contraceptive coverage.[46]

Essentially, the proposed compromise shifts the cost of contraceptive coverage from the employer to the insurance company that issues the employer's plan. HHS reasons that costs can reasonably be shifted to insurance carriers because "[a]ctuaries and experts have found that coverage of contraceptives is at least cost neutral, and may save money, when taking into account all costs and benefits for the issuer."[47] Contraceptive coverage is theoretically cost-neutral for insurance companies because the up-front cost of providing contraceptive coverage is offset by long-term savings in the cost of covering pregnancy and birth.[48] However, financial experts dispute the cost-neutrality of contraceptive coverage.[49]

G. Response to Proposed Compromise & Current Litigation

HHS's February 2012 rule and March 2012 proposed compromise were met with resistance. On May 21, 2012, forty-three Catholic organizations filed a total of twelve lawsuits challenging the inclusion of coverage for contraception within

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42. Certain Preventive Services Under the Affordable Care Act, 77 Fed. Reg. 16,501 (Mar. 21, 2012).

43. *Id.* at 16,503.

44. *Id.* at 16,505.

45. *Id.*

46. *Id.*

47. *Id.* at 16,503.

48. *Id.*

49. Ben Finley, *Cloudy Contraception Costs*, FACTCHECK.ORG (Feb. 24, 2012), http://www.factcheck.org/2012/02/cloudy-contraception-costs/.

the HHS guidelines.[50] The suits contend that HHS's rule violates the plaintiffs' Free Speech, Free Exercise, and Establishment Clause rights under the First Amendment, the Religious Freedom Restoration Act (RFRA), and the Administrative Procedure Act.[51] The Catholic cases joined eleven complaints previously filed on behalf of religious organizations and employers.[52] At the time this Note was written, forty-eight cases representing more than 140 plaintiffs have been filed,[53] many supported by non-profit organizations such as The Becket Fund for Religious Liberty and the Thomas More Law Center (a non-profit law firm dedicated in part to defending religious freedom).[54] These cases—in which the plaintiffs include both non-profit religious organizations and for-profit business owners whose religious beliefs do not permit the use of contraceptives—are progressing through the federal court system with mixed results.[55] Of the twelve Catholic cases filed on May 21, 2012, courts dismissed two cases for lack of standing because HHS announced an intention to work with religious employers during the safe harbor period.[56] In cases brought by for-profit plaintiffs (who were not granted safe harbor and thus subject to the IFR beginning August 1, 2012), court opinions have also diverged.[57] In the Seventh and Eighth circuits, courts have granted the for-profit employers injunctive relief from compliance with the regulation, while courts in the Sixth and Tenth circuits denied it.[58] Most recently, the U.S. Supreme Court denied Hobby Lobby, an

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50. *See* Goodstein, *supra* note 9.

51. *See, e.g.*, Complaint & Demand for Jury Trial, Univ. of Notre Dame v. Sebelius, No. 3:12CV253, 2012 WL 1859163 (N.D. Ind. May 21, 2012) [hereinafter Notre Dame Complaint]. The same law firm, Jones Day, represents the plaintiffs in all twelve lawsuits filed by Catholic entities on May 21, 2012; thus, the complaints are substantially similar in structure and content. *See HHS Information Central*, THE BECKET FUND FOR RELIGIOUS LIBERTY, http://www.becketfund.org/hhsinformationcentral/ (last visited May 12, 2014) [hereinafter *HHS Information Central*].

52. *HHS Information Central*, *supra* note 51 (comprehensively mapping and tracking current lawsuits challenging the IFR).

53. *Id.*

54. *Id.*

55. *Id.*

56. Univ. of Notre Dame v. Sebelius, No. 3:12CV253RLM, 2012 WL 6756332, at *1, *4 (N.D. Ind. Dec. 31, 2012) (holding that, because "HHS announced that it would amend the regulations before the end of the safe harbor to accommodate those entities by requiring their insurers to provide cost-free coverage for the contraceptive and abortion-related services," Notre Dame lacked standing to attack the regulatory requirement); Zubik v. Sebelius, 911 F. Supp. 2d 314, 318 (W.D. Pa. 2012) (same).

57. *HHS Information Central*, *supra* note 51.

58. Hobby Lobby Stores, Inc. v. Sebelius, 133 S. Ct. 641, 642 (2012) ("the Court of Appeals for the Tenth Circuit denied the applicants' motion for an injunction pending resolution of the appeal"); Order, O'Brien v. U.S. Dep't Health & Human Servs., No. 4:12-CV-00476-CEJ (8th Cir. Nov. 28, 2012), *available at* http://c0391070.cdn2.cloudfiles.rackspacecloud.com/pdf/8th-circuit-order-granting-temporary-injunction-in-obrien-v-hhs.pdf (granting, without opinion, plaintiff's motion for stay pending appeal); Korte v. Sebelius, No. 12-3841, 2012 WL 6757353, at *4-5 (7th

Eleventh Circuit for-profit plaintiff, application for an injunction pending appellate review.[59]

H. 2013 Proposed Changes—New Definition & Accommodation

On February 6, 2013, HHS proposed two changes to the contraceptive coverage requirement: amendment of the religious employer definition and adoption of the cost-sharing compromise.[60] First, HHS proposed to strike the first three criteria from the religious employer exemption.[61] No longer would a religious organization need to show that it (1) has "the inculcation of religious values as its purpose," (2) "primarily employs persons who share the religious tenets of the organization," or (3) "serves primarily persons who share the religious tenets of the organization."[62] As a result, a religious employer "that is organized and operates as a nonprofit entity and referred to in section 6033(a)(3)(A)(i) or (iii) of the Code would be considered a religious employer for purposes of the religious employer exemption."[63] Again, the applicable code sections refer to "churches, their integrated auxiliaries, and conventions or associations of churches."[64]

As HHS notes, however, the change would not "expand the universe of employer plans that would qualify for the exemption beyond that which was intended in the 2012 final rules."[65] Rather, HHS states that the exemption was always intended to apply to "group health plans of houses of worship that provide educational, charitable, or social services to their communities."[66] These organizations, such as "a church [that] maintains a soup kitchen that provides free meals to low-income individuals irrespective of their religious faiths," likely would have failed the third prong of the test (primarily serves persons who share

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Cir. Dec. 28, 2012) (holding that plaintiffs, Catholic owners of a construction company, demonstrated reasonable likelihood of success on their claims and irreparable harm such that "the balance of harms tips strongly in the [plaintiffs'] favor" for granting an injunction pending appeal); Order, Autocam Corp. v. Sebelius, No. 12-2673, at 2 (6th Cir. Dec. 28, 2012), *available at* http://www.becketfund.org/wp-content/uploads/2012/05/order-denying-injunctionAutocam-CA6.pdf (denying plaintiffs' motion for injunction pending appeal because "plaintiffs have not demonstrated more than a possibility of relief").

59. *Hobby Lobby*, 133 S. Ct. at 643 (holding that plaintiffs, operators of for-profit corporations with Christian leadership, "do not satisfy the demanding standard for the extraordinary relief they seek").

60. Coverage of Certain Preventive Services Under the Affordable Care Act, 78 Fed. Reg. 8456, 8456-57 (Feb. 6, 2013) [hereinafter Proposed Rules].

61. *Id.* at 8461.

62. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(3) (2012).

63. Proposed Rules, *supra* note 60, at 8461.

64. 26 U.S.C. § 6033(a)(3)(A)(i) (2006).

65. Proposed Rules, *supra* note 60, at 8461.

66. *Id.*

its religious tenets).[67] Because that was not the intention, HHS proposed to strike the first three criteria.[68] As a result, organizations operated directly by a church, such as the soup kitchen or a church-run parochial school, would be automatically exempt.[69] But large religiously-affiliated organizations, such as non-profit Catholic hospitals, still no longer qualify under the preserved fourth prong. The proposed definition would still "focus the religious employer exemption on the unique relationship between a house of worship and its employees in ministerial positions."[70]

Second, HHS officially proposed that it establish an "accommodation" for non-exempt religious employers who object for religious reasons to contraceptive services.[71] The accommodation, first outlined in the March 2012 ANPRM, creates an arrangement in which a non-exempt religious employer's insurance company offers directly to employees a separate contraceptive services plan.[72] This insulates the employer from "contracting, arranging, paying, or referring" for contraceptive coverage.[73] Although the February 2013 proposed rules give additional detail beyond the ANPRM, the accommodation essentially operates the same way; it shifts the cost of contraceptive coverage from the employer to the insurance company.[74]

II. THE DEBATE

A. Contraception—Use, Benefits, and Costs

The WHA was introduced "to guarantee women access to preventive health care screenings and care at no cost."[75] In introducing the WHA, Senator Mikulski expressed concern about the large gender disparities in health care services costs:

> Women are often confronted by the punitive practices of insurance companies. We face gender discrimination. We pay more and get less . . . A 40-year-old woman is charged anywhere from two to 140 percent more than a 40-year-old man with the same health status for the same insurance policy. A 25-year-old woman is charged up to 45 percent more than a 25-year-old man.[76]

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67. *Id.*.
68. *Id.*
69. *Id.*
70. *Id.* (internal quotation marks and citation omitted).
71. *Id.*
72. *Id.*
73. *Id.* at 8462.
74. *Id.* at 8463.
75. Press Release, Senator Barbara A. Mikulski, Mikulski Puts Women First in Health Care Reform Debate (Nov. 30, 2009), http://www.mikulski.senate.gov/media/pressrelease/11-30-2009-2.cfm [hereinafter Mikulski Press Release].
76. *Id.*

As HHS notes, "owing to reproductive and sex-specific conditions, women use preventive services more than men, generating significant out-of-pocket expenses for women."[77] The HHS rule and the WHA aim to eliminate these gender-based cost disparities.[78]

For consumers of contraception, the cost of coverage varies widely by the type of contraception used.[79] One article found that the cost of common contraception methods varied from $60 to $600 per year.[80] Another study found that the highest potential cost of the most commonly used contraceptive methods ranges from $200 to $1210 per year for consumers without insurance.[81] The same study estimates that costs with insurance are considerably lower and more uniform, ranging from $100 to $215 per year.[82] Partly because of contraceptive costs, women of reproductive age spend sixty-eight percent more than men on out-of-pocket health care costs.[83]

Contraceptive use is very common among American women—ninety-eight percent of all women who have had intercourse have used at least some form of contraception at some time.[84] In addition to common use, IOM included contraceptives in the recommended covered services to help "reduce the rate of unintended pregnancies."[85] Studies show that:

> Women with unintended pregnancies are more likely to receive delayed or no prenatal care and to smoke, consume alcohol, be depressed, and experience domestic violence during pregnancy. Unintended pregnancy also increases the risk of babies being born preterm or at a low birth weight, both of which raise their chances of health and developmental problems.[86]

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77. Final Rule, *supra* note 31, at 8728.

78. *Id.* at 8729 ("The contraceptive coverage requirement is . . . designed to serve . . . compelling public health and gender equity goals . . .").

79. Kimberly Palmer, *The Real Cost of Birth Control*, U.S. NEWS & WORLD REP. ALPHA CONSUMER BLOG (Mar. 5, 2012), http://money.usnews.com/money/blogs/alpha-consumer/2012/03/05/the-real-cost-of-birth-control.

80. *Id.*

81. *The High Costs of Birth Control*, CENTER FOR AM. PROGRESS (Feb. 15, 2012) http://www.americanprogress.org/wp-content/uploads/issues/2012/02/pdf/BC_costs.pdf.

82. *Id.* at 2.

83. *Id.* at 1.

84. WILLIAM D. MOSHER, PH.D. ET AL., CTRS. FOR DISEASE CONTROL & PREVENTION, USE OF CONTRACEPTION & USE OF FAMILY PLANNING SERVICES IN THE UNITED STATES: 1982-2002, at 1 (2004), http://www.cdc.gov/nchs/data/ad/ad350.pdf (based on the 1982, 1995, and 2002 National Surveys of Family Growth).

85. News Release, National Academies, IOM Report Recommends Eight Additional Preventive Health Services to Promote Women's Health (July 19, 2011), http://www8.nationalacademies.org/onpinews/newsitem.aspx?RecordID=13181 [hereinafter National Academies News Release].

86. *Id.*

In addition, many women use oral contraceptive pills at least in part for health benefits other than pregnancy prevention.[87] A 2011 report found that more than half of pill users, fifty-eight percent, use the pill for health conditions such as cramps or menstrual pain, menstrual regulation, acne, and endometriosis.[88]

Women also use contraception because it helps them achieve their life goals.[89] A 2011 survey found that women reported using contraception because it allows them to better care for themselves or their families, support themselves financially, complete their education, or find or maintain work.[90] In the United States, the introduction of safe, effective birth control helped opened economic doors for women in the 1960s and 1970s.[91] As *New York Times* columnist Gail Collins explains:

> Young women did not have widespread access to the Pill until the early 1970s—which not coincidentally was the same time they began to apply to medical, law, dental, and business schools in large numbers. This was an enormous shift. . . .
>
> Once young women had confidence that they could make it through training and the early years in their profession without getting pregnant, their attitude toward careers that required a long-term commitment changed.[92]

In addition to economic freedom, widespread access to birth control has also enhanced women's sexual freedom and equality.[93] Although HHS frames the

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87. RACHEL K. JONES, GUTTMACHER INST., BEYOND BIRTH CONTROL: THE OVERLOOKED BENEFITS OF ORAL CONTRACEPTIVE PILLS 3 (2011), http://www.guttmacher.org/pubs/Beyond-Birth-Control.pdf.

88. *Id.*

89. *See generally* JENNIFER J. FROST & LAURA DUBERSTEIN LINDBERG, GUTTMACHER INST., REASONS FOR USING CONTRACEPTION: PERSPECTIVES OF US WOMEN SEEKING CARE AT SPECIALIZED FAMILY PLANNING CLINICS 2 (2012), http://www.guttmacher.org/pubs/journals/j.contraception.2012.08.012.pdf.

90. *Id.* at 2.

91. GAIL COLLINS, WHEN EVERYTHING CHANGED: THE AMAZING JOURNEY OF AMERICAN WOMEN FROM 1960 TO THE PRESENT 102 (2009) ("The [birth control] Pill, which went on the market in 1960, not only gave women more confidence about their ability to plan a career; it gave employers more confidence that when a woman said she wasn't planning to get pregnant, she meant it.").

92. *Id*.

93. *Id*. at 102-03 ("And the sexual revolution, which arrived at the same time as widespread Pill use, reassured [young women] that even if they delayed marriage, they would have the same opportunities as unmarried young men for a satisfying sexual life."); *see also* Linda Greenhouse, *Doesn't Eat, Doesn't Pray and Doesn't Love*, N.Y. TIMES, Nov. 27, 2013, http://www.nytimes.com/2013/11/28/opinion/greenhouse-doesnt-eat-doesnt-pray-and-doesnt-love.html?_r=0. She writes:

> To the extent that the "contraceptive project" changes anything on the American

contraception requirement exclusively in terms of health benefits, the economic and social benefits women derive from widespread access to effective birth control should not be ignored.[94]

B. Religious Concerns and the Cost of Non-Compliance

Some religious sects object on moral and religious grounds to the use of contraception and sterilization procedures. Most prominently, the Roman Catholic Church has long opposed the use of artificial birth control.[95] The Church's teachings condemn abortion, sterilization, and "any action which either before, at the moment of, or after sexual intercourse, is specifically intended to prevent procreation."[96] The United States Conference of Catholic Bishops (USCCB), an "assembly of the hierarchy" of the Catholic Church in the United States,[97] objects strongly to the characterization of contraception and sterilization as "preventive" services because pregnancy is "not a disease."[98] In addition, the USCCB believes that at least one form of FDA-approved contraception is an abortifacient.[99]

> reproductive landscape, it will be to reduce the rate of unintended pregnancy and abortion. The objection, then, has to be not to the mandate's actual impact but to its expressive nature, its implicit endorsement of a value system that says it's perfectly O.K. to have sex without the goal of making a baby. While most Americans surely share this view, given the personal choices they make in their own lives, many nonetheless find it uncomfortable to acknowledge.

Id.

94. Greenhouse, *supra* note 93 ("From the Obama administration's point of view, of course, the contraception mandate is about health care. . . . But there's a missing piece. One of the failures of the Affordable Care Act saga, it seems to me, has been the president's unwillingness or inability to present universal health care as a moral issue, a moral right in a civilized society.").

95. *See* CHARLES E. CURRAN, CATHOLIC MORAL THEOLOGY IN THE UNITED STATES 45-50 (2008) (summarizing the history of the Church's teachings on artificial contraception).

96. Pope Paul VI, *Humanae Vitae*, § 14 (July 25, 1968), http://www.vatican.va/holy_father/paul_vi/encyclicals/documents/hf_p-vi_enc_25071968_humanae-vitae_en.html; *see also* CURRAN, *supra* note 95, at 85 ("Pope Paul VI's encyclical *Humanae vitae*, written in 1968, reaffirmed the teachings of the hierarchical magisterium that condemned artificial contraception for spouses."); MARTIN RHONHEIMER, ETHICS OF PROCREATION AND THE DEFENSE OF HUMAN LIFE: CONTRACEPTION, ARTIFICIAL FERTILIZATION, AND ABORTION 33-38 (2010) (summarizing the philosophical underpinnings of the Roman Catholic Church's moral teachings on contraception, as expressed in the *Humanae Vitae*).

97. *About USCCB*, U.S. CONF. OF CATHOLIC BISHOPS, http://www.usccb.org/about/index.cfm (last visited May 12, 2014).

98. Comments on Interim Final Rules Imposing Contraceptive Mandate, Office of the General Counsel, U.S. Conference of Catholic Bishops 1 (Aug. 31, 2011) [hereinafter USCCB Comments], *available at* http://www.usccb.org/about/general-counsel/rulemaking/upload/comments-to-hhs-on-preventive-services-2011-08-2.pdf.

99. *Id.* at 5 (claiming that "studies show that at least one drug approved by the FDA for

Due to its long-standing objection to contraception and sterilization use, Church leaders assert that "selling, buying, or brokering the coverage" violates the Church's moral precepts.[100] One Catholic organization asserts that the purchase of insurance plans that cover contraceptive services violates its conscience because it would require the organization to "provide, pay for, and/or facilitate those services to others."[101] The USCCB speculates that "it seems entirely probable that many individuals and organizations, instead of purchasing and sponsoring [insurance] plans, will feel obligated in conscience . . . [to drop] coverage altogether, rather than compromising their religious and moral beliefs."[102]

Not all religious organizations that oppose the inclusion of contraception and sterilization procedures in the IFR are affiliated with the Catholic Church. The Becket Fund for Religious Liberty lists seven cases brought by non-Catholic employers, all Protestant or non-denominational Christian organizations.[103] In addition, the cases brought by secular businesses with religious owners or directors represent both Catholic and non-Catholic religious traditions.[104]

Under the PPACA, employers may abstain from providing employees with the "minimum essential coverage."[105] These employers, however, face large tax penalties equal to the number of employees multiplied by an "applicable payment amount" of about $167 per month.[106] Thus, even the smallest qualifying "large employer" with fifty employees would incur fines of approximately $8350 per month.[107] A recent news report suggested that Hobby Lobby, a nationwide arts and crafts retailer founded by evangelical Christians, faces fines of $1.3 million per day for failing to comply with the IFR.[108] As a result, the cost of non-compliance is likely cost-prohibitive for most religious organizations.

'contraceptive use,' a close analogue to the abortion drug RU-486 (mifepristone), can cause an abortion when taken to avoid pregnancy").

100. *Id.* at 8.

101. Notre Dame Complaint, *supra* note 51, ¶ 1.

102. USCCB Comments, *supra* note 98, at 11.

103. *HHS Information Central*, *supra* note 51 (listing the non-Catholic organizations as East Texas Baptist University, Houston Baptist University, Hobby Lobby, Wheaton, Colorado Christian University, Geneva College, and Louisiana College).

104. *Id.*

105. 26 U.S.C. § 4980H(a) (Supp. 2011).

106. *Id.* § 4980H(a), (c)(1) ("The term 'applicable payment amount' means, with respect to any month, 1/12 of $2,000.").

107. *Id.* § 4980H(c)(1)(A) ("The term 'applicable large employer' means, with respect to a calendar year, an employer who employed an average of at least 50 full-time employees on business days during the preceding calendar year.").

108. Eric Marrapodi, *Hobby Lobby Finds Way Around $1.3-Million-a-Day Obamacare Hit—for Now*, CNN (Jan. 11, 2013), http://religion.blogs.cnn.com/2013/01/11/hobby-lobbys-1-3-million-obamacare-loophole/.

III. THE CONSTITUTIONALITY OF CONTRACEPTIVE COVERAGE

Imagine that the IFR did not include a religious exemption at all. Further imagine that the IFR requires all group health plans sponsored by large employers to cover contraceptive and sterilization procedures. Proceeding under these assumptions, this Note argues that a contraceptive services coverage requirement does not violate an employer's religious freedoms under the Free Exercise Clause or the Religious Freedom and Restoration Act. This Note first looks to the U.S. Supreme Court's decisions in *Employment Division, Department of Human Resources of Oregon v. Smith*,[109] as well as *Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah*[110] to examine the constitutionality of a broad contraceptive coverage requirement. Second, this Note examines the impact of the Religious Freedom and Restoration Act (RFRA) on whether a religious exemption is necessary to protect the religious freedom of employers.[111]

A. Neutral and Generally Applicable—The Smith *Standard*

The First Amendment provides "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . . ,"[112] but the Constitution does not describe the extent to which laws may impair religious exercise. In *Employment Division, Department of Human Resources of Oregon v. Smith*,[113] the Court considered whether laws penalizing the consumption of peyote, a controlled substance, interfered with the free exercise of religion.[114] Smith and Black, members of the Native American Church, were fired from their jobs after using peyote for sacramental purposes.[115] Despite their claim that their drug use was religiously-motivated, Oregon denied Smith and Black unemployment benefits because they were fired for work-related misconduct.[116] The Court upheld Oregon's denial of benefits,[117] in part because "an individual's religious beliefs [do not] excuse him from compliance with an otherwise valid law prohibiting conduct that the State is free to regulate."[118] The Court held that "the right of free exercise does not relieve an individual of the obligation to comply with a 'valid and neutral law of general applicability on the ground that the law proscribes (or prescribes) conduct that his religion prescribes (or proscribes).'"[119] The primary inquiry, therefore, as to whether a law unconstitutionally burdens religious exercise is whether the law is neutral and

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109. 494 U.S. 872 (1990).
110. 508 U.S. 520 (1993).
111. 42 U.S.C. § 2000bb (2006 & Supp. 2011).
112. U.S. CONST. amend. I.
113. 494 U.S. 872.
114. *Id.* at 874.
115. *Id.*
116. *Id.*
117. *Id.* at 890.
118. *Id.* at 878-79.
119. *Id.* at 879 (quoting United States v. Lee, 455 U.S. 252, 263 n.3 (1982)).

generally applicable.[120]

Three years later, the Court applied the *Smith* test in *Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah*.[121] In *Lukumi*, members of the Santeria religion—a sect that sacrifices animals as a form of worship—announced plans to build a house of worship, school, cultural center, and museum in the city of Hialeah, Florida.[122] In response to concerns raised by citizens, the city enacted several ordinances specifically restricting ritual animal sacrifice.[123] The Court ultimately found the city ordinances were neither neutral nor generally applicable and invalidated the laws.[124]

Lukumi and *Smith* hold that the law may incidentally burden the free exercise of religion, so long as it does not specifically discriminate against a religious group or exercise.[125] Some employers argue that the IFR specifically targets religious employers.[126] Because many secular employers provided contraceptive coverage to employees prior to the WHA, the WHA disparately impacts the religious employers that did not provide contraceptive coverage due to religious and moral objections.[127] However, this Note argues that the WHA and the IFR's contraceptive coverage requirement do not violate the standards of neutrality and general applicability articulated in *Smith* and *Lukumi*. Therefore, the contraceptive coverage requirement does not violate the First Amendment by unfairly targeting or discriminating against a particular religious group.

1. Neutrality.—Because *Lukumi* closely examines neutrality and general applicability, *Lukumi* is helpful to determine whether the WHA violates the *Smith* standard. Under *Lukumi*, "the minimum requirement of neutrality is that a law not discriminate on its face."[128] Without the religious exemption, the relevant sections of the PPACA,[129] the WHA,[130] and the IFR[131] all appear facially neutral, making no reference to religious groups or activities. In contrast, the ordinances in *Lukumi* used words with "with strong religious connotations," which the Court found were consistent with, though not conclusive proof of, facial

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120. *Id.*

121. 508 U.S. 520, 531 (1993).

122. *Id.* at 526.

123. *Id.* at 528-29.

124. *Id.* at 524.

125. *Id.* at 531.

126. *See, e.g.*, USCCB Comments, *supra* note 98, at 8 ("Moral opposition to all artificial contraception and sterilization is a minority and unpopular belief, and its virtually exclusive association with the Catholic Church is no secret. Thus, although the mandate [to provide contraceptive coverage] does not expressly target Catholicism, it does so implicitly by imposing burdens on conscience that are well known to fall almost entirely on observant Catholics . . . .").

127. *Id.*

128. *Lukumi*, 508 U.S. at 533.

129. 26 U.S.C. § 4980H(c)(2)(A) (Supp. 2011).

130. 42 U.S.C. § 300gg-13(a)(4) (Supp. 2011).

131. *Affordable Care Act Rules*, *supra* note 6.

discrimination.[132]

The *Lukumi* Court did not stop at facial neutrality. The Court then looked to the "record" in the case, including the prior city council enactments, to determine the "object of the ordinances."[133] The Court found that the city enacted the ordinances specifically to target the Santeria religion.[134] In contrast, nothing in the legislative history of the WHA suggests that the amendment passed specifically to target religious employers. Senator Mikulski introduced the WHA "to guarantee women access to preventive health care screenings and care at no cost" and eliminate gender disparities in health care costs.[135] Moreover, by basing preventive services on guidelines supported by HHS, Mikulski noted "all women will have access to similar preventive services that we women in Congress and federal employees have."[136] To determine which preventive services to cover, HHS turned to IOM, which made eight recommendations "based on a review of existing guidelines and an assessment of the evidence on the effectiveness of different preventive services."[137] That HHS adopted IOM's recommendations without modification leaves little room to argue that the HHS regulations were religiously, or politically, motivated.[138]

After examining facial neutrality and the record, the *Lukumi* Court considered "the effect of a law in its real operation."[139] After examining the ordinances, the Court concluded that the "net result" of the carefully drafted laws was that "few if any killings of animals [were] prohibited other than Santeria sacrifice."[140] The Court concluded that "Santeria alone was the exclusive legislative concern," and therefore the law was not neutral.[141]

Perhaps the most persuasive argument against the neutrality of the IFR is that its operative effect is to discriminate against Catholic religious organizations. Although the WHA and the IFR apply broadly to all large employers,[142] the USCCB argues that "the class that suffers under the mandate is defined precisely by their beliefs in objecting to these [contraceptive and sterilization] 'services.'"[143] That is, because most non-religious organizations provided coverage for contraception and sterilization procedures before PPACA's enactment, the operative effect of the law is to target groups that were not

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132. *Lukumi*, 508 U.S. at 534.

133. *Id.*

134. *Id.* at 535.

135. Mikulski Press Release, *supra* note 75.

136. *Id.*

137. National Academies News Release, *supra* note 85.

138. *See* Final Rule, *supra* note 31, at 8729 ("The contraceptive coverage requirement is generally applicable . . . , and is in no way specially targeted at religion or religious practices.").

139. *Lukumi*, 508 U.S. at 535.

140. *Id.* at 536.

141. *Id.*

142. 26 U.S.C. § 4980H(c)(2)(A) (Supp. 2011); 42 U.S.C. § 300gg-13(a)(4) (Supp. 2011).

143. USCCB Comments, *supra* note 98, at 8.

previously providing coverage for religious reasons.[144] Because "[m]oral opposition to all artificial contraception and sterilization is a minority and unpopular belief, and its virtually exclusive association with the Catholic Church is no secret," the law therefore implicitly targets Catholics "by imposing burdens on conscience that are well known to fall almost entirely on observant Catholics."[145]

However, as one commentator has observed, "[e]mployers associated with the Catholic Church are not the only employers impacted by the mandate."[146] "[I]ndeed, several secular employers did not provide contraceptive coverage prior to the federal mandate and must also conform their conduct accordingly."[147] Moreover, the litigation currently in progress involves employers of various religious faiths, not only Catholics.[148] Thus, the operative effect here does not mimic the operative effect of the ordinances in *Lukumi*, where the city ordinances affected only a specific group of Santeria worshipers.[149]

2. General Applicability.—In addition to neutrality, *Lukumi* discussed and applied the second prong of the *Smith* test: general applicability.[150] The *Lukumi* Court noted that "[a]ll laws are selective to some extent."[151] However, "government, in pursuit of legitimate interests, cannot in a selective manner impose burdens only on conduct motivated by religious belief."[152] Therefore, like "operative effect," general applicability looks closely to the affected class to determine whether the law has "every appearance of a prohibition that society is prepared to impose upon [the class] but not upon itself."[153]

The HHS regulation is part of a much larger statutory scheme: specifically, the portion of the PPACA that regulates employer-sponsored group health insurance plans.[154] Thus, the affected class is defined broadly by statute.[155] The PPACA requires all large employers to provide "minimum essential [insurance] coverage under an eligible employer-sponsored plan."[156] The WHA merely clarifies "minimum essential coverage" by delineating a spectrum of required services.[157] Without the religious exemption, the WHA applies to all employers

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144. *Id.*

145. *Id.*

146. Destyn D. Stallings, Comment, *A Tough Pill to Swallow: Whether the Patient Protection and Affordable Care Act Obligates Catholic Organizations to Cover Their Employees' Prescription Contraceptives*, 48 TULSA L. REV. 117, 132 (2012).

147. *Id.*

148. *See supra* Part II.B.

149. *Lukumi*, 508 U.S. at 536.

150. *Id.* at 542.

151. *Id.*

152. *Id.* at 543.

153. *Id.* at 545 (quoting Fla. Star v. B.J.F., 491 U.S. 524, 542 (1989) (Scalia, J., concurring)).

154. 26 U.S.C. § 4980H(c)(2)(A) (Supp. 2011).

155. *Id.*

156. *Id.* § 4980H(a)(1).

157. 42 U.S.C. § 300gg-13(a)(4) (Supp. 2011).

that meet the "large employer" criterion, regardless of the employer's religious affiliation.[158]

Again, the USCCB's argument that "the class that suffers under the mandate is defined precisely by their beliefs" fails because the statute defines the class by size.[159] Moreover, by defining a "minimum" standard, the WHA necessarily imputes new obligations upon groups whose plans did not previously cover the newly required services.[160] The guidelines require a full "package" of women's health services—including not only contraception and sterilization, but well-woman visits, screening for gestational diabetes, breastfeeding support and counseling, and screening and counseling for interpersonal and domestic violence.[161] The requirements suggest neutral standardization of basic women's health services much more than invidious targeting of religiously affiliated employers. Because the WHA and HHS's definitions of preventive services are neutral and generally applicable, the regulation does not require any exemption or accommodation to be constitutional.

B. The Religious Freedom and Restoration Act

In addition to the constitutional challenges under *Smith*, non-exempt religious employers and other opponents of the IFR have challenged the IFR for violating the Religious Freedom and Restoration Act (RFRA).[162] Historically, RFRA and *Smith* are inextricably intertwined. In 1993, Congress enacted RFRA in response to the *Smith* decision.[163] After the decision was handed down, Congress sharply criticized *Smith* for "virtually [eliminating] the requirement that the government justify burdens on religious exercise imposed by laws neutral toward religion."[164] Congress saw *Smith* as a shift away from the Supreme Court's previous free exercise jurisprudence in landmark cases such as *Sherbert v. Verner,*[165] as well as *Wisconsin v. Yoder*.[166] Both cases interpreted religious freedom broadly and held that only a compelling state interest may justify any incidental burden on religious exercise.[167] In both *Sherbert* and *Yoder*, the Supreme Court strictly scrutinized the laws at issue and found that the compelling state interests advanced did not justify the substantial burdens to religious exercise.[168]

In *Sherbert*, a Seventh-day Adventist's employer fired her for refusing to

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158. *Id.*; 26 U.S.C. § 4980H(c)(2)(A) (Supp. 2011).
159. USCCB Comments, *supra* note 98, at 8.
160. Final Rule, *supra* note 31, at 8725.
161. *Affordable Care Act Rules*, *supra* note 6.
162. 42 U.S.C. § 2000bb (2006 & Supp. 2011).
163. *Id.* § 2000bb(a)(4).
164. *Id.*
165. 374 U.S. 398 (1963).
166. 406 U.S. 205 (1972).
167. *Sherbert*, 374 U.S. at 403; *Yoder*, 406 U.S. at 214.
168. *Sherbert*, 374 U.S. at 407; *Yoder*, 406 U.S. at 228-29.

work on Saturday, a day of religious observation.[169] Sherbert was unable to find new work that accommodated her religious practice.[170] South Carolina denied Sherbert unemployment benefits because the state did not consider her inability to find new work for religious reasons good cause to refuse employment opportunities.[171] The Supreme Court found the state's denial of benefits a substantial burden on Sherbert's religious practice.[172] The state argued that its blanket denial of benefits in religious cases served the compelling state interest of preventing fraudulent unemployment benefit claims.[173] However, because the state allocated benefits on a case-by-case basis, the Court held that the state's denial of Sherbert's application, despite infringement on her religious practice, served no compelling state interest.[174]

In *Yoder*, Wisconsin imposed a five-dollar fine on a member of the Old Order Amish for refusing to send his teenage children to public school past eighth grade, as required by state law.[175] Yoder believed that his children's attendance at any public or private high school violated his Amish values and beliefs.[176] The Court held that Wisconsin's requirement substantially burdened Yoder's religious exercise.[177] Moreover, the Court held that the compelling state interests advanced, that compulsory education is necessary to create an informed electorate and that it creates self-reliant and self-sufficient members of society,[178] did not justify the burden.[179]

Congress specifically enacted RFRA "to restore the compelling interest test as set forth in" *Sherbert* and *Yoder* and "to guarantee its application in all cases where free exercise of religion is substantially burdened."[180] RFRA explicitly prohibits the government from burdening "a person's exercise of religion even if the burden results from a rule of general applicability" unless the government shows the burden 1) "is in furtherance of a compelling governmental interest" and 2) "is the least restrictive means of furthering that compelling governmental interest."[181] RFRA provides a person claiming violation of RFRA an avenue for judicial relief.[182] Although the Supreme Court held RFRA unconstitutional as

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169. *Sherbert*, 374 U.S. at 399.
170. *Id.*
171. *Id.* at 401.
172. *Id.* at 404.
173. *Id.* at 407.
174. *Id.* at 410.
175. Wisconsin v. Yoder, 406 U.S. 205, 208 (1972).
176. *Id.* at 209.
177. *Id.* at 219.
178. *Id.* at 221.
179. *Id.* at 228-29.
180. 42 U.S.C. § 2000bb(b)(1) (2006 & Supp. 2011).
181. *Id.* §§ 2000bb-1(a)-(b).
182. *Id.* § 2000bb-1(c) ("A person whose religious exercise has been burdened in violation of this section may assert that violation as a claim or defense in a judicial proceeding and obtain appropriate relief against a government.").

applied to the states,[183] the Court has applied RFRA to federal law.[184]

RFRA therefore sets up a multi-level inquiry to determine whether a law impermissibly burdens religious exercise. First, in order to raise a prima facie case under RFRA, a plaintiff must show that the law at issue would substantially burden a sincere religious exercise.[185] Second, if burdened, the court must then determine (a) whether there is a compelling state interest that justifies the substantial burden of religion, and (b) whether the state has adopted the least restrictive means to achieve its interest.[186]

1. Applicability of RFRA.—As an initial matter, RFRA may not apply to challenges brought by non-exempt religious employers. In *Gonzales v. O Centro Espirita Beneficente Uniao do Vegetal*, the Court held "RFRA requires the Government to demonstrate that the compelling interest test is satisfied through application of the challenged law 'to the person'—the particular claimant whose sincere exercise of religion is being substantially burdened."[187] Indeed, RFRA prohibits burdens to "a *person's* exercise of religion."[188] Moreover, the two cases that RFRA references, *Sherbert* and *Yoder*, deal with burdens to individual exercise.[189] In the recent challenges to HHS's regulations, most claims are brought by religious employers—schools, hospitals, businesses—not individuals.[190] It is unclear if RFRA applies in these cases.[191]

2. Religious Exercise.—Assuming that a court may apply RFRA to an employer's free exercise claim, a court must first determine whether the law

183. City of Boerne v. Flores, 521 U.S. 507, 534 (1997) (holding that RFRA exceeds Congress's powers to enforce provisions of the Enforcement Clause of the Fourteenth Amendment by creating "a considerable congressional intrusion into the States' traditional prerogatives and general authority to regulate for the health and welfare of their citizens.")

184. Gonzales v. O Centro Espirita Beneficente Uniao do Vegetal, 546 U.S. 418, 423 (2006) (applying RFRA to the Controlled Substances Act when determining whether federal law impermissibly burdened a religious sect that used banned hallucinogens in a sacramental tea).

185. *See id.* at 428 (noting that "the Government conceded the [religious sect's] prima facie case under RFRA" because "application of the Controlled Substances Act would (1) substantially burden (2) a sincere (3) religious exercise").

186. 42 U.S.C. §§ 2000bb-1(a)-(b) (2006 & Supp. 2011); *Gonzales*, 546 U.S. at 424;.

187. *Gonzales*, 546 U.S. at 430-31 (quoting 42 U.S.C. § 2000bb-1(b) (2006 & Supp. 2011)).

188. 42 U.S.C. § 2000bb-1(a) (2006 & Supp. 2011) (emphasis added).

189. Wisconsin v. Yoder, 406 U.S. 205 (1972); Sherbert v. Verner, 374 U.S. 398 (1963).

190. *See generally HHS Information Central*, supra note 51.

191. *See* Korte v. Sebelius, No. 12-3841, 2012 WL 6757353, at * 3 (7th Cir. Dec. 28, 2012) ("[T]he government's primary argument is that because K & L Contractors [the plaintiff challenging the IFR] is a secular, for-profit enterprise, no rights under RFRA are implicated at all. This ignores that Cyril and Jane Korte [the business owners] are also plaintiffs." Accordingly, the court permitted the individuals to pursue the RFRA claim.); O'Brien v. U.S. Dep't of Health & Human Serv., 894 F. Supp. 2d 1149, 1158 (E.D. Mo. 2012) (questioning RFRA's application, but ultimately declining "to reach the question of whether a secular limited liability company is capable of exercising a religion within the meaning of RFRA or the First Amendment").

substantially burdens the free exercise of religion.[192] This Note argues that a non-exempt religious organization opposed to the IFR cannot raise a prima facie case under RFRA because there is no religious exercise at stake. Specifically, the purchase of insurance coverage that includes services with which the employer—but not the ultimate third-party consumer—may disagree does not qualify as "religious exercise."

a. Deference.—Under RFRA, religious exercise "includes any exercise of religion, whether or not compelled by, or central to, a system of religious belief."[193] RFRA fails, however, to further define "exercise."[194] As one scholar notes:

> The First Amendment of the Constitution is the source of protection for religious liberty . . . . But the Constitution does not define the operative terms—"religion," "exercise," or "free." Courts and scholars, legal and otherwise, have all wrestled with the definitional problem. To date, there has been little consensus.[195]

By questioning the exercise purportedly burdened, a court risks endorsing a particular religious belief or questioning the religious value of a sect's beliefs.[196] In *Smith*, Justice Scalia noted that "[r]epeatedly and in many different contexts, we have warned that courts must not presume to determine the place of a particular belief in a religion or the plausibility of a religious claim."[197] The result is that courts often defer to a party's claim that his religious beliefs are implicated.[198]

b. Deference and third parties.—In the forty-eight lawsuits pending at the time this Note was written, religious organizations and businesses are suing federal government agencies and directors for alleged violations of their religious freedoms.[199] And yet, Americans typically conceptualize the debate over insurance coverage for contraception as pitting religious freedoms against women's rights.[200] As such, the parties to the suits (religious organizations and

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192. *See Gonzales*, 546 U.S. at 428 (noting that "the Government conceded the [religious sect's] prima facie case under RFRA" because "application of the Controlled Substances Act would (1) substantially burden (2) a sincere (3) religious exercise").

193. 42 U.S.C. § 2000bb-2(4) (2006 & Supp. 2011); *id.* § 2000cc-5(7)(A).

194. *Id.* § 2000cc-5.

195. Jonathan C. Lipson, *On Balance: Religious Liberty and Third-Party Harms*, 84 MINN. L. REV. 589, 595-96 (2000) (citations omitted).

196. *Id.* at 601-02 ("The delicacy of the definitional task appears to reflect at least two related concerns, one constitutional, the other institutional. The constitutional concern is the legitimate fear that the mere act of definition will 'establish' a religion, or prefer one denomination to another. . . . At the institutional level, courts defer because they view themselves as lacking the expertise to define religion. . . . The anxiety of entanglement reflects this healthy reluctance.").

197. Emp't Div., Dep't of Human Res. v. Smith, 494 U.S. 872, 887 (1990).

198. Lipson, *supra* note 195, at 600-01.

199. *HHS Information Central*, *supra* note 51.

200. *See* Jim Rutenberg & Marjorie Connelly, *Obama's Rating Falls as Poll Reflects*

the federal government) do not align with the harms on each side of the debate (religious freedoms and women's health). On the one hand, a religious organization or business owner bringing a suit in this case is the party harmed when its religious freedoms are restricted. On the other side, the people harmed when access to contraception coverage is limited are third parties—the employees of these organizations who wish to access contraceptive and sterilization services without paying additional premiums or out-of-pocket costs that insurance does not subsidize.

The WHA was passed and HHS's regulations were promulgated to secure for women broader insurance coverage for health care services they frequently access.[201] In general, the individuals directly benefiting from the coverage of the WHA's preventive services, including contraceptive services, are female employees of businesses and organizations that fall within the PPACA's definition of "large employer."[202] Although these women may share the religious beliefs of their employers, they may not. For example, the University of Notre Dame, one of the employers challenging the HHS regulation, claims it "employs over 5,000 full- and part-time employees and is the largest employer in St. Joseph County [Indiana]".[203] However, "Notre Dame does not know how many of its employees are Catholic," and it is "unclear whether a simple majority of Notre Dame's employees are Catholic."[204] Therefore, Notre Dame likely employs non-Catholic women who would use the group insurance plan to access contraceptive and sterilization procedures if covered. Moreover, Notre Dame may employ Catholic women who, despite the religious tenets of their employer, would still access these services.[205]

Because the IFR affects third-party employees, courts should closely scrutinize the claim that the IFR implicates a religious exercise. In his article *On*

Volatility, N.Y. TIMES, Mar. 13, 2012, at A1, A15 (including, among a presidential approval poll, results from a poll on "The Birth Control Debate" in which respondents were asked whether the debate was "more about" religious freedom, women's health and their rights, both, or no answer).

201. *See* discussion *supra* Parts I and III.

202. Final Rule, *supra* note 31, at 8728 ("The Departments aim to reduce these disparities [in insurance coverage] by providing women broad access to preventive services, including contraceptive services.").

203. Notre Dame Complaint, *supra* note 51, ¶ 25.

204. *Id.* ¶ 45.

205. *See* GUTTMACHER INST., SUPPLEMENTAL TABLES ON RELIGION AND CONTRACEPTIVE USE (2011), http://www.guttmacher.org/media/resources/Religion-FP-tables.html (showing that ninety-eight percent of sexually experienced women of child-bearing age who self-identify as Catholic have used an artificial method of contraception at some point in their lives, but also, eleven percent of self-identifying Catholic women currently at risk of unintended pregnancy were using no form of birth control at all). Based on this study, news reports widely stated that ninety-eight percent of Catholic women use birth control, but these statements were not accurate. Glenn Kessler, *The Claim That 98 Percent of Catholic Women Use Contraception: A Media Foul*, WASH. POST (Feb. 17, 2012, 6:02 AM), http://www.washingtonpost.com/blogs/fact-checker/post/the-claim-that-98-percent-of-catholic-women-use-contraception-a-media-foul/2012/02/16/gIQAkPeqIR_blog.html.

Balance: Religious Liberty and Third-Party Harms, Professor Lipson argues "deference is unsound when defining an activity as a religious exercise would have the effect of harming third parties."[206] Moreover, "the [Supreme] Court has not deferred deeply to claims that conduct is a religious exercise where third parties would be harmed."[207] On the contrary, "the continuum of deference suggests that deference declines, and judicial scrutiny increases, in proportion to the likelihood of third-party harm."[208] Cases on the less deferential end of the spectrum "involve the overlap of the seemingly disparate worlds of religion and commerce, where churches seek competitive, tax or other 'commercial' advantages not available to secular citizens or groups engaged in the same conduct."[209] Professor Lipson reviews a series of cases and finds "[i]n most of these cases, the Court has not deferred to the claim of religious exercise, but instead independently characterized the transaction that occurred as, for example, a taxable sale or an employment relationship."[210]

c. Economic transaction.—The IFR regulates only an economic transaction between an employer and its insurance provider for the health benefit of third-party employee. The PPACA creates a regulatory scheme that requires employers that generally employ fifty or more individuals to provide employees with minimum insurance coverage.[211] The WHA added an additional requirement that employers provide "additional preventive care and screenings" without cost sharing.[212] By Congress's directive, it was incumbent on HHS to define these terms.[213] What exactly must an employer provide? The contraception coverage requirement is only one of eight services IOM defined and HHS adopted as part of a package of preventive services.[214] In this way, the regulation serves only to define the minimal coverage and services that every employer must offer.

Under Professor Lipson's economic transaction theory, the contraceptive coverage requirement is precisely the type of commercial transaction a court should examine closely before exempting an employer for religious reasons. The Supreme Court examined similar claims of religious exemption in *Tony and Susan Alamo Foundation v. Secretary of Labor*.[215] In that case, the petitioner was a nonprofit religious organization that derived its income from several

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206. Lipson, *supra* note 195, at 595.

207. *Id.* at 615.

208. *Id.*

209. *Id.* at 616 (citing Jimmy Swaggart Ministries v. Bd. of Equalization of Cal., 493 U.S. 378 (1990); Hernandez v. Comm'r of Internal Revenue, 490 U.S. 680 (1989); Tony & Susan Alamo Found. v. Sec'y of Labor, 471 U.S. 290 (1985); United States v. Lee, 455 U.S. 252 (1982); Braunfield v. Brown, 366 U.S. 599 (1961); Follett v. McCormick, 321 U.S. 573 (1944); Murdock v. Pennsylvania, 319 U.S. 105 (1943)).

210. *Id.*

211. 26 U.S.C. § 4980H(a)(1) (Supp. 2011).

212. 42 U.S.C. § 300gg-13(a)(4) (Supp. 2011).

213. *Id.*

214. *Affordable Care Act Rules*, *supra* note 6.

215. 471 U.S. 290 (1985).

commercial businesses it operated.[216] The businesses were staffed by associates—"drug addicts, derelicts, or criminals before their conversion and rehabilitation by the Foundation who were compensated in food, clothing, shelter, and other benefits rather than cash salaries.[217] The Secretary of Labor filed an action against the Foundation for failing to comply with the minimum wage, overtime, and recordkeeping provisions of the Fair Labor Standards Act.[218] The Foundation argued that it was not subject to the Act because its businesses were "infused with a religious purpose."[219] The Court held that because "businesses serve the general public in competition with ordinary commercial enterprises,"[220] no religious exercise was implicated and the Foundation was not exempt.[221] In sum, the "Foundation's commercial activities, undertaken with a 'common business purpose,' [were] not beyond the reach of the Fair Labor Standards Act because of the Foundation's religious character . . . ."[222]

Similarly, the religious character of a large employer under the PPACA should not exempt the employer from regulations designed to advance the health of its employees. There is no logical reason to distinguish between the health needs of employees of religious institutions and those of secular institutions. Moreover, like *Alamo*, exempting religious employers from the IFR would create unfair competitive advantage. An employer's overall cost of providing coverage for contraceptive services is relatively minimal.[223] However, when the law sets the "minimum" coverage threshold at different levels for similarly-situated employers, a lower minimal coverage requirement creates a competitive advantage for employers not required to cover the full range of services.[224] From the perspective of a non-religious employer that may not want to provide insurance coverage for contraceptive services for a non-religious reason such as cost, the exemption seems competitively unfair. For these reasons, an economic transaction made in furtherance of an employment relationship should not be characterized as a religious exercise.

d. Employee action & tenuous connection.—Because the IFR regulates an

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216. *Id.* at 292.

217. *Id.*

218. *Id.* at 293.

219. *Id.* at 298.

220. *Id.* at 299.

221. *See also* Lipson, *supra* note 195, at 617-18 (discussing *Alamo* and its implication for third-party harms).

222. *Alamo*, 471 U.S. at 306.

223. Jacqueline E. Darroch, GUTTMACHER INST., *Cost to Employer Health Plans of Covering Contraceptives: Summary, Methodology and Background* (June 1998), http://www.guttmacher.org/pubs/kaiser_0698.html (finding in 1998 the average annual cost to an employer to provide contraceptive coverage was an estimated $21.40 per employee).

224. *See Alamo*, 471 U.S. at 299 ("[T]he payment of substandard wages would undoubtedly give petitioners and similar organizations an advantage over their competitors. It is exactly this kind of 'unfair method of competition' that the [Fair Labor Standards] Act was intended to prevent . . . and the admixture of religious motivations does not alter a business's effect on commerce.").

economic transaction between an employer and its insurance company for the benefit of a third-party employee, the link between the employer's religious exercise and the employee's benefit is particularly tenuous. That is, before any employer "subsidizes" an employee's use of contraception or sterilization procedures, an employee must first choose to access those services. The U.S. District Court for the Eastern District of Missouri took this position in *O'Brien v. United States Department of Health & Human Services*.[225] O'Brien, a Catholic business owner, brought suit in the Eastern District of Missouri challenging the HHS regulations.[226] The court described the HHS regulation as one that "requires an outlay of funds that might eventually be used by a third party in a manner inconsistent with one's religious values."[227] The court remarked that "[t]he challenged regulations are several degrees removed from imposing a substantial burden on [the business], and one further degree removed from imposing a substantial burden on [the owner]."[228] In other words,"[t]he burden of which plaintiffs complain is that funds, which plaintiffs will contribute to a group health plan, might, after a series of independent decisions by health care providers and patients covered by [the business's] plan, subsidize *someone else's* participation in an activity that is condemned by plaintiffs' religion."[229] The court held the regulation was "at most a de minimus [sic] burden on religious practice."[230]

The district court's definition of the HHS rule as several degrees removed from plaintiffs' religious beliefs supports the idea that religious exercise is not implicated at all. The link between the third-party's medical needs and the employer's religious convictions is simply too tenuous. Because the decision to engage in contraceptive use is entirely employee-driven, there is no appreciable difference between the employee purchasing birth control using her insurance plan and the employee using her own salary to purchase birth control pills over the counter,[231] or donating her salary to Planned Parenthood.

e. The "cost" of religious belief.—Finally, recall that under the PPACA, employers may abstain from providing employees with the minimum essential coverage.[232] These employers, however, are subject to large tax penalties.[233] Although these fines are extremely expensive, the Supreme Court has held constitutional in at least one instance a law that burdens only the *cost* of religious belief.[234] In *Braunfeld v. Brown*, the court held "the statute at bar [mandating that all businesses close on Sundays] does not make unlawful any religious practices

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225. 894 F. Supp. 2d 1149 (E.D. Mo. 2012).

226. *Id.* at 1154.

227. *Id.* at 1160.

228. *Id.*

229. *Id.* at 1159.

230. *Id.* at 1160.

231. *Id.* ("Already, [the business and owner] pay salaries to their employees—money the employees may use to purchase contraceptives or to contribute to a religious organization.").

232. 26 U.S.C. § 4980H(a) (Supp. 2011).

233. *Id.*

234. Braunfeld v. Brown, 366 U.S. 599 (1961).

of appellants; the Sunday law simply regulates a secular activity and, as applied to appellants, operates so as to make the practice of their religious beliefs more expensive."[235] Similarly, because the HHS rule only regulates a secular activity—the parameters of an employer-sponsored health insurance plan—and the alternative to compliance only increases an employer's costs, it is unlikely that a court would find the law unconstitutional.

3. Conclusion.—The IFR does not burden a religious exercise because an economic transaction between an employer and insurance company on behalf of an employee does not qualify as religious exercise under RFRA. This characterization does not require a court to deny that an individual holds a sincere religious belief about a medical service. Under the IFR, religious employees may still abstain from using contraception.[236] And an organization under religious management is free to express disapproval of those who use contraception.[237] However, holding a religious belief about a service does not mean purchasing (or not purchasing) insurance coverage on an employee's behalf is a religious *exercise*. As a result, the IFR may impose upon an employer an obligation to provide employees with coverage for preventive medical services as part of an employee benefit package without violating RFRA.

IV. THE RELIGIOUS EXEMPTION—A PANDORA'S BOX

Now assume, as it does, that the IFR contains a religious exemption. The amended regulations specify that a religious employer objecting to contraceptive use for religious reasons is automatically exempt from providing contraceptive coverage if the employer: (1) has the inculcation of religious values as its purpose; (2) primarily employs persons who share its religious tenets; (3) primarily serves persons who share its religious tenets; and (4) is a non-profit organization under section 6033(a)(1) and section 6033(a)(3)(A)(i) or (iii) of the Code.[238] Section 6033(a)(3)(A)(i) and (iii) refer to churches, their integrated auxiliaries, and conventions or associations of churches, as well as to the exclusively religious activities of any religious order.[239] Because all four criteria must be met before the exemption applies, the exemption is notably narrow.[240] On February 6, 2013, HHS proposed rules to strike the first three criteria of the

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235. *Id.* at 605.

236. *See O'Brien*, 894 F. Supp. 2d at 1159 (noting that "Frank O'Brien [the business owner] is not prevented from keeping the Sabbath, from providing a religious upbringing for his children, or from participating in a religious ritual such as communion. Instead, plaintiffs remain free to exercise their religion, by not using contraceptives and by discouraging employees from using contraceptives.").

237. *Id.*

238. Interim Final Rules, *supra* note 23, at 46,623

239. 26 U.S.C. § 6033(a)(3)(A)(i) (2006); Interim Final Rules, *supra* note 23, at 46,623.

240. *See* Stanley W. Carlson-Thies, *Which Religious Organizations Count as Religious? The Religious Employer Exemption of The Health Insurance Law's Contraceptives Mandate*, 13 ENGAGE: J. FEDERALIST SOC'Y PRAC. GROUPS 58, 59 (2012).

definition.[241] Although these changes have not taken effect at the time this Note was written, HHS claims that the group of qualifying religious employers remains largely unchanged.[242] This Note argues that because HHS chose to include a narrow exemption, the previously constitutional regulation becomes vulnerable under *Smith* and RFRA.

A. Problems Under Smith

1. Neutrality & General Applicability.—Both *Smith* and *Lukumi* hold that a neutral and generally applicable law may incidentally burden religious exercise, provided the law does not unfairly target a particular religion.[243] In Part III, this Note argues that without the religious exemption, the WHA and the IFR are neutral and generally applicable. However, this Note argues that the religious employer exemption negates the neutrality and general applicability of these laws.

Again, the *Lukumi* Court breaks its neutrality inquiry into three factors—facial discrimination, the record, and operative effect.[244] On its face, the religious exemption uses "words with strong religious connotations."[245] The IFR makes specific reference to "religious values," "religious tenets," and "churches."[246] These words, however, are not dispositive proof of discriminatory intent.[247]

Lukumi also examines the record in the case to find evidence of discriminatory intent.[248] HHS adopted both the religious employer exemption and the contraceptive coverage requirement when it amended the July 2010 IFR in August 2011.[249] HHS adopted the religious exemption concurrently with the contraceptive coverage requirement. Beyond the text of the amended IFR, there is little record to examine. In the amendment, HHS notes that it "received considerable feedback regarding which preventive services for women should be considered for coverage."[250] HHS briefly summarized the range of comments it received.[251] HHS concluded that HHS should "provide HRSA additional discretion to exempt *certain* religious employers from the Guidelines where contraceptive services are concerned."[252] HHS then adopted a deliberately narrow

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241. Proposed Rules, *supra* note 60, at 8456-57.

242. *Id.* at 8461.

243. *See* Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah, 508 U.S. 520, 531 (1993); Emp't Div., Dep't of Human Res. of Or. v. Smith, 494 U.S. 872, 879 (1990).

244. *Lukumi*, 508 U.S. at 533-35.

245. *Id.* at 534.

246. 26 U.S.C. §§ 6033(a)(3)(A)(i), (iii) (2006); 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(4) (2012).

247. *See Lukumi*, 508 U.S. at 534.

248. *Id.*

249. Interim Final Rules, *supra* note 23, at 46,623.

250. *Id.*

251. *Id.*

252. *Id.* (emphasis added).

exemption aimed at "a house of worship and its employees in ministerial positions."[253] By exercising this discretion, HHS thus abandoned the broad neutrality of the WHA to create a targeted religious exemption.

The third prong of *Lukumi*'s neutrality inquiry is operative effect.[254] The operative effect of the exemption is two-fold. First, the law divides the large employers subject to the WHA into two classes based on religious belief. Large employers that do not have religious objections to contraception must provide their employees with insurance plans that cover contraceptive services.[255] These employers must bear the cost of these services.[256] On the other hand, only religious employers that object for religious reasons to contraception are relieved of this obligation.[257] In practice, this creates unfair competitive advantage among similarly-situated employers, based exclusively on religious belief.[258]

Although the operative effect initially appears to benefit (rather than unfairly burden) religious employers, the narrow exemption also creates an arbitrary and discriminatory distinction between religious organizations. For example, two religious employers—a church and a religiously-affiliated hospital—may share the same religious objections to contraceptive coverage. Yet, the IFR exemption protects only the one that meets all four criteria of the religious definition. While the church is "religious enough" to qualify for exemption under the fourth prong of the religious definition, the hospital is not.[259] The IFR exemption is therefore under-inclusive of religious groups that hold sincerely-held religious objections to contraception. In light of the *Lukumi* factors, the religious exemption fails to be neutral because it unreasonably discriminates between similarly-situated religious employers, as well as between religious and secular organizations.

Like operative effect, an inquiry into a law's general applicability looks to the affected class to determine the law's scope.[260] Prior to the IFR exemption, the WHA applied to all employers with at least fifty full-time employees.[261] After the exemption, large employers no longer have to provide the same coverage to meet the "minimum essential coverage" standard. The exemption creates a new class of exempt employers, while subjecting secular employers to additional insurance coverage minimums.[262] The law simply ceases to treat all large employers the same.

Thus, the IFR likely fails the *Smith* test for neutrality and general applicability because it carves out an arbitrary exemption for specific religious groups, while excluding other religious organizations. While religious beliefs can

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253. *Id.*
254. Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah, 508 U.S. 520, 535 (1993).
255. *Affordable Care Act Rules*, *supra* note 6.
256. *See* discussion *supra* Part II.B.2.c.
257. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(4) (2012).
258. *See* discussion *supra* Part II.B.2.c.
259. 26 U.S.C. §§ 6033(a)(3)(A)(i), (iii) (2006); 45 C.F.R. § 147.130(a)(1)(iv)(B)(4) (2012).
260. Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah, 508 U.S. 520, 545 (1993).
261. 26 U.S.C. § 4980H(c)(2)(A) (Supp. 2011).
262. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(4) (2012).

be accommodated when religious liberties are at stake, the narrow exemption is under-inclusive because it fails to include all religious organizations that share the same religious belief. Overall, the WHA is less neutral and less generally applicable after HHS promulgated the IFR.

2. System of Individualized Exemptions.—The IFR exemption is also vulnerable under *Smith* because it creates a system of individualized exemptions. In *Smith*, the Court declined to apply the *Sherbert* balancing test, in which only a compelling government interest can justify a substantial burden on religious exercise.[263] The Court noted that the *Sherbert* test "was developed in a context that lent itself to individualized governmental assessment of the reasons for the relevant conduct."[264] While *Smith* did not present such a case because it involved "an across-the-board criminal prohibition on a particular form of conduct," the Court noted that the *Sherbert* test is appropriate where the state has instituted a system of individual exemptions.[265]

The religious exemption in the existing IFR contains three qualifications that invite individual assessment.[266] The organization must first have "the inculcation of religious values [a]s [its] purpose."[267] In addition, it must both primarily employ and primarily serve persons who share its religious tenets.[268] As one commentator has noted, "[t]he terms 'purpose' and 'primarily' are so amorphous that a court could easily view the exemption provision as a grant of unchecked discretion."[269] The inclusion of the exemption thus potentially triggers the strict scrutiny of the *Sherbert* balancing test, discussed below.

B. Problems under RFRA

1. Religious Exercise.—In Part III, this Note argues that the IFR is not vulnerable under RFRA because the IFR regulates only commercial activity and thus does not burden religious exercise.[270] However, existence of the religious exemption substantially weakens the argument that an employer's purchase of insurance for a third-party employee is not a religious exercise. The religious exemption suggests implicitly—if not explicitly—that, in the government's view,

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263. Emp't Div., Dep't of Human Res. v. Smith, 494 U.S. 872, 884 (1990); Sherbert v. Verner, 374 U.S. 398, 402-03 (1963).

264. *Smith*, 494 U.S. at 884.

265. *Id.* Recall that in *Sherbert*, because the state allocated unemployment benefits on a case-by-case basis, the Court held that the state's denial of Sherbert's unemployment benefits, despite infringement on her religious practice, served no compelling state interest. *Sherbert*, 374 U.S. at 407.

266. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(3) (2012). The fourth qualification refers to definitions in separate sections of the Code.

267. *Id.* § 147.130(a)(1)(iv)(B)(1).

268. *Id.* §§ 147.130(a)(1)(iv)(B)(2)-(3).

269. Stallings, *supra* note 146, at 135.

270. *See supra* Part III.B.

the purchase of insurance benefits burdens some religious groups.[271] After all, if there is no religious freedom at stake, why make an exemption at all?

HHS carved out an exemption for only those religious groups that meet the narrow definition of religious employer.[272] The absurd result of the narrow exemption is that it fails to exempt all religious employers that share the same, sincerely-held religious beliefs. Perhaps nothing concedes this point more clearly than HHS's own response to the criticism of the religious exemption. In response to more than 200,000 comments it received from the March 2012 ANPRM,[273] in February 2013, HHS announced its intention to provide a new "accommodation" for non-exempt religious employers.[274] The accommodation would create yet another class of religious employer.[275] The class includes an employer that (1) "opposes providing coverage for [contraceptive and sterilization procedures] on account of religious objections," (2) "is organized and operates as a nonprofit entity," and (3) "holds itself out as a religious organization."[276] These employers would be eligible for an accommodation that relieves the employer of "contracting, arranging, paying, or referring" employees for such coverage.[277] Instead, the employer's insurance provider would provide a separate contraceptive coverage plan directly to the employees.[278]

The proposed accommodation makes abundantly clear the shortcomings of the narrow religious exemption. The definition of religious employer simply does not include the full range of religious employers HHS now seeks to "insulate" from providing insurance coverage for contraceptive services.[279] Together, HHS's religious employer exemption and the proposed accommodation implicitly concede that the contraceptive coverage requirement imposes substantial constraints on the free exercise of religion. Therefore, because the IFR substantially burdens the free exercise of religion, the regulation triggers RFRA's strict scrutiny test.

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271. Final Rule, *supra* note 31, at 8727 ("In response to these comments [on the IFR], the Departments carefully considered whether to eliminate the religious employer exemption or to adopt an alternative definition of religious employer, including whether the exemption should be extended to a broader set of religiously-affiliated sponsors of group health plans and group health insurance coverage. For the reasons discussed below, the Departments are adopting the definition in the amended interim final regulations for the purposes of these final regulations while also creating a temporary enforcement safe harbor, discussed below.")

272. 45 C.F.R. §§ 147.130(a)(1)(iv)(B)(1)-(4) (2012).

273. Proposed Rules, *supra* note 60, at 8459.

274. *Id.* at 8461. The accommodation would also apply to student health insurance plans arranged by qualifying religious institutions of higher education.

275. *Id.* at 8462.

276. *Id.*

277. *Id.*

278. *Id.* at 8462-63. HHS also proposes an accommodation for self-insured employer plans, in which the employer does not purchase insurance from an insurance company, but uses only a third-party to administer a group plan fully funded by the employer. *Id.* at 8463-64.

279. *Id.* at 8462.

2. Strict Scrutiny.—RFRA prohibits the government from substantially burdening a person's exercise of religion unless the government shows the burden (1) "is in furtherance of a compelling governmental interest" and (2) "is the least restrictive means of furthering that compelling governmental interest."[280]

Senator Mikulski's remarks when introducing the WHA reveal a number of arguably compelling interests the government seeks to advance—expanding women's access to preventive care, eliminating gender disparities in health care costs, and standardization of covered insurance services.[281] More specific to contraceptive services, the government might cite the detrimental health effects the medical community attributes to unintended pregnancies.[282] Indeed, HHS states that the IFR is "designed to serve . . . compelling public health and gender equity goals."[283] But what is "compelling" to one court may not seem so to another. As Justice Scalia warned in *Smith*, "[i]f 'compelling interest' really means what it says (and watering it down here would subvert its rigor in the other fields where it is applied), many laws will not meet the test."[284] There is no guarantee that a court would find the interests the WHA advances compelling.[285]

Regardless of whether these interests are compelling, the HHS rule does not employ the least restrictive means to achieve them. The IFR suggests that an exemption for some religious employers is necessary to protect those employers' religious beliefs. Nevertheless, the exemption is so narrow that it fails to include all similarly-situated employers with the same religious objection. It seems that if the least restrictive means to further the compelling interest is to exempt one religious employer, the least restrictive means would be to exempt any employer with a religious objection. The under-inclusiveness of HHS's exemption draws an illogical line between these categories of religious employers. "Very" religious employers are exempt from the contraceptive coverage requirement because the regulation is otherwise too burdensome. On the other hand, "only somewhat" religious employers must bear the burden.

Because the exemption ultimately affects a third-party employee, all religious exemptions will always fail to achieve the interest advanced. Imagine two employees of religious institutions: Anna, an employee of Faithful Church (which qualifies for an exemption), and Betty, who works at Holy Hospital (which likely does not qualify). In both employment situations, the compelling state interests

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280. 42 U.S.C. §§ 2000bb-1(a)-(b) (2006 & Supp. 2011).

281. *See supra* Part III.

282. *See supra* Part II.

283. Final Rule, *supra* note 31, at 8729.

284. Emp't Div., Dep't of Human Res. v. Smith, 494 U.S. 872, 888 (1990).

285. *See* Korte v. Sebelius, No. 12-3841, 2012 WL 6757353, at *4 (7th Cir. Dec. 28, 2012) (Plaintiffs, Catholic owners of a construction company, appealed the district court's denial of their motion for preliminary injunction, which would have prevented enforcement of the contraceptive coverage requirements. The Seventh Circuit, in granting their motion for injunction pending appeal, noted that "[w]hether these interests qualify as 'compelling' remains for later in this interlocutory appeal; the government has not advanced an argument that the contraception mandate is the least restrictive means of furthering these interests.").

and the religious objections are the same. Anna's insurance does not cover the full range of services IOM deemed important for women's health because HHS exempts Faithful Church due to its religious beliefs. In essence, HHS has determined that Anna's employer's religious beliefs outweigh the compelling interest of providing her with expanded insurance coverage. On the other hand, Betty's employer also sincerely rejects coverage of contraceptive and sterilization services for religious reasons. But Betty's insurance will cover the full range of women's health services required, because the compelling government interest of providing Betty with insurance coverage apparently outweighs Holy Hospital's religious objections. Why leave Anna uncovered if the compelling interest is women's health?

The HHS rule reveals the misguided and damaging assumption on which HHS based the exemption. On February 15, 2012, HHS wrote that the narrowness of the exemption is appropriate because "the employees of employers availing themselves of the exemption would be less likely to use contraceptives even if contraceptives were covered under their health plans."[286] HHS explicitly assumes that women like Anna who work for "more religious" institutions are themselves "more religious." Thus, HHS reasons, these employees are less likely to need insurance coverage for contraceptive services. But we know nothing about Anna's religious convictions or her medical needs. No matter what they are, Anna will not receive the same "minimum essential coverage" as a result of her employer's religious beliefs.[287] Where HHS's goal is to promote women's health, this is an impermissible assumption. HHS should not evaluate a woman's religious conviction or medical needs based on her employer's religious beliefs. And HHS should not relieve her employer of an obligation to provide benefits that an independent medical body has deemed minimal and essential to her health.

CONCLUSION

The framework of the PPACA, which expands employer-sponsored insurance programs in order to improve Americans' access to health care services, presents unique and interesting legal challenges. The Women's Health Amendment and the HHS regulation require employers to provide insurance coverage for specific medical services, including contraceptives. For some employers, the purchase and use of contraceptives conflicts with their religious beliefs. Therefore, in an effort to accommodate the religious beliefs of some employers, the Department of Health and Human Services crafted a narrow exemption to the contraceptive services requirement.

However, the poorly-crafted exemption fails to protect adequately the healthcare needs of women in the workplace *and* the sincerely held religious beliefs of some employers. By excluding a woman from coverage based on her employer's beliefs, the HHS exemption denies the woman access to services based on religious convictions she may not share. It is unfair to deny an

286. Final Rule, *supra* note 31, at 8728.

287. 26 U.S.C. § 4980H(a) (Supp. 2011).

employee benefits because of her employer's religious beliefs, particularly if employees of large employers categorically receive those benefits. In addition, the narrowness of the exemption insulates some religious employers from the requirement, while denying an exemption to employers that share the very same religious convictions. If the religious exemption truly seeks to protect the free exercise of religious employers, the exemption should be available to any organization that shares the same religious convictions.

The religious exemption neither protects women's health interests nor ensures employers' religious freedoms. More importantly, the exemption undermines the goals of the Women's Health Amendment. Congress passed the Women's Health Amendment to provide women greater access to preventive care and to decrease gender-based disparities in health care costs. To fulfill the promise of the Amendment, HHS should abandon the exemption and require all employers to cover the services that the Institute of Medicine recommends as necessary for women's health. In this way, HHS can refocus its attention on advancing the health of American women.

BREWING TENSION: THE CONSTITUTIONALITY OF INDIANA'S SUNDAY BEER-CARRYOUT LAWS

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INTRODUCTION

In the United States, beer is big business[1] and 2012 was a landmark year.[2] The $99 billion industry was up 1% overall,[3] and many in the industry saw tremendous growth.[4] Indeed, craft brewers[5]—representing 98% of those brewing[6]—grew by an incredible 15% in volume and 17% in retail dollars.[7] What is more, between June 2011 and June 2012, 350 new breweries got in on the craft-brewing boom,[8] bringing the count of operating domestic breweries well over 2000,[9] finally surpassing a 125-year-old national brewery-count record.[10] Even as new breweries are opening at a rate exceeded only by that on the day Prohibition ended,[11] the market still seems tantalizingly untapped; "macrobreweries,"[12] the remaining 2% of domestic brewers,[13] still dominate,[14]

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1. *Beer Sales*, BREWERS ASS'N, http://www.brewersassociation.org/pages/business-tools/craft-brewing-statistics/beer-sales (last visited Feb. 6, 2014). The overall beer industry is estimated at $99 billion. *Id.*

2. *Brewer's Association Reports 2012 Mid-year Growth for U.S. Craft Brewers*, BREWERS ASS'N (Aug. 6, 2012), http://www.brewersassociation.org/pages/media/press-releases/show?title=brewers-association-reports-2012-mid-year-growth-for-u-s-craft-brewers [hereinafter *Mid-year Growth*].

3. *Beer Sales*, *supra* note 1.

4. *Id.*

5. *Id.* Craft brewers are those who produce six million or fewer barrels of beer annually. *Craft Brewer Defined*, BREWERS ASS'N, http://www.brewersassociation.org/pages/business-tools/craft-brewing-statistics/craft-brewer-defined (last visited Feb. 6, 2014). For perspective, a barrel is thirty-one gallons, or 13.78 cases of twenty-four twelve-ounce bottles. *Beer Sales*, *supra* note 1.

6. *Craft Beer Backgrounder*, BREWERS ASS'N, http://www.brewersassociation.org/pages/media/Craft-Beer-Backgrounder (last visited Feb. 6, 2014).

7. *Beer Sales*, *supra* note 1.

8. *Mid-year Growth, supra* note 2.

9. *Id.*

10. *Id.*; *Number of Breweries*, BREWERS ASS'N, http://www.brewersassociation.org/pages/business-tools/craft-brewing-statistics/number-of-breweries (last visited Feb. 6, 2014) (charting 2126 breweries operating in June 2012 in contrast to just eighty-nine breweries in the late 1970s, and, in 2012, overtaking the most-recent high of 2011 breweries in 1887).

11. *Mid-year Growth, supra* note 2.

12. *Craft Brewer Defined*, *supra* note 5. "Macrobrewery" describes breweries that are too large to be considered craft breweries, therefore, based on the definition of craft breweries, this means brewers who produce more than six million barrels of beer annually. *Id.*; *see also* David

controlling as much as 90% of the $99 billion industry.[15]

As consumers become choosier about their beer,[16] new and established craft brewers are eager to make up ground in the market,[17] earning their share of the multibillion-dollar industry.[18] Furthermore, in a struggling economy,[19] the realized and potential success of homegrown craft breweries is at least one encouraging industry for would-be entrepreneurs, job seekers, and state policy analysts alike. Correspondingly, because of recent changes to Indiana law, the state and its brewers are uniquely positioned to gain.[20]

Between 2004 and 2010, Indiana's brewery count doubled from twenty-one to forty-three.[21] During that period of tremendous growth, in-state brewers began

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Sirota, *Can Beer Save America?*, SALON (May 7, 2012, 11:43 AM), http://www.salon.com/2012/05/07/can_beer_save_america (providing a general discussion of brand impressions of the two). The barrel-per-year limit previously was two million, but was increased to six million at the urging of Boston Beer Company, so Samuel Adams beer could retain craft status. *See* Joe Daley, *Sam Adams Beer Pleads to Keep Craft Status*, HUFFINGTON POST (May 25, 2011, 5:45 PM), http://www.huffingtonpost.com/2010/06/14/sam-adams-craft-status-be_n_607395.html.

13. *Craft Beer Backgrounder*, *supra* note 6.

14. *Beer Sales*, *supra* note 1.

15. Authority differs as to just how much market share the biggest breweries control, but in recent years, sources provide a figure roughly between 80% and 90%. *Craft Beer Backgrounder*, *supra* note 6 (noting that the craft breweries represent about 10% of overall beer sales); David Kesmodel, *MillerCoors Grooms No. 2*, WALL ST. J. ONLINE (Sep. 13, 2010), http://online.wsj.com/article/SB10001424052748703597204575483463004764270.html (indicating Anheuser-Busch InBev and Miller Coors Brewing Co. alone control roughly 79% of the market, 49% and 30.39%, respectively).

16. *See, e.g.*, Sirota, *supra* note 12 (discussing the current "battle between the low-price/quantity business model and the higher-price/quality business model" that is "nowhere . . . more clear than in the world of beer").

17. *See* Tom Rutunno, *As Craft Beer Grows, Some Brewers Spread Out, Others Scale Back*, CNBC (Apr. 12, 2012, 1:37 PM), http://www.cnbc.com/id/47030325/As_Craft_Beer_Grows_Some_Brewers_Spread_Out_Others_Scale_Back (noting how craft brewers are rapidly expanding in response to increased sales).

18. *Beer Sales*, *supra* note 1.

19. *The Employment Situation—January 2013*, BUREAU OF LABOR STATS., http://www.bls.gov/news.release/archives/empsit_02012013.htm (last visited Feb. 6, 2014) (reporting a 7.9% nationwide unemployment rate in January 2013); *Regional and State Employment and Unemployment (Monthly) News Release*, BUREAU OF LABOR STATS., http://www.bls.gov/news.release/archives/laus_01182013.htm (last visited Nov. 25, 2012) (showing Indiana with 8.2% unemployment in December 2012).

20. *See infra* Part V.

21. *Brewer's Almanac*, BEER INSTITUTE (Mar. 28, 2013), http://www.beerinstitute.org/assets/uploads/Brewers_Almanac-_20131.xlsx (open the Microsoft Excel document; navigate to the tab called "Brewers by State"). Notably, too, across the nation, more than 1200 breweries were reportedly in planning stages, compared to just 725 in 2011. *Mid-year Growth*, *supra* note 2.

lobbying for advantageous changes to Indiana's laws.[22] Specifically, the brewers sought to revise Indiana's deep-seated Sunday sales restrictions,[23] which continue to form the most-regulated beverage climate in all the United States.[24] Under the Indiana Code as it existed then,[25] consumers could buy beer on Sundays, but only for on-premises consumption[26]—for example, purchasing a beer with dinner. Consumers could not make Sunday beer purchases that would remove the beverage from the premises,[27] commonly referred to as carryout purchases, such as buying beer at a liquor store, drug store, or grocery store.[28]

For in-state brewers, having access to this fastened-up Sunday carryout market was attractive.[29] Rather than seek to open the Sunday carryout market entirely, which would also give liquor stores, drug stores, grocery stores, and other licensed outlets market access, the brewers limited their lobbying efforts.[30] The brewers sought the exclusive ability to sell their own products for carryout

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22. *State of the Six Pack 2011*, HOOSIER BEER GEEK BLOG (Feb. 17, 2011), http://hoosierbeergeek.blogspot.com/2011/02/2011-state-of-six-pack-part-3-agenda.html [hereinafter *Six Pack*] (indicating through brewery-owner quotations that breweries lobbied for this change for many years, through lobbyist Mark Webb); *see also* Rita Kohn, *Sunday Beer Returns*, NUVO, June 10, 2010, http://www.nuvo.net/indianapolis/sunday-beer-returns/Content?oid=1416414#.ULViZ-Oe9qt. (observing that the change reflects "what the Brewers of Indiana Guild ha[d] been wishing for"); *Mad Anthony to Sell Carry Out on Sunday*, WANE.COM (July 2, 2010, 11:46 AM) [hereinafter *Mad Anthony*], http://www.wane.com/dpp/news/mad-anthony-sunday-carry-out-sales (noting through a quotation that brewery owners have worked toward this change for five years).

23. *Mad Anthony*, supra note 22.

24. Laws limiting the Sunday sale of alcohol trace back to as early as 321 A.D. Michael Lee Carmin, Note, *Indiana's Sunday Alcoholic Beverage Sales: Regulation Without Justification*, 55 IND. L.J. 189, 192 (1979). Yet, in the wake of the Twenty-first Amendment and in light of changing social views as to the morality of alcohol consumption, the states have progressively lifted these restrictions. Elizabeth Maker, *Buy Alcohol on Sunday? Connecticut Now Allows It*, N.Y. TIMES, May 20, 2012, at A19, *available at* http://www.nytimes.com/2012/05/21/nyregion/sunday-liquor-sales-end-an-era-in-connecticut.html?_r=0. Indiana currently has more restrictions on Sunday alcohol sales than any other state. *Id.* (noting how prior to the change to Connecticut law, "Connecticut and Indiana had been the only states with such broad [Sunday sales] restrictions," including a broad restriction on carryout alcohol sales).

25. 2010 Ind. Legis. Serv. Pub. L. No. 10-2010 (S.E.A. 75) (West).

26. *Id.*

27. *Id.*

28. *See* Lindy Thackston, *Group Pushes for Relaxing Sunday Alcohol Sales in Indiana*, WTHR, http://www.wthr.com/story/16325524/group-pushes-for-relaxing-sunday-alcohol-sales-ban (last visited Feb. 6, 2014).

29. *Six Pack*, *supra* note 22; *see also* Kohn, *supra* note 22; *Mad Anthony*, *supra* note 22.

30. *Six Pack*, *supra* note 22. This is not to suggest any bad faith on the part of the brewers, indeed, any other position would likely have met opposition from powerful lobbyists on behalf of liquor stores, who regularly vocalize concerns that an open Sunday market would jeopardize their business. *See id.*; Thackston, *supra* note 28.

on Sundays, a privilege wine producers in the state have enjoyed since 1982.[31]

The brewers' lobbying efforts were ultimately successful, spurring a change to Indiana law that went into effect on July 1, 2010.[32] As a result of the change, certain brewers now have the exclusive ability to sell their own beers on Sundays for off-premises consumption.[33] In other words, if consumers want to purchase beer and bring it home on a Sunday, Indiana breweries are their only in-state option.

Since passed, the propriety of this law (hereinafter "Sunday law") has not been challenged.[34] Indeed, although the Sunday law does treat in-state interests differently, in that in-state breweries have access to a market that other in-state outlets do not, such differential treatment of in-state interests would not affront the Constitution.[35] Nevertheless, because of underlying laws structuring access

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31. *See* Christopher Ayers, *Brewpubs, Wineries Change Little to Prepare for Sunday Competition*, IND. PUB. MEDIA (May 21, 2010), http://indianapublicmedia.org/news/brewpubs-wineries-change-prepare-sunday-competition-8379/ (noting the origins of the long-held Sunday carryout privilege for wineries and how, despite breweries entering the Sunday market, wineries do not fear negative business impact).

32. 2010 Ind. Legis. Serv. P.L. 10-2010.

33. *Id*. Brewers do not enjoy the unlimited ability to sell their beer; qualifying brewers may sell no more than 576 ounces to a customer in one transaction and may also only sell beer at an address where (1) they hold a brewer's permit and (2) only if the address is located within the same city boundaries as where the beer was originally brewed. *Id*.

34. Although no one has formally challenged the Sunday law, there is a pendent challenge over other aspects of Indiana's alcohol legislation. *See* Complaint, Indiana Petroleum Marketers & Convenience Store Ass'n et al. v. Huskey et al., No. 1:13-cv-00784 (S.D. Ind. May 14, 2013) (alleging an equal protection violation because Indiana allows the sale of cold alcohol from some in-state outlets but not others). Further, in-state interests have made efforts to gain access to the Sunday carryout market. *See Group Plans Another Push for Sunday Alcohol Sales*, IND. BUS. J., Dec. 14 , 2011, *available at* http://www.ibj.com/group-plans-another-push-for-sunday-alcohol-sales/PARAMS/article/31374. Interestingly, a 2010 effort resulted in a Senate Bill that would have permitted grocery stores and liquor stores to sell beer on Sundays—but only beer made in Indiana. S.B. 106, 2012 Reg. Sess. (Ind. 2012). What is more, a series of Senate Bills have been proposed in 2013 that would make further changes to Indiana's carryout framework and closely related laws, subject to the constitutional limitations described in this Note. S.B. 13, 2013 Reg. Sess. (Ind. 2013) (proposing the creation of a supplemental dealer's permit that would allow specific permit holders to sell carryout alcohol on Sundays); S.B. 100, 2013 Reg. Sess. (Ind. 2013) (allowing the holder of an in-state or out-of-state brewer's permit to sell microbrewery beer for carryout at a farmers' market); S.B. 231, 2013 Reg. Sess. (Ind. 2012) (making an exception to the current laws restricting the sale of cold beer when delivering the beer cold is necessary to meet a brewer's specified storage and sale temperature requirements); H.B. 1293, 2013 Reg. Sess. (Ind. 2013) (creating an artisan distiller's permit for liquor sampling and sales but restricting access to the permit to those who have held a brewery permit, farm winery permit, or distiller's permit for three years prior to application).

35. *See, e.g.*, Ry. Express Agency v. Virginia, 347 U.S. 359, 372 (1954) (holding that an evenhanded tax is constitutionally permissible but not when it discriminates in some way against interstate commerce). The Commerce Clause is concerned with interstate commerce, not intrastate

to Indiana's alcohol market for out-of-state brewers, the Sunday law for brewers and, with it, a similar law for in-state wineries,[36] invites further examination. Could it be that Indiana's flourishing craft-brewing industry is improperly supported, even indirectly subsidized, through unconstitutional legislative measures? This Note explores that very question, arguing that in light of recent Supreme Court jurisprudence and interpretations of the Commerce Clause and Twenty-first Amendment, Indiana's current beer-sales laws improperly advantage in-state brewers while disadvantaging out-of-state brewers. These laws[37] would not likely withstand a constitutional challenge under the current analytical framework.

Part I of this Note introduces the three-tier distribution system, which is the nationally predominant[38] way of structuring alcohol sales into and throughout the state.[39] Part II provides an illuminative history of alcohol-related legislation in the United States, including the emergence of the three-tier distribution system, while focusing on the historic interplay between the Twenty-first Amendment and the Commerce Clause, leading up to a landmark 2005 Supreme Court decision, *Granholm v. Heald*.[40] Part III discusses the *Granholm* decision. Part IV briefly explores the propriety of the three-tier distribution itself, in light of *Granholm*. Part V assesses Indiana's current regulatory framework under *Granholm*, the Supreme Court's last word on the matter. Part VI lays out the Seventh Circuit's post-*Granholm* approach, paying special attention to the recent *Lebamoff*

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commerce. U.S. CONST. art. I, § 8, cl. 3. Differential treatment of in-state interests would implicate the Equal Protection Clause, but an Equal Protection challenge, if brought, would be dispensed with using the lowest standard of review. *See* City of Cleburne v. Cleburne Living Ctr., Inc., 473 U.S. 432, 441-42 (1985) (using rational basis review to uphold a law that treated some in-state interests differently but advanced a legitimate state interest, applying the lowest form of review because the law did not divide on the basis of a protected class, such as race or gender).

36. Because of the significant scale of the beer industry—nationally, the beer industry represents more than the wine and liquor industries combined—coupled with intensifying beer-related legislative efforts in Indiana, this Note will focus on Indiana's beer-related laws, as a microcosmic analysis of its beverage policy as a whole. At the time of writing, the reasoning and conclusion this Note draws apply to Indiana's current wine-related carryout laws. A deeper exploration of Indiana's myriad, complicated, and ever-changing alcoholic beverage laws could reveal further battlegrounds for a constitutional challenge. For an overview of the size of the beer industry in relation to liquor and wine, see Emily Bryson York, *Liquor, Wine Continue to Take Share From Beer Sales*, CHI. TRIB. ONLINE (Jan. 31, 2012), http://articles.chicagotribune.com/2012-01-31/business/ct-biz-0131-liquor-export-20120131_1_liquor-sales-alcohol-sales-david-ozgo (indicating beer comprises 49.2% of the $59.24 billion alcohol industry, with liquor accounting for 33.6% and wine accounting for just 17.1%).

37. *Id.*

38. IND. CODE § 7.1-5-10-5 (2012); Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, 851 (7th Cir. 2000).

39. *Bridenbaugh*, 227 F.3d at 851.

40. Granholm v. Heald, 544 U.S. 460 (2005).

Industries, Inc. v. Huskey[41] decision. Part VII applies the Seventh Circuit's synthesized approach, ultimately concluding that Indiana's current regulatory system would likely be found unconstitutional. Finally, Part VIII proposes changes to Indiana's beverage laws to comport with post-*Granholm* jurisprudence.

I. AN OVERVIEW OF THE THREE-TIER DISTRIBUTION SYSTEM

An examination of Indiana's Sunday laws requires an understanding of the three-tier distribution system, the most common way states structure alcohol sales.[42] States that have adopted the three-tier distribution system use it to regulate alcohol in commerce.[43] "The system typically permits manufacturers (tier one) to sell only to licensed wholesalers (tier two), who in turn can only sell to licensed retailers (tier three)."[44] For clarity, this Note refers to those at tier one as Producers, those at tier two as Distributors, and those at tier three as Retailers.

For states adopting the three-tier distribution system, Producers include both in-state and out-of-state breweries, wineries, and distilleries.[45] At the next tier, Distributors are either state-run operations or state-licensed businesses that buy the alcohol directly from the Producers and sell the alcohol to the in-state Retailers.[46] General consumers may not purchase alcohol from Distributors.[47] Rather, consumers may only purchase alcohol directly from Retailers, which include bars, restaurants, liquor stores, drug stores, grocery stores, and various other licensed businesses.[48] Depending on the scope of a Retailer's license, the Retailer may sell some or all kinds of alcohol to consumers for on-premises consumption (e.g., drinking a beer at dinner or at the bar) or off-premises/carryout consumption (e.g., bringing beer home to consume).[49] Some Retailers are licensed to sell alcohol for both on-premises consumption and off-premises consumption.[50]

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41. Lebamoff Enter., Inc. v. Huskey, 666 F.3d 455 (2012).

42. *Bridenbaugh*, 227 F.3d at 851.

43. *See infra* Part II.

44. Gregory E. Durkin, *What Does* Granholm v. Heald *Mean for the Future of the Twenty-First Amendment, the Three-Tier System, and Efficient Alcohol Distribution?*, 63 WASH & LEE L. REV. 1095, 1097 (2006).

45. *Id.* at 1098.

46. *Id.* at 1097.

47. *Id.*

48. *Id.*

49. *See, e.g.*, IND. CODE §§ 7.1-3-4-6, -9-9, -14-4 (2012) (defining the scope of certain permits for beer, wine, and liquor, allowing on-premises consumption while restricting quantities sold for off-premises consumption).

50. *Compare id.* § 7.1-3-4-6 (allowing permit holders to sell beer for on-premises and off-premises consumption), *with id.* § 7.1-3-5-3 (defining the scope of different beer permit that allows on-premises consumption but expressly notes that the permit holder "may not sell beer by the drink nor for consumption on the licensed premises nor . . . allow it to be consumed on the licensed

Typically, no entity may operate or exist at more than one tier.[51] In other words, a Distributor may not also operate as a consumer-facing Retailer, or, chiefly at issue in this Note, a Producer typically may not also operate as a Distributor and/or a Retailer. Some exceptions, as they inhere in the three-tier distribution system itself, may be permissible, and will be discussed in subsequent Parts of this Note.[52]

II. ALCOHOL AND INTERSTATE COMMERCE: HISTORICAL BACKGROUND ON ALCOHOL SALES IN THE UNITED STATES

Within Article I, Section 8 of the Constitution is the "Commerce Clause," which gives Congress a certain power "[t]o regulate Commerce . . . among the several states" when it so chooses.[53] In addition to the "positive" power the Commerce Clause gives Congress to actively regulate, courts have inferred a "negative" power; that is, where Congress could elect to regulate interstate commerce, the Commerce Clause impliedly limits how states may regulate interstate commerce.[54] Often referred to as the Negative Commerce Clause or, more often, the Dormant Commerce Clause, this inferred mandate "limit[s] the power of the [states] to adopt regulations that discriminate against interstate commerce."[55] The basis of this interpretation is to reflect a central concern of the Framers,[56] which was to "prohibit economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."[57] As the Supreme Court has stated, "[A]n immediate reason for calling the Constitutional Convention . . . [was] the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic [protectionism] that had plagued relations among the Colonies and later among the States under the Articles of Confederation."[58]

If one considers traditional Commerce Clause jurisprudence in isolation, then alcohol shipped from one state into another state would most certainly be an article of interstate commerce.[59] Thus, Congress could regulate the sale of alcohol and, via the Dormant Commerce Clause, states could not unduly burden

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premises.").

51. *Id.*

52. Granholm v. Heald, 544 U.S. 460, 524 (2005).

53. U.S. CONST. art. I, § 8, cl. 3.

54. West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 192 (1994).

55. *Id. See* City of Phila. v. New Jersey, 437 U.S. 617 (1978); Pike v. Bruce Church, Inc., 397 U.S. 137 (1970).

56. Hughes v. Oklahoma, 441 U.S. 322, 335-36 (1979); *see also* Thurlow v. Massachusetts, 46 U.S. 504, 563 (1847) ("Let it not be forgotten that the oppressed and degraded condition of commerce was one of the most urgent and pressing reasons which induced the formation of the [C]onstitution.").

57. New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 273-74 (1988).

58. *Hughes*, 441 U.S. at 325.

59. Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, 851 (7th Cir. 2000).

interstate commerce through legislation—for example, by imposing additional taxes on out-of-state Producers while using the taxes to subsidize in-state Producers.[60] Nevertheless, when evaluating alcohol-related legislation, the Commerce Clause may not be viewed in isolation. Rather, because of the deeply entrenched "moral nature" of alcohol and its express treatment through the Eighteenth and Twenty-first Amendments, the requisite analysis is not as clear.[61]

A. Pre-Amendment Treatment of Alcohol

"Since the founding of our Republic, power over regulation of liquor has ebbed and flowed between the federal government and the states."[62] As early as 1847, in *The License Cases*,[63] "the Supreme Court recognized broad state authority to regulate alcohol"[64] under the police powers reserved via the Tenth Amendment, "noting that states were free from the implied restrictions of the Commerce Clause."[65] Yet, four decades later in *Leisy v. Hardin*,[66] the Court struck down an Iowa law that permitted the confiscation of alcohol shipped into the state if the alcohol lacked a proper state permit.[67] The court determined that Congress had the power to regulate articles in commerce and, where Congress had not spoken, states could not interfere.[68]

In direct response to *Leisy*, Congress enacted legislation on the matter and passed the Wilson Act,[69] providing that beverages originating from out of state became subject to the laws of the receiving state once they arrived within the receiving state.[70] The passage of the Wilson Act was a success for proponents of the temperance movement, eliminating the prior anomaly that states could ban all in-state production and consumption of alcohol yet remain powerless to control its importation.[71]

The Court found the passage of the Wilson Act to be within Congress's power,[72] yet later determined the Wilson Act did not apply to liquor that was still

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60. *See* West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 192 (1994).

61. *See infra* Parts II.A-VII.

62. Castlewood Int'l Corp. v. Simon, 596 F.2d 638, 641 (5th Cir. 1979).

63. 46 U.S. (5 How.) 504, 579 (1847).

64. Fla. Dep't of Bus. Regulation v. Zachy's Wine & Liquor, Inc., 125 F.3d 1399, 1401 (11th Cir. 1997) (interpreting *The License Cases*, 46 U.S. (5 How.) 504 (1847)).

65. *Id*.

66. 135 U.S. 100 (1890).

67. *Id.* at 119.

68. *Id.* ("The absence of any law of congress on the subject is equivalent to its declaration that commerce in that matter shall be free.").

69. Wilson Act, ch. 728, 26 Stat. 313 (1890) (codified as amended at 27 U.S.C. § 121 (2000)).

70. *Id.*

71. *Id.*

72. *See In re* Rahrer, 140 U.S. 545, 549 (1891).

in transit.[73] Thus, individual states could not prohibit a resident from ordering and receiving alcohol from an out-of-state vendor, so long as it was for personal consumption.[74] Because of the limitation interpreted in the Wilson Act, a state was unable to regulate all the alcohol entering its borders.[75] To eliminate this loophole, Congress passed 1913's Webb-Kenyon Act,[76] which "divest[ed] intoxicating liquors of their interstate character in certain cases"[77] and made all alcohol subject to the receiving state's laws.[78] The Court expressly recognized this function of the Webb-Kenyon Act, finding its purpose "was to prevent the immunity characteristic of interstate commerce from being used to permit the receipt of liquor . . . in States contrary to their laws."[79]

Once the Eighteenth Amendment was ratified and took effect in 1920,[80] Prohibition rendered the Wilson Act and Webb-Kenyon Act obsolete until the passage of the Twenty-first Amendment.[81]

B. The Twenty-first Amendment's Passage and Subsequent Analysis of Alcohol in Commerce, Leading Up to 2005's Granholm *Decision*

The Twenty-first Amendment contains two predominant sections.[82] Section 1 expressly overturns the Eighteenth Amendment.[83] Section 2 appears to embrace the concerns embodied in the Wilson Act and Webb-Kenyon Act, providing that "[t]he transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."[84] Indeed, in early post-Prohibition decisions, the Court seemed to reach back to pre-Prohibition jurisprudence and use Section 2 to divest alcohol of its interstate character, upholding discriminatory state laws that would otherwise be struck down under the Commerce Clause.[85] For

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73. Fla. Dep't of Bus. Regulation v. Zachy's Wine & Liquor, Inc., 125 F.3d 1399, 1401 (11th Cir. 1997) (noting Rhodes v. Iowa, 170 U.S. 412 (1898) and Vance v. W.A. Vandercook Co., 170 U.S. 438 (1898)).

74. *Id.*

75. *Id.*

76. Webb-Kenyon Act, ch. 90, 37 Stat. 699 (1913) (codified as amended at 27 U.S.C. § 122 (2006)).

77. *Id.*

78. *Id.*

79. James Clark Distilling Co. v. W. Md. Ry. Co., 242 U.S. 311, 324 (1917).

80. U.S. CONST. amend. XVIII.

81. Tania K. M. Lex, Case Note, *Case Note: Of Wine and War: The Fall of State Twenty-first Amendment Power at the Hands of the Dormant Commerce Clause*—Granholm v. Heald, WM. MITCHELL L. REV. 1145, 1152-53 (2006).

82. U.S. CONST. amend. XXI, §§ 1-2.

83. U.S. CONST. amend. XXI, § 1 ("The eighteenth article of amendment to the Constitution of the United States is hereby repealed.").

84. U.S. CONST. amend. XXI, § 2.

85. *See* Indianapolis Brewing Co. v. Liquor Control Comm'n of State of Mich., 305 U.S. 391,

example, in *Indianapolis Brewing*, the Court upheld a Michigan law that banned the sale of beer manufactured in certain states, finding that "the right of a state to prohibit or regulate the importation of intoxicating liquor is not limited by the commerce clause."[86] Similarly, in *Young's Market*, the Court upheld a California statute that imposed a license fee on the importation of beer to California, but not on beer produced in California.[87] The court determined the Twenty-first Amendment carried a "broad command" and noted that a state could permissibly go so far as to "permit the domestic manufacture of beer and exclude all made without the State."[88] In these early decisions, therefore, the Court found that the Twenty-first Amendment excluded alcohol from traditional Commerce Clause principles.

Later, however, in *Bacchus Imports Ltd. v. Dias*,[89] the Court seemed less certain as to the proper interpretation of Section 2.[90] The Court was forthright in its uncertainty, stating, "Despite broad language in some of the opinions of this Court written shortly after ratification of the [Twenty-first] Amendment, more recently we have recognized the obscurity of the legislative history."[91] The Court went on to note that "[n]o clear consensus concerning the meaning of the provision is apparent."[92] The Court further noted inconsistent statements by the Amendment's Senate sponsor, statements that reveal two competing interpretations of Section 2 that persist today.[93]

1. The Broad Interpretation of Section 2.—When Senator Blaine, the Twenty-first Amendment's Senate sponsor, reported his view of Section 2, he remarked that Section 2's purpose was "to restore to the States . . . absolute control in effect over interstate commerce affecting intoxicating liquors."[94] This is the broadest interpretation of Section 2, an interpretation that divests alcohol of its interstate character and would permit alcohol-related state laws that would normally offend the Commerce Clause.[95] Indeed, the Court applied this broad interpretation in deciding *Indianapolis Brewing* and *Young's Market*.[96]

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394 (1939); *see also* State Bd. of Equalization of Cal. v. Young's Mkt. Co., 299 U.S. 59, 62-63 (1936).

86. *Indianapolis Brewing*, 305 U.S. at 394.

87. *Young's Mkt.*, 299 U.S. at 62-63.

88. *Id.*

89. 468 U.S. 263, 275 (1984).

90. *Id*.

91. *Id.* at 274 (citation omitted).

92. *Id.*

93. *Id.* at 274-75; *see also* Granholm v. Heald, 544 U.S. 460 (2005) (noting the historic tension between the interpretations of Section 2 and taking a new approach in reconciliation of the issue).

94. 76 CONG. REC. 4143 (Feb. 15, 1933) (Statement of Sen. John James Blaine).

95. *See e.g.*, *Indianapolis Brewing*, 305 U.S. at 394 ("Since the Twentyfirst [sic] Amendment . . . the right of a state to prohibit or regulate the importation of intoxicating liquor is not limited by the commerce clause . . . .")

96. *See supra* Part II.B.

2. The Narrow Interpretation of Section 2.—Yet, Blaine also voiced a narrower view, indicating the Twenty-first Amendment exists only to give states the option, and attendant ability, to remain dry: "So, to assure the so-called dry States against the importation of intoxicating liquor into those States, it is proposed to write permanently into the Constitution a prohibition along that line."[97]

3. The Supreme Court's Evolving Approach to Section 2.—Despite its early jurisprudence,[98] the Court rejected the broadest interpretation in decisions leading up to *Bacchus*[99] and began to adopt[100] what this Note will refer to as the "core concerns test" for evaluating the constitutionality of a state regulation. When using the core concerns test, the Court considers "whether the interests implicated by a state regulation are so closely related to the powers reserved by the Twenty-first Amendment that the regulation may prevail, notwithstanding that its requirements directly conflict with express federal policies."[101] Effectively a "sliding scale" test, the core concerns test marked a departure from the Court's early decisions[102] but offered significantly more protection than the narrowest reading of Section 2, which would merely give states the option to remain dry.[103] The Court justified the new core concerns approach in *Bacchus*, reasoning, "Both the Twenty-first Amendment and the Commerce Clause are parts of the same Constitution [and] each must be considered in light of the other and in the context of the issues and interests at stake in any concrete case."[104]

Critical to the application of the new test is an understanding of just what constitutes a core concern. The Court noted that "mere economic protectionism"[105] was not one of them but at least the following two concerns were: (1) the promotion of temperance and (2) "combatting the perceived evils of unrestricted traffic in liquor."[106] In *Bacchus*, the Court applied the core concerns test to examine a Hawaii liquor tax imposed on all but certain locally produced alcohol.[107] Because Hawaii could not justify the discriminatory alcohol tax under one of these core concerns, the Court determined the tax was designed "to promote a local industry" and was ultimately unconstitutional.[108]

Even in deciding *Bacchus*, though, the Court seemed reluctant, acknowledging a weakness in its position, but brushing it aside due to the sharp protectionism it read into Hawaii's law, stating, "Doubts about the scope of the

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97. 76 CONG. REC. 4141 (Feb. 15, 1933).
98. *See supra* Part II.B.
99. Bacchus Imports Limited. v. Dias, 468 U.S. 263, 263 (1984).
100. Capital Cities Cable, Inc. v. Crisp, 467 U.S. 691, 714 (1984).
101. *Id.* at 713-14.
102. *See supra* Part II.B.
103. *See supra* Part II.B.2.
104. Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324, 331-32 (1964).
105. Bacchus Imports Limited. v. Dias, 468 U.S. 263, 276 (1984).
106. *Id*.
107. *See generally id.*
108. *Id.* at 276.

Amendment's authorization notwithstanding, one thing is certain: The central purpose of [Section 2] was not to empower States to favor local liquor industries by erecting barriers to competition."[109] Three justices dissented, disagreeing with the Court's more middle-of-the-road interpretation of the Twenty-first Amendment, finding the "broad constitutional language" of Section 2 and its historically broad interpretation "confers power upon the States to regulate commerce in intoxicating liquors unconfined by ordinary limitations imposed on state regulation of interstate goods by the Commerce Clause and other constitutional provisions."[110]

C. The Emergence of the Three-tier Distribution System to Address Core Concerns

With this backdrop, it is important to note that when the Twenty-first Amendment was passed, most states[111] began adopting the three-tier distribution system[112] to address the kinds of concerns the Court in *Bacchus* would eventually highlight.[113] First, the system was used as a preventative measure against problematic "tied houses."[114] That is, by separating Producers, Distributors, and Retailers and prohibiting occupancy at more than one tier, states could keep large firms from dominating local markets. One goal of this separation was to prevent product favoritism.[115] More importantly, however, states were concerned that Producers would control establishments, causing widespread intemperance through their sophisticated marketing efforts.[116] Through tiered regulation, states were better able to "prevent organized crime—which had run illegal liquor empires during Prohibition—from dominating the legalized liquor industry."[117] Other advantages of the three-tier distribution system included creating orderly markets and helping states collect tax revenues[118] because all shipments into the

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109. *Id.*

110. *Id.* at 281 (Stevens, J., dissenting).

111. Cal. Beer Wholesalers Ass'n v. Alcoholic Beverage Control Appeals Bd., 96 Cal. Rptr. 297, 300 (Ct. App. 1971).

112. *See supra* Part I.

113. *Bacchus*, 468 U.S. at 276; *see also Cal. Beer Wholesalers*, 96 Cal. Rptr. at 300.

114. Durkin, *supra* note 44, at 1097.

115. Dep't of Alcoholic Beverage Control v. Alcoholic Beverage Control Appeals Bd., 123 Cal. Rptr. 2d 278, 282-83 (Ct. App. 2002).

116. *Cal. Beer Wholesalers*, 96 Cal. Rptr. at 300.

117. Duncan Baird Douglass, Note, *Constitutional Crossroads: Reconciling the Twenty-First Amendment and the commerce Clause to Evaluate State Regulation of Interstate Commerce in Alcoholic Beverages* 49 DUKE L.J. 1619, 1621 (2000).

118. Durkin, *supra* note 44 (quoting Justin Lemaire, Note, *Unmixing a Jurisprudential Cocktail: Reconciling the Twenty-First Amendment, the Dormant Commerce Clause, and Federal Appellate Jurisprudence to Judge the Constitutionality of State Laws Restricting Direct Shipment of Alcohol*, 79 NOTRE DAME L. REV. 1613, 1622 (2004)).

state had to be funneled through in-state entities.[119]

III. 2005: A New Interpretation of the Interplay Between the Twenty-first Amendment and the Commerce Clause Outlined in *Granholm*

The *Bacchus* decision readied the stage for *Granholm*, where the Court consolidated two cases challenging the constitutionality of direct-wine-shipment laws,[120] giving the Court an opportunity to articulate a more workable Twenty-first Amendment analysis. Michigan's law allowed only in-state producers to ship wine directly to consumers, banning direct-to-consumer shipments from out-of-state producers.[121] New York's law allowed direct shipments of wine produced out of state as long as the out-of-state-producer established a local branch in the state of New York.[122] Both New York and Michigan regulated alcohol sales through a three-tier distribution system.[123]

A. Elevation of the Commerce Clause and a Call for Evenhanded Terms

The Court struck down both laws, finding "the object and design of the Michigan and New York statutes is to grant in-state wineries a competitive advantage over wineries located beyond the States' borders."[124] The Court held that the laws "discriminate against interstate commerce in violation of the Commerce Clause . . . and that the discrimination is neither authorized nor permitted by the Twenty-first Amendment."[125]

In its decision, the Court gave credence to the three-tier distribution system, noting, "States can mandate a three-tier distribution scheme in the exercise of their authority under the Twenty-first Amendment."[126] However, Michigan's and New York's laws troubled the Court because the system was "mandated . . . only for sales from out-of-state wineries," [127] as in-state wineries were capable of obtaining a license for direct-to-consumer sales.[128] The Court ultimately held that "[t]he differential treatment between in-state and out-of-state wineries constitutes explicit discrimination against interstate commerce"[129] and that the "discrimination substantially limits the direct sale of wine to consumers, an otherwise emerging and significant business."[130]

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119. Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, 851 (2000).
120. Granholm v. Heald, 544 U.S. 460, 465 (2005).
121. *Id.* at 468.
122. *Id.* at 470.
123. *Id.* at 466.
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.* at 467.
128. *Id.*
129. *Id.*
130. *Id.*

In addressing the interaction between the Commerce Clause and the Twenty-first Amendment, the Court found that Section 2 "does not abrogate Congress's Commerce Clause powers with regard to liquor"[131] and that the "state regulation of alcohol is limited by the nondiscrimination principle of the Commerce Clause."[132] This reasoning marked a significant departure from *Bacchus*, where the Court indicated it would uphold otherwise-discriminatory legislation when the state was acting within its core Twenty-first Amendment concerns.[133]

Ultimately, the *Granholm* Court determined, "State policies are protected under the Twenty-first Amendment when they treat liquor produced out of state the same as its domestic equivalent."[134] The Court found that the Michigan and New York laws involved "straightforward attempts to discriminate in favor of local producers" and such discrimination was "contrary to the Commerce Clause and . . . not saved by the Twenty-first Amendment."[135] The Court further noted that although states may have "broad power" to regulate alcohol under Section 2, the power "does not allow [s]tates to ban, or severely limit, the direct shipment of out-of-state wine while simultaneously authorizing direct shipment by in-state producers."[136] In sum, "[i]f a [s]tate chooses to allow direct shipment of wine, it must do so on evenhanded terms."[137]

B. Examining Discriminatory Laws with the Legitimate Local Purpose Test

After finding the New York and Michigan laws to be discriminatory and not protected by the Twenty-first Amendment, the Court undertook a more traditional Commerce Clause analysis, proceeding to determine whether the laws nevertheless "advance[d] a legitimate local purpose that [could not] be adequately served by a reasonable nondiscriminatory alternative."[138] The Court did not require the local purpose to address a core concern.[139] Here, the states provided two justifications for the laws: preventing minors from accessing alcohol and facilitating tax collection.[140] The Court rejected the minor-access justification, finding minors would be just as likely to purchase wine shipped from out of state as wine shipped from in state, and the state could take less-restrictive steps to minimize the risk to minors.[141] The Court was also not persuaded by any tax-related justification.[142]

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131. *Id.* at 487.
132. *Id.*
133. Bacchus Imports Ltd. v. Dias, 468 U.S. 263, 276 (1984).
134. *Granholm*, 544 U.S. at 463.
135. *Id.* at 489.
136. *Id.* at 493.
137. *Id.*
138. *Id.* at 489 (quoting New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 288 (1988)).
139. *Granholm*, 544 U.S. at 489.
140. *Id.*
141. *Id.* at 490-91.
142. *Id.* at 491.

C. *The* Granholm *Dissent: Alcohol Is Different*

The four dissenting Justices in *Granholm* determined alcohol was an exception to the Commerce Clause by operation of the Twenty-first Amendment and the Webb-Kenyon Act.[143] The dissenters pointed out that the majority seemingly strayed from *Bacchus*, in that the Court did not apply the core concerns test outlined in *Bacchus* and, instead, seemed to treat alcohol like an ordinary article of commerce.[144]

IV. THE THREE-TIER SYSTEM APPEARS TO BE READ INTO SECTION 2 OF THE TWENTY-FIRST AMENDMENT AND IS NOT IN TENSION WITH *GRANHOLM*'S NONDISCRIMINATION PRINCIPLE

Although the dissenters in *Granholm* chide the majority for seemingly straying from *Bacchus*'s call for evaluating the core concerns of the Twenty-first Amendment against the discriminatory nature of the laws,[145] it seems the majority did implicitly accommodate at least some level of such concerns by endorsing the three-tier distribution system.[146] The majority appears to read Section 2 or, at least the Twenty-first Amendment, as first securing the states' absolute ability to sell or not sell alcohol, giving states the option and ability to remain dry.[147] As the Court put it, "A State which chooses to ban the sale and consumption of alcohol altogether could bar its importation; and, as our history shows, it would have to do so to make its laws effective."[148] Thus, a state could secure temperance, if it so chose, and enact the necessary interstate laws to enforce it. In the very next sentence, after it had just acknowledged a core concern of temperance, the Court endorses the three-tier distribution system,[149] even though there may be some discrimination inherent in the system.[150] The Court notes that "[s]tates may . . . assume direct control of liquor distribution through state-run outlets or funnel sales through the three-tier system."[151] Implicitly, the Court is reading more than just temperance into the Twenty-first Amendment.[152] That is,

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143. *Id.* at 497 (Thomas, J. dissenting).

144. *Id.* at 522-26.

145. *Id.*

146. "The decision to invalidate the instant direct-shipment laws also does not call into question their three-tier systems' constitutionality . . . ." *Id.* at 463 (noting North Dakota v. United States, 495 U.S. 423, 432 (1990)).

147. *Id.* at 488-89.

148. *Id.*

149. *Id.* at 489.

150. For example, an out-of-state Distributor cannot sell to bars or restaurants. This privilege is reserved solely for a Distributor operating on Indiana soil. *See, e.g.*, IND. CODE § 7.1-3-3-4 (West Supp. 2013) (setting forth application requirements for a beer wholesalers permit, which includes stating the local county of the wholesaler's warehouse location).

151. *Granholm*, 544 U.S. at 489.

152. *Id.* at 493.

by supporting the three-tier distribution system,[153] *Granholm* allows a state some ability to address its core concerns without facing Commerce Clause challenges.

Commentators have taken issue with the Court's support of the three-tier distribution system, determining the Court's reasoning stems from the very core concerns cases the Court abrogated when making its decision.[154] Such an argument, however, neglects to consider that the three-tier distribution itself addresses a core concern of the states—part of the compromise wrapped into the ratification of the Twenty-first Amendment and embodied in Section 2.[155] The Court did not endorse the broad reading of Section 2, that the Section entirely excepted alcohol from the Commerce Clause, nor did the Court fully endorse the narrowest reading of Section 2, that the Section existed solely to give the states the option to remain dry, with the attendant power to enforce temperance.[156] Rather, the Court seemed to make a reading somewhere in between, but narrower than the core concerns test in *Bacchus*[157]: that Section 2 embodied more than just temperance, that with the "positive" power to remain dry, the Amendment provides a negative power to permit the sale of alcohol[158]—but without the ills[159] that ran rampant during Prohibition.

Notably, had the states not read more than just temperance into the Amendment, it seems unlikely they would have ratified it nor nearly unanimously adopted an unconstitutional distribution system.[160] By supporting the three-tier distribution system,[161] the Court in *Granholm* impliedly acknowledged that Section 2 provides states with some insulation from the Commerce Clause, including and, arguably, up to any discrimination inherent in the three-tier distribution system.[162] Therefore, contrary to commentary that indicates otherwise,[163] the authority to adopt and use the three-tier distribution system does not derive from common-law interpretations the Court may have abrogated or from *Granholm* itself. Rather, a state's authority to adopt and use the three-tier distribution system stems from the historical context of the Twenty-first Amendment.[164] At any rate, per *Granholm*,[165] Supreme Court jurisprudence indicates that a three-tier distribution system, when applied evenhandedly, is not

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153. *Id.* at 488-89.

154. Amy Murphy, Note, *Discarding the North Dakota Dictum: An Argument for Strict Scrutiny of the Three-tier Distribution System*, 110 MICH. L. REV. 819, 823 (2012).

155. *See supra* Parts II.A-B.

156. *Granholm*, 544 U.S. at 488-89.

157. Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 274-76 (1984).

158. *Id.*

159. *See supra* Parts I, II.C.

160. Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, 851-52 (2000).

161. *Granholm*, 544 U.S. at 488-89.

162. *Id.*

163. Murphy, *supra* note 154, at 823 n.19.

164. *See supra* Part II.A-C.

165. *Granholm*, 544 U.S. at 488-89.

constitutionally problematic, and post-*Granholm* courts have so held.[166]

In the Second Circuit's *Arnold's Wines, Inc. v. Boyle*,[167] an Indianapolis retailer challenged New York's law that permitted in-state Retailers to sell directly to consumers but did not permit direct-to-consumer sales from out-of-state retailers.[168] The Second Circuit upheld the law and affirmed the district court decision, finding the attack on the law to be an attack on the three-tier distribution system itself[169]—a system the Court endorsed in *Granholm* as an integral part of the states' Section 2 powers.[170] The court found that the law "treat[ed] in-state and out-of-state liquor evenhandedly under the state's three-tier system, and thus compli[ed] with *Granholm*'s nondiscrimination principle."[171] Similarly, in *Anheuser-Busch, Inc. v. Schnorf*, a district court struck down an Illinois law that let in-state Producers obtain a Distributor's license but prohibited out-of-state Producers from obtaining a Distributor's license.[172] The court relied on *Granholm*, finding that the law was discriminatory and "prevent[ed] out-of-state brewers from competing on equal terms with in-state brewers."[173]

V. Assessing Indiana's Laws Under *Granholm*

Before discussing Seventh Circuit decisions interpreting *Granholm*,[174] it helps to first discuss the reach of *Granholm* and use the Court's newest analysis to assess Indiana's Sunday laws. In deciding *Granholm*, the Court established the nondiscrimination principle for state regulation of alcohol while, at the same time, endorsing the three-tier distribution system.[175] It follows, and *Arnold's Wines* supports,[176] that any discrimination inherent in the three-tier distribution system itself would not offend *Granholm*. Therefore, to stake a challenge to Indiana's Sunday laws, a challenger would have to point to discrimination that originated outside the three-tier distribution framework. As the following argument suggests, Indiana's Sunday laws cannot be insulated by the three-tier distribution system. A challenge could proceed, although the offending discrimination would be of a different character than the discrimination in *Granholm*,[177] and would require a court to adopt a more mature test.[178]

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166. *See* Arnold's Wines, Inc. v. Boyle, 571 F.3d 185, 190-91 (2d Cir. 2009); Anheuser-Busch, Inc. v. Schnorf, 738 F. Supp. 2d 793, 804 (N.D. Ill. 2010).

167. 571 F.3d 185 (2d Cir. 2009).

168. *Id.* at 187.

169. *Id.* at 191-92.

170. *Id.* at 190-91.

171. *Id.* at 191.

172. Anheuser-Busch, Inc. v. Schnorf, 738 F. Supp. 2d 793, 817 (N.D. Ill. 2010).

173. *Id.*

174. *See infra* Part VI.

175. *See supra* Parts III-IV.

176. *Arnold's Wines*, 571 F.3d at 190.

177. *See supra* Part III.

178. For a discussion of a more mature test the Seventh Circuit has alluded to but not yet

As a starting point, it is notable that Indiana's Sunday laws give in-state Producers the ability to sell carryout beer directly to consumers; out-of-state producers cannot sell directly to consumers.[179] A challenger might argue that because out-of-state producers cannot sell directly to Indiana customers without having an in-state presence, just as the wineries in *Granholm* could not ship to New York or Michigan customers without first establishing an in-state presence,[180] Indiana's Sunday laws are in violation of *Granholm*. At first glance, this argument seems to sound in *Granholm* but is nevertheless likely to fall short.

In *Granholm*, the Court struck down a New York law that required an out-of-state winery to establish an in-state presence in order to ship to in-state customers;[181] in-state producers could automatically make direct shipments. Nothing about the three-tier distribution system demanded New York's regulatory framework. In contrast, Indiana's law lets consumers walk into a Producer's storefront, purchase alcohol, and bring it home.[182] Attacking Indiana's laws only on in-state privilege grounds amounts to saying it is discriminatory that an Indiana consumer cannot walk into a Michigan Producer's storefront, purchase alcohol, and bring it home without going to Michigan. Inherent geography would be causing the discrimination, not any uneven regulation. This argument is likely to fall short under *Granholm* for the same reasons the Second Circuit articulated in *Arnold's Wines*, where an out-of-state Retailer unsuccessfully challenged a New York law that allowed only in-state Retailers to sell directly to customers.[183] Indiana's Sunday law operates more like the discriminatory law in *Anheuser-Busch*,[184] giving in-state producers the ability to occupy two tiers as Producer-Retailers whereas out-of-state Producers can only occupy the first tier as Producers.[185] In this way, the law does sound in *Granholm*;[186] as the statute is written, a Michigan Producer cannot sell to Indiana consumers, even after setting up an in-state presence, unless the Producer actually begins brewing in Indiana.[187]

If a court accepts this discriminatory Producer-as-Retailer argument, Indiana would have to point to legitimate interests the state could not advance by any other reasonable alternative.[188] Here, allowing direct-to-consumer sales from in-

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applied, see *infra* Part VI.

179. 2010 Ind. Legis. Serv. P.L. 10-2010.

180. Granholm v. Heald, 544 U.S. 460, 471 (2005).

181. *Id.*

182. *See* 2010 Ind. Legis. Serv. P.L. 10-2010.

183. Arnold's Wines, Inc. v. Boyle, 571 F.3d 185, 186-87, 192 (2nd Cir. 2009).

184. Anheuser-Busch, Inc. v. Schnorf, 738 F. Supp. 2d 793, 793 (N.D. Ill. 2010).

185. *Id.*

186. *See generally Granholm*, 544 U.S. at 463.

187. IND. CODE § 7.1-3-2-7 (2013).

188. *Granholm*, 544 U.S. at 463 ("Our determination that the . . . direct shipment laws are not authorized by the Twenty-first Amendment does not end the inquiry. We must still consider whether [the] state regime 'advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.'" New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 278 (1988)).

state Producers but not from out-of-state Producers arguably alleviates the potential for tax evasion and could help prevent minors from accessing alcohol. Yet, these justifications did not persuade the Court in *Granholm*, partially due to meager evidence.[189] The Court also noted that the state could achieve those and other rationales through less-restrictive steps or "through the alternative of an evenhanded licensing requirement."[190]

Turning to Indiana's Sunday laws, Indiana could, for example, easily require out-of-state brewers to obtain a permit before allowing direct-to-consumer sales. As the law stands, these sales can only occur "at any address for which the brewer holds a brewer's permit . . . if the address is located within the same city boundaries in which the beer was manufactured."[191] Out-of-state craft brewers are already able to obtain the same permit as in-state brewers to receive other advantages[192] under the statute, yet they're restricted from Sunday sales by virtue of being an out-of-state brewer. Even if this discrimination inheres in the three-tier distribution system and is therefore distinguishable from the discrimination in *Granholm*,[193] allowing the out-of-state brewery to establish an in-state storefront and sell its beer would make the law more evenhanded. At any rate, the potential success of such an argument need not be fully considered, as Indiana's Sunday laws contain a deeper flaw.

Indiana's beverage regulation goes beyond any facially discriminatory but three-tier insulated effect, a regulatory framework the *Granholm* Court would protect.[194] Not only can in-state Producers sell carryout alcohol directly to consumers, they can do so seven days a week.[195] At the same time, Indiana prohibits carryout alcohol sales from all other Retailers.[196] Although bars and restaurants may serve alcohol for Sunday consumption[197]—therefore, some out-of-state alcohol reaches the market—in-state Producers enjoy exclusive access to the Sunday carryout market.[198] Thus, 100% of carryout beverages legally sold in Indiana on Sundays are from Indiana's own Producers.[199]

Indiana's Sunday laws thus differ from the facially discriminatory laws the Court analyzed in *Granholm*.[200] Rather, Indiana's laws create a discriminatory

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189. *Granholm*, 544 U.S. at 463.

190. *Id.*

191. IND. CODE § 7.1-3-2-7 (2013).

192. *See id.* The ability to bypass the three-tier distribution system and self-distribute under certain conditions is a key opportunity and, by the way the statute is written, available to in-state and out-of-state breweries alike. *Id.*

193. *Granholm*, 544 U.S. at 463.

194. *Id.* at 488-89.

195. IND. CODE § 7.1-3-2-7 (2013) ("The holder of a brewer's permit . . . may . . . [s]ell the brewery's beer as authorized by this section for carryout on Sunday . . . .").

196. *See* Maker, *supra* note 24.

197. IND. CODE § 7.1-5-10-1 (2013).

198. *Id.* § 7.1-3-2-7.

199. *Id*.

200. *See supra* Part III.

effect, warranting analysis beyond what the Court has articulated. Importantly, the discriminatory operation of Indiana's Sunday laws does not inhere in the three-tier distribution system. Indeed, Indiana created an exception to the three-tier distribution system for in-state Producers;[201] this exception may be permissible via *Granholm* and *Arnold's Wines*, as mere discrimination inherent in the three-tier distribution system.[202] Yet, under a disparate-impact analysis, any constitutional objection would not be to discrimination that solely arises from that exception. Rather, the challenge would be to discrimination arising from how the exception operates in conjunction with other Indiana laws. By preventing Indiana consumers from purchasing out-of-state alcohol for carryout on Sundays, the state directs consumers to its in-state Producers, which puts out-of-state interests on unequal footing. The law arguably acts as a subsidy, supporting the in-state industry and fostering its tremendous growth. Indeed, because Producers enjoy a competition-free day-of carryout sales on the weekend,[203] when the vast majority of consumers are not working and are more free to enter the market, in-state Producers can pad their bottom lines, enabling them to grow more quickly, ramp up production, and begin distributing into other states.[204]

Ultimately, in assessing the constitutionality of Indiana's Sunday laws, the real question the court must address is how to evaluate laws that are not discriminatory on their face yet nevertheless effectuate discriminatory impact. Although the Supreme Court has not spoken on how such an analysis would proceed, the Seventh Circuit revealed an approach it might expect the Supreme Court to take.[205] The Seventh Circuit's referenced approach brings the core concerns back into the analysis,[206] but would not ultimately save Indiana's Sunday laws.[207]

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201. IND. CODE § 7.1-3-2-7 (2013).

202. *See supra* Part IV.

203. *Id.*

204. *See, e.g.*, Win Bassett, *Flat 12 Bierwerks Expands Distribution to Nashville, Tennessee*, ALL ABOUT BEER MAG. (Jan. 15, 2013), http://allaboutbeer.com/daily-pint/whats-brewing/2013/01/flat12-bierwerks-expands-distribution-to-nashville-tennessee/ (reporting how a small Indianapolis-based brewery recently expanded distribution to Tennessee); *see also* Press Release, BEERPULSE.COM (Jan. 29, 2014), http://beerpulse.com/2014/01/flat-12-bierwerks-expanding-distribution-to-kentucky-launching-louisville-with-river-city-2316/ (announcing how, just one year after expansion into Nashville, Tennessee, the same Indianapolis-based brewery has plans to expand into Kentucky).

205. Lebamoff Enter., Inc. v. Huskey, 666 F.3d 455, 460-61 (7th Cir. 2012). *See infra* Part V.A.

206. *Lebamoff*, 666 F.3d at 460-61.

207. *See infra* Part VII.

VI. THE SEVENTH CIRCUIT'S POST-*GRANHOLM* APPROACH AND POSSIBLE DISPARATE-IMPACT ANALYSIS

Because a challenge to Indiana's Sunday laws is subject to Seventh Circuit jurisprudence, a review of the court's post-*Granholm* reasoning is important. So far, the Seventh Circuit has followed *Granholm*'s evenhanded mandate in assessing laws that implicate the Twenty-first Amendment and the Commerce Clause.[208] Further, the court has not expressly resurrected the core concerns test, though it has alluded to it.[209]

A. The Seventh Circuit's First Word on Disparate Impact in Baude v. Heath

In its 2008 decision *Baude v. Heath*,[210] the court assessed the constitutionality of a law allowing direct shipments from in-state and out-of-state wineries to occur only after a face-to-face meeting where the winery verified the purchaser's age.[211] The Seventh Circuit acknowledged that it would apply one of two levels of review to challenged laws.[212] The first level analyzes whether the law discriminates explicitly, in which case it would be "almost always invalid under the Supreme Court's commerce jurisprudence."[213] In *Baude*, because the law applied to every winery no matter the location,[214] the court did not deem the law facially discriminatory and proceeded to its alternative level of analysis: disparate impact.[215] The challengers contended that the evenhanded law nevertheless imposed a burden on interstate commerce, in that it would be more difficult for Indiana residents to achieve the face-to-face verification for wineries on the West Coast, for example, than wineries throughout the state.[216]

In cases of disparate impact, the Seventh Circuit noted that it would apply the Supreme Court's test outlined in *Pike*,[217] often referred to as the *Pike* test.[218] *Pike* provides that "[w]here the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is

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208. *Lebamoff,* 666 F.3d at 460-61

209. *Id. See infra* Part V.A.

210. Baude v. Heath, 538 F.3d 608 (7th Cir. 2008).

211. *Id.* at 611. It should be noted here that the court did strike down one challenged law that needlessly burdened interstate commerce. *Id*. The law effectively banned anyone with a "wholesaler's license" from shipping to a wholesaler in Indiana. *Id.* Because other states permit wineries to ship directly to retailers, many out-of-state wineries are prevented from participating in Indiana's market. *Id*. at 612. Indiana did not defend the law. *Id*.

212. *Id.* at 611.

213. *Id.*

214. *Id.* at 612.

215. *Id.*

216. *Id.*

217. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

218. *Baude*, 538 F.3d at 611.

clearly excessive in relation to the putative local benefits."[219] The Seventh Circuit noted that if a law is facially discriminatory, the burden of production and persuasion rest on the state but where it is not facially discriminatory, "whoever wants to upset the laws bears these burdens."[220] The Seventh Circuit ultimately found that there was not enough evidence to decide the law had anything more than a negligible impact on interstate commerce.[221]

B. Building on Baude*: Core Concerns and Disparate Impact*

The Seventh Circuit extended its analysis in *Baude* more recently in *Lebamoff Enterprises, Inc. v. Huskey*,[222] where the court considered an Indiana law involving wine deliveries.[223] The law permitted motor carriers (such as UPS) to deliver wine to customers, as long as the wine originated from a Producer that had verified the customer's age in a face-to-face meeting.[224] In-state wineries and out-of-state wineries alike could ship wine through common carriers so long as the face-to-face provision had been met.[225] In contrast, Retailers could not deliver wine through a common carrier.[226] Rather, Retailers had to employ their own drivers, who were trained in Indiana's alcohol laws and ID verification.[227]

The Seventh Circuit noted that this law did "not discriminate expressly against out-of-state producers. Both local and out-of-state wineries c[ould] deliver to consumers, and by motor carriers if they want, provided the consumer's age ha[d] been verified at the winery in person."[228] The court acknowledged that the Supreme Court had not yet outlined a perfect standard for such disparate impact alcohol-related cases.[229] The court noted, "One might as an original matter suppose the [Twenty-first] Amendment insulated merely incidental effects on interstate commerce in alcoholic beverages from constitutional challenges based on the commerce clause."[230] But, the court cautioned, "we needn't get ahead of the Supreme Court in the matter."[231] The Seventh Circuit then proceeded to find the effects on interstate commerce to be so limited that the plaintiff would lose even if the Twenty-first Amendment were inapplicable.[232] The court pointed to an out-of-jurisdiction case striking down a similar law, but

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219. *Pike*, 397 U.S. at 142.
220. *Baude*, 538 F.3d at 613.
221. *Id.* at 615.
222. Lebamoff Enter., Inc. v. Huskey, 666 F.3d 455 (7th Cir. 2012).
223. *Id.* at 457.
224. *Id.* at 458.
225. *Id.* at 460.
226. *Id.* at 458-59.
227. *Id.*
228. *Id.* at 460.
229. *Id.* at 461.
230. *Id.*
231. *Id.*
232. *Id.*

where there was a greater showing of an effect on interstate commerce.[233] Ultimately, the Seventh Circuit never applied the disparate-impact approach it speculated to use.[234]

The concurrence departed from the majority's reasoning, and reached back to the core concerns test, determining that the Twenty-first Amendment "should foreclose those balancing tests when the state is exercising its core Twenty-first Amendment power to regulate the transportation . . . of alcoholic beverages for consumption in the state."[235] The concurrence reasoned that the control of direct deliveries fell into core Twenty-first Amendment power and the "law should be upheld even if, as [the Justice] believe[d], its actual benefits are minimal and its burdens on federal interests are significant."[236] The concurrence would ultimately find the Twenty-first Amendment, not minimal impact, saved the law.[237]

VII. APPLYING SEVENTH CIRCUIT JURISPRUDENCE TO ASSESS INDIANA'S LAWS

The Seventh Circuit's speculation and division about how to approach disparate-impact cases[238] is notable. If a court were to find it permissible to give in-state Producers certain privileges not afforded to out-of-state Producers—reasoning that any discrimination either inheres in the three-tier distribution system or nevertheless advances an interest, such as temperance, that cannot otherwise be accommodated[239]—then the court would still have to address the in-state privilege in conjunction with Indiana's ban on Sunday carryout sales from all other outlets.[240] Accordingly, assuming in-state Producer-to-consumer carryout alcohol is a permitted exception from the three-tier distribution system, then arguably Indiana's Sunday carryout ban is evenhanded. That is, all alcohol subject to the three-tier distribution system (not the in-state Producer-to-consumer carryout alcohol), would be treated the same, in that no Retailers could sell it.[241] Nevertheless, this "evenhanded" Sunday ban would still have a disparate impact on out-of-state interests because in-state Producers would be making sales on days when out-of-state Producers would have no way to reach Indiana's potential carryout consumers.[242]

The Seventh Circuit would need to build on *Baude* and *Lebamoff*, and generate its full disparate-impact analysis. As *Baude* and *Lebamoff*

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233. *Id.* at 461, 462 (citing Cherry Hill Vineyards, LLC v. Lilly, 553 F.3d 423 (6th Cir. 2008)).

234. *Id.* at 462.

235. *Id*. (Hamilton, J., concurring) (expressing concern that such balancing tests would "tend to erode states' powers protected by the Twenty-first Amendment").

236. *Id.*

237. *Id*. at 472.

238. *See supra* Part VI.

239. *See supra* Part V.

240. IND. CODE § 7.1-3-2-7 (2013).

241. *Id.*

242. *See supra* Part V.

demonstrate,[243] such analysis would generally begin with *Pike*[244]: "[w]here the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[245] The *Lebamoff* majority seems to suggest, however, that legislation involving Twenty-first Amendment core concerns would act as a "thumb on the scale" in favor of upholding the law.[246] The court could, as the concurrence most likely would, insulate the law because it would serve to promote temperance, a Twenty-first Amendment concern, by making alcohol available through fewer Retailers.[247] Yet, such a narrow view would not take into account the hollowness of such a purported justification. To be sure, when Indiana had prohibited Sunday carryout sales altogether, it was advancing its temperance interests.[248] Yet, why, if Indiana's ultimate goal was to promote temperance, would the state change a seventy-year-old law, tailoring an exception in favor of local Producers, at precisely the same time when in-state craft-brewery business was booming?[249]

VIII. PROPOSALS: RECTIFYING INDIANA'S BEVERAGE LAWS TO COMPORT WITH POST-*GRANHOLM* JURISPRUDENCE

Returning to *Granholm*, the Supreme Court's last word on the tension between the Twenty-first Amendment and the Commerce Clause,[250] it seems that Indiana could achieve any purported or legitimately desired purpose, quite easily, through a "reasonable nondiscriminatory alternative."[251] That is, to avoid affronting the Constitution and achieve objectives it reserved via the Twenty-first Amendment, Indiana could simply eliminate its advantageous, even if constitutionally justified, Sunday exception for Producers by simply prohibiting all Sunday carryout sales, as it had before. Of course, such a reversion would likely upset the in-state Producers that rely on the additional income as well as consumers who have grown accustomed to additional day of sales.[252] For

243. *Id.*

244. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

245. *Id.*

246. Lebamoff Enter., Inc. v. Huskey, 666 F.3d 455, 460-61 (7th Cir. 2012).

247. An argument about preventing minor access, if raised, would not be strong, as carryout sales occur through Indiana's various Retailers every other day of the week.

248. *See* Editorial, *Hot-Button Issues: Chorus of Booze*, INDIANAPOLIS MONTHLY (Jan. 30, 2014), http://www.indianapolismonthly.com/features/2014/1/30/hot-button-issues-chorus-of-booze/print (quoting Retailer lobbyist Patrick Tamm who contends that Sunday sales advocates "try to erode public policy, with zero regard for temperance or selling alcohol responsibly . . . [t]hey want to make selling [alcohol] as easy as selling peanut butter").

249. *See supra* INTRODUCTION.

250. *See supra* Part IV.

251. Granholm v. Heald, 544 U.S. 460, 489 (2005).

252. *See* Hayleigh Colombo, *Sunday Alcohol Sales a Low-Foam Issue for Craft Brewers*, J.

example, on 2013's Super Bowl Sunday alone, one Indianapolis brewery sold 1200 gallons of carryout beer, through 600 container fills, over the course of just five hours.[253] That equals around four gallons a minute. The brewery manager referred to the sales leap as "mindblowing," noting that the brewery's Sunday sales numbers continue to increase year after year.[254] Apart from providing a big day of business for in-state Producers, the Super Bowl Sunday boom demonstrates one seemingly much-appreciated benefit for consumers:[255] the ability to make same-day purchases for Sunday gatherings, eliminating the need to plan ahead or spend money in a bordering state.

Rather than eliminate the popular day of sales, Indiana could open its Sunday carryout market, giving in-state Producers and out-of-state Producers equal access to potential consumers. Although in-state brewers would face additional competition with an open-Sunday market,[256] they do not oppose the idea. According to Lee Smith, Executive Director and spokesperson of the Brewers of Indiana Guild trade association,[257] the brewers are "interested in promoting our breweries and what is good for our breweries," but, she continues, the brewers "are not taking a stance on the issue of broad-based Sunday alcohol sales."[258] Indeed, according to one brewer, in-state breweries as a whole have "absolutely done better with carryout sales" due to the change in legislation, but isolation from competition was not the intent in seeking Sunday carryout privileges.[259] When asked about the impact an open Sunday might have on business, one brewer noted, "For the business, I like us having the ability and them not, but personally I really don't see it as a big deal . . . I'm not worried about our sales decreasing."[260]

Without opposition from in-state Producers,[261] however, and what appears like broad consumer support,[262] year after year, legislative proposals to open Indiana's Sunday market have not advanced past the Senate and House

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& COURIER ONLINE (Feb. 6, 2013), http://www.jconline.com/article/20130205/NEWS02/302050039/Indiana-General-Assembly (noting the tremendous customer turnout and attendant sales that occurred at Indiana craft breweries on 2013's Super Bowl Sunday).

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. *About the Guild*, BREWERS OF INDIANA GUILD, http://www.brewersofindianaguild.com/ (last visited Feb. 6, 2014).

258. Columbo, *supra* note 245.

259. *Id.*; *see also* Douglas Reiser, *Shoot an Email, Save Thousands: The Best Advice I Can Give You About Your Trademark Issue*, BREWERY LAW BLOG (Feb. 13, 2013), http://brewerylaw.com/2013/02/shoot-an-email-save-thousands-the-best-advice-i-can-give-you-about-your-trademark-issue/ (noting the collegiality among brewers and how "the brewery community is a tight one, even though it continues to grow every day").

260. Columbo, *supra* note 245.

261. *Id.*

262. *See id.*

Committees on Public Policy.[263] The opposition to Indiana's discriminatory legal framework comes, perhaps unexpectedly, from in-state, locally owned Retailers—most notably, liquor store owners—who fear they will be forced out of business by big-box competitors.[264] The lobbying group's concerns, however, might deal less with being open seven days a week and, instead, likely reflect broader concerns about advantages they could lose if Indiana makes sweeping changes to its beverage laws.[265] For example, Indiana's other yet-undisturbed beverage laws provide that liquor stores may sell cold beer whereas grocery stores may not.[266] If the legislature began making deeper changes to Indiana's laws, it might eliminate this competitive advantage. According to one lobbyist, "Sunday sales would be a big blow, and it would lead eventually to the cold beer issue being successful. In this state, cold beer has been one of the things that has [sic] kept the package store industry alive."[267]

Despite the writing liquor store lobbyists may see on the wall, Indiana legislators should take steps to cure the discriminatory effect of its current beverage laws so Indiana does not find itself defending a constitutional challenge. Indeed, the liquor stores' concerns may be mere speculation, and the Public Policy Committees in the House and the Senate ought to let an open-Sunday bill survive initial consideration. This would give more legislators the chance to assess the bill's effects, hear the evidence, voice their opinions, and determine what is best for Indiana. After all, those supporting open-Sunday bills already note that other states that have lifted similar Sunday restrictions have actually seen more package stores open.[268] Supporters further note, "[T]he laws allowing Sunday sales and [unrestricted] cold beer sales have 'overwhelming consumer support,'"[269] which, if true, would seem to align the interests of Indiana legislators, Indiana residents, and, most notably, the United States Constitution.

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263. *See, e.g.*, Chris Sikich, *Sunday Liquor Sales Bill Will Die in Indiana House Committee*, INDIANAPOLIS STAR, Feb. 13, 2013, http://www.indystar.com/article/20130213/NEWS05/130213012/Sunday-liquor-sales-bill-will-die-Indiana-House-committee. Notably, the appointment of a new chairman of the House Public Policy Committee might mean better reception for legislative efforts to reform Indiana's approach to Sunday alcohol sales. *Backers See Better Chance for Sunday Alcohol Sales*, CHI. SUN-TIMES POST-TRIB., Dec. 3, 2014, http://posttrib.suntimes.com/news/24148717-418/backers-see-better-chance-for-sunday-alcohol-sales.html

264. Sikich, supra note 263 ("John Livengood, president of the Indiana Association of Beverage Retailers, countered that [non-passage of the open Sunday bill] is good news for consumers . . . point[ing] to a study that package liquor stores would close if sales were expanded.")

265. Francesca Jarosz, *Sunday Alcohol Sales Backers Make Final Push*, IND. BUS. J., Apr. 18, 2011, http://www.ibj.com/article/print?articleId=26615.

266. *Id.*

267. *Id.*

268. *Id.*

269. *Id.*

CONCLUSION

Over the last decade, the craft brewing industry has seen expansive growth[270]—and Indiana has enjoyed its share.[271] The nation has finally surpassed a pre-Prohibition record of operating domestic breweries and an astounding number of new breweries continue to open each year.[272] During the same time as sweeping industry growth, the Supreme Court has again shifted its historically in-flux approach to alcohol-related regulation.[273]

At one time, alcohol was viewed as fully excepted from the Commerce Clause.[274] Later, discriminatory state beverage laws were upheld if they advanced a state's core Twenty-first Amendment concerns, as indicated in *Bacchus*.[275] In 2005, the Supreme Court changed course.[276] In *Granholm*, the Court protected a state's ability to sell or not sell alcohol, while limiting its ability to enact discriminatory regulation.[277] *Granholm*'s interpretation of the Twenty-first Amendment's interaction with the Commerce Clause gives states the ability to sell alcohol through an evenhanded three-tier distribution system, which addresses Twenty-first Amendment concerns, despite any discrimination that inheres in the system.[278]

In the wake of *Granholm*, the Seventh Circuit has applied *Granholm*'s nondiscrimination principle in its *Baude* and *Lebamoff* decisions, but has noted the lack of a fully articulated analytical approach for laws that are not facially discriminatory yet have a discriminatory effect.[279] In *Lebamoff*, the Seventh Circuit alluded to a potential approach, which would resurrect *Bacchus*'s core concerns test and insulate laws with mere discriminatory impact so long as the state was acting, in some way, within its core Twenty-first Amendment concerns.[280]

Indiana currently gives in-state Producers the ability to sell carryout beverages directly to consumers, a privilege not extended to out-of-state Producers.[281] Further, Indiana gives in-state Producers this ability on Sundays, a day when all other Retailers are prohibited from carryout business.[282] Thus, out-of-state Producers have no access to Sunday's carryout market, giving in-state Producers an advantage and putting out-of-state competitors on unequal

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270. *See supra* INTRODUCTION, notes 1-21 and accompanying text.
271. *See supra* note 21 and accompanying text.
272. *See supra* note 10 and accompanying text.
273. *See supra* Parts II.A-IV.
274. *See supra* Part II.A-B.
275. *See supra* Parts II.A.3-IV.
276. Granholm v. Heald, 544 U.S. 460 (2005). *See supra* Part IV.
277. *Granholm*, 544 U.S. at 488-89.
278. *Id.*
279. *See supra* Part VI.
280. *Id.*
281. IND. CODE § 7.1-3-2-7 (2013).
282. *Id.*

footing.[283] Indeed, Indiana's current regulatory framework best accommodates the loudest voices, giving in-state Producers an advantage while ensuring that locally owned Retailers can stay closed on Sundays without losing business to big-box Retailers already open around the clock.[284] Ultimately, should an out-of-state Producer challenge Indiana's current beverage laws, it would likely succeed under the current analytical framework.

For these reasons, the state legislature would be well served to revisit its beverage regulations, before a challenge in front of the judiciary forces its hands. Many Indiana residents have long called for a less-restrictive Sunday market, which would bring Indiana into step with the forty-nine other states.[285] Further, each year already brings proposed legislation that would cure any contra-constitutional defect.[286] All in all, to comply with articulated and speculated binding precedent in the Supreme Court's *Granholm* and the Seventh Circuit's *Baude* and *Lebamoff* decisions,[287] Indiana can and should choose from two readily available options: simply open its Sunday market or close its Sunday market, much as the state may like to do both.

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283. *See supra* Part V.

284. *See supra* Parts V, VII, VIII.

285. *See supra* note 24 and accompanying text.

286. *See supra* Part VIII.

287. *See supra* Parts IV-VII.