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Prominent theories of corporate governance frequently adopt primacy as an organizing theme. Shareholder primacy is the oldest and most used of this genre. Director primacy has grown dramatically, presenting in at least two distinct versions. A variety of alternatives have followed—primacy for CEOs, employees, creditors. All of these theories cannot be right. This article asserts that none of them are. The alternative developed here is one of shared power among the three actors named in corporations statutes with judges tasked to keep all players in the game. The debunking part of the article demonstrates how the suggested parties lack legal or economic characteristics necessary for primacy. The prescriptive part of the article suggests that we can better understand the multiple uses of primacy if we recognize that law is not prescribing first principles for governance of firms, but rather providing a structure that works given the economic and business environment in place for modern corporations where separation of function and efficiencies of managers provide the starting point. Thus, the familiar statutory language putting all power in the board must be read against the reality of the discontinuous nature of board (and shareholder) involvement in governance. Corporate governance documents of the largest American corporations, as discussed in the article, are consistent with this reality, assigning management to officers and using verbs like oversee, review, and counsel as the director functions. The last part examines dispute resolution and the role of judges in such a world, with a particular focus on the shareholder/director boundary. At this boundary there are two distinct judicial roles, the traditional role focusing on use of fiduciary duty to check conflict and other director incapacity and the less-recognized role of protecting shareholder self-help. In this more modern context shareholders, because of market and economic developments, are able to effectively participate in governance in a way that was not practical three decades ago, when the key Delaware legal doctrines were taking root. What is particularly interesting here is how courts, commentators, and institutional investors act in a way that is consistent with a shared approach to power, as opposed to the primacy of any of the theories initially suggested.
Appraisal Arbitrage—Is There a Delaware Advantage?

Gaurav Jetley and Xinyu Ji

The article examines the extent to which economic incentives may have improved for appraisal arbitrageurs in recent years, which could help explain the observed increase in appraisal activity. We investigate three specific issues. First, we review the economic implications of allowing petitioners to seek appraisal on shares acquired after the record date. We conclude that appraisal arbitrageurs realize an economic benefit from their ability to delay investment for two reasons: (1) it enables arbitrageurs to use better information about the value of the target that may emerge after the record date to assess the potential payoff of bringing an appraisal claim and (2) it helps minimize arbitrageurs' exposure to the risk of deal failure. Second, based on a review of the recent Delaware opinions in appraisal matters, as well as fairness opinions issued by targets' financial advisors, we document that the Delaware Chancery Court seems to prefer a lower equity risk premium than bankers. Such a systematic difference in valuation input choices also works in favor of appraisal arbitrageurs. Finally, we benchmark the Delaware statutory interest rate and find that the statutory rate more than compensates appraisal petitioners for the time value of money or for any bond-like claim that they may have on either the target or the surviving entity.

Our findings suggest that, from a policy perspective, it may be useful to limit petitioners' ability to seek appraisal to shares acquired before the record date. We also posit that, absent any finding of a flawed sales process, the actual transaction price may serve as a useful benchmark for fair value. We conjecture that, while the statutory interest rate may not be the main factor driving appraisal arbitrage, it does help improve the economics for arbitrageurs. Thus, the proposal by the Council of the Delaware Bar Association's Corporation Law Section to limit the amount of interest paid by appraisal respondents—by allowing them to pay appraisal claimants a sum of money at the beginning of the appraisal action—seems like a practical way to address concerns regarding the statutory rate. However, paying appraisal claimants a portion of the target's fair value up front is akin to funding claimants' appraisal actions, which may end up encouraging appraisal arbitrage.

Cross-border Tender Offers and Other Business Combination Transactions and the U.S. Federal Securities Laws: An Overview

John M. Basnage and William J. Curtin III

In structuring cross-border tender offers and other business combination transactions, parties must consider carefully the potential application of U.S. federal securities laws and regulations to their transaction. By understanding the extent to which a proposed transaction will be subject to the provisions of U.S. federal securities laws and regulations, parties may be able to structure their transaction in a manner that avoids the imposition
of unanticipated or burdensome disclosure and procedural requirements and also may be able to minimize potential conflicts between U.S. laws and regulations and foreign legal or market requirements. This article provides a broad overview of U.S. federal securities laws and regulations applicable to cross-border tender offers and other business combination transactions, including a detailed discussion of Regulations 14D and 14E under the Securities Exchange Act of 1934 and the principal accommodations afforded to foreign private issuers in these regulations.

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Anti-Primacy: Sharing Power in American Corporations

By Robert B. Thompson*

Prominent theories of corporate governance frequently adopt primacy as an organizing theme. Shareholder primacy is the oldest and most used of this genre. Director primacy has grown dramatically, presenting in at least two distinct versions. A variety of alternatives have followed—primacy for CEOs, employees, creditors. All of these theories cannot be right. This article asserts that none of them are. The alternative developed here is one of shared power among the three actors named in corporations statutes with judges tasked to keep all players in the game. The debunking part of the article demonstrates how the suggested parties lack legal or economic characteristics necessary for primacy. The prescriptive part of the article suggests that we can better understand the multiple uses of primacy if we recognize that law is not prescribing first principles for governance of firms, but rather providing a structure that works given the economic and business environment in place for modern corporations where separation of function and efficiencies of managers provide the starting point. Thus, the familiar statutory language putting all power in the board must be read against the reality of the discontinuous nature of the board (and shareholder) involvement in governance. Corporate governance documents of the largest American corporations, as discussed in the article, are consistent with this reality, assigning management to officers and using verbs like oversee, review, and counsel as the director functions. The last part examines dispute resolution and the role of judges in such a world, with a particular focus on the shareholder/director boundary. At this boundary there are two distinct judicial roles, the traditional role focusing on use of fiduciary duty to check conflict and other director incapacity and the less-recognized role of protecting shareholder self-help. In this more modern context shareholders, because of market and economic developments, are able to effectively participate in governance in a way that was not practical three decades ago, when the key Delaware legal doctrines were taking root. What is particularly interesting here is how courts, commentators, and institutional investors act in a way that is consistent with a shared approach to power, as opposed to the primacy of any of the theories initially suggested.

* Peter P. Weidenbruch Jr. Professor of Business Law, Georgetown University Law Center. Thanks to participants at the UCLA Conference and Micro-Symposium on Competing Theories of Corporate Governance, the 2015 Australian Corporate Law Teachers Conference, and the Loyola Law School, Los Angeles faculty workshop and specifically to Norm Veasey, Russell Stevenson, Elizabeth Pollman, and Michael Guttentag for comments on earlier drafts and for research from Gareth McKibben and Paul Alexander from the Georgetown University Law Center classes of 2014 and 2015, respectively.
I. Introduction

Contemporary debates about the ends and means of corporate law have centered on concepts of primacy of one sort or another. The term is most often as-
signed to shareholders\(^1\) or directors\(^2\) in a seeming duel for corporate power, but the principal protagonist is really management, usually assumed to have de facto power in modern American corporations.\(^3\) In turn, these labels have provoked a series of additional proposals suggesting primacy of other players, for example, employees\(^4\) or creditors.\(^5\)

The multiplicity of recipients to which primacy has been attached ought to suggest the limits of the explanatory power of any primacy theory.\(^6\) The use of primacy theories to describe both ends and means makes it difficult to maintain any consistent theoretical approach. This article points instead to power sharing among the three sets of actors named in all American corporations statutes—shareholders, directors, and officers—each intentionally endowed to check the powers of the others and courts inserted as continuing facilitators of this mandatory power sharing. This balance of power as to the means of exercising corporate power also is visible in the “ends” part of the debate. Corporate law’s purpose is to provide a structure for private ordering within which a broad group of participants can contract for exchange and have available a governance structure to fill gaps. The shared power of shareholders, directors, and managers, each checking the other, facilitates maximizing value of exchange in these relationships.

Part II examines the arguments set out in primacy’s two most developed manifestations in corporate law and why neither is true. Shareholders play a crucial, but decidedly subordinate, role in corporate governance. Despite recurring references to shareholder primacy and to shareholders as owners of the corporation, their power is not the plenary power of a primate or an owner, but rather limited to doing only three things—voting, selling, and suing—and each in very limited doses.\(^7\)

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1. See, e.g., Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 83 Geo. L.J. 439, 440–41 (2001). A Westlaw search for “shareholder w/2 primacy” (as of July 30, 2014) produced 1201 hits in the Journals and Law Reviews database, the earliest in the late 1980s, although as Part II.A describes the core ideas go back considerably further; a similar search for “director w/2 primacy” produced about half that many hits—586—and “manage! w/2 primacy” returned 90 hits.


3. See, e.g., George W. Dent, Jr., Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance, 44 Hous. L. Rev. 1213, 1215 (2008) (“[T]he status quo is not director primacy, shareholder primacy or team production, but CEO primacy, governance by managers largely for their own benefit. The interests not only of shareholders but other constituencies and the public would fare better with shareholder primacy.”); William W. Bratton, Hedge Funds and Governance Targets, 95 Geo. L.J. 1375, 1476 (2007) (describing twentieth-century managerialist approach that puts corporate management at the large corporation’s strategic center).


The strength of directors’ powers is such that they are sometimes described in primacy terms. Yet the board is also a strange choice for a primacy role. Directors have little skin in the game and often have full-time work elsewhere. Their incentive structure, measured by compensation, share ownership, and other sources, is much more low-powered than that for managers, and their access to information is only a fraction of that available to officers. They are simply not in a position to manage a complex enterprise. The other primary theories get less attention here, but fare no better.

Part III presents the shared power alternative. The idea reflects some of the same motivations of the political choices found in our Constitution—limits on the power of government and reliance on a balance of power in making those limits effective. But public corporations are different. In particular: (a) the separation of function with the specialization of efforts that follows if the modern corporation is going to deliver on its efficiency potential; and (b) the standard agency story from economics (and politics) as to risks that flow from that specialization when some actors end up with “power over vast aggregations of property that they do not own.”

The practical reality in large public corporations is that managers make most corporate decisions, a direct result of the triumph of specialization and the efficiencies that come from it. Centralized managers in a hierarchy provide efficiencies in information gathering, decision making, and implementation that dispersed and numerous shareholders (or employees or creditors) simply cannot match. The statutory roles for directors and shareholders are structured in the shadow of that economic reality and only make sense from a starting point that presumes managers as the key (and initial) actors. In this sense the core purpose of corporations law is not to declare first principles as to the power of managers, shareholders, or directors, but rather to provide a governance system for a team of contributors that works in light of the benefits of specialization in large enterprises and the challenges of monitoring agents in that setting.

Directors police conflicts of the managers and sometimes share in the exercise of corporate power where they can bring additional information or perspective to the decision. In turn, shareholders police conflicts or laxness of the board, particularly if the board is captured by management, and occasionally participate in decisions where they can provide additional information or aggregate preferences of owners that may be different than managers. Those two legal effects are commonly accepted and well-understood, but another needs to be put alongside them that has been brought into focus in the current high-profile debate as to the increased power of activist shareholders and the fear that their increased power is too short-term focused in its use. Directors, in addition to their key role in monitoring management, have an additional role to slow down shareholders’ use of their power because shareholders may sometimes be acting out of self-interest. And courts are given the power to resolve disputes where the power of the three groups intersect and are in conflict.

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The result is a legal structure intentionally placed on top of a business and economic reality in which directors, managers, and shareholders are empowered to check the powers of each other with sometimes overlapping powers and have space to interact with each other and work out a solution for the team. Part IV develops dispute resolution in such a structure with specific attention to how Delaware courts perform a referee role at the boundary where the powers of the groups meet. Delaware courts have long been director-centric in their approach, in ways that seem to leave little room for direct shareholder action. But they regularly have noted the need for a balance of power and their decisions illustrate a sensitivity to keeping the shareholders in the game with room for further negotiations among the parties. What is interesting about the most recent period is that the increased space for power to be exercised by shareholders has not come from changes in Delaware law but from changes in the composition of the shareholder population and a nudge from federal regulations. But consistent with the recognition of the value of separation of power in achieving corporate purposes, activists have used this new space not to take absolute control of corporations, but rather to enhance and continue negotiations with directors over corporate policy.

II. PRIMACY AS A SIREN SONG

Corporate governance in large and sophisticated modern American corporations involves so many parties that it might seem unlikely that any one of them could have primacy, but that has not dampened a still growing literature that sees clarity coming from attributing primacy to a particular corporate actor.9 The term is most often affixed to shareholders or directors, often as a way ostensibly to discredit the claims of the other. But even more confusing is that the real use of the primacy label given to each of those parties seems more directed to strengthening their ability to check a third set of actors in corporations—the officers who are the corporations’ top managers—usually acknowledged to have de facto primacy in governance. This part first provides a context for shareholder and then director primacy, showing why each has developed and why neither is true. A subsequent section treats parallel primacy arguments for CEOs and other corporate players. The last section draws some generalizations as to why primacy has been so attractive to so many discussants of corporate law.

A. SHAREHOLDER PRIMACY

Shareholder primacy frames two of the most long-running debates in corporate law. It is one side of a regulatory debate as to how to allocate decision-making power in the corporation, facing off in this context against management authority. The classic description is that provided by Berle and Means as to the separation of management and control in which the specialization of function in the modern corporation has given managers control of a vast amount of assets contributed by others. Shareholder primacy is asserted to provide a means to redress that imbalance.

Shareholder primacy also defines one side of a vigorously contested debate about the purpose of the corporation. Here non-shareholder stakeholders provide the counterweight. Again Berle provides the classic frame, this time in his debate with Merle Dodd, in which Professor Berle argued for shareholders and Professor Dodd for the stakeholders as a way to insure a more public-regarding attitude of business. Other constituency statutes passed in the wake of the takeover rage of the 1980s illustrate a parallel stakeholder concern. Benefit corporations are a contemporary effort to permit other participants to limit the reach of shareholder primacy in corporations.

These two contexts have been frequently noted, but the conflict they can create has received surprisingly little attention. Some discussions of shareholder primacy fit well enough in either context but the two can work at cross-purposes as when empowering shareholders to restrain managers imposes costs on other stakeholders, so that it becomes important to identify in which of the contexts primacy is being asserted.

Part of the difficulty of understanding shareholder primacy is that the concept, like the corporate form itself, has been used for over two hundred years in a variety of relational contexts—from a time in which there was little separation of

10. See D. Gordon Smith, The Shareholder Primacy Norm, 23 J. CORP. L. 277 (1998); see also David Millon, Communitarians, Contractarians, and the Crisis in Corporate Law, 50 Wash. & Lee L. Rev. 1373, 1374 (1993) (finding it clear that shareholder primacy has served as corporate law's governing norm for much of the twentieth century).


13. See, e.g., 15 PA. STAT. AND CONS. STAT. ANN. § 1715(b) (West 2013) (“[D]irectors shall not be required . . . to regard any corporate interest or the interest of any particular group affected by such action as a dominant or controlling interest . . . .”); cf. Comm. on Corporate Laws, ABA Bus. Law Section, Other Constituency Statutes: Potential for Confusion, 45 Bus. Law. 2253, 2268 (1980) (permitting directors to consider other interests without relating such considerations in an appropriate fashion to shareholder welfare would conflict with directors’ responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an effective device for the creation of jobs and wealth).


15. Professor Bainbridge uses them to anchor his means/ends discussion. Bainbridge, supra note 2.
function in a business enterprise and most firms were closely held, to industrial-age enterprises in which separation was assumed but control was often vested in a small group of investors, to the Berle and Means world of separation between owners and managers, to a world of hostile takeovers, and then to today’s world of activist shareholders. The corporate form, and terms like primacy and shareholder wealth maximization, adapted to the various contexts in a manner that requires some effort to keep them all in an understandable perspective.

1. The Two Conceptions of Modern Shareholder Primacy

Henry Hansmann and Reinier Kraakman, in their turn-of-the-century pronouncement of the emergence of a standard model of corporate governance, captured the two core parts of the modern doctrine of shareholder primacy: shareholders’ “ultimate control” over the corporation; and the managers’ duty to put shareholders’ interests first, often described as shareholder wealth maximization. The first suggests actual shareholder decision making for the corporation, the second seems to acknowledge decision making by others—boards or officers with shareholder wealth maximization used by courts to constrain that decision making or internalized by corporate actors.

16. See Smith, supra note 10, at 277 passim, 322 (discussing the nineteenth century development of shareholder primacy and it roots in closely held enterprises, suggesting some skepticism about its jump to publicly held corporations, and concluding “[t]he shareholder primacy norm may be one of the most overrated doctrines in corporate law”).


19. See John H. Matheson & Brent A. Olson, Corporation Cooperation, Relationship Management and the Triadological Imperative for Corporate Law, 78 Minn. L. Rev. 1443, 1461 (1994) (the traditional shareholder primacy model of the corporation derives from the concept that as owners of the corporation, shareholders are entirely to control its destiny, determine its fundamental policies, and decide whether to make fundamental changes).

20. These were the first two of the principal elements of the standard model of corporate governance that Hansmann and Kraakman found to have vanquished all competing theories. The others are that other corporate constituencies should have their interests protected by contract, nonmajority shareholders should receive strong protection, and the market value of publicly traded corporate shares is the principal measure of the shareholder interest. See Hansmann & Kraakman, supra note 1, at 441.

Lyman Johnson and David Millon provided a similar dichotomy at an earlier point distinguishing “shareholder protection” and “shareholder autonomy.” See Lyman P.Q. Johnson & David K. Millon, Misreading the Williams Act, 87 Mich. L. Rev. 1862, 1882–86 (1989). The second usage was common after the passage of the Williams Act in 1968 and through the 1980s, often in the context of an argument for federal preemption of state antitakeover law by “preserving for target shareholders the inviolable right to decide whether to accept tender offers.” Id. at 1882. The U.S. Supreme Court’s 1987 decision in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), rejected the preemption argument. In contrast to the earlier phrasing, this article focuses on shareholder self-help rights attributable to state corporations law. See David Millon, Radical Shareholder Primacy, 10 U. St. Thomas L.J. 1013 (2013) (offering a dichotomy of “radical shareholder primacy” and “traditional shareholder primacy”).

While some uses of shareholder primacy embrace both parts (and both would seem necessary if there is to be primacy in any realistic sense), often the primacy users are really talking only about the second. There is a difference if primacy is limited only to this usage. Stephen Bainbridge, for example, clearly embraces shareholder wealth maximization and then makes that norm a foundation of his director primacy claim. It also makes a difference which of two variations of shareholder wealth maximization is meant: (a) the legal duty/judicial enforcement form that uses shareholder wealth maximization in filling out the meaning of fiduciary duty; or (b) the business school/mission statement form that shareholder wealth maximization is the proper purpose of the corporation. In the first it is left to the court to declare the parameters of shareholder primacy; in the second it is left to the business participants on the board in their decisions, business strategy, or mission statement. In either, filtering shareholder primacy through actions by directors or officers or declarations by judges means the result is usually well short of what would usually be meant by primacy.

If the focus is on duty, what is important is how judges apply corporate law, including the business judgment rule, widely acknowledged as a judicial rule of decision used to insulate director action from challenge by shareholders. The court in *Dodge v. Ford Motor Co.* provides a classic example of this use of shareholder primacy: “A business corporation is organized and carried on primarily for the profit of its stockholders. The powers of directors are to be employed for that end. . . . [I]f the avowed purpose of the defendant directors was to sacrifice the interest of shareholders, it [would be] the duty of the courts to interfere.” Yet the court refused to interfere with management decisions to cut the price of its cars almost 20 percent when the company could sell every car coming off the assembly line at the higher price, a plan the court acknowledged would produce a less profitable company with “the apparent immediate effect . . . to diminish the value of shares and return to shareholders.” The shareholder wealth maximization reasoning in that case extended only to requiring directors to pay dividends in the very unusual situation in which the corporation was already flush with cash and could internally finance a massive expansion while at the same time substantially reducing the price of its product, in a setting that was as close to being able to print money as a private company might find itself.

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25. The court described Henry Ford’s testimony as creating the impression that he thinks “the Ford Motor Company has made too much money, has too large profits, and that although large profits might still be earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken.” *Id.* at 683–84.
26. *Id.*
Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. is another case frequently cited for the director's duty to maximize shareholder profit.27 When a corporation is up for sale, the court declares the directors' duty as getting the best price for the stockholders.28 But subsequent case law made clear that this is well short of a global duty in all takeover contexts. In Paramount Communications, Inc. v. Time, Inc., where the target board rejected a cash bid of $200 a share in favor of continuing an alternative combination with a value of much less—in the range of $120 per share—the Delaware Supreme Court declined to impose the higher scrutiny of asking if the board had gotten the best price.29 The trigger to get to "Revlonland" challenges law students and practitioners.30 Directors of a company looking at a takeover retain considerable flexibility in terms of structuring a transaction to avoid the Revlon duty of best price if they wish.31 This duty to maximize shareholder wealth is an obligation target directors can turn off or on depending on how they structure a transaction. Such shareholder primacy at the option of directors hardly seems to qualify for the name.

As identified above, shareholder wealth maximization is sometimes used in contexts outside judicial enforcement and it is worth separately examining the reach of this use in what might be termed its “mission statement” version. Lynn Stout observed that, by 1990, most scholars, regulators, and even many business practitioners had come to accept shareholder wealth maximization as the proper goal of corporate governance.32 Many of the largest American corporations, including, for example, Apple, Exxon, GE, Berkshire Hathaway, and Google, publish principles of corporate governance saying that management power is to be exercised for the shareholders.33 If the parties acting for the cor-

27. 506 A.2d 173, 182 (Del. 1986).
28. Id.
29. 571 A.2d 1140 (Del. 1990).
30. In a subsequent case, the Delaware Supreme Court applied the Revlon best price obligation to void defensive tactics used to protect a combination preferred by the board where, unlike Time, the acquiring company had a controlling shareholder. Paramount Commc’ns, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994) (focusing on the acquiring shareholders’ loss of their only opportunity to share in a control premium); see also Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009) (noting that the trigger for Revlon is not a company being in play but rather a company embarking on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change in control).
31. For example, they can structure a deal to have the shareholders receive stock instead of cash or by avoiding a stock deal with a company having a controlling shareholder.
32. Stout, supra note 22, at 3. But see Lyman P.Q. Johnson, The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law, 68 Tex. L. Rev. 865, 877 (1990) (“Most persons in this country probably would be astounded to hear that maximization of shareholder wealth is the reason d’etre of corporate existence.”).
33. The New York Stock Exchange listing standards require listed companies to adopt and disclose corporate governance guidelines. See N.Y. Stock Exch., Listed Company Manual § 303A.09 (2015). The statements below are from each company’s corporate governance principles. Apple Inc., Corporate Governance Guidelines 1 (Dec. 21, 2015) (“assures that the long-term interests of the shareholders are being served”); Corporate Governance Guidelines, ExxonMobil (July 1, 2015), http://corporate.exxonmobil.com/en/investors/corporate-governance/corporate-governance-guidelines/guidelines (“the directors’ fiduciary duty is to exercise their business judgment in the best interest of ExxonMobil’s shareholders”); GE, Governance Principles 1 (undated) (“the board of directors is elected by the shareowners to oversee management and to assure that the long-term interest of
poration believe and act on shareholder primacy, enforcement is secondary, if not unnecessary. But these documents provide a good bit of wiggle room. GE, for example, notes: “Both the board of directors and management recognize that the long-term interests of shareowners are advanced by responsibly addressing the concerns of other stakeholders and interested parties including employees, recruits, customers, suppliers, GE communities, government officials and the public at large.” An earlier study by Lorsch and Maclver found widespread ambivalence among directors about shareholder primacy. With the breadth identified here and without enforcement, this use of shareholder wealth maximization provides some guidance and even accountability, but is a long way from primacy.

2. The Normative Arguments as Shaped by Economic Theories of the Firm

The two most widespread theoretical arguments for shareholder primacy stem from economic learning developed in the mid-twentieth century. One thread draws on property rights and concepts of ownership and the other centers on agency costs. Milton Friedman’s 1970 essay on the purpose of a corporation captures the property roots of shareholder primacy:

In a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society.

Bainbridge observed that “[b]ecause private property is such a profound part of the American ethos, this model’s normative implications long dominated our approach to corporate law.” Other economics-based scholarship focused not on ownership of the firm, but rather ownership of residual rights as supporting
shareholder primacy.\textsuperscript{39} Easterbrook and Fischel, for example, have noted that shareholders have the appropriate incentives “to make discretionary decisions . . . . The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise the discretion.”\textsuperscript{40}

Neither variant reaches nearly far enough to support primacy. Financial theory has taught us that shareholders are not the only stakeholders with a claim to residual value.\textsuperscript{41} Options theory suggests that debt holders also have a claim on the residual value\textsuperscript{42} and parallel arguments can be made for other stakeholders.\textsuperscript{43}

Even if these economic arguments were sufficiently consistent to provide a theory for primacy, the law flatly contradicts shareholders’ ability to make all “gap-filling” decisions for the firm or otherwise exercise rights accruing to residual owners to control the firm as does an owner in a sole proprietorship.\textsuperscript{44} Instead, corporations statutes provide that all corporate power is to be exercised by, or under the direction of, the board.\textsuperscript{45} Thus, shareholders cannot, as a rule, force the board to issue dividends to capture that value.\textsuperscript{46} Instead, shareholders’ right to residual claims must be filtered through board decisions (e.g., the board’s legal right to declare dividends, distribute assets, or dissolve) or through the market (by shareholders selling shares as the means to gain liquidity for their investment).\textsuperscript{47}

Shareholder primacy also draws considerable strength from another foundational theory of modern law and economics—agency costs. Jensen and Meckling posit that the exchange of equity for capital establishes a principal-agent relationship between the shareholders and the board of directors.\textsuperscript{48} An agent, the board, will be tempted to extract private benefits using its control of the firm’s assets and therefore the principals, the shareholders, must monitor the agent to protect

\begin{footnotes}
\footnotetext{39.}{See Eugene F. Fama & Michael C. Jensen, \textit{Organizational Forms and Investment Decisions}, 14 J. Fin. Econ. 101, 102–03 (1985) (arguing that shareholders hold residual claims).}
\footnotetext{40.}{Frank H. Easterbrook & Daniel R. Fischel, \textit{The Economic Structure of Corporate Law} 68 (1991).}
\footnotetext{41.}{See Frank Partnoy, \textit{Adding Derivatives to the Corporate Law Mix}, 34 GA. L. Rev. 599 (2000).}
\footnotetext{42.}{See Lynn A. Stout, \textit{Lecture and Commentary on the Social Responsibility of Corporate Entities: Bad and Not-So-Bad Arguments for Shareholder Primacy}, 75 S. Cal. L. Rev. 1189, 1192 (2002).}
\footnotetext{43.}{See Lynn A. Stout, \textit{The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public} 41 (2012); Margaret M. Blair, \textit{Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century} 231 (1995).}
\footnotetext{44.}{See Easterbrook & Fischel, supra note 40, at 66.}
\footnotetext{45.}{See, e.g., Del. Code Ann. tit. 8, § 141(a) (2011) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .”); Model Bus. Corp. Act Ann. § 8.01(b) (2015) (“All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . . .”).}
\footnotetext{46.}{Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (Sup. Ct.) (applying business judgment rule and dismissing shareholder suit seeking to force the board to pay a dividend), aff’d, 387 N.Y.S.2d 993 (App. Div. 1976).}
\footnotetext{48.}{Michael C. Jensen & William H. Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure}, 3 J. Fin. Econ. 305, 312 (1976). This is a theoretical refinement of the Berle and Means’ observation of the separation of ownership and control in the modern corporation. Berle & Means, supra note 11, at 119.}
\end{footnotes}
their interests. When investors give up control of their assets to others as part a specialization of function within a firm, they will price what they seek for their contribution based on incentives of the managers to act for investors, the available monitoring of these agents tempted to extract private benefits, and the residual risk left in the agency relationship after those incentives or monitoring are put in place. Shareholder primacy provides such a monitoring mechanism. But as Bainbridge has pointed out, “this elegant theory breaks down precisely where it would be most useful . . . . In general, shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation’s agents.”

Agency law (as distinguished from agency theory in economics) endows principals with a strong right of control and imposes fiduciary duties on agents that are consistent with the economic case for shareholder primacy. The American Law Institute’s Restatement (Third) of Agency creates an agency relationship “when one person manifests assent to another person that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.” Some courts have adopted a principal-agent frame in describing shareholders’ power. Yet, American corporate law clearly refutes such a relationship. As already noted above, directors have the autonomous power to make virtually all business decisions under all of the states’ corporate statutes, which is difficult to reconcile with them being under the shareholders’ “control.” The Official Comment to section 1.01 of the Restatement (Third) of Agency (following prior Restatements) states explicitly: “Although a corporation’s shareholders elect its directors and may have the right to remove directors once elected, the directors are neither the shareholders’ nor the corporation’s agents as defined in this section, given the treatment of directors within contemporary corporate law in the United States.”

3. Shareholder Primacy as Really Intended for Something Else

As the discussion so far reveals, the theoretical arguments for shareholder primacy fall well short of giving shareholders ultimate control; corporate statutes provide rules that are flatly inconsistent with it and common law statements imposing a duty on directors to maximize shareholder wealth stop considerably short of universal application. Why then do we see such widespread use of the concept and such broad language? In one sense it may be a myth, as explored by Langevoort and others in the corporate setting, reflecting a need or desire to

49. Bainbridge, supra note 2, at 568.
50. Restatement (Third) of Agency § 1.01 (Am. Law Inst. 2006).
51. See, e.g., Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) (finding that judicial review of board decisions alleged to interfere with the shareholder vote “involve the determination of the legal and equitable obligations of an agent toward his principal. . . . [Shareholders are entitled] to restrain their agents, the board, from acting for the principal purpose of thwarting” shareholder action.
52. Restatement (Third) of Agency § 1.01 cmt. f(2).
see the world as understandable or predictable and to avoid paralyzing contra-
diction.53 Kahan and Rock see something similar in the writings of New Dealer
Thurman Arnold about corporate personification as a ritual that lets us live in
contradiction: to let us accept the benefits of specialization and concentration
of capital essential to realizing economics of scale and still hold on to traditional
ideas like rugged individualism.54 Applying Thurman Arnold to today’s corpo-
rate governance, they suggest “we need to believe shareholders control managers
who control huge concentrations of capital.”55

It is possible, too, to overread primacy—that it is not intended so much as an
absolute, but as a proxy for a relative change. Lucian Bebchuk, for example, talks
not about primacy, but rather increasing shareholder power in a relative sense,
which he advocates “to improve corporate performance and value.”56 Hansmann
and Kraakman likewise disavow any intrinsic desire that corporations should be
run in the interest of shareholders alone: “All thoughtful people,” they tell us,
believe corporations should be run for the interests of society as a whole; but
as a consequence of logic and experience, they find a consensus that “the best
means to that end is to make managers directly accountable only to sharehold-
ers.”57 To the extent that shareholder primacy devolves into an instrumental use
of shareholder primacy and reflects a purpose to make managers accountable,
the focus, as in Part III, should be on the interactive balance of shareholders, di-
rectors, and officers, more than a primacy-driven exercise.

B. DIRECTOR PRIMACY

The argument for director primacy falls out a bit differently. Here the words of
corporate statutes declare something that sounds like primacy. Delaware’s Gen-
eral Corporation Law says “the business and affairs of every corporation . . . shall
be managed by or under the direction of a board of directors.”58 The Model Busi-
ness Corporation Act says the business and affairs of the corporation shall be
managed by the board or under its direction and subject to its oversight.59

54. Marcel Kahan & Edward B. Rock, Symbolic Corporate Governance Politics, 94 BOSTON U. L. REV. 1997, 2034 (2014). They also discuss other possible explanations, such as seeking to affect a broader debate about larger principles or various public choice explanations such as managers, lawyers, or groups such as ISS using the debate for their own benefit.
55. Id.
57. Hansmann & Kraakman, supra note 1, at 444–49 (tracing fall of management, labor, state, and stakeholder models).
59. MODEL BUS. CORP. ACT ANN. § 8.01(b) (2011). Like Delaware, the Model Act includes “or under the direction of” as a permissible alternative to direct director management and, in addition, includes
But facts on the ground belie this formal statement of director primacy. First, directors lack the practical ability to be a primate. Theirs is a part-time job; they devote perhaps twenty hours a month on average, only a fraction of the time that officers and senior employees put in. There has been a move in recent decades to pay directors more and with stock that aligns their interest with shareholders, but they often can convert the stock into cash, and their incentives are much more low-powered than those of the officers who are the real managers. The disparity between directors and officers is more glaring on another key dimension to effective decision making—access to information. Again the officers have much more access to the foundational data for decision making than do their nominal superiors. To say that part-time directors with low-powered incentives and much less relative information are, in reality as distinct from legal doctrine, the primates in this governance structure is to engage in a fantasy.

American corporations recognize this reality. It has become common for large American corporations to develop, adopt, and publish on their websites their principles of corporate governance that describe their internal structures. One of the largest 250 American companies described its allocation of authority this way: “[A]ll corporate authority resides in the Board . . . . [T]he Board delegates authority to management to pursue the Company’s mission. Management, not the Board, is responsible for managing the Company.” The document does specify that the board retains specified responsibility to recommend board candidates, to select, evaluate, and terminate the CEO, and to advise management with respect to strategic plans, but that seems at some distance from primacy. It is a discontinuous exercise of legal power—perhaps more commonly exercised than the shareholders’ use of their legal power to elect and replace directors, but still decidedly intermittent in its use.

Other of our largest corporations suggest that their directors play a similar role. Microsoft’s principles of corporate governance provide that “[s]hareholders elect the board to oversee management and to assure that shareholder long-term interests are served. Through oversight, review and counsel, the Board establishes and promotes Microsoft’s business and organizational objectives.” Chevron’s document provides that the board “oversees and provides policy guidance “and subject to the oversight of” that the Official Comment suggests means "operational management [can be] delegated to executive officers and other professional managers." Id. cmt.

60. See Lyman Johnson & Robert Ricca, Reality Check on Officer Liability, 67 BUS. LAW. 75, 80 (2011) (citing studies showing increase in director time from fourteen hours per month prior to Sarbanes-Oxley to about twenty hours through 2009); see also Usha Rodrigues, A Conflict Primacy Model of the Public Board, 2013 U. ILL. L. REV. 1051, 1062.


62. See Rodrigues, supra note 60, at 1062.


64. Id.

65. MICROSOFT CORP., CORPORATE GOVERNANCE GUIDELINES 1 (July 1, 2015), http://www.microsoft.com/investor/CorporateGovernance/PoliciesAndGuidelines/guidelines.aspx. Note the verbs used to describe the board’s roles—“oversees” business affairs, “works with management” to determine strategy,
on the business and affairs of the corporation.”66 GE’s guidelines say its business is “conducted by its employees, managers and officers, under the direction of the chief executive officer (CEO) and the oversight of the board, to enhance the long-term value of the company for its shareholders.”67 These are not verbs used to describe one exercising primacy.68

As a theoretical matter, board primacy has developed in two variants with substantially different implications for corporate governance. Steve Bainbridge draws on Kenneth Arrow and other threads of economic theory to argue for the value of authority and fiat in a manner that ends up being an argument for board sovereignty.69 Margaret Blair and Lynn Stout place director primacy within a team production theory where the board performs as a mediating hierarchy.70 The remainder of this part briefly summarizes each and examines the extent to which there is director primacy in the modern American corporation.

1. The Board as Exercising Fiat and Authority

Stephen Bainbridge has the more muscular of the two main director primacy arguments, making an affirmative case for the efficiency value of authority and the board being able to exercise fiat. Drawing from earlier work of Kenneth Arrow, Bainbridge sees fiat as the defining characteristic of corporate governance and its overarching value.71 The board executes fiat and its sovereign-like authority as part of an efficient decision-making system to reduce transaction costs associated with uncertainty, opportunism, and complexity.72 This economic value of fiat means boards should be viewed as acting for the entity to hire the various factors of production, rejecting a nexus-of-contracts approach to the corporation to the extent that it projects an entity with no primate.

Bainbridge, however, embraces shareholder wealth maximization (“SWM”) as a core part of his director primacy.73 It becomes the critical means for accountability, a concept that under an Arrowian view is reciprocal to authority and in necessary tension with it, but which cannot occur to such a degree that it imperils authority.74 Given those limits, Bainbridge willingly turns to courts as the instrument to implement SWM as an accountability mechanism; he minimizes shareholder self-help via voting or probably other means that would illustrate

“performs” the annual CEO evaluation, “oversees” succession planning, and “oversees” internal controls.

66. See Chevron Corp., Corporate Governance Guidelines 1 (Sept. 30, 2015), http://www.chevron.com/investors/corporategovernance/governanceguidelines/. The other verbs used with regard to the board’s functions are to “monitor” overall corporate performance and “oversee” management and plans for succession of key executives.

67. GE, supra note 33, at 1.

68. See Stout, supra note 22, at 12.

69. Bainbridge, supra note 2, at 603.

70. Blair & Stout, supra note 2.

71. Bainbridge, supra note 2, at 603.

72. Id. at 558 (finding that modern corporation’s decision-making structure precisely fits Arrow’s authority-based model).

73. Id. at 550.

74. Id. at 603.
the ultimate shareholder control prong of shareholder primacy. Indeed a key part of his director primacy argument is to counter shareholder primacy: Director primacy with its emphasis on authority and fiat provides a model for constraints on shareholder control under an efficiency justification. Even the control rights that he may concede to shareholders, such as the right to fire directors via the market for corporate control, he distinguishes from fiat, and, in any event, he explains away any real effect from that potential: “In general shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation’s agents.”

The fiat that Bainbridge rightfully prizes is also characteristic of CEOs and management more generally. Indeed, CEOs as sole individuals at the center of a management hierarchy, usually paid more than anyone else in the business, engrossed in the decisions of the business on a daily, hourly, and sometimes instantaneous basis, are certainly better able to exercise fiat than a collective group, many with day jobs elsewhere, coming together only a few times a year (absent a crisis), with information very dependent on managers. Directors do retain the power to terminate, which they sometimes use, and state law does provide them ultimate authority and requires that they approve some decisions such as mergers. But shareholders can replace directors and shareholders must also give their consent for a merger to be effective. Given the reality of directors’ use of their governing power can it really be said that directors have the “practical ability” or the “desire” to exercise control necessary for them to be considered a primate, even with the formal statutory authority given them? As developed in Part III, directors are a critical part of governance, but a primacy label put about their shoulders has too many ways to fall off.

2. Directors as Mediating Hierarchs in a Team Production Model

Blair and Stout employ a director primacy model to solve a different problem than the fiat that drives Bainbridge. They see the corporation in a team production model where shareholders, employees, customers, and local communities each make investments in the enterprise that are firm-specific, where the inputs have particular value in this investment over some other use, and the return on the investment is not immediate, but at some point in the future. In such a setting the value of the investment, once made, can be appropriated by other participants who can behave opportunistically to renegotiate or threaten to withhold other inputs. Shareholders, like Ulysses of mythology, benefit from tying their own hands, so that other contributors will not decline to invest because of

75. Id. at 603–05 (so small as to be nonexistent).
76. Id. at 570–71 (the right to fire is not the right to exercise fiat—it is only the right to discipline).
77. Id. at 568.
79. Blair & Stout, supra note 2.
fear of misappropriation, which shareholders can do by ceding control to a mediating hierarch picked because the hierarch cannot personally profit.\textsuperscript{80} 

The interactive governance of shareholders, directors, and managers described in Part III has elements of team production, but the difference is not to leave all tie-breaking power in the hands of the board. The biggest challenge for a mediating hierarchs-based theory of corporate governance is that shareholders (and only shareholders) are empowered to replace the hierarch. How can you be a hierarch if one of the parties you are mediating between can kick you out? Blair and Stout do not spend a lot of time on this topic—it seems unimportant or nonexistent, perhaps in the way that Bainbridge sees the vote as so little used as to be capable of being ignored.\textsuperscript{81} But over the decade and a half since Blair and Stout’s work on team production was published, the large increase in shareholder power to throw out directors has made it much more difficult to ignore. The ability of shareholders to exercise something that looks like ultimate control of the board limits a primacy claim for directors so that this discussion fits better within a framework about shared power rather than one framed as director primacy.

**C. CEO OR MANAGERIAL PRIMACY**

What may now be termed managerial primacy dominated much of twentieth century corporate law and management scholarship.\textsuperscript{82} Business advisor Peter Drucker noted that directors are figureheads and shareholders are nonentities.\textsuperscript{83} Myles Mace in an extensive mid-century study of directors and governance concluded that presidents exercise de facto control and determine what directors do and don’t do.\textsuperscript{84} Both Adolf Berle and Merrick Dodd, who figured prominently in the earlier discussion of shareholder primacy, made managerialist assumptions.\textsuperscript{85} 

There has been both a positive and a negative aspect to discussion of managerial primacy, the former emphasizing the value that could arise from managerial primacy given economic conditions of the modern corporation, and the latter worried about the exercise of managerial power without sufficient accountability.

Alfred Chandler, in *The Invisible Hand*, describes the managerialist corporation of the twentieth century with administrative coordination that permitted greater productivity by lowering costs.\textsuperscript{86} William Bratton describes an unspoken bargain

\textsuperscript{80} Id. at 272.
\textsuperscript{81} See Bainbridge, supra note 2 at 569.
\textsuperscript{83} Peter F. Drucker, *Concept of the Corporation* 92 (rev. ed. 1972).
\textsuperscript{84} Myles L. Mace, *Directors: Myth and Reality* (1971).
\textsuperscript{85} See Bratton, supra note 82.
\textsuperscript{86} Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* 1 (1977); see also Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 292 (1998) (discussing corporations that embodied an idea of efficiency as centralized, hierarchical, and vertically integrated: “as long as these worked, these features were seen as expressing basic, incontrovertible, and mutually reinforcing principles of efficiency, governance, and cognition that became synonymous with effective human action”); cf. Robert W. Gordon,
by which management would exchange stable dividends for their freedom to pursue growth; this growth bias left managers close enough to classical profit maximization for the system to be sufficiently value-creating and managers capable of statesmanship.\textsuperscript{87} Adolf Berle, at least after he saw the impact that the New Deal’s social control over finance might have on management power, supported managerial power.\textsuperscript{88}

Some recent discussions of CEO primacy, while acknowledging that CEOs control most corporations, add the normative view that this is largely for managers’ own benefit and that society would do better with shareholder primacy or some other structure.\textsuperscript{89} Steven Ramirez has described this as dictatorship of management, by management, and for management and laments that “at every turn, legislators, judges, and regulators have eliminated or diluted constraints on the power of management.”\textsuperscript{90}

Thomas Piketty provides a twenty-first century theoretical challenge to managerial primacy based on how much of the increase in societal inequality flows from the highest paid managers and their ability to set their own pay and extract rents from shareholders.\textsuperscript{91} Piketty notes that with the unique job functions at the top of corporations, individual managerial production becomes harder to define; evaluating top management in these circumstances yields decisions that are largely arbitrary and dependent on hierarchical relationships and the relative bargaining power of individuals.\textsuperscript{92}

Thus, while managerial primacy remains widely accepted as a descriptive matter, few modern commentators provide a positive theory for its use and many criticize it. But there is not complete agreement about that descriptive story. Marcel Kahan and Ed Rock argue that CEOs have lost decision-making power through a combination of regulatory changes and shareholder activism.\textsuperscript{93} Measured in terms of decision-making power, second-guessing by shareholders and the board of directors, and the scope of the CEO’s power, they see an em-
battled CEO. But as a normative matter in their ideal corporate governance world, centralized managers remain the important decision makers: “boards would retain just that modicum of power that permits them to block, at the margin, more bad ideas than good ideas.” They acknowledge that it is “tough to know whether we are at the point” at which the net benefits of delegation are maximized such that the corporate governance debate becomes a search for the “sweet spot.” Indeed, a common aspiration for many in the various parts of the primacy debate, including shareholder primacy discussed earlier, is the search for a parallel sweet spot in a shared power structure, as developed in Part III.

D. OTHER PRIMACY THEORIES, INCLUDING EMPLOYEES AND CREDITORS

Primacy theories in corporate governance have not been limited just to shareholders, directors, or managers. Fred Tung refers to a “host of new-fangled primacies [working] their way into the corporate law lexicon.” This section focuses on two, employees and creditors, to make two larger points. First, as Tung correctly positions almost all of the new-fangled primacies, they have developed most often to challenge or distinguish shareholder primacy, often within the economic or broader debate about the purpose of the corporation. Second, as we have already seen for parts of shareholder and managerial primacy, it is difficult not to stray from pure primacy to a shared power but with greater recognition of the role of a particular group in realizing a stated purpose of the corporation.

Brett McDonnell provides an effective illustration of the first point in his argument for employee primacy. He would insert employees in place of shareholders in both parts of the traditional description of shareholder primacy. Thus, he sees ultimate employee control over corporate decision making and employee wealth maximization as the corporate objective. Employee primacy is likely to create more surplus given the strong incentives of employees and their relative wealth of information about the firm. More broadly, he argues that employee-primacy corporations are more likely to be socially responsible and, anticipating Piketty, less unequal in distribution of wealth. This, in turn, produces citizens better able to participate in political democracy.

94. Id. at 1039 (documenting, for example, the loss to shareholders and directors: “what has changed more than anything else is the ability and incentive for other players to second guess”).
95. Id. at 1049.
96. Id. at 1051.
97. Tung, supra note 5, at 817–18.
99. Id. at 339.
100. Id. at 347–64.
101. Id. at 336.
102. Id.
Henry Hansmann, who has written in various settings about different aspects of worker participation in governance,\textsuperscript{103} suggests such a concept is most attractive when heterogeneity is less or the need for outside financing is less.\textsuperscript{104} The challenge of employee primacy as a primacy theory is to explain the various contexts in which employees might have different interests from other constituents. In time of technological or market change when the firm or the economy cannot support the traditional level of wages, employee primacy may make it difficult for the firm to make adaptive decisions. Germany, and some other corporate governance systems in Europe, empower labor through a governance system of co-determination employing two corporate boards and specifying that employees are able to choose one half of the supervisory board.\textsuperscript{105} However, in Germany, which statutorily requires the existence of a supervisory board, legal rules do not necessarily result in employee empowerment that would suggest primacy.\textsuperscript{106} Hansmann notes that large German firms are often managed by a handful of shareholders who exercise control of the advisory board through coalitions and elections.\textsuperscript{107} The managing board, which must face reelection and the prospect of premature termination by the vote of the supervisory board, is by extension also affected by these shareholders.\textsuperscript{108} Co-determination today fills a smaller part in worldwide corporate governance than several decades ago, and even where it is used, it gives workers a veto over half, but not more than half, of the supervisory board as opposed to outright control that primacy would suggest.

Creditor primacy arguments likewise seek to place another constituency into the position of shareholders in the shareholder primacy model, albeit in a space that is temporally limited. Here there is a longer history of judicial support for finding that director duties shift to creditors in times of financial distress.\textsuperscript{109} The substitution argument is fairly straightforward—where financial reversals or risks have left the company able to pay only some financial claimants but not all of them and the shareholders’ claim (the residual claim that would be paid last) has been wiped out, it no longer seems appropriate to have the direc-


\textsuperscript{104} Hansmann, When Does Worker Ownership Work?, supra note 103, at 1783.

\textsuperscript{105} Martin Gelter, The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance, 50 Harv. Int’l L.J. 129, 158 (2009) (citing section 76 of the German Stock Corporation Act which requires a supervisory board, elected by shareholders with half the board being employees, to monitor the management board).

\textsuperscript{106} Id. at 160.

\textsuperscript{107} Hansmann, supra note 103, at 1803.

\textsuperscript{108} Gelter, supra note 105, at 160.

tors responsive to shareholders’ interests, but rather to the financial holders who still have skin in the game.\textsuperscript{110}

While the creditors arguably have a strong claim to step into the shoes of shareholders in such a setting, they also inherit the same arguments that challenge a primacy position. Their claims are as similarly incomplete as those made against shareholders—neither may be the best residual claimants for some or all enterprises.\textsuperscript{111} The argument reduces to one of a more effective way to exercise control in particular circumstances\textsuperscript{112} with the larger theory more consistent with shared power than primacy.

III. A NON-PRIMACY VIEW OF CORPORATE GOVERNANCE: INTENTIONAL SHARING OF POWER AMONG SHAREHOLDERS, DIRECTORS, AND OFFICERS

As the previous part makes clear, primacy theory falls short as an accurate description of the role of shareholders or directors (or other parties) in the governance of modern American public corporations. This part suggests an alternative approach to governance based on intentionally shared power among the three actors named in American corporations statutes: shareholders, directors, and officers. Such an approach is familiar to students of American public governance where separation of power has been engrained since the founding of the republic. This first part develops the antecedents of such a philosophy and how corporate governance reflects somewhat different needs and contexts. It then develops how a shared power approach fits even within a statutory approach that vests all corporate power in the board and a legal/business environment that often explains the purpose of the corporation in terms of shareholder wealth maximization. The short answer is that law does not claim primacy for itself in terms of providing corporate governance rules, but rather recognizes the private bargaining and the market and economic realities that provide the foundation for corporate governance. Managers in the modern American public corporation provide hierarchy and efficiency, which permits officers to be the realistic starting point for corporate decisions; law structures the roles for directors and shareholders to reflect that reality. This part spells out in more detail how the specific roles assigned to both shareholders and directors under statutory policy and prevailing governance theory parallel both economic and agency theory as to roles for the key players in the corporate governance setting.

\textsuperscript{110} See N. Am. Catholic Educ. Programming Fund, Inc. v. Gheewalla, 930 A.2d 92, 1101 (Del. 2007) (creditors of insolvent corporation have standing to make derivative claims against directors).

\textsuperscript{111} See Smith, supra note 10, at 301; see also Lipson, supra note 109, at 1245 (arguing not all creditors are equal with differences as to power imbalance, volition, cognition, and ability to exit).

A. SEPARATION-OF-POWER IDEAS DRAWN FROM THE POLITY

Separation of power can be clearly seen in our public governance as a part of Madison’s balance of power reflected in the structure of the Constitution. Commentary on corporate governance suggests that “the degree to which we ought to push for government-like procedures and legitimacy is the most important policy or normative question that lies ahead in corporate governance.” For Madison the focus of balance of power was to produce “ambition designed to counter ambition.” This policy of “supplying, by opposite and rival interests, the defect of better motives might be traced through the whole system of human affairs, private as well as public.” Corporate writers frequently identify balance of power in the corporate form, as between, for example, boards and the CEO, shareholders and board, or between shareholders and management/directors.

Yet any such balance was for decades mostly invisible as boards were quite deferential to managers without the separateness seen in the polity. Managers frequently voted themselves onto boards and shareholders rarely showed any kind of independence. The numerous checks and balances of government were absent in corporations, freeing managers of the type of accountability found in political decision making. More importantly, the Madisonian principle of ambition countering ambition was in some ways “obviously unsuited to corporate governance . . . . [T]he corporation thrives on strong, flexible and adaptive leadership.” Madison’s checks and balances would supply the opposite: “a tendency to produce impasse in decision making that thwarts effective leadership.” Yet separation of power, in a broader sense, remains a precondition for accountability in the corporate form that embraces hierarchy. Market and regulatory changes in the twenty-first century corporation have made separation and balance more realistic as a governance approach for these business entities. Independent directors, the expanded role for internal controls, and greater use of gatekeepers such as auditors and lawyers bolster public acceptance of the legit-

113. See The Federalist No. 51, at 320 (James Madison).
115. Id. at 163.
116. Id. at 159.
119. See Coglianese, supra note 114, at 159.
120. See id.
123. See id. at 442 (emphasizing earlier pre-Madisonian sense of separation of power (based on impartiality and accountability more than checks and balances) as central to corporate self-regulation with deep roots in the republican tradition).
imacy of American corporations that have an increasingly large publicness aspect.124

B. SHARED POWER REFLECTED IN CORPORATIONS STATUTES AND ECONOMIC REALITIES

Corporate statutes specifically identify three parties for corporate governance roles—managers (officers), directors, and shareholders.125 Other stakeholders have interests in, and the ability to influence, corporate decisions, for example employees, suppliers, creditors, and affected communities. But their interactions usually occur via contracts, levers provided in market interactions, or regulatory actions, not structural claims to decision making. Among the three named groups, managers make most corporate decisions, directors monitor that decision making in a discontinuous way becoming involved particularly where there is a manager conflict, and shareholders monitor director decisions, albeit in an even more limited space.

This governance structure reflects a combination of positive law and private ordering of economic relationships, a structure that facilitates separation of function in the enterprise and the economic advantages that can come from that. If one looked only at the corporate statutes, governance would be described in director primacy terms, given statutes like Delaware General Corporation Law section 141, which vests all power in the board, backed up by the deference to director decision making found in the business judgment rule that is at the heart of most judicial review in the corporate space.126 But directors delegate away most of their governance powers either expressly or by not interfering with management actions. And this pattern makes economic sense. In an enterprise taking advantage of specialization of function and the gains that can flow from that, managers devote more time to the enterprise, have more high-powered incentives to pay attention to corporate decisions, and often possess more expertise in the industry. Directors practically limit their active decision making to matters where they have a relative advantage over managers, for example where managers have a conflict. Shareholder governance, as would be appropriate for a group specializing in providing capital, is limited to an even smaller number of decisions where directors may be conflicted or captured by management or shareholders have a different view on a fundamental question such as a takeover.127

125. See, e.g., MODEL BUS. CORP. ACT ANN. §§ 8.01 (as to directors), 7.28 (as to shareholders), 8.40 (as to officers) (2015).
127. See Edelman et al., supra note 36, at 137.
As described in more detail in the remainder of this part, the shared governance approach requires understanding how these core groups share power in a continuing interactive dance that reflects five core principles:

(1) Managers are the key decision makers in corporate decisions, a point that reflects the influence of market and economic realities more than a command from law;

(2) Directors have broad legal power over corporate decisions but when viewed in the economic context of modern American public corporations, the directors’ role is primarily one of monitoring managers;

(3) Shareholders, with a much more limited, but still powerful, space to act under corporate law, can use their powers to provide monitoring of the board and sometimes get to express decisional preferences reflecting their financial stake in the business;

(4) The board can use its broad powers to slow down the shareholders’ use of their limited powers, an allocation that reflects a need to balance the value of shareholder monitoring of conflicted or captured directors against the possibility that shareholders will sometimes be looking to use their limited power for selfish advantage; and

(5) Friction among managers, boards, and shareholders will regularly play out in recurring business interactions, but courts, particularly the Delaware courts, play a role to referee disputes arising out of the exercise of power identified in points (1) through (4) above, a context that requires additional elaboration in Part IV.

1. The Starting Point of Corporate Governance: Economic Reality Makes Managers the Key Decisions Makers in a World of Specialized Inputs and Large Economic Enterprises

Managers make most corporate decisions in large American public corporations and have for almost all of the last century. This derives more from economics than law. Most state corporations statutes are virtually silent as to the responsibilities of managers, in contrast to the more fulsome authority given to directors and shareholders. Instead, management power flows from the specialization of economic effort facilitated by the advances of the industrial age. Centralized managers in a hierarchy provide efficiencies in information gather-
ing, decision making, and implementation that autonomous small enterprises or larger entities organized via shared collective decision making among numerous, dispersed participants simply cannot match on a recurring scale.

Law does not create or mandate this specialization, but statutes and judicial decisions based on fiduciary duty do provide a legal form that facilitates it. There is a symbiotic relationship of law and markets in organizing human behavior. The purpose of corporate law is to provide a governance system that works in light of the benefits of specialization in large enterprises such as the modern American public corporation and the challenges of monitoring agents in that setting.

The corporate governance documents of large American public corporations quoted in Part II reflect this reality, as do statements of observers of this governance system. Then-Federal Reserve Board Chairman Alan Greenspan, in the run-up to the passage of Sarbanes-Oxley legislation in 2002, put the fulcrum of corporate governance squarely within the domain of the CEO, not the directors: “the state of corporate governance to a very large extent reflects the character of the CEO.”

2. Directors as Policing Agency Costs of Managers and as a Source of Additional Information, or To Be a Mediating Hierarch

Only a small subset of corporate decisions—for example, approval of fundamental changes such as mergers—actually requires board action that cannot be delegated to management and directors have reason not to exercise much of the authority they have. Large American public corporations, as evidenced by the corporate governance documents discussed in the previous part, declare such intermittent, discontinuous director decision making as their corporate policy. The obligation to pick and replace CEOs and approve executive compensation are relatively recent additions to the mandatory statutory list, but do not fundamentally alter the discontinuous nature of director decision making.

Director characteristics seem suited for such discontinuous duties. Their part-time status, usually with day jobs outside the corporation, less high-powered in-

129. See CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 149 (7th ed. 2014) (the corporate form can be used in entities where the same persons occupy the shareholder, director, and officer positions—think close corporations—or the public corporation where participants desire to take full advantage of that specialization).


131. See MODEL BUS. CORP. ACT ANN. § 11.04 (2015); DEL. CODE ANN. tit. 8, §§ 251(b) (directors must approve a plan of merger), § 261 (same for sale of assets), § 241 (same for proposals to amend articles).

132. See Adam B. Badawi, Influence Costs and the Scope of Board Authority, 39 J. CORP. L. 675 (2014) (board will intentionally decline to exercise much of their statutory power to avoid the disruptive effects from efficiency that would flow from the increase in managers’ effort to lobby the board that would follow).

133. See supra text at notes 63–67.

134. See supra text at notes 63–67.
centives as compared to the CEO and other top managers, and lack of easy access to information about the enterprise all combine to limit their capacity to govern a large complex enterprise. Corporate governance theory has long-recognized these realities. For more than four decades, the primary role for a board has been as a monitor. This is most evident in contexts where management has a conflict of interest or other loyalty problem, but can also include monitoring of decisions involving care in the management of the firm and risk management.

There are, of course, functions of directors other than monitoring. Mid-twentieth century descriptions of board functions identified advising management as a key director function, providing management information and insights that otherwise might have been missed. Boards, unlike management, act collectively by a group decision, often characterized by consensus. Having multiple decision makers can lead to more information and arguably better decisions than one made by a single decision maker where the answer is uncertain but capable of a correct answer. Boards continue to provide such an advising and information function, but on a much reduced scale than these earlier descriptions might have suggested.

Blair and Stout’s team production model sees the value of the board in offering assurance to providers of firm-specific assets that decisions about the use of those assets will be made by a neutral decision maker less likely to have incentives that would distort a firm-efficient decision. The effectiveness of this board function turns on how often directors mediate the decisions of managers and how often other constituencies discount directors’ likelihood of not being sufficiently active to protect their interests.

3. Shareholders’ Function to Police Agency Costs, as a Source of Additional Information, and to Sometimes Express Preferences

Shareholders’ authority by statute can only be exercised on an even more discontinuous basis than the board’s authority. Their power, too, is best explained in monitoring terms, but can also be supported by some information explanations or the value of decision making by the parties who have more at risk than officers and directors. By law, shareholders can only do a few things:

135. See supra note 60.
137. Directors with expertise as to financing or industry knowledge might be expected to appear frequently on boards, but research shows that this is more likely to occur in firms controlled by private equity investors. See Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance, 76 U. Chi. L. Rev. 219 (2009).
138. See Edelman et al., supra note 36, at 1380 (discussing example of decision about an action with an uncertain effect on share price where a decision made by majority vote versus one person has a higher probability of being correct); see also, Paul H. Edelman, On Legal Interpretations of the Condorcet Jury Theorem, 31 J. LEGAL STUD. 327, 328 (2002).
139. See Rodrigues, supra note 60, at 1054–55.
140. Blair & Stout, supra note 2.
• Elect/remove directors;\textsuperscript{141}

• Approve fundamental corporate changes such as mergers but only after those changes have been proposed to them by the directors;\textsuperscript{142}

• Amend bylaws (also a shared power with directors; shareholders cannot use this authority to intrude into director authority to manage the corporation);\textsuperscript{143}

• Sell their shares, which becomes a governance tool in the context of tendering to a bidder seeking to acquire control to move the corporation in a different direction;\textsuperscript{144}

• File derivative suits or other litigation usually to trigger judicial review of director decision making;\textsuperscript{145} and

• Inspect certain corporate records.\textsuperscript{146}

Millon describes such voting and informational rights as vestiges of an older age when shareholders, like partners, controlled their firms.\textsuperscript{147} Perhaps that also explains Bainbridge’s dismissal of shareholder voting and Blair and Stout’s passing fairly quickly over these rights.\textsuperscript{148} But it seems too cavalier to ignore so much of corporate law, particularly in a current setting where economic and market conditions have facilitated the use of these governance rights.

The principal governance use of these powers in modern American corporations is as a monitoring function similar to that just discussed for directors. Shareholders can monitor directors most often when the directors are conflicted or are captured by management. In earlier periods of corporate law, such shareholder rights were described as serving to protect shareholders’ property rights in their ownership interests in the enterprise.\textsuperscript{149} It can still be argued that including shareholders in corporate decision making provides an informational advantage in certain contexts.\textsuperscript{150} But the most viable and recurring use of shareholder power is to address conflicts of interest that flow from the separation of power already discussed when the board itself is tainted by the conflict or too

\textsuperscript{142} See, e.g., id. § 11.04.
\textsuperscript{143} See, e.g., id. § 10.20.
\textsuperscript{144} The right to sell is not typically in corporations statutes but rather flows from basic property rights to transfer property. See \textit{Blasius Indus., Inc. v. Atlas Corp.}, 564 A.2d 651, 659 (Del. Ch. 1988) (“Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members.”).
\textsuperscript{146} See, e.g., id. § 220.
\textsuperscript{147} Millon, supra note 20, at 1025, 1044.
\textsuperscript{148} See supra notes 73–75 and accompanying text.
\textsuperscript{150} See Edelman et al., supra note 36, at 1378.
close to management and therefore incapable of effectively providing the necessary policing.

4. Directors’ Actions to Slow Down Shareholders’ Use of Their Power

The first three principles are generally understood and longstanding in discussions of corporate governance, but this fourth one is of more recent vintage and subject to a vigorous debate. The need for a principle like this, however, is obvious given the first three. As Dr. Suess told us, if we need and employ a “bee-watcher,” we will then need a “bee-watcher-watcher” and so on and so on.151 The corporate law solution is a bit more nuanced, if less rhythmic. The shareholders can monitor the board, but what (or who) is to keep them from using their power in ways that harm other constituents, for example by electing directors who will declare large dividends or by empowering a buyer to prefer short-term profit maximization.152 In cases like Unitrin, the court emphasized the potential for shareholders to act out of ignorance,153 perhaps to take a deal with “hot” money, but the debate has moved from ignorance to encompass the fear that shareholders will more directly seek to implement strategies that benefit their own investment preferences at the expense of other constituents.154 The need now is to separate value-enhancing monitoring by shareholders from rent seeking. While it would be possible to impose fiduciary duties on shareholders, that would be messy and perhaps incomplete. Courts to this point have preferred to work this out within the space of judicial review of director power as in Blasius.155 We let the board use its authority to slow down the share-

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151. DR. SEUSS, DID I EVER TELL YOU HOW LUCKY YOU ARE? 26–29 (Random House 1973) (“Out west near Hawtch-Hawtch there’s a Hawtch-Hawtcher bee watcher, his job is to watch. Is to keep both his eyes on the lazy town bee, a bee that is watched will work harder you see. So he watched and he watched, but in spite of his watch that bee didn’t work any harder not mawtch. So then somebody said “Our old bee-watching man just isn’t bee watching as hard as he can, he ought to be watched by another Hawtch-Hawtcher! The thing that we need is a bee-watcher-watcher!” Well, the bee-watcher-watcher watched the bee-watcher. He didn’t watch well so another Hawtch-Hawtcher had to come in as a watch-watcher-watcher!”).

152. See Leo B. Strine, Jr., Toward a Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America, 119 HARV. L. REV. 1759, 1783 (2006) (“a continued preoccupation solely with management’s flaws ignores the reality that the growing influence of institutional investors during the last quarter century has not been an unadulterated good”).


155. Leo B. Strine, Jr., If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take that Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft, 60 BUS. LAW. 877, 893 (2005) (“though Blasius obviously taught boards and their advisors that they must be very careful in the election context, [it] left it open to them to act so long as they were prepared to justify, in a situationally specific way, their behavior. In other words, whether or not it can be argued that the Atlas board’s actions were wrongly set aside by the Blasius decision, that decision did not totally inhibit future conduct, as the subsequent cases applying Blasius demonstrate.”). On the larger point of the particular ability of judges, as compared to legislatures and markets, to produce legal rules that protect shareholder interests, see Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. CIN. L. REV. 1061, 1086–96 (2000).
holders’ use of their “ultimate” powers, thus requiring shareholders and directors/managers to continue to talk to one another much like the divided branches of our government push back and forth, trying this or that, until they find a result that each can live with, or lets each live to fight another day with neither group getting to exercise absolute power.

This recognition of shared power was slow to get to corporate law. As previously described, shareholders have only very limited statutory and market-based powers and for most of the last century economic and market conditions were such that it was seldom worthwhile for any shareholder to actively pursue use of those powers. The Wall Street Rule was by far the dominant shareholder response—if you didn’t like the way things were going, selling via the market was the only realistic strategy. But the twenty-first century has seen the emergence of a different governance world. Shareholders are now institutions, rather than mom-and-pop individuals, often with greater economic sophistication and larger economic stakes to support their investment positions. Greater computing power has facilitated their ability to gather information and lowered the costs of communicating among like-situated investors. Institutional investors, particularly hedge funds, have developed an effective strategy to make shareholder activism pay. The government now requires many institutional investors to vote the shares they hold for beneficial owners such as shares in retirement plans, and powerful proxy advisors, such as Institutional Shareholder Services, have grown up to advise them and have become powerful players in corporate governance. This greater activism by shareholders has challenged management in a way not seen since the “raider” period of the pre-Williams Act years. Directors’ ability to slow down shareholder action has been part of a larger debate about whether shareholder activism is good for corporations and society.

5. Dispute Resolution by the Parties Themselves or by the Courts as a Referee

What should be the role of courts in this governance structure of intentionally shared authority among management, directors, and shareholders with each empowered to balance the other? Sometimes disputes between these players will get worked out by private ordering among these parties, but it should not be surprising that courts have a role in these disputes. Of course, courts are not the only possible dispute resolution mechanism; a government regulator could work out the allocation of power. In some common law countries, it is common for shareholder-director disputes in a merger context to be put to a takeovers

157. See Edelman et al., supra note 36, at 1395.
160. See Lipton, supra note 154.
panel, often made up of industry experts and participants and perhaps some government officials. But in the United States, this role of resolving disputes between shareholders and directors, particularly as to those of the type described in point (4) above, have been left to the courts, and most particularly to the Delaware courts, a context that is addressed in more detail in Part IV.

IV. THE ROLE FOR COURTS IN A NON-PRIMACY CORPORATE GOVERNANCE WORLD

When governance powers are split among different groups as in modern corporations, disputes can be expected to arise at the boundary where each group’s rights and interests intersect with the rights and interests of others. The American corporate law structure gives courts the principal role at these boundaries, particularly at the boundary of shareholder and director authority.

When stakeholders other than the three named in corporate statutes raise corporate governance issues, the judicial role is typically limited to interpreting contracts or applying regulatory rights found in more general laws outside of the corporations statutes. The absence of a structural role for these players in corporate law limits judicial involvement.

Even within the three named groups, if the dispute is between managers and directors, there will be almost no judicial involvement. Managers will make most decisions ostensibly under the direction of the board. The board retains the legal authority to overturn every decision management makes, but realistically holds for itself only a small subset of corporate decisions. But if the board does override the management, there is little legal basis for management to seek judicial intervention to reverse the decision. Management will look to non-judicial channels to address its concerns about director actions. This ends up being less of a legal boundary policed by the courts but rather one where boundaries are defined by economic and market relationships.

At the shareholder/director boundary things are more active. Here there are two distinct judicial roles. The first, ordinary director action fiduciary duty claims, arises when an individual shareholder (no collective action is required) goes to court alleging that directors or managers breached their fiduciary duty (e.g., conflict, lack of good faith or due care). This has long been a core part of American corporate law and is the most common way that courts are involved in corporate governance. Judges are tasked to decide whether director and manager actions meet long-established standards of care and loyalty for


162. Badawi, supra note 132 (describing how managers with more intense preferences given un-diversified human capital and typically high-powered incentives will lobby the board as to possible board actions that may intrude on management decisions; boards will intentionally decline to exercise all (or most) of the power given to them by corporate statutes to avoid being subject to more lobbying by managers).

163. See supra Part III.B.3.
A. THE TWO DISTINCT JUDICIAL ROLES

The judicial role is different in these two settings just described. In the ordinary director action fiduciary duty context, the core issue is whether judges should displace director decision making. Courts regularly acknowledge it is neither their role nor their expertise to make business decisions. Judges feel comfortable evaluating conflict and process that can destroy a fiduciary’s capacity to act for the entity, but stay away from the substance of business decisions. The broad control over other peoples’ money given to directors and management by corporate statutes has long been understood to trigger fiduciary duties by those parties. Individual shareholders can file suit in the name of the corporation or on behalf of a class of shareholders alleging breach of such duties. Judges rule on these claims following a well-defined path: the beginning point is one of deference; courts will defer to the business judgment unless the plaintiff shows something such as conflict, gross negligence, bad faith, fraud, illegality, or waste. Upon such a showing, the court will move off of deference to a more intrusive review of the challenged act under an entire fairness or other standard. The focus here is on the board’s (or management’s) domain. In particular, courts focus on whether there is some reason or disability causing the board or managers to have lost the capacity to act. Courts are quick to distinguish such failures from judicial interference with the insiders’ business judgments.

In the shareholder self-help context, the governance question is broader. It is not just a question of whether a judge should decline to defer to director decision making because of conflict or insufficient process or another deficiency, but whether shareholders as a matter of governance should supplant the directors and be the decision makers for the corporation even if there is no conflict or other deficiency. It is possible to use the language of the ordinary director action in the fiduciary duty context to resolve shareholder self-help claims as when both director conflict and the right to shareholder decision making appear in the
same setting; Delaware courts in developing enhanced judicial review under Unocal\textsuperscript{171} and Revlon\textsuperscript{172} frequently discuss the conflict of directors of a target company when taking defensive tactics to fend off an unwanted takeover. The result may be to invalidate action taken by such boards that interfere with shareholder actions. But that approach gives short shrift to the distinctive governance question posed in a self-help context and how it is different from the ordinary fiduciary duty context. The first tasks courts to use fiduciary duty to protect shareholders against director or management action that does not meet traditional standards of loyalty or care and the second to leave room for shareholder self-help as an independent component of governance.

The two different kinds of judicial roles just described correspond to the dichotomy in the versions of shareholder primacy discussed in Part II. Ordinary director action in the fiduciary duty context corresponds to the older and more established version of shareholder primacy linked to the purpose of the corporation and focused on how courts ought to define that purpose in interpreting a director's fiduciary duty.\textsuperscript{173} It also reflects the core of Bainbridge's director primacy view that is focused on broad director authority so long as courts can use fiduciary duty with a strong shareholder wealth maximization norm to rein in director action.\textsuperscript{174} Shareholder self-help corresponds to the younger variant of shareholder primacy that extends to permit shareholders to act on their own as a recognized part of corporate governance.\textsuperscript{175} As set out in Part II, none of the primacy approaches alone has sufficient descriptive power to be the foundation of corporate governance theory, but this recognition of the two distinct ways in which the director-shareholder relationship is addressed in corporate governance contributes to the separation-of-power understanding of corporate governance.

This difference between the two distinct roles that judges are called on to perform is also reflected in judicial decisions and academic writings beyond primacy. The Delaware Supreme Court, for example, has distinguished enterprise from ownership decisions,\textsuperscript{176} as have writers in law reviews.\textsuperscript{177} Former U.S. Securities

\textsuperscript{171} Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953–56 (Del. 1985).
\textsuperscript{172} Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (the “omnipresent specter that a board may primarily be acting in its own interest rather than those of the corporation or its shareholders”).
\textsuperscript{173} See Smith, supra note 10.
\textsuperscript{174} See Bainbridge, supra note 2.
\textsuperscript{175} See Johnson & Millon, supra note 20.
\textsuperscript{176} Omnicare, Inc. v. NSC Healthcare, Inc., 818 A.2d 918, 930 (Del. 2003); see also Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1998) (discussing shareholder ownership rights); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 26 Del. J. Corp. L. 859, 886 (2001) (noting that Blasius was a “ringing endorsement” of the need for protection of shareholder rights and that post-Blasius cases have recognized the reality that some sorting mechanism is needed to insulate from Blasius director actions “consistent with their legitimate authority”).
\textsuperscript{177} That distinction reflects earlier writing by a Delaware chief justice in a law review about enterprise and ownership decisions. E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, 394 (1997) (finding that ownership issues may sometimes implicate the traditional business judgment rule, but often ownership decisions recognize an enhanced court scrutiny that goes beyond the traditional rule). This, in turn, draws on writing by a distinguished aca-
and Exchange Commissioner Troy Paredes has made a parallel distinction between managerial control and residual control that picks up on similar themes:

The board (and the officers to whom the board delegates authority) ultimately exercises managerial control, subject to the shareholders’ residual control rights over the enterprise. Most notably, shareholders have the right to elect and remove directors, but they also have the right to sell. Shareholders have the right to sell their shares when they disapprove of the way the board and the management team are running the company or for any other reason. Not only do individual shareholders have the right to sell their shares in the company, but, at least as a default matter, shareholders have the right to sell their shares collectively so as to transfer control of the company, in effect retracting the board’s control. Indeed, alienability is typically understood to be a key feature of one’s property rights.178

At the same time, Delaware courts have avoided any clear statement on shareholder-versus-director primacy. Certainly their rulings on poison pills and in other takeover contexts reflect their longstanding adherence to a corporate governance system in which their foremost rule is to trust directors to make business decisions.179 But their jurisprudence requires room for shareholder decision making. Together these two strands cannot support a pure form of shareholder or director primacy. Indeed, the Delaware Supreme Court has noted the express balance of power that its law requires,180 an approach that supports the balancing analysis suggested here.

While there has been recognition of the two different judicial roles in refereeing shareholder and director governance roles, we should be careful not to claim too much clarity as yet. Development of the shareholder self-help prong in the law has been hampered because, for most of the twentieth century, economic realities did not permit shareholders to effectively use the self-help provided them under the law and, therefore, there was little reason for academics or judges to spend much time developing a theory. Collective action problems e-
effectively discouraged shareholders from using their legal power. The dominant strategy for shareholders unhappy with their managers was the Wall Street Rule to simply sell their stock.181

Even when technology and market developments made tender offers more feasible, there was concern that bidders making tender offers would prey on shareholders of target companies to the disadvantage of those companies and greenmailers would take advantage of the developing takeover market. Federal legislation via the Williams Act required additional disclosure in those settings and added some SEC regulation of the tender offer process.182 At state law, a principal judicial focus was to permit target directors to take action to protect shareholders against such abuses183 and, at the same time, to bolster judicial review of defensive tactics to permit some bulwark against the possibility that the directors were making arguments that they were protecting shareholders from raiders to effectively insulate themselves from any hostile bids.184

Subsequent developments make those concerns no longer what they were in the early 1980s. Federal rules, for example, limit two-tier coercive bust-up takeovers as occurred in Unocal.185 Institutional shareholders now occupy a much greater percentage of the shareholder census and the costs to collective action have gone down dramatically.186 Delaware judicial doctrine has recognized the additional space for shareholder decision making in corporate governance.187

B. SPEED BUMPS IN THE RECOGNITION OF SHARED POWER

Two historical speedbumps have slowed the development of a more coherent development of shared power governance. The first is a lingering confusion whether shareholder action by selling (tender offers) and by voting are fundamentally different in a governance context. The second is a reluctance to recognize the extent to which shareholder self-help, as provided in corporations statutes, is on the same plane as directors’ authority under section 141 of the Delaware General Corporation Law.188 Put a different way, there does seem too quick a willingness to recognize director authority to make corporate decisions that trumps the various shareholder self-help powers. The context underlying each of these questions has changed over the last twenty-five years, both in the legal rules provided by Delaware law and in the market forces that shape

181. See Donald E. Schwartz, In Search of Corporate Soul, The Structure of the Corporation: By Melvin Aron Eisenberg, 87 YALE L.J. 685, 688 (1978) (describing Wall Street Rule that unhappy shareholders sell rather than seeking alternatives such as vote).
186. See Edelman et al., supra note 36, at 1397–1401.
187. See infra notes 221–24 and accompanying text.
188. See DEL. CODE ANN. tit. 8, § 141 (2011).
what shareholders can do. Both make more sense within an approach to corpo-
rate governance that recognizes the benefits of shared and balanced power
among the three different corporate constituents named in the corporations
statutes.

1. Shareholder Action by Tender Offer vs. Voting

The limited powers given to shareholders in corporate governance include the
power to vote their shares to replace directors or to sell their shares, including
selling collectively to a bidder who will thereby acquire sufficient shares to con-
trol the company. Delaware has struggled to articulate how those two share-
holder powers fit within a unified corporate governance regime, having for
many years preferred voting over selling in the hierarchy of shareholder powers,
but not necessarily explaining the difference.

Recall that unfavorable market conditions made conditions for shareholder
selling unfavorable for much of the twentieth century (and the prospects for vot-
ing may not have seemed much better). When market changes occurred, one
Delaware response was to treat the two forms of shareholder action in parallel.
That can be illustrated by two decisions issued by Chancellor William Allen
months apart in 1988, one addressing director action to block shareholder sell-
ing into a tender offer and the other director action to block shareholder voting.
In the voting case, Blasius Industries, Inc. v. Atlas Corp., the target board had in-
creased the size of the board to block or delay an insurgent buyer from acting by
written consent to gain control of the board and change the corporation’s
policy.189 In City Capital Associates Ltd. Partnership v. Interco, Inc., the target
board used a poison pill and then a restructuring (e.g., selling off assets and bor-
rowing money to provide a big cash payout to shareholders) to effectively block a
tender offer that would have provided $74 cash for shares that had been trading
in the $40s.190 Chancellor Allen approached the voting and selling settings in
remarkably similar fashion. In Blasius, he posed the question as whether the
board may validly act for the principal purpose of preventing the shareholders
from electing a majority of new directors if the board’s action was in good
faith and not selfish.191 The chancellor found that “the shareholder franchise
is the ideological underpinning upon which the legitimacy of directorial
power rests”; he described the Blasius context as one “involving allocation, be-
tween shareholders as a class and the board, of effective power with respect to
governance of the corporation” that he distinguished from other forms of corpo-
rate action that may have an entrenchment effect—such as the stock buyback
present in Unocal and other prior Delaware cases.192

Later that year in addressing the poison pill defense to block shareholder sell-
ing, and applying the still new Unocal test of enhanced scrutiny (he termed Unocal

189. 564 A.2d 651 (Del. Ch. 1988).
190. 551 A.2d 787, 794 (Del. Ch. 1988).
191. Blasius, 564 A.2d at 658.
192. Id. at 660.
“the most innovative and promising case in our recent corporate law”), 193 Chancellor Allen declared “there may come a time when a board’s fiduciary duty will require it to redeem the rights and to permit shareholders to choose.” 194 In finding that there was no threat as required by the enhanced scrutiny of Unocal, the chancellor observed that “the only function left for the pill at this end state is to preclude the shareholders from exercising a judgment about their own self-interest that differs from the directors who have some interest in the question.” 195 In language that echoes the legitimacy foundations of Blasius, he concluded that result “would, it seems, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our corporate law.” 196

There was no Delaware Supreme Court review in either case (no appeal being taken), 197 but in the years to come that court carved out separate paths in the two areas. In Paramount Communications, Inc. v. Time, Inc., the supreme court rejected the chancellor’s analysis in Interco as to what would satisfy the “threat” prong of the Unocal test as a “fundamental misconception” of Unocal. 198 The flaw, as identified by the supreme court, was that “it would involve the court in substituting its judgment as to what is a ‘better’ deal for that of a corporation’s board of directors.” 199 The result has been that a board may use a poison pill to block a bid irrespective of stockholders’ desire to accept it. 200 In contrast, Blasius subsequently received a more positive reception from the supreme court. In 1992, it accepted “the basic tenets” of Blasius 201 and has applied the Blasius holding to strike down director actions and let shareholders decide on whether to accept a takeover. 202 The result was enhanced protection for shareholder voting over shareholder selling (and more specifically only one kind of voting when shareholders vote to elect directors). In contrast a wide berth was given to boards to block selling by use of poison pills and other defensive tactics.

193. Interco, 551 A.2d at 796.
194. Id. at 798.
195. Id. While acknowledging that “perhaps there is a case in which it is appropriate for a board of directors to in effect permanently foreclose their shareholders for accepting a noncoercive offer . . . the threat here is far too mild to justify such a step.” Id.
196. Id. at 800.
197. Although winning an injunction against a poison pill and receiving tenders for a large majority of Interco shares, the bidders declined to go forward. The plaintiffs would have had to challenge another ruling of the chancellor that had permitted Interco’s restructuring to go forward that would have dramatically changed the financial attractiveness of the company to be acquired. Further, the bidders’ financial backers, Drexel Burnham and Michael Milken, were facing legal challenges of their own. See Thompson, Mergers and Acquisitions, supra note 126, at 257.
198. 571 A.2d 1140, 1152 (Del. 1989).
199. Id. at 1153.
201. Stroud v. Grace, 606 A.2d 75, 91 (Del. 1992) (accepting basic tenets but declining to apply them where it could not be said that the primary purpose of the board’s action was to interfere with or impede exercise of the shareholder franchise).
202. MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003) (striking down defensive measures that changed the size and composition of the board taken for the primary purpose of impeding the shareholders’ right to vote effectively in impending election for successor directors).
Explanations for the difference between shareholders acting by voting and by selling have been sporadic. Delaware Supreme Court Justice Jack Jacobs, sitting by designation as vice chancellor in a 2004 case, *In re Emerging Communications, Inc. Shareholders Litigation*, cited an earlier chancery case acknowledging arguments that the “tender offer form is more coercive” for the receiving shareholders than merger votes. That opinion stated that a tender offer should not be treated “as the equivalent of an informed vote,” pointing to materially different interests at stake when tendering as opposed to voting such as shareholder vulnerability to being frozen out at an even lower price after a tender offer.

As market conditions have developed over the last three decades, shareholders have moved back and forth between the two channels of voting and selling, regularly combining them, for example, by using a proxy fight to replace directors who can then act to redeem poison pills that would then permit shareholder action to accept a hostile tender offer. In that context, prior distinctions between the two forms of action make less practical sense.

In addition, Delaware courts in a series of cases sometimes grouped under the *Siliconix* label have used fiduciary duty law to address the perceived shareholder vulnerability in tendering. These cases hold that a fairness review under fiduciary duty law is available to protect minority shareholders acting in response to a tender offer by a controlling shareholder unless certain conditions have been met. These conditions, in effect, would replicate the core of protections for shareholders in an arm’s-length merger—action by independent directors and by a majority-of-minority shareholders. In addition, the controlling shareholder must agree to consummate a short-form merger promptly after increasing its holdings above 90 percent, protecting non-tendering dissenters from not getting equivalent consideration.

204. Id. at *31 (quoting *In re Pure Res., Inc. S’holders Litig.*, 808 A.2d 421, 442–43 (Del. Ch. 2002)).
205. Id. Shareholders receiving a tender offer lack the shareholder voters’ ability to vote no and still get the transactional consideration or pursue appraisal under section 262, which does not include tender offers in its list of events triggering those statutory rights. *Del. Code Ann. tit. 8, § 262* (2011).
207. From a perspective of the practical impact on what the defensive tactics made the shareholders do differently, the defensive tactics struck down in the voting cases (which get the enhanced judicial protection) seem to cause noticeably less displacement of shareholder power than the tactics upheld in the selling cases. For example, extra seats added by the board in *MM Cos.* meant that the insurgent shareholders would face a five–two deficit on the board for the next governance period instead of a three–two deficit. That is to say they were being deprived of being a larger minority but not being deprived of control (and if the insurgents were successful in passing an additional bylaw proposal to amend the bylaws to add four additional seats they would have had a majority of the board in either case). *See* *MM Cos.*, 813 A.2d at 1123. In contrast, the board declining to redeem the poison pill in *Interco* meant the insurgents who received a large majority of shares tendered into their offer could not translate that majority into effective control indefinitely.
209. Id. at 445.
210. *See Del. Code Ann. tit. 8, § 251(b), (c) (2011).*
211. *See id.* Some Delaware chancery court decisions have called for a unified construct to address tender offer and mergers. *See, e.g., In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 642–48
The Delaware legislature has now acted to treat tendering and voting as similarly able to demonstrate the shareholder consent needed for fundamental changes such as mergers or takeovers via tender offers. The Delaware merger statute permits a new form of “intermediate merger” that can be accomplished without a shareholder vote if the acquiring party acquires sufficient shares via a tender offer.\(^{212}\) The recognition of shareholder action by selling reflects a significant move toward a parallel recognition of the two forms of shareholder action and together with the common-law Siliconix cases should provoke the Delaware courts to rethink the traditional distinction between board defensive actions targeted to shareholder selling and those relating to shareholder voting.


The balance-of-power approach to corporate governance recognizes two core mechanisms providing checks on management power. Judges use fiduciary duty and accompanying legal doctrines both when shareholders assert the claim that directors or officers have misused authority given to managers to take action for the corporation and in the more particular setting where shareholders allege the director actions prevent shareholders from exercising the authority given directly to them by corporate law. The powerful lever wielded by judges under traditional application of fiduciary duty law sometimes makes them vulnerable to the mentality of a carpenter with a hammer to whom every problem seems like a nail. Their inclination can be to view every problem as one calling for a decision by a judge to protect shareholders as opposed to focusing on shareholders acting for themselves.

This can be seen in *Paramount Communications, Inc. v. Time, Inc.*, another of the classic takeover cases of the 1980s.\(^{213}\) There the court disapproved of the chancery court’s approach in *Interco* and labeled *Interco* a “fundamental misconception” of Delaware’s standard of review under *Unocal* “principally because it would involve the court in substituting its judgment as to what is a better deal for that of the corporation’s board of directors.”\(^{214}\) Using a template familiar to the ordinary director action fiduciary duty context, the court focused on limited judicial

\(^{212}\) See *Del. Code Ann.* tit. 8, § 251(h) (Supp. 2014). A 2014 amendment extended this right to use tender offers to an interested shareholder, a context that had been excluded in the original amendment to section 251(h). Fiduciary duty obligations remain for controlling shareholders in the tender offer portion of the transaction and appraisal remains available to dissenting shareholders in the merger portion of the transaction.

\(^{213}\) *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

\(^{214}\) *Id.* at 1153.
power in reviewing the board’s business decision: “the precepts of the business judgment rule militate against a court attempting to appraise or evaluate the relative merits of a long term versus short term investment goal for shareholders.”  

Of course, Paramount Communications was only addressing judicial review under Unocal, a form of intermediate review triggered by the perceived incompleteness in then-prevailing applications of judicial review of some board actions where there is the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders. A different approach should apply where the primary question is not judicially enforced fiduciary duties as the only governance protection for shareholders, but where the shareholders seek to use the specific governance powers of voting and selling provided to them. But Paramount Communications, a 1980s decision in the still early development of takeover jurisprudence, conflates these two protections in rejecting Paramount’s argument that the action of the Time board precluded Time shareholders from accepting a control premium. Here the court returned to its “fundamental misunderstanding” approach to tell the chancery court where the power of corporate governance lies: “Delaware law confers the management of the corporate enterprise to the stockholders’ duly elected representatives.”

The evolution of market conditions and regulation in the time since Paramount Communications, as discussed above, have reduced the need to rely solely on judicial use of the fiduciary duty tool and increased the space and effectiveness of shareholders using their self-help powers to vote and sell. The next section identifies this later development within the context of a shared-power approach that has developed over the last three decades.

C. Judicial and Investor Acceptance of Shared Power

In the decades since the Paramount Communications decision, courts have embraced more explicitly a balance-of-power approach to corporate governance. This can be seen in the specific context of each of the shareholder powers outside of litigation discussed above:

- The Delaware Supreme Court has recognized that shareholders’ statutory right to have the final say on mergers means that “the Delaware corporations law expressly provides for a balance of power between boards and stockholders”.

215. Id.
217. Paramount Comm’ns, 571 A.2d at 1154.
218. Id. (“The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders.”).
220. See supra Part III.B.3.
• Shareholders have the power to adopt, amend, or repeal bylaws and the Delaware Supreme Court has recognized that “both the board and shareholders, independently and concurrently, possess the power to adopt, amend and repeal the bylaws”; 222

• Shareholders have the right to elect or remove directors, which has been described in balancing terms: “Maintaining a proper balance in the allocation of power between the stockholders’ right to elect directors and the board of directors’ right to manage the corporation is dependent on the stockholders’ unimpeded right to vote effectively in an election of directors”; 223 and

• Shareholders have the right to sell their shares and courts have recognized the interconnectedness of voting and selling (although courts broadly permit defensive tactics to selling such as poison pills). 224

Decisions in this self-help space are different than the ordinary director action fiduciary duty cases discussed above. The decisions are not simply a question of a court substituting its judgment as to what is a “better deal” for that of the corporation’s board of directors (which the courts have long been averse to doing under the business judgment rule), but whether shareholders are able to substitute their judgment of a “better deal.”

Of course, balanced power is not necessarily equal power and Delaware courts have interpreted director power in a way that seems skewed toward directors and away from shareholders. There is an acknowledged reluctance by the Delaware courts to use the Blasius line of cases, the most visible cases upholding shareholder power. 225 The benefit to shareholders of the Unocal line of cases, once seen as innovative, has shrunk over time as the threat prong of the Unocal test seems to be satisfied by almost anything and the only bite in its second prong—“preclusive or coercive”—has been read only to cover actions that seem to completely prevent shareholder action by selling or voting. 226 The effect of the combination of these two trends is illustrated by the juxtaposition of the reasoning in Unitrin. There, the Delaware Supreme Court declined to apply the more enhanced scrutiny of Blasius to board defensive tactics where it found the shareholders were

222. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A. 2d 227 (Del. 2008) (recognizing shareholder bylaws cannot improperly intrude on the directors’ power to manage the corporation’s business and affairs under Delaware General Corporation Law section 141, but that the proposed bylaw in the case—providing reimbursement of a shareholder’s proxy expenses in seeking to elect directors—did not invade the director realm).


224. Stroud, 606 A.2d 75.

225. See Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 330 (Del. Ch. 2010) (“the trigger under Blasius is as extreme as the standard it invokes. . . . [T]his Court has noted that the non-deferential Blasius standard of enhanced judicial review, which imposes upon a board of directors the burden of demonstrating a compelling justification for such actions, is rarely applied either independently or within the Unocal standard of review.” (quoting Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996))).

perfectly capable of protecting themselves by exercising their right to vote in an
election of directors. Yet, just a few paragraphs later the court found those
same shareholders sufficiently incapable of protecting themselves so as to autho-
rize the board to take defensive tactics, making it much more difficult for share-
holders to act in opposition to directors. There should be a higher burden to
characterizing shareholders as both smart and dumb in such close proximity.

Yet even while not embracing broad rights for shareholders, Delaware courts
have consistently recognized the importance of keeping all players in the game,
certainly an important precondition to a balance-of-power approach. For exam-
ple, in Moran, the Delaware Supreme Court approved the board’s adoption of the
then new poison pill that in the time since that decision has proven to be the
most consistent weapon for insiders to fend off an unwanted takeover. But
the court required that the board’s later failure to redeem the poison pill be tested
by its fiduciary duties at the time of its decision not to redeem. The result was
to preserve a channel for shareholder action—shareholders could use the vote to
replace the board which could then redeem the poison pill under the redemption
feature that was (and is) common to most pills. Then Vice Chancellor (and
later Supreme Court Justice) Jacobs in Carmody recognized that Delaware courts
are “extremely reluctant” to order redemption of poison pills so long as at least
one other avenue of shareholder action remains available and the Delaware
Supreme Court cited this with approval a dozen years later.

This is not endorsement of that line of cases. The space left for shareholders to
act has sometimes been so small as to seem invisible. The standards for applying
the most intense review—Blasius—have lacked guidance so that it seldom gets
applied. The Unocal test, “the most attractive” alternative vehicle in the ab-

227. Id. at 1383 (“it is hard to imagine a company more readily susceptible to a proxy contest con-
erning a pure issue of dollars”).
228. Id. at 1385.
229. See THOMPSON, MERGERS AND ACQUISITIONS, supra note 126, at 307.
231. Id. at 1357.
232. See Wachtell, Lipton, Rosen & Katz, The Shareholder Rights Plan, reprinted in THOMPSON, MERGERS
AND ACQUISITIONS, supra note 126, at 229 (describing redemption as one of ten core features of a poison
pill).
statutorily permitted classified board as a defensive device that would “delay—but not prevent—a
hostile acquirer from obtaining control of the board, since a determined acquirer could wage a
proxy contest and obtain control of two-thirds of the board over a two-year period, as opposed to
seizing control in a single election”).
234. Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 604 (Del. 2010) (rejecting plaintiff’s ar-
gument that a particular type of poison pill was preclusive in the context of a target with a classified
board, quoting Carmody’s “delay but not prevent” and concluding, “[i]n the fact that a combination of
defensive measures makes it more difficult for an acquirer to obtain control of a board does not make
measures realistically unobtainable, i.e., preclusive”).

In Unitrin, as already discussed, the Delaware Supreme Court permitted board action that effec-
tively insulated the action against an adverse shareholder action on a merger, on the basis that share-
holders retained an effective route to turn out the directors in a separate voting channel, this being
235. Allen et al., supra note 176, at 886.
sence of Blasius,\textsuperscript{236} has had its component parts eroded so that most anything satisfies the threat prong of the test\textsuperscript{237} and the only real bite of the proportionality prong is in “preclusion,” seemingly only met if all remaining shareholder channels are closed. It is not surprising that Chancellor Chandler in a context where he concluded that a target’s poison pill had served “its legitimate purpose” and that a sophisticated and well-informed shareholder base knew “what they needed to know . . . to make an informed decision” still felt constrained by Delaware law to let the board block the hostile bid irrespective of stockholders’ desire to accept it.\textsuperscript{238}

Delaware courts have long preferred a court-centric use of fiduciary duty as the solution to governance problems and to start from a point of trusting directors.\textsuperscript{239} As a result, they have been slow to embrace shareholder self-help that is clearly set out in the Delaware General Corporation Law and now enabled by recent changes in the makeup of the shareholder group and the incentives of shareholders to engage in governance. In this new world, the uncertainty that has characterized the Blasius trigger and the narrowness now reflected in Unocal seems to close off too much of the balance of power that is reflective of modern corporate governance.

There are cases that recognize shareholder self-help, such as the chancery court decision raising a Revlon claim in a takeover of The Topps Company. Then-Vice Chancellor Strine found a likely Revlon violation from the target company’s declining to waive a standstill agreement with a potentially higher bidder at a time when a merger vote was scheduled on a bid management preferred.\textsuperscript{240} The solution to this breach was an injunction against the standstill to permit the

\textsuperscript{236} Id.

\textsuperscript{237} Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 56–57 (Del. Ch. 2011) (“Although I have a hard time believing that inadequate price alone (according to the target’s board) in the context of a non-discriminatory, all-cash, all-shares, fully financed offer poses any ‘threat’—particularly given the wealth of information available to Airgas’s stockholders at this point in time—under existing Delaware law, it apparently does. Inadequate price has become a form of ‘substantive coercion’ as that concept has been developed by the Delaware Supreme Court in its takeover jurisprudence. That is, the idea that Airgas’s stockholders will disbelieve the board’s views on value (or in the case of merger arbitrageurs who may have short-term profit goals in mind, they may simply ignore the board’s recommendations), and so they may mistakenly tender into an inadequately priced offer. Substantive coercion has been clearly recognized by our Supreme Court as a valid threat.”).

\textsuperscript{238} Id. at 57–58 (“That being said, however, as I understand binding Delaware precedent, I may not substitute my business judgment for that of the Airgas board. The Delaware Supreme Court has recognized inadequate price as a valid threat to corporate policy and effectiveness. The Delaware Supreme Court has also made clear that the ‘selection of a time frame for achievement of corporate goals . . . may not be delegated to the stockholders.’ Furthermore, in powerful dictum, the Supreme Court has stated that “[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy. “Although I do not read that dictum as eliminating the applicability of heightened Unocal scrutiny to a board’s decision to block a non-coercive bid as underpriced, I do read it, along with the actual holding in Unitrin, as indicating that a board that has a good faith, reasonable basis to believe a bid is inadequate may block that bid using a poison pill, irrespective of stockholders’ desire to accept it.” (quoting Paramount Commc’ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989))).

\textsuperscript{239} THOMPSON, Mergers and Acquisitions, supra note 126, at 25 (the foremost rule of the Delaware courts to trust directors).

\textsuperscript{240} In re The Topps Co. S’holders Litig., 926 A.2d 58, 91 (Del. Ch. 2007).
Topps shareholders, receiving full information, to “rationally decide for themselves between two competing, non-coercive offers.”

This is not to say that shareholders will always get it right (just as directors or managers will not always get it right). The rise in the price of Airgas in the period after the poison pill was upheld provides ex post evidence that the company and its shareholders could have been better off with the board’s rejection. After-the-fact performance of Time, Inc. can be used to argue that the company and its shareholders were substantially worse off given the board decision to reject the Paramount offer. What is at issue here is whether Delaware’s traditional approach to leave very little room for shareholder self-help still is appropriate.

The possible narrowness of Delaware’s judicial balancing has shrunk in recent years as market and regulatory changes have broadened the avenues available to shareholders. Classified boards, long one of the most effective bulwarks of directors’ ability to forestall contrary action by shareholders, have disappeared in most large public corporations, a result that reflects shareholder market power and activism beyond the courts. Individual shareholders or groups have used proxy access provided by Rule 14a-8 to include a non-binding shareholder vote on the agenda of an annual meeting (as part of the company’s proxy). Institutional shareholders, whose incentives to be activist in matters of corporate governance have been traditionally suspect, have voted for such proposals to the extent that many proposals gain more than 50 percent support of the voting shareholders.

For many years, management was able to effectively ignore such votes, even when they garnered more than 50 percent of the votes as they were non-binding. But then proxy advisory firms such as Institutional Shareholder Services arose, and otherwise passive institutional investors were willing to vote against directors at a subsequent annual meeting. This combination, indirect and multi-step as it was, produced a credible threat to management leading to management’s proposing or supporting binding action to amend the firm’s articles to remove the staggered board provisions.

Shareholders now have a parallel and indirect ability to participate in governance regarding executive compensation, through the precatory voting requirements of Dodd-Frank on that topic and the increased willingness of...
institutional shareholders to use their voting power to support greater responsiveness on this issue facilitated by the activism of shareholder advisors like Institutional Shareholders Services. Shareholder access to director nominations is also growing through use of Rule 14a-8 and the more active involvement of institutional shareholders.

What is important for this article regarding those changes is what institutional shareholders are doing with their broader powers. The most prevalent approach is not to use them to replace management in one fell swoop as might have occurred in 1968 or 1983, but something that clearly resembles a shared balance-of-power approach. Institutional shareholders have embraced a strategy of influence and dialogue, rather than conquer and burn. Activist shareholders have the ability and the votes to take over companies but they regularly refrain from the use of this power to turn out incumbent managers. Shareholders seem comfortable with divided government, a message we often see delivered in our polity. In *Liquid Audio*, for example, a Delaware case presenting the current state of play on the *Blasius* line of cases, the shareholders backed insurgents for the two seats up for election on the company’s staggered board but voted down a bylaw amendment that would have increased the size of the board and provided the insurgents a clear majority. In that case as well as others, the vote followed a divided recommendation from Institutional Shareholders Services, so it is worth examining the impact of proxy advisory firms on the process. The prevalence of short-slate proposals by activist shareholders to gain representation but not control of the board illustrates a similar preference for shared power.

Kahan and Rock have explored what they see as the “odd reluctance” of shareholder activists to pursue issues that have a more material impact on governance and instead pursuing matters that seem small or irrelevant, shying away, for example, from mandatory bylaw proposals that would bring additional power to shareholders. Their examples include shareholder activists pursuing a shareholder proposal to redeem an existing poison pill provision but would not prevent the board’s future adoption and use of a poison pill with a result that the proposal would “have no impact on the company’s ability to resist a hostile bid.” They offer a variety of explanations, including a focus on “big picture” approaches such as shifting management’s conception of the board to a more shareholder-centric view, or public choice theories of the roles of proxy advisers and other players that also could impact such choices. But their preferred expla-

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248. See supra Part IV.A.
251. Id. at 1125.
252. See Bratton, supra note 3.
254. Id. at 2001.
nation can fit into the approach suggested here. The shareholders recognize, as did Thurman Arnold during the New Deal, that society needs a ritual to deal with the contradiction of the social reality between the recurring desire to attack bigness and the benefits that come if large enterprises flourish. The end game they take from Arnold fits within a shared power approach by providing space for the key players to figure out how to make institutions serve social needs.255

CONCLUSION

As market and technological development regarding corporate governance continue apace, the primacy discussion is different than a decade or two ago. Shareholders now monitor to address conflict situations (courts do not have a monopoly on this) and also retain the right to speak for themselves, even in the absence of traditional insider incapacity that would generate judicial intervention in director decisions. But when shareholders engage in such self-help, they may be harming others. Modern corporate governance has evolved to preserve shareholder monitoring, but to let directors slow it down. This necessarily invokes an explicit system in which the different actors in corporate governance check each other.

A generation ago Delaware permitted director action to close off the selling channel for shareholder action via judicial approval of poison pills in almost any context and shutting down much of the voting channel as well. That seems to have created less space for shareholder action than specified by the corporations statutes. In the years since, the antidote to this narrowness has come not from judicial decisions, but from market and economic forces that have empowered shareholders in ways not anticipated in the 1980s or 1990s. Activist shareholders have taken to these new possibilities, but have not used them to their maximum degree. Instead we live in a corporate governance world in which shareholders want influence and voice, but not necessarily control. They will use any levers, including those that might be labeled ultimate control, to ensure space for a conversation that continues to take advantage of the hierarchy and efficiency of management, while subjecting that decision making to a shared power structure in which management continues to have the central role but not absolute primacy. There remains an important role for judges in this shared power world, but it requires a greater recognition of the self-help that the corporations statutes permits shareholders and a more transparent reasoning process in the set of cases in which shareholder self-help powers conflict with director efforts to slow down the use of that power.

255. Id.
The article examines the extent to which economic incentives may have improved for appraisal arbitrageurs in recent years, which could help explain the observed increase in appraisal activity. We investigate three specific issues. First, we review the economic implications of allowing petitioners to seek appraisal on shares acquired after the record date. We conclude that appraisal arbitrageurs realize an economic benefit from their ability to delay investment for two reasons: (1) it enables arbitrageurs to use better information about the value of the target that may emerge after the record date to assess the potential payoff of bringing an appraisal claim and (2) it helps minimize arbitrageurs’ exposure to the risk of deal failure. Second, based on a review of the recent Delaware opinions in appraisal matters, as well as fairness opinions issued by targets’ financial advisors, we document that the Delaware Chancery Court seems to prefer a lower equity risk premium than bankers. Such a systematic difference in valuation input choices also works in favor of appraisal arbitrageurs. Finally, we benchmark the Delaware statutory interest rate and find that the statutory rate more than compensates appraisal petitioners for the time value of money or for any bond-like claim that they may have on either the target or the surviving entity.

Our findings suggest that, from a policy perspective, it may be useful to limit petitioners’ ability to seek appraisal to shares acquired before the record date. We also posit that, absent any finding of a flawed sales process, the actual transaction price may serve as a useful benchmark for fair value. We conjecture that, while the statutory interest rate may not be the main factor driving appraisal arbitrage, it does help improve the economics for arbitrageurs. Thus, the proposal by the Council of the Delaware Bar Association’s Corporation Law Section to limit the amount of interest paid by appraisal respondents—by allowing them to pay appraisal claimants a sum of money at the beginning of the appraisal action—seems like a practical way to address concerns regarding the statutory rate. However, paying appraisal claimants a portion of the target’s fair value up front is akin to funding claimants’ appraisal actions, which may end up encouraging appraisal arbitrage.
I. INTRODUCTION

There has been an increase in recent years in appraisal rights actions filed in the Delaware Chancery Court. The uptick is seen both in the number of appraisal petitions being filed and the total dollar amount at stake in appraisal proceedings. Commentators have linked the recent rise in appraisal actions to the emergence of appraisal arbitrageurs—hedge funds that seek transactions where the court-appraised value is likely to be higher than the transaction price. Merion Capital and Magnetar Financial are two of the prominent appraisal arbitrageurs. For example, it is reported that as of early 2015, Merion Capital had about $1 billion under management and was participating in several active appraisal cases.

Appraisal arbitrageurs take relatively large positions in the common stocks of public companies that are targets of mergers or acquisitions. For example, in 2014, Merion Capital sought an appraisal of 1,255,000 shares of Ancestry.com common stock, which were worth more than $40 million at the transaction price of $32 per share. Arbitrageurs take a position after an M&A transaction is announced, often several months after the deal announcement. They then dissent from the proposed merger, forego the merger consideration, and seek a higher value than the transaction price via an appraisal action pursuant to section 262 of the Delaware General Corporation Law.

Appraisal arbitrage is not risk free. Arbitrageurs spend considerable time and resources identifying potential investment opportunities. Once an appraisal action is launched, the arbitrageurs must go through a fairly lengthy litigation pro-
cess to demonstrate that the consideration offered to the target shareholders is lower than the fair value of the target stock. Of course, after that lengthy process, there is always a possibility that the court-determined value turns out to be even lower than the consideration paid in the transaction.

Market observers have devoted a fair amount of attention to possible reasons underlying the recent rise in appraisal actions. A number of commentators have connected the increase to recent rulings reaffirming appraisal rights of shares bought by appraisal arbitrageurs after the record dates of the relevant transactions.6 Other reasons posited for the current surge in appraisal activity include the relatively high interest rate on the appraisal award and a belief that the Delaware Chancery Court may feel more comfortable finding fair values in excess of, rather than below, the transaction price. This hypothesis seems to be based on the observation of recent rulings in which court-determined fair values have been mostly at or above the transaction price.7 Of course, one needs to be mindful of the potential selection bias when drawing conclusions based on outcomes of appraisal actions—that is, dissenting shareholders may be more likely to seek appraisal in instances where the transaction price is in fact lower than the fair value.

However, it is interesting to note that in the Ancestry.com matter (one recent case in which the court-appraised fair value was equal to the actual transaction price), Vice Chancellor Glasscock’s valuation result was $31.79, but he chose to adopt the slightly higher actual transaction price of $32 as “the best indicator of Ancestry’s fair value as of the Merger Date.”8 On the other hand, in the Ramtron matter, where the transaction at issue was the result of a hostile bid by the acquirer, Vice Chancellor Parsons deducted synergies of $0.03 per share from the transaction price of $3.10 and used the resulting figure ($3.07 per share) as his estimate of the target’s fair value.9 In these recent matters in which the court-determined fair value was based on the transaction price, the court also found that the sales process was robust and fair. Decisions such as these do show that appraisal arbitrage is not without risk. However, the downside risk seems modest, and recent rulings lend support to the notion that the Delaware Chancery Court is likely to determine fair value that is at least equal to the transaction price.


8. In re Appraisal of Ancestry.com, Inc., No. 8173-VCG, 2015 Del. Ch. LEXIS 21, at *74–76 (Jan. 30, 2015). Furthermore, Vice Chancellor Glasscock stated the following in his opinion to support the adoption of the transaction price: “It would be hubristic indeed to advance my estimate of value over that of an entity for which investment represents a real— not merely an academic—risk, by insisting that such entity paid too much.” Id. at *74.

In this article, we examine the extent to which economic incentives may have improved for appraisal arbitrageurs in recent years, which could help to explain the observed increase in appraisal activity. We investigate three specific issues.

First, we examine the economic implications of permitting appraisal rights to shares that were purchased after the record date. We do not question the judicial determination or legislative intent behind this law; instead, we simply investigate the economic implication. The ability to delay the investment allows appraisal arbitrageurs to get a better sense of the value of the target, while at the same time helping reduce their exposure to the risk of loss related to investing in a target that fails to close the transaction. It is fairly well established in finance that the ability to delay an investment is akin to owning a call option. Allowing appraisal arbitrageurs to delay their investment in target company stock, therefore, is akin to giving them such an option. All else being equal, an appraisal arbitrageur is likely to wait for as long as possible prior to buying the target stock in order to reduce the risk (primarily the risk of the deal failing) and thereby to maximize the return. The goal of appraisal arbitrage is to increase the cost of acquisition, and the payoff from a successful appraisal action is borne by the acquiring company—the entity that is ultimately responsible for paying the fair value. Applying the option construct, one can say that the acquirer has written the option that the arbitrageur owns. But one key question remains: do the arbitrageurs pay the acquirers, or anyone else, for the option? We argue that appraisal arbitrageurs do not pay for this option, and, thus, the value of the option is essentially a transfer of value from the acquiring company to the arbitrageurs. Clearly, no payment (direct or indirect) is made by the appraisal arbitrageurs to the acquirer.

We also posit that the stock price of the target subsequent to the announcement of a transaction does not incorporate the value of the delay option. In other words, the arbitrageurs do not pay the target’s shareholders for the option either. We do not think the value of the option is impounded into the target stock price because, for a transaction that market participants like—the ones in which enough shareholders are expected to vote in favor of the transaction—there are potentially enough sellers, such as merger arbitrageurs, who would be happy to exit the deal at a price that is close to the merger price. From the perspective of investors who are happy with the deal, cashing out a few days or weeks earlier only results in a loss of time value of money, but it avoids the slight chance that the deal may fail. Investors who are happy with the transaction and are looking to cash out would not incorporate the value of an option to bring an appraisal action (the value of which is determined primarily by the likelihood that the court-appraised fair value of the target would be greater than the deal price).

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11. One can think of the cost of the investment to be the strike price and the return on the investment to be the payoff from the investment. See AVINASH K. DIXIT & ROBERT S. PINDYCK, INVESTMENT UNDER UNCERTAINTY 6 (1994) (detailing how the ability to delay can be modeled as a call option).
Second, recent rulings in appraisal matters have signaled a preference by the Delaware Chancery Court for the discounted cash flow ("DCF") valuation method in determining the fair value of the target stock. We examine the extent to which the chancery court’s preferences, with respect to certain inputs to the DCF method, may be affecting economic incentives for appraisal arbitrageurs. Specifically, we find that recent rulings in appraisal proceedings suggest that the court prefers to use the supply-side equity risk premium in computing the target firm’s cost of equity. While use of the supply-side equity risk premium is consistent with the view generally accepted by academic researchers that, going forward, the equity risk premium is likely to be lower than was observed in the past, it may be inconsistent with the common practice of investment bankers advising M&A deals (as shown in Table 2 later). This finding implies that appraisal arbitrageurs may be able to take advantage of the wedge between the valuation inputs commonly used by investment bankers providing fairness opinions to parties in M&A transactions and those preferred by the court.

Finally, we examine the Delaware statutory rate on the appraisal award. We find that during the five-year period between 2010 and 2014, the statutory interest rate, which is set at the Federal Reserve Discount Rate plus 5 percent, was higher than the yield on corporate bonds with maturity and credit risk that correspond to risk of appraisal (three-year with credit ratings of BB or higher), as shown in Table 4 and discussed later. This shows that the Delaware statutory rate compensates appraisal petitioners for significantly more than the time value in question (i.e., the risk-free rate of return). However, given that the statutory rate was designed to compensate petitioners for assuming risk, the comparison to the risk-free rate may not be appropriate. The comparison of the statutory rate to yields of risky bonds suggests that, in instances where the credit rating of the entity responsible for paying the court-determined fair value to the petitioner is BB or higher, the statutory rate more than compensates the petitioner on a risk-adjusted basis as well. While the extent to which the statutory rate may drive arbitrageurs to seek appraisal is debatable, our findings are consistent with the notion that the relatively high current statutory rate does improve the economics for arbitrageurs.

12. As discussed in more detail below, the equity risk premium is a key input when estimating a company’s cost of equity. The supply-side equity risk premium is one of several ways to measure the equity risk premium.

13. Throughout this paper, we use Standard & Poor’s credit rating designations. Moody’s credit rating equivalent to S&P’s BB is Ba2.

14. By way of background, the legislative intent behind setting the Delaware statutory rate at 5 percent over the Federal Reserve discount rate seems fairly clear: it was enacted as the presumptive rate in appraisal cases in order to eliminate expensive, time-consuming “trials within trials” over the appropriate prejudgment interest rate. The specific presumptive rate selected is drawn from the Delaware statute that generally establishes the rate of prejudgment interest on debt obligations. The Delaware General Corporation law has long provided that “[e]xcept as otherwise provided in this Code, any judgment entered on agreements governed by this subsection, whether the contract rate is expressed or not, shall, from the date of the judgment, bear post-judgment interest of 5 percent over the Federal Reserve discount rate including any surcharge thereon or the contract rate, whichever is less.” Del. Code Ann. tit. 6, § 2301(a) (2011). We thank the referee for pointing this out.
A few policy implications flow from our results: First, from an economic perspective, it seems reasonable to limit a dissenting shareholder’s appraisal rights to only the shares held as of the record date. This is, at least in part, because doing so would prevent situations of appraisal on shares that were voted in favor of the deal by prior owners. This concern is not new and has been made by several commentators.\(^{15}\) Moreover, setting the cut-off at the record date would still give investors a considerable amount of time after the announcement of a transaction to evaluate the transaction from the perspective of investing in the target’s shares in order to seek appraisal. Setting the cut-off earlier—at, say, the announcement date—would give appraisal arbitrageurs virtually no time to invest in shares for purposes of seeking an appraisal later. Denying appraisal rights to shares acquired after the record date also helps limit the value transfer (i.e., the value of the delay option) from the acquirer to appraisal arbitrageurs. Assuming all shareholders are entitled to equal treatment, there seems to be little economic merit in giving appraisal arbitrageurs privileges that are not granted to others. For example, an institutional investor who has acquired the target stock prior to the announcement of a transaction and is unhappy with the pending transaction is entitled to seek an appraisal. However, unlike appraisal arbitrageurs, the institutional investor would have to vote against the transaction on the date of record. In this case, the institutional investor’s dissent would contribute to the risk that the transaction may fail to obtain shareholder approval, which may then cause the target’s stock value to fall well below the price offered by the acquirer. It is unclear why appraisal arbitrageurs should not be required to carry the same risk.

Second, with respect to the potential wedge between the court’s preference and investment bankers’ common practices for certain valuation inputs, we do not suggest that the court should simply adopt investment bankers’ valuation assumptions, as doing so would defeat the purpose of an appraisal action. The Delaware appraisal statute calls upon the court to perform an independent evaluation of “fair value.” Because the core of the DCF method (which is Delaware’s preferred valuation technique) involves cash flow projections and assumptions on various key valuation inputs, asking the court to simply adopt investment bankers’ assumptions on such valuation inputs would be inconsistent with the statutory mandate of an independent valuation. However, our findings do indicate that the court may want to be mindful of certain systematic differences in valuation inputs that could create profit opportunities for those seeking appraisal. Conversely, investment bankers and deal lawyers should also be sensitive to these systematic differences, and they should at least be aware of the potential implication of continuing to adopt certain valuation assumptions.

Finally, our benchmarking analysis of the Delaware statutory interest rate indicates that it may be useful to contemplate a change in either the interest rate itself

\(^{15}\) See, e.g., Theodore N. Mirvis, Delaware Court Decisions on Appraisal Rights Highlight Need for Reform, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 21, 2015), http://corpgov.law.harvard.edu/2015/01/21/delaware-court-decisions-on-appraisal-rights-highlight-need-for-reform/.
or the amount on which the interest rate is paid (or both). We recognize that it may not be possible to set an interest rate based on the characteristics of a particular acquirer without increasing the scope of issues that are likely to be litigated in an appraisal proceeding. Given this consideration, it may be more practical to adopt a change that limits the amount on which the interest rate is paid. For example, one possible approach would allow an appraisal respondent to pay a certain amount of money to the petitioners early in the litigation process, thus preventing the accrual of interest on that amount. Interest would only accrue on the portion of the court-determined fair value over and above the amount already paid.

The rest of this article is organized as follows: In Part II, we discuss the value of delay. Part III explores differences in valuation inputs used by market participants and the Delaware Chancery Court. Part IV compares the Delaware statutory rate to several different benchmarks. Part V concludes the paper.

II. THE FREE OPTION

Recent opinions related to the appraisal of Ancestry.com, Inc.16 and BMC Software, Inc.17 have affirmed that, pursuant to section 262 of the Delaware General Corporation Law, an appraisal proceeding can be sought by a stockholder who acquired the stock of the target company after the record date, as long as the number of shares for which appraisal is sought does not exceed the total number of shares that voted against the M&A transaction.18

So, how do the Ancestry.com and BMC Software rulings help appraisal arbitrageurs? As an initial matter, we ignore legal issues surrounding the eligibility of shareholders with no ability to vote on the transaction to bring an appraisal action. Similarly, we also ignore the judicial determination or legislative intent to allow such shareholders to bring an appraisal suit. We limit our discussion to economic issues only; that is, we examine whether, and how, granting appraisal rights to shares bought after the record date helps appraisal arbitrageurs.

A. VALUE OF DELAY

It is well established in finance that the ability to delay an investment is valuable because it allows the investor to make a more informed investment decision.19 A simple hypothetical example helps illustrate the value of delay. Suppose that an investor has the opportunity to invest $100 in an asset today. Further assume that, as of today, the best information available suggests that there is an equal chance that at

18. Id. at *16; see also In re Appraisal of Transkaryotic Therapies, Inc., No. 1554-CC, slip op. at 3, 5 (Del. Ch. May 2, 2007). Consistent with the provisions in section 262(a) of the Delaware General Corporation Law, the court ruled in Transkaryotic Therapies that for the purposes of determining whether appraisal can be sought by the petitioner, shares that abstained or did not vote should be treated as votes against the transaction.
19. For a detailed discussion of this topic, see Dixit & Pindyck, supra note 11, at 8.
the end of some period of time, say $T$, the $100 will become either $120 or $80.\(^{20}\)

Now assume that this investor has the ability to delay investing the $100 in the asset for some time, such that she could refine her assessment of the possible outcomes at the end of time period $T$ using new information that may emerge after today. Suppose the new information allows the investor to figure out that the likelihood of the positive scenario—i.e., $100 becoming $120—is 75 percent. She can then invest her $100 in the asset with the expectation of making a gain of $10.\(^{21}\)

Similarly, if waiting results in the revelation that the asset value at the end of period $T$ is more likely to be $80, then the investor can simply avoid making the investment. Thus, in either outcome of this hypothetical example, the investor benefits from the ability to delay the investment decision.

One can use a similar construct to analyze an appraisal arbitrageur’s ability to delay purchasing a target’s stock, and to surmise the effect that such ability has on the economics of the appraisal arbitrageur. We start by assuming that on date $t_a$, a target, say Company A, announces a friendly all-cash transaction at a consideration of $X$ per share. On the announcement date $t_a$, an appraisal arbitrageur learns about the transaction (along with the rest of the public). Suppose that subsequently, on date $t_n$ (the notice date), Company A gives a notice to its shareholders that a shareholder meeting will be held on $t_m$ (the meeting date), in which those who hold Company A stock as of $t_r$ (the record date) will be able to vote on the transaction.\(^{22}\) The Delaware appraisal statute requires that the fair value determination be done as of the date of deal closing, $t_c$.\(^{23}\) Thus, the question facing the arbitrageur is how likely it is that the fair value of Company A’s stock as of $t_c$ will be higher than the contemplated offer price of $X$.

Under the current statute, the arbitrageur can seek appraisal for shares bought after the record date.\(^{24}\) In order to perfect appraisal rights, the statute also requires that a dissenting shareholder deliver (via the record holder of the shares) a written demand for appraisal to the target company before the shareholder

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\(^{20}\) In economic terms, the expected gain from this investment is zero as of today. The expected gain is equal to the expected value of the asset at the end of period $T$ minus the cost of the investment (which is $100). When there is an equal chance that at the end of period $T$ the $100 could become either $120 or $80, the expected value of the asset at the end of period $T$ is calculated to be $100 (i.e., $120 \times 0.50 + $80 \times 0.50$). For the purposes of this illustration, we ignore the time value of money.

\(^{21}\) This hypothetical example assumes that waiting for some time does not result in an increase in the cost of the investment, i.e., that it remains at $100. In the scenario where delay is possible, a revised probability of 75 percent to realize an asset value of $120 at the end of period $T$, and the corresponding revised probability of 25 percent to realize only $80, result in a new expected value of $110 (i.e., $120 \times 0.75 + $80 \times 0.25$). Thus, the expected gain from the investment is $110 minus $100, or $10.

\(^{22}\) The notice of call for a shareholders’ meeting is different from the notice of setting a record date. Public companies are required to give the exchange on which their shares are listed ten days’ advance notice of the setting of a record date. See, e.g., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 204.21 (2013).


meeting on the at-issue transaction (i.e., before $t_m$). Thus, allowing an arbitrageur to seek appraisal for shares bought after the record date effectively enables her to postpone the share purchase until at least $t_m$. In practice, however, the extant interpretation of the statute is that the written demand for appraisal that needs to be delivered to the target company prior to the shareholder meeting can simply be a generic one, without specifying the number of shares for which appraisal will be sought. Thus, an appraisal arbitrageur could make a demand before the shareholder vote without having established any significant position in the target’s stock, thereby preserving the flexibility to acquire a larger portion of target shares at any time before the deal closing. To sum up, allowing arbitrageurs to seek appraisal for shares bought after the record date enables them, in practice, to delay the share purchase until $t_c$. Alternatively, if appraisal rights were available only to the shares held as of the record date, then once a target company announces the setting of the record date, an arbitrageur would have to buy the target stock during the period between the announcement of the setting of the record date and the record date ($t_r$) itself. So, how does allowing the appraisal arbitrageur to postpone the investment decision from $t_r$ to $t_c$ help her?

To understand the economic implication of such a delay, we empirically examine the typical length between $t_r$ and $t_c$ by reviewing the timeline of cash-only friendly deals. For the purposes of our review, we identified 562 transactions involving U.S. targets with a deal value of at least $500 million that were closed between January 1, 2010, and December 31, 2014. We then further limited our review to transactions meeting the following criteria: (1) the initial reception of the target’s board of directors to the deal was not hostile; (2) the acquirer did not own more than 50 percent of the target shares before the deal announcement, but owned more than 50 percent of the target shares after the transaction closing; (3) the consideration was paid entirely in cash; and (4) the target shareholders voted on the deal. The resulting sample contains 156 transactions.

26. As a practical matter, the time it takes to close a friendly deal, i.e., the number of days between the deal announcement ($t_a$) and the deal closing ($t_c$), is dependent on, among other things, the amount of time required to obtain clearance or approvals from the U.S. Securities and Exchange Commission and other regulatory authorities. However, our focus here is on the length of time from the record date ($t_r$) to the deal closing ($t_c$). We recognize that looking at the average length of the periods taken to close deals may understate the length of more common timeframes for deals subject to regulatory delay. This is because, in transactions that do not face a meaningful regulatory approval hurdle, the deal closing frequently takes place immediately following the shareholder vote. However, in deals subject to regulatory delay, there may be months of holdup. In these deals, the ability to wait for regulatory approval increases the value of the option provided to appraisal arbitrageurs.
27. We used the Thomson Reuters SDC Platinum M&A Database to select transactions.
28. By requiring that the target shareholders voted on the deal, we effectively excluded any transactions completed through a tender offer that required no shareholder vote for approval. In a two-step transaction, an acquirer that has acquired 90 percent of the target shares in the first-step tender offer can acquire the remaining minority interest without a shareholder vote (i.e., a “short-form merger”). Traditionally, parties used so-called top-up options to give an acquirer that had consummated the first-step tender offer an option to purchase a certain number of additional target shares necessary to reach the threshold that would qualify the second step as a short-form merger. In August 2013, Delaware adopted new section 251(h) permitting a “medium-form merger,” thus eliminating the need for...
Figure 1 shows the evolution of a typical cash-only friendly transaction. The chart shows that, on average, a friendly cash-only deal takes 128 days to close. The average time period between the announcement date and the record date is 54 days, and the average time period between the record date and the deal consummation is 74 days (i.e., 5 days between the record date and the notice date, plus 32 days between the notice date and the shareholder meeting date, plus 37 days between the meeting date and the deal consummation).

Casual observation of the financial markets suggests that many things can happen during a 74-day period from $t_r$ to $t_c$ that may affect the valuation. While the fair value of a company is not expected to fluctuate as much or as frequently as the market value of its stock, it would nevertheless be in the economic interest of the appraisal arbitrageur to delay the investment decision for the following reasons: First, postponing the share purchase to after the record date enables the arbitrageur to take advantage of any development or new information, including any relevant information concerning the at-issue transaction that may not be available until after the record date has been set. This, in turn, would help the arbitrageur better assess how likely it is that the fair value of the target company stock as of the deal closing will be higher than the contemplated offer price. Second, a delay may also help the arbitrageur minimize deal risk, i.e., the risk of investing in shares of a target company that later fails to close the transaction.29

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29. In addition, keeping the return in dollar terms constant, an investor would generally prefer a shorter holding period. Allowing appraisal arbitrageurs to postpone the share purchase until the deal closing (thereby shortening the holding period as much as possible) is particularly beneficial if the appraisal matter is later resolved through a quick settlement.
The Free Option

The Delaware appraisal determination is based on the valuation of the target company as of the transaction closing date (tc in Figure 1). From an appraisal arbitrageur’s point of view, it is clearly best to wait until as close as possible to the closing date tc to make a share purchase decision. This is because, by waiting, the arbitrageur can take into consideration any developments or new information when assessing the value of the target company relative to the transaction price.

A recent example that helps illustrate the value of waiting to invest is the precipitous decline in oil prices during the second half of 2014. Lower oil prices may help reduce the production cost for manufacturers using oil as a raw material (e.g., plastic packaging makers), thereby improving their profitability. Lower oil prices may also mean more disposable income at the consumer level, which in turn would boost the outlook of retail or grocery company stocks. Thus, an arbitrageur evaluating appraisal actions for deals announced during the second half of 2014 could benefit from waiting in one of the two ways: (a) bringing actions against transactions where the drop in oil prices is likely to have a positive impact on the value of the target or (b) avoiding appraisal actions against transactions involving oil companies and other firms that were negatively impacted by the drop in oil prices.

Waiting could also allow the arbitrageur to take advantage of a target-specific development such as a positive quarterly earnings surprise, an upward revision to the estimated reserve size of the target’s natural resource assets, or an FDA approval of the target’s new drug. For example, pharmaceutical company Transkaryotic Therapies, Inc., which was the subject of a Delaware appraisal matter about a decade ago, released “extraordinarily positive” phase III clinical trial outcomes for one of its drugs ten days after the record date, but about a month before the shareholder vote on the transaction.30

Even if there are no such developments within the relevant timeframe, waiting to invest may be worthwhile for the arbitrageur. This is because, as Figure 1 shows, there is a key event between tr and tc, namely, the target company’s delivery of a notice to its shareholders and the simultaneous filing of a definitive proxy statement (e.g., Form DEFM14A) with the U.S. Securities and Exchange Commission, on tr. In the definitive proxy statement, the target notifies its shareholders of the date, time, and place of the upcoming shareholder meeting on the transaction. More important, the definitive proxy statement provides detailed information regarding the background of the transaction, deal process, valuation, and opinions of the target’s financial advisors, as well as the company’s financial forecasts. While much of this information may have already been disclosed to the public in the target’s preliminary proxy filings, the definitive proxy statement

30. See In re Transkaryotic Therapies, Inc., 954 A.2d 346, 355 (Del. Ch. 2008). Despite the new positive outcomes, the offer price for Transkaryotic Therapies was not negotiated up. In addition, no other bidder emerged after the release of the clinical trial results. Plaintiffs in the case argued that the positive clinical trial outcomes demonstrated that Transkaryotic Therapies’s stock was worth more than the offer price of $37 per share.
sometimes contains new information not available prior to the notice date, and this can help an investor better assess the target’s value relative to the contemplated offer price.

Recent appraisal arbitrageurs have in fact taken advantage of this opportunity to delay investment. For example, Merion Capital started purchasing shares of Ancestry.com on December 4, 2012, the second trading day after the company’s filing of the definitive proxy statement.31 Merion Capital continued purchasing shares through December 17, 2012, which was ten calendar days before the scheduled shareholder meeting.32 Similarly, Merion Capital began purchasing shares of BMC Software in July 2013, with its last purchase on July 17, 2013.33 These purchases were made between BMC Software’s filing of the definitive proxy statement on June 25, 2013, and the shareholder meeting on July 24, 2013.34

Arbitrageurs’ ability to delay investing can be viewed as equivalent to owning a call option. Specifically, in our hypothetical example above involving the acquisition of Company A, the call option held by the arbitrageur gives her the right (but not the obligation) to purchase Company A’s stock before the deal closing date \( t_c \) at a price of \( X \) per share.35 The arbitrageur will exercise the option—i.e., purchase Company A’s stock and later initiate an appraisal action—if at some point before \( t_c \) she estimates, based on the information available, that the fair value of Company A’s stock as of \( t_c \) will exceed \( X \) per share.36 Conversely, if the arbitrageur determines that the expected payoff from exercising the option is less than \( X \) per share, then she will not purchase Company A’s stock or initiate the appraisal action.

The option to delay purchase of shares is valuable, and our expectation is that it will likely be exercised more often by appraisal arbitrageurs after Delaware’s recent reaffirmation of appraisal rights to shares bought after the record date.37 As discussed above, arbitrageurs do not pay for this option. Thus, the Delaware appraisal statute essentially requires that companies that survive

---

32. Id.
35. For the purposes of this discussion, we have made a number of simplifying assumptions so as to better focus on the underlying intuition, while avoiding technical exposition of options. For example, we assume that the strike price (i.e., the price at which the holder of the call options can buy the underlying security when the option is exercised) is equal to the contemplated offer price. Typically, after the announcement of a friendly cash-only deal, a target company’s stock trades slightly below (but close to) the offer price.
36. For ease of exposition, we ignore that the arbitrageur will not be able to realize the fair value of Company A’s stock immediately. As we discuss later, it usually takes about three years for appraisal awards to be determined and paid. In reality, an arbitrageur has to consider other factors such as the time delay to receive the appraisal award, the risk of losing the appraisal case, and the potential litigation costs when deciding whether or not to exercise the option.
M&A transactions (and ultimately their shareholders) give such an option to arbitrageurs for free.

In addition to the option to delay, the Delaware appraisal statute also gives arbitrageurs sixty days after a deal closes to decide whether to bring an appraisal action or accept the transaction price.\textsuperscript{38} The flexibility available to petitioners or arbitrageurs post-closing can also be viewed as an option. Whereas the ability to delay investment is akin to a call option, the ability to choose between bringing an appraisal action and accepting the transaction price is equivalent to a put option.\textsuperscript{39} This is because, in the context of appraisal actions, the post-closing flexibility allows arbitrageurs to either sell their shares to the entity that survives the transaction and receive the transaction price (that is, exercise the put option) or bring the appraisal action with the expectation of realizing an appraisal award higher than the transaction price.

\section*{Minimizing Deal Risk}

Another benefit of delaying investment in a target’s stock is that it helps minimize exposure to deal risk, i.e., the risk that the announced transaction may not actually close. It is in an appraisal arbitrageur’s interest to avoid investing tens or hundreds of millions of dollars in shares of a target that fails to later close the deal. This is because deal failure not only derailed the goal of launching an appraisal lawsuit, but also exposes the appraisal arbitrageur to a potentially significant loss.

It is well established that the announcement of a transaction attracts merger arbitrageurs who assume deal risk in exchange for realizing the arbitrage spread.\textsuperscript{40} For all-cash deals, the arbitrage spread is the difference between the offer price of the pending transaction and the trading price of the target stock during the period between the deal announcement and the deal resolution (either successful consummation or deal failure).\textsuperscript{41} Over the last few years, the average arbitrage spread for all-cash friendly deals, as measured a few days after the transaction announcement, has been around 2 percent.\textsuperscript{42} Thus, in the current environment, a merger arbitrageur hopes to earn about 2 percent on average (before accounting for any transaction or hedging costs and ignoring the effect of leverage).

\textsuperscript{38} \textsc{Del. Code Ann. tit. 8, § 262(e) (2011 & Supp. 2014).}
\textsuperscript{39} A put option gives the holder the right, but not the obligation, to sell an asset at a predetermined price.
\textsuperscript{41} For example, once an all-cash acquisition of a target firm at the offer price of $100 per share is announced, the stock price of the target is likely to evolve from somewhere around $98 immediately after the deal announcement to essentially $100 upon the deal closing. The difference between the offer price of $100 and the trading price of the target stock prior to the deal closing, say $98, is called the arbitrage spread.
\textsuperscript{42} Unpublished research by the authors (available upon request).
While the chance of deal failure has historically been low in general, failed deals do expose arbitrageurs—both merger arbitrageurs and appraisal arbitrageurs—to potentially significant losses. The potential severity of loss stems from the fact that news about a possible deal failure can result in sharp declines in the target’s stock price. For example, in October 2014, pharmaceutical company AbbVie Inc. withdrew its proposed acquisition of Shire Plc after the Treasury Department announced new rules taking aim at tax inversion deals. In response, Shire’s stock price fell by more than 26 percent during the week after the deal termination.

Given the deal failure risk, it is economically sensible for appraisal arbitrageurs to wait to invest, because the risk of deal failure generally declines as the closing date draws nearer. Specifically, by waiting, appraisal arbitrageurs can observe the merger arbitrage spread, which contains information concerning the market’s assessment of the deal failure risk. In addition, by waiting to invest, appraisal arbitrageurs can better assess the likelihood or actuality of regulatory approval and deal financing, both of which would improve the chance of a successful close.

In summary, delaying investment until as close as possible to the date of deal closing helps arbitrageurs reduce their exposure to the risk of deal failure. This is because the ability to delay the investment allows arbitrageurs to observe the resolution of uncertainties that drive such risk.

B. POLICY IMPLICATIONS

From a public policy perspective, it seems to be a good idea to have a group of professional investors dedicated to identifying and litigating deals done at prices that might not be fair to all shareholders. If the deal announcement date was set as a cut-off for purchase of shares eligible for appraisal action, it would eliminate this “monitoring” function. However, there does not seem to be an obvious economic argument for giving appraisal arbitrageurs the ability to “free ride” during the period between the record date and the deal closing, allowing them to wait while factors that might affect the value of the target company and the deal risk evolve. Accepting the notion that some period of time after a deal announcement probably should be given to appraisal arbitrageurs to make a decision regarding whether they should invest and seek appraisal, the question is: how much time should be given?

43. Studies have shown that, in the United States, well over 90 percent of deals have eventually closed successfully since 2000 (with the exception of the 2008/2009 financial crisis, during which the deal failure rate spiked). See Jetley & Ji, supra note 40, at 56; see also unpublished research for recent years by the authors (available upon request).


46. Id.
We suggest that the record date could be used as the cut-off for determining the eligibility of appraisal claims. As Figure 1 (above) shows, in recent years, the average number of days between the deal announcement and the record date has been fifty-four days. Allowing appraisal arbitrageurs the opportunity to delay investment until the record date would give them a meaningfully long period to observe the evolution of the merger arbitrage spread and the deal process. It would also enable them to process any new information (e.g., new macroeconomic or firm-specific developments, or information concerning the deal valuation and process disseminated via the target’s preliminary proxy filings or press releases) when assessing the potential risk and reward of launching an appraisal lawsuit.

Further, setting the cut-off at the record date would also preclude the possibility of situations of appraisal on shares that were voted in favor of the deal by prior owners. This would help ensure that all shareholders of the target firm are treated equally: appraisal arbitrageurs, like other dissenting investors of the target stock, would have to vote against the deal and thus assume deal risk.

Some commentators have found that transactions with lower takeover premia or going-private transactions are more likely to face a counselled appraisal petition.47 Others suggest that cases in which Delaware determines an appraisal award significantly higher than the transaction price tend to be “interested transactions.”48 To the extent that such information—the takeover premium implied in a proposed transaction price, the going-private nature of a deal, or the dealing with “interested parties”—is useful for arbitrageurs to assess the merit and potential payoff of an appraisal action, it is typically known to the public well before the record date.

Furthermore, a waiting period of fifty-four days can help appraisal arbitrageurs better evaluate the deal risk. For example, in the United States, a preliminary antitrust review by the Federal Trade Commission (“FTC”) or the U.S. Department of Justice typically takes up to thirty days.49 According to the FTC, the vast majority of deals reviewed by these two agencies are allowed to proceed after the first preliminary review.50 Thus, a waiting period of fifty-four days is sufficient for many deals to clear the regulatory hurdle.

III. DCF-Related Arbitrage

Valuation is central to appraisal rights cases. However, the Delaware Chancery Court does not mandate that fair valuation be established using any particular method. The general preference is “to take a more robust approach involving multiple techniques—such as a DCF analysis, a comparable transactions analysis (looking at precedent transaction comparables), and a comparable companies analysis (looking at trading comparables/multiples)—to triangulate a value

47. See, e.g., Myers & Korsmo, supra note 1, at 1595.
48. Richter et al., supra note 7, at 22.
50. Id.
range, as all three methodologies individually have their own limitations."51 With that said, a review of the recent Delaware opinions in appraisal matters suggests that the court often rejects the comparable transactions analysis or comparable companies analysis in favor of a DCF analysis. The court recognizes that “where the purported ‘comparables’ involve significantly different products or services than the company whose appraisal is at issue, or vastly different multiples, a comparable companies or comparable transactions analysis is inappropriate.”52 In In re Appraisal of Ancestry.com, Vice Chancellor Glasscock, when commenting on the fact that both sides’ valuation experts exclusively relied on the DCF approach, called the comparable companies and comparable transactions analyses “irrelevant and unhelpful . . . given Ancestry’s unique business and the concomitant difficulty of finding comparable companies or transactions.”53

With respect to the DCF analysis, Vice Chancellor Parsons explained in his order in 3M Cogent that, in simple terms, a DCF analysis “involves three basic components: (1) cash flow projections; (2) a discount rate; and (3) a terminal value.”54 Over the years, the Delaware Chancery Court seems to have developed a preference for certain valuation inputs into the discount rate estimation. When the court’s preference differs from the choices commonly used by investment bankers advising on the deal valuation, such a divergence can create a systematic difference between the deal price and the fair value established by the court.

A. EQUITY RISK PREMIUM

One key input to the discount rate estimation is the cost of the target company’s equity capital. One of the most widely used models for estimating the cost of equity capital is the Capital Asset Pricing Model (“CAPM”).55 According to the CAPM, the cost of equity for any publicly traded firm is equal to the risk-free rate plus a risk premium that accounts for non-diversifiable risk.56 Equation (1) below shows the CAPM-based formula for a firm’s cost of equity.

\[
\text{Cost of Equity} = R_f + \beta_e \times ERP
\]

55. For a detailed discussion of the CAPM and related concepts, see Tim Koller, Marc Goedhart & David Wessels, Valuation 293–315 (4th ed. 2005); see also Aswath Damodaran, Investment Valuation 69–71 (2d ed. 2002).
56. See Koller, Goedhart & Wessels, supra note 55, at 294. A basic tenet of finance is that risk that is diversifiable can be easily avoided and therefore should not lead to a high expected return. In other words, one should not expect to be compensated for risk that can easily be avoided. If all of the risk associated with an investment is diversifiable, then the investment should earn a risk-free rate of return. However, in reality, the risk associated with an investment is typically not completely diversifiable because the outcomes (or payouts) of the investment are at least partially correlated with the
In this formula, \( R_f \) is the risk-free rate, \( \beta_e \) is the equity beta, and ERP represents the estimate of the market equity risk premium. The beta of a company’s stock measures the non-diversifiable, or systematic, risk associated with investing in the company’s stock, which is driven by the correlation of the returns of the company’s stock to the returns of the market portfolio. If a stock has a beta of 1, then the expected return of the stock will match the return of the market portfolio. The expected return of a stock with a beta of less (more) than 1 will be less (more) than that of the market portfolio. ERP is typically measured as the average return over the risk-free rate that an investor expects to earn from investing in a diversified portfolio of risky assets, i.e., the market portfolio. As can be seen from Equation (1), all else being equal, a lower estimate of beta or ERP leads to a lower cost of equity.

Many academic studies have suggested that the market equity risk premium that investors should expect to receive going forward is likely to be lower than the observed historical equity risk premium, which is measured as an average excess return of the broad stock market over and above the risk-free rate over some reasonably long historical period.\(^57\) However, in terms of how a forward-looking ERP should be measured, there is considerable debate among academics. For example, a number of models have been proposed that seek to determine the forward-looking ERP by connecting equity returns to the production of the real economy.\(^58\)

Overall market. To the extent that one faces non-diversifiable risk, one could expect to earn a return higher than the risk-free rate to compensate for that additional non-diversifiable risk. Non-diversifiable risk is also known as systematic risk.

\(^{57}\) See, e.g., Eugene F. Fama & Kenneth R. French, *The Equity Premium*, 57 J. FIN. 637 (2002). In this paper, Fama and French demonstrate that stock returns between 1951 and 2000 were higher than returns based on growth in dividends and earnings. Similarly, economist Jeremy Siegel claims that the forward-looking equity risk premium may be significantly lower than the historical average. See Jeremy J. Siegel, *The Equity Premium: Stock and Bond Returns Since 1802*, 48 FIN. ANALYSTS J. 28 (1992); Jeremy J. Siegel & Richard H. Thaler, *Anomalies: The Equity Premium Puzzle*, 11 J. ECON. PERSP. 191 (1997); Jeremy J. Siegel, *The Shrinking Equity Premium*, 26 J. PORTFOLIO MGMT. 10 (1999). Siegel updated his outlook on the equity premium estimate in 2011 and projected significantly lower bond returns and a much higher equity premium for the next decade, stating that “[t]en-year TIPS are now yielding about 1 percent, so the excess returns of stocks over bonds should be in the 5–6 percent range, which is higher than the historical average.” Jeremy J. Siegel, *Long-Term Stock Returns Unshaken by Bear Markets*, in 2011 *Rethinking the Equity Risk Premium* 143, 147 (Research Found. of CFA Inst. ed., 2011).

\(^{58}\) See, e.g., Jeffrey J. Diermeier, Roger G. Ibbotson & Laurence B. Siegel, *The Supply for Capital Market Returns*, 40 FIN. ANALYSTS J. 74 (1984). In this paper, the authors make a distinction between the returns that investors require to compensate them for risk (i.e., the demand for returns in the capital market) and the returns made available from macroeconomic performance (i.e., the supply of returns). They suggest that the returns available for distribution among the various claimants are set by the productivity of businesses. See also Richard Grinold & Kenneth Kroner, *The Equity Risk Premium: Analyzing the Long-Run Prospects for the Stock Market*, INV. RES. J. (Barclays), July 2002, at 7. Grinold and Kroner propose a model that links equity returns to gross domestic product (“GDP”) growth and divides equity returns into three components: income returns (the percentage of market value distributed to shareholders through both dividends and share repurchases), nominal earnings growth, and returns from the evolution of P/E ratio. By contrast, Ibbotson and Chen divide the historical equity risk premium into four factors: the income return, inflation, the growth in real earnings per share (“EPS”), and the growth (i.e., change) in the P/E ratio and claim that the first three factors of equity returns are generated by “the productivity of the corporations in the real economy,” or the “supply side,” while the fourth factor stems from investor demand and is unrelated to the supply side of the economy. Roger G. Ibbotson & Peng Chen, *Long-Run Stock Returns: Participating in the
Over the past few years, the Delaware Chancery Court seems to be moving away from using a historical ERP in favor of one that reflects the growing academic opinion that the forward-looking ERP is likely to be lower than the ERP that has been observed in the past. For example, in *Global GT LP v. Golden Telecom, Inc.*, 59 then-Vice Chancellor Strine adopted a 6 percent ERP, which was 1.1 percent lower than the comparable historical ERP. In explaining his reasons for selecting the 6 percent over the historical 7.1 percent ERP, he referred to academic studies on forward-looking ERPs, including, in particular, the studies that proposed estimation of ERPs by linking equity returns to productivity of the real economy. For example, the *Golden Telecom* opinion stated that:

Although it is true that Ibbotson does not disavow the use of the Historic ERP as a basis for valuing corporations on a going forward basis, the text is utterly devoid of any explanation of why the Historic ERP should be used. By contrast, the 2003 article by Ibbotson and Chen explains that “investors’ expectations for long-term equity performance should be based on the supply of equity returns produced by corporations” because “[t]he supply of stock market returns is generated by the productivity of the corporation in the real economy.” And, Ibbotson’s 2008 Valuation Yearbook makes a strong argument for the supply side method by stating that “over the long run, equity returns should be close to the long-run supply estimates.”

Ibbotson’s reasoning comports with the strong weight of professional and academic thinking . . . that the most responsible estimate of ERP is closer to 6.0% than 7.1%.60

As Table 1 (below) shows, subsequent to the *Golden Telecom* decision, other Delaware Chancery Court judges have also embraced, to varying degree, supply-side ERP measures that are lower than the historical ERPs. We reviewed all Delaware appraisal opinions issued since 2010 and found eight (including *Golden Telecom*) that discussed and disclosed the choice of the ERP by the court. In five of them, the opinions explained that the ERPs adopted by the court were based on a supply-side estimate.62 Additionally, in *IQ Holdings, Inc. v. American Commercial Lines, Inc.*, Vice Chancellor Laster used a 5.5 percent ERP estimate and stated that this measure was based on “several sources, including Duff & Phelps, Ibbotson Associates, and Pratt & Grabowski.”63 Even though the court did not explic-
itly label the 5.5 percent estimate as a supply-side ERP, we note that the figure was much closer to the applicable supply-side measure than to the historical ERP. In *Laidler v. Hesco Bastion Environmental, Inc.*, an ERP of 6.14 percent, based on Ibbotson’s estimate for the years 1926 through 2011, was adopted by the court. Here again, the court did not explain in the opinion whether the chosen ERP was a supply-side or historical measure. However, an examination of the applicable Ibbotson publication shows that 6.14 percent was Ibbotson’s supply-side ERP estimate for the years 1926 through 2011. Lastly, in *Rural Metro Corp. Stockholders Litigation*, Vice Chancellor Laster gave consideration to both the historical ERP and the supply-side ERP.

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### Table 1

<table>
<thead>
<tr>
<th>Case Name</th>
<th>Decision Date</th>
<th>Delaware Chancery Court Judge</th>
<th>ERP Adopted by Court</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global GT LP v. Golden Telecom, Inc.</td>
<td>4/23/2010</td>
<td>Leo Strine</td>
<td>6%</td>
</tr>
<tr>
<td>Gearreald v. Just Care, Inc.</td>
<td>4/30/2012</td>
<td>Donald Parsons, Jr.</td>
<td>5.73%</td>
</tr>
<tr>
<td><em>In re Appraisal of The Orchard Enterprises, Inc.</em></td>
<td>7/18/2012</td>
<td>Leo Strine</td>
<td>5.2%</td>
</tr>
<tr>
<td>IQ Holdings, Inc. v. American Commercial Lines, Inc.</td>
<td>3/18/2013</td>
<td>Travis Laster</td>
<td>5.5%</td>
</tr>
<tr>
<td>Merion Capital, L.P. v. 3M Cogent, Inc.</td>
<td>7/8/2013</td>
<td>Donald Parsons, Jr.</td>
<td>5.20%</td>
</tr>
<tr>
<td>Laidler v. Hesco Bastion Environmental, Inc.</td>
<td>5/12/2014</td>
<td>Sam Glasscock, III</td>
<td>6.14%</td>
</tr>
<tr>
<td><em>In re Rural Metro Corp. Stockholders Litigation</em></td>
<td>10/10/2014</td>
<td>Travis Laster</td>
<td>Both 6.7% and 6% were considered</td>
</tr>
<tr>
<td><em>In re Appraisal of Ancestry.com, Inc.</em></td>
<td>1/30/2015</td>
<td>Sam Glasscock, III</td>
<td>6.11%</td>
</tr>
</tbody>
</table>

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64. For example, in 2010 (i.e., the year when the American Commercial Lines transaction was closed), the historical ERP calculated by Ibbotson for the period from 1926 to 2009 was 6.7 percent, whereas its supply-side measure for the same period was 5.2 percent. See *Ibbotson SBBI 2010 Valuation Yearbook* 66 (2010).


While the purpose of this article is not to participate in the ERP debate, we do investigate the extent to which Delaware’s recent shift away from the historical ERP might have created an opportunity for appraisal arbitrages. We start by comparing the ERP estimates commonly used by target financial advisors to contemporaneous measures of the supply-side ERP measure. For this analysis, we focus on M&A deals that were closed between 2010 and 2014. We further limit our sample to transactions involving a U.S. publicly traded target with a transaction value of at least $500 million.68

Out of the 268 deals reviewed, only 25 targets disclosed the ERP that the financial advisors used in their DCF analyses. These are presented in Table 2.

Table 2

<table>
<thead>
<tr>
<th>Date of Target Fairness Opinion</th>
<th>Target Financial Advisor</th>
<th>Acquirer Name</th>
<th>Target Name</th>
<th>ERP Used by Target’s Banker [A]</th>
<th>Supply-Side ERP [B]</th>
<th>Spread of [A] Over [B]</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/17/2009 Goldman Sachs</td>
<td>72 Mobile Holdings LLC</td>
<td>Airvana Inc.</td>
<td>6.47%</td>
<td>5.70%</td>
<td>6.47%</td>
<td>0.77%</td>
</tr>
<tr>
<td>4/11/2010 Goldman Sachs</td>
<td>Cerberus Capital Management LP</td>
<td>DynCorp International LLC</td>
<td>6.67%</td>
<td>5.20%</td>
<td>6.67%</td>
<td>1.47%</td>
</tr>
<tr>
<td>9/17/2010 Jefferies</td>
<td>Hellman &amp; Friedman Capital</td>
<td>Internet Brands Inc.</td>
<td>6.70%</td>
<td>5.20%</td>
<td>6.70%</td>
<td>1.50%</td>
</tr>
<tr>
<td>11/14/2010 Qatalyst Partners</td>
<td>EMC Corp.</td>
<td>Isilon Systems Inc.</td>
<td>5.20%–6.70%</td>
<td>5.20%</td>
<td>6.70%</td>
<td>0.75%</td>
</tr>
<tr>
<td>11/14/2010 Morgan Stanley</td>
<td>EMC Corp.</td>
<td>Isilon Systems Inc.</td>
<td>6.00%</td>
<td>5.20%</td>
<td>6.00%</td>
<td>0.80%</td>
</tr>
<tr>
<td>11/8/2010 Jefferies</td>
<td>Chevron Corp.</td>
<td>Atlas Energy Inc.</td>
<td>7.10%</td>
<td>5.20%</td>
<td>7.10%</td>
<td>1.90%</td>
</tr>
</tbody>
</table>

Continued

68. Similar to our analysis underlying Figure 1 above, we also limited our review to observations meeting the following criteria: (1) the initial reception of the target’s board of directors to the deal was not hostile; (2) the acquirer did not own more than 50 percent of the target shares before the deal announcement, but owned more than 50 percent of the target shares after the transaction closing; and (3) the consideration was paid entirely in cash. However, for the fairness opinion review, we did not limit the data to deals that required target shareholder voting. Our sample for this analysis contains 268 deals.

69. In instances where more than one ERP was used by a target’s banker, the spread represents the difference between the supply-side ERP and the midpoint of the range of ERPs used by the banker.
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>11/22/2010 Perella Weinberg Partners</td>
<td>J. Crew Group Inc. SPV</td>
<td>J. Crew Group Inc.</td>
<td>6.70%--10.05%</td>
<td>5.20%</td>
<td>3.18%</td>
<td></td>
</tr>
<tr>
<td>3/31/2011 Houlihan Lokey</td>
<td>Providence Equity Partners LLC</td>
<td>SRA International Inc.</td>
<td>5.25%</td>
<td>6.00%</td>
<td>(0.75%)</td>
<td></td>
</tr>
<tr>
<td>4/25/2011 Barclays</td>
<td>Saleen Acquisition Inc.</td>
<td>SMART Modular Technologies</td>
<td>6.70%</td>
<td>6.00%</td>
<td>0.70%</td>
<td></td>
</tr>
<tr>
<td>5/9/2011 Gleacher &amp; Company</td>
<td>Apollo Global Management LLC</td>
<td>CKx Inc.</td>
<td>7.17%</td>
<td>6.00%</td>
<td>1.17%</td>
<td></td>
</tr>
<tr>
<td>8/3/2011 Morgan Stanley</td>
<td>Blackstone Capital Partners VI</td>
<td>Emdeon Inc.</td>
<td>4.00%--6.00%</td>
<td>6.00%</td>
<td>(1.00%)</td>
<td></td>
</tr>
<tr>
<td>3/9/2012 Sandler O’Neill</td>
<td>MUFG Americas</td>
<td>Pacific Capital Bancorp, CA</td>
<td>6.10%</td>
<td>6.14%</td>
<td>(0.04%)</td>
<td></td>
</tr>
<tr>
<td>3/18/2012 Moelis &amp; Company</td>
<td>Zayo Group LLC</td>
<td>AboveNet Inc.</td>
<td>6.60%</td>
<td>6.14%</td>
<td>0.46%</td>
<td></td>
</tr>
<tr>
<td>7/2/2012 Macquarie Capital</td>
<td>One Equity Partners LLC</td>
<td>MModal Inc.</td>
<td>6.50%</td>
<td>6.14%</td>
<td>0.36%</td>
<td></td>
</tr>
<tr>
<td>7/8/2012 JPMorgan</td>
<td>Thomson Reuters Corp.</td>
<td>FX Alliance Inc.</td>
<td>7.50%--8.50%</td>
<td>6.14%</td>
<td>1.86%</td>
<td></td>
</tr>
<tr>
<td>7/3/2013 Peter J. Solomon Company</td>
<td>Investor Group</td>
<td>American Greetings Corp.</td>
<td>6.70%</td>
<td>6.11%</td>
<td>0.59%</td>
<td></td>
</tr>
<tr>
<td>5/9/2013 Guggenheim Securities</td>
<td>TowerBrook Capital Partners LP</td>
<td>True Religion Apparel Inc.</td>
<td>5.50%--6.50%</td>
<td>6.11%</td>
<td>(0.11%)</td>
<td></td>
</tr>
<tr>
<td>12/17/2012 Guggenheim Securities</td>
<td>Nielsen Holdings NV</td>
<td>Arbitron Inc.</td>
<td>5.50%--6.50%</td>
<td>6.14%</td>
<td>(0.14%)</td>
<td></td>
</tr>
<tr>
<td>1/30/2013 Macquarie Capital</td>
<td>Scientific Games Corp.</td>
<td>WMS Industries Inc.</td>
<td>6.14%</td>
<td>6.11%</td>
<td>0.03%</td>
<td></td>
</tr>
<tr>
<td>3/6/2013 Guggenheim Securities</td>
<td>Sycamore Partners LLC</td>
<td>Hot Topic Inc.</td>
<td>5.50%--6.50%</td>
<td>6.11%</td>
<td>(0.11%)</td>
<td></td>
</tr>
</tbody>
</table>

Continued
In one of the 25 deals, the targets retained two separate financial advisors and disclosed the ERP choice by each financial advisor; therefore, Table 2 lists 26 entries. Of the 26 observations, bankers’ ERPs exceeded the contemporaneous supply-side ERPs published by Ibbotson in its valuation yearbooks in 18 instances, or 70 percent of the time.\textsuperscript{70} When bankers’ ERPs exceeded the contemporaneous supply-side ERPs, the median spread\textsuperscript{71} was 78 basis points.

Information presented in Table 2 suggests that the academic community and the Delaware Chancery Court may have moved toward ERP measures that are lower, on average, than those used by investment bankers when valuing target companies. Such a gap in the ERP estimates between the chancery court and investment bankers seems to be favorable to appraisal arbitrageurs because, all else being equal, a lower ERP results in a lower discount rate, which in turn leads to a higher valuation outcome under a DCF valuation approach. Of course, we do not claim that the use of the historical ERP by a target’s financial advisor can help predict, with any degree

\begin{table}[h]
\centering
\begin{tabular}{|l|l|l|l|l|l|l|}
\hline
Date of Target Fairness Opinion & Target Financial Advisor & Acquirer Name & Target Name & ERP Used by Target’s Banker [A] & Supply-Side ERP [B] & Spread\textsuperscript{89} of [A] Over [B] \\
\hline
8/11/2013 & Lazard & Investor Group & Dole Food Co. Inc. & 6.70% & 6.11% & 0.59% \\
6/21/2013 & JPMorgan & Tenet Healthcare Corp. & Vanguard Health Systems Inc. & 6.50%–7.50% & 6.11% & 0.89% \\
7/15/2013 & Macquarie Capital & Bally Technologies Inc. & SHFL entertainment Inc. & 6.14% & 6.11% & 0.03% \\
11/18/2013 & BMO Capital Markets & DSM Pharmaceutical Products & Patheon Inc. & 6.10% & 6.11% & (0.01%) \\
6/8/2014 & Deutsche Bank & Analog Devices Inc. & Hittite Microwave Corp. & 6.90% & 6.11% & 0.79% \\
7/31/2014 & Macquarie Capital & Scientific Games Corp. & Bally Technologies & 6.11% & 6.11% & 0.00% \\
\hline
\end{tabular}
\caption{Continued}
\end{table}

\textsuperscript{70} In one of the 18 observations, the contemporaneous supply-side ERP fell within the range of the banker’s ERP choices but was lower than the midpoint of the range.

\textsuperscript{71} For the observed instances in which the midpoint of the ERP range exceeded the supply-side ERP, the spread represents the extent to which the midpoint exceeded the supply-side ERP.
of certainty, that the fair value of the target company appraised by the Delaware Chancery Court will be higher than the transaction price. Rather, the inference we draw from Table 2 is that when the chancery court uses a lower ERP (e.g., the supply-side ERP) to compute the cost of equity, but adopts all other valuation assumptions used by a target’s financial advisor, the DCF-based estimate of the target’s value is likely to be higher than that calculated by the financial advisor.72

The existence of a wedge in the ERP estimates between the Delaware Chancery Court and investment bankers raises some interesting questions. For example, why is it that investment bankers seem to prefer higher ERP estimates? The question becomes all the more intriguing if one recognizes that there is little reason to doubt that institutional investors, equity analysts, and other sophisticated market participants should be generally aware of the academic literature that questions the market’s ability to deliver an equity risk premium in the future that is in line with the historical risk premium. Does all of this imply that acquirers will get a good deal if they can get targets to accept valuation numbers based on a higher ERP? Or does the higher ERP used by bankers suggest some skepticism regarding the cash projections (often provided by target management) used for determining a target’s DCF value? We leave these and related questions for others to explore.

For the purposes of this article, we point to the wedge between bankers’ ERP assumptions and those used by the chancery court (as shown in Table 2) and posit that the existence of such a wedge may have contributed to the recent surge in appraisal arbitrage. We do not suggest that the court should adopt investment bankers’ ERP choices—for them to do so would defeat the purpose of an appraisal action (which calls upon the court to perform an independent evaluation of “fair value”).73 However, our findings do indicate that the court may want to be mindful that its embrace of a lower ERP, such as the supply-side ERP, could create opportunities for appraisal arbitrageurs. This is because valuations done in connection with appraisals are predicated on the assumption that there exists a point estimate, to the penny, of the target company’s fair value, while valuations done in the marketplace are the product of negotiation around a range of reasonable values for the firm. Thus, a finding of a lower or higher fair value based on valuation inputs such as ERP gives appraisal arbitrageurs an opportunity to exploit differences in valuations caused by varying preferences for modeling assumption, between the Delaware Chancery Court and the marketplace. Conversely, investment bankers and deal lawyers should also be sensitive to the use of a higher ERP, such as the historical ERP, and should at least understand the potential implications of such a choice.

72. Of course, even if the DCF-based value determined by the court is higher than that estimated by the target’s financial advisor, whether this means that the court-appraised fair value will be higher than the transaction price will depend on how the transaction price compares to the DCF-based value calculated by the financial advisor.

73. In appraisal practices, the Delaware Chancery Court typically does not consider valuation inputs used by investment banks advising parties to an M&A transaction during a negotiation process. Similarly, experts hired by both parties also tend to develop their own independent assumptions regarding inputs to a DCF model or other valuation methods.
B. POINT ESTIMATE

Delaware’s appraisal statute provides that, through the appraisal proceeding, “the Court shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation.”74 We understand that, under the appraisal statute, the term “fair value” is a legal concept. There may be an issue equating fair value to a transaction price, as the latter is likely to reflect some synergies associated with the transaction, whereas fair value is not supposed to include synergies.75 With that said, however, it is clear that an observed M&A transaction price is the result of negotiations around a given set of valuation estimates. When this is the case, the transaction price will, at least in part, reflect the negotiating skills of the parties involved in the deal. For example, an acquirer and a target could agree that the value of the target’s stock is somewhere between $16 and $20 per share, but ultimately consummate the deal at $17.25 due to the superior negotiating ability of the acquirer or its advisors.

Delaware’s appraisal statute requires the court to determine a point estimate, rather than a range, of the fair value of the target company. An implication of this requirement is that the court may determine a fair value that is higher than the transaction price but still within the range of values considered by the transaction parties. In the example above, this would happen if the court-appraised fair value of the target stock were somewhere between $17.26 and $20 per share.

So, what is the potential implication for appraisal arbitrage? We argue that transactions consummated at a price that is on the lower end of the DCF value range established by the target’s financial advisors might be more attractive to appraisal arbitrageurs, because arbitrageurs could start by showing that the fair value of the target is at least equal to the midpoint of the target financial advisor’s DCF value range.

A review of recent M&A transactions shows that transaction prices are frequently below the midpoint of the DCF price range. Table 3 (below) displays the details of this analysis. The information shown in the table is collected from the same sample as that used for Table 2. Table 3 contains more observations than Table 2 because DCF ranges are disclosed much more often in targets’ proxy filings than ERP values. Specifically, out of the 268 deals reviewed, all but nine reported the DCF ranges.

As Table 3 demonstrates, over the period from 2010 to 2014, over one third of the deals were consummated at a price below the midpoint of the DCF range established by the target’s financial advisor(s). In some years, this was true for over 40 percent of the deals. Of course, this fact alone does not mean that the Delaware appraisal statute gives appraisal arbitrageurs any particular advantage. However, a combination of various factors—including Delaware’s preference for the ERP, the statutory requirement for determining a point estimate of value, and

the court’s general practice of relying on valuation methodologies such as DCF—
does present a favorable environment for appraisal arbitrageurs.

The court’s preference for independent valuations over the merger price in de-
termining fair value seems to be based on the statutory requirement that fair
value be computed without giving any consideration to the anticipated gains
from the merger.77 Clearly, it would not make sense, economic or otherwise,
to give weight to the actual transaction price if a sales process is found to be
flawed. However, in the absence of such a finding, it might be useful for the
court to keep the actual transaction price in mind when appraising the fair
value of a publicly traded target company.

Recently, there have been several instances in which the Delaware Chancery
Court has relied on the actual transaction price. For example, in Huff Fund Invest-
ment Partnership v. CKx, Inc., the chancery court did “rely on the merger price as
the best and most reliable indication of CKx’s value.”78 In In re Appraisal of
Ancestry.com, Inc., the court also ultimately deferred to the actual transaction
price.79 In April 2015, Vice Chancellor Noble ruled in the AutoInfo, Inc.
appraisal
that the deal price in the transaction was a strong indicator of the target’s value
and, accordingly, set the fair value of the target company at the transaction
price.80 Similarly, in LongPath Capital LLC v. Ramtron International Corp., Vice
Chancellor Parsons ruled that the transaction price minus estimated synergies
provided the most reliable method for determining the fair value of Ramtron’s
shares.81 In several of the cases mentioned above, the court determined that

---

Table 3
Deal Prices Relative to DCF Price Ranges Established by Target
Financial Advisors76

<table>
<thead>
<tr>
<th>Year of Deal Closing</th>
<th># of Deals</th>
<th>Deal Price Below Lower Bound of Range</th>
<th>Deal Price Within Lower Half of Range</th>
<th>Deal Price Within Higher Half of Range</th>
<th>Deal Price Above Higher Bound of Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>49</td>
<td>0%</td>
<td>24%</td>
<td>53%</td>
<td>22%</td>
</tr>
<tr>
<td>2011</td>
<td>59</td>
<td>2%</td>
<td>34%</td>
<td>49%</td>
<td>15%</td>
</tr>
<tr>
<td>2012</td>
<td>53</td>
<td>2%</td>
<td>40%</td>
<td>40%</td>
<td>19%</td>
</tr>
<tr>
<td>2013</td>
<td>59</td>
<td>3%</td>
<td>36%</td>
<td>49%</td>
<td>12%</td>
</tr>
<tr>
<td>2014</td>
<td>39</td>
<td>3%</td>
<td>23%</td>
<td>54%</td>
<td>21%</td>
</tr>
<tr>
<td>Total</td>
<td>259</td>
<td>2%</td>
<td>32%</td>
<td>49%</td>
<td>17%</td>
</tr>
</tbody>
</table>

---

76. When a target company hired multiple bankers to value the proposed transaction, we com-
bined the valuation outcomes of all bankers to establish a DCF price range.
77. Hamermesh & Wachter, supra note 75, at 148.
2015).
none of the traditional valuation methodologies, including DCF, could be reliably applied for the purposes of conducting a valuation. In these recent matters in which the court-determined fair value was based on the transaction price, the court also found that the sales process was robust and fair. In sum, recent decisions do show that appraisal arbitrage is not without risk. However, the downside risk seems modest, as recent rulings continue to lend support to the notion that the Delaware Chancery Court is likely to determine fair value that is at least equal to the transaction price.

Even in instances in which the sales process is less than ideal, it may still be useful to subject the DCF value of a publicly traded target to some form of a market check. While it is possible that market participants, including institutional investors, may not fully understand the value of the target’s assets or strategy, it is unlikely that the value of a public company can remain hidden from sophisticated investors.

IV. INTEREST RATE

Under the current Delaware appraisal statute, absent good cause (e.g., appraisal petitioners pursuing claims in bad faith), a petitioner is awarded interest, regardless of whether the court-appraised fair value is higher or lower than the transaction price. The statute provides that “interest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5 percent over the Federal Reserve discount rate.” Recently, market observers have devoted a fair amount of attention to the Delaware statutory interest rate. Some argue that in today’s low-interest-rate environment, the relatively generous statutory interest rate may have encouraged appraisal cases.

Benchmarking the statutory rate against market rates may shed some light on the extent to which the statutory rate could facilitate appraisal arbitrage. For the purposes of benchmarking, we focus on both the risk-free rate and the yield on U.S. corporate bonds, both with a maturity of three years. Our reason for benchmarking to three-year rates is that, in recent years, the resolution of an appraisal matter has typically taken about three years. To approximate the risk-free rate,

85. See, e.g., Appraisal Rights—The Next Frontier in Deal Litigation?, KIRKLAND UPDATE (Kirkland & Ellis LLP, New York, NY), May 1, 2013, at 1.
86. We identified thirteen appraisal matters from 2010 through January 2015 for which the Delaware Chancery Court determined a fair value: Sunbelt, Golden Telecom, Just Care, Orchard Enterprises, American Commercial Lines, AT&T Mobility Wireless Operations, Cox Radio, 3M Cogent, Trados, CKx, Hesco Bastion, Rural Metro, and Ancestry.com. For these thirteen cases, the time to resolution ranges from 1.9 years to 12.1 years, with an average of 3.6 years. The case that took 12.1 years to resolve was In re Sunbelt Beverage Corp. Shareholder Litigation, which was stayed for a number of years pending the outcome of a related matter in a different jurisdiction. Excluding Sunbelt, the average time to resolution is estimated to be 2.9 years.
we use the three-year constant maturity Treasury ("CMT") rate.\textsuperscript{87} As stated above, comparing the statutory rate to the risk-free rate may not be useful, as the statutory rate is designed to compensate petitioners for more than the time value of money only. On the other hand, the yields of corporate bonds with three years to maturity serve as useful benchmarks for the purpose of examining the extent to which the statutory rate compensates petitioners for having a bond-like claim on the acquiring entity (or the entity that will be responsible for paying the fair value). A bond-like claim is more appropriate than an equity-like one, because the risk faced by a petitioner is mostly idiosyncratic. Aside from litigation risk, the remaining risk is that the post-transaction entity is unable to pay the judgment from the appraisal action.

Table 4 compares the Delaware statutory rate to selected benchmark interest rates for the years 2010 through 2014. We benchmark the statutory rate against the yields of a broad range of corporate bonds, issued by either industrial or financial firms in the United States, with credit ratings between AA and BB.\textsuperscript{88} For a given year, the statutory rate is based on the average Federal Reserve discount

\begin{table}
\centering
\caption{Benchmarking the Delaware Statutory Rate Against Selected Benchmark Interest Rates, 2010 to 2014\textsuperscript{89}}
\begin{tabular}{lcccccc}
\hline
\textbf{Interest Rate} & \textbf{2010} & \textbf{2011} & \textbf{2012} & \textbf{2013} & \textbf{2014} \\
\hline
\textit{Avg. Delaware Statutory Rate} & 5.18\% & 5.10\% & 5.14\% & 5.11\% & 5.09\% \\
\textit{Avg. 3-Year CMT Yields} & 1.11\% & 0.75\% & 0.38\% & 0.54\% & 0.90\% \\
\textit{Avg. Yields on Industrial Bonds} & & & & & \\
\textit{3-Year AA Industrial Bonds} & 1.72\% & 1.29\% & 0.81\% & NA & NA \\
\textit{3-Year A Industrial Bonds} & 1.63\% & 1.38\% & 0.91\% & 1.06\% & 1.27\% \\
\textit{3-Year BBB Industrial Bonds} & 2.14\% & 2.03\% & 1.60\% & 1.64\% & 1.70\% \\
\textit{3-Year BB Industrial Bonds} & 4.49\% & 4.05\% & 3.45\% & 2.56\% & 2.28\% \\
\textit{Avg. Yields on Financial Bonds} & & & & & \\
\textit{3-Year AA Financial Bonds} & 1.95\% & 1.71\% & 1.26\% & 1.16\% & 1.25\% \\
\textit{3-Year A Financial Bonds} & 2.40\% & 2.03\% & 1.47\% & 1.43\% & 1.47\% \\
\textit{3-Year BBB Financial Bonds} & 3.36\% & 2.83\% & 2.32\% & 1.89\% & 1.83\% \\
\textit{3-Year BB Financial Bonds} & 6.56\% & 5.03\% & 3.97\% & 2.87\% & 3.09\% \\
\hline
\end{tabular}
\end{table}

\textsuperscript{87}. A constant maturity Treasury rate is an interpolated yield based on the yields of the recently auctioned U.S. Treasury securities. A three-year CMT rate is the yield on Treasury securities with a three-year term. On any given day, a three-year CMT rate represents an estimate of what the yield on a three-year Treasury security would be if it were issued on that day.

\textsuperscript{88}. Based on Standard & Poor’s credit rating designations. Moody’s credit ratings equivalent to S&P’s AA to BB are Aa2 to Ba2. Under each rating in our analysis, we include the half-plus notch and the half-minus notch as well. For example, the A rating covers A+, A, and A-.

\textsuperscript{89}. Data are from Bloomberg LP and the Federal Reserve Bank.
rate for the year. The table shows that, based on the average Federal Reserve discount rate, the Delaware statutory interest rate was between 5.09 percent and 5.18 percent during the period from 2010 to 2014. During the same period, the risk-free rate (i.e., the yearly average three-year CMT rate) went from a high of 1.11 percent in 2010 to a low of 0.38 percent in 2012, with a recent climb up to 0.90 percent in 2014. A comparison of the statutory rate to the risk-free rate unsurprisingly shows that the former compensates appraisal petitioners for much more than the time value of money.

Table 4 also presents a comparison of the statutory rate to the yields of three-year corporate bonds issued by U.S. industrial or financial firms. Between 2010 and 2014, the average yields on BBB bonds issued by industrial firms ranged from 1.60 percent to 2.14 percent, compared to the relatively stable statutory rate of slightly over 5 percent. Thus, the Delaware statutory rate easily exceeded the yield of investment-grade corporate bonds (i.e., those with credit ratings of BBB-90 or higher) in recent years. In fact, the statutory rate has also been higher than the BB-rated yield (which is below investment grade). In 2013 and 2014 in particular, the Delaware statutory rate was about twice the average yield of the BB-rated credit. Thus, in cases where the credit of the acquiring company (or the entity responsible for paying the fair value awarded to the petitioner) is rated BB or higher, the statutory rate appears to overcompensate petitioners for a bond-like claim.

The lower panel of Table 4 repeats this comparison but uses the yield of corporate bonds issued by financial, instead of industrial, firms. In general, the yields of corporate bonds issued by financial firms are higher than those issued by industrial firms.91 Assuming the objective of the prejudgment interest rate is to cover the required rates of return on bond-like claims, and given that a large fraction of acquirers are financial buyers, as opposed to strategic ones, it seems reasonable to benchmark the statutory rate to the yields of bonds issued by financial firms.92 Table 4 shows that, with the exception of 2010,93 the yields on BB-rated corporate bonds issued by financial firms were lower than the statutory rate. The table also shows that, for 2013 and 2014, the Delaware statutory rate exceeded the yields of BB-rated financial bonds by at least two percentage points. These results also support the notion that, in recent years, the statutory rate has compensated appraisal petitioners for more than the time value of money and for more than a bond-like claim. While the extent to which the statutory rate drives arbitrageurs’ decision to seek appraisal may be debatable, the data presented above do demonstrate that the Delaware statutory rate, at least

90. Moody’s equivalent rating is Baa3.

91. See, e.g., Edwin J. Elton et al., Explaining the Rate Spread on Corporate Bonds, 56 J. Fin. 247 (2001).

92. In our sample of 268 transactions, about one third of the acquirers were financial firms (based on the first two digits of their SIC codes falling between 60 and 67).

93. In 2010, yields of bonds issued by financial firms likely still reflected the market’s concerns related to the 2008/2009 financial crisis. As Table 4 shows, the annual average yield of BB-rated financial bonds never exceeded that of BB-rated industrial bonds by more than 100 basis points after 2010, but that spread was much higher in 2010, at 207 basis points.
during the period from 2010 to 2014, was higher than the rate commensurate with the risk of a bond-like claim on an entity with a credit rating of BB or higher.

From a policy perspective, we recognize that it may not be possible to set an interest rate based on the characteristics of a target or an acquirer without increasing the scope of issues that are likely to be litigated in an appraisal proceeding. Given this consideration, it may be more practical to adopt a change that limits the amount on which the interest rate is paid. In this regard, a recent legislative proposal presented by the Council of the Delaware Bar Association’s Corporation Law Section recommended that respondents to an appraisal proceeding be given “the option to cut off the accrual of interest by paying to the appraisal claimants a sum of money of the corporation’s choosing. Thereafter, with respect to the amount paid, interest would not accrue. Interest would only accrue if the judicial award exceeded the amount paid, and then would accrue only on the excess.” On one hand, the Council’s proposal appears to be a practical way to limit the extent to which the statutory rate may serve to improve the economics for appraisal arbitrageurs. On the other hand, however, prepaying part of the fair value at the beginning of an appraisal proceeding might further encourage appraisal arbitrage. This is because paying appraisal claimants a portion of the target’s fair value up front effectively supplies capital to claimants to pre-fund their appraisal pursuits, which in turn is likely to reduce the cost of bringing an appraisal action.

Recent discussion around the statutory rate has also focused on its possible compensation of petitioners for their litigation risk. From an economic perspective, and under the assumption that parties to a lawsuit are expected to bear their own costs and risks, we see little reason to expect the statutory rate to defray any part of the litigation risk or costs associated with appraisal litigations (e.g., the risk that the court-appraised fair value may be lower than the transaction price).

V. CONCLUSION

In the article, we explore three possible reasons for the observed increase in appraisal actions. First, we examine the extent to which appraisal arbitrage may be facilitated by petitioners’ ability to bring an appraisal claim based on shares acquired after the record date of the at-issue transaction. Relying on basic finance principles, we argue that allowing a petitioner to delay the purchase of shares on which appraisal is sought does in fact favor appraisal arbitrage—that, by delaying their investment in the target’s stock until as close
to the valuation date (that is, the date on which the transaction closes) as possible, arbitrageurs are able to benefit from better information about the value of the target and, potentially, to avoid taking on a deal with a high risk of failure. One way to rebalance the playing field would be to allow appraisal only on shares acquired prior to the record date. Setting the record date as a cut-off would give sophisticated investors that specialize in appraisal arbitrage nearly two months after a deal is announced, on average, to evaluate the transaction. At the same time, it would force arbitrageurs to assume some of the deal risk, including the risk that the fair value of the target may fall between the record date and the date of deal closing.

A review of recent Delaware Chancery Court opinions suggests that Delaware currently prefers the DCF method to other valuation methods in determining the fair value of a corporation. In the article, we document the emergence of a systematic difference between the ERP used in DCF value determination by the court and that used by investment banks advising target companies. We show that the ERP used by the court is typically lower than that used by the targets’ bankers. Fundamental finance theory informs us that, all else being equal, the lower the ERP, the lower a firm’s measured cost of capital and, consequently, the higher the DCF valuation. We posit that the wedge between the ERPs used by bankers and the ERPs that the Delaware Chancery Court apparently prefers may have also contributed to the recent rise in appraisal arbitrage.

We recognize that the ERP continues to be one of many unsolved puzzles in corporate finance and, thus, ERPs used by different people are likely to vary. From a policy perspective, it clearly does not make sense for courts to simply adopt valuation assumptions made by targets’ bankers, as this would defeat the purpose of the appraisal process. However, it may be useful to keep the merger price in mind when determining the fair value of publicly traded targets. The merger price is likely to be a useful benchmark in instances where the sales process that resulted in the transaction was fair, and, in general, it would be reasonable to assume the merger price to be higher than the standalone value of the target. This is because numerous studies have concluded that, on average, targets are able to extract a good share, if not most, of the expected benefits of the transaction from the acquirer. Even in instances in which the sales process may be deficient, a DCF method-based valuation of a public firm could benefit from a market check.

Finally, we examine the extent to which the Delaware statutory interest rate may encourage appraisal arbitrage. Benchmarking the statutory rate against an array of recent bond and CMT yields shows that the statutory rate more than compensates appraisal petitioners for the time value of money or for a bond-like claim on the surviving entity, so long as the debt of the entity bearing the

appraisal claim is rated at least BB. Our conjecture is that, while the statutory rate may not be the main factor driving appraisal arbitrage, it does help improve the economics for arbitrageurs. The proposal by the Council of the Delaware Bar Association’s Corporation Law Section to limit the amount of interest paid by appraisal respondents—by allowing them to pay appraisal claimants a sum of money at the beginning of the appraisal action, on which no interest would accrue—seems like a practical way to address concerns regarding the statutory rate. However, at the same time, such a practice might further encourage appraisal arbitrage, because paying appraisal claimants a portion of the target’s fair value up front would effectively supply capital to claimants to pre-fund their appraisal pursuits.
Cross-border Tender Offers and Other Business Combination Transactions and the U.S. Federal Securities Laws: An Overview

By John M. Basnage and William J. Curtin III*

In structuring cross-border tender offers and other business combination transactions, parties must consider carefully the potential application of U.S. federal securities laws and regulations to their transaction. By understanding the extent to which a proposed transaction will be subject to the provisions of U.S. federal securities laws and regulations, parties may be able to structure their transaction in a manner that avoids the imposition of unanticipated or burdensome disclosure and procedural requirements and also may be able to minimize potential conflicts between U.S. laws and regulations and foreign legal or market requirements. This article provides a broad overview of U.S. federal securities laws and regulations applicable to cross-border tender offers and other business combination transactions, including a detailed discussion of Regulations 14D and 14E under the Securities Exchange Act of 1934 and the principal accommodations afforded to foreign private issuers in these regulations.

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INTRODUCTION

Even though tender offers and other business combination transactions may involve only non-U.S. companies, such transactions may nonetheless be subject to various U.S. laws and regulations, including U.S. federal securities laws and regulations. The application of U.S. federal securities laws and regulations generally depends on how the transaction is structured, whether any of the companies is subject to U.S. securities law reporting obligations, and whether any of the companies’ security holders are located or resident in the United States. This article provides an overview of U.S. federal securities laws and regulations applicable to cross-border tender offers and other business combination transactions involving, in the case of a tender offer, a “target” or, in the case of a business combination transaction not involving a tender offer, a “subject company” that is organized in a jurisdiction outside the United States.1 This article is not intended to provide a comprehensive analysis of all securities laws and regulations of consequence in such transactions, but to provide practitioners and other interested persons with a general guide regarding the substance and scope of the principal U.S. federal securities laws and regulations a practitioner might encounter in such transactions.2

1. In this article “tender offer” refers generally to an offer by a bidder company to acquire shares of another company, whether for cash, securities, or a combination of the two, which is made directly to security holders of the target company and may or may not be supported by management of the target company; references to a “business combination transaction” mean a combination of two entities’ businesses by means of a tender offer or otherwise. See also infra note 21; infra section 3.

2. This article does not address all the U.S. legal, procedural, and other issues related to a cross-border tender offer or business combination transaction. Among other things, this article does not address a tender offer by an issuer for its own securities governed by Rule 13e-4, 17 C.F.R. § 240.13e-4 (2015), under the Securities Exchange Act of 1934, as amended, ch. 404, 48 Stat. 881 (the “Exchange Act”); it does not discuss the so-called U.S. “proxy rules” applicable in the context of a solicitation of votes or consents of certain U.S. companies’ shareholders under Section 14(a) of the Exchange Act, 15 U.S.C. § 78n (2012); it does not address the regulation of so-called “going-private” transactions under Exchange Act Rule 13e-3, 17 C.F.R. § 240.13e-3 (2015); it does not consider the regulation of tender offers and other business combination transactions pursuant to U.S. or foreign antitrust/competition laws (principally, the Sherman Antitrust Act of 1890, ch. 647, 26 Stat. 209, the Clayton Act of 1914, ch. 323, 38 Stat. 730, the Federal Trade Commission Act of 1914, ch. 311, 38 Stat. 717, and the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435, § 201, 90 Stat. 1383, 1390, which amended the Clayton Act by adding the requirement that parties to certain transactions, including the acquisition of assets or shares, provide “pre-merger” notification to both the U.S. Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice), which require deferring consummation of the transaction until the expiration or termination of a waiting period. This article does not address laws of the various states of the United States, for instance, laws designed to shield companies incorporated or operating in such states from unsolicited offers, which may prevent the consummation of certain transactions without board or shareholder approval. This article also does not discuss the statutory and other restrictions applicable to business combination transactions involving regulated industries, such as communications, shipping, energy, and defense-related businesses, and does not discuss U.S. government review (pursuant to provisions of the Defense Production Act of 1950, ch. 932, 64 Stat. 798, as amended by the Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 5021, 102 Stat. 1107, 1425) of the national security implications of business combination transactions whereby non-U.S. entities seek to gain control of U.S. entities and related actions to suspend or prohibit such transactions where U.S. national security cannot otherwise be protected. Additionally, U.S. federal laws such as the International Investment Survey Act of 1976, Pub. L. No. 94-472, 90 Stat. 2059, the Agricultural Foreign Investment Disclosure Act of 1978, Pub. L. No. 95-460, 92 Stat. 1263, and the Domes-
APPLICATION OF U.S. SECURITIES LAWS

A fundamental goal of the U.S. securities laws is the protection of U.S. investors. The Commission has historically taken the view that U.S. securities laws potentially apply to any transaction that is conducted in the United States or that employs U.S. jurisdictional means. Specifically, U.S. securities laws may be implicated as follows:


4. See Schoenbaum v. Firstbrook, 405 F.2d 200, 206–08 (2d Cir. 1968) (reviewing the extraterritorial reach of the Exchange Act and holding that U.S. district courts have subject matter jurisdiction over violations of the Exchange Act “at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors,” even though the transactions took place outside of the United States); Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 988–89 (2d Cir. 1975), abrogated by Morrison v. Natl’ Australia Bank Ltd., 561 U.S. 247 (2010); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972); see also Concept Release on Multinational Tender and Exchange Offers, 55 Fed. Reg. 23751, 23752 n.2 (proposed June 12, 1990) (to be codified at 17 C.F.R. pts. 230 & 240) [hereinafter 1990 Concept Release] (Commission noting that tender offer provisions of the Williams Act are “extraterritorial in scope” and suggesting that jurisdictional means can be established where it is “reasonably foreseeable that U.S. shareholders of a foreign issuer that have been excluded from an offshore offer will sell their shares into the market in response to that offer”). While the authors believe that this remains the view of the Commission, it is uncertain whether, in light of [Morrison v. National Australia Bank Ltd., 561 U.S. 247 (2010)], courts would find that U.S. securities laws, including the Williams Act, are extraterritorial in scope: conduct that fails to meet the jurisdictional means test is not subject to the securities laws but other conduct that meets the test may also be excluded from the scope of the law depending on how courts apply Morrison. See infra notes 5 & 310. For more background on the Williams Act, see infra note 9.
the general anti-fraud provisions of the Exchange Act may be violated where fraudulent conduct occurs in the United States, or where the effects of the fraudulent conduct are felt in the United States;\(^5\)

- if a tender offer is made for securities of a class that is registered under the Exchange Act, it is generally necessary for the bidder to comply with the tender offer provisions of the Exchange Act subject to available exemptions, if any;

- even where the target company does not have a class of securities registered under the Exchange Act, the Exchange Act proscribes certain “fraudulent, deceptive, or manipulative” acts or practices in connection with tender offers that are potentially applicable; and

- if securities are to be offered to persons in the United States, it may be necessary to register such securities pursuant to the Securities Act of 1933, as amended (the “Securities Act”),\(^6\) or to confirm the availability of an exemption from registration.

U.S. federal securities laws apply to a tender offer or other business combination transaction notwithstanding the nationality of the bidder or target or the protections afforded by their respective home market regulators if extended to holders in the United States. This approach contrasts with the approach taken in many European jurisdictions, where the jurisdiction of the organization of the target or the jurisdiction of its primary listing, rather than the residency of the investors or the means by which the offer is made, will determine the regulatory implications of the transaction.\(^7\)

\(^5\) These tests are sometimes referred to as the “conduct test” and the “effects test.” The general anti-fraud provisions are set forth in Exchange Act § 10(b), 15 U.S.C. § 78j (2012); Rule 10b-5, 17 C.F.R. § 240.10b-5 (2015); and, in the case of a tender offer, Exchange Act Rule 14e-3, 17 C.F.R. § 240.14e-3 (2015). But see Morrison, 561 U.S. at 247 (holding that the anti-fraud provisions of the Exchange Act do not cover the claims of “foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges”). The court rejected the conduct and effects tests, stated that whether a statute has extraterritorial application turns on whether there is “an affirmative indication” in the statute that it applies extraterritorially, and held that Exchange Act Section 10(b) applies only to transactions in securities listed on domestic exchanges and domestic transactions in other securities. Id. at 248. The U.S. Circuit Courts have responded to the test applied in Morrison and are developing parameters to satisfy the definition of “domestic” transactions in light of the Supreme Court’s ruling. See Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60 (2d Cir. 2012) (holding that transactions involving securities that are not traded on domestic exchanges are “domestic” and subject to Section 10(b) and Rule 10b-5 if irrevocable liability is incurred or if title passes within the United States). Section 929P(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), 15 U.S.C. §§ 77v(c), 78aa(b) (2012), which restored U.S. federal court jurisdiction over actions or proceedings brought by the Commission and the U.S. Department of Justice (but not private litigants) pursuant to the anti-fraud provisions of the securities laws based on the conduct and effects tests, adds confusion to the principle stated in Morrison. See infra note 310.


\(^7\) For instance, the United Kingdom’s City Code on Takeovers and Mergers, TAKEOVER PANEL (2013), http://www.thetakeoverpanel.org.uk [hereinafter City Code], applies to offers for all public companies and societas europaea, whether listed or unlisted, resident in the United Kingdom, the Channel Islands, or the Isle of Man (see City Code at paragraph 3(a) of the Introduction); South African take-
THE EXCHANGE ACT

The Exchange Act governs reporting, disclosure, and other obligations of “reporting companies” and certain persons having interests in such companies. The Exchange Act and the rules adopted by the Commission under that Act also govern tender offers. Certain provisions of the Exchange Act potentially apply to any tender offer that is extended to U.S. investors or that otherwise employs U.S. jurisdictional means. Other provisions of the Exchange Act apply only to an offer for a class of securities registered under the Exchange Act. A business combination transaction that does not involve a tender offer is not regulated by the tender offer provisions of the Exchange Act.

THE SECURITIES ACT

The Securities Act governs offers and sales of securities and, in general, requires the registration of securities in connection with offers and sales unless an exemption from registration is available or an exclusion applies. The Securities Act potentially applies to any tender offer involving the exchange of one security in consideration for the tender of another, whether the exchange security

over regulations apply to companies that are deemed to be resident in South Africa (see South Africa's Securities Regulation Code on Take-overs and Mergers § A(3), in GUIDE TO THE COMPANIES ACT AND REGULATIONS 10-280 (Walter D. Geach ed., 1992)); and, in France, the rules relating to tender offers generally apply only where the target company is a French entity listed in France—the residency of the shareholders of the target is irrelevant (see, e.g., Takeover Bids, ION 2006-387 (Mar. 31, 2006) (published as Law No. 2006-387 of Mar. 31, 2006, J.O. Apr. 1, 2006, p. 4882)).

8. As used in this article, “reporting company” refers to a U.S. domestic issuer or a foreign private issuer that is required to file reports with the Commission under Section 13(a) or Section 15(d) of the Exchange Act.


11. The extraterritorial application of the Exchange Act and rules adopted by the Commission under that Act is not expressly delineated by statute or regulation, but depends on the scope of U.S. authority generally, as well as the intended or expressed extraterritorial application of the relevant statute or regulation. In the context of exclusionary offers, the Commission has provided guidance as to the avoidance of U.S. jurisdictional means. See infra section 4; see also Alan P.W. Konevsky & Jessica King, America Sans Frontières? Cross-border Business Deals: Excluding U.S. Shareholders After Morrison, M&A J., at 18, 18-19 Nov. 2010.


13. Registration under the Exchange Act is discussed in infra section 5.1. Tender offers and business combinations involving companies organized in the United States or companies that fall outside the definition of “foreign private issuer,” discussed in infra note 40, are subject to a broader application of the Exchange Act requirements, including, in particular, the so-called “proxy rules” set forth in Section 14(a), 15 U.S.C. § 78n, and the reporting obligations under Section 16, 15 U.S.C. § 77o (2012). A discussion of these rules is beyond the scope of this article. Exchange Act Rule 3a12-3, 17 C.F.R. § 240.3a12-3 (2015), provides an exemption from the proxy rules and certain other requirements for securities of certain foreign issuers.
is newly issued or already outstanding and whether the exchange security is issued or delivered by the bidder or a third party.\textsuperscript{14}

The Securities Act also applies to a business combination transaction that does not involve a tender offer but pursuant to which a plan is submitted to security holders to vote on the transaction or to elect whether to accept an exchange security for their existing security.\textsuperscript{15} Here again, such new securities must be registered with the Commission as part of the business combination transaction, unless an exemption or exclusion applies.

\textbf{STATE SECURITIES LAW CONSIDERATIONS}

In addition to U.S. federal regulation, the “blue sky”\textsuperscript{16} securities laws of the several states of the United States may apply to tender offers in which the consideration offered consists at least in part of exchange securities. Most states of the United States require securities to be registered or qualified prior to the public offer or sale of such securities in the state, including in connection with the offer or sale of securities pursuant to an exchange offer. With the adoption of the National Securities Markets Improvement Act of 1996,\textsuperscript{17} the circumstances in which a bidder must register or qualify securities with state regulators were substantially reduced. In such circumstances, U.S. federal law effectively “preempts” the application of state blue sky laws. Section 18\textsuperscript{18} of the Securities Act provides that certain categories of “covered securities” are exempt from state securities law registration or qualification. Among the securities so exempted are securities that (i) are listed (or that are authorized for listing, or upon completion of the relevant transaction will be so listed) on the New York Stock Exchange, Inc. (“NYSE”), the NASDAQ Stock Market (“NASDAQ”), or another U.S. securities exchange with listing standards substantially similar to those of the NYSE or NASDAQ, or (ii) are issued or placed in certain transactions exempt from the registration requirements of the Securities Act.\textsuperscript{19}

\textbf{GENERAL STRUCTURE OF OUR ARTICLE}

Depending on the requirements of local law and the desired result, companies may effect an acquisition or combination by means of a tender offer, a statutory

\textsuperscript{15} See Securities Act Rule 145, 17 C.F.R. § 230.145 (2015). Rule 145 provides that an “offer” or “sale” within the meaning of Section 2(3) of the Securities Act occurs in connection with certain business combination transactions pursuant to which the transaction is submitted to the vote of shareholders, implicating the registration provisions of the Securities Act.
\textsuperscript{16} State securities laws are generally referred to as “blue sky” laws as a result of their initial objective of thwarting the actions of securities promoters who would sell interests with no more substance than “so many feet of blue sky.” Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).
\textsuperscript{19} For example, securities issued in private placements conducted in accordance with Rule 506 of Regulation D under the Securities Act, 17 C.F.R. § 230.506 (2015), are covered securities, as are securities placed by reporting companies in reliance on Rule 144A, 17 C.F.R. § 230.144A (2015).
merger, a corporate amalgamation, or a court-approved combination transaction. We discuss in sections 1, 2, and 3 below the application of the U.S. securities laws and regulations to the principal methods of effecting tender offers and other business combination transactions. In section 4, we discuss actions that may constitute “U.S. jurisdictional means” for purposes of U.S. federal securities laws and the effect that the existence of jurisdictional means may have on the regulation of a business combination transaction. In section 5, we discuss certain related matters, including Exchange Act registration and deregistration, succession, certain registration exemptions for foreign private issuers, beneficial ownership reporting, and corporate governance.

1 TENDER OFFERS

BACKGROUND

A tender offer generally involves a broad solicitation by a bidder (i.e., a company or other entity) to purchase a substantial percentage of a target company’s securities for a limited period of time. As described in more detail below, tender offers are regulated in the United States pursuant to Section 14(d) and (e) of the Exchange Act and the Commission’s regulations under that section.

The term “tender offer” is not defined in the U.S. securities laws. Although a purchaser may acquire securities through a variety of means without triggering the tender offer rules, including in negotiated transactions with existing securities holders and through regular market transactions, offers structured in a manner that imposes pressure on security holders to sell their securities will likely fall within the definition. In Wellman v. Dickinson, the U.S. District Court for the Southern District of New York identified eight factors, the existence of one or more of which could indicate the existence of a tender offer:

- the active and widespread solicitation of public shareholders for the shares of a company;
- a solicitation made for a substantial percentage of a company’s shares;
- an offer to purchase made at a premium over the prevailing market price;
- the terms of the offer are firm rather than negotiable;
- the offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
- the active and widespread solicitation of public shareholders for the shares of a company;
- a solicitation made for a substantial percentage of a company’s shares;
- an offer to purchase made at a premium over the prevailing market price;
- the terms of the offer are firm rather than negotiable;
- the offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;

20. See, e.g., Tender Offers, U.S. SEC. & EXCH. COMMISSION (Jan. 16, 2013), http://www.sec.gov/answers/tender.htm. Consideration offered in a tender offer can be cash, securities, or a combination of the two. A tender offer in which at least a portion of the consideration offered consists of securities is referred to in this article as an “exchange offer.”

21. But see Proposed Amendments to Tender Offer Rules, SEC Release No. 33-6159, 1979 WL 182307 (Nov. 29, 1979) (proposing a definition of “tender offer” as, among other things, an offer extended to more than ten persons; the proposed definition was withdrawn from the final rules adopted).

• the offer is open only for a limited period of time;
• the shareholders are subjected to pressure to sell their shares; and
• public announcement(s) of a purchasing program precede or accompany rapid accumulation of large amounts of the target company’s securities.

APPLICATION OF SECTION 14(D) AND (E) OF THE EXCHANGE ACT

Tender offers are governed principally by Section 14(d) and Section 14(e) of the Exchange Act.23 Section 14(d) of the Exchange Act and rules adopted by the Commission under that section (referred to as “Regulation 14D”)24 set forth detailed disclosure obligations, procedural requirements, and substantive provisions. Section 14(d) and Regulation 14D apply to a tender offer for a class of equity securities25 registered under Section 12 of the Exchange Act, as a result of which the bidder would, after completion of the offer, be the direct or indirect beneficial owner of more than 5 percent of such class of equity securities.26 We refer to equity securities registered under Section 12 of the Exchange Act in this article as “Registered Securities.”27

Section 14(e) of the Exchange Act and rules adopted by the Commission under that section (referred to as “Regulation 14E”)28 contain certain anti-fraud and anti-manipulation rules, as well as procedural rules governing tender offers. Section 14(e) and Regulation 14E apply to a tender offer for any security,29 whether equity or debt and whether issued by a U.S. company or a foreign company, made directly or indirectly.

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24. Exchange Act Section 14(d) and Regulation 14D are discussed in detail below. See infra section 1.3.
25. The term “equity security” is defined in Rule 3a11-1, 17 C.F.R. § 240.3a11-1 (2015), under the Exchange Act.
27. See Exchange Act § 12, 15 U.S.C. § 78l (2012). Registered Securities include: (i) securities listed on U.S. securities exchanges, such as the NYSE or NASDAQ; (ii) equity securities not listed on a U.S. securities exchange, but which are “widely held” by U.S.-resident investors and are not exempt under Rule 12g3-2(a) of the Exchange Act, 17 C.F.R. § 240.12g3-2(a), (b) (2015); (iii) equity securities of certain insurance companies exempt from Exchange Act registration; and (iv) equity securities issued by closed-end investment companies registered under the U.S. Investment Company Act of 1940, ch. 686, tit. I, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (2012)) [hereinafter Investment Company Act]. The registration status of a company’s securities can be determined by consulting company filings available on public databases (including reviewing company filings on the Commission’s Electronic Data Gathering, Analysis and Retrieval (“EDGAR”) database) or by inquiring of the Commission.
28. Exchange Act Section 14(e) and Regulation 14E are discussed in detail below. See infra section 1.2.
Tender offers may be stand-alone efforts by a bidder to acquire a certain amount or percentage of a target’s securities, may be triggered by local mandatory offer provisions, or may be an initial step in a merger, acquisition, or other combination of businesses or assets.

**Registration Requirements of the Securities Act**

Section 5 of the Securities Act provides that no security (whether outstanding or newly issued and whether issued by the bidder or another person) may be offered or sold using U.S. jurisdictional means, unless a registration statement relating to the offer has been filed with the Commission, absent an available exemption or exclusion. An exclusion and a number of exemptions may be available for the offer of exchange securities in the context of a tender offer or other business combination transaction, including (i) an exclusion for offshore transactions, including offers and sales made outside of the United States pursuant to Regulation S under the Securities Act ("Regulation S"), (ii) exemptions for offers and sales not involving any public offering of securities, (iii) an exemption for certain cross-border exchange offers and business combination transactions that fall within the exemption provided by Rule 802 under the Securities Act, and (iv) an exemption for securities issued in certain exchange transactions where, among other things, a court or authorized governmental entity approves the fairness of the terms and conditions of the exchange. Registration of securities under the Securities Act may be a lengthy and disclosure-intensive process and in many cases may not be practicable for a bidder that has not previously registered securities with the Commission under the Securities Act or is not currently a reporting company. The registration and other requirements of the Securities Act applicable in the context of business combinations are discussed in more detail in section 2.4 below.

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30. See, e.g., City Code, supra note 7, r. 9 (among other things, compelling a person to make a mandatory offer when it acquires an interest in shares, which, together with shares in which it is already interested, carry 30 percent or more of the voting rights of a target company).


34. Security Act Rule 802, 17 C.F.R. § 230.802 (2015); see infra section 2.1.


36. Registration may be impractical due to timing considerations and for other reasons, including the burden of preparing financial statements under U.S. generally accepted accounting principles ("U.S. GAAP"), international financial reporting standards maintained by the International Accounting Standards Board ("IASB IFRS"), or U.S. GAAP-reconciled financial statements, as well as the significant ongoing regulatory and disclosure burdens to which a registrant would be subject.
In light of the foregoing, many non-U.S. companies seeking to acquire other offshore companies with limited numbers of U.S. security holders (or where the participation of U.S. security holders is not otherwise critical to the success of the transaction) historically have sought to avoid the application of U.S. securities laws by excluding U.S. persons from their tender offers and avoiding U.S. jurisdictional means. These so-called “exclusionary offers” conducted to exclude U.S. jurisdictional means or otherwise avoid application of U.S. laws and regulations are described in more detail in section 4 below.

1.1 THE CROSS-BORDER TENDER OFFER RULES

Due at least partially to concerns that U.S. investors were routinely being excluded from cross-border tender offers and other business combination transactions, the Commission adopted regulations under the Exchange Act and the Securities Act in October 1999 to address conflicts between U.S. and foreign regulation, to provide relief from certain disclosure and procedural requirements of the Exchange Act and the Securities Act, and to facilitate inclusion of U.S. investors in such transactions. These regulations codified prior informal Commission guidance, no-action or exemptive relief, and Commission interpretive positions, and also included new substantive accommodations. The Commission sought to encourage bidders to include U.S. security holders in their transactions while also extending the protections of U.S. federal securities laws to all investors. The 1999 cross-border regulations attempted to balance competing concerns by focusing relief where U.S. ownership was smallest or where there was a direct conflict between U.S. and foreign regulations. The 1999 cross-border regulations provided many helpful accommodations to participants in cross-border tender offers, but in some cases the rules proved difficult or impractical to apply.

In September 2008, the Commission adopted revised regulations and interpretive guidance under the Exchange Act and the Securities Act to (i) address recurring issues that arose with the adoption of the 1999 cross-border regulations or continued to exist after such adoption, (ii) expand and enhance the utility of the exemptions available for cross-border business combination transactions with regard to certain disclosure and procedural requirements, and (iii) limit further the circumstances in which bidders decide to exclude U.S. investors from participating in cross-border business combination transactions.

The cross-border amendments provide for two tiers of relief from applicable provisions of the Exchange Act and the Securities Act, based broadly on the


38. See 1999 Cross-border Release, supra note 3, at 61384–85 (Part II.A.1); see also supra note 3.

level of U.S. interest in a transaction. The “Tier I” exemption provides relief from substantially all U.S. tender offer regulation if U.S. security holders of a “foreign private issuer” target hold no more than 10 percent of the target’s securities (calculated in the manner prescribed by the Commission and described below in section 1.1.1). The “Tier II” exemption provides limited relief from Regulations 14D and 14E where U.S. security holders of a foreign private issuer target hold more than 10 percent but no more than 40 percent of the target’s securities. In the Securities Act context, Rule 802 provides exemptions from the registration provisions of the Securities Act if criteria substantially similar to the Tier I criteria are met. None of the cross-border regulations exempts a bidder from the general anti-fraud, anti-manipulation, or civil liability provisions of U.S. securities laws.

In this article, we refer to U.S. security holders determined in accordance with instructions to paragraphs (c) and (d) of Rule 14d-1 as “U.S. holders.” The Commission has expressed its view that U.S. beneficial ownership of the target’s securities is “most closely tied to U.S. interest” in the target company’s securities and, consequently, the best measure of the extent to which U.S. rules should apply to the transaction.

1.1.1 Determination of U.S. Ownership

Look-through Analysis

To determine the percentage of U.S. holders, a bidder must “look through” the record ownership of certain brokers, dealers, and banks (or nominees for any of them) holding securities of the target company for the accounts of their customers and determine the residency of those customer accounts. Specifically, the obligation to look through record holdings applies to securities held of record by brokers, dealers, banks, and nominees located: (i) in the United States, (ii) in the target’s country of incorporation (or that of each participant in a business combination transaction not involving a tender offer), and (iii) in the country that is

40. A “foreign private issuer” is any corporation or other organization incorporated or organized under the laws of a country other than the United States, other than a corporation or other organization more than 50 percent of the outstanding voting securities of which are held of record directly or indirectly by residents of the United States, for which any of the following is also true: (i) the majority of its executive officers or directors are United States citizens or residents, (ii) more than 50 percent of its assets are located in the United States, or (iii) its business is administered principally in the United States. See Securities Act Rule 405, 17 C.F.R. § 230.405 (2015); Exchange Act Rule 3b-4, 17 C.F.R. § 240.3b-4 (2015). The Staff has granted relief under Regulation 14E where the target was incorporated outside of the United States, but did not qualify as a foreign private issuer under Rule 3b-4(c). See Tender Offer for Shares of Chemoil Energy Limited, SEC No-Action Letter, 2009 WL 4811441 (Dec. 14, 2009); Offer by SAP for Any and All Ordinary Shares, including Ordinary Shares Represented by ADSs, Warrants and Convertible Bonds, of Business Objects, SEC No-Action Letter, 2007 WL 4603213 (Dec. 5, 2007) [hereinafter SAP letter]; Offer for Shares of ProSiebenSat.1 Media AG by Laven Holding 4 GmbH, SEC No-Action Letter, 2007 WL 491128 (Jan. 30, 2007); Axel Springer AG Offer for ProSiebenSat.1 Media AG, SEC No-Action Letter, 2005 WL 2291629 (Sept. 12, 2005).


43. See supra note 34.

44. See infra section 1.2.5.

the primary trading market for the target’s securities (if different from its home jurisdiction). The inquiry need extend only to confirming the aggregate amount of a nominee’s holdings that correspond to U.S. accounts. The obligation to look through requires that “reasonable inquiry” be made of nominees to determine the residency of the underlying account holder.

The bidder’s inquiry must include a review of any beneficial ownership reports filed with respect to the target in the United States (in particular, Schedules 13D and 13G and Form 13F) and filed or available in the target’s home jurisdiction. The bidder also should review security ownership information contained in other materials publicly filed by the target, including, for instance, the target’s annual report on Form 20-F if the target is a reporting company. If the tender offer is conducted pursuant to an agreement between the target and the bidder (i.e., a “friendly” offer), the bidder should send or request that the target send inquiry letters to brokers, dealers, banks, and other nominee holders inquiring as to the aggregate amount of their holdings that correspond to U.S. accounts.

If, after reasonable inquiry, the bidder is unable to obtain information about a nominee’s customer accounts, or a nominee’s charges for supplying the information are “unreasonable,” a bidder may assume that beneficial owners are resident where the nominee has its principal place of business.

In the case of a non-negotiated, or “hostile,” transaction, where the bidder is not an affiliate of the target and is not conducting the tender offer pursuant to an agreement between the target and the bidder, the bidder may presume that U.S. holders do not hold in excess of 10 percent or 40 percent (as the case may be) of the target’s securities unless the results of the inquiries summarized above indicate otherwise. In a hostile business combination transaction, a bidder may be

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47. See Exchange Act Rule 14d-1(d), 17 C.F.R. § 240.14d-1(d) (instructions to paragraphs (c) and (d)). A bidder may consider speaking to the Staff for guidance as to what constitutes a “reasonable inquiry” for purposes of Rule 14d-1, particularly in situations where third-party brokers, dealers, and banks are unaccustomed to inquiries made as to their clients’ holdings or are prohibited from responding to such inquiries by local law or contractual restrictions.
50. See Exchange Act Rule 14d-1, 17 C.F.R. § 240.14d-1 (instruction 2(v) to paragraphs (c) and (d)). Such reports would be available on EDGAR. For Canadian issuers, information on U.S. ownership reported on Form 40-F would be relevant. See Form 40-F, 17 C.F.R. § 249.240f (2015).
51. See 1999 Cross-border Release, supra note 3, at 61392–93 (Part II.F.1). However, in the 2008 Cross-border Release, the Commission stated that “the need to dedicate time and resources to the look-through analysis alone will not support a finding that a bidder is unable to conduct the analysis.” 73 Fed. Reg. at 60057 (Part II.A.1.c).
52. See Exchange Act Rule 14d-1, 17 C.F.R. § 240.14d-1 (instruction 2(iv) to paragraphs (c) and (d)). An “affiliate” of, or a person “affiliated” with, a specified person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. See Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (2015).
able to rely alternatively on the average daily trading volume ("ADTV") test discussed below to assess U.S. ownership.

When to Calculate U.S. Ownership

The Tier I and Tier II exemptions incorporate a ninety-day window to calculate U.S. ownership to determine the availability of the exemptions. A bidder must calculate U.S. ownership as of a date no more than sixty days before and no more than thirty days after the "public announcement"54 of its offer.55 If calculation of U.S. ownership within the ninety-day window is not possible, it may be made as of the most recent practicable date before the public announcement, but no earlier than 120 days before the announcement.

American Depositary Shares; Convertible or Exchangeable Securities; Securities Held by Bidder

In many cases, securities of a foreign private issuer are represented in the United States by American Depositary Shares ("ADSs"). Each ADS represents a specific number of shares of the issuer, which are held by a depository on behalf of the ADS holders.56 To assess U.S. ownership in relation to ADSs, bidders are required to examine the participant lists of depositaries for the target's ADR program and must make inquiries of brokers, dealers, and other nominees appearing on those lists to determine the number of ADSs held by U.S. holders. Shares underlying ADSs must be counted in determining both the aggregate number of securities outstanding and the number of U.S. holders.57

A bidder is not required to take into account securities other than ADSs that are convertible into, or exchangeable for, the securities to which the tender offer relates, such as warrants, options, and convertible securities, unless such securities are also the subject of the tender offer.58

54. The Commission considers a public announcement to be "any oral or written communication by the bidder or any party acting on its behalf, which is reasonably designed to inform or has the effect of informing the public or security holders in general about the transaction." See Exchange Act Rule 14d-2, 17 C.F.R. § 240.14d-2 (2015) (instructions to paragraph (b)(2)); 2008 Cross-border Release, supra note 3, at 60055–56; see also supra note 3.
55. See Exchange Act Rule 14d-1, 17 C.F.R. § 240.14d-1 (instruction 2(i) to paragraphs (c) and (d)). By allowing a range of dates within a ninety-day window to be used by a bidder to assess U.S. ownership, the Commission addressed a conflict, expressed in a number of no-action letters preceding the 2008 Cross-border Release, such as Equant N.V., SEC No-Action Letter, 2005 WL 1173099 (Apr. 18, 2005), and Saipem SpA, SEC No-Action Letter, 2002 WL 1841561 (July 29, 2002) [hereinafter Saipem letter], between U.S. regulation, which required U.S. ownership to be assessed on the thirtieth day prior to commencement of the offer, and local practice, which did not permit completion, or completion on a confidential basis, of a look-through analysis as of a specific date or in a period as short as thirty days.
56. In common usage, an ADS refers to the security that represents the ownership interest in the underlying, deposited security and an American Depositary Receipt ("ADR") refers to the physical certificate that evidences an ADS.
57. See Exchange Act Rule 14d-1, 17 C.F.R. § 240.14d-1 (instruction 2(ii) to paragraphs (c) and (d)).
58. Id.
It is important to note that target securities held by the bidder are excluded from the calculation of U.S. holders.59

**Average Daily Trading Volume Test**

There are two circumstances in which a bidder may rely on an alternate ADTV test to assess U.S. ownership: (i) when the bidder is unable to conduct the look-through analysis and there is a “primary trading market”60 for the subject securities outside of the United States and (ii) when the bidder is not an affiliate of the target and is not conducting the tender offer pursuant to an agreement between the target and the bidder (the so-called “hostile presumption”).61 In these circumstances, a bidder may rely on the ADTV test to presume that the percentage of subject securities held by U.S. holders is no more than 10 percent or 40 percent (as the case may be) of outstanding subject securities unless any of the following applies:

- the ADTV of the target’s securities in the United States in a recent twelve-month period ending no more than sixty days before the public announcement of the transaction exceeds 10 percent or 40 percent (as the case may be) of the worldwide ADTV of the subject securities;
- the most recent annual report or annual information filed or submitted by the target “with securities regulators in its home jurisdiction or with the Commission or any jurisdiction in which the target’s securities trade” before the public announcement of the transaction indicate that U.S. holders hold more than 10 percent or 40 percent (as the case may be) of all outstanding subject securities; or
- the bidder knows or has reason to know before public announcement of the transaction62 that the level of U.S. ownership exceeds 10 percent or

59. *Id.*

60. “Primary trading market” means at least 55 percent of the trading in a foreign private issuer’s securities takes place in, on, or through the facilities of a securities market or markets in a single foreign jurisdiction or in no more than two foreign jurisdictions during a recent twelve-month period and if a foreign private issuer aggregates the trading of its securities in two foreign jurisdictions, the trading for the issuer’s securities in at least one of the two foreign jurisdictions must be larger than the trading in the United States for the securities. See Exchange Act Rule 12g3-2, 17 C.F.R. § 240.12g3-2 (2015) (note 1 to paragraph (b)(1)).

61. See Exchange Act Rule 14d-1, 17 C.F.R. § 240.14d-1 (instruction 3 to paragraphs (c) and (d)).

62. See *id.* (instruction 3(iii) to paragraphs (c) and (d) for a non-exclusive list). While the Commission notes in the 2008 Cross-border Release that it “do[es] not intend this language to mean that an issuer or acquiror must take into account information publicly available from any source, no matter how obscure or costly,” 2008 Cross-border Release, supra note 3, at 60059, the provision acts to attribute to a bidder specific sources of knowledge and consequently places a substantial onus on a bidder to consider relevant publicly available data and, in friendly transactions, information in the possession of the target. It is doubtful in the authors’ view that the Commission intended to retain Instruction 3(iv), which was adopted pursuant to the 1999 cross-border regulations, but differs from Instruction 3(iii) adopted pursuant to the 2008 cross-border regulations, insofar as it does not limit the time at which the bidder’s knowledge is relevant. There is, for example, no analogous instruction in relation to Rule 802, 17 C.F.R. § 230.800(h) (2015), and the opinion of most practi-
40 percent (as the case may be) of all outstanding subject securities. The bidder will be deemed to know information about U.S. ownership available from the target or obtained or readily available from any other source that is reasonably reliable, including from persons it has retained to advise it about the transaction, as well as from third-party information providers.

Outside of the context of a hostile transaction, the Commission provided a non-exhaustive list of circumstances in which a target may be justified in relying on the ADTV test. These circumstances include the following: (i) security holder lists are generated only at fixed intervals during the year and a security holder list is not available at the time it would be required to conduct a look-through analysis, (ii) when the subject securities are in bearer form, and (iii) where nominees may be prohibited by law from disclosing information about the beneficial owners on whose behalf they hold. The Commission warns, however, that the need to dedicate time and resources to the look-through analysis alone will not support a finding that a bidder is unable to conduct the analysis, nor would concerns about the completeness and accuracy of the information obtained.63

Practical Difficulties

Although the 2008 cross-border regulations were intended to make the ownership calculation process easier, quantifying the number of U.S. holders remains problematic for a number of reasons. First, companies in many jurisdictions outside the United States are not required to maintain a share register of the record holders of their securities. Although there may be statutory procedures available to companies to obtain information from their shareholders as to their holdings in the context of a non-hostile transaction (for instance, section 793 under the United Kingdom Companies Act 200664) or from the clearing systems through which the target’s securities are settled, such procedures may not result in an accurate assessment of beneficial ownership as of a specified or even any single date.65 Second, non-U.S. companies in most cases will need to rely on

63. See supra note 51.
64. Companies Act 2006, c. 46 (Eng.). Section 793 of the Companies Act permits a company by written notice to require a person to confirm if that person has in the three years preceding the date of notice had an interest in the shares of the company and to provide certain other information as to that person’s interest. This right allows the target to identify the beneficial owners underlying the nominees registered in the CREST system (which acts as the United Kingdom’s central securities depository). The target effectively sends a cascading set of notices, tracing ownership from the registered position of an intermediary down to the ultimate beneficial owner. Each party in the ownership chain is required to provide the identity of the person on whose behalf it holds its interest in the shares. However, this process presents a number of challenges: it is manual, with requests being sent in writing or by email, there is no standard template for response, response times can vary widely, and it is extremely difficult to obtain compliant responses where ultimate beneficial ownership extends outside the United Kingdom.
65. For instance, in France, a report known as a Titre au Porteur Identifiable (a “TPI Report”) can be requested by the target from Euroclear (which acts as France’s central securities depository). The TPI
the cooperation of brokers, dealers, or other nominees for information as to the residency of their customers and, in many cases, such cooperation may not be forthcoming. In Germany and Spain, for example, such intermediaries are not subject to a legal duty to disclose information regarding the underlying owners. Even if the information is provided voluntarily, it may be unreliable. European bank secrecy and privacy laws also may restrict the ability of nominees to cooperate with such requests. In situations where a determination of U.S. ownership cannot be made or there is uncertainty as to the percentage of U.S. holders, in certain circumstances, the Staff may nevertheless be willing to provide no action or exemptive relief.

1.1.2 The Tier I Exemption

The Tier I exemption provides exemptive relief from the provisions of Section 14(d)(1) through 14(d)(7) of the Exchange Act, Rules 14d-1 to 14d-11 under Regulation 14D (including Schedule 14D-9 and Schedule TO), and Rules 14e-1 and 14e-2 under Regulation 14E. Bidders for targets that fall within the Tier I exemption may also be eligible for relief under Rules 14e-5 and 13e-3 under the Exchange Act.

Availability

The Tier I exemption is available if (i) the target is a foreign private issuer, (ii) the target is not an investment company registered or required to be registered under the Investment Company Act, other than a closed-end investment company, and (iii) U.S. holders hold 10 percent or less (calculated in the manner prescribed by the Commission) of the target’s securities for which the tender Report sets forth, among other information, the names of persons that hold, either for themselves or as nominees, securities of a company through Euroclear. Upon receiving the TPI Report, the target (but not the bidder) may request that a nominee identified in the TPI Report that holds shares on behalf of clients disclose the identity of the beneficial owners. However, information set forth in the TPI Report is confidential and disclosure to the bidder could result in criminal sanctions.

66. For instance, nominees holding through Euroclear or Clearstream (the two principal EU central securities depositaries) may be unable or unwilling to provide information as to their beneficial owner customers as of a specified date.
67. In the authors’ experience, many third-party financial analysts engaged by bidders to assist with the look-through analysis are unfamiliar with the requirements of the 2008 cross-border regulations described in this article and the materials that they produce vary widely in scope.
70. See id. §§ 240.13e-4(h)(8), 240.14e-5(b)(10).
71. See id. §§ 240.13e-4(h)(8), 240.14e-5(b)(10).
offer is being made, whether or not the target’s securities are Registered Securities.73

If the Tier I exemption is available, a bidder is generally able, subject to certain procedural requirements described below, to extend its offer to shareholders in the United States solely in compliance with substantive procedures and requirements of its home jurisdiction. The bidder will not be subject to any of the specified disclosure, dissemination, and Commission filing, minimum offer period, or mandatory withdrawal rights obligations that are designed to ensure that security holders are provided with adequate disclosure and sufficient time to consider whether to participate in a tender offer. If an exchange offer is contemplated, an offer satisfying the Tier I exemption will generally also be exempt from the registration requirements of the Securities Act pursuant to Rule 802.74 The target company’s board may distribute to its security holders its recommendation relating to the bidder’s offer without complying with the disclosure requirements of Regulation 14E75 and, in relation to Registered Securities, without filing its recommendation with the Commission on, or making the specific disclosures mandated by, Schedule 14D-9.76

Subsequent Bidder

To provide a level playing field for competing offers, if an initial bidder relies on the Tier I exemption to make its offer, a subsequent, competing bidder will not be subject to the 10 percent ownership limitation condition of the Tier I exemption if its offer is made while the initial bidder’s offer is pending.77 As a result, the subsequent bidder will not be disadvantaged by any movement of securities into the United States following the announcement of the initial bidder’s offer.

Conditions—Equal Treatment; Exceptions

Shareholders in the United States must be permitted to participate in the tender offer on terms at least as favorable as those offered to other shareholders, subject to certain exceptions78:

• Blue sky exemptions. In connection with an exchange offer conducted pursuant to Rule 802, a bidder need not extend its offer to shareholders in

73. Exchange Act Rule 14d-1(c), 17 C.F.R. § 240.14d-1(c).
74. See supra note 34.
75. See Exchange Act Rule 14e-2(d), 17 C.F.R. § 240.14e-2(d) (2015). Exchange Act Rule 14e-2 would otherwise require management to distribute to its security holders its recommendation relating to the bidder’s offer no later than ten U.S. business days from the date the offer was first published, sent, or given to target security holders.
76. See Exchange Act Rule 14d-9, 17 C.F.R. § 240.14d-9 (2015). Schedule 14D-9 requires disclosure relating to, inter alia, the relationship between the bidder and the target company, the bidder’s interest in the securities of the target company, the target’s position with respect to the offer, and the purposes of the transaction. 17 C.F.R. § 240.14d-101 (2015).
states of the United States that require registration or qualification, so long as any cash alternative offered in any other jurisdiction is offered to holders in such state. Similarly, if a bidder offers securities registered under the Securities Act in circumstances where Section 18 of that Act does not preempt state blue sky laws, the bidder need not extend its offer to holders in states that prohibit the offer or sale of securities after the bidder has made a good-faith effort to register or qualify the offer and sale of the exchange securities in that state.

- **Cash-only alternative.** A bidder may offer U.S. security holders only cash consideration if it has a reasonable basis for believing that the amount of cash offered is substantially equivalent to the value of the shares or other consideration offered to non-U.S. holders, subject to certain conditions.

- **Loan note exception.** In the United Kingdom, it is customary for a bidder to offer a loan note alternative in an offer where at least a portion of the offer consideration consists of cash. A loan note is effectively a short-term debt instrument that may be redeemed in whole or in part for cash at par on a future date and affords certain tax benefits to holders subject to United Kingdom taxation. The Tier I exemption permits the issuance of a loan note alternative exclusively to non-U.S. security holders so long as the loan notes are not listed on an exchange, are not registered under the Securities Act, and are offered solely to allow target shareholders tax advantages not available in the United States.

**Conditions—Offering Materials**

Offering materials, in English, must be provided to shareholders in the United States on a basis comparable to that provided to shareholders in the home jurisdiction. Offering materials typically contain certain customary or mandated legends advising U.S. security holders as to the basis of their preparation. If

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80. See Exchange Act Rule 14d-1(c)(2)(i), 17 C.F.R. § 240.14d-1(c)(2)(i). Although U.S. federal law preempts state blue sky laws in respect of exchange securities that are listed on the NYSE and NASDAQ for example, exchange securities registered under the Securities Act, but which are not so listed, are generally subject to state blue sky laws.
81. See Exchange Act Rule 14d-1(c)(2)(iii), 17 C.F.R. § 240.14d-1(c)(2)(iii). The cash-only alternative is available if the offered security is a “margin security” or if, on request from the Commission or a U.S. holder, an opinion is provided to the effect that the cash alternative is substantially equivalent to the value of the securities offered outside the United States. In any case, as a practical matter, the opinion of an independent expert may be required to support the bidder’s determination of substantial equivalence.
82. See 1999 Cross-border Release, supra note 3, at 61386 (acknowledging the common use of loan notes in the United Kingdom); see also GARY EABORN, TAKEOVERS: LAW AND PRACTICE § 11.22 (Lexis-Nexis Butterworths, 2d ed. 2014).
the Tier I exemption applies and securities offered as consideration will not be registered under the Securities Act, there is no mandated disclosure, and financial information, if any, can be presented in accordance with home jurisdiction generally accepted accounting principles without reconciliation to U.S. GAAP.85

**Conditions—Submission/Filing Requirements**

If the target’s securities are Registered Securities, then, in addition to providing English language offering materials to shareholders in the United States, a bidder must submit offering materials in English to the Commission under cover of Form CB no later than the next U.S. business day after the offering materials are published or disseminated in the home jurisdiction.86 If the bidder is a non-U.S. company, the bidder must also file with the Commission a consent to service of process in the United States on Form F-X and appoint an agent for service of process in the United States.87 There is no fee for submitting Form CB or Form F-X. Forms CB and F-X must be submitted or filed, as the case may be, on EDGAR.88 If the target’s securities are not Registered Securities, the bidder’s offer document does not need to be submitted to the Commission under Regulation 14D or 14E, although a bidder may be required to furnish its informational document, in English, to the Commission on Form CB in the context of a cross-border exchange offer conducted pursuant to Rule 802. A bidder does not incur “prospectus liability” in respect of offering materials submitted to the Commission under cover of Form CB, but may be liable under applicable anti-fraud rules.89

1.1.3 The Tier II Exemption

The Tier II exemption provides limited relief from Regulations 14D and 14E.90 Bidders for targets that fall within the Tier II exemption may also be eligible for limited relief under Rule 14e-5.91

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85. See 1999 Cross-border Release, supra note 3, at 61385 n.22; see also supra note 3.
87. Id.
88. The paper filing exception for companies that are not Exchange Act reporting companies was eliminated as part of the 2008 cross-border regulations. See Rule 101(a)(1)(vi) of Regulation S-T, 17 C.F.R. § 232. 101(a)(1)(vi) (2015).
89. See infra section 2.4.2 for a discussion of prospectus liability. The distinction between “filing” and “submitting” materials in this paragraph and elsewhere in this article relates to potential liability for the contents of such materials. Materials that are filed with the Commission are subject to the liability provisions of Section 18 of the Securities Act, which do not apply to materials that are submitted.
91. See id. §§ 240.14e-5(b)(11), (12), 240.13e-3(g)(6).
Availability

The Tier II exemption is available if (i) the target is a foreign private issuer, (ii) the target is not an investment company registered or required to be registered under the Investment Company Act, other than a closed-end investment company, and (iii) U.S. holders hold 40 percent or less of the target’s securities for which the tender offer is being made. Although a bidder remains generally subject to the U.S. tender offer rules, certain accommodations are provided to address traditional areas of conflict between non-U.S. tender offer rules and U.S. tender offer rules. These accommodations are described in sections 1.2 and 1.3 below as part of the discussion of the substantive provisions of Regulations 14D and 14E. If an exchange offer is contemplated, an offer satisfying the Tier II exemption will not be exempt from the registration requirements of the Securities Act by virtue of Rule 802.

Subsequent Bidder

Consistent with relief provided by the Tier I exemption, if an initial bidder is able to rely on the Tier II exemption to make its offer, a subsequent bidder making an offer that commences while the initial bidder’s offer is still pending will not be subject to the 40 percent ownership limitation condition of the Tier II exemption.

1.2 PROVISIONS APPLICABLE TO TENDER OFFERS FOR ALL SECURITIES

All tender offers, including offers for debt securities and equity securities that are not Registered Securities (to which Exchange Act Section 14(d) and Regulation 14D do not apply), are subject to Exchange Act Section 14(e) and Regulation 14E. These requirements are described below, along with any express relief from such requirements afforded to transactions that fall within the Tier II exemption. As discussed in section 1.1.2, the Tier I exemption relieves bidders from complying with Rule 14e-1, Rule 14e-2, and, subject to certain conditions, Rule 14e-5 of Regulation 14E and Rules 14d-1 to 14d-11 under Regulation 14D. The Tier II exemption, on the other hand, provides only limited relief from complying with Regulations 14D and 14E.
1.2.1 Minimum Offer Period; Notice

A tender offer must remain open for a minimum of twenty U.S. business days\(^96\) from the time the tender offer commences.\(^97\) There is, however, no specified time by which a tender offer must be completed. The primary reason for the minimum offer period is to provide investors with sufficient time to make a well-informed investment decision.\(^98\)

The Staff has granted relief from the requirements of Rule 14e-1(a) when there is a conflict between mandatory local law requirements and the requirements of that Rule, or when the Staff has found that international policy considerations apply, both in the context of transactions that met the requirements of the Tier II exemption and transactions that were unable to meet those requirements due to the extent of U.S. ownership of the target's securities. In those circumstances, the bidder has assured the Staff that protections afforded by Rule 14e-1(a) will otherwise be provided to target shareholders.\(^99\)

A tender offer must remain open for at least ten U.S. business days after notice of a change is published, sent, or given in relation to any of the following: (i) the consideration offered, (ii) the percentage of the securities being sought, or (iii) the dealer's soliciting fee.\(^100\) In addition, a Commission interpretive release states that a tender offer should remain open for at least ten U.S. business days in respect of a material change as significant as a change to the consideration offered or the percentage of the securities being sought and for at least five U.S. business days in respect of any other material change.\(^101\)

The Staff has provided relief under Rule 14e-1(b) in the context of transactions where local law required an upward adjustment to consideration paid on tendered securities, reflecting interest payable on such securities accruing to the time of tender (and thus increasing continually during the pendency of the offer). The Staff has specifically granted such relief in the context of a subsequent offering period for transactions that were unable to meet the require-

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96. The term “U.S. business day” means any day other than Saturday, Sunday, or a U.S. federal holiday and consists of the time period from 12:01 a.m. through 12:00 noon Eastern (New York City) Standard Time. See Exchange Act Rule 14d-1(g)(3), 17 C.F.R. § 240.14d-1(g)(3) (2015).


101. See Interpretive Release Relating to Tender Offers Rules, SEC Release No. 34-4296, 1987 WL 847536 (Apr. 3, 1987); see also Exchange Act Rule 14d-4(d)(2), 17 C.F.R. § 240.14e-4(d)(2) (2015) (establishing minimum time periods during which an exchange offer must remain open after notice of a material change in its terms is communicated to target holders). Although by its terms Rule 14d-4(d)(2) applies only to early commencement exchange offers, the Staff has stated that it views the time periods set forth in Rule 14d-4(d)(2) as generally applicable to all tender offers. See 2008 Cross-border Release, supra note 3, at 60068 nn.245 & 251; see also supra note 3.
ments of the Tier II exemption. Where the Tier II exemption is available, Rule 14d-1(d)(2)(vi) provides that the payment of interest in a subsequent offering period will not breach the provisions of Rule 14d-11(f) and Rule 14d-10(a)(2) and, by implication, Rule 14e-1(b).

Under Rule 14e-1(d), a bidder must provide notice of any extension by a press release or other public announcement before the earlier of (i) 9:00 a.m. Eastern Standard Time on the next U.S. business day after the scheduled expiration of the offer and (ii) the opening of trading on the next business day after the scheduled expiration of the offer. The notice must include disclosure of the approximate number of securities tendered to date. The Tier II exemption permits a bidder to provide notice of extensions in accordance with the requirements of local law or market practice. In addition, the Staff has granted relief from the requirements of Rule 14e-1(d) in the context of transactions that were unable to meet the requirements of the Tier II exemption where due to local practice or logistical requirements related to the conduct of a cross-border tender offer (for instance, relating to the tender of ADSs and withdrawal of underlying shares), the bidder was unable to disclose the number of securities that had been tendered when it announced the end of the initial offering period.

1.2.2 Early Termination of an Initial Offering Period

The Commission takes the position that once the time at which a tender offer will expire has been announced, whether at the outset of the offer or subsequently, any change to the time of expiration constitutes a material change to the offer, requiring a public announcement and a formal extension of the offer. The Commission has justified its position on the basis that an extension would permit security holders that have already tendered into the offer time to react to the change by withdrawing their tendered securities in response to the change, and those that have not tendered time to choose to tender in response to the change.

These announcement and mandatory extension requirements have historically conflicted with law and practice in a number of non-U.S. jurisdictions, such as


the United Kingdom, Hong Kong, Singapore, and South Africa, where bidders typically are required to terminate an offer immediately upon all offer conditions being satisfied. In other jurisdictions, bidders may be required to accept and pay for tendered securities as soon as all offer conditions are satisfied, even if this occurs before the scheduled expiration date of the initial offering period. The 2008 cross-border regulations codify exemptive relief that the Staff had historically granted on a case-by-case basis.108 Accordingly, the Tier II exemption permits a bidder to terminate an initial offering period, including a voluntary extension of that period, if at the time the initial offering period ends:

- the initial offering period has been open for at least twenty U.S. business days and all offer conditions have been satisfied;
- the bidder has adequately disclosed the possibility and the impact of the early termination in the original offer materials;
- the bidder provides a subsequent offering period after the termination of the initial offering period;
- all offer conditions are satisfied as of the time when the initial offering period ends; and
- the bidder does not terminate the initial offering period or any extension of that period during any mandatory extension required under U.S. tender offer rules.109

1.2.3 Prompt Payment of Consideration

Consideration must be paid or securities returned promptly after termination or withdrawal of an offer.110 “Promptly” in this context is generally construed to mean within three U.S. business days.111


111. See also 1999 Cross-border Proposing Release, supra note 72, at 69144 (“prompt payment standard is satisfied if payment is made in accordance with normal [U.S.] settlement periods”).
The Tier II exemption permits a bidder to comply instead with the legal or market practice settlement requirements of the target’s home jurisdiction, which may be materially in excess of three U.S. business days. In addition, the Staff has granted relief from the requirements of Rule 14e-1(c) in the context of transactions that were unable to meet the requirements of the Tier II exemption where, due to local practice or requirements unique to the conduct of a cross-border tender offer, such as government currency exchange approvals, consideration is paid less promptly than in three U.S. business days. For instance, in the United Kingdom, payment must be made within fourteen calendar days after the later of the date on which the offer has become or is declared wholly unconditional or receipt of a valid tender. If an offer is terminated or withdrawn, a bidder is required to return tendered securities within fourteen calendar days and payment for securities tendered in any subsequent offering period is made on a rolling basis, within fourteen calendar days of a valid tender. Generally, payment for tendered securities is effected in the United Kingdom in seven to ten calendar days. The Staff has also granted relief from the requirements of Rule 14e-1(c) to permit consideration to be paid, or tendered securities returned, in accordance with local law in the context of transactions that were unable to meet the requirements of the Tier II exemption.

1.2.4 Response of the Target Company

Within ten U.S. business days after commencement, the target must publish or give its security holders a statement that it (i) recommends acceptance or rejection of the bidder’s offer, (ii) expresses no opinion and is remaining neutral toward the bidder’s offer, or (iii) is unable to take a position with respect to the bidder’s offer, including the reasons for the position disclosed. There is no mandated form of disclosure if the target is not a reporting company and the statement is neither submitted to, nor filed with, the Commission. For an offer for Registered Securities, refer to the discussion regarding Schedule 14D-9 in section 1.3.2 below.

1.2.5 General Anti-Fraud Provisions

The general anti-fraud provisions of the Exchange Act, including Section 14(e), Section 10(b), and Rule 10b-5 under Section 10(b), prohibit, in connection with any tender offer, the bidder or its agents from making any untrue statement

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1.2.6 Purchases Outside of the Offer

**Rule 14e-5**

Rule 14e-5 under the Exchange Act generally prohibits purchases or arrangements to purchase securities of the subject class outside of a tender offer. The rule aims to protect investors by preventing a bidder “from extending greater or different consideration to some security holders by offering to purchase their shares outside the offer, while other security holders are limited to the offer’s terms.” In the Commission’s view, “the rule prohibits the disparate treatment of security holders, prohibits the avoidance of proration requirements, and guards against the dangers posed by a bidder’s purchases outside an offer that may involve fraud, deception and manipulation.”

This prohibition applies from the time the tender offer is publicly announced until it expires. Subject to ensuring that activities conducted prior to announcement do not themselves constitute a tender offer, no restrictions under Rule 14e-5 then apply. Rule 14e-5 applies generally to the bidder and its affiliates, the bidder’s advisers (as long as the advisers’ compensation is dependent upon completion of the offer), the bidder’s dealer-manager and its affiliates, and any person acting in concert with any of the foregoing (collectively, “covered persons”). The Commission has consistently taken the view in discussions with practitioners that if a tender offer is made in the United States, Rule 14e-5 applies to all purchases, whether inside or outside of the United States, subject to the exceptions noted below.

In many cases, however, the restrictions under Rule 14e-5 conflict with market practice in jurisdictions outside of the United States, where purchases out-

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120. Id.
122. See Wellman v. Dickinson, 475 F. Supp. 783, 823–25 (S.D.N.Y. 1979), aff’d, 682 F.2d 355 (2d Cir. 1982). Rule 14e-5(b)(7) permits purchases or arrangements to purchase outside of a tender offer pursuant to an unconditional and binding contract entered into before public announcement of the tender offer.
side the offer (both open market purchases and privately negotiated purchases) may be permitted and are customary, particularly in jurisdictions were market practice, mandated disclosures related to certain mandatory offer requirements, and other factors may mean that a significant amount of time passes from announcement to commencement of a tender offer.123

**Blanket Tier I exemption.** The Tier I exemption provides blanket relief under Rule 14e-5 for purchases outside of a tender offer during the pendency of the offer, including in the United States, as long as each of the following conditions is satisfied: (i) offering materials provided to U.S. holders must disclose prominently the possibility of such purchases or arrangements to purchase, or the intent to make such purchases, (ii) offering materials must explain how information about any such purchases will be disclosed, (iii) the bidder must disclose in the United States information as to any such purchases or arrangements in a manner comparable to information provided by the bidder in the target’s home jurisdiction, and (iv) all such purchases must comply with applicable laws and regulations in the target’s home jurisdiction.124

**Relief for market making activities under the City Code.** Rule 14e-5 expressly permits purchases or arrangements to purchase by “connected exempt market makers” and “connected exempt principal traders” in an offer subject to the City Code if (i) the target is a foreign private issuer, (ii) the connected exempt market maker or the connected exempt principal trader complies with the applicable provisions of the City Code, and (iii) tender offer documents disclose the identity of the connected exempt market maker or the connected exempt principal trader and disclose, or describe how U.S. security holders can obtain information regarding, market making or principal purchases by such market maker or principal trader to the extent that this information is required to be made public in the United Kingdom. This exemption effectively permits a bidder’s dealer-managers and advisers to continue to conduct customary market-making activities in respect of the target’s securities. Subject to satisfying the conditions, such purchases may be made in any tender offer, not just tender offers eligible for Tier I or Tier II relief.125

**Relief for separate offers in Tier II offer.** A Tier II tender offer is often structured as two concurrent, but separate offers in order to facilitate a bidder’s compliance with conflicting regulatory requirements and market practice. One offer is made to the target’s U.S. security holders, and another is made to target security holders outside the United States.126 Technically, purchases made pursuant to a for-

123. In the United Kingdom, where Rule 30.1 of the City Code, supra note 7, provides that an offer document must be posted within twenty-eight days from announcement of a bidder’s firm intention to make an offer, an announcement often proceeds commencement of an offer by several weeks. In other jurisdictions, such as India, commencement of the tender offer may be subject to review and approval of documentation by the relevant securities regulator and outside the control of the bidder.


126. See infra section 1.3.6.
eign offer made during the pendency of the U.S. offer would breach Rule 14e-5. The 2008 cross-border regulations codified prior class exemptive relief\textsuperscript{127} provided by the Staff to permit purchases or arrangements to purchase in a foreign offer made concurrently or substantially concurrently with a U.S. offer where: (i) the U.S. and foreign offers meet the conditions for reliance on the Tier II exemption, (ii) the economic terms and consideration in the U.S. offer and foreign offer are the same (provided that any cash consideration to be paid to U.S. security holders may be converted from the currency to be paid in the foreign offer to U.S. dollars at an exchange rate disclosed in the U.S. offer document), (iii) the procedural terms of the U.S. offer are at least as favorable as the terms of the foreign offer, (iv) the intention of the bidder to make purchases pursuant to the foreign offer is disclosed in U.S. offering documents, and (v) purchases by the bidder not made in the U.S. offer are made solely pursuant to the foreign offer, and not pursuant to open market transactions, private transactions, or other transactions.\textsuperscript{128} The Staff has also granted exemptive relief under Rule 14e-5 permitting purchases in the context of a tender offer structured as separate U.S. and non-U.S. offers where all conditions of Rule 14e-5(b)(11) were satisfied other than the condition that the offers qualified for the Tier II exemption.\textsuperscript{129}

Relief for purchases outside the United States in Tier II offers. The 2008 cross-border regulations also codified class exemptive relief permitting purchases or arrangements to purchase outside of a tender offer by the bidder and its affiliates and by the bidder’s financial advisor, subject to certain conditions designed to promote the fair treatment of tendering security holders. Purchases outside the tender offer are permitted if: (i) the target is a foreign private issuer, (ii) the covered person reasonably expects that the offer meets the conditions for reliance on the Tier II exemption, (iii) no purchases or arrangements to purchase other than pursuant to the tender offer are made in the United States, (iv) U.S. offering materials disclose prominently the possibility of, or the intention to make, purchases or arrangements to purchase outside of the tender offer, (v) disclosure of such purchases is made in the United States to the extent that such information is made public in the home jurisdiction, and (vi) the tender offer price must be increased to equal any higher price paid outside of the tender offer.\textsuperscript{130}


If an affiliate of a financial advisor purchases or arranges to purchase outside of a tender offer, (i) the financial advisor and the affiliate must implement and enforce written policies and procedures reasonably designed to prevent the transfer of information among the financial advisor and affiliate that might result in a violation of U.S. federal securities laws, (ii) the financial advisor must have an affiliate that is registered as a broker or dealer under Section 15 of the Exchange Act, (iii) the affiliate must have no officers or employees (other than clerical, administrative, or support staff) in common with the financial advisor that direct, effect, or recommend transactions in the target securities (or related securities) who also will be involved in providing the bidder or the target with financial advisory services or dealer-manager services, and (iv) purchases or arrangements to purchase may not be made to facilitate the tender offer.131

The Staff has also granted exemptive relief under Rule 14e-5 permitting purchases or other arrangements to purchase outside of the tender offer where all conditions of Rule 14e-5(b)(12) were satisfied other than the condition that the offers qualify for the Tier II exemption.132 The Staff has also granted exemptive relief in circumstances where technical compliance with Rule 14e-5(a) may not be possible.133

Irrevocable undertakings. In the United Kingdom, there is an established practice in recommended offers whereby a bidder will seek to obtain a firm commitment to accept the offer from key target shareholders before announcing the offer. Such “irrevocable undertakings” constitute a commitment to tender into a bidder's offer at the offer price for no additional consideration.134 Such undertakings may be truly irrevocable or may be irrevocable subject only to a higher competing offer not being made.135 Bidders typically seek to enter into such ar-
rangements prior to announcement of the offer, but irrevocable undertakings can be agreed to at any time. These undertakings are typically deemed to constitute tenders into the bidder’s offer and hence are not restricted by Rule 14e-5’s prohibition on purchases outside of the bidder’s offer, but the form and method of soliciting such undertakings should be considered carefully to ensure that they fall within the scope of arrangements the Staff has approved in the past.136

Subsequent offering period. Rule 14e-5(a)137 expressly permits purchases or arrangements to purchase made outside of a tender offer during the time of any subsequent offering period if consideration paid is in the same form and amount as the consideration offered in the initial offering period.

Regulation M

In an exchange offer or other business combination transaction pursuant to which securities are offered in the United States, Regulation M under the Exchange Act may apply.138 Regulation M prohibits bidders and target companies (in negotiated transactions), distribution participants (principally underwriters, brokers, dealers, and other persons that have agreed to participate in a distribution of securities), and their affiliated purchasers, directly or indirectly, from bidding for, purchasing, or attempting to induce others to bid for or purchase any securities of the subject class139 during the period of one or five U.S. business days before the date of commencement of the offer until the offer expires or the business combination transaction is completed. Bidders, targets, and other distribution participants that are financial institutions will generally need to request relief from the Staff under Regulation M to allow them to engage in ordinary course business activities, such as market making, asset management activities, unsolicited brokerage, and stock borrowing and lending. While there are a number of exemptions to Regulation M, including in respect of “actively-traded reference securities,”140 in the context of a cross-border tender offer these exemptions are unlikely to apply. The Commission declined to propose or adopt changes to Regulation M with respect to cross-border tender offers or similar transactions,141 but the Staff has granted relief under Regulation M on a case-by-case basis.142

136. See supra note 135.
139. “Covered securities” include other securities into which the reference securities may be converted or exchanged or for which the reference securities may be exercised. See Regulation M Rule 100(b), 17 C.F.R. § 242.100(b).
140. See Regulation M Rule 102, 17 C.F.R. § 242.102.
1.3 ADDITIONAL PROVISIONS APPLICABLE TO TENDER OFFERS FOR REGISTERED SECURITIES

A tender offer by a bidder for any Registered Securities that is not exempt pursuant to the Tier I exemption must comply not only with the requirements of Exchange Act Section 14(e) and Regulation 14E, but also with Exchange Act Section 14(d) and Regulation 14D. These requirements, and any express relief from such requirements afforded to transactions that fall within the Tier II exemption, are described below.

In addition to these obligations, if the tender offer is made by a bidder or an affiliate of a bidder for Registered Securities and is not eligible for the Tier I exemption, the transaction will also be subject to Exchange Act Rule 13e-3, if the tender offer would result in the target “going private.” If the transaction is subject to Exchange Act Rule 13e-3, a bidder or its affiliate would be required to file with the Commission a Schedule 13E-3, setting forth information regarding the offer, and disclose certain information to security holders of the subject class of securities, as well as to comply with various anti-fraud provisions set forth in Rule 13e-3.

1.3.1 Announcements and Tender Offer Documents for Registered Securities

A tender offer is commenced when the bidder first publishes, sends, or gives to target security holders transmittal forms or discloses instructions as to how to tender securities into the offer. A bidder must file with the Commission a tender offer statement on Schedule TO on the date of commencement of the offer. The U.S. “offer to exchange” forms a substantial part of Schedule TO and must be disseminated to the target’s U.S. holders as soon as practicable on the date of commencement of a tender offer. Dissemination is typically effected by mailing or other delivery of the offer to exchange to the target’s share-
holders and in certain circumstances by summary publication in a U.S. newspaper with national circulation. In addition, the U.S. tender offer rules provide the bidder with the right to have its tender offer materials disseminated pursuant to the target company’s shareholder lists. Under Rule 14d-5, the target may elect either to provide the bidder with its shareholder list or to distribute the bidder’s offer to exchange to its shareholders on behalf of the bidder. In the case of an exchange offer, the offer to exchange will also constitute the bidder’s prospectus under the Securities Act. After commencement of the offer, the bidder must report promptly on Schedule TO material changes to information previously filed with the Commission, including additional tender offer materials, such as press releases, investor presentations, and similar materials relating to the tender offer.

The tender offer rules also require the filing of pre-commencement communications regarding the tender offer. A bidder must file on Schedule TO press announcements and other written communications prior to commencement of a tender offer no later than the date of first use of the communication. Each pre-commencement written communication must include a prominent legend advising security holders to read the tender offer statement when it becomes available because it contains important information. The legend must also advise security holders that they can obtain copies of the tender offer statement and other documents on the Commission’s website and explain which documents may be obtained free of charge from the bidder.

1.3.2 Target’s Response Document and Communications

The target must file with the Commission on Schedule 14D-9 as soon as practicable on the date of publication or dispatch any solicitation, recommendation, or statement made in relation to the offer to its security holders, including any information disseminated by the target pursuant to Rule 14e-2.

The target also is required to file any pre-commencement communications (such as press releases) regarding the tender offer with the Commission on Schedule 14D-9 no later than the date of release. Each pre-commencement communication must include a prominent legend advising investors to read the tender offer statement when it becomes available because it contains important information. The legend must also advise security holders that they can obtain copies of the tender offer statement and other documents on the Commission’s website and explain which documents may be obtained free of charge from the bidder.

152. The offer to purchase would nevertheless be required to be filed with the Commission on Form F-4 or S-4. See infra section 2.4.
155. See Exchange Act Rule 14d-2, 17 C.F.R. § 240.14d-2 (2015) (instruction 3 to paragraph (b)(2)) (providing that the legend must advise investors to read the tender offer statement when it is available and that they can obtain the tender offer statement and other filed documents for free at the Commission’s website).
156. Id.
158. See Exchange Act Rule 14e-2, 17 C.F.R. § 240.14e-2 (2015) (providing that within ten U.S. business days of the publication of the tender offer, the target must publish, send to, or give security holders a statement as to whether it recommends acceptance or rejection of the offer, expresses no opinion as to the offer, or is unable to take a position regarding the offer).
communication must be accompanied by a prominent legend advising shareholders of the target company to read the target’s recommendation or solicitation statement when it becomes available. The legend must also advise security holders that they can obtain copies of the recommendation and other filed documents on the Commission’s website and explain which documents may be obtained for free from the target.

1.3.3 Withdrawal Rights

Tendering shareholders have the right to withdraw tendered securities during the initial offering period of a tender offer under Rule 14d-7 and after the passing of sixty calendar days from the date of commencement of the tender offer if the tender offer remains open under Section 14(d)(5) of the Exchange Act (we refer to the latter as “back-end withdrawal rights”). The Commission generally takes the view that withdrawal rights must be available to target shareholders worldwide, not only to those shareholders resident in the United States. As a consequence of the requirement for withdrawal rights, a bidder cannot purchase any tendered securities until the expiration of the initial offering period.

In many jurisdictions, withdrawal rights are not customary and may require express consent from regulators in the home jurisdiction. The requirement to provide back-end withdrawal rights may also conflict with the centralization and counting of tendered securities in non-U.S. jurisdictions. A bidder in a Tier II transaction is expressly permitted to suspend back-end withdrawal rights during the initial offering period or a subsequent offering period provided that: (i) it has provided an offer period including withdrawal rights for a period of at least twenty U.S. business days; (ii) at the time that the withdrawal rights are suspended, all offer conditions, other than the minimum acceptance condition, have been satisfied or waived; and (iii) withdrawal rights are suspended only

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160. See id. (instruction 3).
161. Id. (instruction 3).
164. See 1999 Cross-border Release, supra note 3, at 61385 (providing that “equal treatment requires that the procedural terms of the tender offer . . . [including] withdrawal rights, must be the same for all security holders”).
165. But see Saipem letter, supra note 55, 2002 WL 1841561 (providing an example where in the context of separate U.S. and non-U.S. offers, withdrawal rights were not afforded to holders tendering into the non-U.S. offer).
166. For instance, in the United Kingdom, where withdrawal rights would typically only apply from the forty-second day after commencement of an offer until the date the minimum condition has been satisfied, in the experience of the authors, the Panel on Takeovers and Mergers (the body that regulates offers pursuant to the City Code) typically grants relief permitting withdrawal rights to subsist throughout the initial offering period, on the condition that the bidder does not declare its offer unconditional as to acceptances until the offer becomes wholly unconditional. In Russia, withdrawal rights do not exist, but since under Russian law only a shareholder’s last tender offer is deemed to be valid, the shareholder is afforded some scope to change his or her election in the initial offering period. The Staff has provided relief in such circumstances. See Offer by Pepsi-Cola (Bermuda) Ltd. for Ordinary Shares and American Depositary Shares of Wimm-Bill-Dann Foods OJSC, SEC No-Action Letter, 2011 WL 1142774 (Mar. 18, 2011) [hereinafter Pepsi-Cola Letter].
until tendered securities are counted and are reinstated immediately thereafter to the extent that they are not automatically cancelled by the acceptance of tendered securities.167 In a Tier II transaction, a bidder is also not required to provide back-end withdrawal rights from the close of the initial offering period to the commencement of the subsequent offering period.168

The Staff has also provided relief in the context of transactions that were unable to meet the requirements of the Tier II exemption. For instance, in the United Kingdom, once an offer becomes or is declared unconditional as to acceptances, withdrawals are not permitted, as tendering shareholders’ shares become the beneficial property of the bidder at the time the offer becomes or is declared unconditional as to acceptances (and, in any case, permitting withdrawals at such time could reverse satisfaction of the minimum acceptance condition). After an offer becomes or is declared unconditional as to acceptances, a subsequent offering period is commenced. While withdrawal rights are not required in the subsequent offering period under Rule 14d-7, back-end withdrawal rights under Section 14(d)(5) could apply after the sixtieth calendar day from the date of commencement of the tender offer and would conflict with U.K. market practice.169

In some jurisdictions, local laws and procedures for centralizing and counting tendered securities, particularly in relation to ADSs or where the offer is separated into two or more separate offers, may in effect require that withdrawal rights are terminated prior to the end of the initial offering period and the Staff has also provided relief in such circumstances.170

1.3.4 Terminating Withdrawal Rights After Reducing or Waiving the Minimum Acceptance Condition

In the United Kingdom, it is common for a bidder to reduce the minimum condition from 90 to 50 percent plus one share, once all other conditions to the offer are satisfied, and immediately purchase the tendered securities. Under the City Code, the offer then must remain open for fourteen days in a subsequent offering period. During the subsequent offering period, the offer is open for acceptances, but not withdrawals. Bidders anticipate that during the subsequent offering period, sufficient tenders will come in to satisfy the 90 percent minimum condition.171 (The 90 percent minimum condition is important to achieve because 90 percent is the threshold for conducting a compulsory acquisition in the United Kingdom.172) A similar practice exists in certain other juris-

171. See City Code, supra note 7, r. 32.1.
While waiving or reducing the minimum acceptance condition is considered a material change in the terms of the offer that would trigger an obligation to keep the offer open for ten U.S. business days with withdrawal rights, the Commission adopted an interpretive position, which it expressed in the 1999 Cross-border Release, permitting a bidder that qualifies for the Tier II exemption to reduce or waive the minimum condition of the offer without extending withdrawal rights during the remainder of the offer or keeping the offer open for ten U.S. business days, subject to certain conditions. In the 2008 Cross-border Release, the Staff reaffirmed this interpretive position, with some further modifications. The Staff indicated that it would not object to a bidder conducting a cross-border tender offer under the Tier II exemption waiving or reducing a minimum acceptance condition without providing withdrawal rights, as long as each of the following conditions were satisfied:

- the bidder must announce that it may reduce the minimum condition at least five U.S. business days prior to the time that it reduces the condition;
- the announcement must be disseminated through a press release and other methods reasonably designed to inform U.S. holders;
- the press release must state the exact percentage to which the acceptance condition may be reduced and that a reduction is possible; the bidder must announce its actual intention regarding waiver or reduction as soon as required under the rules of its home jurisdiction;
- during the five-day period after the announcement of a possible waiver or reduction, withdrawal rights must be provided;
- the announcement must advise security holders that have tendered their target securities to withdraw their tendered securities immediately if their willingness to tender would be affected by a reduction in the minimum condition;
- the procedure for waiving or reducing the minimum acceptance conditions must be described in the offering materials;
- the offer must remain open for at least five U.S. business days after the waiver or reduction of the minimum acceptance condition;
- all offer conditions must be satisfied or waived when withdrawal rights are terminated;


173. Netherlands law and practice allows a bidder to reduce or waive a minimum acceptance condition at or after the end of the initial offering period without providing tendering holders with the ability to withdraw their securities after the reduction or waiver.
• the potential impact of the waiver or reduction of the minimum acceptance condition must be fully discussed in the initial offering materials or any supplemental materials; and

• the bidder may not waive or reduce the minimum acceptance condition below the percentage required for the bidder to control the target company after the tender offer under applicable law and, in any case, may not reduce or waive the minimum acceptance condition below a majority of the outstanding securities of the subject class.174

### 1.3.5 Subsequent Offering Period

A bidder may provide for a subsequent offering period of at least three U.S. business days immediately following the initial offering period after the termination of the initial offering period if (i) the initial offering period of at least twenty U.S. business days has expired, (ii) the offer is for all outstanding securities of the subject class and if the bidder is offering security holders a choice of form of consideration, there is no ceiling on any form of consideration, (iii) the bidder immediately accepts and promptly pays for all securities tendered during the initial offering period, (iv) the bidder announces the results of the tender offer, including the approximate number and percentage of securities deposited, no later than 9:00 a.m. Eastern Standard Time on the next business day after expiration of the initial offering period and immediately begins the subsequent offering period, (v) the bidder immediately accepts and promptly pays for all securities as they are tendered during the subsequent offering period, and (vi) the bidder offers the same form and amount of consideration to security holders in both the initial and the subsequent offering period.175 No withdrawal rights apply during the subsequent offering period.176

The subsequent offering period provides a U.S. statutory basis that accommodates takeover practice in a number of European jurisdictions, where tender offers are typically held open for a period after all conditions have been satisfied to assist bidders in reaching the statutory minimum number of shares necessary to engage in a compulsory acquisition or other squeeze-out transaction with the target.177 The subsequent offering period also provides target security holders that remain after all offer conditions have been satisfied with another opportunity to tender into an offer and avoid the delay in receiving squeeze-out consid-

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177. In the United Kingdom, for instance, an offer must remain open for fourteen days following the date on which the offer becomes unconditional as to acceptances. See City Code, supra note 7, r. 31.4; see also supra note 7. In practice, transactions in the United Kingdom are often structured so as to provide for a subsequent offering period open for a period longer than the mandatory fourteen calendar days and longer than the twenty U.S. business days provided for in Exchange Act Rule 14d-11, in many cases until further notice is given. See SERENA letter, supra note 172, 2004 WL 842524.
eration and selling into the illiquid market that can result after a completion of a tender offer and before a statutory squeeze-out is accomplished.

A number of the Commission’s requirements regarding subsequent offering periods have proven problematic for non-U.S. bidders. For instance, Rule 14d-11(c) conditions the launch of a subsequent offering period on the immediate acceptance and prompt payment of securities tendered in the initial offering period. In certain jurisdictions, such as the United Kingdom, Ireland, France, and Spain, payment of consideration in compliance with local law or market practice would not constitute “prompt” payment. In such circumstances, the Staff has granted relief to permit a subsequent offering period notwithstanding a bidder’s inability to comply with the requirements of Rule 14d-11(c).

Rule 14d-11(d) requires that a bidder announce the results of the tender offer, including the approximate number and percentage of securities tendered, no later than 9:00 a.m. Eastern Standard Time on the next U.S. business day after expiration of the initial offering period and immediately begin the subsequent offering period. The Tier II exemption provides that if the bidder announces the results of the tender offer, including the approximate number of securities tendered to date, and pays for tendered securities in accordance with the requirements of the home jurisdiction law or practice then the subsequent offering period commences immediately following such announcement. The Staff has granted analogous relief in transactions not strictly falling within the Tier II exemption.

Rule 14d-11(e) provides that securities tendered during a subsequent offering period must be paid for as soon as they are tendered, on a “rolling” basis. Since the transaction is no longer subject to any conditions, the Commission deems it appropriate for tendering security holders to be paid immediately upon tender. In many cases, local law or market custom is such that securities tendered during a subsequent offering period are paid for within a certain number of days after the expiration of the subsequent offering period or “bundled up” and paid for on specified periodic take-up dates. The Tier II exemption permits a bidder to pay for securities tendered in the subsequent offering period within twenty


U.S. business days of the date of tender.181 The Staff has granted analogous relief in transactions not strictly falling within the Tier II exemption.182

Rule 14d-11(f) provides that a bidder must offer the same form and amount of consideration to security holders in both the initial and the subsequent offering period. In some foreign jurisdictions, such as Germany, bidders are legally obligated to pay interest on securities tendered during a subsequent offering period at a rate set by law. Interest may accrue from the date of tender or a fixed date unrelated to the date of tender. Paying interest on securities tendered during a subsequent offering period would violate Rule 14d-11(f), which mandates that security holders that tender in a subsequent offering period receive the same consideration as those that tender during the initial offering period. The Tier II exemption permits a bidder to pay interest on securities tendered during a subsequent offering period if required under applicable foreign law.183 The Staff has granted analogous relief in transactions not strictly falling within the Tier II exemption184 and has also permitted an upward adjustment to consideration paid on tendered securities in the subsequent offering period, reflecting interest payable on such securities accruing to the time of tender (and thus increasing continually during the pendency of the subsequent offering period).185 The Staff has also permitted different consideration to be offered where mandated by local law and where such arrangements are not “coercive, do not serve as an inducement to tendering and do not otherwise conflict with the purposes of U.S. tender offer rules.”186

Rule 14d-11(f) also has the effect, with Rule 14d-11(b), of prohibiting “mix and match” offers, where a bidder offers a specified mix of cash and securities in exchange for each target security, but permits tendering holders to request a different proportion of cash and securities. Rule 14d-11(b) prohibits a “ceiling” on any form of consideration offered if target securities holders are offered a choice of different forms of consideration. In mix and match offers, elections by tendering holders are satisfied to the extent that other tendering security holders make offsetting elections, subject to a maximum amount of cash or securities that the bidder is willing to make available or issue. A bidder in a mix and match offer typically would employ separate proration and offset pools for the initial offering period and the subsequent offering period, with the result that different consideration likely would be payable in the initial offering period and the subsequent offering period to shareholders requesting the same proportion of cash and securities. The Tier II exemption expressly permits bidders to offset and prorate separately securities tendered during

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185. See Embratel letter, supra note 102, 2010 WL 4635127.

the initial and subsequent offering periods. The Tier II exemption also expressly permits a bidder to establish a ceiling on one or more forms of consideration offered for offsetting the elections of target shareholders. The Staff has granted analogous relief in transactions not strictly falling within the Tier II exemption.

### 1.3.6 All-Holders Best-Price Rule

Rule 14d-10 under the Exchange Act sets forth the “all-holders best-price” requirement, providing that the tender offer must be made to all holders of the target’s securities and all holders must be paid the highest consideration paid to any other holder of the target’s securities.

Rule 14d-10(a)(1) requires that a tender offer be open to all target security holders wherever located. However, a bidder may find it difficult or impracticable to conduct its tender offer as a single global tender offer, due to procedural and technical conflicts between U.S. and foreign tender offer rules and market practice. To afford bidders with maximum flexibility to comply with two (or more) sets of regulatory regimes and to accommodate frequent conflicts in tender offer practice between U.S. and foreign jurisdictions, the Tier II exemption permits the separation of a bidder’s offer into multiple offers: one offer made to U.S. holders, including all holders of ADSs representing interests in the subject securities, if any, and one or more offers made to non-U.S. holders (including U.S. holders where the laws of the jurisdiction governing such foreign offers expressly preclude the exclusion of U.S. holders). The U.S. offer must be made on terms at least as favorable as those offered to any other holder of the same class of securities as the foreign offers. U.S. holders may be included in the foreign offer only if the laws of the jurisdiction governing the foreign offer expressly preclude the exclusion of U.S. holders and if the offer materials distributed to U.S. holders fully and adequately disclose the risks of participating in the foreign offers. The Staff has granted analogous relief in transactions not strictly falling within the Tier II exemption and has also provided relief where in the context of separate offers for shares and underlying ADSs, local law did not permit the U.S. offer to include an offer for shares.

As discussed above in the discussion of Rule 14d-11(f), in some foreign jurisdictions, bidders may be legally obligated to pay interest on securities tendered

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188. Id.


191. See Exchange Act Rule 14d-1(d)(2)(ii), 17 C.F.R. §§ 240.14d-1(d)(2)(ii) (2015). Rule 14d-1(d)(2)(i) provides the loan note exception, which is the only other express exception to the equal treatment rule under Tier II.


during a subsequent offering period. Paying interest on securities tendered during a subsequent offering period would violate Rule 14d-10(a)(2), which provides that the consideration paid to any security holder for securities tendered is the highest consideration paid to any other security holder for securities tendered. The Tier II exemption allows a bidder to pay interest on securities tendered during a subsequent offering period if required under the applicable foreign law.\footnote{194} The Staff has also granted relief in transactions not strictly falling within the Tier II exemption.\footnote{195}

As mentioned above in the discussion of Rule 14d-11(f), it is customary for a bidder in some foreign jurisdictions to offer a loan note alternative to foreign holders in an offer where at least a portion of the offer consideration consists of cash. Providing a loan note alternative could violate Rule 14d-10(a)(2) and (c). The Tier II exemption, however, expressly permits a bidder to offer loan notes to foreign holders to grant such holders tax advantages not available in the United States, provided that the notes are neither listed on any organized securities market nor registered under the Securities Act.\footnote{196} The Staff has also granted relief in transactions not strictly falling within the Tier II exemption.\footnote{197}

The proration features of “mix and match” offers discussed above, where separate proration pools are created in the initial and subsequent offering periods and tendering security holders’ elections may result in the receipt of a different mix of consideration in the initial and subsequent offering periods, could also violate Rule 14d-10(a)(2). The Tier II exemption however, expressly permits bidders to conduct “mix and match” offers where securities are separately offset and prorated in the initial and subsequent offering periods.\footnote{198}

\section*{1.4 Special Considerations Relating to ADSs}

A bidder for a non-U.S. target that has established an ADR program in the United States should consider whether, in order to facilitate the tender of ADSs into the offer, to appoint a U.S. exchange agent and establish separate tender mechanics for ADS holders so that ADS holders are not required to withdraw the shares underlying their ADSs from the ADS depositary facility in order to tender the underlying shares into the offer.

From the bidder’s perspective, the simpler approach is to require U.S. ADS holders to withdraw underlying ordinary shares from the ADS depositary facility and to tender such shares in accordance with customary tender offer procedures under local law. Under this approach, the bidder would supply the ADS holders with, in addition to offering materials, instructions explaining how to participate in the offer by withdrawing the shares underlying their ADSs and instructing a designated financial intermediary to tender such shares into the bidder’s offer. In
most cases, tendering ADS holders would be required to pay a withdrawal fee, which may act as a disincentive to tendering, particularly where target security holders are uncertain as to the success of the offer. Accordingly, this approach is usually considered only when the number of shares held in the form of ADSs is relatively small and the receipt of such securities is not necessary to ensure the success of the offer.

Alternatively, a bidder may provide for separate ADS tender and acceptance procedures. This approach involves appointing a U.S. exchange agent to accept tenders from ADS holders. Under this approach, separate forms of acceptance (typically in the form of a U.S.-style letter of transmittal) are distributed to ADS holders along with the offering materials. ADS holders that desire to accept the offer do so by completing the letter of acceptance indicating the number of ADSs to be tendered and delivering the letter along with the tendered ADSs to the U.S. exchange agent prior to the closing date of the offer. Such letters are deemed to be instructions to the depositary and its custodian with respect to the tendering of the underlying securities held by or on behalf of ADS holders. All such tenders are then counted as valid acceptances of the offer. After successful completion of the offer, the U.S. exchange agent distributes the requisite cash (typically converted into U.S. dollars, unless prior arrangement has been made) or share consideration to the tendering ADS holders, less any required withholding tax under U.S. law and, if borne by the ADS holder, the fees of the U.S. exchange agent and the depositary.

### 1.5 Disclosure

For a tender offer not involving Registered Securities, there are no specific requirements governing the content of offering materials disseminated to target holders, whether or not such materials are required to be submitted to the Commission under cover of Form CB. A bidder is, of course, subject to the anti-fraud provisions of Rule 14e-3 and Rule 10b-5, which will affect decisions about what information to disclose.

In connection with an offer for Registered Securities, a filing on Schedule TO, if applicable, must include specified information, including a detailed summary of the bidder’s past contacts, transactions, and negotiations with the target and its advisers. In the context of any offer, U.S. shareholders and their counsel may scrutinize this narrative section for evidence of an unfair transaction process, failure to maximize price, and other potential violations of fiduciary duties in support of legal action against the bidder and the target. Where negotiations for an agreed transaction have broken down or where an offer is otherwise hostile, the description of any breakdown in negotiations may also create a sensitive disclosure issue. Furthermore, without the target’s cooperation, certain mandated information may not be available. It is important for the bidder and its financial advisers to understand this requirement early in the process so that ap-

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199. But see infra note 221.

propriate records of conversations and correspondence are kept and inquiries of the bidder are timely made and recorded. Schedule TO also requires disclosure about (i) the business and operations of the bidder and the target, (ii) the terms of the offer, (iii) the bidder’s plans for the target, (iv) certain information about the bidder’s advisers, (v) information about the bidder’s interest in, and dealings in, the target’s securities, (vi) material non-public information that may have been furnished to the bidder, and (vii) a detailed explanation of the mechanics for tendering securities and procedures for acceptance and settlement. Disclosed intentions about the bidder’s future plans for the target tend to be broad and somewhat generic due to the inherent sensitive and uncertain nature of potential ownership, management, and operational changes.

Financial statements of the bidder are required to be included with Schedule TO when the bidder’s financial condition is material to the decision by the target’s shareholders of whether to tender. Financial statements are not considered material when (i) only cash consideration is offered, (ii) the offer is not subject to any financing condition, and (iii) either the bidder is a reporting company that files reports electronically on EDGAR or (iv) the offer is for all of the target’s outstanding securities of the subject class.

If financial statements are required, the bidder must provide the same financial information as would be required under Item 17 of Form 20-F. If financial statements are required in the context of a cash tender offer, only two years of statements need to be provided and can be incorporated by reference into the Schedule TO, as long as a summary is provided in the actual Schedule TO. Pro forma financial information may also be required in negotiated third-party cash tender offers when securities are intended to be offered in a subsequent merger or other transaction in which remaining target securities are acquired and the acquisition of the subject company meets certain “significance” tests.

As discussed in sections 1.2.4 and 1.3.2 above, a target company may have certain disclosure obligations pursuant to Rule 14d-9 and Rule 14e-2 under the Exchange Act.

2 Exchange Offers

In addition to compliance with the tender offer rules described in section 1 above, tender offers pursuant to which exchange securities constitute at least part of the offer consideration are subject to the registration and other require-


202. See id. (instructions to Item 10).

203. See id. (instruction 2 to Item 10).


205. See Schedule TO, Exchange Act Rule 14d-100, 17 C.F.R. § 240.14d-100 (instruction 3 to Item 10).

206. See id. (instruction 5 to Item 10).
ments of the Securities Act, unless an exemption or exclusion applies. A number of exemptions may be available for the offer of securities in the exchange offer context, including Rule 802, which may be available in the case of a tender offer falling within the Tier I exemption.

2.1 RULE 802

A bidder may offer its shares in exchange for the shares of a non-U.S. target without having to register the shares being offered. Relying on the Rule 802 exemption allows the bidder to avoid preparing and filing the detailed disclosure specified in a registration statement on Form F-4 or Form S-4 and frees the transaction from the timing constraints of the Commission’s registration and review process.

Availability

The Rule 802 exemption is available if (i) the target or the entity whose securities will be exchanged is a foreign private issuer and is not an investment company registered or required to be registered under the Investment Company Act, other than a closed-end investment company, (ii) U.S. holders hold no more than 10 percent of the target’s securities, and (iii) the bidder permits U.S. holders to participate in the tender offer on terms at least as favorable as those offered to other shareholders. Where the Tier I exemption is available, Rule 802 should generally also be available. As in the case of assessing U.S. ownership for purposes of the Tier I exemption, there is an obligation to look through the record ownership of certain brokers, dealers, banks, and other nominees, and the calculation is based on U.S. ownership of the target as of a date no more than sixty calendar days before and thirty days after public announcement of the exchange offer. If calculation of U.S. ownership within such time period is not possible, it may be made as of the most recent practicable date before the public announcement, but no earlier than 120 days before the announcement. Rule 802 is not available when there are no U.S. security holders of the target.

Other than in the case of an exchange offer conducted (i) by the issuer of the securities to which the tender offer relates (or the issuer’s affiliate) or (ii) pursuant

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207. See supra notes 14–15 and accompanying text; see also infra section 3.1.
211. The method of calculating the percentage is substantially similar to the method prescribed in Exchange Act Rule 14d-1, as discussed in supra section 1.1.1. See Securities Act Rule 800(h), 17 C.F.R. § 230.800(h).
214. Id.
215. See Third Supplement, supra note 135 (Q II.C.1); see also supra note 135.
to an agreement with the issuer of the subject securities, there is a rebuttable presumption that the issuer of the securities is a foreign private issuer and that U.S. holders hold 10 percent or less of the outstanding securities. The presumption will not be available where (i) the ADTV of the subject securities in the United States over the twelve-calendar-month period ending sixty calendar days prior to the public announcement of the exchange offer exceeds 10 percent of the worldwide trading volume of the subject class of securities, (ii) the most recent annual report filed or submitted by the target (or security holders of the target’s securities) with the Commission or regulators in the target’s home jurisdiction, before public announcement of the offer, indicates that U.S. holders hold more than 10 percent of the outstanding subject securities, or (iii) the bidder knows or has reason to know, before public announcement of the offer, that the level of U.S. holding exceeds 10 percent of the outstanding subject securities. The bidder will be deemed to know information about U.S. ownership available from the target or obtained or readily available from any other source that is reasonably reliable, including from persons it has retained to advise it about the transaction, as well as from third-party information providers.

Offering Materials

The bidder must disseminate offering materials to U.S. holders in English on a comparable basis to those provided to shareholders in the home jurisdiction. If the bidder disseminates by publication in its home jurisdiction, it must publish the information in the United States in a manner “reasonably calculated” to inform U.S. holders of the offer. Accordingly, if materials are mailed to non-U.S. holders, then materials should be mailed to U.S. holders; if notice of the offer is effected by publication outside of the United States, publication, rather than actual delivery of offering materials, would ordinarily be sufficient.

Filing Requirements

Offering materials sent to shareholders in the United States must be submitted to the Commission under cover of Form CB. The Form CB must be submitted no later than the first business day after the offering materials have been published or disseminated in the home jurisdiction. There is no fee for submitting Form CB. If the bidder is a non-U.S. company, it must file with the Commission a con-

217. See Securities Act Rule 800(h)(7), 17 C.F.R. § 230.800(h)(7); see also supra note 62.
218. See supra note 217.
219. See Securities Act Rule 802(a)(3)(ii), (iii), 17 C.F.R. § 230.802(a)(3)(ii), (iii). Although foreign law may require a detailed advertisement, the Staff will permit a summary advertisement with a toll-free number for investors to use to obtain the complete disclosure document. See Third Supplement, supra note 135 (Q II.D.1); see also supra note 135.
sent to service of process in the United States on Form F-X and appoint an agent for service of process in the United States.223 There is no filing fee for Form F-X.

Blue Sky Exception

A bidder may exclude certain shareholders in the United States if the shareholders are in states of the United States that do not exempt the exchange securities from state registration requirements.224 This exception is effectively a “blue sky” exception225 and applies where a bidder has made a good-faith effort to seek the registration of the exchange securities in such states. A bidder must, however, offer the same cash alternative to security holders in any such state that it has offered to security holders in any other state or jurisdiction.

Legends

Any document disseminated in the United States must include the following prominent legend, or equivalent statement in clear, plain language, on the cover page or other prominent portion of the document:

This exchange offer or business combination is made for the securities of a foreign company. The offer is subject to disclosure requirements of a foreign country that are different from those of the United States. Financial statements included in the document, if any, have been prepared in accordance with foreign accounting standards that may not be comparable to the financial statements of United States companies.

It may be difficult for you to enforce your rights and any claim you may have arising under the federal securities laws, since the issuer is located in a foreign country, and some or all of its officers and directors may be residents of a foreign country. You may not be able to sue a foreign company or its officers or directors in a foreign court for violations of U.S. securities laws. It may be difficult to compel a foreign company and its affiliates to subject themselves to a U.S. court’s judgment. You should be aware that the issuer may purchase securities otherwise than under the exchange offer, such as in open market or privately negotiated transactions.226

Transfer Restrictions

The securities offered by the bidder in exchange for those of the target will be characterized the same as that of the target securities.227 If the securities of the target are “restricted securities” within the meaning of the Securities Act, then the bidder’s securities offered in exchange will also be restricted securities.228 If,

224. See Securities Act Rule 802(a)(2), 17 C.F.R. § 230.802(a)(2); see also supra note 79.
225. See supra note 17.
226. See Securities Act Rule 802(b), 17 C.F.R. § 230.802(b). The legend required by Rule 802 may be tailored to avoid confusion in the case of an offeror that is a domestic issuer incorporated in the United States. See Third Supplement, supra note 135 (Q II.C.2); see also supra note 135.
228. “Restricted securities” are securities acquired by the issuer or an affiliate of the issuer of such securities in a transaction or chain of transactions not involving any public offering, including
however, the target’s securities are unrestricted (for instance, because they were
issued in certain offshore transactions in compliance with Regulation S or pur-
suant to a registration statement under the Securities Act), then the bidder’s se-
curities offered in exchange will be freely tradable in the hands of a non-affiliate
of the issuer of the securities.  

Integration

An offer of securities pursuant to Rule 802 will not be integrated with any
other exempt offer by the bidder, even if the other transaction occurs simulta-
neously. Accordingly, the use of the Rule 802 exemption will not render un-
available or otherwise prevent a bidder from relying on another exemption under
the Securities Act in respect of the offer and sale of securities contemporaneous
with or in close proximity to the exchange offer.

No Exchange Act Reporting Obligations

The use of the Rule 802 exemption will not result in the bidder incurring re-
porting obligations under Section 15(d) of the Exchange Act, as no registration
under the Securities Act is implicated. Nor does the use of Rule 802 preclude
a foreign private issuer from relying on the exemption from Exchange Act regis-
tration pursuant to Rule 12g3-2(b) under that Act.

Subsequent Bidder

If an initial bidder is able to rely upon Rule 802 to extend its exchange offer
into the United States, a competing bidder will not be subject to the 10 percent
ownership limitation condition of the Rule 802 exemption. As a result, the
subsequent bidder will not be precluded from relying on Rule 802 by any move-
ment of securities into the United States following announcement of the initial
bidder’s offer.

dealer taking place prior to the expiration of forty calendar days from the time the shares were first
offered to the public).


231. Exchange Act Section 15(d) provides that any issuer that has had a registration statement de-
cleared effective by the Commission under the Securities Act with respect to any class of debt or equity
securities shall have an obligation to file with the Commission the periodic reports that would oth-
erwise be required to be filed had such class of securities been registered under Exchange Act Sec-
tion 12. 15 U.S.C. § 78o(d) (2012). No such obligation is incurred in the absence of the filing of a
registration statement. See infra section 2.4.

232. See Exchange Act Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (2015); see also infra section
5.1.1. The securities of many foreign private issuers that rely on the Rule 12g3-2(b) exemption are
quoted on “services” such as the OTC Markets. See OTC MARKETS, http://www.otcmarkets.com
(last visited Jan. 18, 2016).

Practical Difficulties

For the reasons enumerated in section 1.1.1 above, it may be difficult for a bidder to confirm its eligibility to rely on Rule 802. Furthermore, Rule 802 does not provide an express safe harbor for a second step “squeeze-out” merger. For instance, in many European jurisdictions, a bidder has the right upon obtaining typically between 90 percent and 95 percent of the target’s securities to serve notice upon minority shareholders whereupon, by operation of law, such minority shareholders’ target securities will be cancelled and reissued to, or transferred directly to, the bidder. Because securities held by the bidder are excluded from the U.S. holder calculation, a bidder that has relied upon Rule 802 to effect an exchange offer may find that when it seeks to effect statutory squeeze-out procedures it is ineligible to rely on Rule 802 on the basis that U.S. holders then hold in excess of 10 percent of outstanding securities. However, the Staff has stated that in the case of a business combination transaction involving multiple steps, a bidder’s initial assessment of U.S. ownership will be sufficient to determine eligibility for the use of the Rule 802 exemption in the subsequent transaction so long as (i) the disclosure document discloses the bidder’s intent to conduct a subsequent “clean-up” transaction and the terms of such transaction and (ii) the subsequent step is consummated within a reasonable time following the first step. It is unclear what the Staff would consider a “reasonable time” in this regard. It may be prudent, therefore, to consult the Staff in connection with any particular transaction.

2.2 Regulation S

In the context of an exchange offer, Regulation S may provide a “safe harbor” from the application of the registration requirements of the Securities Act for offers and sales of a foreign private issuer bidder’s securities outside the United States, subject to certain conditions and selling restrictions. Briefly, these conditions and restrictions require that an offer of securities be made in “offshore transactions.” Certain other conditions apply depending on the status of the issuer and the interest of U.S. investors in the subject class of securities. For instance, the bidder cannot engage in “directed selling efforts” to condition the U.S. market for the bidder’s securities being offered. In a large cross-border exchange offer where

234. See, e.g., Companies Act 2006, c. 46, § 979 (Eng.) (providing a right for a bidder to buy out minority shareholders where nine-tenths of the class of securities to which the offer relates has been obtained). In France, Article 237-1 of the General Regulations of the French Autorité des marchés financiers provides for the transfer of securities not tendered by minority shareholders to the majority shareholder or shareholder group, provided that minority shareholders constitute no more than 5 percent of the equity or voting rights of the target company.

235. See Third Supplement, supra note 135 (Q II.E.9); see also supra note 135.


237. “Directed selling efforts” means “any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on Regulation S. Such activity includes placing an advertisement in a publication ‘with a general circulation in the United States’ that refers to the offering of securities being made in reliance upon this Regulation S.” 17 C.F.R. § 230.902(c)(1). But see Prelim-
the bidder has relied upon Rule 14d-1(d)(2)(ii) under the Exchange Act or otherwise determined to conduct separate U.S. and non-U.S. offers, a non-U.S. bidder would typically rely on Regulation S to avoid registering securities offered pursuant to the non-U.S. offer with the Commission. Reliance on Regulation S in the context of exclusionary offers may, however, be problematic.\textsuperscript{238}

2.3 VENDOR PLACEMENTS

For an offer falling within the Tier I exemption, a bidder may offer U.S. holders cash in place of the securities offered to target shareholders outside of the United States so long as the bidder has a reasonable basis for believing that the amount of cash is substantially equivalent to the value of the securities offered to non-U.S. holders, subject to certain conditions.\textsuperscript{239} The Tier II exemption does not provide similar relief.

Historically, however, the Staff was willing to consider requests for relief under the Rule 14d-10 all-holders best-price provisions on a case-by-case basis\textsuperscript{240} to permit U.S. holders to be cashed out in the context of an exchange offer, such that the bidder was not required to register consideration shares under the Securities Act.\textsuperscript{241} Typically this would be achieved by a bidder allotting securities otherwise allocable to U.S. security holders to a third-party “vendor” that causes such securities to be “placed” outside of the United States on

\textsuperscript{238} See, e.g., Mittal Steel Co. N.V., Form F-4 (Mar. 23, 2006). The question has arisen whether the furnishing of tender offer materials under cover of Form 6-K could be viewed as a public announcement in the United States and an inducement to U.S. security holders to tender. See Third Supplement, supra note 135 (Q II.G.1) (stating that tender offer materials may be furnished to the Commission without triggering the U.S. tender offer rules so long as the issuer takes three steps to assure that the information is not used as a means to induce indirect participation by U.S. holders of the securities: (i) the materials must not include a transmittal letter or other means of tendering the securities, (ii) the materials must prominently disclose that the offer is not available to U.S. persons or is being made only in countries other than the United States, and (iii) the issuer must take precautionary measures to ensure that the offer is not targeted to persons in the United States or to U.S. persons). The interpretation concludes: “Alternatively, the issuer may choose not to submit these materials to the Commission.” Although an issuer may determine not to submit offering materials to the Commission, an issuer would nonetheless need to consider its U.S. securities law disclosure obligations regarding the transaction. See also Coral Gold Corp., SEC No-Action Letter, 1991 WL 176737 (Feb. 19, 1991), in which the Staff concurred that the furnishing of an offering circular under cover of Form 6-K containing only the information legally required in Canada (the jurisdiction in which a securities offering was made) and setting forth a restrictive legend in accordance with Regulation S would not constitute directed selling efforts for purposes of Regulation S.

\textsuperscript{239} See 2008 Cross-border Release, supra note 3, at 60076–77 (Part II.G.2); supra section 2.3.

\textsuperscript{240} See Singapore Telecommunications Limited, SEC No-Action Letter, 2001 WL 533462 (May 15, 2001); TABCORP Holdings Limited, SEC No-Action Letter, 1999 WL 766087 (Aug. 27, 1999); Durban Roodepoort Deep, SEC No-Action Letter, 1999 WL 1578786 (June 22, 1999). In each of the placings described in these letters, procedures were established to ensure that U.S. resident target security holders would not be entitled to any of the incidents of ownership of the bidder’s securities.

\textsuperscript{241} See 1999 Cross-border Release, supra note 3, at 61388. Moreover, laws or regulations of the home jurisdiction may, in many cases, restrict a bidder from withholding share consideration from a portion of its security holders including, for instance, security holders resident in the United States.
behalf of U.S. holders and then remitting the proceeds of such placement to U.S. holders, less costs. Bidders argued that as no offer or sale of the bidder’s securities occurs in the United States, no registration under the Securities Act is required. Vendor placements were often desirable from a bidder’s perspective because they permitted a bidder to issue non-cash consideration only. Additionally, in jurisdictions with laws requiring a bidder to offer the same or substantially identical consideration to all target shareholders, a vendor placement may afford a mechanism to provide cash to U.S. holders and shares to all other holders in compliance with such laws.

The Commission indicated in the 2008 Cross-border Release that the Staff would no longer issue vendor placement no-action letters regarding registration under Section 5 of the Securities Act, but provided a number of factors that it suggested should be considered in analyzing whether registration under Section 5 would be required. These include the following:

- the level of U.S. ownership in the target company;
- the quantum of securities to be issued in the offer, as a proportion of the quantum of bidder securities outstanding before the offer;
- the quantum of securities to be issued to tendering U.S. holders and subject to the vendor placement, as a proportion of the amount of bidder securities outstanding before the offer;
- the existence of a highly liquid and robust trading market for the bidder’s securities;
- the likelihood that the vendor placement can be effected within a very short period of time after the termination of the offer and the bidder’s acceptance of shares tendered in the offer;
- the likelihood that the bidder plans to disclose material information around the time of the vendor placement sales;
- the process used to effect the vendor placement sales and whether sales of a bidder’s securities in the vendor placement can be accomplished within a few business days of the close of the offer and whether the bidder announces any material information in such time; and
- whether the vendor placement involves special selling efforts by bidders or their agents (any such efforts could result in the cash value of securities sold differing from the historical value).

The Commission also expressed its view that in the context of an analysis under Rule 14d-10, it would not be permissible (i) to exclude from the tender offer all but a limited class of U.S. holders, such as large institutional investors (for whom an exemption from Section 5 of the Securities Act may be available);242 or (ii) to

include all U.S. holders in the tender offer, but issue securities only to some U.S. holders, such as U.S. institutions on a private placement basis, while providing cash to all others pursuant to a vendor placement arrangement.\textsuperscript{243}

In circumstances where the all-holders best-price provisions of Rule 14d-10 do not apply,\textsuperscript{244} it may be possible to include certain U.S. security holders in an unregistered exchange offer by relying on the private placement exemption afforded by Section 4(a)(2) of the Securities Act,\textsuperscript{245} where an offer has been extended into the United States and U.S. security holders are generally limited to receiving cash consideration. A practice developed in Europe such that a bidder’s consideration securities were placed with a limited number of “qualified institutional buyers,”\textsuperscript{246} in compliance with certain private placement procedures. Securities placed privately with qualified institutional buyers pursuant to Section 4(a)(2) are restricted securities for purposes of the Securities Act.\textsuperscript{247} In practice, reliance on private placement procedures to permit certain institutional or sophisticated investors to participate in an exchange offer will be limited generally to circumstances where the number of U.S. security holders and/or the monetary value of the shares issued in the exchange offer is limited or where the bidder requires the participation of only a limited number of a wider group of U.S. target shareholders that are eligible to rely on a private placement exemption.

\section*{2.4 Registration Under the Securities Act in the Context of an Exchange Offer}

If the registration requirements of the Securities Act apply and Rule 802 or another exemption is unavailable, the bidder must file a registration statement with the Commission in connection with an exchange offer. In practice, because of the expense and time involved in preparing an initial registration statement and responding to Staff comments, the filing of a registration statement is generally reasonable in the context of an exchange offer only when the bidder (and the target, in the case of a hostile transaction) is already subject to the reporting requirements of the Exchange Act and has filed at least one annual report with the Commission. This occurs, for example, when the bidder has previously offered its securities publicly in the United States or when the bidder’s securities trade on a U.S. securities exchange, such as the NYSE or NASDAQ.

\textsuperscript{243} See 2008 Cross-border Release, supra note 3, at 60077–78 (Part II.G.3).
\textsuperscript{244} For instance, in a transaction not subject to Regulation 14D, or subject to Regulation 14D but within the parameters of the Tier I exemption. The Commission suggests that the practice of offering securities only to certain target shareholders on a private placement basis is not consistent with the all-holders best-price provisions of Rule 14d-10. See id. at 60078 & n.367.
\textsuperscript{246} The term “qualified institutional buyer” is defined in Securities Act Rule 144A and includes, broadly, certain institutional investors with at least $100 million in securities under management. 17 C.F.R. § 230.144A (2015). However, such offers would not typically be made in reliance upon Rule 144A, which is a resale exemption and not available for use by an issuer itself.
\textsuperscript{247} See supra note 227.
A foreign private issuer undertaking a registered exchange offer in the United States must prepare and file with the Commission a registration statement on Form F-4.248 A U.S. bidder would use Form S-4. Both forms consolidate the Exchange Act requirements of Schedule TO and the Securities Act requirements for the registration of securities and include the prospectus/offer to exchange to be distributed to target shareholders. The registration statement contains detailed information about the bidder and the target, the exchange offer transaction, the securities being registered, the bidder’s plans with respect to the target, the means and effects of tendering shares, audited financial statements of both the bidder and target, and pro forma financial information showing the effects of the tender offer.249 The financial statements of foreign private issuers may be presented in U.S. GAAP, IASB IFRS, or local home-country generally accepted accounting principles (“local GAAP”). No reconciliation to U.S. GAAP is required for foreign private issuers that use IASB IFRS. However, if local GAAP or non-IASB IFRS is used, financial information must be reconciled to U.S. GAAP.250 In the case of a hostile exchange offer, certain mandated information may not be made available by the target.251 In such a case, a bidder may need to request that the Staff grant relief under Rule 409252 of the Securities Act or otherwise in respect of the unavailable information.253 Relief under Rule 437254 may be required in respect of any consents required, but unavailable.

To the extent that audited financial statements are required to be included in a Commission filing, the bidder should confirm, at an early stage, that audits were conducted in accordance with the auditing standards required by the Public Company Accounting Oversight Board (the “PCAOB”),255 that the auditors satisfy the PCAOB’s and the Commission’s independence criteria, and that the financial statements comply with the applicable Commission requirements.256

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248. Where the bidder intends to issue securities in the form of ADSs, the bidder would also separately need to arrange for ADSs to be registered with the Commission on Form F-6, unless sufficient ADSs have already been so registered. See General Instruction II to Form F-6.


251. In particular, in an exchange offer, U.S. GAAP or IASB IFRS financial information of the target satisfying the staleness requirements of Item 8.A of Form 20-F.


253. Id. See, e.g., Mittal Steel Co. N.V., Form F-4 (Mar. 23, 2006), at 8; Gas Natural SDG SA, Form F-4 (Feb. 28, 2006), at 15; Harmony Gold Mining Co. Ltd., Form F-4 (Oct. 21, 2004), at vi.


Should any issue concerning the ability to comply with these requirements arise, it may be prudent for bidders and their legal counsel to initiate discussions with the Staff at the earliest practicable time.

The preparation of a registration statement (and the prospectus/offer to exchange contained within) can take several months and must be filed before commencement of the exchange offer. If the Staff decides to review the registration statement, it will so notify the bidder and will provide comments on the registration statement to the bidder. If the Staff’s comments result in any material changes to the prospectus/offer to exchange and such document has already been distributed to the target security holders, a supplement to the prospectus/offer to exchange would need to be re-circulated to the target’s security holders and the offer would need to be kept open, and possibly extended, for an additional period of at least five U.S. business days, depending on the changes.\textsuperscript{257}

Before a bidder may accept and settle any tendered securities, the Commission must have declared the registration statement effective. Effectiveness occurs at the bidder’s request after all of the Commission’s comments and questions have been resolved. While the Staff has undertaken to expedite the review of a registration statement filed in an early commencement offer, the registration process can ordinarily take anywhere from four to eight weeks or more from first filing, depending on a variety of factors, including whether the bidder is a reporting company and whether the Staff affords the bidder’s registration statement limited review treatment. Where the bidder is not subject to Commission reporting, a full Commission review should be anticipated.

Subject to local law timing requirements and practical considerations, a bidder may (i) launch its exchange offer upon the filing of its registration statement with the Commission, (ii) await an initial round of Commission comments prior to launching the offer, or (iii) wait until all Commission comments are resolved and the Commission has declared the bidder’s registration statement effective.\textsuperscript{258}

To the extent that the bidder’s disclosure is being reviewed by, and subject to comments from, other regulators (in foreign jurisdictions or U.S. states), it is generally necessary and advisable to resolve those comments prior to finalizing the Commission registration statement.\textsuperscript{259}

Registering securities under the Securities Act will subject the issuer to substantial periodic reporting obligations. Exchange Act Section 13(a)\textsuperscript{260} provides

\textsuperscript{257} See Exchange Act Rule 14d-4(d)(2), 17 U.S.C. § 240.14-4(d)(2) (2015) (mandating the prompt dissemination to security holders of material changes in information previously provided and that the offer remain open for at least five additional U.S. business days from the date such materials are so disseminated).

\textsuperscript{258} Prior to the adoption of Exchange Act Rule 14d-1 with the adoption of the 1999 cross-border regulations, an exchange offer could not be launched until the registration statement had been declared effective by the Commission. Rule 162 was amended again with the adoption of the 2008 cross-border regulations to permit a bidder to commence early an exchange offer that is subject only to Regulation 14E, subject to it providing certain protections to target security holders. See Securities Act Rule 162, 17 C.F.R. § 230.162 (2015).

\textsuperscript{259} Ordinarily an issuer will want to avoid finalizing the disclosure document with one regulator until it is confident it has received and resolved all material comments from all regulators.

that every issuer of a security registered under Section 12 of the Exchange Act must file certain annual and other periodic reports with the Commission. Exchange Act Section 15(d)\(^{261}\) provides that any issuer that has had a registration statement declared effective by the Commission under the Securities Act with respect to any class of debt or equity securities shall have an obligation to file with the Commission the periodic reports that would otherwise be required to be filed had such class of securities been registered under Exchange Act Section 12. An issuer’s Exchange Act Section 15(d) obligation will be suspended automatically if and so long as the issuer has any class of securities registered under Exchange Act Section 12 pursuant to Section 13(a).\(^{262}\) A foreign private issuer may subsequently deregister its securities and terminate its Exchange Act reporting obligations under Exchange Act Section 15(d) as set forth below in section 5.3.

An issuer that is subject to Exchange Act Section 15(d) will also be subject to applicable provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act.

As discussed above, in addition to U.S. federal regulation, the blue sky securities laws of the several states of the United States may apply to tender offers in which the consideration offered consists at least in part of exchange securities and to tender offers conducted in reliance on Rule 802. Although U.S. federal law preempts state blue sky laws in respect of exchange securities that are listed on the NYSE, NASDAQ, and certain other U.S. securities exchanges or are issued in certain transactions exempt from the registration requirements of the Securities Act, exchange securities registered under the Securities Act, but which are not so listed, or are issued in reliance on Rule 802 and on the Section 3(a)(10) exemption are generally subject to state blue sky laws.\(^{263}\)

2.4.1 Disclosure

For a registered exchange offer, extensive information will need to be disclosed to target security holders and filed with the Commission pursuant to the Securities Act. Substantially all of the information required in a bidder’s Schedule TO will be included in the prospectus/offer to exchange filed on Form F-4 or S-4, as the case may be.

For an exchange offer exempt from the registration requirements of the Securities Act pursuant to Rule 802, there are no specific requirements as to the content of offering materials disseminated to target holders other than legends mandated by Rule 802. The form of offer document will generally conform to local law disclosure requirements and/or local law market practice. A bidder will, of course, be subject to the anti-fraud provisions of Rule 14e-3 and Rule 10b-5.\(^{264}\)


\(^{262}\) Id.

\(^{263}\) See supra notes 17 & 80 and accompanying text; see also Staff Legal Bulletin No. 3A (CF), U.S. SEC. & EXCH. COMMISSION (June 18, 2008), https://www.sec.gov/interps/legal/cfslb3a.htm.

2.4.2 Prospectus Liability

In the context of an unregistered exchange offer, as in the case of any tender offer, a bidder (and its directors and officers) may have liability under Section 10(b) of, and Rule 10b-5 under, the Exchange Act, which prohibit manipulative or deceptive practices in connection with the purchase or sale of securities. Effectively, the bidder and any person who acted as a “maker” of the statements contained in the offering materials (e.g., by signing the offering materials) may be liable under Rule 10b-5 in respect of a material misstatement or omission contained in the offering materials to the extent that the material misstatement or omission was made with “scienter”—which means that the defendant knew that the published information was false or misleading or acted with reckless disregard for the truth. Although “deliberate” or “conscious” recklessness may be sufficient to establish liability under Rule 10b-5, negligence is not. A private party bringing an action under Rule 10b-5 must prove that he or she relied on such misstatement or omission to his or her detriment.

In the case of a registered exchange offer, the bidder and its directors, officers, and controlling persons will be subject to liability under Section 11 and possibly Section 12(a) of the Securities Act in respect of material misstatements and omissions in the prospectus/offer to exchange, in addition to potential liability under Rule 10b-5. Section 11 of the Securities Act creates a right of action against the bidder, its directors, and every person who signs the registration statement (including director nominees who consent to be named in the
registration statement), if the registration statement, at the time it is declared effective, contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading. The right of action is imposed by the mere status of a person as described above and not as a result of any action taken or omitted to be taken. Unlike Rule 10b-5, no “scienter” is required under Section 11. The liability of the bidder under Section 11 is therefore effectively strict liability. Directors and persons who have signed the registration statement may avoid liability if they can establish that they met an appropriate standard of due diligence, generally, the “reasonable investigation” standard, in connection with the preparation of the registration statement.

Section 12(a) of the Securities Act provides that a person who offers or sells a security in violation of the registration requirements of the Securities Act or offers or sells a security by means of a prospectus or an oral communication that contains an untrue statement of a material fact or omits to state a material fact necessary to avoid rendering the statements, under the circumstances made, misleading will be liable to the person purchasing the security. It should be noted that the Securities Act defines “prospectus” extremely broadly so that it effectively includes any written communication (including radio and television communications and any communication that is available on a company’s website) used in connection with an offer or sale of securities. As in

278. Id. (providing the right to sue those individuals identified in Securities Act Section 11 without conditioning the right on a link to any specific action on their part). Under Securities Act Section 11, the issuer (the bidder, in this context) is strictly liable for any material misstatements or omissions in the registration statement, while the other individuals identified in Securities Act Section 11 have a due diligence defense. See Huddleston, 459 U.S. at 382 (“Liability against the issuer of a security is virtually absolute, even for innocent misstatements. Other defendants bear the burden of demonstrating due diligence.”).
280. Generally, a defendant has a due diligence defense if he or she can establish that “he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” Securities Act § 11(b), 15 U.S.C. § 77k(b). A slightly different standard of due diligence applies with respect to “expertized” portions of the registration statement (those prepared by or on the authority of an expert). Id.
283. Section 12(a)(2) has been construed to permit claims to be brought only by “those persons who purchased securities pursuant to public offerings made via a prospectus” and only against a “person who passes title or interest in a security to a buyer for value or solicits an offer to buy a security.” In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp. 2d 334, 401 (D. Md. 2004). Consistent with those limitations, persons who acquired securities in a private offering or in a post-offering, secondary market transaction are beyond the scope of protection afforded by Section 12(a)(2). Similarly, when an issuer sells all of its securities to an underwriting syndicate in a “firm commitment” underwriting, the issuer will likely not be deemed to have directly passed title to a public investor and consequently will not be liable under Section 12(a)(2). Id.
284. The term “written communication” is defined in Securities Act Rule 405, 17 C.F.R. § 230.405 (2015). “Prospectus” is defined, with certain exceptions, as “any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale
the case of Section 11, Section 12(a)(2) provides a due diligence defense, the “reasonable care” standard, for any person (including the bidder) who can sustain the burden of proving that he or she did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. Unlike Rule 10b-5, no “scienter” is required under Section 12.

The potential liability that a bidder has for the contents of its offering materials is, of course, in addition to its potential liability under Exchange Act Section 14(e) and Rule 14e-3 adopted by the Commission under that section, which are discussed above in section 1.2.5.

**2.4.3 Gun-Jumping Issues**

Section 5 of the Securities Act generally prohibits the making of (i) offers by an issuer prior to the time that its registration statement has been filed with the Commission (the making of which is commonly referred to as “gun-jumping”), and (ii) after a registration statement has been filed with the Commission, offers other than pursuant to the prospectus/offer to exchange then filed. Public announcements and shareholder communications relating to an exchange offer are restricted, from the time of first public announcement of the transaction until the registration statement has been declared effective by the Commission, except as permitted by Rules 165 and 425 under the Securities Act, which permit free written and oral communications in the context of an exchange offer before the filing of the bidder’s registration statement, provided that written communications are filed with the Commission on the day first used and contain a legend advising recipients to read the prospectus/offer to exchange when filed. These rules also permit the use of written communications other than in the form of the statutory prospectus/offer to exchange after the filing of the bidder’s registration statement, subject to certain conditions.
3 BUSINESS COMBINATION TRANSACTIONS NOT INVOLVING A TENDER OFFER

There are alternatives to effecting an acquisition by means of a tender offer. Parties may, particularly in the case of a negotiated transaction, elect to combine their businesses via a statutory merger, a corporate amalgamation, a “synthetic merger,” or a “scheme of arrangement” (or other court-approved combination transaction) pursuant to which shareholders of the participating companies vote to approve the transaction. The form of the transaction is generally a function of the legal requirements of the jurisdictions in which the constituent companies are organized, as well as tax, regulatory, and other practical considerations. A business combination transaction involving a vote by shareholders of the participating companies to approve the transaction and the issuance of new securities is subject to the Securities Act if U.S. jurisdictional means are utilized. Hence, any securities issued pursuant to such a transaction must be registered under the Securities Act unless an exemption or exclusion is available. Although the Exchange Act regulates the solicitation of votes of a company’s shareholders, relevant rules adopted by the Commission are applicable only in connection with the solicitation of votes in respect of Registered Securities and do not apply, in any case, with respect to the securities of a foreign private issuer. Business combination transactions that do not constitute tender offers for purposes of U.S. securities laws are not subject to Section 14(d) or Section 14(e) of the Exchange Act or Regulation 14D or Regulation 14E under those sections, which by their terms only apply to tender offers.

For a business combination transaction not comprising a tender offer, the various exemptions and the Regulation S safe harbor may be available as an alternative to Securities Act registration. Rule 802 provides an exemption from

291. The phrase “synthetic merger” generally refers to a transaction or series of related transactions that have substantially the same effects as a statutory merger and may be employed where no statutory merger procedures exist. A synthetic merger could include, for instance, the acquisition by a “successor” company of substantially all of the assets of a “target” company, in exchange for a combination of cash, securities, and/or the assumption of all or a portion of the target company’s liabilities. See, e.g., Equant N.V., Form 6-K (Apr. 25, 2005) (shareholders’ circular, dated April 22, 2005, attached as Exhibit 3 to the Form 6-K).

292. The availability of statutory merger procedures varies from jurisdiction to jurisdiction. In jurisdictions in which a statutory merger procedure applies, applicable law generally permits only entities organized under the laws of such jurisdiction to merge. In other countries, such as the United Kingdom, no such procedure is available, but other procedures, such as a court-mediated scheme of arrangement, are available and there is a statutory procedure available to “squeeze out” minority shareholders subsequent to a tender offer. See Companies Act 2006, c. 46, §§ 979–982 (Eng.).


295. See Exchange Act Rule 3a12-3, 17 C.F.R. § 240.3a12-3 (2015); see also supra note 143 and accompanying text. Pursuant to Exchange Act Rule 13e-3, a going private transaction by a bidder or its affiliate not exempt pursuant to Rule 802 or the Tier I exemption may require the filing with the Commission of Schedule 13E-3 and compliance with the other provisions of Rule 13e-3. Even though foreign private issuers are exempt from the proxy rules, the disclosure documents prepared by foreign private issuers in Rule 13e-3 going-private transactions are subject to filing with, and review by, the Commission. See, e.g., Kerzner Int’l Ltd., Schedule 13E-3 (May 24, 2006).

296. See supra section 2.2.
the registration requirements of the Securities Act with respect to the issuance of securities to shareholders for foreign private issuers with a limited U.S. security holder base. Section 3(a)(10)\textsuperscript{297} of the Securities Act exempts securities issued in connection with a business combination transaction in which the exchange of securities has been approved by a court after a hearing on the fairness of the exchange. In the absence of such an exemption or exclusion, however, any securities issued would have to be registered under the Securities Act.

3.1 Exemptions and Exclusions to the Registration Requirements of the Securities Act

3.1.1 Rule 802

As discussed above, Rule 802 permits the successor in a business combination transaction (or the surviving company in an amalgamation) to offer its shares in exchange for the shares of a non-U.S. target without having to register the shares being offered. Without having to comply with the registration requirement, the bidder avoids the need to prepare and file the detailed disclosure specified in the Form F-4 or Form S-4. Rule 802 may be available if (i) the target or the entity whose securities will be exchanged is a foreign private issuer and is not an investment company registered or required to be registered under the Investment Company Act, other than a closed-end investment company, (ii) U.S. holders hold no more than 10 percent of the target’s securities, and (iii) the bidder permits U.S. holders to participate in the tender offer on terms at least as favorable as those offered to other shareholders, calculated substantially as set forth above in section 1.1.1.\textsuperscript{298}

3.1.2 Schemes of Arrangement—Section 3(a)(10)

In many jurisdictions, acquisitions or business combinations may be effected by schemes of arrangement, or similar statutory arrangements involving both a vote of affected security holders and a court determination regarding the fairness of the transaction. Schemes of arrangement structured to comply with the Securities Act Section 3(a)(10) exemption may provide significant advantages over tender offers because the timing, disclosure, and other requirements of the Exchange Act and registration requirements of the Securities Act will not apply. Schemes of arrangement may afford additional advantages under local law, including, for instance, the ability to structure a transaction to avoid security transfer tax, provide roll-over tax relief, and to eliminate objecting/minority investors as part of the scheme transaction.\textsuperscript{299}


\textsuperscript{298} As described in supra section 1.1.1, certain “look-through” provisions apply in the context of assessing the availability of Rule 802.

\textsuperscript{299} Under the laws of certain jurisdictions, such as the United Kingdom, not only is the approval of a minimum percentage in value of the relevant class of securities required, but the approval of a
Section 3(a)(10) of the Securities Act provides an exemption from the registration requirements of the Securities Act for any security that is issued in exchange for one or more bona fide outstanding securities, claims, or property or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court expressly authorized by law to grant such approval.

The Staff has identified the following conditions that must be satisfied in order for an issuer to be entitled to rely on the exemption provided by Section 3(a)(10):

- the securities must be issued in exchange for securities, claims, or property—they cannot be offered for cash;
- a court or governmental entity authorized by statute (which can be a non-U.S. court or entity) must approve the fairness of the terms and conditions of the exchange to security holders;
- the reviewing court or authorized governmental entity must (i) find, before approving the transaction, that the terms and conditions of the exchange are fair to those to whom securities will be issued and (ii) be advised before the hearing that the issuer will rely on the Section 3(a)(10) exemption based on the court’s or authorized entity’s approval;
- the court or authorized governmental entity must hold a hearing before approving the fairness of the terms and conditions of the transaction;
- a governmental entity must be expressly authorized by law to hold the hearing, although it is not necessary that the law require the hearing;
- the fairness hearing must be open to everyone to whom securities would be issued in the proposed exchange;
- adequate notice of the hearing must be given to all those persons; and
- there cannot be any improper impediments to the appearance by those persons at the hearing.300

majority in number is also required. See Companies Act 2006, c. 46, § 899 (Eng.). If the subject company has an ADS program, the record holder of securities underlying the ADSs (effectively the custodian of the ADS depositary) will typically be treated as a single holder of record. Companies may want to consult with the relevant depositary and their legal counsel to determine whether a means exists, through a temporary custodianship or otherwise, to permit the record or beneficial owners of ADSs to be counted as record holders for the purpose of satisfying the test based on approval by a specified percentage of the number of security holders.

300. See Staff Legal Bulletin No. 3A (CF), U.S. SEC. & EXCH. COMMISSION (June 18, 2008), https://www.sec.gov/interp/legal/cfslb3a.htm; see also supra note 35.
No mandated information disclosure provisions apply, although the anti-fraud requirements of Rule 10b-5 are applicable.

The Section 3(a)(10) exemption has been relied upon in numerous cross-border business combination transactions, including “schemes of arrangement” under section 899 of the United Kingdom Companies Act 2006 and in jurisdictions such as Canada, South Africa, Australia, Bermuda, and Hong Kong\(^{301}\) with similar procedures providing for a court-convened meeting of shareholders, followed by a ruling on the fairness of the transaction. Many transactions conducted under Section 3(a)(10) proceed without “no-action” relief from the Staff; however, the Staff may be consulted and may be willing to issue “no-action” relief in novel circumstances or where it is otherwise uncertain as to whether Section 3(a)(10) is available.

Securities issued pursuant to Section 3(a)(10) are not “restricted securities” within the meaning of Rule 144 and may generally be resold without regard to Rule 144 if the sellers are not affiliates of the issuer of the securities and have not been affiliates within ninety days of the date of the Section 3(a)(10)–exempt transaction.\(^{302}\) If securities are held by affiliates of the issuer, holders may be able to resell the securities in accordance with the provisions of Rule 144.

As discussed above in the context of an exchange offer, in addition to U.S. federal regulation, the blue sky securities laws of the several states of the United States may apply to schemes of arrangement and other transactions structured to comply with Section 3(a)(10).\(^{303}\)

3.2 REGISTRATION UNDER THE SECURITIES ACT FOR BUSINESS COMBINATIONS NOT INVOLVING AN EXCHANGE OFFER

Registration of securities by foreign private issuers to be issued in connection with business combination transactions are effected on Form F-4.\(^{304}\) As in the case of an exchange offer, public announcements and shareholder communications relating to a business combination transaction are restricted, except as permitted by Rules 165 and 425 under the Securities Act. These rules permit written and oral communications before the filing of the bidder’s registration statement and permit the use of written communications other than the statutory prospectus after the filing of the bidder’s registration statement, subject to certain

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303. See supra section 2.4; see also supra notes 17 & 80 and accompanying text; Staff Legal Bulletin No. 3A (CF), U.S. SEC. & EXCH. COMMISSION (June 18, 2008), https://www.sec.gov/interps/legal/cfslb3a.htm.

304. See supra section 2.4.
The potential liability issues discussed above in section 2.4.2 in relation to registered exchange offers apply in the case of a registered business combination transaction.

4 TRANSACTIONS NOT INVOLVING U.S. JURISDICTIONAL MEANS

Notwithstanding the accommodations available under the cross-border tender offer rules, in some instances, bidders making offers for securities of non-U.S. targets that do not constitute Registered Securities decide not to extend their offers to the target’s U.S. security holders for a variety of reasons, including the following:

- reducing the prospect of private litigation in U.S. courts or Commission enforcement proceedings;
- minimizing procedural complexities;
- avoiding conflicts between U.S. and non-U.S. regulatory schemes;
- reducing the length of time the offer must remain open;
- reducing costs;
- avoiding becoming a reporting company;
- avoiding preparing pro forma documents and other financial information; and
- where only a small percentage of the target’s shareholders are U.S. security holders or are otherwise not necessary to complete the transaction.

To exclude offers from the reach of U.S. tender offer rules, bidders have structured offshore transactions to avoid the use of U.S. jurisdictional means. Although this approach has been challenged in U.S. courts, and the Commission has expressed a restrictive view as to the circumstances in which “exclusionary offers” are justified, U.S. courts have generally taken the view that tender offers made outside the United States are not subject to the procedural or registration...
requirements of U.S. securities laws\textsuperscript{308} and the Commission has “recognized that bidders who are not U.S. persons may structure a tender offer to avoid the use of the means or instrumentalities of interstate commerce or any facility of a U.S. securities exchange in making its offer and thus avoid triggering application of our rules.”\textsuperscript{309} The anti-fraud provisions of the U.S. securities laws may, however, apply to misstatements or omissions affecting U.S. purchasers or sellers.\textsuperscript{310}

To avoid the use of U.S. jurisdictional means, an offer may not be made, directly or indirectly, in the United States. To reduce the chance that the offer could be deemed to have been made in the United States indirectly, procedures are implemented to avoid the use of U.S. jurisdictional means (including telephone, fax, and internet to, in, or from the United States) by the bidder or any other participant in the transaction. Such procedures may include, among others, placing legends on offer documents, prohibiting the distribution of offer documents into the United States, and placing restrictions on publicity and communications regarding the offer in the United States (including submissions or filings required to be made by the bidder pursuant to any extant Exchange Act reporting obligations it may have).

No statutory or administrative “safe harbor” exists to avoid U.S. jurisdiction. There can be no assurance, therefore, that compliance with the procedures de-

\textsuperscript{308} See, e.g., Exchange Act § 30(b), 15 U.S.C. § 78dd (2012) (“The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title.”). It should be noted that the Commission has never adopted any rules to implement Section 30(b).


\textsuperscript{310} See Plessey Co. plc v. Gen. Elec. Co. plc, 628 F. Supp. 477 (D. Del. 1986) (where an exclusionary offer for a target with only a small U.S. float in the form of ADRs listed on U.S. securities exchange was deemed not subject to the procedural, disclosure, or substantive requirements of U.S. tender offer rules); John Labatt Ltd. v. Onex Corp. LBT, 890 F. Supp. 235, 245 (S.D.N.Y. 1995) (where the court found no tender offer was present due to the efficacy of the exclusionary measures implemented by the bidder); see also Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1975), abrogated by Morrison v. Nat’l Australia Bank Ltd., 561 U.S. 247 (2010); Schoenbaum v. Firstbrook, 405 F.2d 200, 206–08 (2d Cir. 1968). However, private suits asserting a claim under the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder would be subject to the jurisdictional limits of the statute defined by the U.S. Supreme Court in [Morrison v. National Australia Bank Ltd., 561 U.S. 247 (2010)]. In addition, at least one commentator has contended that, although Morrison focused solely on claims brought under Section 10(b), its holding restricting the extraterritorial reach of Section 10(b) is equally applicable to other claims brought under the Exchange Act, including Section 14(e). See Vladislava Soshkina, Beyond Morrison: The Effect of the “Presumption Against Extraterritoriality” and the Transactional Test on Foreign Tender Offers, 54 WM. & MARY L. REV. 263, 281 (2012). At the same time, the test adopted in Morrison to determine whether conduct falls within or without the jurisdictional reach of Section 10(b) was driven by the Court’s interpretation of Congress’s intended scope for Section 10(b) based on the statute’s specific language. That test has no application to the statutory language of Sections 14(d) or (e) or any other distinct provisions of the Securities Act or Exchange Act and it remains to be seen what tests the courts will craft to apply the teaching of Morrison to the extraterritorial limits of the securities laws. Furthermore, any extraterritorial limits that might apply to private suits under Section 14(e) would not preclude claims by the Commission or the U.S. Department of Justice under the Exchange Act’s anti-fraud provisions, which would be subject to the “conduct” and “effects” jurisdictional test codified by the Dodd-Frank Act. See supra note 5.
scribed in this article or other procedures would preclude either a judicial finding that the U.S. federal securities laws apply to an offer or the imposition of a judicial remedy, such as an injunction against the offer, for failure to comply with such laws. Moreover, in many cross-border offer situations, particularly where the number of U.S. holders of the target’s securities is relatively significant, the Commission has encouraged by informal means the bidder to extend its offer into the United States. While the Commission has supported exclusionary offers in the past, in the 1990 Concept Release, the Commission took the position, notwithstanding the views of the Delaware court in *Plessey Co. plc v. General Electric Co. plc* that “U.S. jurisdictional means” exist whenever it is reasonably foreseeable that excluded U.S. security holders of a foreign issuer will sell their securities into the secondary market in response to that offer. The Staff appears to be less willing to accept jurisdictional arguments in support of the exclusion of U.S. holders since the adoption of the cross-border amendments. The Commission will view with skepticism a purported exclusionary offer for Registered Securities. The Commission has further suggested that “a legend or disclaimer stating that the offer is not being made into the United States, or that the offer materials may not be distributed there, is not likely to be sufficient in itself to avoid U.S jurisdiction because, if the bidder wants to support a claim that the offer has no jurisdictional connection to the United States, it also will need to take special precautions to prevent sales or tenders from U.S. target holders,” and noted that in the future it would more closely monitor exclusionary offers.

Summarized below are the procedures customarily followed in European tender offers in which the offer is not extended in the United States. These procedures are based on U.S. court decisions and observations of the Commission and take into account past practice in other similar offer situations.
• The offer documents, forms of acceptance, other shareholder communications, press releases, and offer-related materials may not be made available to U.S. security holders (or their brokers, nominees, or other intermediaries); all offer-related materials must include legends stating that the materials do not constitute an extension of the offer into the United States; that no money, securities, or other consideration is being solicited from U.S. residents and, if sent, will not be accepted; and if the bidder subsequently determines to extend the tender offer into the United States, the procedural and filing requirements of the Commission will be satisfied at such time. No means to tender securities (or forms that could be returned to indicate interest in participating in the tender offer) may be provided as part of any press materials or on any website.

• Appropriate legends, click-through certifications, or other filtering procedures must be incorporated on the bidder’s website (and any other relevant website) to ring-fence offer-related materials from U.S. holders.320

• The bidder and its advisers and agents (including the institution(s)) receiving acceptances, brokers, nominees, depositaries, and other intermediaries must be instructed not to, and must ensure that they do not, accept under any circumstances the delivery of any written communication relating to the offer (including a form of acceptance) that is postmarked in, bears a return address from, or otherwise appears to have been dispatched from the United States.

• No cash, and in the case of an exchange offer no new securities, should be issued to holders in the United States.321

• The bidder and its advisers and agents should avoid any physical distribution of the offer documentation to persons resident or otherwise in the United States, including to the target’s shareholders with registered addresses in the United States. Efforts must be made to prohibit the forwarding of offer documents, shareholder communications, press releases, and offer-related materials by brokers, nominees, depositaries, and other intermediaries to U.S. holders or the acceptance by such persons of the offer on behalf of U.S. holders.

• The bidder and its advisers and agents should establish procedures to identify whether security holders are resident or otherwise in the United

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320. But see Third Supplement, supra note 135 (Q II.F.1) (stating that “a company using Regulation S to allow participation in a business combination offshore (but not a tender or exchange offer) may put the proxy statement/prospectus on an unrestricted web site”).

321. U.S. holders should generally be barred from voting in an exclusionary offer requiring the approval of security holders (the vote may be deemed to constitute an investment decision), though they may be permitted to receive securities if the transaction is approved and is effected by operation of law. See Securities Act Rule 145, 17 C.F.R. § 230.145 (2015); supra note 15.
States and to handle telephone, e-mail, and other inquiries from such persons. Generally, if an inquiry is made by a U.S. resident, or a security holder or intermediary that intends to disseminate information concerning the offer in the United States, the inquirer should be informed that the offer is not being made in the United States or by any U.S. jurisdictional means, and that no information concerning the offer may be so conveyed to or by the inquirer.

- In certain circumstances, bidders may require a representation or certification from tendering holders that they are not U.S. holders.

- Publicity concerning the offer should be conducted in a manner to minimize contact with U.S. electronic and print media and U.S.-based financial analysts, both preceding and during the term of the offer. No press or analyst conferences, meetings, or telephone calls to discuss the offer should be held in the United States at any time during the offer. Ordinary course communications may continue in accordance with prior practice.

- Representatives of the U.S. media may be invited to briefings outside the United States regarding the offer in accordance with Rule 14d-1(e) if (i) access is provided to both U.S. and non-U.S. journalists and (ii) any offer documentation, press releases, or any other related materials provided by the bidder or its advisers and agents to such journalists contains a legend to the effect that the materials do not constitute an extension of a tender offer in the United States for a class of equity securities of the target company, although in many cases bidders determine not to provide such access to U.S. journalists on the basis that access may undermine its argument that it has avoided U.S. jurisdictional means.

These procedures have been implemented in many European offers, where the target is not listed on a U.S. securities exchange, is not a reporting company, the percentage of the target’s securities in the hands of U.S. holders is small, and the bidder does not need to acquire U.S. holders’ securities to meet the minimum acceptance condition or effect a mandatory squeeze-out threshold.}

322. In the case of an exchange offer, Rule 135e under the Securities Act, 17 C.F.R. § 230.135e (2015), provides an exemption from Section 5 of the Securities Act for certain offshore press conferences and the offshore release of press-related materials, including to members of the U.S. press. There is an analogous safe harbor exemption in Regulation 14D, which appears to be available for exclusionary offers. However, in the authors’ experience, most bidders conducting an exclusionary offer determine to prohibit U.S. journalists from attending offshore press conferences. See Exchange Act Rule 14d-1(e), 17 C.F.R. § 240.14d-1(e) (2015).

Compliance with such procedures may be difficult or impossible however. Certain factors may increase the risk of courts or the Commission challenging a bidder’s assertion that its exclusionary offer was appropriate or effectively conducted. In the authors’ experience, these factors include, in addition to the target’s nexus to the United States and the relevance of U.S. holders’ securities to the success of the bidder’s offer, the following:

- Whether under applicable local law, a bidder is permitted to conduct an exclusionary offer (if local law requires that the bidder’s offer is made to all holders, it may be difficult to argue that an offer that purports to exclude U.S. holders is effective).

- The existence and size of the target’s ADR program, and whether the program is sponsored or unsponsored.

- The proportion of trading in the target’s securities that occurs in the United States, on a U.S. securities exchange, over the counter, or off-market.

- Whether, as a matter of local law, offer documents, forms of acceptance, other shareholder communications, press releases, and offer-related materials will be posted on an unrestricted website accessible to U.S. holders.

- The means by which any pre-offer stake-building was conducted, particularly if target securities were acquired in the United States or from U.S. holders.

- The premium implied by the bidder’s offer and the size and liquidity of the trading markets for the target’s securities (and U.S. holders’ access to such markets), which may affect the extent to which U.S. holders are prejudiced by being excluded from the bidder’s offer.

From a business perspective, it may be difficult or impossible for a U.S. bidder to comply with the restrictions on U.S. press and analyst contact. In U.S.-excluded offers where the U.S. holdings of the target’s securities are quite small, this business and legal dilemma has been resolved by the bidder preparing a short descriptive U.S. press release and/or by the bidder filing a brief descriptive statement with the Commission in a periodic report, providing a copy to the NYSE, if applicable, and refusing all further comment in the United States during the term of the offer.\(^{324}\) Such press releases or Commission filings or submissions would typically be prepared in consultation with the bidder’s U.S. legal counsel.\(^{325}\)

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324. See supra note 237.

325. In addition to not directing the offer into the United States or to U.S. residents, bidders may also want to consider avoiding the use of any U.S. jurisdictional means in connection with the planning or implementation of the offer, in order to minimize the risk of the application of U.S. anti-fraud provisions. See Bersch v. Drexel Firestone, Inc., 519 F.2d 992–93 (2d Cir. 1975).
5 Certain Related Matters

5.1 Exchange Act Registration

A bidder in an exchange offer or the surviving entity in a business combination transaction may decide to list its securities on a U.S. securities exchange at the time that the bidder makes its offer to ensure that a liquid U.S. trading market develops for its securities upon completion of the transaction and thereby potentially increase the attractiveness of the transaction to security holders. To list on a U.S. securities exchange, the bidder’s securities must be registered under Section 12(b) of the Exchange Act and the requisite listing formalities must be completed before such securities are eligible to be listed. A bidder in an exchange offer also may become subject to the reporting obligations under the Exchange Act by reason of its securities being held by more than a specified number of persons (Section 12(g) of the Exchange Act), as a result of registering securities issued as consideration under the Securities Act (Section 15(d) of the Exchange Act), or via succession (Rule 12g-3 under the Exchange Act).

A foreign private issuer must register a class of equity securities under Section 12(g) of the Exchange Act within 120 days after the last day of the fiscal year in which the foreign private issuer has assets in excess of $10 million and the class is held of record by either (i) 2,000 persons or (ii) 500 persons who are not “accredited investors” (and, in both cases, held by 300 or more persons resident in the United States), subject to look-through procedures similar to those discussed above in section 1.1.1.

Registration under Section 12 of the Exchange Act will subject the registrant not only to the periodic reporting obligations under the Exchange Act pursuant to Section 13(a) of that Act, but also to applicable provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act to the extent that such provisions are not already applicable.

326. Other potential benefits of a U.S. listing could include enhanced liquidity, broader research coverage, and a currency for U.S. acquisitions.
332. See Exchange Act § 12(g)(1), 15 U.S.C. § 78(g)(1); Exchange Act Rule 12g3-2(a), 17 C.F.R. § 240.12g3-2(a).
333. The definition of “held of record” is set forth in Rule 12g5-1 under the Exchange Act. However, pursuant to Rule 12g3-2(a), there is an obligation to “look through” securities held of record by a broker, dealer, bank, or nominee for beneficial owners resident in the United States. Note that the Commission has proposed amendments to Rule 12g5-1 that would exclude persons that received securities pursuant to an employee compensation plan in transactions exempt from registration under the Securities Act. See Section 12(g) Proposing Release, supra note 331, 2014 WL 7533958, at *3.
In certain circumstances, as discussed in section 5.2 below, a bidder or surviving entity may be deemed to “succeed” to the Exchange Act registration of the target or predecessor entity. Where succession does not occur, registration under the Exchange Act in connection with a listing on a U.S. securities exchange is effected by the bidder or surviving entity filing a relatively simple Form 8-A with the Commission during the Securities Act registration process. For securities in connection with an exchange offer or a business combination transaction conducted pursuant to an exemption from Securities Act registration by a foreign private issuer not already subject to Section 13 or 15(d) reporting obligations, registration under the Exchange Act would be effected by filing with the Commission a registration statement on Form 20-F (or Form 40-F in the case of a Canadian issuer).

A bidder or surviving entity that initially determines that it is not required to register its securities under the Exchange Act and is not otherwise subject to an Exchange Act reporting obligation under Section 15(d) of the Exchange Act may nevertheless become obligated to register its securities under the Exchange Act. Registration would be required (i) in connection with a subsequent listing of its securities on a U.S. securities exchange or (ii) upon its equity securities being held by more than the requisite number of U.S. residents if it is unable to rely upon the exemption from registration provided by Rule 12g3-2(b).

5.1.1 Rule 12g3-2(b)

Rule 12g3-2(b) under the Exchange Act provides an exemption to foreign private issuers from the “held of record” registration requirements under Section 12(g) the Exchange Act, even if the foreign private issuer’s equity securities are traded on the over-the-counter market in the United States. The exemption is automatically available for a class of securities issued by a foreign private issuer under Rule 12g3-2(b) if:

- the foreign private issuer is not required to file or furnish reports under Section 13(a) or Section 15(d) of the Exchange Act;
- the foreign private issuer maintains a listing of the relevant securities on at least one non-U.S. securities exchange, which, individually or in combination with the trading of the same securities in another foreign jurisdiction, constitutes the “primary trading market for those securities”; and

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336. See supra note 232.
337. See Exemption from Registration Under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers, SEC Release No. 34-58465, 2008 WL 4108124 (Sept. 5, 2008) [hereinafter Rule 12g3-2(b) Release] (amending Rule 12g3-2(b), inter alia, to eliminate the written application and paper submission requirements under Rule 12g3-2(b) by automatically exempting from Exchange Act Section 12(g) a foreign private issuer that meets specified conditions).
• the foreign private issuer has published, in English, on its website or through an electronic information delivery system, information material to an investment decision that it (i) has made public or been required to make public, (ii) has filed or has been required to file with the stock exchange on which its securities are listed (and has been made public by the exchange), or (iii) has distributed or been required to distribute to its security holders (including, whether or not material, its annual and any interim reports, along with financials, press releases and any communications distributed directly to security holders) since the beginning of its fiscal year.

To constitute a “primary trading market,” at least 55 percent of the ADTV of the relevant class of securities must take place on or through the facilities of a securities exchange in no more than two non-U.S. jurisdictions in the most recently completed fiscal year. 338

The exemption remains in effect until the issuer (i) no longer maintains a listing of the class of securities on at least one non-U.S. securities exchange that constitutes a primary trading market, (ii) fails to publish electronically the specified information, (iii) registers the class of securities under Section 12 of the Exchange Act, or (iv) incurs a reporting obligation under Section 15(d) of the Exchange Act.

5.2 Succession

Pursuant to Rule 12g-3 under the Exchange Act, if in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets, or similar transaction, securities of an entity not already registered under Section 12(b) or 12(g) of the Exchange Act are issued to holders of securities of an entity that was registered under the Exchange Act, then, upon consummation of the transaction, the securities issued by the bidder or surviving entity will generally be deemed registered under the Exchange Act. In addition, pursuant to Rule 15d-5 under the Exchange Act,339 if in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets, or similar transaction, securities of an entity not required to file reports under Section 15(d) of the Exchange Act are issued to holders of an entity that was required to file reports under Section 15(d) of the Exchange Act, then the duty to file such reports shall be assumed by the bidder or the surviving entity.

For purposes of Rule 12g-3 and Rule 15d-5, “succession” occurs only in connection with a direct acquisition of the assets comprising a going business. 340 Succession is not triggered merely by gaining control of a company, unless such control is accompanied by the direct acquisition of assets. 341 Succession is potentially applicable to a business combination transaction effected by way of a tender
offer (if the tender offer comprises the acquisition of assets of the target as a going business), statutory merger, corporate amalgamation, transfer of assets, or court-approved merger, such as a scheme of arrangement.\(^{342}\) We refer to a bidder or surviving entity that has succeeded to the Exchange Act registration or reporting obligations via the operation of Rule 12g-3 as a “successor.”

Succession for purposes of Rule 12g-3 will not occur if (i) upon consummation of the business combination transaction, the bidder or surviving entity has fewer than 300 record holders of its securities or, in the case of a foreign private issuer bidder, fewer than 300 holders resident in the United States,\(^{343}\) or (ii) the class of securities issued by the bidder or surviving entity is exempt from registration pursuant to Rule 12g3-2.\(^{344}\)

The principal benefit of succession, particularly in the context of a corporate reorganization, is that a bidder or the surviving entity need not file an Exchange Act registration statement with the Commission in order to effect registration under the Exchange Act of its securities (which it might be obliged to do if its securities are widely held or if it seeks to list or maintain a listing on a U.S. securities exchange). Another benefit of succession is that it facilitates the continuous listing of the target shareholders’ securities in the United States without requiring the bidder to coordinate the filing and declaration of effectiveness of a new Exchange Act registration statement.\(^{345}\) Succession may also permit a bidder to take advantage of certain short-form registration statements\(^{346}\) available to certain issuers in

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\(^{342}\) In the authors’ experience, participants in a business combination transaction effected as a tender offer may conclude that the requisite acquisition of assets occurs upon completion of a second-step, squeeze-out transaction, if contemplated.

\(^{343}\) See Exchange Act Rule 12g-3(b)(2), 17 C.F.R. § 240.12g-3(b)(2) (2015). Pursuant to rules proposed by the Commission, the threshold would be increased to 1,200 for certain U.S. banks, savings and loan holding companies, and bank holding companies. See Section 12(g) Proposing Release, supra note 331, 2014 WL 7533998, at *4. As of the date of this article final rules have not been adopted by the Commission.

\(^{344}\) See Exchange Act Rule 12g3-2(a), 17 C.F.R. § 240.12g3-2(a) (2015). Prior to September 2008, a successor issuer could not rely on the Rule 12g3-2(b) exemption. See also Rule 12g3-2(b) Release, supra note 337, 2008 WL 4108124, at *16.

\(^{345}\) Securities may not be traded on the NYSE or NASDAQ until a company’s Exchange Act registration statement has been declared effective. Effectiveness of a bidder’s Exchange Act registration statement, in the case of a simultaneous Securities Act registration, will occur in coordination with a declaration of the effectiveness of the Securities Act registration statement pursuant to Exchange Act Rule 12d1-2.

connection with capital raising under the Securities Act, notwithstanding its re-
cent incorporation and/or recently incurred obligation to file reports under the 
Exchange Act, and may facilitate re-sales of its securities under Rule 144.347 
The Staff has permitted the use of a predecessor company’s Exchange Act report-
ing history when determining a successor’s compliance with the current public 
information requirements of Securities Act Rule 144(c)(1) and trading volume 
limitations under Rule 144(e).348

Succession may, however, have unintended consequences for a bidder or 
surviving entity, particularly where it was not previously subject to periodic re-
porting under the Exchange Act. Where succession operates, the successor be-
comes subject to the predecessor entity’s periodic reporting and other obliga-
tions under the Exchange Act, notwithstanding the fact that it may never have 
accessed U.S. capital markets and/or sought to list its securities on a U.S. secu-
rities exchange. A successor will also become liable for filings made by the pre-
decessor entity and will be obliged to make or correct filings that were not made 
or were made and are required to be amended.349 If succession has occurred, as 
discussed in section 5.3, the successor may seek to terminate its registration or 
reporting obligations pursuant to Exchange Act Rule 12h-6(d).350

Foreign private issuers provide notice of succession by submitting a Form 6-K 
to the Commission.351 Were the bidder or surviving entity to desire a new listing 
of securities on a U.S. securities exchange subsequent to succession, it would do 
so by completing the requisite listing application and filing a short form Ex-
change Act registration statement with the Commission on Form 8-A.352

Parties’ specific filing and other obligations in the context of succession will 
depend on many factors, including the nature of the relevant business combina-
tion transaction, the Exchange Act reporting status of the parties to the transac-
tion, the intended timing, if any, of the listing of the bidder’s or surviving entity’s 
securities, the total number of shareholders of the parties (and the number of

exemption from the registration requirements of the Securities Act for the sale of restricted securities 
and the sale of “control securities” by or for the account of affiliates of an issuer.

WL 6665444; see also UBS AG—Holding Company Reorganization, SEC No-Action Letter, 2014 WL 
5336762 (Sept. 29, 2014).

349. See Keir D. Gumbs, Understanding Succession Under the Federal Securities Laws, INSIGHTS, Apr. 2005, 
at 17.


351. Notwithstanding Exchange Act Rule 12g-3(f), the Staff has permitted foreign private issuers 
to provide notification of succession under Rule 12g-3 on Form 6-K rather than Form 8-K. See UBS 
AG and UBS Group AG, SEC No-Action Letter, 2014 WL 4980286 (Oct. 1, 2014); Hungarian Tele-
phone and Cable Corp. and Invitel Holdings A/S, SEC No-Action Letter, 2009 WL 914355 (Feb. 27, 
2009); Coca-Cola Hellenic letter, supra note 129, 2013 WL 1177933; Reuters Group PLC Thomson 
Reuters PLC, SEC No-Action Letter, 2008 WL 756687 (Mar. 20, 2008); Royal Dutch Petroleum Com-
guidance, the predecessor entity must publish notice of the succession by filing a certificate of termi-
nation of its registration with the Commission on Form 15. See Exchange Act Compliance and Disclo-
guidance/exchangeactrules-interps.htm.

352. See supra note 334.
shareholders resident in the United States) at the time of succession, and the total number of shareholders of the target or predecessor entity resident in the United States at the target’s financial year end.

A bidder or surviving entity that is deemed to have registered a class of securities under Section 12 of the Exchange Act or incurs a reporting obligation under Section 15(d) of the Exchange Act, in each case by succession, will become subject to the periodic reporting obligations under the Exchange Act, as well as to applicable provisions of the Sarbanes-Oxley Act\(^{353}\) and the Dodd-Frank Act.

### 5.3 DEREGISTRATION/Termination of Reporting Obligations

A bidder or surviving entity in a business combination transaction that (i) has succeeded to another entity’s Section 12(b) or Section 12(g) Exchange Act registration or (ii) has previously registered a class of securities under the Exchange Act in connection with the listing of such securities (for instance, in the context of an exchange offer involving equity securities registered under the Securities Act), will continue to be subject to the periodic reporting requirements and other provisions of the Exchange Act until such registration is terminated.\(^{354}\)

A bidder or surviving entity that has filed a registration statement to register securities with the Commission under the Securities Act (including, in particular, in connection with an exchange offer), or has succeeded to another party’s Section 15(d) Exchange Act reporting obligations pursuant to Rule 15d-5, will have an active reporting obligation under Section 15(d) of the Exchange Act,\(^{355}\) unless (in the case of a U.S. domestic issuer) such obligation is suspended or (in the case of a foreign private issuer) the obligation is suspended or terminated.

**Delisting.** If a class of securities of a bidder or surviving entity is listed on a U.S. securities exchange, the bidder or surviving entity may seek to terminate its registration under Section 12(b) of the Exchange Act by delisting its securities from the exchange.\(^{356}\) Delisting and termination would be effected by the relevant exchange filing with the Commission a notification of removal from listing and reg-

\(^{353}\) See infra section 5.5. The Staff has considered, and granted relief in connection with, a number of other issues in transactions involving succession, including (i) the ability of the successor to file post-effective amendments to the predecessor’s registration statements pursuant to Securities Act Rule 414, 17 C.F.R. § 230.414 (2015), (ii) the ability of the successor to take into account the reporting history of the predecessor in determining the eligibility of the successor to use Forms F-3, F-4, S-3, S-4, and S-8 under the Securities Act and in determining whether the successor meets the “current public information” requirements of Securities Act Rule 14a(c), and (iii) the obligation of beneficial owners that have filed ownership reports on Schedules 13D or 13G to file additional or amended Schedules 13D or 13G as a result of the reorganization. See, e.g., Gastar Exploration, Inc. and Gastar Exploration USA, Inc., SEC No-Action Letter, 2013 WL 6235096 (Nov. 26, 2013).

\(^{354}\) See Exchange Act Rules 12d2-2(d) & 12g-4(b), 17 C.F.R. §§ 240.12d2-2(d), 240.12g-4(b) (2015).


istra tion on Form 25. An application to withdraw from listing on a U.S. securities exchange on Form 25 will become effective ten days after the form is filed with the Commission. An application to withdraw registration of a class of securities under Section 12(b) will become effective within ninety days after the form is filed. A foreign private issuer must satisfy and certify in its Form 25 that:

- it is in compliance with all applicable laws in effect in the state in which it is incorporated and with the applicable U.S. securities exchange’s rules governing an issuer’s voluntary withdrawal of a class of securities from listing and/or registration;

- it has provided written notice to the Commission of its determination to withdraw the class of securities from listing on such exchange; and

- it has simultaneously published via a press release (and, if it has a publicly accessible website, on that website) notice of such intention, along with its reasons for such withdrawal.

Once the applicable U.S. securities exchange receives written notice of the foreign private issuer’s intention to delist, the exchange must provide notice on its website of the foreign private issuer’s intention by the next business day. Such notice must remain posted on the exchange’s website until the delisting on Form 25 is effective. Deregistration under Section 12(b) of the Exchange Act will not, however, result in the termination of the bidder’s or surviving entity’s obligations to file reports under Section 13(a) (if Section 12(g) applies) or 15(d) of the Exchange Act.

Exchange Act Rule 12h-6. A foreign private issuer whose securities are not registered under Section 12(b) of the Exchange Act may terminate both the registration of a class of equity securities registered pursuant to Section 12(g) of the Exchange Act and its Section 15(d) reporting obligations, by filing a Form 15F with the Commission pursuant to Exchange Act Rule 12h-6.

A foreign private issuer may deregister a class of equity securities under Section 12(g) and terminate its obligations under Section 15(d) by certifying to the Commission on a Form 15F:

- that it (taking into account the predecessor entity) was subject to the reporting obligations under Section 13(a) or Section 15(d) of the Exchange Act for at least the twelve months preceding the filing of the Form 15F, has filed or furnished all reports required for the period, and has filed at least one annual report pursuant to Section 13(a) of the Exchange Act;

358. See supra note 357.
359. Prior to amendments to the Commission’s rules, which took effect in June 2007, the obligation to file reports could only be suspended, but not terminated. See Termination of a Private Issuer’s Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, SEC Release No. 34-55540, 2007 WL 907996 (Mar. 27, 2007).
its securities have not been sold in the United States in a registered offering under the Securities Act during the twelve months preceding the filing of the Form 15F, subject to certain exceptions; and

it has maintained a listing of the subject class of securities for at least the twelve months preceding the filing of the Form 15F on one or more exchanges outside of the United States that, either singly or together with the trading of the same class of the issuer’s securities in another foreign jurisdiction, constitute the “primary trading market” for those securities and either:

- the foreign private issuer’s U.S. ADTV over a recent twelve-month period has been 5 percent or less of the ADTV of that class of securities on a worldwide basis for the same period; or

- on a date within 120 days before the filing date of the Form 15F, the foreign private issuer’s securities were held by no more than 300 shareholders worldwide or no more than 300 persons resident in the United States.

The counting method used for determining the number of U.S. holders is substantially similar to the counting method that the Commission adopted for assessing the availability of the Tier I and Tier II exemptions.

The deregistration provisions of Rule 12h-6 are, however, unavailable to a foreign private issuer for one year after it has (i) had its class of equity securities delisted from a U.S. securities exchange or (ii) terminated a sponsored ADR program, unless it had 5 percent or less of its ADTV in the United States at the time of delisting or termination.

In most cases, all reporting obligations are suspended immediately upon the filing of Form 15F, pending the ninety days permitted for the Commission to approve deregistration. If the Commission does not object to the filing of the Form 15F within ninety days (or such shorter period as it may determine), the bidder or surviving entity’s (1) termination of the registration of securities under Section 12(g) shall become effective and (ii) termination of its duty to file reports under Section 15(d) shall be effective.

Rule 12h-6(d) provides that following a merger, consolidation, exchange of securities, acquisition of assets or otherwise, a foreign private issuer that has succeeded to the registration of a class of equity securities under Exchange Act Section 12(g) pursuant to Rule 12g-3, or to the reporting obligations of another issuer under Exchange Act Section 15(d) pursuant to Rule 15d-5, may file a Form 15F to terminate those reporting obligations if the successor issuer meets the conditions

360. See supra note 60.
361. See supra note 47.
362. If the Form 15F is subsequently withdrawn or denied, the foreign private issuer must, within sixty days after the date of the withdrawal or denial, file with or submit to the Commission all reports that would have been required had the issuer not filed the Form 15F. See Exchange Act Rule 12h-6, 17 C.F.R. § 240.12h-6 (2015).
under Rule 12h-6(a). When determining whether it meets the prior reporting condition under Rule 12h-6, a successor issuer may take into account the reporting history of the issuer whose reporting obligations it has assumed pursuant to Rule 12g-3 or 15d-5. This enables a foreign private issuer that is not a reporting company and that acquires a foreign private issuer that is a reporting company in a transaction that does not involve the registration of securities under the Securities Act (for instance, in reliance on Rule 802 or Section 3(a)(10)) to terminate its successor Exchange Act reporting obligations under Rule 12h-6 immediately (as long as the successor issuer meets the rule's foreign listing, dormancy and quantitative conditions, and the acquired company's reporting history fulfills Rule 12h-6's prior reporting condition).

*Exchange Act Rules 12g-4 and 12h-3.* A foreign private issuer whose securities are not registered under Section 12(b) of the Exchange Act may also terminate its registration under Section 12(g) of the Exchange Act pursuant to Rule 12g-4 and suspend (but not terminate) its reporting obligations under Section 15(d) pursuant to Rule 12h-3 by filing a Form 15 with the Commission. Deregistration pursuant to Rule 12h-6, however, will generally offer advantages to an issuer that are not available under Rules 12g-4 and 12h-3, and consequently, in the authors’ experience, most foreign private issuers now rely on Rule 12h-6 to effect deregistration. A detailed discussion about deregistration under Exchange Act Rules 12g-4 and 12h-3 is beyond the scope of this article.

Foreign private issuers that deregister a class of securities pursuant to Rule 12h-6 may immediately be eligible for the exemption from registration under Rule 12g3-2(b), subject to meeting the conditions of that rule.363 Deregistration may implicate the going-private rules set forth in Rule 13e-3, although as discussed above, there are certain accommodations (outside the scope of this article) provided in the case of Tier I transactions.

5.4 REPORTING OF BENEFICIAL OWNERSHIP

Section 13(d) of the Exchange Act provides that entities that alone or in concert with other entities acquire, directly or indirectly, the beneficial ownership of more than 5 percent of a class of Registered Securities must file a beneficial ownership report with the Commission.364 “Beneficial ownership” exists where a person has or shares the power to vote or dispose of a security, either directly or indirectly through a contract, arrangement, relationship, understanding, or otherwise, whether formal or informal.365 More than one person may be deemed to be the beneficial owner of the same security.366 Beneficial ownership also exists and must be reported where a person has the right to acquire securities

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363. See supra section 5.1.1.
366. Pursuant to Rule 13d-3, a beneficial owner of a security includes any person who, directly or indirectly, has or shares voting power or investment power with respect to a security. If two or more persons share voting power or investment power over the same security, they may each be deemed a beneficial owner for purposes of Rule 13d-3.
if the right is exercisable within sixty calendar days or the right was acquired with the purpose or effect of changing or influencing control of the issuer.367 For instance, parties to an irrevocable undertaking granted in connection with a tender offer may have a Section 13(d) reporting obligation in respect of the shares that are the subject of such undertaking if such shares are Registered Securities. The reporting obligation applies regardless of whether the target or the bidder (or both) are non-U.S. entities and/or whether the interest in the securities was acquired in the United States or abroad.

If a bidder acquires more than 5 percent of the target company’s Registered Securities, it must file a beneficial ownership report on Schedule 13D.368 Schedule 13D requires, among other things, a description of the identity of the bidder, including directors, officers, and controlling persons, the purpose of the transaction and plans that the bidder may have for the target or for accumulating additional target shares, the source and amount of funds used to acquire the securities, the percentage of the target’s share capital acquired, details about transactions in the target’s securities in the preceding sixty calendar days, and the nature of any arrangements to which the bidder is a party relating to the target’s securities.369 An initial filing on Schedule 13D must be made within ten calendar days of the acquisition; amendments must be made promptly—in the authors’ experience, generally interpreted by the Staff to mean within one or two days after the date on which the transaction to which the filing relates has occurred.370 Failure to comply with the Section 13(d) disclosure requirements may result in litigation or enforcement actions and could delay the consummation of a transaction.

5.5 CORPORATE GOVERNANCE ISSUES

Under the Sarbanes-Oxley Act, a bidder that has filed a registration statement under the Securities Act with the Commission or has an obligation to file reports under Section 13(a) or Section 15(d) of the Exchange Act (or has securities registered under Section 12 of the Exchange Act) will be subject to certain corporate governance and other requirements. A foreign private issuer bidder that becomes subject to the Sarbanes-Oxley Act must comply with certain requirements, including the following371:

368. Exchange Act Schedule 13D, 17 C.F.R. § 240.13d-101 (2015). See Schedule TO, Instruction H, supra note 201, which provides that the final amendment to a bidder’s Schedule TO will satisfy the reporting requirements of Section 13(d) of the Exchange Act with respect to all securities acquired by the bidder in the tender offer.
370. It should be noted that although Section 13(d) relates to an “equity security,” under Rule 13d-1, the term does not include securities of a class of non-voting securities. Care must be taken, however, insofar as a security referred to as “non-voting” may still be considered a voting security if it has the right to vote in certain special circumstances under home country law. See Exchange Act Rule 13d-1(i), 17 C.F.R. § 240.13d-1(i) (2015).
371. A foreign private issuer listed on the NYSE or on NASDAQ will have to comply with additional corporate governance requirements; certain accommodations may be available to foreign private issuers, however. See, e.g., NYSE COMPANY MANUAL § 303A.00 (2015); NASDAQ MARKETPLACE r. 4350(a)(1) (2015). A description of such requirements is beyond the scope of this article.
• a bidder whose securities are listed on a U.S. securities exchange will be subject to certain requirements applicable to its audit committee, including that (i) its audit committee members be independent, properly funded, and vested with authority to engage independent legal counsel;372 (ii) its audit committee establish certain whistleblower procedures to deal with complaints and concerns relating to auditing matters (and a prohibition on the termination or harassment of whistleblowers);373 (iii) its audit committee pre-approve services provided by the company’s auditors, subject to certain de minimis exceptions;374 (iv) its directors and officers not exert improper influence in relation to the audit process;375 (v) its auditors are restricted from providing certain services;376 (vi) its lead, reviewing, and concurring audit partners must rotate periodically;377 and (vii) the audit committee must disclose whether it has an “audit committee financial expert”;

• the bidder must disclose whether it has adopted a “code of ethics” for its principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions, and, if it has adopted such a code, the bidder must make such code available on its website and must disclose changes and waivers to the code;379

• the bidder’s chief executive officer and chief financial officer must certify the bidder’s compliance with the Exchange Act and the fair presentation of the bidder’s financial condition and results of operations in annual and periodic reports that contain financial statements;380

• the bidder must establish and maintain, and its principal executive and principal financial officers must review and disclose, their conclusions with respect to disclosure controls and procedures that are designed to ensure that information required to be disclosed in the bidder’s reports under the Exchange Act is recorded, processed, summarized, and timely reported;381

• a bidder will be required, with the participation of its principal executive and principal financial officers, to evaluate annually the effectiveness of

its internal controls over financial reporting (including any changes thereto) and report on such controls in its annual report; such report must (i) include a statement of management’s responsibility for establishing and maintaining adequate internal controls over financial reporting; (ii) identify the framework used by management to evaluate the effectiveness of its internal control procedures; (iii) assess the effectiveness of such internal controls; and (iv) include a statement that the company has issued an attestation report on management’s assessment of the bidder’s internal controls;\footnote{Exchange Act Rules 13a-15(c) & 15d-15(c), 17 U.S.C. §§ 240.13a-15(c), 240.15d-15(c) (2015); Regulation S-K Item 308, 17 C.F.R. § 229.308 (2015); Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262 (2012).}

- a bidder will be required to include in each annual report an attestation from its auditors on their assessment of the bidder's internal controls over financial reporting;\footnote{See Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262.}

- directors and officers of the bidder may not make equity trades in the bidder’s securities during certain “black-out” periods under the bidder's share-based retirement (or bonus, incentive, or profit-sharing) plans, if any, subject to certain exceptions;\footnote{See id. § 306(a), 15 U.S.C. § 7244 (2012); Regulation BTR, 17 C.F.R. §§ 245.100–.104 (2015).}

- the bidder cannot extend loans or other credit to its directors or executive officers, subject to certain exceptions;\footnote{See Exchange Act § 13(k), 15 U.S.C. § 78m(k) (2012).}

- the bidder’s chief executive officer and chief financial officer are required to repay to the bidder certain bonus and other incentive-based compensation and certain trading profits following a restatement of the bidder’s accounts due to material noncompliance as a result of misconduct, with any financial reporting requirement under U.S. federal securities laws.\footnote{See Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243 (2012).}

A full description of Sarbanes-Oxley Act (and, in particular, the application of such Act to domestic companies) is beyond the scope of this article. In view of the significance of these matters, bidders should discuss these matters in detail with legal counsel prior to structuring an offering.

CONCLUSION

Many business combination transactions involving non-U.S. companies are subject to U.S. securities laws and regulations. These laws and regulations may impose significant substantive, disclosure and procedural obligations and, as a result, may significantly impact the timing, structure and consequences of such transactions. By understanding the extent to which a proposed transaction
may be subject to U.S. securities laws and regulations, the transaction may be structured in a manner that avoids unanticipated or undesirable effects and minimizes potential conflicts between U.S. and home jurisdiction regulation. Early consideration of potentially applicable U.S. federal securities laws also may help assess the need for formal exemptive or other relief from the Staff or regulators in other jurisdictions. The early involvement of knowledgeable legal counsel should increase the likelihood that parties will achieve their business objectives in compliance with U.S. federal and local securities laws.

By Lev E. Breydo*

Editor’s Note
Each year, the Business Law Section sponsors the Mendes Hershman Student Writing Contest to encourage and reward law student writings on business law subjects of general and current interest. Essays submitted for consideration must be the work of the submitting student without substantial editorial input from others. The papers are judged on research and analysis, choice of topic, writing style, originality, and contribution to the literature available on the topic. Depending on the topic, whether the paper has been previously published, and other factors, the winning essay is considered for publication in The Business Lawyer.

The winning essay for the 2014–2015 contest was submitted by Lev E. Breydo. Mr. Breydo was awarded the Mendes Hershman Student Writing Contest Prize at the Section’s luncheon at the Spring Meeting in April 2015.

For the United States, financial crises are not new; since the presidency of George Washington, they have struck on an eerily regular basis, every fifteen to twenty years. Meanwhile, Canada, a broadly similar economy that is highly intertwined with the United States, has not had a banking crisis since 1840—not even during the Great Depression.

This article deconstructs the factors underlying Canada’s relative outperformance; then, based on these insights, it proposes carefully calibrated changes to incorporate aspects of Canada’s time-tested approach.

Broadly, this article posits that Canada’s superior regulatory architecture is responsible for the strength of its banking system. Most importantly, Canada has a single regulator with jurisdiction over the entire financial sector—encompassing banks, insurers, private pension plans, and housing finance—the Office of the Superintendent of Financial Institutions (“OSFI”). In contrast, America’s highly

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I would like to express my tremendous gratitude to Professor David Skeel—this article would not have been possible without his invaluable insights, support, and mentorship. This paper also benefited from the diligent efforts of the University of Pennsylvania Journal of Business Law. Any errors or omissions are entirely my own.
balkanized framework relies on well over 100 distinct regulatory bodies to fulfill OSFI’s role, resulting in vast inefficiency and dangerous gaps in regulatory oversight. Furthermore, Canada’s regulatory architecture—which, unlike that of the United States, was designed to oversee a modern financial system—circumscribes regulatory domains based on the required functions of financial regulation, rather than historical happenstance or political expedience.

This article is organized in five parts. Part I illustrates the sharply divergent performance of the American and Canadian banking sectors through empirical analyses of equity and credit default swap (“CDS”) data, as well as assessment of consumer welfare. It finds that between 2000 and 2014, Canadian banks generated total returns of nearly 525 percent; U.S. banks lost 23 percent with nearly twice the volatility. During the financial crisis, the cost of insuring against the default of American banks through CDS understandably skyrocketed. In contrast, market participants perceived the default risk of Canadian banks to be essentially immaterial—CDS referencing most Canadian banks barely existed, let alone actively traded. At the same time, Canadian banks enjoy tremendous public respect. An impressive 90 percent of Canadians have a favorable impression of Canadian banks; the corresponding figure for Americans is just 21 percent.

Part II provides a cross-disciplinary bridge between the law underpinning financial regulation and the macroeconomics literature focusing on banking crises and the relationship between financial institutions and the broader economy. This part of the paper also proposes a taxonomical framework regarding the regulatory architecture required for overseeing the financial sector. Finally, it thoroughly analyzes the American and Canadian regulatory frameworks, while critiquing various aspects of the American approach.

Part III focuses on cost-benefit analysis (“CBA”) with respect to financial regulation. First, it illustrates the clear causal mechanism between Canada’s regulatory architecture and the stability of its financial sector through a case study of JPMorgan’s now-infamous “London Whale” trading loss. Then, it builds on existing scholarly work to develop an enhanced CBA framework for financial regulation. After empirically incorporating financial and accounting data into this framework, the article finds that, adjusted for banking sector size, the United States spends nearly three times as much on regulation—an inefficiency that costs the American economy over $30 billion each year.

Part IV addresses counterarguments, largely centered on cultural differences or industry structure. First, it demonstrates that cultural differences are unlikely responsible for Canada’s financial stability through examples highlighting that Canadian financial institutions can be just as aggressive as their American counterparts, while succumbing to similar legal issues when operating in the United States. Then, building on the analysis of societal welfare and public trust from Part I, this part of the article calls into question the proposition—advocated by influential scholars including Simon Johnson of MIT—that Canada’s banking industry structure harms consumers.

Part V proposes structural changes to strengthen America’s regulatory framework. Because we are not starting with a blank canvas, this article emphasizes
consolidation of regulatory functions, rather than agencies, to achieve many of the benefits of Canada’s regulatory architecture. Notably, the changes envisioned broadly resemble Senator Dodd’s original legislative proposal to modernize American financial regulation, which, due to political pressure, was ultimately abandoned in favor of the Dodd-Frank Act.

In addition, Part V presents quantitative models—largely borrowed from corporate finance—to estimate cost savings based on European and Canadian benchmarks. The analysis suggests that, in net present value terms, the proposed reforms could save taxpayers nearly $83 billion based on European projections—and over $350 billion if U.S. regulation became as efficient as Canada’s. At the same time, the structural changes proposed in this paper could generate cost savings exceeding $585 billion for the financial industry. Putting all this together, the aggregate value to society may well exceed a trillion dollars.

As the evidence presented in this paper will show, though seemingly quite simple, Canada’s regulatory architecture is a powerful bulwark against crises; America’s, on the other hand, is merely a Maginot line—elaborate and extensive, but inherently permeable. By incorporating insights that have consistently proven effective for Canada, the United States can save billions—and, most importantly, build a lasting foundation to ensure financial stability and sustainable economic growth for the future.

For access to the complete article, please email Lev Breydo at: lev.breydo@gmail.com, or download it at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2641801.
Changes in the Model Business Corporation Act—Proposed Section 2.08

By the Corporate Laws Committee, ABA Business Law Section

The Corporate Laws Committee of the ABA Business Law Section (the “Committee”) develops and from time to time proposes changes in the Model Business Corporation Act (the “Act” or “Model Act”).

The Committee has approved, on second reading, new section 2.08 of the Act, permitting the articles of incorporation or the bylaws to specify the forum or forums for litigation of internal corporate claims, and invites comments from interested persons. Comments should be addressed to Karl John Ege, Chair, Corporate Laws Committee, 1201 3rd Avenue, Suite 4900, Seattle, Washington 98101, or sent to him by e-mail at kege@perkinscoie.com. Comments should be received by May 20, 2016, in order to be considered by the Committee before adoption of section 2.08 on third reading.

Proposed section 2.08 is set forth below.

§2.08. Forum Selection Provisions

(a) The articles of incorporation or the bylaws may require that any or all internal corporate claims shall be brought exclusively in any specified court or courts of this state and, if so specified, in any additional courts in this state or in any other jurisdictions with which the corporation has a reasonable relationship.

(b) A provision of the articles of incorporation or bylaws adopted under subsection (a) shall not have the effect of conferring jurisdiction on any court or over any person or claim, and shall not apply if none of the courts specified by such provision has the requisite personal and subject matter jurisdiction. If the court or courts of this state specified in a provision adopted under subsection (a) do not have the requisite personal and subject matter jurisdiction and another court of this state does have such jurisdiction, then the internal corporate claim may be brought in such other court of this state, notwithstanding that such other court of this state is not specified in such provision,
and in any other court specified in such provision that has the requisite jurisdiction.

(c) No provision of the articles of incorporation or the bylaws may prohibit bringing an internal corporate claim in the courts of this state or require such claims to be determined by arbitration.

(d) “Internal corporate claim” means, for the purposes of this section, (i) any claim that is based upon a violation of a duty under the laws of this state by a current or former director, officer, or shareholder in such capacity, (ii) any derivative action or proceeding brought on behalf of the corporation, (iii) any action asserting a claim arising pursuant to any provision of the Act or the corporation’s articles of incorporation or bylaws, or (iv) any action asserting a claim governed by the internal affairs doctrine that is not included in clauses (i)–(iii).

CROSS-REFERENCES

Articles of incorporation generally, see § 2.02.
Bylaws generally, see § 2.06.
Derivative proceedings, see ch. 7D.

OFFICIAL COMMENT

Section 2.08(a) authorizes a provision in either the articles of incorporation or the bylaws creating an exclusive forum or forums for the adjudication of internal corporate claims. Under section 2.08(a), the provision must specify at least one court of this state (i.e., a state court rather than a federal court). The provision may also include additional specified courts or all courts of this state or courts in this state (such as federal courts) or in one or more additional jurisdictions with a reasonable relationship to the corporation. In addition, the provision may prioritize among the specified courts. For example, the provision may specify that the claim shall be brought exclusively in a particular court of this state unless such court does not have the requisite personal and subject matter jurisdiction, in which case the claim shall be brought in other specified courts.

Under the last sentence of section 2.08(b), an internal corporate claim will always be permitted to be brought in at least one court of this state unless there is no court of this state that has the requisite personal and subject matter jurisdiction. For example, if the articles of incorporation or the bylaws provide that an internal corporate claim may only be brought in a specified court of this state and in the courts of another state with a reasonable relationship to the corporation, and the specified court of this state does not have the requisite personal and subject matter jurisdiction, then the claim can be brought in any other court of this state that does have the requisite jurisdiction or in the courts of the specified other state (so long as those courts have the requisite jurisdiction). Similarly, if the articles of incorporation or the bylaws provide that an
internal corporate claim may only be brought in a specified court of this state and in the federal courts in this state, and the specified court of this state does not have the requisite personal and subject matter jurisdiction, then the claim can be brought in any other court of this state that does have the requisite jurisdiction or in the federal courts in this state (so long as the federal court has the requisite jurisdiction). In each of the foregoing examples, (i) if the specified court of this state does have the requisite personal and subject matter jurisdiction, then such court would be the only court of this state in which the internal corporate claim could be brought, and (ii) if no court of this state has the requisite personal and subject matter jurisdiction, then the courts of the other state (in the first example) or the federal courts in this state (in the second example) would become the exclusive forum for such internal corporate claim, in each case so long as such court has the requisite jurisdiction.

If no court of this state has the requisite personal and subject matter jurisdiction, and none of the other courts, if any, specified in the provision of the articles of incorporation or the bylaws has the requisite jurisdiction, then the provision will have no effect and the internal corporate claim may be brought in any court that does have the requisite jurisdiction.
Changes in the Model Business Corporation Act—Proposed Amendments to Chapter 16

By the Corporate Laws Committee, ABA Business Law Section

The Corporate Laws Committee of the ABA Business Law Section (the “Committee”) from time to time develops and proposes changes to the Model Business Corporation Act (the “Act”).

The Committee has approved, on a second reading, amendments to section 16.20 and to certain provisions of other sections of chapter 16 of the Act (the “Amendments”) that address, among other things, the obligations of corporations to make financial statements available to shareholders, the maintenance of corporate records, and the inspection rights of shareholders and directors of corporations. The Committee invites comments on the Amendments, which should be addressed to Karl John Ege, Chair, Corporate Laws Committee, 1201 3rd Avenue, Suite 4900, Seattle, Washington 98101, or sent to him by email at kege@perkinscoie.com. Comments should be received by May 20, 2016, in order to be considered by the Committee before adoption of the Amendments.

Section 16.20, as proposed to be amended, requires a corporation, upon the written request of a shareholder, to deliver or make available annual financial statements. However, as amended, section 16.20 will no longer (1) require a corporation to prepare formal financial statements for purposes of delivering or making them available to a shareholder; (2) provide normative standards for the preparation of financial statements, in recognition that whether a corporation prepares financial statements and the form of any such financial statements depend on the nature and complexity of the corporation’s business and the requirements of third parties such as banks, suppliers, and taxing authorities. The Amendments also include corresponding changes to the provisions of chapter 16 regarding the maintenance of financial statements and the right to inspect financial statements and accounting records upon demand by shareholders or directors of a corporation. The Amendments also reorganize and, in some instances, revise the provisions of chapter 16 addressing the maintenance of corporate records and the inspection rights of shareholders and directors to more

1. The amendments to section 16.02 will also require amendments to the references in sections 13.20 and 13.24 to the financial statements currently specified in section 16.02. The Committee will be proposing such changes as part of a forthcoming overall revision of the Act.
closely reflect modern recordkeeping practices and the balance between the interests of the corporation and the interests of the shareholder with respect to confidential or competitively sensitive information.

The Amendments are set forth below. Changes to the existing provisions are marked with deletions shown by strikes and additions by double underscoring. The unmarked text of chapter 16, as proposed to be amended, follows the marked version.

Records and Reports

Subchapter A.

RECORDS

§ 16.01. Corporate records
§ 16.02. Inspection rights of records by shareholders
§ 16.03. Scope of inspection right
§ 16.04. Court-ordered inspection
§ 16.05. Inspection rights of records by directors
§ 16.06. Exception to notice requirements

Subchapter B.

REPORTS

§ 16.20. Financial statements for shareholders
§ 16.21. Annual report for secretary of state

Subchapter A.

RECORDS

§ 16.01. Corporate Records

(a) A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

(b) A corporation shall maintain appropriate accounting records.

(c) A corporation or its agent shall maintain a record of its shareholders, in a form that permits preparation of a list of the names and addresses of all shareholders, in alphabetical order by class of shares showing the number and class of shares held by each.
(d) A corporation shall maintain its records in the form of a document, including an electronic record or in another form capable of conversion into paper form within a reasonable time.

(e) A corporation shall keep a copy of the following records at its principal office:

1. its articles or restated articles of incorporation, all amendments to them as currently in effect, and;
2. any notices to shareholders referred to in section 1.20(k)(5) regarding facts on which a filed document is dependent; if those facts are not included in the articles of incorporation or otherwise available as specified in section 1.20(k)(5);
3. its bylaws or restated bylaws and all amendments to them as currently in effect;
4. resolutions adopted by its board of directors creating one or more classes or series of shares, and fixing their relative rights, preferences, and limitations, if shares issued pursuant to those resolutions are outstanding;
5. the minutes of all shareholders’ meetings, and records of all action taken by shareholders without a meeting, for the past three years;
6. all written communications within the past three years to shareholders generally within the past three years, including the financial statements furnished for the past three years under section 16.20;
7. minutes of all meetings of, and records of all actions taken without a meeting by, its shareholders, its board of directors, and board committees established under section 8.25;
8. a list of the names and business addresses of its current directors and officers; and
9. its most recent annual report delivered to the secretary of state under section 16.21.

(b) A corporation shall maintain all annual financial statements prepared for the corporation for its last three fiscal years (or such shorter period of existence) and any audit or other reports with respect to such financial statements.

(c) A corporation shall maintain accounting records in a form that permits preparation of its financial statements.

(d) A corporation shall maintain a record of its current shareholders in alphabetical order by class of shares showing the number and class of shares held by each shareholder.
(c) A corporation shall maintain the records specified in this section in a manner that may be made available for inspection within a reasonable time.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.
Articles of amendment, see § 10.06.
Bylaws, see § 2.06, ch. 10B.
Committees of board of directors, see § 8.25.
“Deliver,” see § 1.40.
Directors’ action without meeting, see § 8.21.
Inspection of corporate records, see §§ 16.02 & 16.04.
Meetings of board of directors, see § 8.20.
Officers, see § 8.40.
“Principal office”:
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Reports of corporation, see §§ 16.20–16.21.
Restatement of articles of incorporation, see § 10.07.
Series of shares, see § 6.02.
Shareholders’ action without meeting, see § 7.04.
Shareholders’ meeting, see §§ 7.01–7.03.
Shareholders’ voting list, see § 7.20.

OFFICIAL COMMENT

Section 16.01 describes in general terms the records every corporation must keep or maintain, the form in which they may be maintained, and, to a limited extent, where the records must be kept.

§ 1. RECORDS TO BE MAINTAINED

Section 16.01(a) requires certain basic records to be maintained by the corporation. The Act does not generally specify how records must be maintained other than in a manner in which they may be made available for inspection within a reasonable time, where they must be located or, with the exception of section 16.02(a), where they must be available. They may be maintained in one or more offices within or without the state and, in some cases, such as shareholder records, may be maintained by agents of the corporation; indeed, in the case of records in nonwritten form, it may be impossible to determine “where” they are located.
2. MINUTES AND RELATED DOCUMENTS

Section 16.01(a) requires a corporation to “keep” as permanent records the minutes of meetings of its shareholders and board of directors, and a record of actions taken by consent by its shareholders or board of directors. In addition, each corporation must “keep” a record of all actions taken by a committee of the board of directors when acting on behalf of the board of directors for the corporation; this includes, for example, action taken by an executive committee between meetings of the board and final action of a special litigation committee authorized to act on behalf of the board. Section 16.01(a) does not require a record of actions taken by a committee when the committee is not acting in place of the board of directors, e.g., when the committee is discussing policy and formulating recommendations for action by the board of directors. Also, it does not require either minutes or a record of committee deliberations under any circumstances. Committee meetings are preserved as forums for open and frank discussion and discussion of sensitive corporate data without fear of recordation or disclosure.

Section 16.01 also does not address the amount of detail that should appear in the minutes of meetings of shareholders or the board of directors—the content of minutes is largely fixed by tradition and no inference about their content should be drawn from the section’s treatment of the records of committee deliberation and action.

2. SHAREHOLDERS’ LISTS

Section 16.01(a) does not address the amount of detail that should appear in minutes or written actions. Minutes of meetings customarily include the formalities of notice, the time and place of the meeting, those in attendance, and the results of any votes. Minutes of meetings and written actions without a meeting show formal action taken. The extent to which further detail is included is a matter of judgment which may depend upon the circumstances. Section 7.04, which addresses written actions taken by shareholders, requires that written actions by shareholders be delivered to the corporation for filing with corporate records.

3. FINANCIAL STATEMENTS AND ACCOUNTING RECORDS

The Act does not provide normative standards for the financial statements and accounting records to be prepared or maintained. The financial statements to be maintained under section 16.01(b) are those that the corporation prepares in the operation of its business, including in response to third party requirements. The form of the financial statements prepared by a corporation depends to some extent on the nature and complexity of the corporation’s business and third party requirements such as those governing the preparation and filing of tax returns with applicable tax authorities. To accommodate the needs of the many different types of business corporations that may be subject to these provisions, including closely held corporations, the Act does not require that the corporation prepare and maintain financial statements on the basis of generally accepted accounting principles (“GAAP”) if it is not otherwise required to prepare GAAP financial
statements. The Act does not define what accounting records must be maintained or mandate how long they must be maintained. The accounting records to be maintained under section 16.01(c) depend upon the form of the corporation's financial statements. For example, annual tax returns filed with the relevant taxing authorities may be the only annual financial statements prepared by small businesses operating on a cash basis and, in those instances, the requisite accounting records to be maintained may consist of only a check register, vouchers and receipts.

4. SHAREHOLDERS’ LISTS
Sections 16.01(b) and (c) require the corporation to “maintain” appropriate accounting and shareholder records. The word “maintain” is used to denote current records only and does not require the corporation to keep on hand as permanent records, data, or information of historical interest only; the periods for which these records, data, or information should be kept is not addressed by the Model Act.

Section 16.01(b) relates to accounting records. The word “appropriate” is used to indicate that the nature of the financial records to be kept is dependent to some extent on the nature of the corporation’s business; the phrase “adequate records” is used in some state statutes to convey essentially the same meaning. “Appropriate” records are generally records that permit financial statements to be prepared which fairly present the financial position and transactions of the corporation. In some very small businesses operating on a cash basis, however, “appropriate” accounting records may consist only of a check register, vouchers, and receipts.

Section 16.01(c) requires the corporation to maintain such records of its shareholders as will permit it to compile a list of current shareholders when required. These records may consist of vary from stubs from which certificates have been detached in the case of corporations with a few shareholders or of, to elaborate electronic data retrievable only by modern technology in the case of large, publicly held corporations whose shares are publicly traded. The record may be maintained by the corporation or an agent, who traditionally is the transfer agent but may be another agent. A corporation may maintain additional information regarding its shareholders, such as a list of nominees and nonobjecting beneficial owners if its shares are publicly traded.

3. FORM OF RECORDS
Section 16.01(d) generally authorizes corporations to retain records in the form of a “document,” which includes a writing as well as an “electronic record,” or in another form capable of conversion into paper form in a reasonable time. See subsections 1.40(6A), (7B), and (28). The basic requirement is that the method chosen must be capable of reduction to paper form within a reasonable time. In addition, in the case of the record of shareholders, the method must permit the development of an alphabetical list of shareholders of record as required by section 16.01(c).
4. KEEPING RECORDS AT PRINCIPAL OFFICE

Section 16.01(e) requires certain basic records to be kept at the principal office of the corporation, including minutes of shareholders’ meetings for the preceding three years and records of shareholder action taken without a meeting during the same period. This requirement is imposed because these records must be available for inspection by any shareholder at that office. See section 16.02(a). The “principal office” of the corporation is defined in section 1.40 to be the location of the executive offices of the corporation and its address must be set forth by the corporation in its annual report required by section 16.21. The Model Act does not generally specify where records other than those described in section 16.01(e) must be kept. They may be kept in one or more offices within or without the state; indeed, in the case of records kept in nonwritten form, it may be impossible to determine “where” they are located.

§ 16.02. INSPECTION RIGHTS OF RECORDS BY SHAREHOLDERS

(a) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at the corporation’s principal office, any of the records of the corporation described in section 16.01(e), excluding minutes of meetings of, and records of actions taken without a meeting by, the corporation’s board of directors and board committees established under section 8.25, if the shareholder gives the corporation a signed written notice of the shareholder’s demand at least five business days before the date on which the shareholder wishes to inspect and copy.

(b) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at a reasonable location specified by the corporation, any of the following records of the corporation if the shareholder meets the requirements of subsection (c) and gives the corporation a signed written notice of the shareholder’s demand at least five business days before the date on which the shareholder wishes to inspect and copy:

(1) the financial statements of the corporation maintained in accordance with section 16.01(b);

(2) accounting records of the corporation;

(3) excerpts from minutes of any meeting of, or records of any actions taken without a meeting by, the corporation’s board of directors and board committees maintained in accordance with section 16.01(a); and

(4) the record of shareholders maintained in accordance with section 16.01(d).
A shareholder may inspect and copy the records described in subsection (b) only if:

1. the shareholder's demand is made in good faith and for a proper purpose;
2. the shareholder's demand describes with reasonable particularity the shareholder's purpose and the records the shareholder desires to inspect; and
3. the records are directly connected with the shareholders' purpose.

The corporation may impose reasonable restrictions on the confidentiality, use or distribution of records described in subsection (b).

For any meeting of shareholders for which the record date for determining shareholders entitled to vote at the meeting is different than the record date for notice of the meeting, any person who becomes a shareholder subsequent to the record date for notice of the meeting and is entitled to vote at the meeting is entitled to obtain from the corporation upon request the notice and any other information provided by the corporation to shareholders in connection with the meeting, unless the corporation has made such information generally available to shareholders by posting it on its website or by other generally recognized means. Failure of a corporation to provide such information does not affect the validity of action taken at the meeting.

A shareholder of a corporation is entitled to inspect and copy, during regular business hours at a reasonable location specified by the corporation, any of the following records of the corporation if the shareholder meets the requirements of subsection (d) and gives the corporation a signed written notice of the shareholder's demand at least five business days before the date on which the shareholder wishes to inspect and copy:

1. excerpts from minutes of any meeting of the board of directors or a committee of the board of directors while acting in place of the board of directors on behalf of the corporation, minutes of any meeting of the shareholders, and records of action taken by the shareholders, board of directors, or a committee of the board without a meeting, to the extent not subject to inspection under section 16.02(a);
2. accounting records of the corporation; and
3. the record of shareholders.

A shareholder may inspect and copy the records described in subsection (e) only if:

1. the shareholder's demand is made in good faith and for a proper purpose;
(2) the shareholder describes with reasonable particularity the shareholder's purpose and the records the shareholder desires to inspect; and

(3) the records are directly connected with the shareholder's purpose.

(e) The right of inspection granted by this section may not be abolished or limited by a corporation’s articles of incorporation or bylaws.

(f) This section does not affect:

(1) the right of a shareholder to inspect records under section 7.20 or, if the shareholder is in litigation with the corporation, to the same extent as any other litigant; or

(2) the power of a court, independently of this Act, to compel the production of corporate records for examination- and to impose reasonable restrictions as provided in section 16.04(d), provided that, in the case of production of records described in subsection (b) at the request of a shareholder, the shareholder has met the requirements of subsection (c).

(g) For purposes of this section, “shareholder” includes a record shareholder, a beneficial owner whose shares are held in a shareholder, and an unrestricted voting trust or by a nominee on the shareholder’s behalf.

**CROSS-REFERENCES**

Articles of incorporation, see § 2.02.
Bylaws, see § 2.06, ch. 10B.
Committees of board of directors, see § 8.25.
Corporate records required, see § 16.01.
Court-ordered inspection, see § 16.04.
“Deliver,” defined, see § 1.40.
Directors’ action without meeting, see § 8.21.
Effective date of notice, see § 1.41.
Meeting of board of directors, see § 8.20.
Notices and other communications, see § 1.41.
Notice to corporation, see § 1.41.
“Principal office”: defined, see § 1.40.
designated in annual report, see § 16.21.
“Shareholder” defined, see § 1.40.
Shareholders’ action without meeting, see § 7.04.
Shareholders’ list inspection, see § 7.20.
Shareholders’ meeting, see §§ 7.01–7.03.
Voting trusts, see § 7.30.
OFFICIAL COMMENT

1. SECTION 16.02(A)

Section 16.02(a) provides that every shareholder is entitled, upon delivery of a signed written demand at the principal office of the corporation, all to inspect documents described in section 16.01(e). These documents all that deal with the shareholder's interest in the corporation. The right to inspection includes the right to make copies, as such in the corporation, further described in section 16.03. While some of these documents may also be a matter of public record in the office of the secretary of state, a shareholder should not be compelled to go to a public office that may be physically distant to examine the basic documents relating to the corporation. The “principal office” of the corporation is defined in section 1.40 to be the location of the executive offices of the corporation and its address must be set forth by the corporation in its annual report required by section 16.21.

2. SECTION 16.02(B)

Section 16.02(b) gives In contrast to the right to inspect minutes of meetings of, and written actions taken without a meeting by, shareholders, a shareholder is entitled to inspect only excerpts of meetings of, and records of written actions taken by, the board of directors and board committees related to the purpose of the inspection. A shareholder is entitled to inspect the shareholders' list under section 16.02(b) without regard to the size or value of the shareholder's holding. This right is independent of the right to inspect a shareholders' list immediately before a meeting under section 7.20.

3. SECTION 16.02(C)

Section 16.02(c) permits inspection of the financial statements and records described in section 16.02(b) by a shareholder only if the demand is made in good faith and for a “proper purpose.” Although not defined in the Act, “proper purpose” under section 16.02(c) has been defined in case law to involve a purpose that is reasonably relevant to the demanding shareholder's interest as a shareholder.

Section 16.02(c) requires that a shareholder designate “with reasonable particularity” the purpose and the records he or she desires to inspect. Also, the records demanded must be “directly connected” with that purpose. If disputed by the corporation, the “connection” of the records to the shareholder's purpose may be determined by a court's private examination of the records.

4. SECTION 16.02(D)

The reasonable restrictions on the confidentiality, use or distribution of financial statements and records permitted by section 16.02(d) allow for the protection of confidential or proprietary information in the corporation's records or
sensitive matters that might be disclosed in a shareholder inspection. Such restrictions might include, for example, requiring the demanding shareholder to sign a confidentiality and use agreement. A similar provision is found in section 16.04(d) in connection with court-ordered inspections.

5. **Section 16.02(e)**

Section 16.02(e) provides shareholders of a corporation the right to receive from the corporation the notice and other information provided by the corporation to shareholders in connection with a meeting if the record date for voting is subsequent to the record date for notice and the shareholder became entitled to vote after the record date for notice. The information is to be provided on request, except that the corporation may satisfy this requirement by making the information generally available on its website or by other generally recognized means. The failure of the corporation to provide the information does not affect the validity of the action taken at the meeting. This provision does not apply to information provided to shareholders by persons other than the corporation.

3. **Sections 16.02(e)** grants a shareholder who meets the requirements of (f) and (g)

The prohibition in section 16.02(d) the right to inspect three classes of corporate records:

1. Excerpts from minutes of meetings of the board of directors, records of action of committees of the board of directors when acting in place of the board on behalf of the corporation, and minutes of meetings of shareholders (to the extent they do not fall within section 16.02(a)). The corporation is required to make available only relevant excerpts of minutes and need not make available minutes of entire meetings merely because a portion of the minutes is directly connected with the shareholder's purpose.

2. The accounting records of the corporation. The Act does not attempt to define what accounting records must be kept. See the Official Comment to section 16.01.

3. The record of shareholders, subject to section 16.03(c). If a shareholder makes a demand in good faith and with a proper purpose apply to an agreement permissible under section 16.02(d), the shareholder is entitled to inspect the shareholders' list under section 16.02(c) without regard to the size or value of his holding. This right is independent of the right to inspect a shareholders' list immediately before a meeting under section 7.20.16.02(f).
4. Section 16.02(d)

Section 16.02(d) follows earlier versions of the Model Act and permits inspection of the records described in section 16.02(c) by a shareholder only if the demand is made in good faith and for a “proper purpose.” A “proper purpose” means a purpose that is reasonably relevant to the demanding shareholder’s interest as a shareholder. Some statutes do not use the phrase “proper purpose”; the Model Act continues to use it because it is traditional and well understood language defining the scope of the shareholder’s right of inspection and its use ensures that the very substantial case law that has developed under it will continue to be applicable under the revised Act.

As a practical matter, a shareholder who alleges a purpose in general terms, such as a desire to determine the value of his or her shares, to communicate with fellow shareholders, or to determine whether improper transactions have occurred, has been held to allege a “proper purpose.” Section 16.02(d) thus attempts to require more meaningful statements of purpose, if feasible, by requiring that a shareholder designate “with reasonable particularity” the purpose and the records he or she desired to inspect; the records demanded must also be “directly connected” with that purpose. If disputed by the corporation, the “connection” of the records to the shareholder’s purpose may be determined by a court’s in-camera examination of the records.

5. Sections 16.02(e) and (f)

Section 16.02(e) states that the inspection rights granted by this chapter are inherent rights of shareholders and may not be abolished or limited by the articles of incorporation or bylaws; the subsection is based on California Corporations Code Annotated section 1600(d). No inference of any kind should be drawn from this subsection the prohibition in section 16.02(f) as to whether other, unrelated sections of the Model Act may be modified by provisions in the articles of incorporation or bylaws.

Section 16.02(f) provides that the right of inspection granted by section 16.02 is an independent right of inspection that is not a substitute for or in derogation of rights of inspection that may exist (1) under section 7.20, to inspect the shareholders’ list following the establishment of a record date for a meeting; (2) as part of a right of discovery that exists in connection with litigation; and (3) as a “common law” right of inspection, if any is found to exist by a court, to examine corporate records. Section 16.02(f) simply Section 16.02(g) preserves whatever independent right of inspection exists under these referenced sources and does not create or recognize any rights, either expressly or by implication.

6. Section 16.02(g)

Section 16.02(g) extends the inspection rights provided by section 16.02 to beneficial owners of shares held by a nominee or in a voting trust. It was
added as a technical correction to the revised Model Act in 1986. A shareholder also has the right to obtain financial statements under section 16.20.

§ 16.03. Scope of Inspection Right

(a) A shareholder’s right may appoint an agent or attorney to exercise the same shareholder’s inspection and copying rights as the shareholder represented under section 16.02.

(b) The corporation may, if reasonable, satisfy the right of a shareholder to copy records under section 16.02 includes, if reasonable, by furnishing to the right to receive shareholder copies by xerographic photocopy or other means; chosen by the corporation including copies furnished through an electronic transmission if available and so requested by the shareholder.

(c) The corporation may comply at its expense with a shareholder’s demand to inspect the record of shareholders under section 16.02(b)(3) by providing the shareholder with a list of shareholders that was compiled no earlier than the date of the shareholder’s demand.

(d) The corporation may impose a reasonable charge, covering the costs of labor and material, for providing copies of any documents provided to the shareholder. The charge may not exceed the estimated cost based on an estimate of production, reproduction or transmission of the records such costs.

Cross-References

Corporate records, see § 16.01.
Court-ordered inspection, see § 16.04.
“Electronic transmission” defined, see § 1.40.
Inspection right generally, see § 16.02.
Shareholders’ list inspection, see § 7.20.

Official Comment

The right Section 16.03(a) provides that the rights of inspection set forth and copying granted to shareholders in section 16.02 includes the general right to copy the documents inspected. Section 16.03 follows precedent established under earlier statutes and extends the right may be exercised by agents and attorneys of shareholders appointed by shareholders to conduct such inspection to an agent or attorney of a shareholder as well as the shareholder. The right to copy by longhand and extends to the right to receive copies by xerographic photocopy or through an electronic transmission with the cost of reproduction and transmission being paid in section
16.03(b), including by the shareholder. The requirement of availability with respect to electronic transmissions is intended to insure that the corporation can provide the document electronically and that an undue burden is not placed on the corporation to provide copies through an electronic transmission or other similar means.

Section 16.03(c) is designed to give the corporation, at its option of providing and expense, the right to provide a reasonably current list of its shareholders instead of granting the right of inspection. A list will be reasonably current if the list is defined in section 16.03(c) as one compiled no earlier than the date of the written demand, which under section 16.02(b) must provide at least five days’ notice.

Many corporations make available to shareholders without charge some or all of the basic documents described in section 16.01(e). Section 16.03(d) authorizes the corporation to charge a reasonable fee based on reproduction costs (including labor and materials) for providing a copy of any document. The phrase “estimated cost of production, reproduction or transmission of the records” in section 16.03(d) refers to the cost of assembling information and data to meet a demand as well as the cost of reproducing and transmitting documents that are already in existence.

Under applicable law, a list of shareholders generally will include underlying information in the corporation’s possession relating to stock ownership, including, where applicable, breakdowns of stock holdings by nominees and nonobjecting beneficial ownership (NOBO) lists. However, a corporation generally is not required to generate this information for the requesting shareholder and is only required to provide NOBO and other similar lists to the extent such information is in the corporation’s possession.

Section 7.20 creates a right of shareholders to inspect a list of shareholders in advance of and at a meeting that is independent of the rights of shareholders to inspect corporate records under chapter 16.

Section 16.03(d) permits the corporation to be reimbursed for the expense of providing copies of documents to a shareholder.

§ 16.04. Court-Ordered Inspection

(a) If a corporation does not allow a shareholder who complies with section 16.02(a) to inspect and copy any records required by that section to be available for inspection, the [name or describe court] of the county where the corporation’s principal office (or, if none in this state, its registered office) is located may summarily order inspection and copying of the records demanded at the corporation’s expense upon application of the shareholder.

(b) If a corporation does not within a reasonable time allow a shareholder who complies with section 16.02(b) to inspect and copy any other record the records required by that section, the shareholder who complies
with section 16.02(b) and (c) may apply to the [name or describe court] in the county where the corporation’s principal office (or, if none in this state, its registered office) is located for an order to permit inspection and copying of the records demanded. The court shall dispose of an application under this subsection on an expedited basis.

(c) If the court orders inspection and copying of the records demanded, it may impose reasonable restrictions on their confidentiality, use or distribution by the demanding shareholder and it shall also order the corporation to pay the shareholder’s expenses incurred to obtain the order unless the corporation proves that it refused inspection in good faith because it had a reasonable basis for doubt about the right of the shareholder to inspect the records demanded.

(d) If a reasonable basis for doubt about the court orders inspection and copying right of the shareholder to inspect the records demanded, it may impose, or

(2) required reasonable restrictions on the confidentiality, use or distribution of the records bydemanded to which the demanding shareholder had been unwilling to agree.

CROSS-REFERENCES

Corporate records, see § 16.01.
“Principal office”:
  defined, see § 1.40.
  designated in annual report, see § 16.21.
“Expenses” defined, see § 1.40.
“Principal office”:
  defined, see § 1.41.
  designated in annual report, see § 6.21.
Registered office:
  designated in annual report, see § 16.21.
required, see §§ 2.02 & 5.01.
Service on corporation, see § 5.04.
Shareholders’ list inspection, see § 7.20.
Voluntary inspection, see § 16.02.

OFFICIAL COMMENT

Section 16.04 provides a judicial remedy if a corporation refuses to grant the right of inspection provided by section 16.02.

If the right of inspection under section 16.02(a) is invoked and the corporation refuses to grant inspection, the shareholder may seek a summary order compelling inspection at the corporation’s expense. A summary order is appropriate
since the right of inspection under this subsection section 16.02(a) is either automatic or subject only to a determination that the person is in fact a shareholder of the corporation. By contrast, if inspection is demanded under section 16.02(b), a number of matters may be at issue, including the shareholder’s good faith and proper purpose may be in issue; in this situation for demands under section 16.02(b) or the reasonableness of the restrictions required by the corporation on the confidentiality, use or distribution of the records. Accordingly, section 16.04(b) directs the court to handle the proceeding “on an expedited basis.” instead of in a summary proceeding. The purpose of this phrase is to discourage dilatory tactics to avoid or delay inspection without requiring the court to resolve these issues on a summary basis. This language does not mandate any specific procedure by which these issues are to be resolved.

If a court enters a summary order directing inspection under section 16.02(a), the expense of reproducing the records, if any, is placed on the corporation. Section 16.04 does not address who should bear the expense of reproducing other records ordered by the court; this is a matter for the courts to decide in light of the policy of the Model Act that expenses of reproduction are generally the responsibility of the requesting shareholder and should be assessed against such shareholder.

The principal sanction against unreasonable delay or refusal to grant inspection is provided by section 16.04(c), which imposes on the corporation the plaintiff’s expenses unless the corporation can establish that it acted reasonably. The corporation may avoid these expenses by showing that the corporation refused inspection in good faith because it had a reasonable basis for doubt about the right of the shareholder to inspect the records demanded. This normally will involve reasonable doubt whether the shareholder had the necessary good faith and proper purpose or whether the records demanded are directly connected to the shareholder’s purpose. The phrase “in good faith because it had a reasonable basis for doubt” establishes a partially objective standard, in that the corporation must be able to point to some objective basis for its doubt that the shareholder was acting in good faith or had a purpose that was proper. For example, a corporation may point to earlier shareholder’s expenses unless the corporation establishes that it refused inspection in good faith on the grounds specified in section 16.04(c)(1) or (2). For example, a corporation may point to conduct of the shareholder involving improper use of information obtained from the corporation in the past as indicating that reasonable doubt existed as to the shareholder’s present purpose. A corporation may not avoid the imposition of expenses under this section merely or by showing it had no information one way or that the other about corporation refused inspection because the issues in controversy shareholder had been unwilling to agree to reasonable restrictions on the confidentiality, use or distribution of the records demanded.

Earlier versions of the Model Act and the statutes of many states imposed a penalty upon the corporation or its officers for refusal to permit inspection of books and records by shareholders who (1) had been shareholders for at least six months or (2) owned 5% or more of the outstanding shares. This provision
has been omitted. A penalty unrelated to the expenses of securing inspection was arbitrary and, as a result, was seldom actually enforced; further, a qualification based on the size or duration of the shareholder’s holding unrelated to the shareholder’s actual purpose was subject to the criticism that it constituted unreasonable discrimination against small shareholders.

§ 16.05. INSPECTION RIGHTS OF RECORDS BY DIRECTORS

(a) A director of a corporation is entitled to inspect and copy the books, records and documents of the corporation at any reasonable time to the extent reasonably related to the performance of the director’s duties as a director, including duties as a member of a committee, but not for any other purpose or in any manner that would violate any duty to the corporation.

(b) The [name or describe court] of the county where the corporation’s principal office (or if none in this state, its registered office) is located may order inspection and copying of the books, records and documents at the corporation’s expense, upon application of a director who has been refused such inspection rights, unless the corporation establishes that the director is not entitled to such inspection rights. The court shall dispose of an application under this subsection on an expedited basis.

(c) If an order is issued, the court may include provisions protecting the corporation from undue burden or expense, and prohibiting the director from using information obtained upon exercise of the inspection rights in a manner that would violate a duty to the corporation, and may also order the corporation to reimburse the director for the director’s expenses incurred in connection with the application.

CROSS-REFERENCES

Corporate records, see § 16.01.
Court-ordered inspection, see § 16.04.
“Expenses” defined, see § 1.40.
Director standards of conduct, see § 8.30.
Functions of board of directors, see § 8.01.
“Principal office:” defined, see § 1.41.
designated in annual report, see § 6.21.
Registered office:
designated in annual report, see § 16.21.
required, see §§ 2.02 & 5.01.
OFFICIAL COMMENT

The purpose of subsection 16.05(a) is to confirm the principle that a director always is entitled to inspect books, records and documents to the extent reasonably related to the performance of the director’s oversight or decisional duties provided that the requested inspection is not for an improper purpose and the director’s use of the information obtained would not violate any duty to the corporation. The statute attempts to reconcile and balance competing principles articulated in the common law which suggest that a director has a nearly “absolute” right to information subject only to limitation if it can be shown that the director has an improper motive or intent in asking for the information or would violate law by receiving the information. In addition, the statutory provision in addition, section 16.05 sets forth a remedy for the director in circumstances where the corporation improperly denies the right of inspection.

Under subsection (a), a director typically would be entitled to review books, records and documents relating to matters such as (i) compliance by a corporation with applicable law, (ii) adequacy of the corporation’s system of internal controls to provide accurate and timely financial statements and disclosure documents, or (iii) the proper operation, maintenance and protection of the corporation’s assets. In addition, a director would be entitled to review records and documents to the extent required to consider and make decisions with respect to matters placed before the Board.

Section 16.05(b) provides a director with the right to seek court order on an expedited basis for inspection and copying of the books, records and documents of the corporation, at the corporation’s expense. There is a presumption that significant latitude and discretion should be granted to the director, and the corporation has the burden of establishing that the director is not entitled to inspection of the documents requested. Circumstances involving circumstances where the director’s inspection right might be denied include requests which (i) are not reasonably related, for example, when it would be contrary to the interest of a director’s duties (e.g., seeking a specified confidential document not necessary for the performance of a director’s duties), (ii) impose an unreasonable burden and expense on the corporation (e.g., compliance because of adversity with the request would be duplicative of information already provided or would be unreasonably expensive and time consuming), (iii) violate the director duty to the corporation (e.g., the director could reasonably be expected to use or exploit confidential information in personal or third party transactions), or (iv) violate any applicable law (e.g., the director does not have the necessary government security clearance to see the requested classified information).

Section 16.05 does not directly deal with the ability of a director to inspect records of a subsidiary of which he or she is not also a director. A director’s ability to inspect records of a subsidiary generally should be exercised through the parent’s rights or power, and section 16.05(a) does not independently provide that right or power to a
director of the parent. In the case of wholly owned subsidiaries, a director’s ability to inspect should approximate his or her rights with respect to the parent. In the case of a partially owned subsidiary, the ability of the director to inspect is likely to be influenced by the level of ownership of the parent (this ability can be expected to be greater for a subsidiary which is part of a consolidated group than for a minority owned subsidiary). In any case, the inspection by a director of the parent will be subject to the parent’s fiduciary obligation to the subsidiary’s other shareholders.

Section 16.05(c) provides that the court may place limitations on the use of information obtained by the director and may include in its order other provisions protecting the corporation from undue burden or expense. Further, the court may order the corporation to reimburse the director for expenses incurred in connection with the application. The amount of any reimbursement is left in the court’s discretion, since it must consider the reasonableness of the expenses incurred, as well as the fact that a director may be only partially successful in the application.

Subchapter B.
REPORTS

§ 16.20. Financial Statements for Shareholders

(a) Upon the written request of a shareholder, a corporation shall deliver or make available to such requesting shareholder by posting on its shareholders’ website or by other generally recognized means annual financial statements, which may be consolidated or combined statements for the most recent fiscal year of the corporation and one or more of its subsidiaries, as appropriate, that include a balance sheet as of the end of the fiscal year, an income statement for that year, and a statement of changes in shareholders’ equity for the year unless that information appears elsewhere in the financial statements for which annual financial statements have been prepared for the corporation. If financial statements are prepared for the corporation on the basis of generally accepted accounting principles for such specified period, the corporation shall deliver or make available such financial statements to the requesting shareholder and if the annual financial statements must also be prepared on that basis.

(b) If delivered or made available to the annual financial statements requesting shareholder are audited or otherwise reported upon by a public accountant, the report must accompany them. If not, the statements must be accompanied by a statement of the president or the person responsible for the corporation’s accounting records shall also be delivered or made available to the requesting shareholder.
(1) stating such person’s reasonable belief whether the statements were prepared on the basis of generally accepted accounting principles and, if not, describing the basis of preparation; and

(2) describing any respects in which the statements were not prepared on a basis of accounting consistent with the statements prepared for the preceding year.

(c) Within 120 days after the close of each fiscal year, the 

(1) a corporation shall send the annual deliver, or make available and provide written notice of availability of, the financial statements required under subsection (a) to each the requesting shareholder. Thereafter, on within five business days of delivery of such written request from a shareholder to whom the statements were not sent, the corporation shall send the shareholder the latest financial statements. A public

(c) A corporation may fulfill its responsibilities under this section by delivering the specified financial statements, or otherwise making them available, in any manner permitted by the applicable rules and regulations of the United States Securities and Exchange Commission.

(d) Notwithstanding the provisions of subsections (a) and (b) of this section:

(1) as a condition to delivering or making available financial statements to a requesting shareholder, the corporation may require the requesting shareholder to agree to reasonable restrictions on the confidentiality, use and distribution of such financial statements; and

(2) the corporation may, if it reasonably determines that the shareholder’s request is not made in good faith or for a proper purpose, decline to deliver or make available such financial statements to that shareholder.

(e) If a corporation does not respond to a shareholder’s request for annual financial statements pursuant to this section in accordance with subsection (b) within five business days of delivery of such request to the corporation:

(1) The requesting shareholder may apply to the [name or describe court] for an order requiring delivery of or access to the requested financial statements. The court shall dispose of an application under this subsection on an expedited basis.

(2) If the court orders delivery or access to the requested financial statements, it may impose reasonable restrictions on their confidentiality, use or distribution.

(3) In such proceeding, if the corporation has declined to deliver such financial statements because the shareholder had been unwilling to agree to restrictions proposed by the corporation on the confidential-
(4) In such proceeding, if the corporation has declined to deliver such financial statements pursuant to section 16.20(d)(2), the corporation shall have the burden of demonstrating that it had reasonably determined that the shareholder’s request was not made in good faith or for a proper purpose.

(5) If the court orders delivery or access to the requested financial statements it shall order the corporation to pay the shareholder’s expenses incurred to obtain such order unless the corporation establishes that it had refused delivery or access to the requested financial statements because the shareholder had refused to agree to reasonable restrictions on the confidentiality, use or distribution of the financial statements or that the corporation had reasonably determined that the shareholder’s request was not made in good faith or for a proper purpose.

**CROSS-REFERENCES**

“Deliver” defined, see § 1.40.
Inspection of records, see § 16.02.
“Shareholder” defined, see § 1.40.
Shareholder agreements, see § 7.32.

**OFFICIAL COMMENT**

The requirement that a corporation regularly provide some financial information to shareholders is appropriate considering the relationship between corporate management and the shareholders as the ultimate owners of the enterprise. This requirement was first added as an amendment in 1979 to the 1969 Model Act.

Section 16.20 has its principal impact on small, closely held corporations, since enterprises whose securities are registered under federal statutes are required to supply audited financial statements to shareholders. The securities of the vast majority of corporations in the United States are not registered under federal law. It is these corporations that section 16.20 principally affects.

Section 16.20 requires every corporation to prepare and submit to shareholders annual financial statements consisting of a balance sheet as of the end of the fiscal year, an income statement for the year, and a statement of changes in shareholders’ equity for the year. The last statement may be omitted if the data that normally appears in that statement appears in the other financial statements or in the notes thereto. Consolidated statements of the corporation and any subsidiary, or subsidiaries, or combined statements for corporations under common
control, may be used. Section 16.20 does not require financial statements to be delivered or made available annual financial statements that have been prepared, it does not require a corporation to prepare financial statements. This recognizes that many small, closely held corporations do not regularly prepare formal financial statements unless required by banks, suppliers or other third parties.

Section 16.20 does not limit the financial statements to be delivered or made available to shareholders to financial statements prepared on the basis of generally accepted accounting principles (“GAAP”). Many small corporations have never prepared financial statements on the basis of GAAP. “Cash basis” financial statements (often used in preparing the tax returns of small corporations) do not comply with GAAP. Even closely held Smaller corporations that keep accrual basis records, and file their federal income tax returns on that basis, frequently do not make the adjustments that may be required to present their financial statements on a GAAP basis. In light of these considerations, it would be too burdensome on some small and closely held corporations to require GAAP statements. Accordingly, internally or externally prepared financial statements prepared on the basis of other accounting practices and principles that are reasonable in the circumstances, including tax returns filed with the Federal Internal Revenue Service (if that is all that is prepared), will suffice for these types of corporations and they may satisfy their obligations under section 16.20 by delivering or making available the requested financial statements in whatever form that they have been prepared for other purposes. If a corporation does prepare financial statements on a GAAP basis for any purpose for the particular year, however, it must send or make available those statements to the shareholder requesting shareholder as provided by the last sentence of section 16.20(a). A corporation whose shares are registered under the federal securities laws is, of course, required to provide annual audited financial statements to shareholders.

Section 16.20(a) refers to a “public accountant.” The same terminology is used in section 8.30 (standards of conduct for directors) of the Model Act. In various states different terms are employed to identify those persons who are permitted...
under the state licensing requirements to act as professional accountants. Phrases like “independent public accountant,” “certified public accountant,” “public accountant,” and others may be used. In adopting the term “public accountant,” the Model Act uses the words in a general sense to refer to any class or classes of persons who, under the applicable requirements of a particular jurisdiction, are professionally entitled to practice accountancy.

In requiring a statement by the president or person responsible for the corporation’s financial affairs, it is recognized that in many cases this person will not be a professionally trained accountant and should not be held to the standard required of professional. To emphasize this difference, section 16.20 requires a “statement” (rather than a “report” or “certificate”) and calls for the person to express “reasonable belief” (rather than “opinion”) about whether the statements are prepared on the basis of GAAP or, if not, to describe the basis of presentation and any inconsistencies in the basis of the presentation as compared with the previous year. The person providing the statement is not required to describe any inconsistencies between the basis of presentation and GAAP. If the statements are not prepared on a GAAP basis, the description would normally follow guidelines of the accounting profession as to the reporting format considered appropriate for a presentation which departs from GAAP. See, e.g., “Statement on Auditing Standards No. 14” of the American Institute of Certified Public Accountants. For example, the description might state, with respect to a cash basis statement of receipts and disbursements, that the statement was prepared on that basis and that it presents the cash receipts and disbursements of the entity for the period but does not purport to present the results of operations on the accrual basis of accounting.

Section 16.20(c) specifies that annual financial statements are to be sent to each shareholder within 120 days after the close of each fiscal year, further emphasizing that the statements required to be delivered are annual statements and not interim statements. In addition, if the corporation’s latest annual financial statements were not sent to a shareholder, he may obtain them on written request. See also section 16.01(e)(5).

A shareholder may also seek access to the financial statements of the corporation through the inspection rights established in section 16.02.

Failure to comply with the requirements of section 16.20 does not adversely affect the existence or good standing of the corporation. Rather, failure to comply gives an aggrieved shareholder rights to compel compliance or to obtain damages, if they can be established, under general principles of law.

2. Section 16.20(d)

In establishing restrictions with respect to confidentiality, use or distribution that are reasonable under the circumstances, a corporation may consider a number of factors, including the potential competitive harm to the corporation and its other shareholders that could result if the confidential financial information were used to compete with the corporation or disclosed to third parties such
as competitors. As provided in section 16.20(d)(2), a corporation may withhold delivery or making available its financial statements to a requesting shareholder if it reasonably determines that the shareholder’s request is not made in good faith and for a proper purpose.

3. SECTION 16.20(E)

If a corporation fails to comply with section 16.20(b) in a timely manner, the judicial remedy of 16.20(e) directs the court to handle the proceeding on an expedited basis in order to discourage dilatory tactics to avoid or delay delivery or access to financial statements, but does not require the court to resolve these issues on a summary basis. Section 16.20(e), like section 16.04, establishes a sanction against unreasonable delay or refusal to deliver or provide access to financial statements by imposing on the corporation the shareholder’s expenses unless the corporation can establish that the shareholder had been unwilling to agree to reasonable restrictions on the confidentiality, use or distribution of the requested financial statement or the corporation had reasonably determined that the shareholder’s request was not made in good faith or for a proper purpose.

§ 16.21. ANNUAL REPORT FOR SECRETARY OF STATE

(a) Each domestic corporation, and each foreign corporation authorized to transact business in this state, shall deliver to the secretary of state for filing an annual report that sets forth:

(1) the name of the corporation and the state or country under whose law it is incorporated;

(2) the address of its registered office and the name of its registered agent at that office in this state;

(3) the address of its principal office;

(4) names and business addresses of its directors and principal officers;

(5) a brief description of the nature of its business;

(6) the total number of authorized shares, itemized by class and series, if any, within each class; and

(7) the total number of issued and outstanding shares, itemized by class and series, if any, within each class.

(b) Information in the annual report must be current as of the date the annual report is signed on behalf of the corporation.

(c) The first annual report must be delivered to the secretary of state between January 1 and April 1 of the year following the calendar year in which a domestic corporation was incorporated or a foreign corporation was authorized to transact business. Subsequent annual reports must be deliv-
erred to the secretary of state between January 1 and April 1 of the following calendar years.

(d) If an annual report does not contain the information required by this section, the secretary of state shall promptly notify the reporting domestic or foreign corporation in writing and return the report to it for correction. If the report is corrected to contain the information required by this section and delivered to the secretary of state within 30 days after the effective date of notice, it is deemed to be timely filed.

**CROSS-REFERENCES**

Administrative dissolution for failure to file annual report, see § 14.20.
Annual report form prescribed by secretary of state, see § 1.21.
Authorized shares, see § 2.02.
“Deliver,” defined, see § 1.40.
Effective date of notice, see § 1.41.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Issuance of shares, see §§ 6.01–6.03.
Notices and other communications, see § 1.41.
Notice to the corporation, see § 1.41.
Officers, see § 8.40.
“Principal office” defined, see § 1.40.
Registered agent, see §§ 5.01 & 15.07.
Registered office, see §§ 5.01 & 15.07.
Revocation of certificate of authority for failure to file annual report, see § 15.30.
Series of shares, see § 6.21.

**Official Comment**

The requirement relating to the annual report that each corporation must submit to the secretary of state has been modified in section 16.21 in an effort to make it a limited information document for use by the secretary of state, members of the general public, and shareholders. The purpose of the annual report is to show the location of the principal office of the corporation, the names and business addresses of its directors and principal officers, the general nature of the corporation’s business, and its capital structure. It permits members of the general public to ascertain the identity of the corporation and communicate directly with it. It also establishes the alternative to the registered office for service of process and related matters. The “principal office” of the corporation is defined in section 1.40 as the location of its executive office in section 1.40.
The reference to “principal officers” in section 16.21(a)(4) is intended to simplify reporting requirements of corporations with very large numbers of employees who have some managerial responsibility and who, for business reasons, are designated as officers. The “principal officers” of a corporation include at least the chair of the board of directors, the chief executive officer, and the officers performing the traditional functions performed by the corporate secretary and treasurer, no matter what their designation.

The annual report is required of both domestic corporations and foreign corporations qualified to transact business in the state. The failure to file the annual report, like the failure to satisfy other mandatory requirements of the Act, is a ground for administrative dissolution or revocation of the certificate of authority to transact business. See section 15.03.

* * *

As proposed to be amended, chapter 16 would read as follows:

Records and Reports

Subchapter A.

RECORDS

§ 16.01. Corporate records
§ 16.02. Inspection rights of shareholders
§ 16.03. Scope of inspection right
§ 16.04. Court-ordered inspection
§ 16.05. Inspection rights of directors
§ 16.06. Exception to notice requirements

Subchapter B.

REPORTS

§ 16.20. Financial statements for shareholders
§ 16.21. Annual report for secretary of state

Subchapter A.

RECORDS

§ 16.01. Corporate Records

(a) A corporation shall maintain the following records:

   (1) its articles of incorporation as currently in effect;
(2) any notices to shareholders referred to in section 1.20(k)(5) specifying facts on which a filed document is dependent if those facts are not included in the articles of incorporation or otherwise available as specified in section 1.20(k)(5);

(3) its bylaws as currently in effect;

(4) all written communications within the past three years to shareholders generally;

(5) minutes of all meetings of, and records of all actions taken without a meeting by, its shareholders, its board of directors, and board committees established under section 8.25;

(6) a list of the names and business addresses of its current directors and officers; and

(7) its most recent annual report delivered to the secretary of state under section 16.21.

(b) A corporation shall maintain all annual financial statements prepared for the corporation for its last three fiscal years (or such shorter period of existence) and any audit or other reports with respect to such financial statements.

(c) A corporation shall maintain accounting records in a form that permits preparation of its financial statements.

(d) A corporation shall maintain a record of its current shareholders in alphabetical order by class of shares showing the number and class of shares held by each shareholder.

(e) A corporation shall maintain the records specified in this section in a manner that may be made available for inspection within a reasonable time.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.
Articles of amendment, see § 10.06.
Bylaws, see § 2.06, ch. 10B.
Committees of board of directors, see § 8.25.
Directors’ action without meeting, see § 8.21.
Inspection of corporate records, see §§ 16.02 & 16.04.
Meetings of board of directors, see § 8.20.
Officers, see § 8.40.
“Principal office”:
   defined, see § 1.40.
   designated in annual report, see § 16.21.
Reports of corporation, see §§ 16.20–16.21.
Restatement of articles of incorporation, see § 10.07.
Series of shares, see § 6.02.
Shareholders’ action without meeting, see § 7.04.
Shareholders’ meeting, see §§ 7.01–7.03.
Shareholders’ voting list, see § 7.20.

OFFICIAL COMMENT

1. RECORDS TO BE MAINTAINED

Section 16.01(a) requires certain basic records to be maintained by the corporation. The Act does not generally specify how records must be maintained other than in a manner in which they may be made available for inspection within a reasonable time, where they must be located or, with the exception of section 16.02(a), where they must be available. They may be maintained in one or more offices within or without the state and, in some cases, such as shareholder records, may be maintained by agents of the corporation; indeed, in the case of records in nonwritten form, it may be impossible to determine “where” they are located.

2. MINUTES AND RELATED DOCUMENTS

Section 16.01(a) does not address the amount of detail that should appear in minutes or written actions. Minutes of meetings customarily include the formalities of notice, the time and place of the meeting, those in attendance, and the results of any votes. Minutes of meetings and written actions without a meeting show formal action taken. The extent to which further detail is included is a matter of judgment which may depend upon the circumstances. Section 7.04, which addresses written actions taken by shareholders, requires that written actions by shareholders be delivered to the corporation for filing with corporate records.

3. FINANCIAL STATEMENTS AND ACCOUNTING RECORDS

The Act does not provide normative standards for the financial statements and accounting records to be prepared or maintained. The financial statements to be maintained under section 16.01(b) are those that the corporation prepares in the operation of its business, including in response to third party requirements. The form of the financial statements prepared by a corporation depends to some extent on the nature and complexity of the corporation’s business and third party requirements such as those governing the preparation and filing of tax returns with applicable tax authorities. To accommodate the needs of the many different types of business corporations that may be subject to these provisions, including closely held corporations, the Act does not require that the corporation prepare and maintain financial statements on the basis of generally accepted accounting principles (“GAAP”) if it is not otherwise required to prepare GAAP financial statements. The Act does not define what accounting records must be main-
tained or mandate how long they must be maintained. The accounting records to be maintained under section 16.01(c) depend upon the form of the corporation’s financial statements. For example, annual tax returns filed with the relevant taxing authorities may be the only annual financial statements prepared by small businesses operating on a cash basis and, in those instances, the requisite accounting records to be maintained may consist of only a check register, vouchers and receipts.

4. Shareholders’ Lists

Section 16.01(d) requires the corporation to maintain such records of its shareholders as will permit it to compile a list of current shareholders when required. These records may vary from stubs from which certificates have been detached in the case of corporations with a few shareholders, to elaborate electronic data in the case of large corporations whose shares are publicly traded. The record may be maintained by the corporation or an agent, who traditionally is the transfer agent but may be another agent. A corporation may maintain additional information regarding its shareholders, such as a list of nominees and nonobjecting beneficial owners if its shares are publicly traded.

§ 16.02. Inspection Rights of Shareholders

(a) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at the corporation’s principal office, any of the records of the corporation described in section 16.01(a), excluding minutes of meetings of, and records of actions taken without a meeting by, the corporation’s board of directors and board committees established under section 8.25, if the shareholder gives the corporation a signed written notice of the shareholder’s demand at least five business days before the date on which the shareholder wishes to inspect and copy.

(b) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at a reasonable location specified by the corporation, any of the following records of the corporation if the shareholder meets the requirements of subsection (c) and gives the corporation a signed written notice of the shareholder’s demand at least five business days before the date on which the shareholder wishes to inspect and copy:

(1) the financial statements of the corporation maintained in accordance with section 16.01(b);

(2) accounting records of the corporation;

(3) excerpts from minutes of any meeting of, or records of any actions taken without a meeting by, the corporation’s board of directors and board committees maintained in accordance with section 16.01(a); and
(4) the record of shareholders maintained in accordance with section 16.01(d).

(c) A shareholder may inspect and copy the records described in subsection (b) only if:

(1) the shareholder’s demand is made in good faith and for a proper purpose;

(2) the shareholder’s demand describes with reasonable particularity the shareholder’s purpose and the records the shareholder desires to inspect; and

(3) the records are directly connected with the shareholder’s purpose.

(d) The corporation may impose reasonable restrictions on the confidentiality, use or distribution of records described in subsection (b).

(e) For any meeting of shareholders for which the record date for determining shareholders entitled to vote at the meeting is different than the record date for notice of the meeting, any person who becomes a shareholder subsequent to the record date for notice of the meeting and is entitled to vote at the meeting is entitled to obtain from the corporation upon request the notice and any other information provided by the corporation to shareholders in connection with the meeting, unless the corporation has made such information generally available to shareholders by posting it on its website or by other generally recognized means. Failure of a corporation to provide such information does not affect the validity of action taken at the meeting.

(f) The right of inspection granted by this section may not be abolished or limited by a corporation’s articles of incorporation or bylaws.

(g) This section does not affect:

(1) the right of a shareholder to inspect records under section 7.20 or, if the shareholder is in litigation with the corporation, to the same extent as any other litigant; or

(2) the power of a court, independently of this Act, to compel the production of corporate records for examination and to impose reasonable restrictions as provided in section 16.04(d), provided that, in the case of production of records described in subsection (b) at the request of a shareholder, the shareholder has met the requirements of subsection (c).

(h) For purposes of this section, “shareholder” means a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner.
CROSS-REFERENCES

Articles of incorporation, see § 2.02.
Bylaws, see § 2.06, ch. 10B.
Committees of board of directors, see § 8.25.
Corporate records required, see § 16.01.
Court-ordered inspection, see § 16.04.
“Deliver” defined, see § 1.40.
Directors’ action without meeting, see § 8.21.
Effective date of notice, see § 1.41.
Meeting of board of directors, see § 8.20.
Notices and other communications, see § 1.41.
Notice to corporation, see § 1.41.
“Principal office”:
  defined, see § 1.40.
  designated in annual report, see § 16.21.
“Shareholder” defined, see § 1.40.
Shareholders’ action without meeting, see § 7.04.
Shareholders’ list inspection, see § 7.20.
Shareholders’ meeting, see §§ 7.01–7.03.
Voting trusts, see § 7.30.

OFFICIAL COMMENT

1. Section 16.02(a)

Under section 16.02(a), each shareholder is entitled to inspect documents that deal with the shareholder’s interest in the corporation. The right to inspection includes the right to make copies, as further described in section 16.03. While some of these documents may also be a matter of public record in the office of the secretary of state, a shareholder should not be compelled to go to a public office that may be physically distant to examine the basic documents relating to the corporation. The “principal office” of the corporation is defined in section 1.40 to be the location of the executive offices of the corporation and its address must be set forth by the corporation in its annual report required by section 16.21.

2. Section 16.02(b)

In contrast to the right to inspect minutes of meetings of, and written actions taken without a meeting by, shareholders, a shareholder is entitled to inspect only excerpts of meetings of, and records of written actions taken by, the board of directors and board committees related to the purpose of the inspection. A shareholder is entitled to inspect the shareholders’ list under section 16.02(b) without regard to the size or value of the shareholder’s holding.
This right is independent of the right to inspect a shareholders' list immediately before a meeting under section 7.20.

3. **Section 16.02(c)**

Section 16.02(c) permits inspection of the financial statements and records described in section 16.02(b) by a shareholder only if the demand is made in good faith and for a “proper purpose.” Although not defined in the Act, “proper purpose” under section 16.02(c) has been defined in case law to involve a purpose that is reasonably relevant to the demanding shareholder's interest as a shareholder.

Section 16.02(c) requires that a shareholder designate “with reasonable particularity” the purpose and the records he or she desires to inspect. Also, the records demanded must be “directly connected” with that purpose. If disputed by the corporation, the “connection” of the records to the shareholder’s purpose may be determined by a court’s private examination of the records.

4. **Section 16.02(d)**

The reasonable restrictions on the confidentiality, use or distribution of financial statements and records permitted by section 16.02(d) allow for the protection of confidential or proprietary information in the corporation’s records or sensitive matters that might be disclosed in a shareholder inspection. Such restrictions might include, for example, requiring the demanding shareholder to sign a confidentiality and use agreement. A similar provision is found in section 16.04(d) in connection with court-ordered inspections.

5. **Section 16.02(e)**

Section 16.02(e) provides shareholders of a corporation the right to receive from the corporation the notice and other information provided by the corporation to shareholders in connection with a meeting if the record date for voting is subsequent to the record date for notice and the shareholder became entitled to vote after the record date for notice. This provision does not apply to information provided to shareholders by persons other than the corporation.

6. **Sections 16.02(f) and (g)**

The prohibition in section 16.02(f) does not apply to an agreement permissible under section 7.32. No inference should be drawn from the prohibition in section 16.02(f) as to whether other, unrelated sections of the Act may be modified by provisions in the articles of incorporation or bylaws.

Section 16.02(g) preserves whatever independent rights of inspection exist under the referenced sources and does not create any rights, either expressly or by implication. A shareholder also has the right to obtain financial statements under section 16.20.
§ 16.03. SCOPE OF INSPECTION RIGHT

(a) A shareholder may appoint an agent or attorney to exercise the shareholder’s inspection and copying rights under section 16.02.

(b) The corporation may, if reasonable, satisfy the right of a shareholder to copy records under section 16.02 by furnishing to the shareholder copies by photocopy or other means chosen by the corporation including copies furnished through an electronic transmission.

(c) The corporation may comply at its expense with a shareholder’s demand to inspect the record of shareholders under section 16.02(b)(4) by providing the shareholder with a list of shareholders that was compiled no earlier than the date of the shareholder’s demand.

(d) The corporation may impose a reasonable charge to cover the costs of providing copies of documents to the shareholder, which may be based on an estimate of such costs.

CROSS-REFERENCES

Corporate records, see § 16.01.
Court-ordered inspection, see § 16.04.
“Electronic transmission” defined, see § 1.40.
Inspection right generally, see § 16.02.
Shareholders’ list inspection, see § 7.20.

OFFICIAL COMMENT

Section 16.03(a) provides that the rights of inspection and copying granted to shareholders in section 16.02 may be exercised by agents and attorneys of shareholders appointed by shareholders to conduct such inspection and copying. Providing the corporation with the right to choose among alternative delivery methods for copies in section 16.03(b), including by electronic transmissions, is intended to reduce burdens on the corporation.

Section 16.03(c) gives the corporation, at its option and expense, the right to provide a reasonably current list of its shareholders instead of granting the right of inspection. A list will be reasonably current if the list is one compiled no earlier than the date of the written demand, which under section 16.02(b) must provide at least five days’ notice.

Section 16.03(d) permits the corporation to be reimbursed for the expense of providing copies of documents to a shareholder.

§ 16.04. COURT-ORDERED INSPECTION

(a) If a corporation does not allow a shareholder who complies with section 16.02(a) to inspect and copy any records required by that section
to be available for inspection, the [name or describe court] may summarily order inspection and copying of the records demanded at the corporation’s expense upon application of the shareholder.

(b) If a corporation does not within a reasonable time allow a shareholder who complies with section 16.02(b) to inspect and copy the records required by that section, the shareholder who complies with section 16.02(c) may apply to the [name or describe court] for an order to permit inspection and copying of the records demanded. The court shall dispose of an application under this subsection on an expedited basis.

(c) If the court orders inspection and copying of the records demanded, it may impose reasonable restrictions on their confidentiality, use or distribution by the demanding shareholder and it shall also order the corporation to pay the shareholder’s expenses incurred to obtain the order unless the corporation establishes that it refused inspection in good faith because the corporation had:

(1) a reasonable basis for doubt about the right of the shareholder to inspect the records demanded; or

(2) required reasonable restrictions on the confidentiality, use or distribution of the records demanded to which the demanding shareholder had been unwilling to agree.

CROSS-REFERENCES

Corporate records, see § 16.01.
“Principal office”: defined, see § 1.40.
designated in annual report, see § 16.21.
“Expenses” defined, see § 1.40.
“Principal office”: defined, see § 1.41.
designated in annual report, see § 6.21.
Registered office:
designated in annual report, see § 16.21.
required, see §§ 2.02 & 5.01.
Service on corporation, see § 5.04.
Shareholders’ list inspection, see § 7.20.
Voluntary inspection, see § 16.02.

OFFICIAL COMMENT

Section 16.04 provides a judicial remedy if a corporation refuses to grant the right of inspection provided by section 16.02.
If the right of inspection under section 16.02(a) is invoked and the corporation refuses to grant inspection, the shareholder may seek a summary order compelling inspection at the corporation’s expense. A summary order is appropriate since the right of inspection under section 16.02(a) is either automatic or subject only to a determination that the person is in fact a shareholder of the corporation. By contrast, if inspection is demanded under section 16.02(b), a number of matters may be at issue, including the shareholder’s good faith and proper purpose for demands under section 16.02(b) or the reasonableness of the restrictions required by the corporation on the confidentiality, use or distribution of the records. Accordingly, section 16.04(b) directs the court to handle the proceeding “on an expedited basis” instead of in a summary proceeding. The purpose of this phrase is to discourage dilatory tactics to avoid or delay inspection without requiring the court to resolve these issues on a summary basis.

The principal sanction against unreasonable delay or refusal to grant inspection is provided by section 16.04(c), which imposes on the corporation the shareholder’s expenses unless the corporation establishes that it refused inspection in good faith on the grounds specified in section 16.04(c)(1) or (2). For example, a corporation may point to conduct of the shareholder involving improper use of information obtained from the corporation in the past as indicating that reasonable doubt existed as to the shareholder’s present purpose or by showing that the corporation refused inspection because the shareholder had been unwilling to agree to reasonable restrictions on the confidentiality, use or distribution of the records demanded.

§ 16.05. Inspection Rights of Directors

(a) A director of a corporation is entitled to inspect and copy the books, records and documents of the corporation at any reasonable time to the extent reasonably related to the performance of the director’s duties as a director, including duties as a member of a committee, but not for any other purpose or in any manner that would violate any duty to the corporation.

(b) The [name or describe court] may order inspection and copying of the books, records and documents at the corporation’s expense, upon application of a director who has been refused such inspection rights, unless the corporation establishes that the director is not entitled to such inspection rights. The court shall dispose of an application under this subsection on an expedited basis.

(c) If an order is issued, the court may include provisions protecting the corporation from undue burden or expense, and prohibiting the director from using information obtained upon exercise of the inspection rights in a manner that would violate a duty to the corporation, and may also order the corporation to reimburse the director for the director’s expenses incurred in connection with the application.
OFFICIAL COMMENT

The purpose of section 16.05(a) is to confirm the principle that a director always is entitled to inspect books, records and documents to the extent reasonably related to the performance of the director’s duties provided that the requested inspection is not for an improper purpose and the director’s use of the information obtained would not violate any duty to the corporation. In addition, section 16.05 sets forth a remedy for the director in circumstances where the corporation improperly denies the right of inspection.

Section 16.05(b) provides for court order on an expedited basis because there is a presumption that significant latitude and discretion should be granted to the director, and the corporation has the burden of establishing that the director is not entitled to inspection of the documents requested. There may be circumstances where the director’s inspection right might be denied, for example, when it would be contrary to the interest of the corporation because of adversity with the director, and the courts have broad discretion to address these circumstances. Section 16.05 does not directly deal with the ability of a director to inspect records of a subsidiary of which he or she is not also a director. A director’s ability to inspect records of a subsidiary generally should be exercised through the parent’s rights or power, and section 16.05(a) does not independently provide that right or power to a director of the parent.

Subchapter B.
REPORTS

§ 16.20. FINANCIAL STATEMENTS FOR SHAREHOLDERS

(a) Upon the written request of a shareholder, a corporation shall deliver or make available to such requesting shareholder by posting on its website or by other generally recognized means annual financial statements for the most recent fiscal year of the corporation for which annual financial state-
ments have been prepared for the corporation. If financial statements have been prepared for the corporation on the basis of generally accepted accounting principles for such specified period, the corporation shall deliver or make available such financial statements to the requesting shareholder and if the annual financial statements to be delivered or made available to the requesting shareholder are audited or otherwise reported upon by a public accountant, the report shall also be delivered or made available to the requesting shareholder.

(b) A corporation shall deliver, or make available and provide written notice of availability of, the financial statements required under subsection (a) to the requesting shareholder within five business days of delivery of such written request to the corporation.

(c) A corporation may fulfill its responsibilities under this section by delivering the specified financial statements, or otherwise making them available, in any manner permitted by the applicable rules and regulations of the United States Securities and Exchange Commission.

(d) Notwithstanding the provisions of subsections (a) and (b) of this section:

(1) as a condition to delivering or making available financial statements to a requesting shareholder, the corporation may require the requesting shareholder to agree to reasonable restrictions on the confidentiality, use and distribution of such financial statements; and

(2) the corporation may, if it reasonably determines that the shareholder’s request is not made in good faith or for a proper purpose, decline to deliver or make available such financial statements to that shareholder.

(e) If a corporation does not respond to a shareholder’s request for annual financial statements pursuant to this section in accordance with subsection (b) within five business days of delivery of such request to the corporation:

(1) The requesting shareholder may apply to the [name or describe court] for an order requiring delivery of or access to the requested financial statements. The court shall dispose of an application under this subsection on an expedited basis.

(2) If the court orders delivery or access to the requested financial statements, it may impose reasonable restrictions on their confidentiality, use or distribution.

(3) In such proceeding, if the corporation has declined to deliver such financial statements because the shareholder had been unwilling to agree to restrictions proposed by the corporation on the confidentiality, use and distribution of such financial statements, the corporation
shall have the burden of demonstrating that the restrictions proposed by the corporation were reasonable.

(4) In such proceeding, if the corporation has declined to deliver such financial statements pursuant to section 16.20(d)(2), the corporation shall have the burden of demonstrating that it had reasonably determined that the shareholder's request was not made in good faith or for a proper purpose.

(5) If the court orders delivery or access to the requested financial statements it shall order the corporation to pay the shareholder’s expenses incurred to obtain such order unless the corporation establishes that it had refused delivery or access to the requested financial statements because the shareholder had refused to agree to reasonable restrictions on the confidentiality, use or distribution of the financial statements or that the corporation had reasonably determined that the shareholder’s request was not made in good faith or for a proper purpose.

CROSS-REFERENCES
“Deliver” defined, see § 1.40.
Inspection of records, see § 16.02.
“Shareholder” defined, see § 1.40.
Shareholder agreements, see § 7.32.

OFFICIAL COMMENT
1. SECTION 16.20(A)

Although section 16.20 requires a corporation, upon the written request of a shareholder, to deliver or make available annual financial statements that have been prepared, it does not require a corporation to prepare financial statements. This recognizes that many small, closely held corporations do not regularly prepare formal financial statements unless required by banks, suppliers or other third parties.

Section 16.20 does not limit the financial statements to be delivered or made available to shareholders to financial statements prepared on the basis of generally accepted accounting principles (“GAAP”). Many small corporations have never prepared financial statements on the basis of GAAP. “Cash basis” financial statements (often used in preparing the tax returns of small corporations) do not comply with GAAP. Smaller corporations that keep accrual basis records, and file their federal income tax returns on that basis, frequently do not make the adjustments that may be required to present their financial statements on a GAAP basis. Internally or externally prepared financial statements prepared on the basis of other accounting practices and principles that are reasonable in
the circumstances, including tax returns filed with the U.S. Internal Revenue Service (if that is all that is prepared), will suffice for these types of corporations and they may satisfy their obligations under section 16.20 by delivering or making available the requested financial statements in whatever form that they have been prepared for other purposes. If a corporation does prepare financial statements on a GAAP basis for any purpose for the particular year, however, it must send or make available those statements to the requesting shareholder as provided by section 16.20(a). A corporation whose shares are registered under the federal securities laws is, of course, required to provide annual audited financial statements to shareholders.

The last sentence of section 16.20(a) requires that if the financial statements to be delivered or made available have been reported upon by a public accountant, that report must be furnished. Section 16.20(a) refers to a “public accountant.” The same terminology is used in section 8.30 (standards of conduct for directors). In various states different terms are employed to identify those persons who are permitted under the state licensing requirements to act as professional accountants. Phrases like “independent public accountant,” “certified public accountant,” “public accountant,” and others may be used. In adopting the term “public accountant,” the Act uses the words in a general sense to refer to any class or classes of persons who, under the applicable requirements of a particular jurisdiction, are professionally entitled to practice accountancy.

A shareholder may also seek access to the financial statements of the corporation through the inspection rights established in section 16.02.

Failure to comply with the requirements of section 16.20 does not adversely affect the existence or good standing of the corporation.

2. Section 16.20(d)

In establishing restrictions with respect to confidentiality, use or distribution that are reasonable under the circumstances, a corporation may consider a number of factors, including the potential competitive harm to the corporation and its other shareholders that could result if the confidential financial information were used to compete with the corporation or disclosed to third parties such as competitors. As provided in section 16.20(d)(2), a corporation may withhold delivery or making available its financial statements to a requesting shareholder if it reasonably determines that the shareholder’s request is not made in good faith and for a proper purpose.

3. Section 16.20(e)

If a corporation fails to comply with section 16.20(b) in a timely manner, the judicial remedy of 16.20(e) directs the court to handle the proceeding on an expedited basis in order to discourage dilatory tactics to avoid or delay delivery or access to financial statements, but does not require the court to resolve these issues on a summary basis. Section 16.20(e), like section 16.04, establishes a
sanction against unreasonable delay or refusal to deliver or provide access to financial statements by imposing on the corporation the shareholder’s expenses unless the corporation can establish that the shareholder had been unwilling to agree to reasonable restrictions on the confidentiality, use or distribution of the requested financial statement or the corporation had reasonably determined that the shareholder’s request was not made in good faith or for a proper purpose.

§ 16.21. Annual Report for Secretary of State

(a) Each domestic corporation, and each foreign corporation authorized to transact business in this state, shall deliver to the secretary of state for filing an annual report that sets forth:

(1) the name of the corporation and the state or country under whose law it is incorporated;

(2) the address of its registered office and the name of its registered agent at that office in this state;

(3) the address of its principal office;

(4) names and business addresses of its directors and principal officers;

(5) a brief description of the nature of its business;

(6) the total number of authorized shares, itemized by class and series, if any, within each class; and

(7) the total number of issued and outstanding shares, itemized by class and series, if any, within each class.

(b) Information in the annual report must be current as of the date the annual report is signed on behalf of the corporation.

(c) The first annual report must be delivered to the secretary of state between January 1 and April 1 of the year following the calendar year in which a domestic corporation was incorporated or a foreign corporation was authorized to transact business. Subsequent annual reports must be delivered to the secretary of state between January 1 and April 1 of the following calendar years.

(d) If an annual report does not contain the information required by this section, the secretary of state shall promptly notify the reporting domestic or foreign corporation in writing and return the report to it for correction. If the report is corrected to contain the information required by this section and delivered to the secretary of state within 30 days after the effective date of notice, it is deemed to be timely filed.
CROSS-REFERENCES

Administrative dissolution for failure to file annual report, see § 14.20.
Annual report form prescribed by secretary of state, see § 1.21.
Authorized shares, see § 2.02.
“Deliver” defined, see § 1.40.
Effective date of notice, see § 1.41.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Issuance of shares, see §§ 6.01–6.03.
Notices and other communications, see § 1.41.
Notice to the corporation, see § 1.41.
Officers, see § 8.40.
“Principal office” defined, see § 1.40.
Registered agent, see §§ 5.01 & 15.07.
Registered office, see §§ 5.01 & 15.07.
Revocation of certificate of authority for failure to file annual report, see § 15.30.
Series of shares, see § 6.21.

OFFICIAL COMMENT

The purpose of the annual report is to show the location of the principal office of the corporation, the names and business addresses of its directors and principal officers, the general nature of the corporation’s business, and its capital structure. It permits members of the general public to ascertain the identity of the corporation and communicate directly with it. It also establishes the alternative to the registered office for service of process and related matters. The “principal office” of the corporation is defined in section 1.40 as the location of its executive office.

The reference to “principal officers” in section 16.21(a)(4) simplifies reporting requirements of corporations with very large numbers of employees who have some managerial responsibility and who, for business reasons, are designated as officers. The “principal officers” of a corporation include at least the chair of the board of directors, the chief executive officer, and the officers performing the traditional functions performed by the corporate secretary and treasurer, no matter what their designation.

The annual report is required of both domestic corporations and foreign corporations qualified to transact business in the state. The failure to file the annual report, like the failure to satisfy other mandatory requirements of the Act, is a ground for administrative dissolution or revocation of the certificate of authority to transact business. See section 15.03.
The Annual Survey Working Group reports annually on judicial decisions that it believes are of the greatest significance to M&A practitioners. This year’s survey covers:

**Contract Interpretation**


7. *Cigna Health & Life Insurance Co. v. Audax Health Solutions, Inc.* (Del. Ch. Nov. 26, 2014) (limits on enforceability of indemnities and other requirements against stockholders not party to merger agreement)


**SUCCESSOR LIABILITY**


**FIDUCIARY DUTY**


13. *In re Comverge, Inc. Shareholders Litigation* (Del. Ch. Nov. 25, 2014) (granting motion to dismiss as to process, but denying motion as to deal protections, in take-under context)

14. *Corwin v. KKR Financial Holdings LLC* (Del. Oct. 2, 2015) (fully informed, uncoerced vote of disinterested stockholders invokes business judgment rule, even if that vote is required by statute)

CONTRACT INTERPRETATION

1. Gore v. Al Jazeera America Holdings I, Inc. (Objection to Buyer’s Retention of Escrowed Cash Based on Buyer’s Failure to Give Proper Notice of Claims)

In Gore v. Al Jazeera America Holdings I, Inc., the Delaware Court of Chancery held that certain written notices of indemnification claims did not meet the requirements set forth in a merger agreement and, as a result, were invalid.

Background

The claims arose from a merger agreement pursuant to which Current Media, LLC (the “Company”) was sold by the Company’s former members (collectively, the “Plaintiffs”) to Al Jazeera America Holdings I, Inc. (the “Defendant”). Under the merger agreement, a portion of the merger consideration was set aside in an escrow account to satisfy certain indemnity obligations which included, among other things, indemnification for breaches of the Company’s representations and warranties.

The Defendant informed the Plaintiffs, in written claim notices for indemnification (each, a “Claim Certificate”), that certain of the Company’s customers had alleged that the Company had not complied with the “most favored nation” (or “MFN”) obligations under the Company’s distribution agreements, which was inconsistent with the Company’s representations and warranties. The core issue in this case was whether the Claim Certificates were sufficient to allow the Defendant to retain certain amounts from the escrow account as indemnity under the terms of the merger agreement. The Plaintiffs moved for judgment on the pleadings, claiming that the Defendant had failed to give the Plaintiffs proper notice and opportunity to participate in or control the defense of the claims arising out of the Company’s breach of the MFN obligations.

In the first Claim Certificate (the “DirecTV Claim Certificate”), the Defendant sought indemnification in the amount of $28.5 million, which was the amount that one of the Company’s customers, DirecTV, LLC, had demanded for an MFN violation. The Defendant also asserted that it anticipated incurring future damages of up to $32 million plus attorney’s fees from one party and future damages of unknown sums from similarly situated claimants, and that a specific customer had made claims for similar sums and attorney’s fees, all constituting or resulting from circumstances constituting breaches of the Company’s representations and warranties in the merger agreement.
In the second Claim Certificate (the “DISH Claim Certificate”), the Defendant sought indemnification in the amount of $10 million, which was the amount another customer of the Company, DISH Network, LLC, had demanded for an MFN violation.9 The Defendant also asserted that, as a result of the alleged breaches, the Defendant had incurred $1.37 million in attorney’s fees and expenses, and that the Defendant may be required to make payments of up to $40 million to three other similarly situated claimants.10

Analysis

The court found that the DirecTV Claim Certificate was facially invalid under Section 8.8(a) of the merger agreement, which in pertinent part provided that:

On or before the last day of the General Escrow Period . . . [the Defendant] may deliver . . . a written notice . . . :

(i) stating that an Indemnified Party has incurred or paid or that it reasonably believes it will incur or pay Damages.11

The DirecTV Claim Certificate, however, provided only that the Defendant “may incur” damages (as opposed to “will incur” damages).12 The court noted that the Defendant would be permitted to develop a factual record as to whether this defect was material such that it would invalidate the corresponding portions of the DirecTV Claim Certificate.13

The court also found that Section 8.10 of the merger agreement required that any notice of a third-party claim by the Defendant “describe the Third Party Claim in reasonable detail . . . and . . . indicate the estimated amount . . . of the Damages that have been or may be sustained.”14 The Defendant argued that Section 8.10 set forth form and notice requirements for indemnification claims that were different from the requirements for indemnification for non-third-party claims under Section 8.8(a). The court disagreed, holding that “any” claim for indemnification must be made by a Claim Certificate under Section 8.8 regardless of whether it is a third-party claim. In support of such holding, it cited cross-references in Sections 8.7 and 8.9 of the merger agreement that indicated that Section 8.8 governed the requirements for making claims, as opposed to Section 8.10, which dealt with preserving the right to participate in the defense of third-party claims.15

With respect to both the DirecTV Claim Certificate and the DISH Claim Certificate, the Defendant argued that any claim must be made within the escrow period and must be based upon “[d]amages” then “paid, incurred or demanded.”16 The court noted that Article VIII of the merger agreement estab-

9. Id. at *8.
10. Id.
11. Id. at *9.
12. Id. at *10.
13. Id.
14. Id. at *13.
15. Id. at *19.
16. Id. at *25.
lished a deadline for commencing a claim for indemnification, rather than for paying, incurring, or receiving a demand for damages. The issues were (i) whether certain Claim Certificates could serve as “placeholders” for certain claims and (ii) whether the Defendant had a right to commence an indemnity claim where there was an indemnifiable event but no third-party claim to provide a basis for such event. The court found that these “placeholder” claims could be made if they complied with the requirements of Section 8.8(a) of the merger agreement and that the receipt of an actual third-party claim was not required. The court further found that while these “placeholder” claims satisfied Section 8.8(a)(iii) of the merger agreement, which required a reasonably detailed description of the indemnifiable event, the issue at hand was whether they satisfied subsections (i) and (ii) of Section 8.8(a), which respectively required a statement that the Defendant has or will incur damages and a statement specifying the amount of such damages.19

The court found that the DirectTV Claim Certificate did not set forth a sufficient claim as a result of the Defendant’s failure to certify that it believed it “will” incur damages. With respect to the DISH Claim Certificate, however, the court noted that the Defendant did state that, as a result of the claimed MFN violation, the “Defendant believes that it will eventually be required to make payments.” Accordingly, the court found that the DISH Claim Certificate met the requirements for “placeholder” claims and “non-placeholder” claims under Section 8.8(a)(i) of the merger agreement.21

The court held that the claim descriptions sufficed to survive a motion for judgment on the pleadings with respect to the DirecTV, LLC demand and the demands made by certain specifically named third-party distributor affiliates, but not for the unidentified “other distributor” claims.22 The court noted that, while Section 8.8(a)(ii) of the merger agreement would likely permit a claim for indemnification based on an open-ended statement of damages, the provision unequivocally requires some concrete damages figure either paid, incurred, or projected.23 Thus, the court held that except for the claim for $420,000 plus interest for audit expenses and attorney’s fees already incurred, the claim for up to $32 million for potential future damages arising from the DirecTV, LLC demand, and the claim for up to $28.5 million for potential future damages arising from a similar demand made by certain specifically named third-party distributor affiliates, the DirecTV Claim Certificate was facially invalid pursuant to Section 8.8(a)(ii) of the merger agreement as to any other “potential” claims.24

17. Id. at *29.
18. Id. at *30.
19. Id. at *32.
20. Id. at *33.
21. Id.
22. Id. at *35.
23. Id. at *37.
24. Id. at *36–37.
Conclusion

This case demonstrates the importance of carefully tracking the wording or phrasing of a defect claim clause to minimize the risk of losing a potentially valid claim before a court has a chance to consider the merits of such a claim.

2. Alliant Techsystems, Inc. v. MidOcean Bushnell Holdings, L.P.
(INTERPRETING REMEDIES PROVISION RELATING TO NET WORKING CAPITAL CALCULATION DISPUTE)

In Alliant Techsystems, Inc. v. MidOcean Bushnell Holdings, L.P., the court found that a determination by an independent accountant designated to resolve issues with respect to a post-closing purchase price adjustment was also the appropriate remedy to address disputes regarding the accounting methodology used in calculating the adjustment.

Background

Alliant Techsystems, Inc. (“Alliant”) entered into a stock purchase agreement (the “Purchase Agreement”) with MidOcean Bushnell Holdings, L.P. (“MidOcean”) to acquire Bushnell Group Holdings, Inc. (the “Target”). The Purchase Agreement contained a purchase price adjustment based on the net working capital of the Target as of closing. MidOcean’s estimate of the net working capital was delivered before closing and indicated that a positive purchase price adjustment was payable to MidOcean. However, during Alliant’s post-closing true up of the adjustment, Alliant determined that it was owed approximately $26 million based on its calculation of net working capital.

Alliant’s adjustment claims were based on MidOcean’s failure to follow generally accepted accounting principles (“GAAP”) in calculating working capital. Alliant sought to refer the matter to an independent accountant, pursuant to the purchase price adjustment procedure. MidOcean claimed that such dispute should rather be heard by a court, in accordance with the Purchase Agreement’s indemnification procedure, because the dispute involved questions raised by the Target’s financial statements and inventory representations.

The court highlighted two significant differences between the purchase price adjustment procedure and the indemnification procedure. First, a claim under the purchase price adjustment procedure is brought before an independent accountant in accordance with a strict timeline, whereas a claim under the indem-
nification procedure is brought before a court in accordance with normal judicial procedures.\(^{34}\) Second, under the purchase price adjustment procedure, Alliant would be able to recover up to $12.3 million.\(^{35}\) In comparison, under the indemnification procedure, Alliant would be able to recover only $7.3 million and only after Alliant exceeded an indemnification threshold of $4.9 million.\(^{36}\)

**Analysis**

In reaching its conclusion that the dispute between the parties was properly brought under the purchase price adjustment procedure, the court first looked at the exclusive remedy provisions contained in the Purchase Agreement. The purchase price adjustment procedure contained a provision stating that such procedure was the exclusive remedy with respect to any purchase price adjustment dispute.\(^{37}\) The exclusive remedy provision included in the indemnification section stated that indemnification was the exclusive remedy for the parties, but specifically stated that the indemnification procedure was in no way intended to interfere with the purchase price adjustment procedure.\(^{38}\) Accordingly, the court stated that a hierarchy between the exclusive remedy provisions had been established, with the purchase price adjustment procedure taking priority over the indemnification procedure in the event both were applicable.\(^{39}\)

Second, the court looked at whether MidOcean’s alleged failure to calculate its estimated net working capital in accordance with GAAP could be a disputed item for the independent accountant to review. Although the court acknowledged that MidOcean made certain representations about its financials being prepared in accordance with GAAP, the Purchase Agreement also specifically required that MidOcean’s estimate statement, and Alliant’s post-closing statement, regarding net working capital be prepared in accordance with GAAP.\(^{40}\) Thus, a claim that MidOcean failed to make such calculations in accordance with GAAP was an appropriate dispute that Alliant could raise as part of the purchase price adjustment procedure.\(^{41}\)

The court rejected MidOcean’s argument that the independent accountant was only charged with mathematical calculations, reasoning that the parties would not have required an independent accounting firm of national reputation to serve as an expert if they just needed simple calculations performed.\(^{42}\) Therefore, the court concluded that the parties must have wanted the independent accountant to be able to exercise more expertise if needed.\(^{43}\)

\(^{34}\) Id. at *4.  
\(^{35}\) Id.  
\(^{36}\) Id.  
\(^{37}\) Id. at *3.  
\(^{38}\) Id. at *9.  
\(^{39}\) Id.  
\(^{40}\) Id. at *7–8.  
\(^{41}\) Id. at *9.  
\(^{42}\) Id. at *10.  
\(^{43}\) Id. at *10–11.
Conclusion

Although this case may not have been surprising for many, it reminds practitioners of the importance of drafting dispute resolution provisions with specificity, particularly with respect to those that may be in conflict.

3. **Kumiva Group, LLC v. Garda USA Inc. (Rejecting Buyer’s Claims of Fraud, in Part Because of Merger Agreement Disclaimers)**

In **Kumiva Group, LLC v. Garda USA Inc.**, the Supreme Court of New York awarded $10,489,140 to the former shareholders of an acquired company in a dispute over a post-closing price adjustment. The court rejected the buyer’s claims of fraud, in part because of explicit merger agreement disclaimers.

Background

On February 25, 2007, Garda USA Inc. (“Garda”) acquired ATI Services, LLC (“ATI”) pursuant to an Agreement and Plan of Merger (the “Agreement”). The Agreement provided for the calculation of a post-closing price adjustment based on ATI’s net working capital as of closing (“NWC”). Section 2.10(f) of the Agreement provided that: (i) if the NWC was below $35 million, Garda was to receive $6.25 million, the amount remaining in escrow after all other disbursements had been properly made; (ii) if the NWC was between $35 million and $41 million, Kumiva Group, LLC (“Kumiva”), as representative of ATI’s former shareholders, was to receive the $6.25 million; and (iii) if the NWC exceeded $41 million, then Kumiva was to receive the $6.25 million in escrow, plus an assignment of a portion of Garda’s accounts receivable—up to a $9 million cap.

The parties failed to agree on the NWC and, pursuant to the arbitration provision in the Agreement, Deloitte Touche Tohmatsu Limited (“Deloitte”) determined that the NWC was $45,101,217 and, accordingly, Garda owed $6,250,000 plus an assignment of its accounts receivables equaling $4,161,217. The Agreement provided that the parties would pay the arbitrator’s fees in equal shares, but Garda refused to pay Deloitte’s bill and the amount awarded in arbitration. In order to obtain Deloitte’s report, Kumiva paid for Garda’s portion of the bill, which was $77,923. Kumiva filed suit for breach of contract, claiming as damages both the amount awarded in arbitration and

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45. Id. at *16.
46. Id. at *8–11.
47. Id. at *1.
48. Id. at *2.
49. Id. at *2–3.
50. Id. at *3–4.
51. Id.
52. Id.
Garda’s share of Deloitte’s bill. Garda filed counterclaims for fraud, fraudulent inducement, fraudulent concealment, and breach of contract. The counterclaims were based in part upon the fact that ATI had acquired CDC Systems, Inc. (“CDC”) shortly before ATI was in turn acquired by Garda and failed to disclose problems with the integration of CDC into ATI in order to induce Garda into paying an inflated price.53

Analysis

With respect to Garda’s counterclaims, the court stated that neither Garda nor its experts had relied on a valuation of ATI at the time Garda acquired it.54 Instead, their claim was that the deal could have been more profitable but for the alleged misrepresentations.55 The court held that the out-of-pocket rule precluded Garda from seeking damages based solely on “the possibility of a ‘better’ deal.”56 Under the out-of-pocket rule, the measure of damages for fraud is indemnity for the actual monetary loss sustained as a direct result of the wrong, as opposed to the profits that would have been received in the absence of fraud.57 Because Garda offered no evidence of an initial valuation of ATI, the court dismissed Garda’s counterclaim for failing to prove the actual monetary loss that it sustained.58

The court also held that there was insufficient evidence to support a finding of fraud because there was no justifiable reliance on any misrepresentation.59 First, the disclosure schedules attached to the Agreement expressly indicated that the integration of CDC posed the risk of potential profit loss.60 Second, the Agreement contained disclaimers of all representations and warranties not expressly provided therein.61 The court stated that such broad disclaimers generally insulate sophisticated parties from tort liability.62 If Garda wished to preserve fraud claims, then it should have included an “appropriate prophylactic provision.”63 As justifiable reliance is an essential element of fraud, fraudulent inducement, and fraudulent concealment, each of these counterclaims failed.64

Finally, Garda claimed that Kumiva breached Section 3.6(a) of the Agreement, which required ATI to deliver “correct and complete financial statements” to

53. Id. at *4.
54. Id. at *6.
55. Id. at *6–7.
56. Id. at *6.
58. Id. at *7.
59. Id. at *10.
60. Id. at *9.
61. Id. at *8.
64. Id. at 10–11.
Garda. The court held that Garda failed to raise any issue of material fact as to such counterclaims and dismissed them.

With respect to Kumiva’s claims, the court held that Garda breached the Agreement by failing to pay the amounts awarded by Deloitte as well as its half of Deloitte’s bill. Therefore, the court granted summary judgment in Kumiva’s favor.

Conclusion

Kumiva illustrates the utility of disclaimer provisions in transactional drafting. Generally, when two sophisticated parties execute a contract stating that implied representations and warranties are expressly disclaimed, courts will interpret such provisions as having been entered into with full understanding of their scope. If a party wants to protect itself in cases of potential fraud, it should review and negotiate such provisions with care.


Two recent Delaware cases reinforce the importance of specificity when setting forth the buyer’s obligations with respect to achievement of post-closing earn-out revenue targets.

Implied Covenants Apply Only to Fill Gaps in the Contractual Language

In Fortis Advisors LLC v. Dialog Semiconductor PLC, Fortis Advisors LLC ("Fortis"), as representative of the former equity holders of iWatt, Inc., sued Dialog Semiconductor PLC, as buyer ("Dialog"), for Dialog’s failure to meet certain revenue targets and pay $35 million in earn-out payments. Payment of the earn-out was contingent upon achievement, post-closing, of certain revenue targets with respect to Dialog’s Power Conversion Business Group. The merger agreement specified that Dialog was to use its “commercially reasonable best efforts” to achieve the earn-out revenue targets. The agreement also contained a specific list of requirements further restricting Dialog’s actions with respect to the earn-out.
Among other claims, Fortis claimed that Dialog failed to use commercially reasonable best efforts and, in the alternative, Dialog breached its implied covenant of good faith and fair dealing because it did not take certain actions in order to achieve the earn-out.74 Dialog brought a motion to dismiss the latter claim.75 The court granted Dialog’s motion to dismiss stating that the implied covenant of good faith and fair dealing is only applicable where there are gaps in the contractual language leaving an ambiguity as to the obligation of a party.76

In this instance, the court found that Fortis failed to identify any gaps in the merger agreement. Therefore, the court was unwilling to imply an obligation on the part of Dialog through the implied covenant of good faith and fair dealing.77

**Unambiguous, Plain Language Will Control Contractual Interpretation**

In *Lazard Technology Partners, LLC v. Qinetiq North America Operations LLC*,78 the Delaware Supreme Court interpreted unambiguous contractual language in accordance with its plain meaning.79

At issue was a $40 million earn-out payment due from Qinetiq North America Operations LLC, as buyer (“Qinetiq”), to the former stockholders of Cyveillance, Inc. (whom Lazard Technology Partners, LLC (“Lazard”) represented), as seller, in the event certain post-closing revenue targets were achieved.80 When the earn-out targets were not met, Lazard brought suit on behalf of the selling stockholders claiming that Qinetiq breached the merger agreement’s implied covenant of good faith and fair dealing.81 The merger agreement provided specifically that Qinetiq would not take any action or divert revenue with the “intent of reducing or limiting” the earn-out payments.82

The court stated that “intent” has a well-established legal meaning.83 Thus, it was not sufficient to show that Qinetiq knew certain decisions or actions would cause the earn-out revenue targets not to be met.84 Instead, Lazard would have had to show that a business decision by Qinetiq was motivated in part by a desire to avoid or reduce the earn-out.85

The court rejected the argument that Qinetiq breached the merger agreement’s implied covenant of good faith and fair dealing.86 Just as in the lower court, the justices relied on the fact that the post-closing obligations of Qinetiq were highly

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74. Id. at *3.
75. Id.
76. Id. at *4.
77. Id. at *5.
78. 114 A.3d 193 (Del. 2015).
79. Id. at 195.
80. Id. at 194.
81. Id.
82. Id. (quoting the merger agreement).
83. Id. at 195.
84. Id.
85. Id.
86. Id. at 196 n.13.
negotiated and specific, yet resulted in the single intent-based obligation recited above. Accordingly, both courts reasoned that the implied covenant could not be breached unless Qinetiq possessed the requisite intent to avoid the earn-out payment.

**Conclusion**

These two cases reinforce the importance of using clear language in drafting earn-out provisions, particularly when addressing the post-closing obligations of the parties with respect to earn-outs or other contingent consideration.

If parties are not clear about post-closing obligations, the parties may be able to rely on an implied covenant of good faith and fair dealing by identifying ambiguity or gaps in the contract with respect to post-closing obligations of the parties, but courts are reluctant to apply the covenant where there is no apparent gap.


In *Grant Prideco, Inc. v. Empeiria Conner L.L.C.*, a divided three-judge panel of the Texas Court of Appeals held that a provision requiring the sellers to indemnify the buyer for product liability claims as to which “the facts, events and circumstances . . . first arose” prior to the closing date was an unambiguous obligation triggered upon the occurrence of any actionable conduct rather than only when the right to seek judicial remedy accrues. The dissent, however, found the emphasized language rendered the parties’ intent unclear.

**Background**

Grant Prideco, Inc. (“Grant Prideco”) entered into a Stock Purchase Agreement (“Purchase Agreement”) with Empeiria Conner L.L.C. and certain affiliates (collectively, “Empeiria”), pursuant to which Grant Prideco purchased all the outstanding equity of the indirect parent of Aggregate Plant Products Company (“APPCO”).

Under Section 10.2 of the Purchase Agreement, Empeiria agreed to indemnify Grant Prideco “for any and all Losses to the extent such Losses are based upon, arise out of, or are related to . . . any Claims of Product Liability for which the facts, events and circumstances with respect to such Product Liability Claim first arose prior to the Closing Date.” The closing date was May 25, 2011. In March 2012, a third party sued APPCO and others asserting various product li-
ability claims allegedly arising out of severe injuries he had suffered on or about September 1, 2011, while working with a multi-sander allegedly manufactured, designed, marketed, and distributed by APPCO and others.93

Grant Prideco and APPCO (now a Grant Prideco subsidiary) sought indemnification from Empeiria pursuant to Section 10.2 of the Purchase Agreement. While Empeiria did not dispute that at least some of the claims were “Product Liability Claims” for purposes of Section 10.2,94 it asserted that Section 10.2 required the claim to have actually accrued prior to Closing—i.e., that facts existed sufficient to authorize a claimant to seek a judicial remedy—and no such accrual occurred until several months post-closing, when the third party suffered his injuries.95 Grant Prideco and Empeiria each sought declaratory relief, and the trial court sided with Empeiria.96 The appeals court reversed.

**Analysis**

Stating that indemnity agreements were to be strictly construed under the usual principles of contract interpretation to give effect to the parties’ intent as expressed in the agreement,97 the appeals court held that the terms contained in the indemnity provision should be given their generally accepted meaning unless the agreement indicated otherwise.98 The court found nothing in the Purchase Agreement to suggest that those terms, which it considered “ordinary words,” were used in a technical sense or in any way other than to convey their generally accepted meaning.99 Noting that the phrase “arising out of” had been interpreted broadly by courts to mean “originating from, having its origin in, growing out of, or flowing from,”100 it held that the indemnity language encompassed the allegedly actionable conduct that was the basis of the third party’s claims.101 In the court’s view, in Texas jurisprudence, the word “accrue,” although related to “arise,” was too narrow a “concept,” because it would require not only that the “facts, events and circumstances,” but also a cognizable injury, have occurred.102

The dissent, while agreeing with the majority’s conclusion that the terms used in the indemnity should be given their everyday meaning and were broad in scope, nevertheless found the provision to be ambiguous with respect to whether

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93. Id. at 159, 161.
94. Id. at 161.
95. Id.
96. Id. at 159.
97. Id. at 160.
98. Id.
99. Id. at 161–62.
100. The court also cited as support the definition of “arise” in Black’s Law Dictionary (“in relevant part . . . , ‘[t]o originate[,] to stem (from[,)’ and ‘[t]o result (from’”). Id. at 162.
101. Id. The court remanded the case to the trial court to determine when the actionable conduct “first arose.”
102. Id. The court observed that if the parties had intended to permit indemnification only for legal causes of action that had “accrued” prior to the closing date, it easily could have used that term, which has a specific legal meaning.
those “ordinary words” should be applied individually or collectively. Noting that the indemnity provision contained “elements that happen at different points in time,” the dissent viewed the use of the words “the” and “and” to suggest that the parties may have intended that all, not just any, of the facts, events, and circumstances with respect to the Product Liability Claim must have occurred for the indemnity obligation to be triggered.

Conclusion

Grant Prideco illustrates the importance of precision when drafting indemnification provisions. While the majority found the phrasing unambiguous, the decision was a split one.

6. Halpin v. Riverstone National, Inc. (Declining to Enforce Drag-Along Rights When Invoked After Closing)

In Halpin v. Riverstone National, Inc., the Delaware Court of Chancery denied enforcement of a drag-along provision in a stockholders agreement, finding that the controlling stockholder had not effectively exercised its rights in accordance with the provision’s explicit procedures. Thus, the minority stockholders subject to the drag-along had not waived appraisal rights.

Background

In 2009, the minority common stockholders (the “Minority Holders”) of Riverstone National, Inc. (“Riverstone”) entered into a stockholders agreement with Riverstone (the “Agreement”) that included a drag-along provision (the “Drag-Along”). The Agreement provided that if at any time a stockholder or group of stockholders owning a majority of Riverstone’s voting stock “propose[d]” to enter into any change-of-control transaction, then Riverstone could require the Minority Holders to vote and/or tender their shares upon at least ten days’ advance notice of the transaction. The Agreement also gave the majority a proxy to vote the minority shares.

In 2014, at a time when the Minority Holders were pursuing litigation to investigate potential breaches of fiduciary duties by Riverstone’s officers and directors, Riverstone sent a letter to its stockholders (the “Information Statement”) informing them that Riverstone had consummated a merger with a third party.

103. Id. at 165.
104. Id. at 164–65 (characterizing the indemnity obligation language as “unusual,” the dissent also found ambiguity in the parties’ use of the word “first” in “first arose”).
106. Id. at *4.
107. Id. at *5.
108. Id. at *5.
109. Id. at *5–6.
110. Id. at *7.
pursuant to which the Minority Holders would be cashed out. The merger had been authorized by the written consent of Riverstone’s controlling 91 percent stockholder and had become effective prior to the mailing of the Information Statement. The Information Statement further advised the Minority Holders that Riverstone was exercising its rights under the Drag-Along in connection with the merger. The Minority Holders would be required to vote to approve the merger by written consent within ten days. The Information Statement stated that the Minority Holders “may be entitled to exercise appraisal rights under Section 262 of the [Delaware General Corporation Law],” but only if they did not execute the written consent to approve the merger, which would in turn constitute a breach of the Agreement.

Upon receipt of the Information Statement, the Minority Holders sought to exercise their appraisal rights in connection with the merger. Riverstone brought counterclaims seeking specific performance of the Minority Holders’ obligations under the Drag-Along so as to cause stockholders to waive their appraisal rights. The court considered the case on cross-motions for summary judgment.

Analysis

The Minority Holders raised a number of arguments in support of their position. First, they argued that a common stockholder cannot waive its statutory appraisal rights ex ante. The court, however, did not find it necessary to resolve this issue under the facts of the case because Riverstone did not strictly follow the procedures set forth in the Agreement, which rendered the Drag-Along unenforceable. Nevertheless, the court characterized the issue as “more nuanced than is the case with preferred stockholders” and acknowledged that no Delaware case had settled the question. The court noted that even if the sole purpose of the Drag-Along was to waive the Minority Holders’ appraisal rights in future change-of-control transactions, the language of the Drag-Along did not explicitly waive appraisal rights. Rather, the Drag-Along obligated the Minority Holders to undertake certain actions—vote or tender their shares—that would have the effect of waiving their appraisal rights.
Second, the Minority Holders argued that the Drag-Along could only be exercised prospectively, not after the merger was already consummated. The court observed that the language obligating the Minority Holders to vote or tender their shares was prospective in nature; the Minority Holders agreed to take such actions in favor of a “propose[d]” merger upon advance notice thereof. Here, Riverstone was seeking to require the Minority Holders to consent to a merger that had already been consummated without receipt of any advance notice. The court concluded that Riverstone had no such power under the express terms of the Drag-Along.

Similarly, the court rejected Riverstone’s argument for specific performance of the Drag-Along because the Minority Holders breached the implied covenant of good faith and fair dealing. The court explained that the implied covenant is a gap filler that “only applies to developments that could not be anticipated, not developments that the parties simply failed to consider.” The court found no such gap to fill in, noting that the Minority Holders and Riverstone were sophisticated parties which were, or should have been, aware of the various ways to effect a merger under Delaware law, including by written consent, at the time they entered into the Agreement. Because Riverstone agreed to language that limited the Drag-Along to prospective mergers, the court denied Riverstone’s motion to specifically enforce the Drag-Along.

Conclusion

Halpin reminds practitioners to follow all procedures under a drag-along provision, including use of proxies where required. Delaware courts are likely to hold parties to the terms of their contract even in circumstances, like those in Halpin, where procedural compliance would have likely cut off the Minority Holders’ appraisal rights.

Halpin also underscores that a question may remain as to the enforceability against holders of common stock (as opposed to preferred stock) of advance waivers of appraisal rights.

125. Id. at *16.
126. Id. at *33.
127. Id.
128. Id.
129. Id. at *38–39.
130. Id. at *38 (quoting Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010)).
131. Id. at *37.
132. See id. at *38.
133. Id. at *39.
7. **Cigna Health & Life Insurance Co. v. Audax Health Solutions, Inc. (Limits on Enforceability of Indemnities and Other Requirements Against Shareholders Not Party to Merger Agreement)**

In *Cigna Health & Life Insurance Co. v. Audax Health Solutions, Inc.*, the Delaware Court of Chancery deemed unenforceable against a stockholder not party to a merger agreement (1) indemnification obligations in the merger agreement that were unlimited in amount and duration and (2) a release in a letter of transmittal.

**Background**

Optum Services, Inc. ("Optum") acquired Audax Health Solutions, Inc. ("Audax") in a merger, at which time Cigna Health and Life Insurance Co. ("Cigna") owned preferred stock of Audax. The merger agreement provided for the appointment of Shareholder Representative Services, LLC ("SRS") as the representative of all Audax stockholders and included indemnification provisions under which the Audax stockholders agreed to indemnify Optum, up to the pro rata amount of merger consideration they received, for breaches of certain representations and warranties made by Audax in the merger agreement. Most of the representations and warranties survived the closing of the merger for eighteen months. However, certain representations and warranties survived for thirty-six months, and certain fundamental representations and warranties, along with the relevant indemnification obligations, survived indefinitely.

The merger was approved by the written consent of holders of 66.9 percent of the Audax stock entitled to vote. Cigna did not sign the merger agreement, vote in favor of the merger, or sign a support agreement. Under the terms of the merger agreement, receipt of the merger consideration was conditioned on the surrender of Audax shares and the execution of a letter of transmittal. In the merger agreement, the letter of transmittal was defined as "a letter of transmittal in form and substance reasonably acceptable to [b]uyer" under which the Audax stockholders would be required to "make standard representations and warranties" and agree to the provisions of the merger agreement, including the indemnification obligations. The letter of transmittal distributed after consummation of the merger required each Audax stockholder to agree to the appointment of SRS, agree to the indemnification obligations in the merger agreement, and agree to release certain claims against the acquirer.

134. 107 A.3d 1082 (Del. Ch. 2014).
135. Id. at 1085.
136. Id. at 1086.
137. Id.
138. Id. at 1085.
139. Id. at 1085–86.
140. Id. at 1086.
141. Id.
142. Id.
Cigna demanded its merger consideration but refused to sign the letter of transmittal on the grounds that it violated the Delaware General Corporation Law ("DGCL"). Consequently, the acquirer refused to pay Cigna its merger consideration. Cigna filed a complaint, and after the defendants answered, Cigna moved for judgment on the pleadings.

Analysis

The court held that the release in the letter of transmittal was unenforceable. The court noted that the right to receive the merger consideration vested as a matter of law under section 251 of the DGCL when the merger was consummated. Therefore, the release obligation set forth in the letter of transmittal was a new obligation that the acquirer sought to impose after the merger without providing any additional consideration to Cigna, and, as a result, the letter of transmittal was an unenforceable contract that lacked separate, independent consideration.

Cigna also contended that the indemnification obligations in the merger agreement violated section 251 of the DGCL. Cigna's primary challenge was that certain indemnity claims were not limited by time or by the amount of money that might be subject to clawback from the Audax stockholders after the closing. Cigna did not challenge the post-closing purchase price adjustment in Section 2.10 of the merger agreement based on Audax's post-closing financial statements and the potential clawback resulting from a downward adjustment under Section 2.10, likely because these adjustments were limited in time. As such, the Audax court limited its review of the indemnification issue to only the potential indemnity claims that were unlimited in duration and amount.

The court concluded that the merger consideration was effectively a cash payment subject to an open-ended purchase price adjustment because all of the cash paid to the Audax stockholders would be subject to indemnification claims by the acquirer indefinitely. The court noted that post-closing purchase price adjustments generally are permissible if they satisfy the requirements of section 251 of the DGCL. Section 251(b) of the DGCL provides that a merger agreement "may be made dependent upon facts ascertainable outside of such agreement, provided that the manner in which such facts shall operate upon the terms of the agreement is clearly and expressly set forth" in the merger agreement. The court agreed that the indemnification obligations on their face complied

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143. *Id.*
144. *Id.*
145. *Id.* at 1087.
146. *Id.* at 1090–91.
147. *Id.* at 1091.
148. *Id.* at 1093.
149. *Id.* at 1094 n.46.
150. *Id.* at 1094.
151. *Id.* at 1095.
152. *Id.* at 1093.
153. DEL. CODE ANN. tit. 8, § 251(b) (2011).
with the “facts ascertainable” provision in section 251(b), because the indemni-
fication provisions were clearly and expressly set forth in the merger agreement,
and because a determination about whether a particular indemnification claim
was valid could be made by a court outside of the terms of the merger
agreement.154

However, the court held that the indemnification obligations did not comply
with section 251(b)(5), which requires the merger agreement to state “the cash,
property, rights or securities of any other corporation or entity which the holders
of such shares are to receive.”155 The court noted that although the Audax stock-
holders were nominally entitled to receive their pro rata share of the merger con-
sideration under the terms of the merger agreement, they would never know the
exact value of that share because the entire amount of their merger consideration
would be subject to indemnification claims by the acquirer indefinitely.156

The court made clear that its opinion “does not concern escrow agreements”
and does not “rule on the general validity of post-closing purchase price adjust-
ments requiring direct payment from the stockholders.”157 The court did, how-
ever, note that “[p]ost-closing purchase price adjustments that could require in-
dividual stockholders to repay part of their merger consideration occupy an
uncertain status under Delaware law.”158 The court expressly stated that it
was not ruling on whether either a purchase price adjustment that covers all
of the merger consideration but is time limited or an adjustment that has an in-
definite duration as to only a portion of the merger consideration would be valid
under section 251.159

The court ruled that Cigna was entitled to tender its Audax shares and receive
its merger consideration without being bound by those indemnification obliga-
tions that were not subject to a monetary cap or a time limit of thirty-six months
(the longest specified survival period in the merger agreement) or less.160

Cigna also challenged the validity of the appointment of SRS as the stockhold-
ers’ representative on the grounds that the appointment improperly deprived
Cigna of its ability to defend against any indemnity claims.161 Because the
court had already determined that the indemnification obligations in the merger
agreement, to the extent they were unlimited in duration and amount, were in-
vail as to Cigna, the court declined to rule on whether the appointment of SRS
to represent Cigna was valid.162

154. Id. at 1094.
155. DEL. CODE ANN. tit. 8, § 251(b)(5).
156. Cigna, 107 A.3d at 1095.
157. Id. at 1099.
158. Id.
159. Id.
160. Id.
161. Id. at 1086.
162. Id. at 1095–96.
Conclusion

M&A practitioners should be mindful that seeking to impose additional obligations on target stockholders in a letter of transmittal without the payment of additional consideration may not be enforceable. Furthermore, in light of the court’s holding, provisions in a merger agreement purporting to require non-signatory stockholders to return merger consideration already paid to them may be of questionable validity.

The uncertainty noted by the Audax court underscores the importance to acquirers of holding back a portion of the merger consideration, or placing a portion of the merger consideration in escrow, in order to make downward purchase price adjustment provisions more effective—even if the purchase price adjustment is determined relatively soon after the closing and is based on objective financial metrics.

8. *FOX V. CDX HOLDINGS, INC. (INTERPRETING OPTION PLAN LANGUAGE TO DETERMINE SHAREHOLDERS’ PARTICIPATION IN ESCROW)*

In *Fox v. CDX Holdings, Inc.*,163 the Delaware Court of Chancery considered whether holders of options cashed out in a merger received adequate value for those options. The court held that the option plan, which required payment of fair market value (as determined by the board) less the exercise price, and not the merger agreement, was the operative contract for such determination. Since the definition of fair market value made no allowance for escrow holdbacks, the court found that the board’s acceptance of the merger agreement’s requirement that option holders contribute to an escrow fund breached the target’s contractual obligations under the plan.

Moreover, the plan required that fair market value be determined by the board and that the exercise price of the options be appropriately adjusted by the board to reflect the spinoff of two businesses immediately prior to closing. Because the value assigned the spun-off companies was not only materially but intentionally understated, and because in any event the board never made either determination, the court found the company in breach of its contractual obligations on these grounds as well.

Background

Caris Life Sciences, Inc., a privately held Delaware corporation (“Caris”), operated three business units: Caris Diagnostics, TargetNow, and Carisome.164 To secure financing for the latter two and generate a return for its stockholders, Caris effected a complex spin/merger transaction pursuant to which Caris first

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164. *Id.* at *1.*
spun off TargetNow and Carisome to its stockholders (the “Spinoff”) and then sold itself in a reverse triangular cash merger to Miraca Holdings, Inc.\textsuperscript{165}

Caris had two principal stockholders: the founder, CEO, and controlling stockholder, who owned 70.4 percent, and a private equity fund that owned 26.7 percent, of Caris’s fully diluted equity.\textsuperscript{166} Each received a proportionate equity stake in the spun-off companies, as well as a proportionate share of the $725 million paid by Miraca for what remained of Caris.\textsuperscript{167}

Most of the remaining 2.9 percent of Caris’s fully diluted equity took the form of stock options.\textsuperscript{168} Under the stock option plan, each holder was entitled on cancellation of the options in the merger to receive for each underlying share the amount by which the fair market value of the share exceeded the exercise price.\textsuperscript{169} Fair market value was defined as an amount determined by the Caris board of directors (the “Board”).\textsuperscript{170} The plan also required the Board to adjust the exercise price of the options to account for the Spinoff.\textsuperscript{171} Under the terms of the plan, the Board’s good-faith determinations were conclusive unless arbitrary and capricious.\textsuperscript{172}

The merger agreement provided that option holders would receive the difference between $5.07 per share and the exercise price of the options, less 8 percent that would be contributed to the escrow account established in connection with the indemnification obligations under the merger agreement.\textsuperscript{173} Of the $5.07, $4.46 represented the per share merger consideration being paid under the merger agreement, and the remaining $0.61 purported to represent the value attributable to the spun-off companies.\textsuperscript{174}

\textbf{Analysis}

The court found that completion of the merger was effectively dependent on ensuring that no tax would be payable by Caris in connection with the Spinoff.\textsuperscript{175} The court further found that Caris’s CFO and controlling stockholder engaged in an exercise of undervaluing the spun-off businesses to achieve

\textsuperscript{165.} Id. Following the merger, Caris changed its name to CDx Holdings, Inc.
\textsuperscript{166.} Id.
\textsuperscript{167.} Id. They reinvested $100 million of those proceeds in a financing of the spun-off businesses.
\textsuperscript{168.} Id. at *2. The holders received no continuing equity interest in the spun-off companies.
\textsuperscript{169.} Id. at *2. *16.
\textsuperscript{170.} Id. at *2. *17.
\textsuperscript{171.} Id.
\textsuperscript{172.} Id. at *2. *24.
\textsuperscript{173.} Id. at *2.
\textsuperscript{174.} Id.
\textsuperscript{175.} Id. at *6. Under section 355(e) of the Internal Revenue Code, the Spinoff would be treated as if Caris had sold TargetNow and Carisome to Caris’s stockholders for the fair market value of those businesses on the Spinoff date. If the fair market value of those businesses exceeded their tax basis, Caris would owe tax on the difference. Marica, which would then be the owner of Caris, insisted as a condition to the merger that the spun-off businesses (and thus indirectly the two principal stockholders of Caris pre-merger) indemnify Miraca for any such tax liability. If the value of the spun-off businesses was less than Caris’s basis in those entities, however, then the Spinoff would result in zero exposure. See id. at *10.
such result.\textsuperscript{176} The CFO informed Caris’s tax advisor of the targeted valuation and supplied the advisor with reduced projections for the two businesses to support that target.\textsuperscript{177} As the court observed, the CFO, once committed to under-valuing the businesses for tax purposes, could not then value them fairly for the option holders.\textsuperscript{178} Even though the tax advisor’s analysis did not value the spun-off businesses as going concerns,\textsuperscript{179} and even though the $65 million valuation resulting from that analysis conflicted with the belief of the CFO, Caris’s controlling stockholder, and Caris’s financial advisors that the businesses were worth far more,\textsuperscript{180} the CFO recommended and the controlling stockholder approved using the $65 million valuation as the amount by which the fair market value of the Caris common stock had decreased as a result of the Spinoff.\textsuperscript{181} Although the plan required that the Board (not the CFO) proportionately adjust the option exercise prices to reflect the Spinoff, and that the Board (not the CFO) determine the fair market value of a share of Caris’s common stock, the Board did neither. The CFO, with the approval of the controlling stockholder, made such determinations.\textsuperscript{182}

The court ruled that Caris had breached its contractual obligations to the option holders in numerous respects. As to the escrow contribution, the court held that the relationship between Caris and its option holders was contractual in nature and governed by the option plan, not the merger agreement.\textsuperscript{183} While the plan gave the Board discretion as to whether to cancel options in the event of a merger, the plan required that in such event the option holders receive “the difference between Fair Market Value and the exercise price”—the plan did not permit any holdback for an escrow.\textsuperscript{184} While section 251(b) of the DGCL permits the terms of a merger agreement to convert shares into the right to receive consideration subject to an indemnification arrangement, options are not shares.\textsuperscript{185} Accordingly, by deducting the escrow amount, Caris breached that obligation.\textsuperscript{186}

\textsuperscript{176.} Id. at *2, *28–30.  
\textsuperscript{177.} Id. at *2, *12, *28–30.  
\textsuperscript{178.} Id. at *5.  
\textsuperscript{179.} Id. at *13, *31. The valuation in question was a tax transfer valuation that, for example, omitted goodwill. Id. at *31.  
\textsuperscript{180.} Id. at *2–3, *26–28.  
\textsuperscript{181.} Id. at *2–5, *22, *28–30. This valuation also contrasted with higher values that a different accounting firm had generated for the same businesses in reports prepared that year. When Miraca questioned the accuracy of the $65 million tax transfer valuation, Caris engaged this accounting firm to perform an independent “valuation” analysis. The court found that the CFO orchestrated that effort, with the result that the report came in with a slightly lower valuation that “largely—and admittedly—copied [the tax advisor’s] analysis.” Id. at *2, *15, *18–20.  
\textsuperscript{182.} Id. at *2–5, *22, *28–30.  
\textsuperscript{183.} Id. at *34.  
\textsuperscript{184.} Id.  
\textsuperscript{185.} Id. at *34–35.  
\textsuperscript{186.} Id. at *35. The court noted that the plan “could have been drafted” in a way that would have permitted the desired outcome, “such as by providing that holders of options cancelled in connection with the merger would receive the same consideration received by holders of stock, less the exercise price.” Id.
As to the Spinoff adjustment to the exercise price and the determination of fair market value, not only did the Board fail to make either determination required under the plan, but those determinations that were made—not by the Board, but by the CFO and the controlling stockholder—violated the plan’s requirements that they be made in good faith and not be arbitrary and capricious.\(^\text{187}\)

The court awarded the option holders the difference between what the court concluded the Board should have determined in good faith to be fair market value and the amount those holders actually received.\(^\text{188}\)

**Conclusion**

This decision reminds those drafting stock option plans and award agreements to consider giving the plan administrator the flexibility, when cancelling or cashing out options in a merger, to tie payouts to the price being paid in the merger and to accommodate the indemnification, earn-outs, and similar payout structures that may relate to shares in the merger. It also reminds practitioners to review the terms of a target’s option plans to ensure they do not raise valuation issues.

This decision also illustrates the importance of observing the procedural (much less substantive) requirements of an option plan with respect to any such valuation.

**Successor Liability**


In *Tsareff v. ManWeb Services Inc.*,\(^\text{189}\) the United States Court of Appeals for the Seventh Circuit held that for purposes of imposing successor liability on an asset purchaser for the target’s withdrawal from a multiemployer pension plan, the requirement that the successor have notice of the claim before the acquisition occurred is met by a showing that the successor had notice of a contingent withdrawal liability.\(^\text{190}\)

**Background**

ManWeb Services, Inc. (“ManWeb”) entered into an asset purchase agreement (“Purchase Agreement”) with Tiernan & Hoover (“T&H”) pursuant to which it

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\(^{187}\) Id. at *24–32. The court observed that, under Delaware law, a contractual requirement that a party act in good faith, without any qualifier, means that the party must act in subjective good faith. The court here found that the CFO’s and controlling stockholder’s actions, as well as the process surrounding the preparation of the second accounting firm’s valuation, supported a finding of subjective bad faith. Id. at *28, *32.

\(^{188}\) Id. at *35–37.

\(^{189}\) 794 F.3d 841 (7th Cir. 2015).

\(^{190}\) Id. at 844–47.
purchased the assets of T&H.\textsuperscript{191} ManWeb was a nonunion employer, but T&H was a party to a collective bargaining agreement ("CBA"), in accordance with which it made contributions to a multi-employer pension fund (the "Plan").\textsuperscript{192} ManWeb was made aware of T&H's obligations as a union employer during its due diligence, and the Purchase Agreement contained a clause providing that ManWeb was not obligated to assume, and did not assume, any liability or obligation arising out of or related to union-related activities, including pension obligations.\textsuperscript{193} After the asset purchase, T&H ceased operations and was no longer obligated to contribute to the Plan.\textsuperscript{194} However, ManWeb continued to do the same kind of work in the jurisdiction of the CBA for which contributions were previously required of T&H, and ManWeb made no contributions to the Plan.\textsuperscript{195}

Counsel for the Plan sent a letter to T&H, indicating that T&H had effectuated a complete withdrawal from the Plan and that, pursuant to section 4202 of the Employee Retirement Income Security Act ("ERISA"),\textsuperscript{196} the Plan had assessed withdrawal liability in the amount of $661,978 against T&H.\textsuperscript{197} The letter was forwarded to ManWeb's address.\textsuperscript{198}

The Plan filed a collection action in federal court against T&H and added ManWeb as a defendant under a theory of successor liability.\textsuperscript{199} The parties filed cross-motions for summary judgment at the close of discovery. The district court then granted the Plan's motion in part, finding that T&H had waived its right to dispute the assessment of withdrawal liability by failing to initiate arbitration proceedings. However, the court held that ManWeb was not liable under the successor liability claim.\textsuperscript{200}

\textbf{Analysis}

The Seventh Circuit has imposed successor liability under federal common law, which reaches beyond the limits of state common law, in a variety of employment-related contexts when "(1) the successor had notice of the claim before the acquisition; and (2) there was 'substantial continuity in the operation of the business before and after the sale.'\textsuperscript{201} The district court's holding that ManWeb was not liable, as a successor, for the withdrawal liability was based upon its view that pre-acquisition notice of a contingent liability does not suffice; speci-

\begin{itemize}
  \item \textsuperscript{191} \textit{Id. at 843.}
  \item \textsuperscript{192} \textit{Id.}
  \item \textsuperscript{193} \textit{Id. at 847–48.}
  \item \textsuperscript{194} \textit{Id. at 843–44.}
  \item \textsuperscript{195} \textit{Id. at 844.}
  \item \textsuperscript{197} \textit{Tsareff}, 794 F.3d at 844.
  \item \textsuperscript{198} \textit{Id.}
  \item \textsuperscript{199} \textit{Id.}
  \item \textsuperscript{200} \textit{Id.}
  \item \textsuperscript{201} \textit{Id. at 845 (quoting Pension Fund v. Tasemkin, Inc., 59 F.3d 48, 49 (7th Cir. 1995) (quoting EEOC v. G-K-G, Inc., 39 F.3d 740, 748 (7th Cir. 1994))).}
\end{itemize}
fically, because the Plan did not assess the amount of the withdrawal liability until after the asset purchase, the district court concluded that it was impossible for ManWeb to have notice of any existing withdrawal liability prior to the acquisition.\footnote{202}{Id. at 844–45.}

The Seventh Circuit reversed. Its opinion reviewed the policy goals of the MPPAA in imposing withdrawal liability, which it summarized as to “(1) relieve the financial burden placed upon remaining contributors to a multiemployer fund when one or more of them withdraws from the plan, . . . (2) avoid creating a severe disincentive to new employers entering the plan, . . . and (3) prevent the creation of funding deficiencies.”\footnote{203}{Id. at 845–46.} The court of appeals found that “[i]mposing successor liability for unpaid multiemployer pension fund contributions and withdrawal liability effectuates those congressional policies and goals.”\footnote{204}{Id. at 846.}

The Seventh Circuit noted that, while the precise amount of withdrawal liability is not ascertainable pre-acquisition if the employer is found to have withdrawn after it sold its assets, the precise amount of withdrawal liability may be known prior to the asset sale if the employer withdraws before the sale, e.g., ceases operations due to bankruptcy.\footnote{205}{Id.} Given this, the court stated that if the notice requirement were to exclude notice of contingent liabilities, as the district court held, “a liability loophole would exist: multiemployer plan sponsors would be foreclosed in some situations (but not others) from seeking withdrawal liability from asset purchasers who would otherwise qualify as successors, and the plans would be left ‘holding the bag.’”\footnote{206}{Id. at 847.} The opinion continued: “We do not believe that this result would further Congress’s goal of ensuring that the responsibility for a withdrawing employer’s share of unfunded vested pension benefits is not shifted to remaining employers.”\footnote{207}{Id.}

Recognizing that it would be inequitable to impose successor liability when the successor did not have an opportunity to protect itself through indemnification or a lower purchase price, the court noted that such measures are still available in an asset sale where the buyer has notice that the seller may be contingently liable for withdrawal liability.\footnote{208}{Id. at 847. The court ultimately held that notice of contingent withdrawal liability satisfies the notice requirement.\footnote{209}{Id. The court also held that the evidence presented in this case established that ManWeb had sufficient pre-acquisition notice of T&H’s contingent withdrawal liability.\footnote{210}{Id. at 848.} Finally, the court reversed the determination of the district court that, even if notice of a contingent liability satisfies the notice requirement, the imposition of successor liability on ManWeb would be inequitable.\footnote{211}{Id. at 849–50}}
Conclusion

Tsareff is a reminder that, in many employment-related contexts, asset purchasers may run the risk of successor liability under the federal common law’s relaxed “substantial continuity” test for both actual and contingent liabilities. This risk must be kept in mind in due diligence, in pricing the acquisition, and in negotiating the indemnification and other provisions of the asset purchase agreement.

Fiduciary Duty

10. In re Dole Food Co., Inc. Stockholder Litigation (Control Stockholder Liability for Fraud)

In November 2013, David Murdock, the chairman, CEO, and controlling stockholder of Dole Food Co., Inc. (“Dole”), took the company private in a single-step merger.212 After trial in consolidated stockholder actions alleging breaches of fiduciary duty, the Delaware Court of Chancery held that Murdock and Michael Carter, a Dole officer and director and Murdock’s “right-hand man,” had breached their fiduciary duty of loyalty by intentionally driving down Dole’s stock price before the merger and by undermining the work of a special committee.213 The court awarded damages of $148 million.214

Background

The court found that, in the months leading up to Murdock’s initial offer, Carter sought to depress Dole’s stock price.215 He intentionally furnished the market with a “subterranean” estimate of Dole’s cost savings in connection with another transaction and cancelled a stock repurchase program for pretextual reasons.216 With Dole’s share price having declined to $10.20, Murdock offered to purchase the company for $12.00 per share.217 Murdock expressly conditioned his offer on approval from a committee of independent Dole directors and the affirmative vote of holders of a majority of the unaffiliated shares.218 Dole’s board formed a special committee.219 The court concluded that Murdock and Carter intentionally undermined the committee process by, among other things, supplying the committee with “lowball” projections and withholding financial information and business plans from the committee that they shared with Murdock’s own advisors.220 Carter attempted to undermine the committee’s process in other

213. Id. at *1–2.
214. Id.
215. Id. at *2.
216. Id. at *28.
217. Id. at *15.
218. Id. at *1.
219. Id. at *15.
220. Id. at *2.
ways, including by (i) seeking to restrict the committee’s mandate at the outset, (ii) resisting the hiring of the committee’s preferred financial advisor and attempting to steer the selection toward Carter’s preferred choice, (iii) insisting that it was “his job” and not the committee’s to negotiate confidentiality agreements, (iv) refusing to comply with instructions of the committee, and (v) secretly advising Murdock on how to negotiate against the committee.221

The special committee ultimately approved a going-private merger at $13.50 per share, after which the merger was also approved by the holders of 50.9 percent of the stock held by unaffiliated stockholders.222 Despite those approvals, the court held that Murdock and Carter’s conduct violated their duty of loyalty.223

Analysis

Standard of Review: Business Judgment Rule or Entire Fairness? Under the Delaware Supreme Court’s earlier decision in Kahn v. M&F Worldwide Corp.,224 a controlling stockholder going-private merger can be subject to judicial review under the deferential business judgment rule, rather than the entire fairness standard of review, if the transaction is conditioned from the outset on approval by both a special committee of independent directors and the holders of a majority of the unaffiliated shares and certain other conditions are satisfied.225 The court in Dole Foods nonetheless applied the entire fairness standard of review,226 finding that “despite mimicking MFW’s form, Murdock did not adhere to its substance” through his and Carter’s attempts to undermine the committee and its process.227

Effect of a Well-Functioning Special Committee in the Face of Fraud. The court lauded the special committee and its advisors for carrying out their tasks with integrity and diligence, which allowed them to overcome “most of Murdock’s and Carter’s machinations.”228 Still, the court rejected the defendants’ “no harm, no-foul” argument that the transaction was fair despite their misconduct.229 According to the court, when the committee requested updated management forecasts, Carter provided projections that he knew were falsely low.230 The court found that Carter’s supplying of false information, combined

221. Id. at *32.
222. Id. at *2.
223. Id.
224. 88 A.3d 635, 644 (Del. 2014).
227. Id. at *1.
228. Id. at *2.
229. Id. at *31.
230. Id. at *30–31.
with his and Murdock’s other improper actions, including Carter’s efforts to depress Dole’s stock price, were tantamount to fraud. The court explained, “[F]raud vitiates everything. Here it rendered useless and ineffective the highly commendable efforts of the Committee and its advisors . . . .”

Even assuming the ultimate deal price fell within a range of reasonableness, the court held that Dole stockholders were entitled to a “fairer price designed to eliminate the ability of [Murdock and Carter] to profit from their breaches of the duty of loyalty.”

**Murdock’s Financial Advisor Not Liable for Aiding and Abetting.** The plaintiffs also alleged that Murdock’s financial advisor, Deutsche Bank, was liable for aiding and abetting the breaches of fiduciary duty by Murdock and Carter. In finding that Deutsche Bank was not liable under an aiding and abetting theory, the court reiterated that “liability depends on . . . knowing participation in the breaches of duty that give rise to causally related damages.” The court found that Deutsche Bank had “improperly” assisted Murdock in preparing his bid at a time when Deutsche Bank was also advising Dole on another transaction. However, there was no showing that Deutsche Bank participated in Carter’s efforts to depress Dole’s stock price. Nor did Deutsche Bank “have any reason to think that the information it received” from Murdock and Carter “was different than the information the [Special] Committee received.” Because Deutsche Bank was not aware of and did not participate in Murdock and Carter’s breaches, the bank could not be liable for aiding and abetting.

**Conclusion**

*Dole* serves as a stark reminder that the *M&F Worldwide* conditions for invoking business judgment rule review of a controlling stockholder transaction must be adhered to not just in form, but also in substance. Moreover, a fully functioning, diligent committee of independent directors cannot fully cleanse a process that is undermined by misinformation and misdirection.

The opinion also provides guidance to financial and other advisors who may be concerned about potential aiding and abetting liability.

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231. Id. at *31.
232. Id. at *26.
233. Id. at *2.
234. Id. at *41.
235. Id. at *44.
236. Id. at *2.
237. Id. at *42.
238. Id.
239. Id. at *44.
In C&J Energy Services, Inc. v. City of Miami General Employees’ & Sanitation Employees’ Retirement Trust, the Delaware Supreme Court reversed the Court of Chancery’s preliminary injunction of C&J Energy Services, Inc.’s (“C&J’s”) acquisition of a division of Nabors Industries Ltd. (“Nabors”) in a “corporate inversion.” The court held that the Court of Chancery misapplied the standard for a preliminary injunction, based its ruling “on an erroneous understanding of what Revlon requires,” and improperly ordered C&J to engage in a go-shop process.

**Background**

In January 2014, C&J and Nabors began discussions for C&J to acquire one of Nabors’s subsidiaries (“Nabors CPS”), which was incorporated in Bermuda. During negotiations, the parties determined that a “corporate inversion” structure—whereby the surviving company is domiciled outside of the United States—could generate “substantial” tax benefits (approximately $200 million in net present value). However, “to be effective for tax purposes, Nabors would need to own a majority of the [surviving] company.” Accordingly, although in economic terms C&J was acquiring Nabors CPS for approximately $2.86 billion, the transaction was structured as a merger of C&J into a new Nabors subsidiary (“Red Lion”) holding 100 percent of Nabors CPS, with C&J’s public stockholders receiving 47 percent of Red Lion’s shares and Nabors receiving the other 53 percent plus an additional approximately $938 million in cash.

The merger agreement contained a number of corporate governance protections for C&J stockholders, including the right to designate four board members, the imposition of various standstill and transfer restrictions on Nabors, and a bylaw that could only be amended by unanimous stockholder approval requiring that all stockholders be treated equally in any future sale of the company.

The merger agreement also contained deal protection provisions, including “an unusual buy-side ‘fiduciary out’” to C&J’s no-solicitation covenant “allowing for a lengthy and viable post-signing market check” for third parties to make superior offers to acquire C&J, “a modest $65 million termination fee (2.27% of

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241. Id. at 1054.
242. Id. at 1067.
243. Id. at 1057.
244. Id.
245. Id.
246. Id. at 1061.
247. Id. at 1062–63.
248. Id. at 1066.
the deal value),249 and a voting agreement with C&J’s chairman and CEO (who held approximately 10 percent of C&J’s outstanding shares) that would fall away if the C&J board changed its recommendation in favor of the deal.250

Following public announcement of the transaction in June 2014, C&J stockholders sued to enjoin the stockholder vote on the merger agreement, alleging that the C&J directors breached their Revlon duties in agreeing to sell majority control of the company to Nabors and that Nabors aided and abetted those breaches of fiduciary duty.251 Ruling from the bench on the plaintiffs’ preliminary injunction motion on November 24, 2014, the Court of Chancery found that “the C&J board harbored no conflict of interest and was fully informed about its own company’s value,” but that “there was a ‘plausible’ violation of the board’s Revlon duties because the board did not affirmatively shop the company either before or after signing.”252 As a remedy, the trial court ordered C&J to solicit alternative proposals to purchase the company, and it further ordered that any such solicitation would not constitute a breach of C&J’s no-solicitation covenant in the merger agreement.253 The Court of Chancery did not make any formal finding regarding whether Nabors had aided and abetted the alleged fiduciary breaches by the C&J board.254

In the five months between public announcement of the transaction and the Court of Chancery’s ruling, no third-party bidders had expressed any interest in acquiring C&J.255

Analysis

In reversing the Court of Chancery’s injunction, the Delaware Supreme Court held that the Court of Chancery: (1) applied the wrong standard and evidentiary burden for a preliminary injunction,256 (2) based its ruling on an erroneous understanding of what Revlon requires of a board of directors,257 and (3) erred by entering a mandatory injunction requiring C&J to shop itself without applying the correct procedural standard or considering the contractual rights of Nabors, an innocent third party.258

Standard for a Preliminary Injunction. The Delaware Supreme Court first reaffirmed the standard for granting a motion for a preliminary injunction. In its oral ruling, the Court of Chancery had stated that it found “a plausible showing of a likelihood of success on the merits,” rather than a “reasonable probability of

249. *Id.* at 1063.
250. *Id.*
251. See *id.* at 1052–53.
252. *Id.* at 1052.
253. *Id.* at 1052–53.
254. *Id.* at 1053.
255. *Id.* at 1066–67.
256. *Id.* at 1066.
257. *Id.* at 1067.
258. *Id.* at 1071–72.
success on the merits.”259 Because the Court of Chancery “misapplied the standard,” and because “[t]he Court of Chancery’s own decision indicates that the plaintiffs did not carry [their evidentiary] burden,” the Delaware Supreme Court held that the Court of Chancery erred in granting the injunction.260

Requirements Imposed by Revlon. The Delaware Supreme Court also held that the Court of Chancery’s “ruling rested on an erroneous understanding of what Revlon requires.”261 While reaffirming that Revlon prohibits directors from “take[ing] actions inconsistent with achieving the highest immediate value reasonably attainable,” the supreme court held that “Revlon does not require a board to set aside its own view of what is best for the corporation’s stockholders and run an auction whenever the board approves a change of control transaction.”262 Specifically, the court held that any “effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so”—which “does not have to involve an active solicitation”—is sufficient to “permit[] a board to pursue the transaction it reasonably views as most valuable to stockholders.”263

The court noted the following facts, among others, as showing that the C&J board satisfied its Revlon duties:

1. “C&J’s board had no improper motive”—in fact, several directors were, or were affiliated with, large stockholders, which provided “a strong motive to maximize the value of [their] shares”—and the board otherwise “was well-informed as to C&J’s value”;264

2. the board “was aware that Nabors would own a majority of the voting stock” of the surviving company and “took steps to mitigate the effects of that change of control” by negotiating for specific governance protections;265 and

3. “there were no material barriers that would have prevented a rival bidder from making a superior offer” because the board obtained “a broad ‘fiduciary out’” to accept superior proposals, the chairman and CEO’s voting agreement would terminate upon the board’s recommendation change, the termination fee was relatively “modest,” and the expected five-to-six-month pre-closing period was “more than sufficient for a serious bidder to express interest and to formulate a binding offer.”266

Finally, the Delaware Supreme Court observed that, “[a]lthough the C&J board had to satisfy itself that the transaction was the best course of action for stock-

260. Id. at 1066–67.
261. Id. at 1067.
262. Id.
263. Id. at 1067–68.
264. Id. at 1068–69.
265. Id. at 1069.
266. Id. at 1070.
holders,” the stockholders’ fair chance to evaluate the board’s decision for themselves was “contextually relevant,” and the directors were allowed to weigh the fact that the “stockholders will have the chance to vote on whether to accept the benefits and risks that come with the transaction, or to reject the deal and have C&J continue to be run on a stand-alone basis,” especially where the information relating to the plaintiffs’ allegations of breaches of duty was publicly disclosed to the stockholders.267

The court expressly “recognize[d] that [Paramount Communications, Inc. v. QVC Network, Inc.] suggests that contractual provisions limiting the power of a majority stockholder and securing the minority’s ability to share in any future control premium might take a transaction out of Revlon’s reach,” but it “decline[d] to reach the question” of whether the governance provisions limiting Nabors’s control over the surviving company were sufficient to render Revlon inapplicable “given the timing exigencies” of the expedited appeal.268

Standard for a Mandatory Injunction. Lastly, the Delaware Supreme Court held that the Court of Chancery erred by issuing a mandatory injunction requiring C&J to solicit alternative transactions for two reasons, one procedural and the other substantive.269 Procedurally, “[t]o issue a mandatory injunction requiring a party to take affirmative action . . . the Court of Chancery must either hold a trial and make findings of fact, or base an injunction solely on undisputed facts.”270 Here, the Court of Chancery had ordered C&J to conduct a go-shop process based on a contested, preliminary record.271 Substantively, the supreme court held that a mandatory injunction “stripping [a party] of bargained-for benefits should only be undertaken on the basis that the party ordered to perform was fairly required to do so, because it had, for example, aided and abetted a breach of fiduciary duty.”272 Because Nabors was not found to have aided and abetted any breach by the C&J board, it was inappropriate for the Court of Chancery, on the one hand, to “blue-pencil” the merger agreement and deny Nabors the benefit of the no-shop covenant for which it had bargained and, on the other hand, deny Nabors the right to “regard the excision as a basis for relieving it of its own contractual duties.”273

Conclusion

C&J Energy represents one of the Delaware Supreme Court’s most in-depth discussions of Revlon duties and vested contract rights since the control contest between Viacom and QVC for Paramount in the mid-1990s. It makes clear that Revlon does not prescribe any particular action a board of directors must follow

267. Id. at 1070 & n.105.
268. Id. at 1069 & n.98 (citing Paramount Commc’ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 n.12 (Del. 1994)).
269. See id. at 1071–72.
270. Id. at 1071.
271. See id.
272. Id. at 1072.
273. Id.
so long as the directors act consistently with the objective to obtain the highest value for the company reasonably attainable and provide a reasonable opportunity for interested bidders to make value-maximizing offers.

12. **In re Kenneth Cole Productions, Inc. Shareholder Litigation**

   (Business Judgment Rule for a Going Private Transaction by a Controlling Stockholder with a Special Committee and a Majority-of-Minority Shareholder Vote Condition)

In *In re Kenneth Cole Productions, Inc. Shareholder Litigation*, the Appellate Division of the New York Supreme Court affirmed a decision of a New York trial court and held that the business judgment standard of review, rather than the stringent entire fairness standard, will apply to going-private mergers with controlling stockholders if certain conditions are satisfied.

**Background**

Kenneth Cole ("Cole"), together with certain related entities and trusts, owned approximately 46 percent of the issued and outstanding shares of common stock of Kenneth Cole Productions, Inc. ("KCP") and 100 percent of KCP’s Class B common stock, which together represented in the aggregate approximately 89 percent of the total voting power of the outstanding common stock. KCP commenced a transaction process and engaged substantively with two potential counterparties, the first of which proposed an acquisition of the company. A special committee composed of four independent directors was formed and given broad authority to reject the proposal from the initial counterparty, negotiate a transaction, or consider alternatives. The board eventually terminated discussions with this party because it concluded that a transaction was not likely to be consummated. The second party proposed a licensing transaction that would have left KCP independent. These negotiations were also terminated when the board determined they were unlikely to be fruitful.

After termination of these discussions, Cole informed the board that he intended to submit a proposal to acquire the shares of common stock that he did not own. A special committee was formed, consisting of the directors who had previously served on the special committee that considered the initial two proposals. The special committee was vested with broad authority to review and evaluate Cole’s proposal, reject the proposal, negotiate a transaction

276. Id. at 17–18.
277. Id. at 17.
278. Id. at 18.
279. Id.
280. Id. at 18.
281. Id.
with Cole, or seek an alternative proposal from third parties. \(^{282}\) Cole subsequently submitted a proposal to acquire KCP, which made clear that (1) he would not move forward with the proposal unless it was approved by a special committee and (2) any transaction would be subject to a non-waivable condition requiring the approval of a majority of the shares not already owned by Cole. \(^{283}\) Cole’s proposal also indicated that he had no interest in a sale of his interest in KCP, but that if the special committee did not recommend or the public shareholders of KCP did not approve the proposed transaction, such a determination would not adversely affect his future relationship with KCP. \(^{284}\)

After some negotiation on price that ultimately resulted in an increase from Cole’s initial bid, the special committee approved the transaction and recommended that the board of directors approve it, which the board did. \(^{285}\) KCP shareholders filed suit challenging the merger on the grounds that, among other things, the special committee and board breached their fiduciary duties. \(^{286}\) The trial court granted the defendants’ motion to dismiss, finding that the business judgment rule was the applicable standard of review. \(^{287}\)

### Analysis

In a very short opinion, the court distinguished the Cole transaction from a New York precedent for a going-private transaction with a controlling shareholder that did not feature a non-waivable majority-of-the-minority condition. \(^{288}\) The court also held that, although the plaintiffs alleged that the members of the special committee were controlled by Cole, it is not enough to allege that a director is nominated or elected by a controlling stockholder, and that the allegations were not sufficient to demonstrate that the special committee members were interested or failed to act in good faith. \(^{289}\)

Leave to appeal was granted on June 10, 2015. \(^{290}\)

### Conclusion

*Kenneth Cole Productions* provides controlling stockholders and boards of directors of controlled New York corporations with a pathway to review a going-private transaction with the controlling stockholder under the business judgment rule, rather than entire fairness review. Although the decision did not go into the detail provided by the Delaware Supreme Court in *Kahn v. M&F Worldwide*.

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282. Id. at 18.
283. Id. at 19.
284. Id.
285. Id. at 28.
287. Id. at *5
289. Id. at 2.
such as whether the requirements of special committee approval and a non-waivable majority-of-the-minority condition must be proposed from the outset, it may represent a confluence of New York and Delaware law on this topic.

13. IN re COMVERGE, INC. SHAREHOLDERS LITIGATION (GRANTING MOTION TO DISMISS AS TO PROCESS, BUT DENYING MOTION AS TO DEAL PROTECTIONS, IN TAKEUNDER CONTEXT)

In In re Comverge, Inc. Shareholders Litigation, the Delaware Court of Chancery considered on a motion to dismiss claims relating to H.I.G. Capital, LLC’s (“HIG’s”) acquisition of Comverge, Inc., a Delaware corporation (the “Company”), for less than the Company’s trading price at the time of the acquisition. The court rejected the stockholder-plaintiffs’ claims that the Company directors breached their fiduciary duties as to the sale process, but refused to dismiss the claims that the directors breached their fiduciary duties in agreeing to certain preclusive deal protection measures in the merger agreement.

Background

The Company was experiencing a liquidity crisis and had explored a number of alternatives to address the issue when it was approached by HIG in November 2011 to explore a possible acquisition. The parties executed a non-disclosure agreement (the “NDA”), which contained a two-year standstill provision. Following due diligence, HIG offered to acquire the entire Company for $1.75 per share. After negotiations, HIG raised its offer to $2.15 per share, but conditioned its offer on the Company entering into an exclusivity agreement, to which the Company agreed. During the exclusivity period, the Company received an unsolicited proposal to acquire the Company for $4–6 per share, but could not engage in discussions or negotiations because of the exclusivity agreement with HIG. Following further negotiations, HIG raised its offer to $2.25 per share. Finding the offer inadequate, the Company board rejected it and let the exclusivity period expire.

HIG, still interested in acquiring the Company, caused its affiliate to acquire a Company note (the “Note”), the terms of which gave HIG blocking rights over competing acquisition proposals. The Company board considered taking

291. 88 A.3d 635 (Del. 2014).
293. Id. at *2.
294. Id. at *27–28.
295. Id. at *8.
296. Id.
297. Id. at *11.
298. Id. at *12.
299. Id.
300. Id.
301. Id. at *12–13.
302. Id. at *14–15.
legal action against HIG in connection with its purchase of the Note, which was arguably in violation of the NDA’s standstill, but instead decided to move forward with a proposed transaction. HIG subsequently notified the Company that it was in default under the Note, reduced its final offer to $1.75 per share (which represented a negative premium to the market price of $1.88 per share), and threatened to accelerate the Note if the Company did not sign a merger agreement with HIG within two days.

The Company board voted unanimously to approve the merger agreement. The merger agreement provided for a thirty-day go-shop period and a two-tier termination fee structure where the Company would be required to pay $1.206 million if it terminated to enter into a superior transaction during the go-shop period and $1.93 million if it terminated after the go-shop period, plus up to $1.5 million as an expense reimbursement in either situation. HIG was also required to provide the Company with a $12 million convertible bridge loan with a conversion price of $1.40 per share.

The merger closed in May 2012, and the stockholder-plaintiffs promptly filed suit. The Company and the director-defendants moved to dismiss all of the claims, arguing that: (1) the directors faced no liability for any duty-of-care claims because the section 102(b)(7) provision in the Company’s charter eliminated monetary damages resulting from any such breach and (2) the plaintiffs did not plead facts that would implicate the Company directors’ non-exculpated duty of loyalty. HIG moved to dismiss claims that it had aided and abetted such breaches.

**Analysis**

The court analyzed the board’s decisions under the intermediate level of Revlon scrutiny, asking whether the board’s actions were “conceivably unreasonable.”

With respect to the board’s decision not to sue under the NDA, the court did not find the board’s actions to be unreasonable. The court stated that in light of the Company’s financial situation, the suit would have likely resulted in the Company losing the only bidder that made a firm offer and facing potential bankruptcy.

With respect to the flawed sales process and unfair price claims, the court found that, while the board’s conduct may have constituted a breach of the

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303. Id. at *15.
304. Id. at *18.
305. Id.
306. Id. at *19–20.
307. Id. at *19.
308. Id. at *23.
309. Id. at *25.
310. Id.
311. Id. at *29.
312. Id. at *28.
313. Id. at *39–40.
board’s duty of care, the section 102(b)(7) provision in the Company’s charter excused the directors from liability for any such breach.\textsuperscript{314} To overcome the exculpation provision, the plaintiffs needed to plead facts from which a violation of the non-exculpated duty of loyalty or bad faith could conceivably be inferred, which they failed to do.\textsuperscript{315} The court noted that even though HIG acquired the Company at a per share price that was lower than the Company’s market value, the board could not be said to have “utterly fail[ed] to attempt to obtain the best sales price.”\textsuperscript{316} In support of this finding, the court pointed to the Company’s eighteen-month strategic process, its wide canvass of the market, its hiring of independent legal and financial advisors, its consideration of different strategic alternatives, and its “hard-fought” negotiations with HIG.\textsuperscript{317}

With respect to the deal protections, the court was troubled by the combination of the termination fee, the expense reimbursement requirements, and the convertible notes.\textsuperscript{318} The board’s apparent “passive acceptance” of such combination conceivably could have had an “unreasonably preclusive effect on potential bidders” who might have provided greater value to the shareholders.\textsuperscript{319} The court observed that when combined with the expense reimbursement requirements, the termination fee represented either 5.5 percent or 7 percent of the deal’s equity value (for termination during or after the go-shop period, respectively).\textsuperscript{320} The court noted that even if the lower 5.5 percent percentage were used, “that percentage test[ed] the limits of what [the] Court ha[d] found to be within a reasonable range for termination fees.”\textsuperscript{321} Combined with the convertible notes, the total termination fee structure could represent up to 13.1 percent of the equity value of the transaction.\textsuperscript{322} According to the court, this was “cause for legitimate concern, particularly in the context of a deal with a negative premium to market.”\textsuperscript{323} The court ultimately concluded that the board’s passive acceptance of deal protections could be “so far beyond the bounds of reasonable judgment that it seem[ed] inexplicable on any ground other than bad faith” and, thus, implicated the non-exculpated duty of loyalty.\textsuperscript{324} Accordingly, the court denied the defendants’ motion to dismiss this claim.\textsuperscript{325}

Having found that the Company directors conceivably acted in bad faith in approving the termination fee structure, the court considered whether HIG

\textsuperscript{314} Id. at *43–44.
\textsuperscript{315} Id. at *46.
\textsuperscript{316} Id.
\textsuperscript{317} Id.
\textsuperscript{318} See id. at *50–53.
\textsuperscript{319} Id. at *59–60.
\textsuperscript{320} Id. at *50.
\textsuperscript{321} Id. at *51 (citing In re Answers Corp. S’holders Litig., C.A. No. 6170-VCN, 2011 WL 1366780, at *9 (Del. Ch. Apr. 11, 2011); In re Topps Co. S’holders Litig., 926 A.2d 58, 86 (Del. Ch. 2007)).
\textsuperscript{322} Id. at *53.
\textsuperscript{323} Id. at *58.
\textsuperscript{324} Id. at *60 (citing In re BJ’s Wholesale Club, Inc. S’holders Litig., C.A. No. 6623-VCN, 2013 WL 396202, at *8 (Del. Ch. Jan. 31, 2013)).
\textsuperscript{325} Id. at *62.
“knowingly participated” in this potential breach, particularly with regard to HIG’s acquisition of the Note and the use of resulting increased bargaining power.326 The court noted that arm’s-length bargaining cannot give rise to aiding and abetting liability on the part of the acquirer “so long as the bidder does not induce the target’s fiduciaries to sell out the target’s stockholders by creating or exploiting self-interest on the part of the fiduciaries.”327 Although the arm’s-length negotiations became hostile at times with HIG pursuing a “hard-nosed” and “aggressive” negotiation strategy, there were no allegations that gave rise to an inference that HIG knowingly participated in any potential breach by the Company board.328

**Conclusion**

The Comverge decision confirms that the Delaware courts will view a board decision—even one agreeing to a below-market merger price—in the context in which it is made. Board decisions will generally be upheld so long as they are un-conflicted and reasonable. However, even if there is no conflict, where such decisions are not reasonable and the board has arguably acted passively so as to implicate the duty of loyalty, related claims may survive a motion to dismiss.

The Comverge decision also confirms that tough negotiations and tactical maneuvers to gain leverage will not, standing alone, subject a third party to aiding and abetting liability.

14. **CORWIN V. KKR FINANCIAL HOLDINGS LLC** *(FULLY INFORMED, UNCOERCED VOTE OF DISINTERESTED STOCKHOLDERS INVOKES BUSINESS JUDGMENT RULE, EVEN IF THAT VOTE IS REQUIRED BY STATUTE)*

In Corwin v. KKR Financial Holdings LLC,329 the Delaware Supreme Court affirmed a decision of the Delaware Court of Chancery330 and held that, where a merger is not subject to judicial review under the stringent entire fairness standard, approval by a fully informed, disinterested stockholder majority will invoke the business judgment rule in an action for post-closing damages.331

**Background**

Stockholders of KKR Financial Holdings LLC (“Financial Holdings”) filed an action challenging a stock-for-stock acquisition of Financial Holdings by KKR & Co. L.P. (“KKR”).332 The plaintiffs asserted that the entire fairness standard

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326. Id. at *63.
327. Id. at *68 (citing Malpiede v. Townson, 780 A.2d 1073, 1097 (Del. 2001)).
328. Id. at *70.
332. Id.
of review applied to the transaction. In support of that contention, the plaintiffs argued that KKR was a controlling stockholder of Financial Holdings because Financial Holdings’ primary business was financing KKR’s leveraged buyout activities and Financial Holdings was managed by an affiliate of KKR under a management agreement.

In granting the defendants’ motion to dismiss, the Court of Chancery held that plaintiffs’ allegations did not support a reasonable inference that KKR was a controlling stockholder of Financial Holdings. The Court of Chancery also held that, when a merger transaction is not subject to the entire fairness standard of review, the business judgment rule applies for a post-closing damages action if the merger was approved by a majority of disinterested stockholders in a fully informed, uncoerced vote.

**Analysis**

**Controlling Stockholder.** The Delaware Supreme Court explained that the Court of Chancery correctly determined that the plaintiffs’ complaint failed to plead facts that supported an inference that KKR was the controlling stockholder of Financial Holdings. The Court of Chancery reasoned that KKR did not control Financial Holdings’ board of directors such that those directors could not freely exercise their judgment in determining whether to approve and recommend to the stockholders a merger with KKR. The Court of Chancery also found that KKR owned less than 1 percent of the shares of Financial Holdings, had no right to appoint any directors, and had no contractual right to veto any board action. In addition, the supreme court noted that the Court of Chancery looked for, but did not find, “a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock.”

**Standard of Review.** The court held that the business judgment rule standard of review (rather than enhanced scrutiny) was properly applied to the transaction because the transaction was approved by a fully informed, uncoerced stockholder majority and was not subject to the entire fairness standard of review.

The supreme court cited three reasons for upholding the Court of Chancery’s decision:

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333. *Id.* The court acknowledged that Financial Holdings was a limited liability company and that KKR was a limited partnership, but because the parties argued the case on the assumption that corporate law principles applied, the court also applied corporate law principles (as had the Court of Chancery). *Id.* at *1 n.3.
334. *Id.* at *1.
335. *Id.*
336. *Id.* at *4.
337. *Id.* at *2–3.
338. *Id.* at *3.
339. *Id.* at *1.
340. *Id.* at *2.
341. *Id.* at *4.
First, the supreme court rejected the plaintiffs’ contention that invoking the business judgment rule in this context would “impair the operation of Unocal\(^3\) and Revlon\(^4\)”—cases that provide for enhanced scrutiny review in certain circumstances involving mergers.\(^5\) The court explained that Unocal and Revlon were not designed for application in post-closing money damages cases and instead were designed to be used as tools for injunctive relief to address important deal decisions “in real time, before closing.”\(^6\) The court also noted that the standards articulated by Unocal and Revlon do not match the Van Gorkom\(^7\) standard of gross negligence for due care liability of directors.\(^8\) Second, and “most important” in the supreme court’s view, the application of the business judgment rule (rather than enhanced scrutiny) following stockholder approval of a transaction that is not subject to entire fairness review is limited to situations involving fully informed, uncoerced stockholder votes, and it will not apply if troubling material facts regarding director behavior are not disclosed to stockholders.\(^9\) Here, all facts regarding the parties’ objectives and interests were fully disclosed.\(^10\) Third, when a transaction is not subject to the entire fairness standard of review, the “long-standing policy” of Delaware law “has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves.”\(^11\) Narrow Interpretation of Gantler. The Delaware Supreme Court also rejected the plaintiffs’ contention that Gantler v. Stephens\(^12\) required the Court of Chancery to give the informed stockholder vote no effect in determining the standard of review.\(^13\) Instead, the supreme court agreed with the Court of Chancery’s narrow interpretation of Gantler as a decision solely intended to clarify the meaning of the term “ratification” and not, as plaintiffs argued, a decision addressing the standard of review that should apply if a transaction not subject to entire fairness is approved by a fully informed and voluntary vote of disinterested stockholders.\(^14\) Conclusion

KKR Financial Holdings clarifies that claims for post-closing money damages will be subject to the business judgment rule standard of review (rather than en-

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345. Id.
348. Id.
349. Id.
350. Id.
351. 965 A.2d 695 (Del. 2009).
353. Id.
hanced scrutiny under Revlon or Unocal) when a transaction is not subject to the entire fairness standard and is approved by a fully informed, uncoerced vote of the disinterested stockholders.

This case is also a reminder that the Delaware courts will be reluctant to second-guess decisions of fully informed, impartial stockholders because they “can easily protect themselves at the ballot box by simply voting no.”354

15. **RBC Capital Markets, LLC v. Jervis** (Upholding Liability for Aiding and Abetting Breach of Fiduciary Duties Against Financial Advisor to a Target Board Despite Exculpation of Target Directors)

**Background**

In *RBC Capital Markets, LLC v. Jervis*, the Delaware Supreme Court upheld several Court of Chancery decisions from 2014 finding Rural/Metro’s financial advisor, RBC Capital Markets, LLC, liable for aiding and abetting breaches of fiduciary duty by the company’s directors in connection with the sale of the company and awarding a $76 million judgment against the financial advisor, despite also finding that the target directors were exculpated from any personal liability.356

**Analysis**

**Aiding and Abetting Liability.** The Delaware Supreme Court affirmed the Court of Chancery’s ruling that a financial advisor may be liable for aiding and abetting a board’s breach of its fiduciary duty if the advisor knows that the board is breaching its fiduciary duty and “participates in the breach by misleading the board or creating the informational vacuum.”357 The court noted that in this case the financial advisor had “induced” the breach by “exploiting its own conflicted interests” and “creating an informational vacuum.”358 In particular, the advisor failed to disclose its interest in financing a separate transaction in the same industry proceeding at the same time and its interest in, and attempts to secure a role in, financing the company’s sale; the advisor also modified its own valuation analysis and knew that the board was uninformed about the value of the company.359 The result was “a poorly timed sale at a price that was not the product of appropriate efforts to obtain the best value reasonably available.”360

354. Id. at *6.
358. Id. at *33.
359. Id.
360. Id.
In addition, the Delaware Supreme Court confirmed that, while a board may consent to certain conflicts, “[a] board’s consent to a conflict does not give the advisor a ‘free pass’ to act in its own self-interest and to the detriment of its client.”

The court rejected the financial advisor’s argument that the board’s retention of a second financial advisor had cleansed the process, “in part” because the second financial advisor also was paid on a contingent basis. The court said that, while a contingent fee can align the interests of the advisor with that of the company in seeking the best value, it also can lead to “misalignment” over “whether to take a deal in the first instance” and “how to proceed during final negotiations.”

The court, however, “did not adopt the Court of Chancery’s description of the role of a financial advisor in M&A transactions” as “gatekeepers.” Rather, the court explained, “the role of a financial advisor is primarily contractual in nature,” and “[t]he engagement letter typically defines the parameters of the financial advisor’s relationship and responsibilities with its client.”

The Board’s Oversight Duty with Respect to Advisors. The court emphasized that a board must play an “active and direct” role in a sales process. While a board is entitled to rely on advisors, and is “free to consent to certain conflicts,” the board still must be “active and reasonably informed,” including by “identifying and responding to actual or potential conflicts of interest.” A board that has consented to disclosed conflicts on the part of its financial advisor must be “especially diligent” in overseeing the advisor and should require “an ongoing basis, [disclosure of] material information that might impact the board’s process.”

The supreme court provided some limits, however, saying that “a board is not required to perform searching and ongoing due diligence on its retained advisors in order to ensure that the advisors are not acting in contravention of the company’s interests, thereby undermining the very process for which they have been retained.”

Conclusion

The Delaware Supreme Court’s decision should provide some comfort to financial advisors that they are not “gatekeepers” responsible for ensuring that the boards they advise meet all their duties to shareholders. Financial advisors’ obligations generally will be limited to those set forth in their engagement letters.
But claims for aiding and abetting against financial advisors nonetheless remain a risk, particularly where the advisor faces potential conflicts. The decision confirms that financial advisors must carefully manage and disclose conflicts of interest when advising on a sales process, and that boards should take steps to inform themselves of those conflicts and provide active and direct oversight of financial advisors.
The Introductions to the past three Annual Surveys\(^1\) have noted many major new mortgage lending regulations issued by the Bureau of Consumer Financial Protection (“CFPB”) in compliance with the mandates of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).\(^2\) The flood of new regulations has abated, with just one additional mortgage lending regulation being issued in final form during the past year. In addition to that regulation, this Annual Survey will feature many developments, including other types of new regulations, federal and state enforcement actions, and private litigation. Several topics are new to the Annual Survey.

The major mortgage lending regulation issued during the past year was the TILA-RESPA Integrated Disclosures Rule (“TRID Rule”), which carried out the mandate of the Dodd-Frank Act that the separate sets of disclosures required for mortgage loans by the Truth in Lending Act (“TILA”)\(^3\) and the Real Estate Settlement Procedures Act\(^4\) be combined in a single set of disclosures to be given to mortgage borrowers.\(^5\) The TRID Rule sets forth the requirements for a new Loan Estimate written disclosure to be given to borrowers before

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\(5\) See Jonathan W. Cannon, Christine Acree & Brandy Hood, TILA-RESPA Integrated Disclosures, 71 BUS. LAW. 639 (2016) (in this Annual Survey); see also Jonathan W. Cannon & Christine Acree,
execution of the transaction is consummated\textsuperscript{6} and a Closing Disclosure to be given before the transaction is closed.\textsuperscript{7} Responding to industry concerns about implementation of the TRID Rule, the CFPB has delayed the effective date of the TRID Rule\textsuperscript{8} and has issued interpretative guidance.\textsuperscript{9}

The developments during the past year under the Telephone Consumer Protection Act of 1997 (“TCPA”)\textsuperscript{10} largely involved the issuance of a ruling by the Federal Communications Commission (“FCC”).\textsuperscript{11} The TCPA issues outlined in last year’s Annual Survey, in both petitions to the FCC\textsuperscript{12} and ongoing litigation,\textsuperscript{13} resulted in pronouncements by the FCC on what constitutes an “automated telephone dialing system,” how consumers may effectively revoke consent to receiving automated calls, how reassigned telephone numbers should be handled, and the definition of “called party.”\textsuperscript{14} Significant litigation continued on these and other issues, including damages questions, what constitutes “advertising” within the meaning of the TCPA, what constitutes “prior express consent” under the Act, and when an offer of judgment under Federal Rule 68 may operate to affect class action liability.\textsuperscript{15}

Two significant state attorney general settlements, one covering thirty-one states, dealt with the issue of how medical debt should be handled by consumer reporting agencies, best practices for consumer reporting agencies, and how consumer disputes should be handled.\textsuperscript{16} The CFPB brought enforcement actions against furnishers of information to consumer reporting agencies over how they handle disputes from the agencies and directly from consumers.\textsuperscript{17} The CFPB also issued important guidance on deficiencies it found in its examinations of consumer reporting agencies, issued a report on medical collections problems, and promulgated a new rule that grants some limited relief from the annual privacy notice requirements of Regulation P.\textsuperscript{18} There was also significant litigation on what brings an entity within the definition of a “consumer reporting agency.”\textsuperscript{19}
The CFPB issued a proposed rule on prepaid cards and similar accounts that includes new disclosure requirements, alternate requirements for periodic statements, and rules for online access to account information for such accounts.\footnote{See David W. Thompson, Roberta G. Torian & Lois S. Woodward, Deposit Products and Payment Systems: Proposed Rules to Regulate Prepaid Accounts, 71 Bus. Law. 671 (2016) (in this Annual Survey).} The CFPB proposal would also modify the limitations for prepaid card issuer liability and error resolution and impose new disclosure requirements under Regulation Z for prepaid cards or accounts that include a credit or overdraft feature.\footnote{See id.}

The CFPB issued guidance to the credit card industry on promotional APR offers, suspended the requirement that credit card issuers submit their card agreements to it for one year while it automates the submission process, issued a request for information about credit card practices under the Credit Card Accountability and Disclosure Act of 2009,\footnote{Pub. L. No. 111-24, 123 Stat. 1734 (2009) (codified as amended in scattered sections of 15 U.S.C.).} and issued a report on consumer access to credit scores.\footnote{See Obrea O. Poindexter & Jeremy R. Mandell, Credit Card Developments, 71 Bus. Law. 683 (2016) (in this Annual Survey).} The CFPB and the Office of the Comptroller of the Currency also entered into several consent orders with credit card issuers concerning their alleged misconduct in the offering of credit card add-on products.\footnote{See id. at 686–88.}

Litigation over alleged breaches of representations and warranties in residential mortgage-backed securities (“RMBS”) became significant during the past year, with cases potentially worth billions of dollars coming before various courts for determination.\footnote{See Richard E. Gottlieb, Fredrick S. Levin, Amanda Raines Lawrence & A. Paul Heeringa, Recent Developments in Residential Mortgage-Backed Securities Litigation, 71 Bus. Law. 689 (2016) (in this Annual Survey).} A significant ruling by the New York Court of Appeals found that the discovery rule should not be applied to extend the six-year New York statute of limitations, which applies to many RMBS transactions, finding that securitizers have no continuing obligation to cure or repurchase the securities indefinitely into the future.\footnote{See id. at 691–93.} Other litigation resulted in a large award for a financial guaranty insurer against a lender that breached RMBS warranties, which promises to provide a road map for the trial of similar cases.\footnote{See id. at 694–95.} More billions of dollars are potentially at stake in suits against securitization trustees that have survived motions to dismiss.\footnote{See id. at 698.} The federal government has also secured large settlements.\footnote{See id. at 698–99.}

On the fair lending front, the U.S. Supreme Court issued a long-awaited decision that found that the disparate impact theory is viable for claims under the Fair Housing Act (“FHA”),\footnote{Pub. L. No. 90-284, tit. VIII, 82 Stat. 73, 81–89 (1968) (codified as amended at 42 U.S.C. §§ 3601–3631 (2012)).} but the opinion set significant limitations on FHA
disparate impact claims by setting a robust causation requirement and finding that statistical evidence alone is insufficient to establish the existence of a disparate impact on protected minority borrowers.\textsuperscript{31} Traditional redlining cases continued to be brought by federal enforcement officials, along with claims of discrimination on the basis of disability and familial status.\textsuperscript{32} Some fair lending cases filed by local governments survived motion practice, while others did not.\textsuperscript{33}

A large automotive finance company and another motor vehicle lender entered into fair lending settlements with the U.S. Department of Justice (“DOJ”).\textsuperscript{34} The CFPB brought non-bank auto finance companies under its supervisory jurisdiction for the first time with a larger participant rule and issued a proxy methodology to explain how it proxies for race and ethnicity for disparate impact cases where there are no other data to establish that status for borrowers.\textsuperscript{35} The large Ally Financial fair lending settlement, which was reported in the previous Survey,\textsuperscript{36} began to be paid out to automobile purchasers.\textsuperscript{37} The CFPB entered into other consent decrees with a buyer of motor vehicle debt and an auto finance company with respect to their debt collection and credit reporting practices.\textsuperscript{38}

There were also developments in the subprime auto finance market.\textsuperscript{39} Media attention to subprime auto finance issues was followed by wide-ranging legislative proposals in New York that were designed to curb perceived abusive practices.\textsuperscript{40} Federal and state enforcement actions included resolution of the first fair lending case against buy-here, pay-here dealers and numerous actions against allegedly deceptive advertising by auto dealers.\textsuperscript{41}

Previous Surveys reported on numerous cases, including decisions by the U.S. Supreme Court, which dealt with the enforceability of consumer arbitration provisions in consumer finance agreements.\textsuperscript{42} The Dodd-Frank Act required the CFPB to study such provisions and report on its findings, and it issued its
final report during the past year. There was significant congressional reaction to the report. Consumer advocates generally supported the report and urged the CFPB to make use of the report’s findings to enter into rulemaking that would restrict consumer arbitration provisions. Industry commenters and others felt that the findings of the report demonstrated that consumer arbitration provisions are working for the benefit of both consumers and the industry, so that a rulemaking was not needed.

Federal enforcement officials filed several actions against small-dollar lenders. State enforcement officials were also active, and several states enacted laws that changed how small-dollar lenders are regulated. The CFPB began its consideration of rulemaking to regulate small-dollar lending with an outline of proposals for a small business advisory review panel that will consider the effects of both prevention and protection requirements to be imposed on a nationwide basis.

Several developments occurred during the past year that began to give shape to the CFPB’s authority under the Dodd-Frank Act to prohibit “abusive” acts or practices as well as unfair or deceptive acts and practices, an expansion of the power long held by the Federal Trade Commission. Several enforcement actions initiated by the CFPB illustrated what it considered to be abusive acts rather than unfair or deceptive acts. In addition, state regulators began to exercise their authority under the Dodd-Frank Act to do the same.

Lending to military servicemembers also was the subject of regulation. The U.S. Department of Defense published a final rule which expands the scope of the Military Lending Act (“MLA”) in ways that differ from traditional credit disclosures required by TILA and Regulation Z promulgated thereunder for persons covered by the MLA database, and which includes an interest cap and other significant restrictions on lending to servicemembers. The U.S. Department of Justice and the prudential regulators also pursued enforcement actions against several lenders for violations of the

44. See id. at 735–36.
45. See id. at 736–37.
46. See id. at 737–38.
48. See id. at 743–47.
49. See id. at 747–48.
51. See id. at 750–55.
52. See id. at 756–57.
55. See Military Lending, supra note 53, at 759–65.
Servicemembers Civil Relief Act ("SCRA"), including liability for assignees of loans even though the SCRA does not provide for such liability.

The Annual Survey also explores the issues that are created by the conflict between the provisions of the Bankruptcy Code, which bars collection efforts under its automatic stay and discharge injunction provisions, and requirements of other federal laws that require communications with mortgage loan borrowers even if they are in bankruptcy. There has been significant litigation concerning informational communications, periodic statements, and discussion of loss mitigation options that are required by federal law as potential violations of the Fair Debt Collection Practices Act.

57. See Military Lending, supra note 53, at 766–69.
58. See Ralph Wutscher, Alan Leeth, Eric Tsai, Ryan Hebson & Andrew Williamson, Communicating with Bankrupt Mortgage Loan Borrowers: Thorny Issues and Attempts at Clarity, 71 BUS. LAW. 771 (2016) (in this Annual Survey) [hereinafter Bankrupt Mortgage Loan Borrowers].
TILA-RESPA Integrated Disclosures

By Jonathan W. Cannon, Christine Acree, and Brandy Hood*

INTRODUCTION

On December 31, 2013, the Bureau of Consumer Financial Protection (“CFPB”) published its long-awaited TILA-RESPA Integrated Disclosures Rule (“TRID Rule”),1 combining the mortgage disclosures consumers receive under the Truth in Lending Act (“TILA”)2 and the Real Estate Settlement Procedures Act (“RESPA”).3 For more than thirty years, the TILA and RESPA mortgage disclosures had been administered separately by the Federal Reserve Board and the U.S. Department of Housing and Urban Development (“HUD”), respectively. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)4 transferred authority over TILA and RESPA to the CFPB and directed the CFPB to create “rules and model disclosures that combine the disclosures required under [TILA] and sections 4 and 5 of [RESPA] into a single, integrated disclosure for mortgage loan transactions covered by those laws.”5 Congress did not, however, amend TILA and RESPA provisions governing timing, responsibility, and liability for the disclosures, leaving it to the CFPB to resolve the inconsistencies.

The TRID Rule was originally scheduled to become effective on August 1, 2015.6 But, “[b]ecause of an administrative error on the Bureau’s part in complying with the Congressional Review Act (“CRA”) with respect to the TILA-RESPA Final Rule,” the CFPB was forced to push back the effective date.7 Even though

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  1. Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 79730 (Dec. 31, 2013) (to be codified at 12 C.F.R. pts. 1024 & 1026) [hereinafter TRID Rule].
  6. See TRID Rule, supra note 1, at 79732.
  7. 2013 Integrated Mortgage Disclosures Rule Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) and Amendments; Delay of Effective Date, 80 Fed. Reg. 43911, 43911 (July 24, 2015).
the CFPB could have chosen a date as early as August 15, 2015, as the new effective date, the CFPB settled on Saturday, October 3, 2015.\footnote{8}

On June 3, 2015, CFPB Director Richard Cordray responded to requests from industry and members of Congress for delayed enforcement of the TRID Rule.\footnote{9} The CFPB did not, as many had hoped, establish a “hold harmless” period during which the TRID Rule would be in effect but public and private enforcement would be limited. Instead, Director Cordray stated that he had spoken with other regulators to clarify “that [the CFPB’s] oversight of the implementation of the [TRID] Rule will be sensitive to the progress made by those entities that have squarely focused on making good-faith efforts to come into compliance with the Rule on time.”\footnote{10} As noted in Director Cordray’s letter, this approach is consistent with the approach taken by the CFPB in early 2014 after other regulations implementing Title XIV of the Dodd-Frank Act took effect.\footnote{11} Director Cordray noted that, in the CFPB’s view, this approach “has worked out well.”\footnote{12}

Although the new disclosures, the Loan Estimate and the Closing Disclosure, are demonstrably more accessible for consumers than their predecessors,\footnote{13} they have proven to be difficult to implement—despite the CFPB’s unprecedented efforts to help the industry implement the TRID Rule.\footnote{14} These difficulties arise because the TRID Rule is often deceptively complex in that it implements many familiar concepts but applies higher, or slightly different, standards to them. These general disclosure requirements, as well as two key issues the industry has struggled to resolve, are discussed below.

\section*{The Loan Estimate}

The Loan Estimate is a three-page written disclosure\footnote{15} that provides consumers with a good faith estimate\footnote{16} of credit costs and key transaction terms and satisfies timing and delivery\footnote{17} requirements in order to promote comparison shopping.\footnote{18} The Loan Estimate combines the early TILA disclosure and the RESPA-required...
Good Faith Estimate. After receipt of an “application,” the Loan Estimate must be delivered or placed in the mail within three business days and not less than seven business days before consummation of the transaction. If a mortgage broker receives a consumer’s application, either the creditor or the mortgage broker may provide the Loan Estimate. If the mortgage broker provides the Loan Estimate, the creditor is responsible for making sure the Loan Estimate is accurate, but the mortgage broker is also obligated to comply with all relevant requirements of the TRID Rule. Disclosures made on the Loan Estimate must be made in good faith and consistent with the best information reasonably available at the time the disclosure is made.

Generally, if the amount eventually “imposed on or paid by” the consumer exceeds the amount originally disclosed on the Loan Estimate, this increase would not be considered in good faith, regardless of whether the increase is later determined to be due to a technical error, a miscalculation, or an underestimation of a charge. Fee amounts disclosed on the Loan Estimate are subject to a zero variance difference (meaning they cannot increase from the amount disclosed on the original Loan Estimate), unless the TRID Rule expressly provides that a different standard applies. Fees in the zero percent variance category include fees paid to the creditor or mortgage broker or an affiliate of either, fees paid for services for which the consumer is not permitted to shop, transfer taxes, and lender credits. Certain fees are allowed to increase, with limitations. These fees include recording fees and fees paid for third-party services for which the consumer is permitted to shop. These fees are in the 10 percent aggregate variance category.

Other fees are required to be disclosed based on the “best information reasonably available” and are permitted to increase between the time they are disclosed on the Loan Estimate and when they are eventually charged to or paid by the consumer, as long as that standard is met. These fees include prepaid interest,
property insurance premiums, amounts placed into escrow, fees paid to third-party service providers selected by the consumer and not on a list provided by the creditor, and fees paid for third-party services not required by the creditor, even if these fees are paid to affiliates.\textsuperscript{32}

Fees can decrease for all categories except lender credits, and fees may increase beyond the applicable variance only if a “permitted” change occurs.\textsuperscript{33} Lender credits may increase but cannot decrease unless a “permitted” change occurs.\textsuperscript{34}

A permitted change occurs if a fee increases for one or more of the following reasons: a changed circumstance affecting settlement charges or eligibility,\textsuperscript{35} a borrower-requested change, a rate lock causes interest-rate-dependent charges to increase, the Loan Estimate expires because the consumer did not indicate an intent to proceed within ten business days, or there was a delayed settlement on a construction loan (provided that special disclosures are included on the original Loan Estimate).\textsuperscript{36} If there is a permitted change,\textsuperscript{37} the Loan Estimate should be re-disclosed within three general business days of the date the creditor or broker received information sufficient to establish this change.\textsuperscript{38}

The Loan Estimate, like the Closing Disclosure, is a dynamic form such that, if a particular part of the form is inapplicable, that part is either left blank or does not appear at all.\textsuperscript{39} Examples of dynamic form features include the adjustable payment (“AP”) and adjustable interest rate (“AIR”) tables.\textsuperscript{40} Some of the principles incorporated in the design include using a minimal amount of text but focus more on the design of the form.\textsuperscript{41} Under this rule-based design, only limited modifications to the forms are allowed.\textsuperscript{42} The Loan Estimate also has specific formatting requirements. For example, sometimes rounding takes place at every

\textsuperscript{32} Id. § 1026.19(e)(3).

\textsuperscript{33} Id. pt. 1026, supp. I, cmt. 1026.19(e)(3)(i)-5 (defining and giving examples of lender credits); see also id. § 1026.19(e)(3)(iv).

\textsuperscript{34} Id. § 1026.19(e)(3)(iv); TRID Rule, supra note 1, at 79824 (codified at 12 C.F.R. § 1026.19(e)(3)(iv)) (stating that a “changed circumstance or borrower-requested change” may decrease lender credits).

\textsuperscript{35} Examples of these “changed circumstances” include the following: an extraordinary event beyond the control of any interested party or other unexpected event specific to the consumer or loan, information specific to the consumer or loan that the creditor relied on when providing the Loan Estimate but that was later found to be inaccurate or changed after the Loan Estimate was provided, new information specific to the consumer or loan that was not relied on when the Loan Estimate was provided but is discovered later, and changes affecting the creditworthiness or the value of the security. 12 C.F.R. § 1026.19(e)(3)(iv)(A)–(B).

\textsuperscript{36} Id. § 1026.19(e)(3)(iv).

\textsuperscript{37} Id.

\textsuperscript{38} See id. § 1026.19(e)(4)(i), (e)(3)(iv)(A); but see id. § 1026.19(e)(3)(iv)(D); pt. 1026, supp. I, cmt. 1026.19(e)(3)(iv)(D)-1 (when rate is locked, revised Loan Estimate must be provided within three business days after rate lock).

\textsuperscript{39} Id. § 1026.37 (containing format and design requirements throughout).

\textsuperscript{40} Id. § 1026.37(i), (j) (noting that the tables will appear dynamically based on loan terms, may appear independently of each other, and cannot be left blank, crossed through, or marked N/A).

\textsuperscript{41} See id. § 1026.37(o).

\textsuperscript{42} Id.
step in a calculation and sometimes only the final result is rounded. When rounding is required, the number is rounded to the nearest whole dollar.

The TRID Rule explicitly spells out the Loan Estimate’s required contents. Page one of the Loan Estimate contains general information about the loan, such as property address, loan type, rate lock information, the loan terms, information on projected payments, costs at closing, and a reference to the CFPB’s website for general information and tools.

Page two of the Loan Estimate provides closing cost details. On this page, fees are listed alphabetically, amounts are rounded, and fees are enumerated and subtotaled by category. Loan costs are enumerated in the left column of the page and consist of origination charges, services consumers cannot shop for, services consumers can shop for, and total loan costs. Origination charges are itemized, and these charges include “[percentage] of Loan Amount (Points),” which are points paid to the creditor to reduce the interest rate, which must be itemized separately. Other origination charges that must be enumerated include application fees, rate lock fees, direct broker compensation (paid by borrower), and loan level price adjustments not included in the rate.

Other costs are listed in the right column of the second page of the form and detail taxes and other government fees, prepaids, initial escrow payments made at closing, and other payments made at closing. Prepaids include amounts to be paid by the consumer in advance of the first scheduled payment. The initial escrow payment at closing is the amount that the consumer will be expected to place into a reserve or escrow account at consummation to be applied to recurring periodic charges. Other costs are those not previously disclosed that the consumer is likely to pay and that the creditor is aware of when issuing the

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43. See id. § 1026.37(o)(4)(i), (ii); see also id. pt. 1026, supp. 1, cmt. 1026.37(o)(4)-2.
44. Id. § 1026.37(o)(4)(i).
45. See also id. pt. 1026, app. H-24(A) (providing Loan Estimate Model Form).
46. Id. § 1026.37(a)(6).
47. Id. § 1026.37(a)(11).
48. Id. § 1026.37(a)(13).
49. Id. § 1026.37(a)-(e).
50. Id. § 1026.37(f)-(g); pt. 1026, supp. 1, cmts. 1026.37(f)-1 to (g)(8)-1.
51. Id. § 1026.37(f)-(g); pt. 1026, supp. 1, cmts. 1026.37(f)-1 to (g)(7)-1.
52. Id. § 1026.37(f)(1).
53. Id. § 1026.37(f)(2) (examples include appraisal fee and credit report fee).
54. Id. § 1026.37(f)(3) (examples include pest inspection fee, survey fee, and title fees).
55. Id. § 1026.37(f)(4).
56. Id. § 1026.37(f)(1)(i).
57. See id. pt. 1026, supp. 1, cmt. 1026.37(f)(1).
58. Id. § 1026.37(g)(1) (examples include recording fees and transfer taxes).
59. Id. § 1026.37(g)(2) (examples include a homeowner’s insurance premium, mortgage insurance premium, prepaid interest, and property taxes).
60. Id. § 1026.37(g)(3).
61. Id. § 1026.2(a)(13) (defining “consummation” as occurring when the “consumer becomes contractually obligated on a credit transaction”).
Loan Estimate. Tables on page two also include calculating cash to close, the AP table, and the AIR table, if applicable.

Finally, page three of the Loan Estimate provides additional information about the loan and includes the names, identification numbers, and contact information for the creditor, mortgage broker, and individual loan officer. A “Comparisons” section is designed to compare the cost of the loan to other loans in five years, the APR for the loan, and the total interest percentage for the loan. Other requirements include providing required disclosures regarding appraisal, assumption, homeowner’s insurance, late payments, the possibility that the consumer may not be able to refinance the loan in the future, and servicing, as well as a disclosure regarding the consumer’s obligations upon receipt of the form. Finally, the creditor may opt to include a signature line.

The Closing Disclosure

Creditors are required to provide a Closing Disclosure to consumers for all closed-end consumer credit transactions secured by real property, instead of the final TILA disclosure and the HUD-1/HUD-1A form. The Closing Disclosure combines all the information previously provided on the TILA disclosure and the HUD-1/HUD-1A form into a single, five-page disclosure. The first and second pages of the Closing Disclosure more precisely disclose the same information required on the first and second pages of the Loan Estimate, the third page of the Closing Disclosure requires a cash to close table comparing the amounts disclosed on the Loan Estimate as well as a summary of the borrower’s and seller’s transactions, and the fourth and fifth pages of the Closing Disclosure provide additional disclosures and contact information relating to the loan and real estate transaction.

A consumer also must receive the Closing Disclosure at least three business days before consummation. The Closing Disclosure must reflect the actual terms of the credit and real estate transactions. However, if the creditor does not yet know the actual terms of the transaction, it may then estimate any un-

62. Id. § 1026.37(g)(4).
63. Id. § 1026.37(h)(1).
64. Id. § 1026.37(i)(1)–(5).
65. Id. § 1026.37(j)(1)–(6).
66. Id. § 1026.37(k).
67. Id. § 1026.37(l)(1) (requiring that the table show principal, interest, mortgage insurance, and loan costs paid off over time).
68. Id. § 1026.37(l)(2).
69. Id. § 1026.37(l)(3). This is a new calculation showing the total amount of interest the borrower will pay over the loan term as a percentage of the total loan amount.
70. Id. § 1026.37(m)(1)–(6).
71. Id. § 1026.37(n).
72. Id. § 1026.19(f)(1).
73. See TRID Rule, supra note 1, at 79731.
75. Id. § 1026.38(f)(1)(ii).
76. See id. § 1026.38; id. pt. 1026, supp. 1, cmt. 1026.19(f)-1.
known items as long as it uses “the best information reasonably available.”\textsuperscript{77} This “reasonably available” standard requires the creditor to act in good faith and “exercise due diligence in obtaining the information.”\textsuperscript{78} Unfortunately, these standards do not permit creditors and other providers to simply rely on another transaction to develop an estimate but instead require a proactive determination based on the actual transaction at hand.\textsuperscript{79}

The CFPB recognized that information may change within the last few days before closing and sometimes even after closing. As a result, it also implemented requirements to provide a “corrected” Closing Disclosure in certain situations, including when disclosed information becomes inaccurate before consummation.\textsuperscript{80} For example, if the creditor estimated the interest rate because it was never locked and the interest rate fluctuates after the Closing Disclosure is provided, the creditor must provide a corrected Closing Disclosure to the consumer at or before consummation.\textsuperscript{81} In addition, notwithstanding the requirement to provide a corrected Closing Disclosure, the consumer must be permitted to inspect the Closing Disclosure, which must be updated to reflect any changes known at the time of inspection, during the business day immediately preceding consummation.\textsuperscript{82}

A corrected Closing Disclosure also must be provided and a three-day waiting period applies if certain information in the Closing Disclosure becomes inaccurate before consummation. If any of the following items change before consummation, the creditor must not only provide a corrected Closing Disclosure, but it must also ensure that it is received at least three business days before consummation: the APR becomes inaccurate, as defined in Regulation Z;\textsuperscript{83} the loan product changes, causing the “Product” information required on page one of the Closing Disclosure to become inaccurate; or a prepayment penalty is added.\textsuperscript{84}

The TRID Rule also requires corrected Closing Disclosures to be provided after consummation if settlement costs paid by the consumer change after consummation, a non-numerical clerical error is identified, or a tolerance violation is identified.\textsuperscript{85}

If the transaction involves a seller, then the settlement agent is responsible for providing a Closing Disclosure to the seller at or before consummation reflecting the actual terms of the seller’s transaction.\textsuperscript{86}

\textsuperscript{77} Id. pt. 1026, supp. 1, cmt. 1026.19(f)(1)(i)-2.
\textsuperscript{78} Id.
\textsuperscript{79} Id. (stating that a creditor has not exercised due diligence if it discloses an estimate based on another transaction instead of requesting the actual cost of the lender’s title insurance policy from the title insurance company).
\textsuperscript{80} Id. § 1026.19(f)(2)(ii).
\textsuperscript{81} Id. § 1026.19(f)(2)(i).
\textsuperscript{82} Id.
\textsuperscript{83} Id. § 1026.19(f)(2)(ii); see id. § 1026.22 (defining the APR).
\textsuperscript{84} Id. § 1026.19(f)(2)(ii).
\textsuperscript{85} Id. § 1026.19(f)(2)(iii)–(v).
\textsuperscript{86} Id. § 1026.19(f)(4)(i)–(ii).
within thirty days of consummation, the settlement agent must deliver or place in the mail a corrected Closing Disclosure within thirty days after receiving information sufficient to establish that such event has occurred. 87

**SPECIFIC IMPLEMENTATION CHALLENGES**

The CFPB has issued interpretive guidance through a variety of methods since publishing the final TRID Rule. 88 Despite the unprecedented guidance, many questions remained at the time of implementation. Two are discussed below.

**RESETTING TOLERANCES USING THE CLOSING DISCLOSURE**

As noted, closing costs must be disclosed on the Loan Estimate in “good faith,” and many of the closing costs are subject to variances or “tolerances.” 89 This means that the estimated amounts are in good faith if the actual charge paid by or imposed on the consumer does not exceed the amount originally disclosed on the Loan Estimate by the applicable tolerance (i.e., zero or 10 percent in the aggregate) unless a “permitted” change occurs and the creditor “resets” the tolerances. 90

The creditor may “reset” the tolerances and charge more than originally disclosed by providing a revised Loan Estimate within three business days of receiving information sufficient to establish that a permitted change occurred. 91 However, a revised Loan Estimate cannot be received on or after the date the Closing Disclosure is received, so the consumer must receive any revised Loan Estimate at least four business days before consummation (as the Closing Disclosure must be provided at least three business days before consummation). 92

The CFPB recognized that permitted changes may occur after the Loan Estimate deadline, so it created a narrow exception to allow creditors to reset tolerances by disclosing changes on the Closing Disclosure only if “there are less than four business days between the time the revised version of the disclosures is required to be provided under § 1026.19(e)(4)(i) [the “reset deadline,” which occurs three business days after receiving information sufficient to establish a permitted change] and consummation.” 93

This limitation creates an issue if the creditor provides the Closing Disclosure too early or if the closing is significantly delayed because the creditor will not be able to reset tolerances in such circumstances if there are too many days between

87. Id. § 1026.19(f)(4)(ii).
88. Most of these resources may be found on the CFPB’s website. See TILA-RESPA Integrated Disclosure Rule Implementation, Consumer Fin. Prot. Bureau, http://www.consumerfinance.gov/regulatory-implementation/tila-respa/ (last visited Oct. 8, 2015) (providing a compliance guide, a guide to forms, a closing factsheet, a disclosure timeline, an integrated loan disclosure form with samples, and a video series, along with supervision and examination materials).
90. Id. § 1026.19(e)(3), (e)(4).
91. Id. § 1026.19(e)(4)(i).
92. Id. § 1026.19(e)(4)(ii).
93. Id. pt. 1026, supp. 1, cmt. 1026.19(e)(4)(ii)-1 (emphasis added); id. § 1026.19(e)(4)(i).
consummation and the reset deadline. For example, if there are three or fewer business days between consummation and the reset deadline, then the creditor may simply include the increased charge on the next Closing Disclosure it provides. If there are four or more business days between consummation and the reset deadline, then it must reset tolerances using a revised Loan Estimate (if it has not already issued a Closing Disclosure) or it must not pass along the increased charge.

**DISCLOSING TITLE INSURANCE COSTS**

A creditor also must separately disclose the cost of the owner’s and lender’s title insurance policies in the Loan Estimate and Closing Disclosure. Generally, the full premium rates for each respective title insurance policy must be disclosed. However, where a special premium rate applies due to the simultaneous purchase of both policies, the creditor must follow a specific formula to calculate and disclose the cost of the owner’s title insurance policy. The formula requires the creditor to take the owner’s title insurance premium, add the simultaneous issuance premium for the lender’s coverage, and then deduct the full premium for the lender’s coverage. The creditor must disclose the resulting amount as the cost of the owner’s title insurance policy and, for the lender’s title insurance policy, the creditor must continue to disclose the lender’s full premium rate, without the simultaneous purchase discount. This is true regardless of the title insurance company’s filed rates or applicable state law.

However, the TRID Rule does not explain how the disclosures should be completed if the seller has agreed to pay for the owner’s title insurance policy. In such circumstances, the creditor cannot simply shift the cost of the owner’s title insurance policy to the seller using the TRID Rule’s required calculations because the actual cost of the owner’s title insurance policy is more than the disclosed amount. On the Loan Estimate, the solution is simple: the full amount of the seller’s payment will simply be reflected as a seller credit in the Calculating Cash to Close table, just as any other payment by the seller for loan costs.

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97. Id. § 1026.37(f)(2)(i), (f)(3)(i), (g)(4)(i).

98. Id.; see also id. pt. 1026, supp. 1, cmt. 1026.37(g)(4)-1.

99. Id. pt. 1026, supp. 1, cmt. 1026.37(g)(4)-2.

100. Id.

101. Id.

102. Id. § 1026.37(h)(1)(vi).
The solution for the Closing Disclosure is not as simple. However, CFPB staff advised during an official CFPB webinar that there are at least three ways in which the credit between the seller and consumer may be disclosed on the Closing Disclosure: the remaining credit may be applied toward any other title insurance costs, including the lender’s title insurance cost; the remaining credit may be considered to be a general seller credit and disclosed as such in the Summaries of Transactions table on page three of the Closing Disclosure; or, the remaining credit may be shown on page three, specifying that it is a credit for title insurance under the purchase and sale contract.103

TCPA Regulatory and Litigation Developments: The FCC Opens the Floodgates

By John R. Chiles, Zachary D. Miller, and Rachel R. Friedman*

INTRODUCTION

Over the last several years, a dramatic increase in litigation under the Telephone Consumer Protection Act (“TCPA”) has required the consumer finance industry to closely monitor both regulatory and litigation developments. On July 10, 2015, the Federal Communications Commission (“FCC”) issued a sweeping declaratory ruling and order (“Ruling”) that will likely increase the number of TCPA lawsuits flooding federal courts across the country. The Ruling addressed several critical unsettled questions that have plagued TCPA litigation, including the definition of “automatic telephone dialing system” (“ATDS”), revocation of consumer consent, and liability for calling reassigned wireless numbers. The Ruling answered each question in a way that broadens the scope of the TCPA. In so doing, the Ruling tends to negate many potential defenses to TCPA claims that creditors, debt collectors, and other businesses had been relying upon and had petitioned the FCC to adopt officially. Because the FCC’s rulings are binding on federal courts, the Ruling will likely benefit TCPA plaintiffs, who already benefit from the generous statutory damages provision, which is un-

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2. The exact number of TCPA lawsuits is difficult to determine, but the Federal Communications Commission, citing the American Financial Services Association, stated that TCPA lawsuits were up 116 percent in September 2013, compared to September 2012. In re Rules & Regulations Implementing the Tel. Consumer Prot. Act of 1991, 30 FCC Rcd. 7961, 7968–69 & n.28 (July 10, 2015) [hereinafter 2015 Ruling].
3. See id. at 7963–65.
5. See, e.g., Mais v. Gulf Coast Collection Bureau, Inc., 768 F.3d 1110, 1121 (11th Cir. 2014) (concluding that FCC rulings on the TCPA have the “force of law”).
capped for class action awards. This year’s survey reviews the major points of the Ruling, as well as significant TCPA decisions during the past year.

**The FCC’s 2015 Ruling**

**Definition of “Automatic Telephone Dialing System”**

The TCPA attaches liability to certain calls made using an ATDS, which is defined as “equipment which has the capacity—(A) to store or produce telephone numbers to be called, using a random or sequential number generator; and (B) to dial such numbers.” Often, the first line of defense to claims under these provisions is that the device used to call the plaintiff does not fit within the statutory definition of an ATDS. Prior to the Ruling, FCC decisions had significantly expanded the definition of an ATDS, interpreting the word “capacity” to mean any system that, through modification or other means, could randomly or sequentially dial a number. While the FCC declined to “address the exact contours of the ‘autodialer’ definition” in the Ruling, it reaffirmed its prior rulings that “predictive dialers” satisfy the TCPA’s definition of an ATDS and that dialing equipment can have the requisite “capacity” to store or produce and dial random or sequential numbers, even if the equipment is not presently used for that purpose, such as when calls are made from a set list of customer numbers. The Ruling also reiterated that the “basic function” of an autodialer is “to dial numbers without human intervention.”

Some courts narrowed the definition of an ATDS so that it was restricted to those devices that had the present capacity to randomly or sequentially dial a number without substantial modification to the device, reasoning that inclusion of devices that only had the “potential capacity” to store or produce and call telephone numbers using a random number generator “would capture many of contemporary society’s most common technological devices within the statutory definition.” Noting that Congress intended a broad definition of “autodialer,” the FCC rejected the argument that a device should fall within the definition of an ATDS only if it has the “present ability” to dial random and sequential...
numbers.\textsuperscript{15} Instead, the FCC held that “the capacity of an autodialer is not limited to its current configuration but also includes its potential functionalities.”\textsuperscript{16} Dismissing concerns that such a definition is unnecessarily broad in scope, the FCC stated that otherwise restricting the definition of “capacity” to “present use or present capacity [w]ould render the TCPA’s protections largely meaningless by ensuring that little or no modern dialing equipment would fit the statutory definition of an autodialer.”\textsuperscript{17}

The FCC did recognize, however, that “there are outer limits to the capacity of equipment to be an autodialer” and that these outer limits “do not extend to every piece of malleable and modifiable dialing equipment that conceivably could be considered to have some capacity, however small, to store and dial telephone numbers.”\textsuperscript{18} The Ruling clarified that “there must be more than a theoretical potential that the equipment could be modified to satisfy the ‘autodialer’ definition” and that any determination as to whether a particular piece of equipment meets the definition of ATDS will ultimately require a case-by-case determination.\textsuperscript{19}

\textbf{Revocation of Consumer Consent}

The Ruling also addressed, for the first time, the means by which a called party can revoke prior express consent to receive autodialed calls. The FCC acknowledged that “the TCPA does not speak directly to the issue of revocation,”\textsuperscript{20} but concluded that “any silence in the statute as to the right of revocation should be construed in favor of consumers.”\textsuperscript{21} As a result, the FCC held that “consumers may revoke consent through any reasonable means,”\textsuperscript{22} which is “any manner that clearly expresses a desire not to receive further messages.”\textsuperscript{23} The Ruling stated that permitting revocation of consent by any reasonable means was consistent with “the consumer-protection goals of the TCPA” and “the well-established common law right to revoke prior consent.”\textsuperscript{24} “[C]allers may not infringe on that ability by designating an exclusive means to revoke.”\textsuperscript{25}

The Ruling clarified that revocation may be communicated orally or in writing, and that revocation can occur “by way of a consumer-initiated call, directly in response to a call initiated or made by a caller, or at an in-store bill payment location, among other possibilities.”\textsuperscript{26} Providing instruction to courts faced with examining the validity of a claim of revocation, the Ruling stated that one must look to the “totality of the facts and circumstances surrounding that specific

\begin{footnotes}
\item[15] 2015 Ruling, supra note 2, at 7974–76.
\item[16] Id. at 7974.
\item[17] Id. at 7976.
\item[18] Id. at 7975.
\item[19] Id.
\item[20] Id. at 7993.
\item[21] Id. (quoting Gager v. Dell Fin. Servs., LLC, 727 F.3d 265, 270 (3d Cir. 2013)).
\item[22] Id.
\item[23] Id. at 7996.
\item[24] Id. at 7994.
\item[25] Id. at 7996.
\item[26] Id.
\end{footnotes}
situation, including, for example, whether the consumer had a reasonable expectation that he or she could effectively communicate his or her request for revocation to the caller in that circumstance, and whether the caller could have implemented mechanisms to effectuate a requested revocation without incurring undue burdens.”27 However, the FCC did not further elaborate on what would amount to an “undue burden.”

Importantly, the FCC held that a caller cannot specify the means by which consent can be revoked because such a requirement would “materially diminish the consumer’s ability to revoke by imposing additional burdens [on the consumer].”28 If a caller could limit the means by which revocation could be effectuated, the FCC feared that the caller “would be free to robocall a consumer without facing TCPA liability, despite the consumer’s repeated reasonable attempts to revoke consent.”29

Finally, the FCC addressed compliance under this new regulatory regime, dismissing one petitioner’s concern that permitting oral revocation of consent will put TCPA defendants at a disadvantage in “he said, she said” claims of revocation by stating: “We expect that responsible callers, cognizant of their duty to ensure that they have prior express consent under the TCPA and their burden to prove that they have such consent, will maintain proper business records tracking consent.”30 By permitting a consumer to revoke consent in any “reasonable” way, while placing the evidentiary burden of proving consent entirely on the caller, the FCC puts pressure on callers to maintain precise records of all conversations with consumers. Moreover, the FCC’s focus on the means of revocation leaves open the question of what a consumer must say in order to revoke his or her prior express consent.

LIABILITY FOR CALLING REASSIGNED WIRELESS NUMBERS

Perhaps the most problematic aspect of the Ruling is its treatment of reassigned telephone numbers. This issue arises when a caller calls a number for which it once received prior express consent, but which number subsequently was reassigned to another subscriber, who did not give prior express consent. It is difficult for callers to discover that a number has been reassigned because there is no nationwide directory for cell phones.31 Despite requests for relief on this issue, the FCC instead stated that the “TCPA requires the consent not of the intended recipient of a call, but of the current subscriber (or non-subscriber customary user of the phone) and that caller best practices can facilitate detection of reassignments before calls.”32

27. Id. at 7996 n.233.
28. Id. at 7997.
29. Id.
30. Id. at 7998.
31. Id. at 8005.
32. Id. at 7999–8000 (footnote omitted).
The Ruling purports to provide a safe harbor of sorts for callers that lack knowledge of reassignment of a number by providing that, if a caller makes a call without knowledge that a phone number has been reassigned and has a “reasonable basis” to believe that it had valid consent to make the call, then the caller may make one call after the reassignment, without incurring TCPA liability, in order to “gain actual or constructive knowledge of the reassignment and cease future calls to the new subscriber.” However, “[i]f this one additional call does not yield actual knowledge of reassignment,” the caller is deemed “to have constructive knowledge of such.”

In other words, this safe harbor covers only one call attempt. Thus, if a reassigned number is called, and no one answers, the caller is deemed to have constructive knowledge of the reassignment, and any future calls can result in TCPA liability. While recognizing that “many calls can be made before there is actual knowledge of reassignment,” the FCC concluded that “giving callers an opportunity to avoid liability for the first call to a wireless number following reassignment strikes the appropriate balance” between “a caller’s opportunity to learn of the reassignment and the privacy interests of the new subscriber.” The safe harbor appears hollow, given the likelihood that a called party will not answer a call from an unknown number. Moreover, the “free call” safeguard applies only to reassigned numbers for which the caller had previously obtained prior express consent, and the Ruling makes clear that “[t]he caller, and not the called party, bears the burden of demonstrating . . . that [it] had a reasonable basis to believe that [it] had consent to make the call and that [it] did not have actual or constructive knowledge of reassignment” at the time the call was made.

By listing potential avenues for a caller to obtain knowledge of reassignment, such as by requiring a party giving consent to notify the caller when his or her number has been relinquished, the Ruling implicitly acknowledges that there is no foolproof way to detect whether a number has been reassigned, because there is no public directory of wireless numbers. However, the Ruling makes clear that a consumer’s breach of such an agreement would not “preserve the previously existing consent to call that number,” but would afford the caller contractual remedies against the party who originally provided consent.

33. Id. at 8000.
34. Id.
35. Because the TCPA imposes liability for calls made without the prior express consent of the person who is the customary user or subscriber of the phone at the time the call is made, “calls to reassigned wireless numbers violate the TCPA when a previous subscriber, not the current subscriber or customary user, provided the prior express consent on which the call is based.” Id. at 8001; see infra notes 40–46 and accompanying text.
36. 2015 Ruling, supra note 2, at 8009.
37. Id. at 8007.
38. Id. at 8005–08.
39. Id. at 8008 n.302.
**“Called Party” Defined as the “Subscriber and/or Customary User”**

Under the TCPA, it is generally unlawful to “make any call . . . using any [ATDS] or an artificial or prerecorded voice,” without the “prior express consent of the called party.”40 However, the statute does not define the term “called party.” In the Ruling, for the first time, the FCC acknowledged that the term “called party” is ambiguous.41 Thus, the Ruling declared that “called party” includes “the subscriber, i.e., the consumer assigned the telephone number dialed and billed for the call, or the non-subscriber customary user of a telephone number included in a family or business calling plan.”42 The FCC found that defining “called party” to include the subscriber or customary user at the time the call was placed was consistent with the text and the purpose of the TCPA.43

The Ruling stated that the FCC finds it “reasonable to include in [its] interpretation of ‘called party’ individuals who might not be the subscriber, but who, due to their relationship to the subscriber, are the number’s customary user and can provide prior express consent for the call.”44 The Ruling also recognized that “the consent of a customary user of a telephone number may bind the subscriber.”45 Offering some relief to callers, the Ruling also stated that, “when an individual who is not the subscriber or other customary user answers the phone due to his or her proximity to those individuals, for example a passenger in the subscriber’s car or the customary user’s houseguest, there is no TCPA violation when the current subscriber or customary user has given the necessary prior express consent for the call.”46

**TCPA Case Law Developments**

**Rule 68 Offers of Judgment**

In May 2015, the U.S. Supreme Court granted certiorari in a putative TCPA class action case, *Campbell-Ewald Co. v. Gomez*,47 to decide the much-litigated issue of the effect on class claims of an offer of judgment for the plaintiff’s individual claim under Rule 68 of the Federal Rules of Civil Procedure (“FRCP”). The Court’s forthcoming decision will likely provide clarity on (1) whether a plaintiff lacks standing to assert a claim after receiving an offer of judgment that provides complete relief; and (2) whether the answer to the first question is any different when the plaintiff has asserted a class claim under Rule 23 of the FRCP, but receives an offer of complete individual relief before any class is certified.48

41. 2015 Ruling, supra note 2, at 8001.
42. Id. at 8000–01.
43. Id. at 8001.
44. Id.
45. Id. at 8003.
46. Id. at 8002.
47. 135 S. Ct. 2311 (2015).
In Gomez, the U.S. Court of Appeals for the Ninth Circuit held that an unaccepted Rule 68 offer of judgment that would fully satisfy a class plaintiff’s individual claim is insufficient to render that claim moot and, likewise, that the plaintiff’s failure to accept such an offer of judgment that is made before filing a motion for class certification does not moot the class action.\(^{49}\) The U.S. Courts of Appeals for the Seventh and Eleventh Circuits reached similar conclusions in Chapman v. All American Painting, Inc.\(^{50}\) and Stein v. Buccaneers Ltd. Partnership\(^{51}\) respectively, but the Ninth Circuit’s decision in Gomez was contrary to earlier decisions by other U.S. Courts of Appeals that have held that an offer that fully satisfies a plaintiff’s individual claim moots the class action.\(^{52}\)

**Arbitration of Putative TCPA Class Claims**

In Andermann v. Sprint Spectrum, L.P.,\(^{53}\) the U.S. Court of Appeals for the Seventh Circuit held that putative TCPA class action claims brought against the assignee of a mobile phone service fell within the scope of an arbitration agreement that the named plaintiffs had executed with the original holder of their mobile phone account.\(^{54}\) The plaintiffs originally obtained mobile phone service from U.S. Cellular and executed an arbitration agreement providing that “any controversy or claim arising out of or relating to this [mobile phone service] agreement shall be resolved by binding arbitration” and that “this arbitration agreement survives the termination of this service agreement.”\(^{55}\) U.S. Cellular thereafter assigned the plaintiffs’ account to Sprint.\(^{56}\) Several months later, Sprint contacted its customers, including the plaintiffs, by phone and by mail to remind them that their service was about to expire and to inform them that Sprint had “a great set of offers and devices available to fit [their] needs.”\(^{57}\) The plaintiffs sued Sprint, claiming that the calls were unsolicited advertisements in violation of the TCPA.\(^{58}\)

Sprint moved to compel arbitration on the basis that the claims arose out of and related to the plaintiffs’ mobile phone contract, which had been assigned to Sprint.\(^{59}\) The district court denied the motion to compel arbitration on the basis that the claims could not have arisen from the parties’ contract because, at the time Sprint made the calls, the plaintiffs had already signed up for mobile phone service with another company and their contract with Sprint had terminated.\(^{60}\) The Seventh Circuit rejected this reasoning, finding instead that there

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\(^{50}\) 796 F.3d 783, 786–87 (7th Cir. 2015).

\(^{51}\) 772 F.3d 698, 702–05 (11th Cir. 2014).

\(^{52}\) See, e.g., Hrivnak v. NCO Portfolio Mgmt., Inc., 719 F.3d 564, 567 (6th Cir. 2013).

\(^{53}\) 785 F.3d 1157 (7th Cir. 2015).

\(^{54}\) Id. at 1160.

\(^{55}\) Id. at 1158.

\(^{56}\) Id.

\(^{57}\) Id.

\(^{58}\) Id.

\(^{59}\) Id.

\(^{60}\) Id.
was an “intimate relation” between the claims and the parties’ contract, because the basis for the calls was to communicate with accountholders whose contracts Sprint had acquired via assignment and to offer them new services in order to avoid losing them as customers. Accordingly, the appellate court reversed the lower court’s denial of Sprint’s motion to compel arbitration.

**Meaning of “Willful or Knowing Violation” Under the TCPA**

In *Lary v. Trinity Physician Financial & Insurance Services*, the U.S. Court of Appeals for the Eleventh Circuit made two significant rulings regarding the damages provisions of the TCPA. First, the court held that a single fax could result in two statutory damages awards of $500 each if the fax was found to violate two different TCPA subsections. Second, interpreting the TCPA’s treble damages provision, which applies if the defendant “willfully or knowingly” violates the TCPA, the court held that “[t]he requirement of ‘willfully’ or knowing conduct requires the violator to know he was performing the conduct that violates the statute.” The court stated, “[i]f we interpreted the statute to require only that the violator knew he was making a ‘call’ or sending a fax, the statute would have almost no room for violations that are not ‘willful’ or knowing[].”

During the past year, district courts have interpreted the “willful and knowing” requirement in various ways. For instance, in contrast to the holding in *Lary*, one district court in North Carolina held that knowledge of a violation is not required, but refused to impose treble damages for a violation of the TCPA’s provision prohibiting autodialed or prerecorded message calls to a cell phone where there was no evidence that the defendant intended to call a cell phone number. The court rejected the plaintiff’s claim that the defendant “willfully and knowingly” violated the statute because the defendant “did not claim to have accidentally dialed the number,” finding this to be “insufficient to establish that defendant knew it was making a call to a cellular number, as required under section 227(b)(1)(A)(iii).”

Another district court in Ohio implicitly held that some degree of culpability is required in order to award treble damages. In *Maraan v. Dish Network, LLC*, the court declined to impose treble damages where the defendant called a number that its customer provided but that in fact belonged to a third party, noting that the defendant had been “duped” by its customer. The court therefore im-

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61. *Id.* at 1158–59.
62. *Id.* at 1160.
63. 780 F.3d 1101 (11th Cir. 2015).
64. *Id.* at 1106.
66. *Lary*, 780 F.3d at 1107 (quoting 47 U.S.C. § 227(b)(3)).
67. *Id.* (quoting 47 U.S.C. § 227(b)(3)).
69. *Id.*
71. *Id.* at *6.
posed treble damages only for calls made after the defendant was informed that it had the wrong number.\textsuperscript{72}

In contrast to both of those cases, a district court in California held that the treble damages provision was triggered upon a showing that the defendant’s actions were intentional, “irrespective of any intent to violate any provision[] , rule or regulation.”\textsuperscript{73}

**Meaning of “Advertisement” and “Telemarketing” Under the TCPA**

The U.S. Courts of Appeals for the Sixth and Eighth Circuits addressed the meaning of the term “advertisement” under the TCPA.\textsuperscript{74} The TCPA vaguely defines the term “unsolicited advertisement” as “any material advertising the commercial availability or quality of any property, goods, or services which is transmitted to any person without that person’s prior express invitation or permission, in writing or otherwise.”\textsuperscript{75}

In *Sandusky Wellness Center, LLC v. Medco Health Solutions, Inc.*\textsuperscript{76} the Sixth Circuit held that, to qualify as an “advertisement,” a communication must promote property, goods, or services for sale and must be “commercial in nature,” meaning that it has profit as an aim.\textsuperscript{77} The *Sandusky Wellness* court agreed with the defendant that faxes that it sent as a pharmacy benefits manager to a chiropractic company were not “advertisements” because they did not promote the medicines described in the faxes for sale and there was no evidence that the faxes were sent in order to make a profit.\textsuperscript{78} The Sixth Circuit refused to adopt the plaintiff’s definition of “advertisement” as anything that “makes known” the quality or availability of a good or service, pointing to the inclusion of the word “commercial” in the TCPA’s definition of “unsolicited advertisement.”\textsuperscript{79} The court also rejected the plaintiff’s claim that the faxes were advertisements on the basis that “Medco might financially benefit from these faxes several locks down the stream of commerce” because such “speculative down-the-stream evidence” was insufficient to create a genuine dispute of fact over whether the communications were ads.\textsuperscript{80}

In *Golan v. Veritas Entertainment, LLC*,\textsuperscript{81} the Eighth Circuit addressed the distinction between “advertisements” and “telemarketing” under the Act. The case arose when the plaintiffs received two unsolicited, prerecorded messages on
their home phones, which they claimed were initiated as part of a telemarketing campaign to promote the film Last Ounce of Courage, although the messages stated that the calls were for a “public survey” and did not mention the film.\footnote{82. Id. at 816–18.}

The Golan court agreed with the defendants that the message played on the plaintiffs’ phones did not qualify as an “advertisement” under the TCPA because the message did not mention property, goods, or services, but it nevertheless found that the message did qualify as a “telemarketing” call.\footnote{83. Id. at 819–20.} Elaborating on the TCPA’s implementing regulation, which defines “telemarketing” as the “initiation of a telephone call or message for the purpose of encouraging the purchase or rental of, or investment in, property, goods, or services, which is transmitted to any person,”\footnote{84. Id. at 820 (quoting 47 C.F.R. § 64.1200(f)(12)).} the court held that telemarketing occurs “when the context of a call indicates that it was initiated and transmitted to a person for the purpose of promoting property, goods, or services.\footnote{85. Id. (citing 47 C.F.R. § 64.1200(a)(2)(iii), (f)(12); 2003 Ruling, supra note 8, at 14098).} The Golan court concluded that, “[s]ince the calls were initiated and transmitted to the [plaintiffs] in order to promote Last Ounce of Courage, they qualified as ‘telemarketing’ even though the messages never referenced the film.”\footnote{86. Id. (emphasis added).}

**Meaning of “Prior Express Consent” Under the TCPA**

In Nigro v. Mercantile Adjustment Bureau, LLC,\footnote{87. 769 F.3d 804 (2d Cir. 2014) (per curiam).} the U.S. Court of Appeals for the Second Circuit addressed the limits of the FCC’s ruling that prior express consent is given to a creditor when a phone number is provided in connection with the debt owed. Relying on the FCC’s 2008 ruling that “prior express consent [for automated debt collection calls] is . . . granted only if the wireless number was provided by the consumer to the creditor, and that such number was provided during the transaction that resulted in the debt owed,” the Nigro court held that the plaintiff, who provided his cell phone number to terminate his mother-in-law’s power service, “plainly did not consent” because he did not “provide his phone number ‘during the transaction that resulted in the debt owed.’”\footnote{88. Id. at 806 (quoting 2008 Ruling, supra note 10, at 564–65).} The court explained that the plaintiff provided his phone number “long after the debt was incurred and was not in any way responsible for—or even fully aware of—the debt.”\footnote{89. Id. at 806–07.} Therefore, the Nigro court held that the plaintiff did not consent to receive calls regarding an unpaid balance on the account.\footnote{90. Id. at 807.}

In Mais v. Gulf Coast Collection Bureau, Inc.,\footnote{91. 768 F.3d 1110 (11th Cir. 2014).} the U.S. Court of Appeals for the Eleventh Circuit held that prior express consent can be “provided” to a creditor
within the scope of the FCC's 2008 ruling when a phone number is provided to an intermediary that later provides the number to the creditor. The Mais court held that consent to receive calls from a debt collector existed where the plaintiff’s wife provided the plaintiff’s cell phone number on hospital intake forms, which authorized disclosure by the hospital to radiologists for treatment and payment, and the hospital-based radiologist forwarded the plaintiff’s cell phone number to a debt collection agency when the plaintiff failed to pay his bill for radiology services.92 The court cited the FCC’s 2014 ruling that the TCPA permitted a caller to obtain consent through an intermediary,93 and it concluded that “the appropriate analysis turns on whether the called party granted permission or authorization, not on whether the creditor received the number directly.”94 Because the forms signed by the plaintiff’s wife stated that the hospital could “use and disclose health information about [his] treatment and services to bill and collect payment from [him]” and that “[it] may also use and disclose health information . . . [t]o business associates [it had] contracted with to perform the agreed upon service and billing for it,” the plaintiff’s wife gave prior express consent on behalf of the plaintiff for the radiologist to transmit the plaintiff’s health information to the debt collector to contact him regarding his bill, which the Mais court found included the plaintiff’s cell phone number.95

92. Id. at 1114, 1124.
93. Id. at 1123 (citing In re GroupMe, Inc./Skype Commc’ns S.A.R.L. Petition for Expedited Declaratory Ruling, 29 FCC Rcd. 3442, 3447 (Mar. 27, 2014)).
94. Id.
95. Id. at 1124 (quoting hospital intake forms).
Fair Credit Reporting Act and Financial Privacy Update—2015

By Andrew M. Smith and Peter Gilbert*

INTRODUCTION

During the past year, the regulatory community continued its efforts, reported in the previous survey,¹ to reform the credit reporting system. States’ attorneys general joined the fray in 2015, entering into two important settlements with the nationwide consumer reporting agencies (“CRAs”). The Bureau of Consumer Financial Protection (“CFPB”), for its part, continued to bring enforcement actions and issued reports and guidance under the Fair Credit Reporting Act (“FCRA”),² particularly with respect to data accuracy and the duties of companies that furnish data to CRAs. And, the courts have been active in interpreting the FCRA, including a grant of certiorari by the U.S. Supreme Court to examine who has standing to sue under the statute. With respect to financial privacy, the CFPB amended Regulation P to allow financial institutions to forego the annual mailing of privacy notices in certain limited instances.

SETTLEMENTS WITH STATES’ ATTORNEYS GENERAL

In March 2015, the New York Attorney General announced a settlement (“NY Settlement”) with the three largest nationwide CRAs: Equifax, Experian, and Trans Union.³ Two months later, in May 2015, the Ohio Attorney General announced a thirty-one-state settlement (“Multistate Settlement”) with the same three companies.⁴ Both settlements focused on credit data accuracy, consumer disputes, and

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medical debts, and both impose largely similar requirements on the CRAs. The settlements have phased implementation dates that will require compliance with their provisions beginning in late 2015 and continuing through 2018.\(^5\)

The settlements soften the impact of delinquent medical debt on consumers’ credit profiles.\(^6\) They do this by imposing a 180-day moratorium before CRAs can report medical debt that is in the hands of debt buyers and collection agencies.\(^7\) By the terms of the settlements, the CRAs and collection agencies are to collaborate to delete or suppress from credit files accounts that are ultimately paid by an insurance carrier and therefore are not the lapsed obligation of the consumer.\(^8\) Accounts that go delinquent because insurers have not paid what they owe will therefore be less likely to harm consumers’ credit standing. Lenders and other users of credit reports should take note that, once implemented, these changes will mean that all medical debts, even those not insured in any capacity, will be invisible as collection tradelines for the first 180 days of delinquency, an outcome that could affect the efficacy of current underwriting models.\(^9\)

The settlements also impose other changes that are intended to improve the accuracy of credit reports. Both settlement agreements require the CRAs to create a working group composed of internal data experts from each CRA that is intended to coordinate and review credit data furnisher analytics and metrics and identify data accuracy best practices among the three CRAs.\(^10\) For example, the working group may establish minimum identifying data elements that a CRA should require in order to open a new account tradeline.\(^11\) Likewise, the working group may establish standards regarding the collection and publishing of public record data on credit reports, such as judgments and bankruptcy filings.\(^12\)

Under each settlement, the working group is empowered to take corrective actions against furnishers of data that fail to adhere to the standards set for data furnishing and reinvestigating consumer disputes.\(^13\) Corrective actions could range from warnings to refusing to accept future data.\(^14\) Perhaps most significant for furnishers is that the working group will gather metrics on them, including dispute rates, corrective actions, timeliness of reporting, and proper use of industry standard reporting codes.\(^15\) The working group will report those metrics

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5. NY Settlement, supra note 3, at 11; Multistate Settlement, supra note 4, at 7.
6. As discussed below, see infra notes 57–63 and accompanying text, the effect of medical collections on consumers’ credit profiles is also a concern of the CFPB.
7. NY Settlement, supra note 3, at 13; Multistate Settlement, supra note 4, at 13.
8. NY Settlement, supra note 3, at 13; Multistate Settlement, supra note 4, at 13.
9. As reported in the previous survey, FICO has announced that its new credit scores will weigh medical collections accounts less heavily in the score calculation and will ignore paid medical collections accounts entirely. See Smith & Gilbert, supra note 1, at 592 n.70.
10. NY Settlement, supra note 3, at 29–31; Multistate Settlement, supra note 4, at 28–30.
11. NY Settlement, supra note 3, at 31; Multistate Settlement, supra note 4, at 30.
12. NY Settlement, supra note 3, at 31; Multistate Settlement, supra note 4, at 30.
13. NY Settlement, supra note 3, at 32; Multistate Settlement, supra note 4, at 31–32.
14. NY Settlement, supra note 3, at 32; Multistate Settlement, supra note 4, at 31–32.
to the states on a semi-annual basis, thereby exposing furnisher compliance issues to the states on a regular basis.\textsuperscript{16}

The settlements outline other approaches that are intended to further accuracy and data quality without involvement of the working group. For example, the settlements prohibit the CRAs from accepting data from furnishers that did not arise from a contract or agreement to pay, such as fines, tickets, and other assessments, and require them proactively to remove from their databases tradelines that meet those criteria.\textsuperscript{17} In addition, CRAs must delete from credit files collection accounts that have not been updated by a collection agency furnisher within the last six months.\textsuperscript{18} The impact of this last requirement could be significant, given the CFPB’s observation that most collection agencies do not update their accounts on a monthly basis, unlike lenders, which update active and collections tradelines more consistently.\textsuperscript{19} These reforms may foretell a new willingness in the regulatory and enforcement community to embrace selective reporting and tradeline deletions in order to achieve perceived accuracy and fairness.

The settlements require some changes to the ways in which CRAs investigate and respond to consumer disputes regarding the accuracy of information in their credit files.\textsuperscript{20} The settlements require CRAs to implement an escalated dispute process when consumers claim that the CRAs have mixed their information with that of another consumer and when consumers claim information in their credit files is the result of fraud or identity theft.\textsuperscript{21} For those kinds of disputes, CRAs must engage “representatives from specialized groups with substantial experience processing these types of disputes, who will process the consumer’s dispute through completion.”\textsuperscript{22} The Multistate Settlement notes that the escalated dispute process “may involve direct communication with the furnisher(s) involved in reporting the tradelines at issue.”\textsuperscript{23} Furnishers should prepare for the possibility that this change could result in added steps to their dispute resolution process.

Consistent with a CFPB bulletin that focused on furnishers’ obligations to review all relevant information, including all supplemental documentation provided with disputes,\textsuperscript{24} the settlements require CRAs to conduct a thorough

\begin{thebibliography}{9}
\bibitem{16} NY Settlement, \textit{supra} note 3, at 33–34; Multistate Settlement, \textit{supra} note 4, at 32–34.
\bibitem{17} NY Settlement, \textit{supra} note 3, at 12; Multistate Settlement, \textit{supra} note 4, at 12.
\bibitem{18} NY Settlement, \textit{supra} note 3, at 12; Multistate Settlement, \textit{supra} note 4, at 12.
\bibitem{19} See \textit{Consumer Fin. Prot. Bureau, Consumer Credit Reports: A Study of Medical and Non-Medical Collections 35 (Dec. 2014) [hereinafter Medical Collections Report], http://files.consumerfinance.gov/f/201412_cfpb_reports_consumer-credit-medical-and-non-medical-collections.pdf} (finding that “only a small fraction of medical, utilities, and telecom collections tradelines were updated on a regular monthly basis,” unlike “the large majority of active (i.e., non-collections) tradelines”).
\bibitem{20} NY Settlement, \textit{supra} note 3, at 15–19; Multistate Settlement, \textit{supra} note 4, at 15–19.
\bibitem{21} NY Settlement, \textit{supra} note 3, at 22–23; Multistate Settlement, \textit{supra} note 4, at 24–25.
\bibitem{22} NY Settlement, \textit{supra} note 3, at 22; Multistate Settlement, \textit{supra} note 4, at 24.
\bibitem{23} Multistate Settlement, \textit{supra} note 4, at 24.
\end{thebibliography}
review of that documentation before they can verify the disputed information as accurate. The settlements also require that the CRAs standardize their dispute response templates. The templates will inform consumers of their options in the event that they are dissatisfied with the outcome of a dispute and will direct them to file a dispute directly with the furnisher or to submit a complaint with the CFPB or a state attorney general. These reforms may improve the dispute resolution process. The extent to which they may impose burdens on the CRAs or the furnisher community will likely depend on how the CRAs implement them.

CFPB ENFORCEMENT, GUIDANCE, REPORT, AND RULEMAKING

Consistent with the regulatory emphasis reported in the previous survey, the CFPB continued to prioritize the obligations of data furnishers under the FCRA in its enforcement actions and with its policy guidance. In addition, the CFPB released a report on medical collections and credit reporting, and it revised its Financial Privacy Rule under the Gramm-Leach-Bliley Act (“GLBA”).

CFPB ENFORCEMENT ACTIONS

The CFPB settled two enforcement actions during the past year alleging violations of the FCRA furnisher provisions. In its enforcement action against DriveTime Automotive Group, Inc. (“DriveTime”), a used car dealership group and its financing affiliate, the CFPB alleged that DriveTime maintained inadequate written policies and procedures to ensure the accuracy and integrity of data furnished to CRAs, in violation of the Furnisher Rule in Regulation V, in addition to significant debt collection issues discussed elsewhere in this Annual Survey. Specifically, DriveTime allegedly did not include in its written policies and procedures any discussion of the company’s procedures for investigating consumer disputes of information furnished to CRAs and failed to specify what would constitute a reasonable dispute investigation. The CFPB also alleged that DriveTime failed to update its procedures, noting that, in November 2011, the company began using a third-party servicer to compile the information to be furnished to CRAs. Although this conversion allegedly resulted in numer-

26. NY Settlement, supra note 3, at 19–20; Multistate Settlement, supra note 4, at 21–22.
27. NY Settlement, supra note 3, at 20; Multistate Settlement, supra note 4, at 22.
28. See Smith & Gilbert, supra note 1, at 589–91.
31. DriveTime Consent Order, supra note 29, at 8, 11.
32. Id. at 8–9; see 12 C.F.R. § 1022.42 (2015) (requiring regular updates of written policies and procedures to ensure the accuracy and integrity of the data furnished to CRAs).
ous inaccuracies in the data furnished to CRAs, at no time did DriveTime update its written policies and procedures to address these new risks.33

The CFPB alleged further that DriveTime failed to adequately investigate consumer disputes of information furnished to CRAs, as required by the FCRA.34 It alleged that, in numerous instances, DriveTime’s investigations concluded that information was accurate, when in fact it was not; that disputes were frequently resolved the same day, erroneously; that the company informed its customers that information had been corrected, when it had not been corrected; and that consumers disputed inaccurate information several times without it being corrected.35 The CFPB also alleged that DriveTime received 22,000 disputes per year but had only two employees dedicated to processing these disputes.36

In addition to the failure to maintain written policies, update those policies, and conduct reasonable investigations, the CFPB alleged that DriveTime furnished inaccurate information to CRAs in violation of the FCRA by misstating the dates of vehicle repossessions as well as the dates that accounts first went delinquent.37 As a result of those failures, the CFPB alleged that derogatory repossession information appeared to be more recent than it was and that the information remained in a consumer’s credit report for a longer period of time than was permitted by law. 38

Companies that furnish data to CRAs are required to investigate two types of disputes of the information that they furnish: consumer disputes received via the CRAs39 and disputes received directly from consumers.40 Unlike the DriveTime matter, in which the CFPB alleged violations of the FCRA requirements for handling consumer disputes received through CRAs, the CFPB’s enforcement action against Syndicated Office Systems, LLC (“Syndicated”), a medical debt collector, involved allegedly inadequate investigations of disputes received directly from consumers.41 The CFPB alleged that Syndicated routinely took ninety days or more to investigate consumer disputes, in violation of the requirement of Regulation V that furnishers investigate and resolve disputes received from consumers.

33. DriveTime Consent Order, supra note 29, at 9–12.
34. Id. at 13; see also 15 U.S.C. § 1681s-2(b) (2012) (requiring furnishers to investigate disputes received from credit bureaus).
35. DriveTime Consent Order, supra note 29, at 10, 13.
36. Id. at 10.
37. Id. at 10, 12–13. The “date of first delinquency” provisions of the FCRA are important because derogatory information may remain in a consumer’s credit report for only seven years from the date of the first delinquency immediately preceding the derogatory event. 15 U.S.C. § 1681c(c) (2012). Companies that furnish information to CRAs are specifically required to provide this date of first delinquency. Id. § 1681s-2(a)(5).
40. Id. § 1681s-2(a)(8).
within thirty days. Those violations allegedly stemmed from Syndicated’s failure to maintain policies and procedures “specifically tailored to the handling” of consumer disputes of information furnished to CRAs; where Syndicated instead treated FCRA disputes in the same manner as all other consumer complaints and resolved them in the order received.

**CFPB Supervisory Guidance**

The CFPB regularly publishes *Supervisory Highlights*, a bulletin that advises supervised entities of the CFPB’s supervisory priorities, including anonymized examination findings that would not otherwise be publicly available information. The CFPB addressed FCRA issues in two issues of its *Supervisory Highlights*.

In the Winter 2015 *Supervisory Highlights*, the CFPB reported that, in the course of its examinations of CRAs, it discovered deficiencies in the updating of public record information following consumer disputes. In response, the CFPB directed one or more CRAs to develop training with respect to the investigation of disputes of public record information, and to establish policies and procedures to ensure that, when a provider of public record information notifies the CRA that information in the CRA’s system is incorrect or incomplete, the CRA will modify or delete the item of information promptly.

The Summer 2015 *Supervisory Highlights* also indicated deficiencies with respect to public record information, and it described inadequate CRA procedures to audit public records vendors, including CRAs that did not have defined processes in place to verify the accuracy of public record information and CRAs that had never audited providers of public record information. This concern regarding inaccurate public record information in credit reports echoed the provisions of the Multistate Settlement requiring the establishment of standards for the collection and publication of public record information.

In the Summer 2015 *Supervisory Highlights*, the CFPB also noted other FCRA issues encountered during examinations of CRAs and credit data furnishers to determine their adherence to the legal requirement that they “follow reasonable procedures to assure maximum possible accuracy” of credit report information. The CFPB found that one or more CRAs maintained policies and procedures for ensuring accuracy that included outdated information or had not been updated to describe actual practices. Some CRAs also failed to monitor data furnishers as required by their own policies.
The CFPB examiners also found that one or more CRAs lacked formal programs to manage data supplied by furnishers or provide feedback to furnishers regarding the quality of data furnished. The CFPB noted further that at least one CRA prepared reports of data quality, but would not provide those reports to furnishers without a fee. Notably, none of those findings is an actual violation of law, because CRAs are required only to maintain procedures, but those findings indicate the CFPB’s procedural expectations with respect to CRAs. Moreover, if the CFPB expects CRAs to subject data furnishers to greater oversight, the furnishers should expect more scrutiny from the CRAs with which they do business.

The CFPB also noted examination findings in the Summer 2015 Supervisory Highlights that debt collectors were not investigating disputes received from consumers, but were simply deleting disputed tradelines. Some of those debt collectors reportedly included statements on their websites indicating that they would investigate disputes, elevating their alleged FCRA violation into a deceptive trade practice. The CFPB also noted that some debt collectors failed to establish and implement adequate written policies and procedures to ensure the accuracy and integrity of information furnished to CRAs, as required by Regulation V.

**CFPB Medical Collections Report**

In December 2014, the CFPB issued a report on its study of medical and non-medical collections. According to the report, the unique characteristics of medical collections accounts may unfairly harm a large number of consumers’ credit files. Almost one in five credit reports has a medical collection tradeline. Most of those tradelines are from unpaid bills, not loans, and are the product of billing practices that the CFPB believes may be confusing to consumers, as compared to the relatively well-documented process by which creditors originate and service loans. Many consumers with medical debts in collection are not otherwise in financial trouble and ordinarily pay their other financial obligations on time. Citing previous work, the CFPB noted that “credit scoring models that treat medical collections in the same way as other collections tradelines penalize

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51. Id.
52. Id.
53. See id. at 5.
55. Summer Highlights 2015, supra note 46, at 8.
56. Id. at 9; see 12 C.F.R. § 1022.42 (2015).
57. See Medical Collections Report, supra note 19.
58. Id. at 4–7.
59. Id. at 5, 18.
60. Id. at 5–7, 38–43.
61. Id. at 7, 38.
consumers with medical debt collections by underestimating their creditworthiness with lower scores.” 62 In short, medical debt is prevalent on credit reports and may overstate credit risk. As a result, the CFPB indicated that it would seek to “identify steps that various stakeholders can take to improve the accuracy, integrity, and consistency of data in the [credit] system.” 63

**FINANCIAL PRIVACY: GLBA REGULATORY RELIEF**

Regulation P requires financial institutions to provide an annual privacy notice to their customers informing them of the information that the financial institutions collect, the persons to whom the financial institutions disclose the data, and the rights of customers to opt out of such disclosure. 64 This annual notice must be provided in writing, or, if the consumer agrees, electronically. 65 To provide relief from the burden of mailing an annual privacy notice to customers, the CFPB promulgated a final rule permitting financial institutions to post annual notices online, rather than mail them to customers each year. 66 The notices must be posted in an accessible and conspicuous manner, the financial institution must notify customers of the notice’s location, and it must provide a paper notice to the customer upon the customer’s request within ten calendar days. 67

The CFPB, however, limited the circumstances under which the alternative delivery method can be utilized by financial institutions. A financial institution may not use the alternative delivery method if it has changed the content of its annual privacy notice, if the financial institution discloses information to affiliated or unaffiliated third parties in a manner in which customers may opt out, or if the financial institution does not adhere to the “safe harbor” privacy form notice prescribed by the CFPB. 68 These limitations may make the alternative delivery method of little or no use for those financial institutions that disclose information to affiliated companies, or that are unable to adhere in every respect to the safe harbor form notice. 69 Even minor variances from the safe harbor form would disqualify a financial institution from using the alternative delivery

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62. *Id.* at 43 (citing Consumer Fin. Prot. Bureau, Data Point: Medical Debt and Credit Scores 4–6 (May 2014), http://files.consumerfinance.gov/f/201405_cfpb_report_data-point_medical-debt-credit-scores.pdf; see also Smith & Gilbert, supra note 1, at 592 (discussing the May 2014 study). 63. **Medical Collections Report,** supra note 19, at 52. 64. 12 C.F.R. §§ 1016.5, 1016.6 (2015). 65. *Id.* § 1016.9. 66. Amendment to the Annual Privacy Notice Requirement Under the Gramm-Leach-Bliley Act (Regulation P), 79 Fed. Reg. 64057 (Oct. 28, 2014) (to be codified at 12 C.F.R. pt. 1016) [hereinafter Privacy Notice Amendment]. 67. *Id.* at 64081 (to be codified at 12 C.F.R. § 1016.9(c)(2)). 68. *Id.* (to be codified at 12 C.F.R. § 1016.9(c)(2)(i)). 69. The CFPB conducted a survey of financial institutions’ privacy notices in connection with making the final rule, and it determined that only 21 percent of banks with assets over $10 billion could use the alternative delivery method. Privacy Notice Amendment, supra note 66, at 64076. The agency determined that 81 percent of banks with assets of less than $10 billion could use the alternative delivery method. *Id.*
method, even if the notice is compliant in all other respects with the requirements of Regulation P.

**Litigation Developments**

The FCRA continued to be an active source of litigation for financial institutions and other companies in 2015. Two frequently litigated issues under the FCRA are (1) whether a specific company qualifies as a CRA and (2) whether the information collected, used, or disclosed constitutes a “consumer report.”

In *Sweet v. LinkedIn Corp.*, the online professional network LinkedIn was sued as a CRA based on its Reference Search feature, which allows users to pay to search for “references” for any LinkedIn member. References are individuals who may have worked at the same company during the same period as the consumer who is the subject of the search. The court held that the information disseminated with respect to Reference Search did not fall within the FCRA’s definition of “consumer report,” but rather, was information about LinkedIn’s own transactions and experiences with those same consumers. Moreover, the court held that LinkedIn was not acting as a CRA because the consumers who were the subjects of Reference Searches voluntarily provided their names and employment histories to LinkedIn for the purposes of publication. It found that LinkedIn was sharing Reference Search information to carry out the professional networking objectives of the subject consumers, not disclosing the information for the purposes of providing consumer reports to third parties.

In *Tierney v. Advocate Health & Hospitals Corp.*, the U.S. Court of Appeals for the Seventh Circuit held that a hospital was not a CRA because it did not assemble information on its patients “for the purpose of furnishing consumer reports to third parties,” but, rather, assembled that information for the purpose of providing health care and obtaining payment for health care. Similar to a district court held that a home health care monitoring company that collected information about patients who lived at home was not a CRA because “the FCRA does

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70. See 12 C.F.R. pt. 1016, app. B.1(b) (2015) (“Institutions seeking to obtain the safe harbor through use of the model form may modify it only as described in these Instructions.”).

71. See Final Model Privacy Form Under the Gramm-Leach-Bliley Act, 74 Fed. Reg. 62890, 62891 (Dec. 1, 2009) (“While the model form provides a legal safe harbor, institutions may continue to use other types of notices that vary from the model form so long as these notices comply with the privacy rule.”).


74. Id. at *1–3.

75. Id. at *3.

76. Id. at *4 (quoting 15 U.S.C. § 1681a(d)(2)(A)(i) (excluding from the definition of “consumer report” a “report containing information solely as to transactions or experiences between the consumer and the person making the report”)).

77. Id. at *6.

78. Id.

79. 797 F.3d 449 (7th Cir. 2015).

80. Id. at 452 (quoting 15 U.S.C. § 1681a(f)).
not cover . . . communications with insurance companies regarding whether patient’s existing insurance policies will cover [healthcare] services.”

The U.S. Supreme Court granted certiorari in Spokeo, Inc. v. Robins, in which the U.S. Court of Appeals for the Ninth Circuit held that the plaintiff had adequately alleged standing under Article III to sue website operator Spokeo under the FCRA for publishing inaccurate personal information about the plaintiff, even though the plaintiff did not allege any actual damages. The FCRA allows for the recovery of statutory damages for “willful” violations of the statute. The issue presented to the Court is whether this statutory right created by the FCRA constitutes injury-in-fact under the U.S. Constitution, even if the plaintiff has not suffered any actual harm. Although Spokeo arises under the FCRA, it has important implications for any statute that allows for the recovery of statutory damages.

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82. 742 F.3d 409 (9th Cir. 2014), cert. granted, 135 S. Ct. 1892 (2015).
83. Id. at 413–14.
Deposit Products and Payment Systems:
Proposed Rules to Regulate Prepaid Accounts

By David W. Thompson, Roberta G. Torian, and Lois S. Woodward*

INTRODUCTION

As the Bureau of Consumer Financial Protection (“CFPB”) has noted, prepaid products are among the fastest growing types of payment instruments in the United States.¹ These products may take many forms. Some, but not all, are “re-loadable,” which allows a consumer or other party to add funds after the prepaid account is established.² Some are “open-loop” and can be used on payment and automated teller machine (“ATM”) networks, while others are “closed-loop” and can be used only at specific merchants or groups of merchants.³ Prepaid products may be sold directly to consumers in retail locations, over the phone, or online, or they may be used by third parties to disburse funds to consumers.⁴ According to the CFPB, payroll cards are the most common example of prepaid products used by third parties to disburse funds to consumers.⁵ Prepaid cards also are used by a variety of other third parties, including institutions of higher education to disburse student financial aid proceeds, insurance providers to pay certain insurance claims, tax preparers or government entities to disburse tax refunds, and federal and state governments to disburse government benefits.⁶ Regulation E currently includes provisions regulating payroll card accounts (“Payroll Card Rules”),⁷ gift cards and gift certificates (“Gift Card Rules”),⁸ and government benefits accounts (“Government Benefits Rules”).⁹

² Id. at 77104.
³ Id. at 77108.
⁴ Id. at 77104, 77108.
⁵ Id. at 77108.
⁶ Id. at 77109–10.
⁸ Id. § 1005.20.
⁹ Id. § 1005.15(a) (“A government agency is deemed to be a financial institution [under Regulation E] if directly or indirectly it issues an access device to a consumer for use in initiating an
In May 2012, the CFPB published an Advance Notice of Proposed Rulemaking about general purpose reloadable (“GPR”) prepaid cards (“Prepaid ANPR”). The CFPB subsequently engaged a third-party vendor to coordinate consumer testing consisting of focus groups and one-on-one interviews, and it conducted a study of publicly available account agreements for prepaid products. Based on responses to the Prepaid ANPR and its outreach and research, the CFPB determined that prepaid products, particularly GPR cards, increasingly are being used by consumers as a substitute for a checking account, a credit card, or both. In November 2014, the CFPB released the Proposed Prepaid Rules to bring other prepaid products within the ambit of Regulation E, and to amend Regulation Z to regulate prepaid products with overdraft services or credit features. This survey provides a high-level overview of this complicated and multi-faceted proposal.

Scope of Proposed Prepaid Rules

The Proposed Prepaid Rules revise the definition of “account” in Regulation E to include a “prepaid account,” which is defined broadly to include a wide range of prepaid products. A prepaid account is a card, code, or other device that is not otherwise covered as an “account” under Regulation E and is established primarily for personal, family, or household purposes. Prepaid accounts are either loaded with funds in a specified amount or capable of later being loaded with funds; and prepaid accounts can be used at multiple, unaffiliated merchants for goods or services, at ATMs, or for person-to-person transfers. Prepaid accounts need not be reloadable, by either a consumer or a third party; however, because they must be capable of being loaded with funds, a digital wallet that holds only payment credentials for other accounts is not a prepaid account. The term “prepaid account” includes a “payroll card account,” as defined in the Payroll Card Rules, and a “government benefit account,” as defined in the Government Benefits Rules. The term “prepaid account” excludes a “gift certificate,” a “store gift card,” a “loyalty, award, or promotional gift card,” each as defined in the Gift Card Rules, as well as any “general-use prepaid card,” also as defined in the Gift Card Rules, that is both marketed and labeled as a
DISCLOSURES FOR PREPAID ACCOUNTS

The Proposed Prepaid Rules generally require a financial institution to provide two separate sets of disclosures before a consumer acquires a prepaid account—a shorter form that requires disclosure of the fee types that the CFPB believes are most important to consumers (“Short Form Disclosures”)—and a longer form that sets forth all of a prepaid account product’s fees and their qualifying conditions (“Long Form Disclosures”). Short Form and Long Form Disclosures provided in writing or electronically must be in a retainable form, with the information in the form of a table substantially similar to the Model Forms, with the text in specified sizes and colors, and with the requisite information appropriately segregated.

SHORT FORM DISCLOSURES

The Short Form Disclosures include a “top-line” of four fees that must be displayed more prominently than the other fees, a format adopted by the CFPB based on its consumer testing. By utilizing this “visual hierarchy,” the CFPB hopes to mitigate the risk of information overload to consumers. These top-line fees include: the periodic fee charged for holding a prepaid account (e.g., a monthly or annual fee); two fees for making a purchase on a prepaid account (one for purchases using a PIN, and the other for those using a signature); two fees for ATM withdrawals (one for those within the institution’s network, and the other for those outside the network); and the fee for loading cash into a prepaid account. Immediately under those top-line fees, the Short Form Disclosures must include a statement indicating whether any overdraft or credit-related fees may apply to the prepaid account.

In addition to the top-line fees, the Short Form Disclosures also must include two ATM balance inquiry fees (for both those inside and outside the network), the customer service fee, and the inactivity fee. As with the top-line fees, all of these additional fees must be included in the Short Form Disclosures, even if a fee relates to a feature that is not offered or is otherwise never charged for a
particular prepaid account product. In such instances, the financial institution would disclose a fee of $0.30

The Short Form Disclosures also must include up to three fees, other than those already disclosed, that were incurred most frequently in the previous twelve-month period by consumers of that particular prepaid account product.31 For new prepaid accounts, the financial institution must disclose up to three fees that it reasonably anticipates will be most frequently incurred by consumers during the next twelve-month period.32 A financial institution must re-evaluate the accuracy of these incidence-based fee disclosures annually and also if it changes the fee schedule for an existing prepaid account product.33 Disclosure revisions generally must be made within ninety days; however, disclosures provided on the packaging material of prepaid account devices (e.g., in retail stores) need not be revised until the financial institution is printing new packaging material for the devices.34

The Short Form Disclosures must also contain a statement of the number of fees (other than those already disclosed) that could be imposed upon the consumer, a statement advising consumers that a prepaid account must be registered with a financial institution or service provider in order for the funds loaded into the account to be protected, and the URL of the CFPB’s website.35 If a prepaid account product is not eligible for FDIC deposit or NCUSIF share insurance, the Short Form Disclosures must include a statement that funds loaded into the prepaid account are not insured.36 If a financial institution chooses not to provide the Long Form Disclosures before a consumer acquires a prepaid account, as discussed more fully below, the Short Form Disclosures must also include a toll-free telephone number and the unique URL of a website that a consumer may use to access the Long Form Disclosures.37 For payroll card accounts and government benefits accounts, the Short Form Disclosures must include a statement that a consumer does not have to accept the account and can ask about other ways to get wages or salary from the employer or payments from the government agency.38

**LONG FORM DISCLOSURES**

The Long Form Disclosures must include all fees that may be imposed by the financial institution in connection with a prepaid account.39 For each type of fee,
the financial institution must disclose the amount of the fee and any conditions under which the fee may be imposed, waived, or reduced, including, to the extent known, any third-party fee amounts that may apply. 40 If, at any point, a credit plan that would be a credit card account under Regulation Z is offered in connection with the prepaid account, the Long Form Disclosures must include the specified credit card disclosures required under Regulation Z. 41 The Long Form Disclosures also must include the telephone number, website, and mailing address of the person or office that consumers may contact to learn about the prepaid account, to obtain prepaid account balances, to request a written account history if the financial institution does not provide periodic statements, or to provide notice about an unauthorized electronic fund transfer. 42 As with the Short Form Disclosures, the Long Form Disclosures must include a special statement if the prepaid account is not protected by FDIC or NCUSIF insurance 43 and must set forth the URL for the CFPB's website. 44 The Long Form Disclosures also require a CFPB telephone number that a consumer can contact and the URL a consumer can visit to submit a complaint related to a prepaid account. 45

Although financial institutions generally must provide the Long Form Disclosures before a consumer acquires a prepaid account, 46 the Proposed Prepaid Rules provide two exceptions to this general requirement. First, for a prepaid account acquired by a consumer in person in a retail store, an institution may provide the Long Form Disclosures after acquisition if the following conditions are met: the prepaid account access device is inside the packaging material; the Short Form Disclosures are provided on or are visible through an outward-facing, external surface of that packaging material; and the Short Form Disclosures include the telephone number and website URL where a consumer may access the Long Form Disclosures. 47 Second, for prepaid accounts acquired orally by telephone, a financial institution may provide the Long Form Disclosures after acquisition if the financial institution communicates to a consumer orally, before the consumer acquires the prepaid account, that the information in the Short Form Disclosures and the Long Form Disclosures is available by telephone and on a website. 48

ACCESS TO PREPAID ACCOUNT INFORMATION

The existing Payroll Card Rules and the Government Benefits Rules provide that, as an alternative to furnishing periodic statements for a prepaid account,

40. Id. (to be codified at 12 C.F.R. § 1005.18(b)(2)(ii)(A)).
41. Id. at 77300–01 (to be codified at 12 C.F.R. § 1005.18(b)(2)(ii)(B)).
42. Id. at 77301 (to be codified at 12 C.F.R. § 1005.18(b)(2)(ii)(C)).
43. Id. (to be codified at 12 C.F.R. § 1005.18(b)(2)(ii)(D)).
44. Id. (to be codified at 12 C.F.R. § 1005.18(b)(2)(ii)(E)).
45. Id. (to be codified at 12 C.F.R. § 1005.18(b)(2)(ii)(E)).
46. Id. at 77299 (to be codified at 12 C.F.R. § 1005.18(b)(1)(i)).
47. Id. (to be codified at 12 C.F.R. § 1005.18(b)(1)(ii)).
48. Id. (to be codified at 12 C.F.R. § 1005.18(b)(1)(iii)).
a financial institution may make the following available to the consumer: account
balance information by telephone; an electronic history of the consumer’s ac-
count transactions (e.g., through a website); and, promptly upon the consumer’s
request, a written account history. The Proposed Prepaid Rules extend this al-
ternative to all prepaid accounts, but modify it to require that both the electronic
and written account histories cover at least eighteen months, and not the sixty-
day period required under the existing rules. Under the Proposed Prepaid
Rules, a periodic statement, any electronic account history, and a written ac-
count history provided under this alternative must disclose the amount of any
fees assessed against the account, and they must include a summary of the
total amounts of all fees assessed against the consumer’s prepaid account, all
deposits to the account, and all debits from the account, for both the previous
calendar month and the calendar year to date.

As with the Payroll Card and Government Benefits Rules, if a financial insti-
tution elects to use the alternative method to provide prepaid account informa-
tion, it must modify the initial disclosures for the prepaid accounts to include the
following: a telephone number that the consumer may call to obtain an account
balance, the means by which the consumer can obtain an electronic account his-
tory (such as a website), a summary of the consumer’s right to receive a written
account history, and a modified error resolution notice. A financial institution
using this alternative also must provide a modified annual error resolution
notice.

INTERNET POSTING OF ACCOUNT AGREEMENTS

The Proposed Prepaid Rules require prepaid account issuers to provide con-
sumers with online access to their prepaid account agreements, which must in-
clude the fees required in the Long Form Disclosures. Issuers generally must
make quarterly submissions to the CFPB of the prepaid account agreements
that the issuer offers to the public, in the form and manner specified by the
CFPB. The Proposed Prepaid Rules provide two exceptions to this requirement
for submitting agreements to the CFPB. First, under the de minimis exception,
an issuer is not required to submit any prepaid account agreements to the
CFPB if the issuer had fewer than 3,000 open prepaid accounts as of the last
business day of the calendar quarter. Second, under the product testing expe-

49. 12 C.F.R. §§ 1005.15(c), 1005.18(b) (2015).
50. Proposed Prepaid Rules, supra note 1, at 77302 (to be codified at 12 C.F.R. § 1005.18(c)(1));
51. Proposed Prepaid Rules, supra note 1, at 77302 (to be codified at 12 C.F.R. § 1005.18(c)(3)).
52. Id. (to be codified at 12 C.F.R. § 1005.18(c)(4)).
54. Proposed Prepaid Rules, supra note 1, at 77298, 77302–03 (to be codified at 12 C.F.R.
§§ 1005.15(e)(1), 1005.18(d)(1)).
55. Id. (to be codified at 12 C.F.R. §§ 1005.15(e)(2), 1005.18(d)(2)).
56. See id. at 77305 (to be codified at 12 C.F.R. § 1005.19(c)–(d)).
57. Id. at 77304 (to be codified at 12 C.F.R. § 1005.19(b)(1)).
58. Id. at 77304–05 (to be codified at 12 C.F.R. § 1005.19(b)(4)).
tion, an issuer is not required to submit to the CFPB a prepaid account agree-
ton if, as of the last business day of the calendar quarter, the agreement satisfies
the following: it is offered as part of a product test to only a limited group of
consumers for a limited period of time, it is used for fewer than 3,000 open pre-
paid accounts, and it is not offered to the public except with the product test.\textsuperscript{59}

An issuer also must post and maintain on its publicly available website the pre-
paid account agreements that the issuer is required to submit to the CFPB.\textsuperscript{60}

For any open prepaid account, the agreement must be available to the con-
sumer.\textsuperscript{61} If the agreement is provided to the CFPB and posted to the issuer’s
publicly available website, the issuer is not required to take any further action.\textsuperscript{62}
Otherwise, the issuer must either post and maintain the consumer’s agreement
on its website,\textsuperscript{63} or provide a copy of the agreement to the consumer no later
than five business days after the issuer receives the consumer’s request.\textsuperscript{64}

\textbf{FOREIGN LANGUAGE REQUIREMENTS}

If a financial institution principally uses a foreign language on prepaid account
packaging material, on the telephone, in person, or on the website where con-
sumers may acquire a prepaid account, then both the Short Form and Long
Form Disclosures must be provided in that same foreign language.\textsuperscript{65} Upon the
request of any person who received the Long Form Disclosures in a foreign lan-
guage, the institution must provide the Long Form Disclosures in English.\textsuperscript{66} If a
financial institution provides the Long Form Disclosures in a foreign language on
a website, the institution must include an English version, too.\textsuperscript{67}

\textbf{MODIFIED LIMITATIONS ON LIABILITY AND ERROR RESOLUTION
REQUIREMENTS}

The Proposed Prepaid Rules extend the Payroll Card Rules’ limited liability
and error resolution provisions to all prepaid accounts.\textsuperscript{68} Under those provi-
sions, if a financial institution elects to use the alternative method to provide ac-
cess to prepaid account information (rather than furnishing a periodic state-
ment), the sixty-day period for reporting any unauthorized transfer shall begin
on the earlier of the date the consumer electronically accesses account history
reflecting the unauthorized transfer, or the date the financial institution, in

\textsuperscript{59} Id. at 77305 (to be codified at 12 C.F.R. § 1005.19(b)(5)).
\textsuperscript{60} Id. (to be codified at 12 C.F.R. § 1005.19(c)).
\textsuperscript{61} Id. (to be codified at 12 C.F.R. § 1005.19(d)).
\textsuperscript{62} Id. (to be codified at 12 C.F.R. § 1005.19(d)(1)).
\textsuperscript{63} Id. (to be codified at 12 C.F.R. § 1005.19(d)(1)(i)).
\textsuperscript{64} Id. (to be codified at 12 C.F.R. § 1005.19(d)(1)(ii)).
\textsuperscript{65} Id. at 77302 (to be codified at 12 C.F.R. § 1005.18(b)(6)).
\textsuperscript{66} Id. (to be codified at 12 C.F.R. § 1005.18(b)(6)).
\textsuperscript{67} Id. (to be codified at 12 C.F.R. § 1005.18(b)(6)).
\textsuperscript{68} Id. at 77181, 77303 (to be codified at 12 C.F.R. § 1005.18(e)(1), (2)); see also 12 C.F.R.
§ 1005.6 (2015) (setting forth Regulation E’s general limitations on the liability of a consumer for
unauthorized transfers); id. § 1005.11 (setting forth general procedures for error resolution).
response to the consumer’s request, sends a written account history in which
the unauthorized transfer is first reflected. Alternatively, a financial institu-
tion may comply by limiting the consumer’s liability for an unauthorized
transfer reported by the consumer within 120 days after the transfer was cred-
ited or debited to the consumer’s account. If a financial institution provides
prepaid account information electronically (rather than furnishing periodic
statements), the institution must comply with a notice of error from a con-
sumer that is received sixty days after the consumer electronically accesses ac-
count history reflecting the alleged error, or sixty days after the financial insti-
tution, in response to the consumer’s request, sends a written account history
noting the alleged error, whichever is earlier. Alternatively, a financial insti-
tution may comply with the requirements for resolving errors by investigating
any notice of an error from the consumer that it receives within 120 days after
the allegedly erroneous transfer was credited or debited to the consumer’s ac-
count. The Proposed Prepaid Rules do not modify Regulation E’s existing
requirement to provide the consumer with provisional credit in the amount
of the alleged error if the institution is unable to complete its investigation
within ten business days.

The Proposed Prepaid Rules provide a very narrow exception to these re-
quirements for limitations on liability and error resolution. For prepaid ac-
counts that are not payroll card accounts or government benefits accounts,
if a financial institution has disclosed the risks of not registering a prepaid ac-
count in accordance with the Proposed Prepaid Rules, the institution is not
required to comply with the liability limits and error resolution requirements
for any prepaid account for which it has not completed its collection of con-
sumer identifying information and identity verification. However, the CFPB
has expressed its expectation that, when a consumer calls to assert an error on
an unverified account, the financial institution would inform the consumer of
its policy regarding error resolution on unverified accounts and would begin
the customer identification and verification process at that time. Once a con-
sumer’s identity has been verified, a financial institution must limit the con-
sumer’s liability for unauthorized transfers and resolve any errors that oc-
curred prior to verification that satisfy the applicable timing requirements in
Regulation E.

69. Proposed Prepaid Rules, supra note 1, at 77303 (to be codified at 12 C.F.R. § 1005.18(e)(1)(i)).
70. Id. (to be codified at 12 C.F.R. § 1005.18(e)(1)(ii)).
71. Id. (to be codified at 12 C.F.R. § 1005.18(e)(2)(i)).
72. Id. (to be codified at 12 C.F.R. § 1005.18(e)(2)(ii)).
73. See id. at 77182; see also 12 C.F.R. § 1005.11(c)(2) (2015) (setting forth the requirements for
provisional credit).
74. Proposed Prepaid Rules, supra note 1, at 77303 (to be codified at 12 C.F.R. § 1005.18(e)(3)).
75. Id. at 77185.
76. Id. at 77303 (to be codified at 12 C.F.R. § 1005.18(e)(3)).
**Prepaid Accounts with Overdraft Services or Credit Features**

The Proposed Prepaid Rules change how Regulations Z and E treat overdraft services and other credit features offered with prepaid accounts. In developing the proposed changes, the CFPB considered the extent to which it should regulate credit features offered with prepaid accounts, recognizing the current regulatory framework for overdraft services on traditional deposit accounts.\(^{77}\) The CFPB concluded “that a range of credit features offered in connection with prepaid accounts—including those features structured as overdraft services—should be subject to regulation as credit cards under TILA [Truth in Lending Act], EFTA [Electronic Fund Transfer Act], and their implementing regulations.”\(^{78}\) Under the Proposed Prepaid Rules, prepaid accounts that offer overdraft or other credit services and impose any finance charge, fee, or other charges for the service generally are considered credit card accounts under Regulation Z and, as such, are subject to Subpart B governing open-end accounts and Subpart G governing credit card accounts.\(^{79}\)

**Revisions to Regulation Z Definitions**

The Proposed Prepaid Rules make significant revisions to several key definitions in Regulation Z. The term “credit” is revised to include “an authorized transaction on a prepaid account where the consumer has insufficient or unavailable funds in the prepaid account at the time of the authorization.”\(^{80}\) If a prepaid card is used to access the credit, the prepaid card generally will be considered a credit card under Regulation Z.\(^{81}\) This could mean that, if a prepaid card issuer is unable to prevent the authorization or payment of so-called “force-pay transactions” (e.g., transactions occurring when the processing network is offline), the prepaid card may be considered a credit card, even if the issuer does not otherwise extend credit in connection with that prepaid card. However, if such credit is not subject to any finance charge or any of the fees or other charges that are excluded from the finance charge, and is not payable by written agreement in more than four monthly installments, a prepaid card is not considered a “credit card” and the issuer is not considered a “card issuer.”\(^{82}\)

Currently, under Regulation Z, an overdraft line of credit accessed by a debit card or account number is excluded from the term “credit card account” (as it applies to an open-end account not secured by a home).\(^{83}\) The Proposed Prepaid Rules revise this definition to provide that overdraft lines of credit accessed by an

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\(^{77}\) Id. at 77116.

\(^{78}\) Id. at 77205.

\(^{79}\) Id. at 77103; see id. at 77206 n.331, 77208.

\(^{80}\) Id. at 77327 (to be codified at 12 C.F.R. pt. 1026, supp. I, cmt. 2(a)(14)-3).

\(^{81}\) Id. at 77325, 77327 (to be codified at 12 C.F.R. § 1026.2(a)(15); 12 C.F.R. pt. 1026, supp. I, cmt. 2(a)(15)-2.i.F).

\(^{82}\) Id. at 77327 (to be codified at 12 C.F.R. pt. 1026, supp. I, cmts. 2(a)(7)-2, 2(a)(15)-2.i.F).

account number for a prepaid card may be credit card accounts. Regulation Z also currently provides that a charge imposed on a transaction account is a “finance charge” only to the extent that the amount of the charge exceeds the amount of the charge for a similar account that has no credit feature. Under the Proposed Prepaid Rules, for prepaid accounts, “finance charge” includes the full amount of any charge imposed in connection with extending credit, carrying a credit balance, or making credit available on a prepaid account, without regard to the amount of any fee charged for non-credit transactions on the account. The Proposed Prepaid Rules also provide that, with respect to credit accessed by prepaid accounts, “finance charge” includes any participation fee and any charge for overdrawning the account, even when there is no written agreement about the payment of overdrafts and the imposition of the charges.

APPLICATION OF REGULATION Z TO PREPAID CARDS

When a particular prepaid card qualifies as a credit card under Regulation Z, the prepaid card issuer must comply with the disclosure requirements applicable to open-end credit, including the requirement to send a periodic statement at least twenty-one days before the payment due date on the statement. The prepaid card issuer also is subject to Regulation Z’s rules applicable to credit card accounts, including the following: the requirement for the issuer to evaluate the consumer’s repayment ability before opening the account; the requirement to limit the total fees a consumer is required to pay during the first year to 25 percent of the initial credit limit; limitations on late fees and other penalty fees; and limitations on increasing interest rates, fees, and other charges. The prohibitions on unsolicited credit cards would prevent the addition of unsolicited credit features to the prepaid card.

The Proposed Prepaid Rules also impose requirements on prepaid cards that exceed those for credit cards generally. Regulation Z currently provides that the prohibition against offsets does not prohibit a card issuer, if authorized in writing by the cardholder, from periodically deducting all or part of the credit card debt from a deposit account held by the issuer. For prepaid cards that qualify as credit cards, such deductions can be made no more frequently than once per...
The Proposed Prepaid Rules also require prepaid card issuers to wait at least thirty calendar days after a consumer has registered a prepaid card before offering to the consumer credit features that may be accessed by the prepaid card.

**Compulsory Use**

Although Regulation E generally prohibits conditioning any consumer credit extension on the consumer’s repayment by preauthorized electronic fund transfers, it provides several exceptions, including one for credit extended under an overdraft credit plan. Under the Proposed Prepaid Rules, this exception does not apply to credit accessed by a prepaid card that qualifies as a credit card under Regulation Z. Thus, when a prepaid card issuer extends credit to cover overdrafts on a prepaid card, the issuer cannot require the repayment of those credit extensions with automatic debits from the funds on the prepaid card. The CFPB believes this change to the compulsory use provisions of Regulation E—together with Regulation Z’s requirement to provide periodic statements at least twenty-one days before each payment due date and restriction on making agreed deductions automatically from the prepaid account no more frequently than once per month—will give consumers greater control over the funds in their prepaid accounts.

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92. Proposed Prepaid Rules, supra note 1, at 77325 (to be codified at 12 C.F.R. § 1026.12(d)(3)(ii)).
93. Id. at 77303, 77326 (to be codified at 12 C.F.R. §§ 1005.18(g), 1026.12(h)).
95. Proposed Prepaid Rules, supra note 1, at 77133, 77297 (to be codified at 12 C.F.R. § 1005.10(e)(1)).
96. Id. at 77133.
Credit Card Developments

By Obrea O. Poindexter and Jeremy R. Mandell*

INTRODUCTION

Credit cards have continued to be a focus of federal regulators over the past year. The Bureau of Consumer Financial Protection (“CFPB”) and other regulators have issued substantive guidance and taken significant enforcement actions in the credit card space. The CFPB has also solicited extensive information from the credit card industry to inform its biennial study of the credit card market as required under section 502(a) of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (“CARD Act”).¹ This survey highlights those developments.

CREDIT CARD-RELATED DEVELOPMENTS FROM THE CFPB

GUIDANCE ON CREDIT CARD PROMOTIONAL APR OFFERS

In September 2014, the CFPB issued a bulletin to inform credit card issuers of the risks of engaging in deceptive or abusive acts or practices in connection with the marketing of promotional annual percentage rate (“APR”) offers (“Promotional APR Bulletin”).² In the Promotional APR Bulletin, the CFPB stated that certain solicitations for promotional offers may be determined to be deceptive if they “do not clearly and prominently convey” the terms of a promotional APR offer and the relationship of such an offer to the grace period.³ The Promotional APR Bulletin also cautioned that credit card issuers that “fail to provide adequate information alerting consumers” about the relationship between promotional

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³ Id. at 1. The CFPB indicates that there is a particular risk of deception where a solicitation does not clearly and prominently convey that a consumer who accepts a promotional offer, and continues to use the credit card to make additional purchases, will lose the grace period on additional purchases if the consumer does not pay the entire statement balance, including the amount subject to the promotional APR, by the payment due date. Id. at 2–3.
APR offers and payments on promotional APR balances may be at risk of engaging in abusive conduct.4

The Promotional APR Bulletin stated the CFPB’s expectation that credit card issuers that offer promotional APR programs employ marketing materials that “clearly, prominently, and accurately describe the material costs, conditions, and limitations associated with the [program] and . . . the effect of promotional APR offers on the grace period for new purchases.”5 The Promotional APR Bulletin also stated that credit card issuers are expected to update their compliance management systems and controls to ensure that promotional APR offers are marketed in a manner that “limits the risk of statutory or regulatory violations and related consumer harm.”6

SUSPENSION OF THE REQUIREMENT TO SUBMIT CREDIT CARD AGREEMENTS

In April 2015, the CFPB published a final rule that suspends for one year the requirement under Regulation Z that credit card issuers submit their card agreements to the CFPB on a quarterly basis (“Final Suspension Rule”).7 New section 1026.58(g) of Regulation Z suspends, through the first business day after January 31, 2016, the section 1026.58(c) requirement that card issuers make quarterly submissions of credit card agreements to the CFPB.8 According to the Official Interpretations adopted under the Final Suspension Rule, issuers will be required to resume quarterly submissions on the first business day on or after April 30, 2016.9 Notwithstanding the suspension, issuers must continue to post credit card agreements on their websites.10

The press release issued with the Final Suspension Rule stated that, during the suspension period, the CFPB “will work to develop a more streamlined and automated electronic submission system” that is “easier for issuers to use than the current manual submission system” and that “enable[s] faster posting of new and revised agreements on the [CFPB]’s website.”11

4. Id. at 3.
5. Id. at 5.
6. Id.
8. Final Suspension Rule, supra note 7, at 21158 (to be codified at 12 C.F.R. § 1026.58(g)).
9. Id. (to be codified at 12 C.F.R. pt. 1026, supp. 1, cmt. 58(g)-2).
10. See id. (to be codified at 12 C.F.R. pt. 1026, supp. 1, cmt. 58(g)-3); see also 12 C.F.R. § 1026.58(d) (2015). The CFPB indicated that, during the suspension period, it will manually compile agreements from certain large issuers’ websites and make them available to consumers on the CFPB’s website. See Final Suspension Rule, supra note 7, at 21154.
REQUEST FOR INFORMATION FOR CARD ACT REPORT

In March 2015, the CFPB published a notice and request for information regarding the impact of the CARD Act, as required by section 502(a) thereunder (“2015 RFI”). The 2015 RFI, like the request for information published in 2012, covered the statutory requirements for the review, including (1) the terms of credit card agreements and the practices of credit card issuers; (2) the effectiveness of disclosure of terms, fees, and other expenses of credit card plans; (3) the adequacy of protections against unfair or deceptive acts or practices or unlawful discrimination relating to credit card plans; and (4) whether implementation of the CARD Act has affected (a) the cost and availability of credit, particularly with respect to non-prime borrowers, (b) the use of risk-based pricing, or (c) credit card product innovation.

The 2015 RFI also requested information on additional topics that are beyond the statutory requirements for the review. Specifically, the 2015 RFI requested information regarding online disclosures, rewards products, grace periods, add-on products, fee-harvester cards, deferred interest products, debt collection, and ability-to-pay. Many of these non-statutorily required categories arose from the findings of the 2013 CARD Act report.

On December 3, 2015, the CFPB released its report on the CARD Act based on the 2015 RFI. Notwithstanding data provided by commenters to the contrary, the 2015 CARD Act report concludes that the overall cost of credit to consumers across all risk bands remains stable at the levels reported in the 2013 report. With respect to credit availability, the 2015 CARD Act report concludes that credit cards are now available to more consumers than before the CARD Act was implemented, stating that new account volume has grown every year since implementation of the CARD Act; however, industry data provided in response to the 2015 RFI indicates that new account volume is down across all risk bands since the implementation of the CARD Act, with decreases significantly more prominent in the lower risk bands.

With respect to other issues covered by the 2015 RFI, the 2015 CARD Act report was critical of deferred interest products, despite their popularity.

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14. 2015 RFI, supra note 12, at 14366.
18. 2015 CARD ACT REPORT, supra note 16, at 88–89; see also Comment Letter, supra note 17, at 3.
Specifically, notwithstanding the required Regulation Z disclosures applicable to deferred interest, the 2015 CARD Act report cites a lack of transparency as it relates to the “back-end” cost of these products, particularly because the payoff rates “have declined slightly in recent years.” Moreover, while acknowledging the increasing popularity and diversity of rewards programs, especially on general-purpose credit cards, the 2015 CARD Act report identifies “[t]he number of different disclosures associated with rewards cards, and the timing of when consumers receive them or have access to them,” as one of a series of key areas of potential concern as it relates to cards with rewards features. With respect to debt collection, the 2015 CARD Act report states that the “conduct of debt collectors can present substantial risk to consumers” and discusses the varying practices among issuers during the initial delinquency in-house collection, as well as variations between issuers’ practices of selling debts to debt buyers and using third-party debt collectors.

REPORT ON INCREASED CONSUMER ACCESS TO CREDIT SCORES

In February 2015, the CFPB released a report titled Consumer Voices on Credit Reports and Scores (“Credit Scores Report”). The Credit Scores Report concluded that a “growing number of financial services companies . . . provide their customers with regular access to their credit scores on monthly credit card statements or online,” and that such access “provides an opportunity to engage consumers around their credit reports.” As a result, the Credit Scores Report concluded that consumers “may be motivated to learn more about their credit histories, check their full credit reports, and take action to improve their credit reports and scores.”

ENFORCEMENT ACTIONS

CREDIT CARD ADD-ON PRODUCTS

In July 2015, the CFPB entered into three consent orders with entities that allegedly engaged in misconduct in offering or facilitating the offering of credit card add-on products. In the first case, the CFPB alleged that Citibank, N.A. and its affiliates (“Citibank”) engaged in deceptive marketing of credit card add-on products, conduct that violated the Telemarketing Sales Rule with respect to telemarketing of certain credit card add-on products, and certain unfair acts or practices by billing for add-on products and accepting payments for such

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19. 2015 CARD ACT REPORT, supra note 16, at 16; see also id. at 165.
20. Id. at 229.
21. Id. at 237.
22. Id. at 243–59.
24. Id. at 19.
25. Id.
products without fully providing the services offered in some instances.\textsuperscript{26} As a result of the alleged conduct, the CFPB ordered Citibank to provide $700 million in restitution, discontinue the alleged illegal conduct, and pay a $35 million civil money penalty.\textsuperscript{27}

In the other two cases, two credit card add-on product vendors, Affinion Group Holdings, Inc. and its affiliates and Intersections Inc., allegedly enrolled consumers in credit card add-on products that purported to provide consumers with credit monitoring and credit report retrieval benefits, and billed consumers for such benefits, but in some instances failed to provide the full services offered without refunding fees to those consumers.\textsuperscript{28} In addition to restitution of approximately $6.8 million, the two vendors were ordered to pay $3.1 million in civil money penalties.\textsuperscript{29}

In March 2015, the Office of the Comptroller of the Currency (“OCC”) entered into a consent order with Santander Bank, N.A., alleging that billing practices related to certain credit card add-on products violated section 5 of the Federal Trade Commission Act.\textsuperscript{30} According to the consent order, the bank’s customers who enrolled in credit monitoring and credit report retrieval services were required to provide sufficient personal verification information and consent before their credit reports could be accessed; however, customers who did not provide the required information or consent were billed the full fee of the product.\textsuperscript{31} The OCC further alleged that certain customers were charged for the services multiple times without receiving additional features or benefits from multiple enrollments.\textsuperscript{32} The consent order requires the bank to pay a $6 million civil penalty to the OCC.\textsuperscript{33}


\textsuperscript{32} \textit{Id.}

\textsuperscript{33} \textit{Id.} at 3.
Fee-Harvester Cards

In February 2015, the CFPB entered into a consent order with a subprime credit card company, Continental Finance Co., LLC, for allegedly charging illegal fees and engaging in deceptive acts and practices.34 With respect to the allegations of illegal fees, the CFPB alleged that the company assessed an annual fee and, in certain cases, a paper-based statement fee, which together constituted more than 25 percent of the consumer’s $300 credit limit, in violation of the Truth in Lending Act and Regulation Z limitation on fees during the first year after account opening.35 With respect to deceptive acts and practices, the CFPB alleged that the company made false statements about certain fees and implied that security deposits on certain cards would be insured by the Federal Deposit Insurance Corporation, when that was not the case.36 The company agreed to pay approximately $2.7 million in restitution and a $250,000 penalty, in addition to submitting plans for corrective actions and card agreement documentation to the CFPB for the next five years.37

35. Id. at 6–7; see also 15 U.S.C. § 1637(n)(1) (2012) (providing that the total amount of fees a consumer is required to pay with respect to a credit card account under an open-end (not home-secured) consumer credit plan during the first year after account opening must not exceed 25 percent of the credit limit in effect when the account is opened); 12 C.F.R. § 1026.52(a)(1) (2015) (same).
37. Id. at 9–18.
Recent Developments in Residential Mortgage-Backed Securities Litigation

By Richard E. Gottlieb, Fredrick S. Levin, Amanda Raines Lawrence, and A. Paul Heeringa*

INTRODUCTION

In the wake of the 2007–2008 economic crisis, disputes concerning responsibility for loans in default that are pooled in residential mortgage-backed securities (“RMBS”) became one of the most active areas of mortgage-related consumer finance litigation. This survey will provide a brief primer on residential mortgage securitization for background purposes, will discuss the landmark decision in ACE Securities Corp. v. DB Structured Products, Inc.,1 and will provide an overview of other noteworthy RMBS-related developments.

PRIMER ON RMBS TRANSACTIONS

RMBS litigation involves disputes arising from the securitization of residential mortgage loans.2 One court recently described the securitization process as follows:

The RMBS process begins when lending institutions, or “originators,” make home loans to consumers that are secured by mortgages. An RMBS “sponsor” or “seller”—usually an investment bank affiliate [of the originator]—purchases those mortgages in bulk from one or more originators. . . . Sponsors [then] sell the loans to a “depositor”—often another affiliate of that same bank. The depositor is also . . . the securities’ “issuer.” An issuer typically re-underwrites the loans made by the originators, independently assessing the borrowers’ ability to meet mortgage obligations. . . . [T]he depositor [then] “deposits” all of the loans into [a] trust.3

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Once a trust is established, the trustee may “hire[] a mortgage servicer to administrate the [underlying] mortgages” and, through underwriters, will issue securities (“certificates”) to be “sold to investors, called certificateholders.” The individual mortgage loans serve as collateral for the certificates, and investors receive income in the form of principal and interest, provided that the borrowers make payments on their loans. Many trusts likewise purchase financial guaranty insurance to guard against borrower non-payment.

Generally, securitization trusts are governed by contracts that address the sale of the loans as well as the creation of the trust and the rights, duties, and obligations of the parties involved. These agreements are typically styled as mortgage loan purchase agreements (“MLPA”), pooling and servicing agreements (“PSA”), and sale and servicing agreements (“SSA”).

In such contracts, the depositor will make a variety of representations and warranties regarding the quality and characteristics of the mortgage loans deposited in the trust, which typically include representations about the loan-to-value ratio, appraisals of the subject properties, their occupancy, the accuracy and completeness of the borrower’s documentation, compliance with applicable underwriting guidelines, and the absence of fraud in making the underlying loans.

The operative contracts often contain provisions that, when applicable, authorize the trustee to demand that the depositor cure or repurchase loans in the pool that fail to comply with one or more of the representations and warranties, i.e., “non-conforming loans.” Where a depositor or its affiliates refuse to cure or repurchase non-conforming loans, litigation may follow.

As significant numbers of borrowers defaulted on securitized loans following the 2007–2008 economic crisis, trustees, certificateholders, and monoline financial guaranty insurance carriers have brought lawsuits arising from alleged breaches of representations and warranties in connection with the sale or securitization of

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5. ACE Sec. Corp., 36 N.E.3d at 625.
6. In this context, financial guaranty policies that are issued by “monoline” insurers are designed to guarantee payments on RMBS. See Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 998 N.Y.S.2d 329, 331 (App. Div. 2014).
7. See Ret. Bd. of Policemen’s Annuity, 775 F.3d at 156.
10. See, e.g., Ret. Bd. of Policemen’s Annuity, 775 F.3d at 156; ACE Sec. Corp., 36 N.E.3d at 625; Miller, supra note 8, at 274.
large numbers of loans. The theories of liability in those lawsuits have varied, but primarily have been couched in terms of breach of contract based on breaches of representations and warranties and common law fraud.

**ACE Securities Corp. v. DB Structured Products, Inc.**

**The Ruling by the N.Y. Court of Appeals**

New York law, including its six-year statute of limitations for contract claims, governs under the choice of law provisions of many, if not the majority of, RMBS trusts. Accordingly, many litigants seeking to pursue repurchase claims arising from the economic crisis of 2007–2008 rushed to the courthouse to file claims within that period. Confronted with those filings, courts have analyzed whether the limitations period began to run when the seller made representations and warranties regarding the securities or when an investor subsequently discovered a breach of those representations and warranties. In June 2015, the New York Court of Appeals issued its decision in *ACE Securities Corp. v. DB Structured Products, Inc.*, which may be dispositive of many pending RMBS lawsuits because of its firm rejection of the “subsequent discovery” accrual theory.

In *ACE Securities*, two RMBS certificateholders filed suit against DB Structured Products, Inc. (“DBSP”) in New York state court, arising out of its alleged failure to repurchase non-conforming mortgage loans. DBSP, as sponsor, allegedly made many representations and warranties in the governing documents to ACE Securities Corp., as depositor, regarding the “credit quality and characteristics of the pooled loans ‘as of the Closing Date,’ March 28, 2006,” of the sale of the loans to the trust. The governing agreement provided that the sole remedy in the event of a breach of representations and warranties was for the trustee to request that DBSP cure any defects within sixty days after notice or repurchase non-conforming loans within ninety days after notification. The governing agreement, however, also authorized certificateholders with at least 25 percent of the voting rights to enforce the contract if the trustee refused or neglected to institute action within fifteen days after a written request to the trustee.

Years after March 28, 2006, defaults and delinquencies on the mortgage loans in the pool caused over $300 million in losses to the certificateholders, with over

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12. See id. at 813–14.
15. See id. at 260–63.
16. Id. at 262.
18. See id. at 624.
19. Id. at 625.
20. Id. at 625–26.
21. Id. at 626.
99 percent of the loans allegedly violating at least one of DBSP’s representations and warranties. Thus, in a letter dated January 12, 2012, two certificateholders, citing extremely high breach rates discovered during loan file reviews, demanded that the trustee “put back” to DBSP all of the individual defective loans. When the trustee took no action, the two certificateholders filed suit against DBSP on March 28, 2012, six years to the day from the closing on the sale, alleging a single breach of contract count. Almost six months later, the trustee filed a suit on the trust’s behalf, seeking to be substituted as plaintiff. DBSP moved to dismiss the trustee’s complaint, arguing that the trustee’s claims accrued as of March 28, 2006, and that the lawsuit was time-barred. DBSP also contended that the two certificateholders did not give timely notice before filing their own suit.

The trial court denied the motion, holding that the claims did not accrue until DBSP failed to cure or repurchase and that DBSP’s cure-or-repurchase obligations were recurring, so that an independent breach of the PSA resulted each time that it failed to cure or repurchase a defective loan. The New York Appellate Division reversed, holding that the claims accrued as of the closing date of the sale and that the certificateholders failed to comply with a condition precedent for bringing suit, i.e., that the sixty- and ninety-day cure-and-repurchase periods had not elapsed.

On further appeal, the New York Court of Appeals affirmed the Appellate Division’s decision. The ACE Securities court emphasized that statutes of limitations are designed to meet the “objectives of finality, certainty and predictability” in litigation. Accordingly, the court held that New York does not apply the “discovery rule” in contract cases and, instead, the statute begins to run “when liability for wrong has arisen even though the injured party may be ignorant of the existence of the wrong or injury.” It found that a contrary rule would depend “on the subjective equitable variations of different Judges . . . instead of . . . [being] objective, reliable, predictable, and relatively definitive.”

The ACE Securities court also determined that, while parties generally may agree to undertake an obligation involving future performance, the repurchase obligations undertaken by DBSP were not such an agreement. Rather, unlike

22. Id.
23. Id.
24. Id.; see also Cioffi & Serritella, supra note 11, at 814 (referring to repurchase claims as “put-back” litigation).
25. ACE Sec. Corp., 36 N.E.3d at 626.
26. Id. at 627.
27. Id.
28. Id.
29. Id.
30. Id.
31. Id.
32. Id. at 628 (quoting Ely-Cruikshank Co. v. Bank of Montreal, 615 N.E.2d 985, 987 (N.Y. 1993)).
33. Id. (quoting Ely-Cruikshank Co., 615 N.E.2d at 988).
34. Id.
a true promise for “future performance,” DBSP did not guarantee the performance of the mortgage loans in the pool and only represented certain facts about the loan characteristics as of the closing date of the sale. And, perhaps more important, the court ruled that the operative documents expressly provided that those representations and warranties did not survive closing and that there was nothing in the contracts that otherwise specified that DBSP’s contractual cure-or-repurchase obligation survived closing. Thus, the court concluded that DBSP’s cure-or-repurchase obligation was “dependent on, and indeed derivative of, DBSP’s representations and warranties, which did not survive the closing and were breached, if at all, on that date.”

The ACE Securities court rejected what it called the trustee’s “strongest argument” that the cure-or-repurchase obligation “delayed accrual” of the cause of action because the PSA required that the trustee demand cure or repurchase as a condition precedent to bringing suit. It found that this argument ignored the “difference between a demand that is a condition to a party’s performance, and a demand that seeks a remedy for a pre-existing wrong.” It reasoned that “a cause of action existed for breach of a representation and warranty” before the trustee made a demand, that a demand was only a procedural prerequisite to filing suit rather than a necessary part of the action, and that the trust “was just limited in its remedies for [DBSP’s] breach.” Consequently, the court concluded that “DSBP’s cure or repurchase obligation was not a separate and continuing promise of future performance; . . . the cure or repurchase obligation was not an independently enforceable right” or a continuing obligation; and any cause of action would have accrued “when the MLPA was executed.”

**Effects of the ACE Securities Ruling**

By rejecting a “subsequent discovery” rule of accrual and holding that the statute of limitations starts to run upon the making of representations and warranties, the ACE Securities court established a bright-line endpoint for bringing contract-based claims related to breaches of representations and warranties, with some caveats noted below. Moreover, the decision clarifies that repurchase provisions in RMBS agreements governed by New York law are likely to be construed as merely remedial and not as an independent legal obligation that is distinct from the representations and warranties. This decision appears to put the onus on investors and trustees to discover and provide notice regarding breaches before the statute runs. Because the contracts governing RMBS transactions are not all identical, a court’s interpretation of a particular contract in a particular RMBS transaction will depend on the specific language used in the contract,

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35. Id. at 629 (citing Bulova Watch Co. v. Celotex Corp., 389 N.E.2d 130 (N.Y. 1979)).
36. Id.
37. Id.
38. Id. at 630.
39. Id. (citing Dickenson v. Mayor of N.Y., 92 N.Y. 584 (1883)).
40. Id. at 630–31.
41. Id. at 631.
as confirmed by the ACE Securities ruling. For example, some plaintiffs in RMBS cases have argued that there was a continuing obligation to notify the purchaser of defects in loans. Others have attempted to overcome the statute of limitations by arguing that the later losses triggered an obligation to indemnify.

After the ACE Securities decision, one federal district court in New York appears to have found that a supposed “duty to notify” is not an independent obligation distinct from the underlying representations and warranties, with the result that a breach of that duty would not give rise to a separate claim with its own limitations period. In Bank of New York Mellon v. WMC Mortgage, LLC, the trustee brought a claim based on the defendants’ failure to notify the trustee of breaches of representations and warranties in addition to making a claim for those breaches and for failure to repurchase on demand. Citing ACE Securities, the court held that, under New York law, “failure to comply with a presuit remedial provision . . . does not give rise to a breach of contract claim independent of a claim for breaches of [representations and warranties].”

It remains to be seen how ACE Securities will be applied in the long run. However, it appears poised to eliminate or reduce the scope of many breach of contract cases involving non-conforming loans sold before the 2007–2008 financial crisis, in New York and perhaps in other states as well.

OTHER RECENT RMBS-RELATED PRIVATE LITIGATION

ASSURED GUARANTY MUNICIPAL CORP. v. FLAGSTAR BANK, FSB

In Assured Guaranty Municipal Corp. v. Flagstar Bank, FSB, the plaintiff (“Assured”) alleged that three related Flagstar Bank entities (“Flagstar”) breached a
series of contracts providing financial guaranty insurance for two large securitization pools. Assured claimed that the loans underlying the securities either were materially fraudulent or contained material underwriting defects, in breach of Flagstar’s representations and warranties.48

Assured filed suit in 2011, seeking reimbursement for claims it paid when many of the underlying loans were in default.49 In early 2013, after a bench trial, the court issued a lengthy order that found, inter alia, that Flagstar had breached its contractual representations and warranties as well as its obligation to cure or repurchase defective loans,50 awarded Assured $89.2 million in damages, plus interest,51 and required Flagstar to reimburse Assured for “reasonable fees and costs.”52 Reportedly, the parties settled in June 2013, with Assured receiving from Flagstar $105 million in cash and reimbursement for all future claims.53

Flagstar is significant primarily because it is the first RMBS repurchase case involving a financial guaranty insurer to go to trial,54 and because the opinion describes in detail the parties’ liability theories, expert methodologies, and damages estimates, thus providing financial guaranty insurers with a roadmap for future cases.55 Furthermore, because the court awarded damages and potentially millions of dollars in fees and costs incurred not only in the litigation but also in the repurchase demands that precipitated it,56 Flagstar could make lenders hesitant to go to trial.57

Flagstar also sets the stage for statistical sampling in RMBS-related cases. The court’s ruling relied on Assured’s expert, who reviewed a random sample of roughly 800 out of the 15,000-plus loans to determine that over 75 percent of the loans sampled were materially defective.58 The use of this methodology became an important issue in RMBS-related decisions after Flagstar.59

**FHFA v. Nomura Holding America, Inc.**

In September 2011, the Federal Housing Finance Agency (“FHFA”) filed sixteen lawsuits against several financial institutions along with their officers and

48. Id. at 477.
49. Id.
50. Id. at 508–09, 513.
51. Id. at 515.
52. Id. at 516–17.
56. See id. at 516.
57. See Simpson, supra note 54.
directors, asserting claims under federal and state securities laws relating to $2 billion in RMBS certificates purchased between 2005 and 2007. Only one, against Nomura Holding America and RBS Securities, went to trial by 2015. The FHFA claimed that the defendants made various false representations regarding the origination, underwriting, and other characteristics of loans in the securitizations. After a bench trial, the court ruled in the FHFA’s favor, issuing an opinion finding that the banks had fraudulently misrepresented the quality of the securities being sold, and that the offering materials contained “utterly misleading descriptions of the quality and nature of the loans.” The court ordered the FHFA to submit a proposed judgment calculating its damages pursuant to formulas supplied by the court. Commentators have suggested that damages, including attorney’s fees, “will likely land in the billion-dollar range.”

In addition to being the first, and thus far only, instance of a bank requiring the FHFA to go to trial, Nomura is notable for several other reasons. It is not surprising that, perhaps given the potential damages exposure, several banks settled with the FHFA around the time that Nomura was decided. Moreover, prior to trial, the court denied Nomura’s statute-of-limitations defense under the federal Securities Act, holding that the “limitations period commences not when a reasonable investor would have begun investigating, but when such a reasonable investor conducting such a timely investigation would have uncovered the facts constituting [the] violation . . . irrespective of whether the actual plaintiff undertook a reasonably diligent investigation.” Finally, as in Flagstar, the Nomura court not only conducted an extensive analysis and assessment of the various experts’ methodologies and credibility, but it also permitted the plaintiff’s experts to support the loan defect claims through statistical sampling.

RFC/RESCAP Litigation

In December 2013, the successor to the former Residential Funding Company (“RFC”) filed more than eighty lawsuits, many of which are still pending.

60. Id. at *1, *5.
61. Id. at *1.
62. Id. at *2.
63. Id. at *74.
64. Id. at *136.
66. See Banks Liable in First-Time MBS Suit, COM. LENDING LITIG. NEWS, July 6, 2015, at 13.
against numerous major financial institutions from which RFC had acquired mortgage loans. These cases arose from the 2012 bankruptcy of Residential Capital, LLC (“RESCAP”) and its former RFC subsidiary.\textsuperscript{71} Prior to bankruptcy, RFC was in the business of acquiring and securitizing residential mortgage loans purchased from an array of originators (“correspondent lenders”).\textsuperscript{72} RFC’s suits were not RMBS lawsuits as such because the defendants were not parties to the RMBS transactions, but stemmed from loans that the defendants originated and sold to RFC, which then pooled the loans into RMBS trusts.\textsuperscript{73}

RFC asserted the same two claims against each defendant: breach of contract and indemnification.\textsuperscript{74} In essence, RFC claimed that many of the loans it purchased from the defendants, all former correspondent lenders of RFC, were defective when sold, and that the defendants breached various representations and warranties contained in RFC-crafted client guides, allegedly causing RFC to incur billions of dollars in losses or liabilities to purchasers of these loans when they were resold to investors, including securitization trusts, losses and liabilities for which it sought contractual indemnification.\textsuperscript{75} Some courts dismissed RFC’s breach of contract claims regarding loans sold before May 14, 2006, based on statutes-of-limitations grounds.\textsuperscript{76} Other courts denied motions to dismiss made on those grounds, ruling that the applicability of the statute of limitations for the breach of contract claims was a fact question.\textsuperscript{77}

The courts that allowed the contract claims to survive typically did so based on the “continuing notification” theory that RFC advanced. Under this theory, RFC alleged that the lender breached a specific representation and warranty that the lender would “promptly notify GMAC-RFC of any occurrence, act, or omission regarding [lender], the Loan, the Mortgaged Property or the Mortgagor of which . . . may materially affect [the lender], the Loan, the Mortgaged Property or the Mortgagor.”\textsuperscript{78} Accordingly, courts have ruled that whether a lender allegedly breached its supposed notification duty is a “question of fact that goes beyond the pleadings” that cannot be resolved on a motion to dismiss.\textsuperscript{79} In January 2015, most of the lawsuits pending

\textsuperscript{71} See \textit{In re} Residential Capital, LLC, No. 12-12020-MG (Bankr. S.D.N.Y.).
\textsuperscript{73} See, e.g., Residential Funding, 2014 WL 5207485, at *1.
\textsuperscript{74} See, e.g., id.
\textsuperscript{76} See, e.g., Residential Funding Co. v. HSBC Mortg. Corp. (USA) (\textit{In re} Residential Capital, LLC), 524 B.R. 563, 571–72 (Bankr. S.D.N.Y. 2015).
\textsuperscript{79} Id.
in the District of Minnesota were consolidated for pre-trial purposes.\textsuperscript{80} The parties are undertaking discovery, with trial set for January 2017.\textsuperscript{81}

**LAWSUITS AGAINST TRUSTEES**

RMBS mortgage originators, sponsors, and depositors are not the only parties that have been targeted in RMBS litigation. RMBS investors have also sued the trustees of the securitization trusts for violating enforcement obligations against other parties for breaches of representations and warranties.\textsuperscript{82} The amounts at stake in these cases have been significant, perhaps even more so than in other cases. Several cases were filed in New York state court in 2014 against six leading trustees, one of which involved 841 “private label” RMBS trusts containing over $700 billion in loans that allegedly suffered over $74 billion in losses.\textsuperscript{83}

Two significant rulings were made in other cases against trustees. First, an “extender provision” under federal law can extend the applicable statute of limitations for state law claims brought by government investors in some instances.\textsuperscript{84} Second, investors must state only enough facts at the pleading stage to raise a “plausible inference” that the trustee had knowledge of breaches of representations and warranties by RMBS sponsors to state a breach of contract claim against an RMBS trustee relating to those breaches under New York law.\textsuperscript{85} These holdings increase the likelihood that similar claims against trustees will survive at the pleading stage.

**GOVERNMENT INVOLVEMENT IN RMBS LITIGATION**

The federal government also has been active in RMBS litigation since it launched the RMBS Working Group (“Working Group”) in 2012 comprised largely of investigators and attorneys from the U.S. Securities and Exchange Commission, the U.S. Department of Justice, and the New York State Attorney General’s Office.\textsuperscript{86} The Working Group “investigate[s] those responsible for misconduct contributing to the financial crisis through the pooling and sale of res-
idential mortgage-backed securities. 87 The Working Group has brought cases
alleging violations of state law and of two federal statutes, the False Claims
Act 88 and the Financial Institutions Reform, Recovery, and Enforcement Act of
1989 ("FIRREA"). 89 The ten-year statute of limitations in FIRREA 90 gives the
Working Group considerable reach, allowing it to bring claims regarding mort-
gages sold and securitized prior to the 2007–2008 economic crisis. The Working
Group’s labors have garnered many significant civil and criminal settlements
since its inception, which have reportedly often been in the multi-billion dollar
range. 91 More settlements like these are anticipated. 92 Settlements have also been
substantial in civil litigation. 93

87. Press Release, U.S. Dep’t of Justice, U.S. Attorney General Holder, State and Federal Officials An-
www.stopfraud.gov/iso/op/stopfraud/2012/12-ag-120.html.
89. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73,
fhfaoig.gov/Content/Files/SeventhSemiannualReport_0.pdf; Mark S. Nelson, BofA and FHFA Settle
Mortgage-Backed Securities Row for Over $9 Billion, Corp. Governance Guide Update, Apr. 15, 2014,
at 1, 2014 WL 8772370.
91. See, e.g., Nelson, supra note 89, at 1; Kat Greene, Morgan Stanley to Shell Out $2.6B to End MBS
Probe, Law360 (Feb. 25, 2015, 6:45 PM), http://www.law360.com/articles/625361/morgan-stanley-
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Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial
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pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading;
Press Release, U.S. Dep’t of Justice, Justice Department, Federal and State Partners Secure Record $13 Billion
Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages
record-13-billion-global-settlement.
92. See Emily Glazer & Christina Rexrode, Justice Department Readies New Bank Settlements, Wall
St. J. (June 4, 2015, 6:39 PM), http://www.wsj.com/articles/justice-department-readies-new-bank-
settlements-1433457596.
billion cash settlement and other relief worth $3 billion); Trustee’s Brief in Support of Settlement at
billion settlement).
Fair Lending Developments: Whither Disparate Impact?

By John L. Ropiequet, Christopher S. Naveja, and L. Jean Noonan*

**INTRODUCTION**

The past year saw the U.S. Supreme Court issue a long-awaited decision on whether the Fair Housing Act (“FHA”)\(^1\) allows disparate-impact claims. In *Texas Department of Housing & Community Affairs v. Inclusive Communities Project, Inc.*,\(^2\) the Court narrowly found that the FHA does allow such claims, but only with significant limitations.

While federal enforcement agencies continued to bring enforcement actions asserting alleged discrimination based on race, national origin, familial status, and disability status against lenders, most actions in the previous year appeared to rely on a disparate-treatment theory rather than a disparate-impact theory, perhaps because the Supreme Court had the disparate impact theory under review. The fair lending cases brought by local governmental entities that were reviewed in the previous Annual Survey\(^3\) may have reached a turning point, as some were dismissed and the dismissal of other cases awaited appellate review.

**THE INCLUSIVE COMMUNITIES DECISION**

**THE MAJORITY RULING**

*Inclusive Communities* involved allegations that a state agency, the Texas Department of Housing and Community Affairs (“Department”), distributed low-income housing tax credits to real estate developers in a way that had a disparate impact on protected minorities.\(^4\) The tax credits were provided by the federal government under a statute that directs the states to develop plans with selection criteria for distributing the credits to private persons.\(^5\) The Department

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5. *Id.* at 2513 (citing 26 U.S.C. § 42).
developed a scoring system with criteria that included the financial feasibility of the project and the income level of prospective tenants. The plaintiff, a non-profit corporation, alleged that the Department’s allocation of tax credits had a disparate impact on protected minorities because it granted “too many credits for housing in predominantly black inner-city areas,” and that it had to be modified to provide for construction of low-income housing in the suburbs.

The trial court found that a prima facie case of disparate impact was established, which the Department failed to rebut, and entered a remedial order that required the Department to add additional selection criteria for the tax credits. The U.S. Department of Housing and Urban Development ("HUD") promulgated its Disparate-Impact Rule, after the Department appealed to the U.S. Court of Appeals for the Fifth Circuit. The Fifth Circuit found that, while disparate-impact claims were cognizable under the FHA, the trial court should have applied the burden-shifting analysis contained in the Disparate-Impact Rule. The Supreme Court granted certiorari to answer the question whether disparate-impact claims are cognizable under the FHA.

The majority opinion in Inclusive Communities began its analysis by reviewing the Supreme Court’s earlier decisions on disparate-impact claims under Title VII of the Civil Rights Act of 1964 and under the Age Discrimination in Employment Act of 1967 ("ADEA") in Smith v. City of Jackson. The Griggs Court found that section 703(a)(2) of Title VII permitted disparate-impact claims against employers through language that proscribed acts that “in any way . . . would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status . . . because of such individual’s race.” The Inclusive Communities Court noted that Griggs “put important limits on its holding: namely, not all employment practices causing a disparate impact impose liability under § 703(a)(2)” and that “‘business necessity’ constitutes a defense to disparate-impact claims.” In Smith, the Court found

6. Id. at 2513–14 (citing TEX. GOV’T CODE ANN. § 2306.6710(a)–(b)).
7. Id. at 2514.
8. Id.
10. Inclusive Cmty., 135 S. Ct. at 2514.
11. See id. at 2515 (citing Inclusive Cmty. Project, Inc. v. Tex. Dep’t of Hous. & Cmty. Affairs, 747 F.3d 275, 280–83 (5th Cir. 2014), aff’d, 135 S. Ct. 2507 (2015)).
12. Id.
19. Id. at 2517 (citing Griggs, 401 U.S. at 431).
that similar language in section 4(a)(2) of the ADEA\textsuperscript{20} “focuses on the effects of the action on the employee rather than the motivation for the action of the employer’ and therefore compels recognition of disparate-impact liability.”\textsuperscript{21}

The \textit{Inclusive Communities} Court found that \textit{Griggs} and \textit{Smith} led to the conclusion that “antidiscrimination laws must be construed to encompass disparate-impact claims when their text refers to the consequences of actions and not just to the mindset of actors, and where that interpretation is consistent with statutory purpose.”\textsuperscript{22} The Court further found that the language “otherwise make unavailable” in section 804(a) of the FHA\textsuperscript{23} “refers to the consequences of an action rather than the actor’s intent,” and therefore supported the conclusion that the FHA “encompasses disparate-impact claims.”\textsuperscript{24} It also found that precedent interpreting the language of a different statute that was similar to that of section 805(a) of the FHA\textsuperscript{25} supported disparate-impact liability.\textsuperscript{26} Thus, the language in Title VII, the ADEA, and the FHA all “signal[ed] a shift in emphasis from an actor’s intent to the consequences of his actions.”\textsuperscript{27}

The \textit{Inclusive Communities} majority also found that the fact that Congress amended the FHA in 1988, while retaining the language of sections 804(a) and 805(a), after nine U.S. Courts of Appeals held that the FHA permitted disparate-impact claims was “convincing support for the conclusion that Congress accepted and ratified the unanimous holdings of the Courts of Appeals finding disparate-impact liability.”\textsuperscript{28} The Court found that recognizing disparate-impact claims was “consistent with the FHA’s central purpose” because it “plays a role in uncovering discriminatory intent: It permits plaintiffs to counteract unconscious prejudices and disguised animus that escape easy classification as disparate treatment.”\textsuperscript{29}

In response to concerns raised by the four-Justice dissent, the \textit{Inclusive Communities} majority noted that “disparate-impact liability has always been properly limited in key respects that avoid the serious constitutional questions that might arise under the FHA, for instance, if such liability were imposed based solely on

\begin{itemize}
\item \textsuperscript{20} 29 U.S.C. § 623(a)(2).
\item \textsuperscript{21} \textit{Inclusive Cmty.}, 135 S. Ct. at 2518 (quoting \textit{Smith}, 544 U.S. at 236 (plurality)).
\item \textsuperscript{22} Id.
\item \textsuperscript{23} 42 U.S.C. § 3604(a) (2012).
\item \textsuperscript{24} \textit{Inclusive Cmty.}, 135 S. Ct. at 2518.
\item \textsuperscript{25} 42 U.S.C. § 3605(a) (2012).
\item \textsuperscript{26} \textit{Inclusive Cmty.}, 135 S. Ct. at 2518–19 (citing Bd. of Educ. v. Harris, 444 U.S. 130, 140–41 (1979) (interpreting 20 U.S.C. § 1605)).
\item \textsuperscript{27} Id. at 2519.
\item \textsuperscript{28} Id. at 2520; see id. at 2519 (citing, in order, Huntington Branch, NAACP v. Huntington, 844 F.2d 926, 935–36 (2d Cir. 1988); Resident Advisory Bd. v. Rizzo, 564 F.2d 126, 146 (3d Cir. 1977); Smith v. Clarkson, 682 F.2d 1055, 1065 (4th Cir. 1982); Hanson v. Veterans Admin., 800 F.2d 1381, 1386 (5th Cir. 1986); Arthur v. Toledo, 782 F.2d 565, 574–75 (6th Cir. 1986); Metro. Hous. Dev. Corp. v. Arlington Heights, 558 F.2d 128, 1290 (7th Cir. 1977); United States v. Black Jack, 508 F.2d 1179, 1184–85 (8th Cir. 1974); Halet v. Wend Inv. Co., 672 F.2d 1305, 1311 (9th Cir. 1982); United States v. Marengo Cty. Comm’n, 731 F.2d 1546, 1559 & n.20 (11th Cir. 1984)).
\item \textsuperscript{29} Id. at 2521–22.
\end{itemize}
The court stressed that disparate-impact liability should not displace “valid governmental policies” and cautioned that, on remand, the lower courts might find that the plaintiff’s claim amounted to “an attempt to second-guess which of two reasonable approaches a housing authority should follow in the sound exercise of its discretion in allocating tax credits for a low-income housing.” The court likened giving “housing authorities and private developers leeway to state and explain the valid interest served by their policies” to “the business necessity standard under Title VII” as a defense to disparate-impact liability. The court further cautioned that “a disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to a . . . policy . . . [that] caus[ed] that disparity[, because a] robust causality requirement” ensures that a mere racial imbalance will not establish a prima facie disparate-impact case and will protect “defendants from being held liable for racial disparities they did not create.”

Addressing the facts, the Inclusive Communities Court observed that it seems difficult to say as a general matter that a decision to build low-income housing in a blighted inner-city neighborhood instead of a suburb is discriminatory, or vice versa. If those judgments are subject to challenge without adequate safeguards, then there is a danger that potential defendants may adopt racial quotas—a circumstance that itself raises serious constitutional concerns.

The court therefore cautioned that courts must “examine with care whether a plaintiff has made out a prima facie case of disparate impact,” and that such cases should be dismissed if the facts or statistical evidence do not demonstrate a causal connection, for example, if “federal law substantially limits the Department’s discretion.”

The Dissent

The principal dissent in Inclusive Communities, by Justice Alito, focused on the text of the FHA and found that the words used by Congress in the statute could not support disparate-impact liability. To the dissenters, the “key phrase” in both sections of the FHA was “because of”; this language provides “[t]he link between the actions and the protected characteristics” of race, national origin, or other protected status. Citing the opinion in American Insurance Ass’n v. U.S.

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30. Id. at 2522.
32. Id.
33. Id.
34. Id. at 2523 (citing Wards Cove Packing Co. v. Atonio, 490 U.S. 642, 653 (1989)).
35. Id.
36. Id. at 2523–24.
37. Id. at 2532–51 (Alito, J., dissenting). Justice Thomas dissented separately, but joined the principal dissent. Id. at 2532; id. at 2526–32 (Thomas, J., dissenting).
38. Id. at 2533 (Alito, J., dissenting).
Department of Housing & Urban Development,\textsuperscript{39} which had likewise found that the FHA did not allow disparate-impact liability and had invalidated the Disparate-Impact Rule,\textsuperscript{40} the \textit{Inclusive Communities} dissent stated that “the terms [after] the ‘because of’ clauses in the FHA supply the prohibited motivations for the intentional acts,”\textsuperscript{41} and “Congress accordingly outlawed the covered actions only when they are motivated by race or one of the other protected characteristics.”\textsuperscript{42} The \textit{Inclusive Communities} dissent further remarked that, although nine U.S. Courts of Appeals had ruled in favor of disparate-impact liability under the FHA prior to enactment of the 1988 amendments, the federal government had argued, before 1988, “that the FHA prohibits only intentional discrimination,”\textsuperscript{43} and “policymakers were not of one mind about disparate-impact housing suits.”\textsuperscript{44}

The dissent also took issue with the majority’s discussion of \textit{Griggs} and \textit{Smith}. The dissent observed that the “text-free reasoning” in \textit{Griggs}, where “an intent to discriminate might well have been inferred,” likely “led to the pattern of Court[s] of Appeals decisions in FHA cases upon which the majority now relies.”\textsuperscript{45} It remarked that, when the \textit{Smith} Court dealt with disparate impact, it agreed unanimously that section 4(a)(1) of the ADEA\textsuperscript{46} did not authorize disparate-impact claims, while a majority found that the language in section 4(a)(2) of the ADEA\textsuperscript{47} did authorize such claims,\textsuperscript{48} but only based upon the prohibition of acts that “would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual’s age.”\textsuperscript{49}

Finally, the \textit{Inclusive Communities} dissent stressed the “unfortunate consequences” of the Court’s decision, which had been disregarded by the majority.\textsuperscript{50} For example, the dissent noted that, in the first case where certiorari had been granted, \textit{Gallagher v. Magner},\textsuperscript{51} which had involved attempts to combat “rodent

\textsuperscript{40} See \textit{Am. Ins. Ass’n}, 74 F. Supp. 3d at 32.
\textsuperscript{41} \textit{Inclusive Cmty.}, 135 S. Ct. at 2534 (Alito, J., dissenting) (quoting \textit{Am. Ins. Ass’n}, 74 F. Supp. 3d at 41 n.20).
\textsuperscript{42} Id.
\textsuperscript{43} Id. at 2538.
\textsuperscript{44} Id. at 2540.
\textsuperscript{47} Id. § 623(a)(2).
\textsuperscript{49} 29 U.S.C. § 623(a)(2).
\textsuperscript{50} \textit{Inclusive Cmty.}, 135 S. Ct. at 2548 (Alito, J., dissenting). \textit{Compare id.} at 2525 (“The existence of disparate-impact liability in the substantial majority of the Courts of Appeals for the last several decades has not given rise to . . . dire consequences.” (quoting \textit{Hosanna-Tabor Evangelical Lutheran Church & Sch. v. EEOC}, 132 S. Ct. 694, 710 (2012))).
“infiltration” and other housing code violations, efforts were also attacked on the ground that they had a disparate impact on minority tenants. The dissent further observed that, while granting tax credits for low-income housing in either a lower income area or a higher income area is “a good thing,” either of these decisions “might trigger a disparate-impact suit.” In support of that statement, the dissent noted that one respondent in the case had “sued the Department for not allocating enough credits to higher income areas,” while another respondent had argued that doing so would “violate[ the purpose of the FHA] to improve the substandard and inadequate affordable housing in . . . inner cities.”

**FEDERAL ENFORCEMENT ACTIONS**

**RACIAL AND NATIONAL ORIGIN DISCRIMINATION CASES**

Enforcement actions brought by the U.S. Department of Justice (“DOJ”) and the Bureau of Consumer Financial Protection (“CFPB”) against American Honda Finance Corporation, Evergreen Bank Group, and two “buy-here, pay-here” automobile dealerships, Auto Fare, Inc. and Southeastern Auto Corp., are reported on elsewhere in this Survey. In another race and national origin case, HUD accused Midland States Bancorp, Inc. (“Midland”) of avoiding doing business in predominately African-American and Hispanic neighborhoods, a violation of the FHA. HUD alleged that Midland designated its service area in a discriminatory manner that excluded areas of high minority concentration and failed to market residential real estate loan products to African-American and Hispanic communities. As part of a Conciliation Agreement, Midland agreed to originate $8 million in mortgage loans in majority-minority census tracts over the next three years and make at least $550,000 available in a mortgage program to provide discounted home purchases or refinancing in those markets. Midland will also originate $3 million in home repair loans and make at least $400,000 available in majority-minority census tracts. In addition, Midland will originate $4 million in loans for multifamily housing in majority-minority census tracts, will open at least one full-service branch and one

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52. Inclusive Cmty., 135 S. Ct. at 2532 (Alito, J., dissenting).
53. Id. at 2548.
54. Id. (internal quotations and citation omitted).
57. Id.
58. Id. at 8.
59. Id. at 8–9.
60. Id. at 9.
loan production branch in majority-minority census tracts, and will pay $200,000 to the St. Louis Equal Housing Opportunity Council.

HUD also settled a case against Associated Bank, N.A. (“Associated”) to resolve one of the largest redlining complaints brought by the federal government against a mortgage lender. HUD alleged that the bank had violated the FHA when it discriminated on the basis of race and national origin by disproportionately denying the loan applications of African Americans and Hispanics, while also under-serving neighborhoods with significant African-American or Hispanic populations. As part of the settlement, Associated will invest nearly $200 million through increased mortgage loans in predominately minority communities in five metropolitan areas. Over the next three years, the bank will also make nearly $10 million available to reduce interest rates and down payments to qualified borrowers in majority-minority census tracts. In addition, Associated will provide nearly $3 million to help existing homeowners repair their properties, $1.4 million to market loans in those areas, and $1.35 million for community reinvestment and fair lending education. The bank will open four loan production offices in majority-minority census tracts and provide fair housing training to all its employees.

The DOJ and the CFPB settled a joint enforcement action against Provident Funding Associates, L.P. (“Provident”) for allegedly violating the FHA and the Equal Credit Opportunity Act (“ECOA”) when the bank charged thousands of African-American and Hispanic borrowers higher fees on mortgage loans than it did for non-Hispanic white borrowers. The complaint alleged that Provident allowed its mortgage brokers subjective, unguided discretion in setting the amount of total broker fees charged to individual borrowers from at least 2006 through 2011. Under the terms of the settlement, Provident will pay $9 million to compensate for damages that borrowers may have suffered as a result of the alleged violations.

61. Id. at 6.
62. Id. at 5.
65. Id. at 8–14.
66. Id.
67. Id.
68. Id. at 6–7.
72. Provident Consent Order, supra note 70, at 12.
Another settlement was reached between HUD and U.S. Bank, N.A. and a subsidiary (“U.S. Bank”) resolving allegations that the bank refused to refinance the mortgage of a Native American couple because their property was located on a reservation, a violation of the FHA. The complaint alleged that the loan application was denied because the “value or type of collateral [was] not sufficient” and because the subsidiary was unable to appraise the property as it was located on a reservation. Under the terms of the agreement, U.S. Bank agreed to pay off the couple’s U.S. Bank credit card balance of $11,489 and to approve their application for a home mortgage refinance loan at the same interest rate for which they originally applied. The bank will also review and revise policies regarding mortgage loans on fee-simple land located within the boundaries of a Native American reservation.

Finally, the DOJ entered into a settlement agreement with First United Bank (“First United”) to resolve allegations that First United charged higher interest rates on unsecured consumer loans to Hispanic borrowers as compared to non-Hispanic borrowers from at least 2008 through 2012, a violation of the ECOA. The complaint alleged that the interest rate disparity resulted from First United allowing its employees broad, subjective discretion in every aspect of the loan transaction. Under the settlement, First United will pay $140,000 to compensate the victims of the alleged discrimination, implement a monitoring system to monitor its loans for potential disparities based on national origin, and provide equal credit opportunity training to its employees.

CASES INVOLVING OTHER FORMS OF DISCRIMINATION

In a disability discrimination case, HUD alleged that American Bank FSB violated the FHA when it discriminated against at least six applicants on the basis of disability in processing their applications for home refinance mortgage loans. HUD alleged that the bank required applicants to provide information from their doctors regarding the nature and severity of their disabilities to prove they would
continue to receive disability income for at least three years. Under the terms of the agreement, the bank will pay the couple who filed the complaint $25,000 and will adopt a written policy that addresses the income verification requirements for applicants who receive disability income. The bank will also identify the approximately 2,900 other loan applicants who listed any type of disability insurance as a source of income between 2011 and 2013, and an independent administrator will review the files to identify any other individuals from whom the bank requested medical information. These individuals may be eligible to receive up to $5,500 in compensatory damages.

Another disability discrimination case involved allegations that Freedom Mortgage Corporation (“Freedom”) discriminated against loan applicants by requiring them to provide medical documentation regarding their disabilities. This underwriting practice allegedly subjected applicants who relied on disability income to different terms and conditions than applicants who did not, a violation of the FHA. Freedom and HUD identified sixty-nine applicants with disabilities who were subjected to these practices, and Freedom agreed to pay $104,000 to compensate them for the alleged discrimination.

In a case involving sexual discrimination, HUD alleged that First Bank Mortgage Partners (“First Bank”) discriminated against a couple when it denied them a mortgage loan because one applicant was on maternity leave. The couple alleged that First Bank had approved their loan, but when it learned that the wife was on maternity leave, it notified them that the loan had been denied. First Bank will pay the couple $35,000 to resolve these allegations, adopt a national parental leave policy for mortgage loan applicants, and provide employees with fair lending training.

**Fair Lending Litigation**

In *City of Los Angeles v. Wells Fargo & Co.*, the city alleged that Wells Fargo engaged in “discriminatory and predatory mortgage lending practices that resulted in a disparate number of residential home foreclosures for minority

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84. Id. at 8.
85. Id. at 4–6.
86. Id. at 8.
88. Id.
89. Id. at 5–7.
91. Id.
92. Id. at 5–6.
borrowers” in violation of the FHA. Wells Fargo allegedly engaged in a pattern and practice of reverse redlining since at least 2004 “by extending mortgage credit on predatory terms to minority borrowers in minority neighborhoods in Los Angeles on the basis of the race and ethnicity of its residents.” The city alleged that Wells Fargo’s practices had a disparate impact on minority borrowers. On cross motions for summary judgment, the parties agreed that the majority of the claimed discriminatory practices ended before the limitations period began, with the exception of two of the bank’s loan products, high-cost loans, as defined by the Home Mortgage Disclosure Act, and USFHA loans issued under a federal program that requires mortgage insurance that is financed with the mortgage loan.

With respect to Wells Fargo’s high-cost loans, the city argued that a disparate impact was shown by 12 out of 4,260 loans to minority borrowers, which allegedly created an adverse effect with what the court characterized as “the blistering statistical comparison of ‘0.0033% likelihood’ to ‘0.0008% likelihood.’” Relying on the Supreme Court’s decision in *Inclusive Communities*, the court found that the city’s evidence of statistical disparity did not support a prima facie case because “a statistical disparity relying on thousandths of a percentage” did not provide evidence of a significantly disproportionate effect on minorities.

On the issue of causation, the city argued that “Wells Fargo’s inadequate monitoring policies” on the issuance of high-cost loans caused the disparate impact. Again relying on *Inclusive Communities*, in which the “Supreme Court specifically noted that disparate impact claims must not force private actors to ’adopt racial quotas,’” the court concluded that the city was essentially advocating for improper racial quotas. It accordingly found that Wells Fargo’s high-cost loans to minority borrowers did not violate the FHA.

In *City of Los Angeles v. Wells Fargo & Co.*, the court also found that the bank’s USFHA loans did not have a disparate impact on minority borrowers despite the extra cost for mortgage insurance. The court noted that, “[i]f any disparate impact results from USFHA loans, it is a result of federal policy and not Wells Fargo policy,” because any disparities clearly resulted from purposeful federal gov-

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94. Id. at *1.
95. Id. (quoting complaint).
96. Id.
99. Id. at *7 (quoting the city’s expert).
100. Id. (citing Tex. Dep’t of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project, Inc., 135 S. Ct. 2507, 2523 (2015)).
101. Id. at *8 (quoting the city’s brief).
102. Id. (quoting Inclusive Cmtys., 135 S. Ct. at 2523 (“If those sorts of judgments are subject to challenge without adequate safeguards, then there is a danger that potential defendants may adopt racial quotas—a circumstance that itself raises serious constitutional concerns.”)).
103. Id.
104. Id. at *11.
105. Id. at *13.
ernment action designed to promote minority home ownership through the USFHA lending program, not because of Wells Fargo's decision to participate in the program. Finding that the city's claims were the exact same theories of disparate impact liability that the Supreme Court wanted to prevent, the court granted summary judgment in favor of Wells Fargo and against the city.

The city's case against Bank of America Corp. was also dismissed on summary judgment. In City of Los Angeles v. Bank of America Corp., the city alleged that, in 2004, the bank's predecessor, Countrywide, "began to flood historically underserved minority communities with high cost and other 'predatory' loans, allegedly constituting 'reverse redlining'” in violation of the FHA. The bank moved for summary judgment on several grounds, including that the city presented "no evidence that it suffered injury during the limitations period." The city abandoned its original theory of injury, that it incurred costs to remedy blight resulting from foreclosures, in favor of a new theory, injury to its interest in ensuring that its residents are free from housing discrimination. The court found that the city's new claimed injury did not constitute a “concrete and demonstrable injury,” and with no evidence that it suffered any cognizable injury during the limitations period, the court held that the city lacked standing to pursue an FHA claim.

In County of Cook v. Wells Fargo & Co., the county alleged that Wells Fargo "issued predatory subprime mortgage loans that over the years went into default and drove the mortgaged properties into foreclosure," and that, “because the resulting urban blight and reduced property tax base was concentrated in the county's heavily minority neighborhoods, Wells Fargo's practices violated . . . the Fair Housing Act.” The bank moved to dismiss on the ground that the county lacked standing to sue under Article III and that it did not fall within the FHA's zone of interests, because it is not an 'aggrieved' person within the FHA's meaning.

106. Id.
107. Id. at *14.
109. Id. at *1 (quoting the complaint).
110. Id. at *3.
111. Id. at *4.
112. Id. (quoting Havens Realty Corp. v. Coleman, 455 U.S. 363, 379 (1982)).
113. Id. at *5.
114. Id. at *6.
115. Id.
117. Id. at *1.
118. Id. at *2.
119. Id. at *4 (quoting 42 U.S.C. § 3602(i)(1)).
Following the Supreme Court’s decision in *Gladstone, Realtors v. Village of Bellwood*, which requires plausible allegations of a “concrete and particularized” injury that is “fairly traceable to the challenged action of” Wells Fargo and that will be “redressed by a favorable decision,” the district court held that the county had suffered a cognizable injury within the meaning of Article III. However, the court disagreed with other courts that have held that, where there is Article III standing, there is no need to conduct a separate zone-of-interests analysis under the FHA. Finding that the county’s alleged injury did not fall within the zone of interests protected by the FHA, the court dismissed the county’s complaint for lack of standing, without prejudice.

In *County of Cook v. Wells Fargo & Co.*, the court declined to follow *County of Cook v. Bank of America Corp.*, in which the county also alleged that the bank engaged in reverse redlining. Bank of America Corp. similarly argued that the county lacked Article III standing to sue for the alleged FHA violations and also did not fall within the FHA’s zone of interests. In *County of Cook v. Bank of America Corp.*, the court found that the county had Article III standing to sue for its alleged FHA claims. In contrast to *County of Cook v. Wells Fargo & Co.*, the court, in *County of Cook v. Bank of America Corp.*, found that, having “already determined that the County’s complaint satisfies Article III’s standing requirements, . . . there is no need to undertake a separate zone of interests analysis.” The court nevertheless went on to hold that “the causal connection between Defendants’ alleged conduct and the County’s injuries is at least plausible” and thus that “the County’s claims fall[] within the FHA’s zone of interests.”

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120. 441 U.S. 91 (1979).
122. *Id.* at *3–4 (citing *Gladstone*, 441 U.S. at 110–11).
123. *Id.* at *4–6.
127. *Id.* at *1, *4–6.
128. *Id.* at *2–3.
129. *Id.* at *3.
130. *Id.* at *4.
131. *Id.* at *4–5.
Automotive Finance: The Regulatory Cup Spilleth Over

By Kevin M. McDonald and Kenneth J. Rojc*

INTRODUCTION

Almost every aspect of the life cycle of retail contract and lease transactions, from marketing and account originations to servicing and collections, has received heightened regulatory attention during the past year, since the previous survey.¹ This survey will highlight the most significant developments since the spring of 2015, including the Bureau of Consumer Financial Protection’s (“CFPB’s”) enactment of a larger market participant rule² and the expansion of its examination procedures for automobile finance lenders.³ On the fair lending front, this survey will address consent orders entered by the U.S. Department of Justice (“DOJ”) with American Honda Finance Corporation (“AHFC”⁴ and Evergreen Bank Group (“Evergreen”),⁵ the CFPB’s white paper on the proxy methodology it uses in fair lending cases,⁶ and its announcement that consumers

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¹. See Kevin M. McDonald & Kenneth J. Rojc, Automotive Finance Regulation: Warning Lights Flashing, 70 BUS. LAW. 617 (2015).


subject to alleged credit discrimination by Ally Financial, Inc. and Ally Bank (together, “Ally”) will be receiving instructions on how to apply for restitution.7

On the servicing front, this survey will examine enforcement actions by the CFPB against First Investors Financial Services Group, Inc. (“First Investors”), regarding its credit reporting activities,8 and Security National Automotive Acceptance Company, LLC (“SNAAC”), regarding its collection activities involving servicemembers.9 This survey will also report on the New York Attorney General’s enforcement actions against vehicle dealers’ with regard to their sale and financing of ancillary products.10

**FEDERAL REGULATORY DEVELOPMENTS**

**CFPB NONBANK AUTO FINANCE LARGER PARTICIPANT RULE**

The CFPB promulgated a final rule that became effective in August 2015 that expands its supervision and examination authority to reach larger nonbank auto finance companies.11 The rule extends the CFPB’s supervision of automotive finance from the largest banks and credit unions (i.e., those with assets over $10 billion) to any nonbank auto finance company that makes, acquires, or re-finances 10,000 or more automotive retail installment contracts or leases in a year, regardless of asset size.12 Under the rule, companies that exceed the 10,000-transaction threshold are defined as “larger participants” in this market, and the CFPB may oversee their activities to ensure that they comply with the federal consumer financial laws.13

The CFPB estimated that it will have authority to supervise about thirty-four of the largest nonbank automobile finance companies and their affiliates that engage in auto financing.14 “Those companies together originate around 90 percent of nonbank auto loans and leases, and in 2013 provided financing to approximately 6.8 million consumers.”15 “The final rule also defines additional...
automobile leasing activities for coverage by certain consumer protections of the Dodd-Frank Act."\(^{16}\)

**CFPB Examination Procedures**

To coincide with its new authority over larger participants, the CFPB also updated and expanded its “Supervisory and Examination Manual to provide guidance on how the Bureau will monitor the bank and nonbank auto finance companies that it supervises.”\(^{17}\) The Automobile Finance Examination Procedures now consist of nine modules covering fifty-four pages,\(^{18}\) compared to the original three pages covering the Risks Related to Auto Lending Module within the CFPB Examination Procedures for the Equal Credit Opportunity Act that was published in July 2013.\(^{19}\) Examiners will assess risks to consumers and determine whether auto finance companies comply with the requirements of federal consumer financial law.\(^{20}\) In its press release accompanying the announcement of the larger participant rule and the expanded Supervisory and Examination Manual, the CFPB noted that examiners will focus on determining whether nonbank auto finance larger participants are “fairly marketing and disclosing auto financing terms . . . , providing accurate information to credit bureaus . . . , treating consumers fairly when collecting debts . . . , [and] lending fairly.”\(^{21}\) Nonbank auto finance companies that are subject to CFPB supervision for the first time under the larger participant rule should carefully review the new Examination Procedures because they reveal exactly how the CFPB will conduct its regulatory examinations.

**Fair Lending Developments in Automotive Financing**

**CFPB White Paper on Proxy Methodology**

In order to provide guidance to automotive finance sources on how to use the Bayesian Improved Surname Geocoding (“BISG”) statistical method in disparate impact analyses of consumer portfolios,\(^{22}\) the CFPB published a white paper in summer 2014 to “explain the construction of the proxy for race and ethnicity currently employed by [the CFPB’s] Office of Research and [D]ivision of Supervision, Enforcement, and Fair Lending . . . [and to provide] an assessment of the performance of the proxy method using a sample of mortgage applicants for

\(^{16}\) Id.

\(^{17}\) Id.; see also Auto Finance Examination Procedures, supra note 3, at 1–2.

\(^{18}\) See Auto Finance Examination Procedures, supra note 3, at 1, 54.


\(^{20}\) See Auto Finance Examination Procedures, supra note 3, at 1–2.

\(^{21}\) See Auto Finance Press Release, supra note 2.

\(^{22}\) See McDonald & Rojc, supra note 1, at 619 n.14 (describing history and application of BISG to automotive lending and its limitations, such as misclassifying and overestimating the number of African-Americans in an automotive portfolio).
whom race and ethnicity are reported,”23 unlike automotive finance, where the race and ethnicity of automobile purchasers are not known. The paper concludes that the CFPB’s BISG approach “produces proxies that correlate highly with self-reported race and national origin and is more accurate than relying only on demographic information associated with a borrower’s last name or place of residence alone.”24

However, a subsequent study commissioned by the American Financial Services Association concluded, inter alia, that BISG is “conceptually flawed in [its] application and subject to significant bias and estimation error; the use of biased race and ethnicity proxies creates significant measurement errors, which likely result in overstated disparities and overstatements of alleged consumer harm.”25 As a result, the authors of the study concluded that “[t]he continuous BISG methodology should not be used in any analysis of indirect auto underwriting.”26 The CFPB has not responded to the critique of its proxy methodology as of the date of this writing.

AMERICAN HONDA FINANCE CORPORATION CONSENT ORDER

In July 2015, the DOJ and AHFC submitted a consent order (“AHFC Consent Order”) under which AHFC agreed to pay $24 million to consumers allegedly harmed by AHFC’s motor vehicle dealer compensation policy that the CFPB and DOJ claimed resulted in illegal discrimination against “thousands” of African-American, Hispanic, and Asian and/or Pacific Islander credit purchasers, called “borrowers” in the consent order.27 The alleged disparities were that African-American borrowers paid 36 basis points more than similarly situated white borrowers, resulting in the payment of $250 more in interest over the term of their contracts than similarly situated white borrowers; Hispanic borrowers paid 28 basis points more than similarly situated white borrowers, resulting in the payment of $200 more in interest; and Asian and/or Pacific Islander borrowers paid 25 basis points more than similarly situated white borrowers, resulting in the payment of $150 more in interest.28 In deriving these alleged disparities, the CFPB and the DOJ used the BISG method to form race and national

24. PROXY METHODOLOGY, supra note 6, at 3.
26. Id. at 87.
28. See AHFC Complaint, supra note 27, at 5–6.
origin probabilities. The AHFC Consent Order stipulated that the alleged disparities occurred between January 1, 2011, and July 14, 2015.

The consent order required AHFC to select one of the following three options in reformulating its dealer compensation policy:

Option One: (a) Limit dealer discretion for interest rate markups to 125 basis points for retail installment contracts with terms of 60 months or less, and 100 basis points for retail installment contracts with terms greater than 60 months; (b) maintain compliance management systems and monitor dealer compliance; and (c) submit to the DOJ and the designated Fair Lending Director at the CFPB data on AHFC’s non-subvented indirect auto portfolio semiannually for analysis and monitoring.

Option Two: (a) Limit dealer discretion for interest rate markups to 125 basis points for retail installment contracts with terms of 60 months or less, and 100 basis points for retail installment contracts with terms greater than 60 months; (b) allow dealers to set a lower dealer participation rate than those caps based upon documented permissible exceptions; (c) maintain compliance management systems and monitor dealer compliance; and (d) submit to the DOJ and the designated Fair Lending Director at the CFPB data on AHFC’s non-subvented indirect auto portfolio semiannually for analysis and monitoring.

Option Three: (a) Maintain policies that do not allow dealers any discretion (i.e., flat fees) and (b) maintain compliance management systems.

Significantly, the AHFC Consent Order is the first consent order that requires lowering dealer rate participation markup caps, unless AHFC selects a non-discretionary dealer compensation policy. AHFC is responsible as administrator of the settlement fund to bear all expenses in implementing a redress plan and is required to contact all affected consumers. In addition, AHFC will be required to contribute $1 million to consumer financial education programs.
that are designed to benefit African-American, Hispanic, and Asian and/or Pacific Islander populations.\textsuperscript{37}

**EVERGREEN BANK GROUP CONSENT ORDER**

In May 2015, the DOJ and Evergreen submitted a consent order ("Evergreen Consent Order") under which Evergreen must repay $395,000 to consumers harmed by its motorcycle dealer compensation policies,\textsuperscript{38} which resulted in illegal discrimination against 700 African-American borrowers and 1,500 Hispanic borrowers, according to the Federal Depository Insurance Corporation and the DOJ.\textsuperscript{39}

Evergreen allegedly had the same interest rate disparity as Ally for African-American borrowers, 29 basis points higher than similarly situated white borrowers, and a larger interest rate disparity for Hispanic borrowers, 40 basis points higher than similarly situated white borrowers (compared to a 20-basis-points differential for Ally).\textsuperscript{40} Those allegedly higher rates resulted in the average minority buyer paying $200 to $250 more in interest than similarly situated white borrowers during the term of the contract.\textsuperscript{41} To ensure that such disparities do not occur in the future, Evergreen is required to adopt one of three dealer participation structures: non-discretionary pricing, i.e., flat fees; ongoing dealer and portfolio monitoring with customer remuneration for affected customers; or setting a standard participation rate from which the dealer can diverge downward based on properly documented reasons set forth in Evergreen’s policies and procedures.\textsuperscript{42}

The Evergreen Consent Order demonstrates that the U.S. government continues to pursue fair lending actions on the basis of BISG proxy methodology, even against small lenders that have limited funds to develop and maintain a compliance management system.\textsuperscript{43} In addition, for the first time, a DOJ disparate impact consent order requires the settlement administrator to obtain a liability release from affected consumers as part of the process and has required the

\begin{itemize}
  \item \textsuperscript{37} Id. at 15.
  \item \textsuperscript{38} Evergreen Consent Order, supra note 5, at 1–3, 10.
  \item \textsuperscript{39} See id. at 2; Complaint at 1, United States v. Evergreen Bank Grp., No. 15-cv-04059 (N.D. Ill. May 7, 2015) [hereinafter Evergreen Complaint], http://www.justice.gov/file/evergreen-complaint/download. Evergreen engaged in indirect motorcycle lending through its Freedom Road Financial unit, which purchased annually between 6,000 and 12,000 motorcycle retail installment sales contracts through a network of approximately 400 dealers located in all fifty states. Evergreen Consent Order, supra note 5, at 1–2.
  \item \textsuperscript{42} See Evergreen Consent Order, supra note 5, at 4–10.
  \item \textsuperscript{43} Evergreen is a state-chartered bank headquartered in Oak Brook, Illinois with assets of about $500 million. See id. at 1.
\end{itemize}
delivery of excess funds to organizations advocating for consumers or educating consumers on issues pertaining to motor vehicle finance.44

ALLY FINANCIAL BEGINS REMEDIATING AFFECTED CONSUMERS

As reported in the previous survey, under a consent order filed in December 2013, the CFPB and the DOJ required Ally to pay $80 million in damages to consumers who allegedly were harmed from discriminatory retail contract pricing.45 Their BISG proxy analysis estimated that between April 1, 2011, and December 31, 2013: (1) approximately 100,000 African-American consumers were charged 29 basis points more in dealer markups than similarly situated white consumers, resulting in an average overpayment of $300 in interest over the life of the contract; (2) approximately 125,000 Hispanic consumers were charged 20 basis points more in dealer markups than similarly situated white consumers, resulting in an average overpayment of more than $200 in interest over the life of the contract; and (3) approximately 10,000 Asian/Pacific Islander consumers were charged 22 basis points more in dealer markups than similarly situated white consumers, resulting in an average overpayment of more than $200 in interest over the life of the contract.46 Thus, a total of approximately 235,000 consumers may be eligible to receive a settlement check.

Although the consent order was announced in December 2013, no further information regarding the issuance of settlement checks to affected consumers was provided until June 2015, when Patrice Ficklin, CFPB’s Assistant Director for Fair Lending and Equal Opportunity, published a blog post stating that Ally had retained an administrator for the settlement fund.47 She stated that the administrator will mail packages to borrowers “over the next weeks” that would provide instructions on how to participate in the settlement.48 According to a published report, Ally continues to deny the claims of discrimination and states that it was not responsible for the long delay in paying out the settlement.49

44. See id. at 12–13 (requiring the administrator to “confirm the identities and eligibility of, and obtain the Release . . . from, Identified Borrowers”); id. at 14 (requiring any remaining money from the settlement to be distributed to “one or more organizations that provide services including credit counseling . . . ; legal representation of borrowers seeking to prevent repossession; financial literacy; and other related programs targeted at African-American and Hispanic potential and former motor vehicle loan borrowers”); id. at 21 (Exhibit A: Release).

45. See McDonald & Rojc, supra note 1, at 619. In addition to the $80 million in consumer damages, Ally agreed to pay a civil penalty of $18 million. See Ally CFPB Consent Order, supra note 40, at 20.

46. Ally CFPB Consent Order, supra note 40, at 3, 6–7.


48. See Ficklin Blog, supra note 7.

OTHER FEDERAL ENFORCEMENT ACTIONS

FIRST INVESTORS FINANCIAL SERVICES GROUP, INC.

In August 2014, First Investors entered into a consent order (“First Investors Consent Order”) with the CFPB to resolve issues that arose out of the CFPB’s investigation of First Investors’ credit reporting practices. The CFPB determined that First Investors systematically furnished inaccurate information to credit reporting agencies and, upon learning of the inaccuracies, failed to require its service provider to correct issues that caused inaccuracies in reporting payment histories on motor vehicle retail installment sales contract accounts in violation of Regulation V. In addition, the CFPB concluded that a statement on the company’s website indicating that First Investors reports only accurate information to be a material misrepresentation, in violation of the prohibition on unfair, deceptive, or abusive acts or practices under the Consumer Financial Protection Act of 2010. The CFPB fined First Investors $2.75 million, required it to update its credit reporting procedures, mandated a posting on its website about its inaccurate credit reporting, and directed it to retain an independent consultant to evaluate compliance with the First Investors Consent Order. As an enforcement example, this case demonstrates that an auto finance lender will be held accountable for the actions or omissions of its service providers.

SECURITY NATIONAL AUTOMOTIVE ACCEPTANCE COMPANY, LLC

In June 2015, the CFPB brought an action against SNAAC, a company that specializes in financing motor vehicle purchases by servicemembers. The CFPB alleged that SNAAC committed unfair, deceptive, and abusive acts or practices by: contacting or threatening to contact commanding officers making misleading statements on the adverse impact of payment delinquencies on servicemembers’ careers, using an addendum containing a “buried” provision purporting to authorize contact with the servicemember’s employer or commanding officer, stating that SNAAC intended to file collection actions, making misleading statements that SNAAC could garnish wages before obtaining a judgment, and suggesting that non-payment could result in contempt of court penalties. In October 2015, SNAAC consented to the issuance of an order by the CFPB to resolve the Bureau’s allegations (“SNAAC Consent Order”). Under the SNAAC Consent Order, the company must provide redress to affected consumers in

50. See First Investors Consent Order, supra note 8, at 3–7.
51. Id. at 1, 7–8 (citing 12 C.F.R. § 1022.42(a)).
52. Id. at 1, 8–9 (citing 12 U.S.C. §§ 5531, 5536).
53. Id. at 9–13.
54. See SNAAC Complaint, supra note 9, at 1.
55. Id. at 1, 3–6 (citing 12 U.S.C. §§ 5531, 5536).
the amount of almost $2.3 million, pay a civil monetary penalty of $1 million, and submit to requests for information by the CFPB.57 The allegations against SNAAC, as well as their resolution, signal that the CFPB intends to use its enforcement powers aggressively against auto lenders that appear to implement unfair, deceptive, or abusive collection practices, especially against military servicemembers.

**STATE ENFORCEMENT ACTIONS**

In June 2015, the New York Attorney General announced a settlement with three car dealerships—Paragon Motors of Woodside, Inc., d/b/a Paragon Honda; Worldwide Motors Ltd., d/b/a Paragon Acura; and Civic Center Motors Ltd., d/b/a White Plains Honda (“New York Dealerships”).58 The New York Dealerships allegedly sold worthless “credit repair” and “identity theft prevention” services and other “after-sale” items that imposed hidden charges that were financed as part of purchase or lease transactions.59 The settlement requires that the New York Dealerships pay $13.5 million in restitution and $325,000 in penalties.60 The settlement consists of a $6 million fund to be distributed by a third-party administrator to approximately 15,000 customers and a $500 “settlement card” for those customers that can be used for purchasing or leasing vehicles, purchasing certain maintenance services, or purchasing certain accessories.61 The settlement also prohibits the New York Dealerships from engaging in the following practices:

- selling, offering to sell, or marketing credit repair and identity theft services in connection with the sale or lease of a vehicle; selling, offering to sell, or providing to consumers any after-sale product or service unless, prior to such sale, certain material terms, including the price, are disclosed verbally and in writing; misrepresenting the price of the vehicle in final lease or sale contracts; negotiating any terms of a sale or lease with a consumer in a language other than English without providing a translation of certain material documents in the language in which the terms were negotiated before the consumer signs those documents; [and] failing to provide consumers with sales or lease agreements that clearly and conspicuously itemize each after-sale product or service and its price.62

The settlements are part of a broader initiative against ancillary products that has thus far focused on credit repair and identity theft services.63 The initiative has also included a consent order under which the obligor on the credit repair and identity theft prevention services, Credit Forget, Inc., was dissolved and an
earlier $41,000 settlement involving another dealership—L.I. Autoworld, Inc. d/b/a Generation Kia—that fraudulently sold services provided by Credit Forget, Inc.64 The New York Attorney General also announced his intention to sue several other dealerships for similar practices.65

64. Id.
65. Id.
Subprime Auto Finance Developments

By Christopher M.A. Chamness, Katherine C. Fisher, Eric L. Johnson, and Nicole F. Munro*

INTRODUCTION

Subprime auto finance has faced intense media and regulatory scrutiny during the past year. No longer an insignificant part of the auto finance market, the subprime segment has grown into a multi-billion dollar industry after a period of contraction during the Great Recession of 2008.1 The definition of “subprime” differs by organization and observer. Different definitions include a consumer who has a FICO credit score below 620,2 a Vantage Score 3.0 of 600 or below,3 or a credit score below 640.4 Although the credit score is usually the single most important criterion for what characterizes a subprime customer, some criticize using a credit score as the sole differentiator between prime and subprime auto finance transactions.5

The increased size and visibility of the subprime auto finance market have led to increased media scrutiny. The New York Times ran a series of articles on subprime auto finance that included allegations of “reverse redlining,” or the

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3. See, e.g., Zabritski, supra note 1, at 33.


5. See, e.g., CUTTS & CARLSON, supra note 2, at 2 n.1.
targeting of minorities with the most expensive auto loans, abusive title loans and repossession practices, loan values that exceed the value of the vehicle, and hidden defects in used cars marketed to subprime buyers. The series also condemned the use of geolocation technology and starter interrupt technology in vehicles sold to subprime purchasers. In this media environment, legislators and regulators have focused their efforts on curbing perceived abuses in the subprime marketplace.

**PROPOSED STATE LEGISLATION**

The New York Independent Democratic Caucus ("IDC") published a report on subprime auto lending practices in April 2015. The IDC wrote the report following several developments, including the articles in the *New York Times* about the subprime auto finance market, a request for expression of interest to banks and credit unions in creating a “safe and affordable auto loan product” by the New York City Department of Consumer Affairs in March 2015, and a public hearing on subprime auto finance before the New York Senate Standing Committee on Banks in April 2015. The IDC report focused on eight allegedly deceptive lending practices in the subprime market that were not previously subject to a regulatory framework, including auto credit with “abusively high interest rates” of around 24 percent, high loan-to-value ratios due to negative equity and ancillary product financing, dealer financing markups, without disclosure requirements, dealer fraud in forcing buyers to purchase “optional” ancillary products, completing applications on behalf of buyers, and falsifying

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9. Id.


11. See INDEP. DEMOCRATIC CONFERENCE, ROAD TO CREDIT DANGER: PREDATORY SUBPRIME AUTO LENDING IN NEW YORK (Apr. 2015) [hereinafter IDC REPORT].

12. See supra notes 4, 6–10 and accompanying text.


15. IDC REPORT, supra note 11, at 6.

16. Id. at 7.

17. Id.
income levels;\textsuperscript{18} spot delivery;\textsuperscript{19} and the use of electronic tracking devices and starter interrupt devices.\textsuperscript{20}

The IDC report outlined proposals for eleven bills as “legislative solutions” to combat the allegedly deceptive subprime auto finance practices noted in the report.\textsuperscript{21} Nine different pieces of legislation were introduced in response to the IDC report, addressing many, but not all, of the allegedly deceptive subprime practices, which remain pending as of this writing.\textsuperscript{22} Some of the bills apply to used motor vehicle dealers only. Senate Bill 5484 would provide for a three-day cooling-off period after the purchase of a used motor vehicle from a dealer.\textsuperscript{23} Senate Bill 5485 would require used motor vehicle dealers to maintain a $20,000 surety if the dealer sells fifty or fewer vehicles per year and a $100,000 surety bond if it sells more than fifty a year.\textsuperscript{24}

Although each bill arose out of the IDC report, many apply beyond subprime auto finance markets, by placing supervisory and enforcement powers in the hands of the New York regulators for auto sales and finance more generally. Senate Bill 5269 would prohibit any secured creditor from remotely disabling a vehicle without first providing notice of the disabling to the debtor.\textsuperscript{25} Senate Bill 5488 would authorize the New York Department of Law to write and enforce regulations relating to motor vehicle dealers’ advertising and marketing.\textsuperscript{26} Senate Bill 5489 would grant the New York Department of Financial Services jurisdiction over the financing of motor vehicles and require dealer finance managers to be licensed by the department.\textsuperscript{27} Senate Bill 5490 would authorize the New York Superintendent of Financial Services to oversee and regulate all motor vehicle transactions with consumers, require motor vehicle installment contracts to include an itemized listing of all costs related to the purchase of a motor vehicle, prohibit spot delivery, and require motor vehicle dealers to provide credit applicants with copies of application documents.\textsuperscript{28} Senate Bill 5491 would require motor vehicle dealers to disclose price markups to buyers and would authorize a study of dealer markups.\textsuperscript{29}

\textsuperscript{18} Id. at 8.
\textsuperscript{19} The term “spot delivery” refers to a motor vehicle dealer practice where the dealer allows an installment sale buyer to take possession of the vehicle when financing is not yet final. Id. at 9.
\textsuperscript{20} Id.
\textsuperscript{21} Id. at 25.
\textsuperscript{25} S.B. 5269, 238th Gen. Assemb. (N.Y. 2015). Although starter interrupt technology is primarily used in subprime finance, this bill would govern the use of starter interrupt technology by any secured creditor.
\textsuperscript{26} S.B. 5488, 238th Gen. Assemb. (N.Y. 2015).
\textsuperscript{27} S.B. 5489, 238th Gen. Assemb. (N.Y. 2015).
Finally, with respect to any motor vehicle retail installment credit transaction, Senate Bill 5506 would amend New York’s Personal Property Law, which limits holder-in due-course liability for assignees to the amount owed to an assignee when a claim or defense is asserted, to treat attorney’s fees and costs separately. Thus, a successful consumer can recover up to the amount owing on the contract, and if attorney’s fees and costs are awarded, the consumer may also recover those fees and costs.30

In addition, California was one of the first states to adopt laws governing the use of payment assurance technology to track a vehicle (“electronic tracking technology”) or to disable the starter of a vehicle (“starter interrupt technology”) in connection with collections on motor vehicle sales.31 Among other limits, the California law provides that a buy-here-pay-here (“BHPH”) dealer may not disable a vehicle using starter interrupt technology unless: the dealer gives written notice at the time of the sale that the vehicle is equipped with the technology; the written notice informs the buyer that no less than forty-eight hours’ warning will be given before the starter interrupt technology will be used; the dealer offers the buyer a choice of warning methods; and, in the event of an emergency, the buyer will be provided with the ability to start a disabled vehicle for no less than twenty-four hours after its initial disablement.32

The California law was amended in 2015 to require that dealers send an additional notice five days before using the starter interrupt technology to disable the vehicle for all weekly payment term contracts and ten days before the use of the technology on all other contracts.33 The amendment requires that the written disclosure inform the buyer about the ability to restart a dealer-disabled vehicle in an emergency.34 The amendment also increases the maximum fine amount from $1,000 to $2,000 for violations.35

FEDERAL AND STATE ENFORCEMENT DEVELOPMENTS

A number of federal and state regulators have taken action against dealers in the subprime auto market. The Bureau of Consumer Financial Protection (“CFPB”) announced a consent order against DriveTime Automotive Group, Inc., one of the largest BHPH dealerships in the country, and its affiliated finance company (“DriveTime”) in November 2014.36 In addition to alleged violations of

34. Id.
35. Id.
the credit reporting laws, the CFPB asserted that DriveTime harassed consumers with debt collection calls, including, for example, calling one consumer thirty times after her do-not-call request and causing another consumer to lose her job because of repeated collection calls to her workplace. DriveTime also allegedly called consumers' references repeatedly even after it was asked to stop. Under the consent order, DriveTime agreed to end the debt collection tactics categorized by the CFPB as “unfair” and institute appropriate collection call procedures. It also agreed to pay an $8 million civil penalty.

In February 2015, the U.S. Department of Justice and the North Carolina Department of Justice announced a settlement of the first discrimination lawsuit involving BHPH auto finance. The consent order against two BHPH dealerships, Auto Fare, Inc. and Southeastern Auto Corp., resolved allegations made in January 2014 that the dealerships and their owner engaged in a pattern or practice of discrimination in credit transactions on the basis of race or color and engaged in unlawful repossession activity in violation of state law. The allegations included the claim that the dealerships intentionally targeted African-American customers for the extension and servicing of credit on unfair and predatory terms without meaningfully assessing the customers' creditworthiness, a practice commonly referred to as “reverse redlining.” Under the settlement, the dealerships must establish a $225,000 settlement fund to compensate victims of the past alleged discriminatory and predatory lending. The dealerships must also limit monthly payments to no more than 25 percent of a borrower's income, set interest rates at least 5 percentage points below the state's rate cap, and offer sales prices competitive with other BHPH dealers in the area.

The Federal Trade Commission (“FTC”) also brought several enforcement actions against auto dealers that allegedly made deceptive advertising claims. In

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38. DriveTime Consent Order, supra note 36, at 5.
39. Id. at 6.
40. Id. at 13–16.
41. Id. at 22.
45. Auto Fare Complaint, supra note 43, at 3.
46. Auto Fare Consent Order, supra note 44, at 12.
47. Id. at 3–4.
48. Id. at 5.
49. Id. at 6.
December 2014, the FTC charged that a Texas auto dealer, TXVT Limited Partnership, advertised enticing prices, lease or finance terms, and promotions and then deceptively attempted to disclaim those offers using small text in its print and video advertisements.\footnote{50} For example, one advertisement allegedly misled consumers into thinking that they could get out of their current financing contract or lease for only $1.\footnote{51} The FTC alleged that the advertisement was deceptive because consumers could not get out of their financing contract or lease for $1, and instead the dealership would add the balance of any obligation to the new financing contract.\footnote{52} In addition, the consumer would be required to pay any other amounts, such as lease termination fees.\footnote{53} In other advertisements, the dealer used small, fine print at the bottom of the advertisement to include the financing term, the Annual Percentage Rate, and other required terms.\footnote{54} The FTC approved a final order settling the matter in February 2015.\footnote{55}

In June 2015, the FTC charged that TC Dealership, L.P.\footnote{56} and JS Autoworld, Inc.\footnote{57} ran advertisements that misrepresented the purchase price or leasing offers of vehicles and the amount due at signing. The advertisements also allegedly violated federal law by failing to disclose the required credit and lease terms.\footnote{58} In connection with one of Planet Hyundai’s advertisements, the FTC charged that the dealer misled consumers by prominently advertising a vehicle price for “$0 DOWN AVAILABLE,” but noting in fine print that consumers must turn in a vehicle with a trade-in value of at least $2,500.\footnote{59} The FTC alleged that Planet Nissan included prominent offers for “PURCHASE! NOT A LEASE!” when many of the offers were for leases.\footnote{60} The dealers agreed to settle the FTC charges in June 2015 by agreeing not to misrepresent the cost to purchase or lease a vehicle and to comply with the applicable federal consumer financial laws.\footnote{61}

In March 2015, the FTC and thirty-two law enforcement partners announced “Operation Ruse Control” to target auto finance application fraud, deceptive

\footnote{51}{Id. at 2.}
\footnote{52}{Id. at 4.}
\footnote{53}{Id.}
\footnote{54}{Id. at 5.}
\footnote{58}{TC Dealership Complaint, supra note 56, at 5; JS Autoworld Complaint, supra note 57, at 6, 7.}
\footnote{59}{TC Dealership Complaint, supra note 56, at 3.}
\footnote{60}{JS Autoworld Complaint, supra note 57, at 3.}
practices related to add-on products and services, and deceptive advertising.\textsuperscript{62} In connection with add-on products, the FTC charged that National Payment Network, Inc. (“NPN”) deceptively pitched consumers on a biweekly payment plan program to finance auto purchases that it claimed would save consumers money.\textsuperscript{63} NPN allegedly failed to disclose that it charged significant fees for the service that would cancel out any actual savings from the program.\textsuperscript{64} The FTC approved a final order settling the matter in May 2015.\textsuperscript{65} In a related case, the FTC charged that Matt Blatt Inc. and Glassboro Imports, LLC failed to disclose the fees on NPN’s biweekly payment plan add-on service and that consumers would not save money due to the program’s high fees.\textsuperscript{66} The FTC approved a final order settling the matter in July 2015.\textsuperscript{67}

As part of Operation Ruse Control, the FTC also alleged that three dealers, located in Florida, Alabama, and California, deceptively advertised the sale, financing, and leasing of their vehicles.\textsuperscript{68} The FTC alleged that these dealers’ advertisements touted sales, lease, or financing options that appealed to but were not generally available to their consumers and with benefits that were cancelled out by small, fine-print disclaimers. The FTC approved final orders settling two of the matters in May 2015\textsuperscript{69} and the third matter in July 2015.\textsuperscript{70}


\textsuperscript{64. Id. at 5.}


The CFPB’s Consumer Arbitration Study Takes Center Stage

By Alan S. Kaplinsky, Mark J. Levin, and Martin C. Bryce, Jr.*

For many years, the annual arbitration update has focused primarily on judicial developments regarding the enforcement of consumer arbitration agreements, particularly those containing class action waivers in which the parties agree that any arbitration will be conducted on an individual, non-class basis. Those developments culminated in two landmark U.S. Supreme Court decisions, AT&T Mobility, LLC v. Concepcion1 and American Express Co. v. Italian Colors Restaurants.2 Concepcion held that the Federal Arbitration Act (“FAA”)3 preempts state laws that would invalidate class action waivers in consumer arbitration agreements.4 Italian Colors held that there is no “vindication of rights” exception to Concepcion; the Court rejected the plaintiffs’ argument that the class action waiver in their credit card agreements was unenforceable because it was impossible for them to pursue their statutory claims in an individual arbitration given the great cost of doing so compared to the relatively small amount of individual damages.5

While Concepcion, Italian Colors, and their progeny have substantially reduced the volume of private-party litigation over the enforceability of class action waivers,6 activity in the regulatory arena has increased. In March 2015, the Bureau of

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2. 133 S. Ct. 2304 (2013).
4. Concepcion, 131 S. Ct. at 1753.
5. Italian Colors, 133 S. Ct. at 2310–12.
6. See generally Alan S. Kaplinsky, Mark J. Levin & Martin C. Bryce, Jr., 2014 Arbitration Developments—Courts Continue to Apply Concepcion and Italian Colors, 70 Bus. Law. 649 (2015) (in the 2014 Annual Survey) [hereinafter 2014 Developments]. Such litigation has not completely ceased, however. For example, the U.S. Supreme Court reversed a ruling by the California Court of Appeal that the phrase “law of your state” as used in an arbitration agreement meant only California state law, excluding federal laws such as the FAA, in affirming denial of a motion to compel arbitration. DirecTV v. Imburgia, 170 Cal. Rptr. 3d 190 (Ct. App. 2014), rev’d, No. 14-462, 2015 WL 8546242 (U.S. Dec. 14, 2015).
Consumer Financial Protection (“CFPB”) issued its long awaited arbitration study of consumer arbitration agreements in financial services contracts.\(^7\) Because the Study is a precursor to CFPB rulemaking on consumer arbitration agreements, it occupies center stage in this year’s survey.

Section 1028 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) requires the CFPB to “conduct a study of, and to provide a report to Congress concerning, the use of agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services.”\(^8\) Section 1028 further provides that the CFPB “by regulation, may prohibit or impose conditions and limitations for the use of [such] an agreement” if the CFPB “finds that such a prohibition or imposition of conditions and limitations is in the public interest and for the protection of consumers.”\(^9\) The Study was issued three years after the CFPB first solicited public comments on the scope, methodology, and data sources of the study in April 2012\(^{10}\) and fourteen months after the CFPB released preliminary results in December 2013.\(^{11}\)

**Scope and Key Empirical Conclusions of the Study**

At the field hearing where issuance of the Study was announced, CFPB Director Cordray characterized it as “the most comprehensive empirical study of consumer financial arbitration ever conducted.”\(^{12}\) The 728-page Study includes chapters on: the prevalence of pre-dispute arbitration clauses in six consumer product markets (credit cards, checking accounts, prepaid cards, private student loans, payday loans, and mobile wireless third-party billing); consumer understanding of arbitration; how arbitration procedures differ from court procedures; the types of claims brought in arbitration and how they are resolved; the types of claims brought in litigation and how they are resolved; consumer use of small claims courts; the value of class action settlements; the relationship between public enforcement actions and class actions; and whether arbitration leads to lower prices for consumers.

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\(^9\) *Id.* § 5518(b).


\(^11\) See *Consumer Fin. Prot. Bureau, Arbitration Study Preliminary Results: Section 1028(a) Study Results to Date* (Dec. 12, 2013), http://files.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf; see also 2014 Developments, supra note 6, at 656.

The key empirical conclusions of the Study can be summarized as follows:

- The Study states that “[t]ens of millions of consumers use consumer financial products or services that are subject to pre-dispute arbitration clauses.” More specifically, arbitration is used by 15.8 percent of credit card issuers covering 53 percent of credit card loans, by 7.7 percent of banks covering 44.4 percent of insured deposits, by all of the prepaid card companies studied covering 82.9 percent of the market, by 83.7 percent of storefront payday loan lenders covering 98.5 percent of storefronts, by six of seven private student loan contracts sampled, and by 87.5 percent of mobile wireless providers covering 99.9 percent of subscribers.

- “Consumers are generally unaware of whether their credit card contracts include arbitration clauses . . . [and] of any arbitration clause opt-out opportunities that may have been offered by their card issuer.” In particular, in a telephone survey conducted by the CFPB, 54.4 percent of respondents whose credit card agreements include arbitration clauses stated that they did not know if they could sue their issuing companies in court, and 38.6 percent believed they could sue their issuers in court.

- From 2010 to 2012, 1,847 individual consumer arbitrations were commenced with the American Arbitration Association (“AAA”) in the six product markets examined by the CFPB. In 341 of those arbitrations filed in 2010 and 2011, the arbitrator awarded relief to consumers in thirty-two cases and consumers obtained debt forbearance in forty-six cases. Consumers received a total of $172,433 in affirmative relief and $189,107 in debt forbearance. The average grant of relief on consumers’ affirmative claims was $5,389, an average of fifty-seven cents for every dollar claimed. The average grant of debt forbearance was $3,103.

- The median desk arbitration, decided only on documents, was resolved in four months; the median telephone arbitration was resolved in five months; the median in-person arbitration hearing was resolved in seven months; and when the arbitration settled, the median arbitration proceeding lasted two to five months. Consumers traveled an average of fifteen miles to attend an in-person hearing.

13. STUDY, supra note 7, § 1.4.1, at 9.
15. Id. § 1.4.2, at 11.
16. Id. § 3.3.1, at 3.
17. Id. § 5.5.1, at 19. The CFPB studied only AAA arbitrations because it is the “predominant administrator of consumer financial arbitrations.” Id. § 5.4, at 18.
18. Id. § 1.4.3, at 12.
19. Id.
20. Id. § 5.6.6, at 41.
21. Id. at 42.
22. Id. § 5.7.3, at 72.
23. Id. § 1.4.3, at 13.
The average class action settlement received final court approval in 1.89 years, and federal court multi-district litigation class actions filed in 2010 closed in a median of 2.07 years.\textsuperscript{24}

Before September 14, 2014, the consumer’s portion of the administrative and arbitrator fees charged by the AAA under its consumer rules was capped at $125. The business paid all of the remaining fees. Under the AAA’s revised consumer rules, the consumer’s share of those fees is capped at $200, with the business paying the remainder.\textsuperscript{25}

With respect to 562 putative class actions filed between 2010 and 2012 involving the six product markets studied by the CFPB, 25 percent were resolved through individual settlements and 35 percent were withdrawn by the plaintiff or dismissed for failure to prosecute or serve summons.\textsuperscript{26} Arbitration was a factor in 8 percent of the 562 class actions studied;\textsuperscript{27} the defendant filed a motion to compel arbitration in ninety-four (16.7 percent) of the cases, and in forty-six cases (49 percent) those motions were granted.\textsuperscript{28}

In 419 class actions covering at least 350,000,000 consumers that settled between 2008 and 2012, total gross relief, including cash payments, debt forbearance, in-kind relief, attorney’s fees, and costs, totaled $2.7 billion.\textsuperscript{29} $1.1 billion in cash and debt forbearance was provided to thirty-four million class members,\textsuperscript{30} an average of $32.35 per class member. In-kind relief totaled $644 million.\textsuperscript{31} Class counsel were awarded $424,495,451.\textsuperscript{32} In 105 class actions in which class members were required to submit claim forms, the average claims rate was 21 percent, the median was 8 percent, and the weighted average claims rate was 4 percent.\textsuperscript{33} The median time to approval of the final settlement was 560 days and the average time was 690 days.\textsuperscript{34}

From 2010 to 2012, an average of 1,150 individual actions were filed in federal court each year relating to five of the six product markets studied by the CFPB (auto purchase loans were not included).\textsuperscript{35}

\textsuperscript{24} Id. § 6.6.2, at 48; id. § 6.6.1, at 43.
\textsuperscript{25} Id. § 4.3, at 11. Moreover, consumers are permitted to apply for a hardship waiver if they cannot pay these amounts, and many arbitration provisions offer to pay them for the consumer if requested or unconditionally. Id. § 2.5.10, at 58–59; id. § 5.2.2, at 12; id. § 5.7.5, at 76–77.
\textsuperscript{26} Id. § 6.6.1, at 37.
\textsuperscript{27} Id. at 38.
\textsuperscript{28} Id. § 6.2.2, at 8–9; id. § 6.7.1, at 57–58.
\textsuperscript{29} Id. § 8.1, at 4; id. § 8.3.3, at 23.
\textsuperscript{30} Id. § 8.1, at 4; id. § 8.3.3, at 27–28.
\textsuperscript{31} Id. § 8.3.3, at 24.
\textsuperscript{32} Id. § 8.3.5, at 33.
\textsuperscript{33} Id. § 8.1, at 5.
\textsuperscript{34} Id.
\textsuperscript{35} Id. § 6.2.1, at 6.
quested jury trials in almost all of the cases.\textsuperscript{36} Almost half of the cases settled.\textsuperscript{37} In about 7 percent of the cases, the consumer established some company liability.\textsuperscript{38} Companies invoked arbitration in less than 1 percent of the cases.\textsuperscript{39} In seventy-three of seventy-four individual federal court cases in which a judgment was entered for the consumer, the average amount awarded was $5,245.\textsuperscript{40}

- In 2012, consumers in jurisdictions with a combined total population of eighty-five million filed fewer than 870 small claims court credit card claims, while credit card issuers filed more than 41,000 small claims cases against consumers, mostly debt collection cases.\textsuperscript{41}

- None of the 562 class actions studied by the CFPB went to trial.\textsuperscript{42} Of 341 cases resolved by an arbitrator, in-person hearings were held in 34 percent of the cases, and an arbitrator issued an award on the merits in about one-third of the cases.\textsuperscript{43}

- There were 1,150 enforcement actions filed between 2008 and 2012 by federal and state regulators. In 88 percent of those actions, the CFPB did not find an overlapping class action complaint.\textsuperscript{44}

- There was no statistically significant evidence of an increase in interest and fees charged by credit card companies that ceased using arbitration clauses in 2010 as compared to interest and fees charged by credit card companies that continued using arbitration clauses.\textsuperscript{45}

**Reactions to the Arbitration Study**

**Congressional Reaction**

Although the CFPB did not solicit formal comment letters regarding the Study, members of Congress, consumer advocates, and industry trade groups have voiced widely disparate views. In a letter dated May 21, 2015, fifty-eight Members of Congress urged the CFPB to adopt a regulation eliminating consumer arbitration clauses.\textsuperscript{46} The May 21 letter argued that the Study “underscores the

\begin{footnotes}
\footnote{36. Id.}
\footnote{37. Id. § 6.2.1, at 8.}
\footnote{38. Id.}
\footnote{39. Id.}
\footnote{40. Id. § 6.6.2, at 49 n.85.}
\footnote{41. Id. § 1.4.6, at 15–16. Most of the arbitration clauses reviewed by the CFPB contained small claims carve-outs. Id. at 15.}
\footnote{42. Id. § 6.2.2, at 7; id. § 6.6.1, at 38.}
\footnote{43. Id. § 5.2.2, at 11–12.}
\footnote{44. Id. § 1.4.8, at 17.}
\footnote{45. Id. at 17–18.}
\end{footnotes}
devastating effects of forced arbitration on tens of millions of consumers.” 47 According to the May 21 letter, the Study “found not only that more than three in four consumers were unaware of forced arbitration in their contracts, but also that consumers rarely use arbitration on an individualized basis, especially for small dollar claims, and that there is no evidence that forced arbitration lowers costs for consumers.” 48 By contrast, according to the May 21 letter, the Study’s “findings also demonstrate that forced arbitration clauses often prevent consumers from banding together through class actions, even though it is clear from the study that collective action more effectively compensates individuals and deters abusive corporate practices than arbitration on an individual basis.” 49 The May 21 letter urged the CFPB to “issue strong rules to prohibit the use of forced arbitration clauses in financial contracts and give consumers a meaningful choice after disputes arise.” 50

In response, another group of more than eighty Representatives and Senators sent a letter dated June 18, 2015, asking the CFPB to reopen the Study. 51 The June 18 letter asserted that the process that led to the Study was not “fair, transparent or comprehensive” and that, “[a]s a result, the flawed process produced a fatally-flawed study.” 52 It observed that “[r]ather than focusing on the critical question—whether regulating or prohibiting arbitration will benefit consumers—and devising a plan to address the issues relevant to resolving that question, the Bureau failed to provide even the most basic of comparisons needed to evaluate the use of arbitration agreements.” 53 By way of example, the June 18 letter stated that the CFPB failed to estimate “the transaction costs associated with pursuing a claim in federal court as compared to arbitration” or “the ability of a consumer to successfully pursue a claim in federal court without a lawyer, despite the fact that consumers often are self-represented successfully in arbitration proceedings.” 54 The June 18 letter called upon the CFPB to “reopen the study process, seek public comment, and provide the necessary cost-benefit analysis for understanding how a similarly situated consumer would fare in arbitration versus a lawsuit.” 55

CONSUMER REACTION

Consumer advocates applauded the Study. Dozens of public interest groups and unions joined in a March 24, 2015, letter commending the CFPB for issuing a report that “unequivocally demonstrate[s] that not only do forced arbitration

47. Id. at 2.
48. Id.
49. Id.
50. Id.
52. Id. at 1.
53. Id.
54. Id.
55. Id. at 2.
clauses impose conditions that restrict consumers’ rights and block their access to courts, but very few consumers actually go to individual arbitration to settle disputes.56 The March 24 letter “urge[d] the CFPB to initiate rulemaking to prohibit forced arbitration clauses in contracts for consumer financial services and products under its jurisdiction.”57 The authors also objected to avoiding class actions through arbitration clauses since “[e]liminating class actions prevents consumers from bringing financial services claims of fraud or other abusive or deceptive practices, because often such claims are too small for a consumer to be able to afford to bring alone,” while class actions allow “consumers who have suffered similar patterns of financial abuse from the same corporate wrong-doer to join together to hold the financial institution accountable.”58

Similarly, an article published on the website of the consumer advocate group Public Justice, commenting on the Study and a panel discussion of it sponsored by the CFPB, asserted that “[g]iven the reams of empirical data contained in the report, the industry-side panelists had little ground to stand on. Their responses consisted largely of nit-picking about the report’s methodology and doubling-down on their belief that arbitration is cheaper, faster, and fairer for consumers,” which a consumer advocate characterized as a “fairy tale.”59 The article concluded: “Given the content of the report, the wealth of arguments supporting its conclusions, and the empirically bankrupt arguments from the other side, it is hard to imagine that the Bureau won’t come down hard on these clauses, perhaps even banning them outright.”60

INDUSTRY REACTION

In contrast, industry trade groups found that the CFPB’s statistics supported consumer arbitration. In a comment letter dated July 13, 2015,61 the American Bankers Association, the Consumer Bankers Association, and The Financial Services Roundtable emphasized that the Study “includes a significant quantity of data demonstrating that arbitration is more beneficial to consumers than class action or even individual litigation” and that “[t]hese data weigh heavily against any regulation that would prohibit the use of arbitration provisions in consumer financial services contracts altogether, or materially condition or limit their use (for example, by banning the use of class action waivers).”62 Citing data identified in the Study, the July 13 letter contended that arbitration is faster and less

57. Id.
58. Id. at 2.
60. Id.
62. Id. at 6–7.
expensive than litigation, particularly class action litigation, and that consumers on average recover far more in arbitration than in class action litigation. The July 13 letter also argued that arbitration is not a barrier to class actions because only 8 percent of the class actions studied by the CFPB involved a motion to compel arbitration.

With respect to the “relatively low” number (1,847) of arbitration proceedings filed by consumers against financial services companies” cited in the Study, the July 13 letter asserted that no inference should be drawn that consumers prefer litigation to arbitration or that arbitration is an ineffective remedy compared to class actions. The letter pointed out that the vast majority of consumer disputes are resolved by informal methods without the need for arbitration or litigation, emphasizing that the CFPB itself has established a portal through which financial services companies resolved more than 558,800 alleged consumer complaints from July 2011 through March 1, 2015. The letter also asserted that governmental enforcement actions, including vigorous regulatory and supervisory activities by the CFPB itself, which resulted in $4.6 billion in redress for 15 million consumers through July 2014, have largely supplanted the alleged need for consumers to bring private actions. Also, in response to the CFPB’s conclusion that most consumers are not aware of the arbitration clauses in their contracts, the July 13 letter called upon the CFPB to educate consumers on the benefits that arbitration can provide to consumers compared to class action litigation.

**OTHER REACTION**

A critique of the Study by two law professors concluded that “[s]ome of the CFPB’s findings actually undermine several key arguments that are often asserted to justify restrictions on arbitration, such as the supposed unfairness of arbitration procedures.” For example, they observed that “the CFPB found that arbitration is such a simple and cheap process (now only requiring a $200 filing fee) that consumers achieve good outcomes even when they are not represented by counsel.” They further emphasized that “arbitration may be the only way for consumers to successfully seek outside redress without resort to hiring costly legal counsel.” The authors concluded that the CFPB’s Study “provides no foundation for imposing new restrictions or prohibitions on mandatory arbitration clauses in consumer contracts.”

63. Id. at 7–10.
64. Id. at 10.
65. Id. at 12.
66. Id.
67. Id. at 19.
68. Id. at 13.
70. Id. at 7.
71. Id. at 54.
72. Id. at 5.
CFPB Rulemaking Gets Underway

At a field hearing held in Denver, Colorado on October 7, 2015, the CFPB announced that it is considering rules that would prohibit consumer financial services companies from using class action waivers in their arbitration agreements. The CFPB made public an outline of its proposed arbitration rules in preparation for convening a Small Business Review (“SBREFA”) Panel to gather feedback from small industry stakeholders that might be impacted by the proposed rules if they become final. The SBREFA Panel, which was convened on October 28, 2015, is the first step in the process of rulemaking on the issue of consumer arbitration.

The CFPB’s proposed rules would prohibit companies from including arbitration clauses that block class action lawsuits in their consumer contracts. Thus, if the proposed rules become effective, companies will no longer be able to use class action waivers in consumer arbitration agreements in the numerous areas regulated by the CFPB–i.e., credit cards, checking and deposit accounts, prepaid cards, money transfer services, certain auto loans, auto title loans, small dollar or payday loans, private student loans, and installment loans.

The proposals would not ban consumer arbitration clauses in their entirety. However, for companies still willing to offer arbitration for individual (non-class) cases, the clauses would have to state explicitly that they do not apply to cases filed as class actions unless and until class certification is denied by the court or the class claims are dismissed in court. The CFPB may provide companies with specific “safe harbor” language to that effect that could be included in the companies’ arbitration agreements.

Companies would be permitted to give the consumer a choice of bringing a class arbitration or a class action in court. The CFPB acknowledged that many, if not most, companies would not include this option since, as one industry trade group has put it, class arbitration is “a worst-of-all-worlds Frankenstein’s monster.”

The CFPB’s proposed rules would also require that companies that choose to use arbitration clauses for individual disputes submit to the CFPB the arbitration claims filed and awards issued so that the CFPB can monitor the fairness of the

74. Id.
76. OUTLINE, supra note 73, at 14.
77. Id. at 17.
78. Id.
79. Id. at 18.
80. Id. at 18 n.55.
process.\textsuperscript{81} The CFPB is also considering publishing the claims and awards on its website so that the public can monitor them.\textsuperscript{82}

Any proposed rules will also be subject to a comment period pursuant to the Administrative Procedures Act.\textsuperscript{83}

We will have to wait and see whether the proposed rules conform to the CFPB’s Outline. It is important to note that, under the Dodd-Frank Act, any arbitration rules issued by the CFPB shall apply only “to an agreement between a consumer and a covered person entered into after the end of the 180-day period beginning on the effective date of the regulation as established by the [CFPB].”\textsuperscript{84}

In addition, the CFPB has indicated that it contemplates setting an effective date of thirty days after the rules are published.\textsuperscript{85} Therefore, it is likely that the rules will not apply to arbitration agreements entered into before 210 days after rules are published by the CFPB. All stakeholders in the consumer arbitration arena should pay close attention to these important developing events.

\textsuperscript{81} Id. at 19.
\textsuperscript{82} Id. at 20.
\textsuperscript{83} See 5 U.S.C. § 553(c) (2012) (“After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation.”).
\textsuperscript{84} 12 U.S.C. § 5518(d) (2012).
\textsuperscript{85} Outline, supra note 73, at 22.
Death by a Thousand Cuts: Update on Small-Dollar Lending

By Catherine M. Brennan, Justin B. Hosie, K. Dailey Wilson, and Erica A.N. Kramer*

INTRODUCTION

During the past year, small-dollar lenders continued to face increasing legal and regulatory scrutiny at the state and federal level.¹ One large lender blamed increasing regulatory pressure as the leading reason for ceasing to offer payday and title loans.² This survey reviews some of the key investigation, enforcement, litigation, legislation, and rulemaking developments since August 2014.

FEDERAL ENFORCEMENT ACTIONS

PAYPAL, INC.

In May 2015, the Bureau of Consumer Financial Protection (“CFPB”) announced the settlement of its enforcement action against PayPal, Inc. and its financing subsidiary, Bill-Me-Later, Inc. (“PayPal”).³ In its complaint, the CFPB took direct aim at PayPal’s credit product, PayPal Credit, formerly known as Bill-Me-Later, which allows consumers to pay over time, for a fee, for online and in-store purchases.⁴ The CFPB’s claims focused on advertising, enrollment practices, payment processing, and payment allocation.⁵

The CFPB alleged that PayPal’s advertising was deceptive because PayPal repeatedly offered promotional credit or money back, but did not honor the

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² See Adam Rust, Fearing Regulatory Horizon EZCorp Says It Will Cease Consumer Lending, BANK TALK (Aug. 4, 2015), http://banktalk.org/content/fearing-regulatory-horizon-ezcorp-says-it-will-drop-payday-lending.


⁵ Id.
offers. PayPal also allegedly enrolled some of its customers in PayPal Credit and its electronic billing method without their knowledge or consent, simply because those customers established a PayPal account. The CFPB asserted that this constituted an unfair practice because it caused substantial injury to consumers that they could not reasonably avoid. This injury included a credit report inquiry that impacted consumers’ credit scores, as well as accrued interest and late fees for failing to pay an account they did not know existed.

Additionally, PayPal allegedly caused consumers to pay for purchases with PayPal Credit even where they expressly sought to use a different payment method. Once a PayPal Credit account was established, it allegedly became the default payment method for all purchases, causing consumers to use the account even though they intended to use another payment method, such as a linked bank account. The CFPB also asserted that PayPal abusively applied payment amounts in excess of the minimum payment to lower interest balances, leaving higher interest balances to continue to accrue higher interest. The CFPB asserted that consumers could not clearly understand how PayPal Credit applied payments to deferred-interest promotions, and that it applied payments in a way that consumers would not have chosen.

To settle the lawsuit, PayPal agreed to pay $15 million to consumers who were mistakenly enrolled in PayPal Credit, who mistakenly paid for a purchase with PayPal Credit, or who incurred fees or deferred interest because of inadequate disclosures and flawed customer-service practices. PayPal also agreed to improve its consumer disclosures and to pay a $10 million fine.

OTHER FEDERAL ENFORCEMENT ACTIONS

In January 2015, the Federal Trade Commission (“FTC”) announced enforcement actions against two title lenders, First American Title Lending of Georgia, LLC and Finance Select, Inc., based on allegedly deceptive advertising involving introductory offers of a zero percent rate used to market their title loans. In a decision in one of the enforcement actions, the FTC ordered the title lender to, among other things, not state an introductory or temporary finance charge with-
out clearly and conspicuously disclosing the finance charge after the introductory or temporary period ends.\textsuperscript{17}

In February 2015, the FTC sued Payday Support Center, LLC, a debt relief services provider, and related parties (“PSC”) for deceptive practices in violation of the FTC Act and the Telemarketing Sales Rule.\textsuperscript{18} The FTC alleged that PSC falsely represented that it would pay off, restructure, or eliminate consumers’ payday loans.\textsuperscript{19} The FTC also alleged that PSC fraudulently represented that consumers’ creditors generally would cancel their payday loans after receiving a form letter requesting “validation” of the loans and that their payments to PSC would be applied to pay off their payday loans.\textsuperscript{20} The FTC also alleged that PSC fraudulently claimed that its fee for services was only a small portion of the consumers’ program payments to PSC.\textsuperscript{21} As of this writing, the case was not resolved.

In July 2015, Adrian Rubin pleaded guilty to U.S. Department of Justice (“DOJ”) charges that he conspired to evade state usury laws and other restrictions on payday loans by engaging in deceptive business practices in violation of the Racketeer Influenced and Corrupt Organizations Act (“RICO”).\textsuperscript{22} In its press release announcing the charges, the DOJ claimed that Rubin violated RICO and federal laws banning mail and wire fraud by paying a federally insured bank, which was not subject to state laws, “to pretend that it was the payday lender.”\textsuperscript{23} The DOJ also claimed that Rubin paid “an Indian tribe to pretend” that it was the actual payday lender as part of a scheme to have the tribe claim that “sovereign immunity” prevented application of state usury laws and other regulations.\textsuperscript{24}

\textbf{STATE ENFORCEMENT ACTIONS AND INVESTIGATIONS}


19. \textit{id.} at 11.

20. \textit{id.}

21. \textit{id.} at 12.


24. \textit{id.}

Source used celebrity Montel Williams to generate leads for payday loans and allegedly represented to consumers that Montel Williams would not have endorsed Selling Source “if it were not a legitimate company.”

According to the consent order, Selling Source violated New York law by advertising loans to New York consumers that exceeded the 16 percent cap on interest for unlicensed non-bank lenders. NYDFS also took note of Selling Source’s targeting of consumers for loan rollovers. To settle the enforcement action, Selling Source agreed to pay a $2.1 million civil penalty. Selling Source also agreed to withdraw from the New York market and to place a clear and conspicuous statement on its websites indicating that payday loan referrals are “not available in New York or to New York borrowers due to interest rate limits under New York law.”

In March 2015, the Virginia Attorney General launched a comprehensive effort targeted at predatory lending. In July 2015, he filed a lawsuit against B&B Pawnbrokers, Inc. for allegedly “making illegal, unlicensed motor vehicle title loans, and for charging excessive fees.” The complaint sought restitution on behalf of consumers, civil penalties, attorney’s fees, and injunctive relief.

The Connecticut Department of Banking pursued action against a group of online lenders organized under the laws of the Otoe-Missouria Tribe of Indians, alleging that they made usurious and unlicensed loans. The lenders allegedly solicited business from Connecticut residents via mail, e-mail, and its website. The Department issued an administrative cease-and-desist order and ordered the defendants to pay civil penalties and restitution. After failing to obtain dismissal of the order, the defendants appealed the decision to Connecticut state court.


27. Id. at 5.
28. Id. at 7.
29. Id. at 8.
30. Id. at 11.
35. Id.
36. Id.
In November 2014, the Pennsylvania Attorney General issued a press release announcing a consumer protection lawsuit against several Texas-based corporations, alleging that they used an Indian tribe as a cover to provide payday loans, which are illegal in Pennsylvania. The lawsuit sought injunctive relief, restitution, civil penalties, and removal of negative credit reporting information from affected consumers’ credit reports.

**State Legislation**

Several states enacted legislation during the past year that made significant changes to the laws that regulate small-dollar lending. Georgia House Bill 299, effective May 6, 2015, applies to: loans made pursuant to the Georgia Industrial Loan Act, retail installment and home solicitation sales under the Retail Installment and Home Solicitation Sales Act, motor vehicle sales financing contracts entered into pursuant to the Motor Vehicle Sales Finance Act, and insurance premium finance agreements. The law permits a lender or merchant to collect a nonrefundable convenience fee from any person who chooses to pay electronically. The convenience fee must be in an amount equal to the actual cost borne by the lender or merchant. However, the law permits an alternative, under which a lender or merchant may impose a convenience fee that does not exceed the average cost of the electronic payment method. Convenience fees are prohibited unless a lender or merchant also provides a direct payment option by check, cash, or money order. A convenience fee cannot be imposed for the direct payment method. The new law also imposes notice requirements regarding convenience fees.

Indiana House Bill 1287 revises, effective July 1, 2015, the Indiana Code to require that all those regularly engaging in making small loans to have a small loan license. The newly revised statutory provision prohibits any person from “regularly engaging” in making small loans, taking assignment of small loans, or “undertaking the direct collection of payments from or the enforcement of rights against debtors arising from small loans” without a license. Those

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40. Id.
42. Id. § 13-1-15.
43. Id. § 13-1-15(a)(1).
44. Id. § 13-1-15(a)(2), (b).
45. Id. § 13-1-15(c).
46. Id.
47. Id. § 13-1-15(d).
48. Ind. Code Ann. § 24-4.5-7-102 (West, Westlaw current through end of 2015 1st Reg. Sess.). A person “regularly engages” in making small loans, taking assignment of small loans, or undertaking the direct collection of payments of small loans if he or she either (a) performs any of the aforementioned activities one time in the previous calendar year or (b) performs or will perform any of the aforementioned activities one time in the current calendar year. Id. § 24-4.5-7-102(7).
49. Id. § 24-4.5-7-102(2).
engaging in these activities as both small loan lenders and consumer lenders in Indiana must obtain both the small loan license and the consumer loan license—merely holding the consumer loan license will not be sufficient. 50 Similar prohibitions on making small-dollar loans were enacted in Connecticut and Oregon. 51 The new Indiana law also prohibits lenders from imposing payment plan terms that would require payments before the original maturity date of the outstanding small loan. 52 In addition, if a borrower is eligible for a payment plan and has not entered into one, then the new limitations prohibit lenders from entering into a new small loan with the borrower. 53 Nevada Senate Bill 242, the Payday Lender Best Practices Act, effective October 1, 2015, 54 requires licensees under the deferred deposit, high interest, and title loan provisions to adhere to eleven so-called best practices. 55 Those practices include disclosure requirements, 56 procedural requirements, 57 and advertising notice requirements. 58 The law also sets forth several other provisions that mimic already existing requirements under Nevada law. 59

Through House Bill 644, effective January 1, 2016, 60 New Hampshire completely overhauled its statute that regulates small loans, payday loans, and title loans. 61 For example, the phrase “small loan” was revised to mean any title loan, payday loan, open-end loan, or closed-end loan that is $10,000 or less with an annual percentage rate of 10 percent or more. 62 Certain fees are exempted from interest under this definition of a small loan, including fees paid to a public official for filing or recording and the reasonable costs and fees associated with the repossession and sale of a security. 63

South Dakota House Bill 1027, effective July 1, 2015, 64 revised the South Dakota Money Lending Licenses Act in several respects, including explicitly defining the term “business of lending money.” 65 Under existing South Dakota law,
any person that engages in the business of lending money is required to have a money lender’s license. The term business of lending money now includes “originating, selling, servicing, acquiring, or purchasing loans, or servicing, acquiring, or purchasing retail installment contracts.”

**CFPB Proposal for Small-Dollar Lending Rulemaking**

Pursuant to the consultation process required by the Small Business Regulatory Enforcement Fairness Act, the CFPB announced in March 2015 that it is considering proposing rules covering several types of small-dollar lending: payday loans; deposit advance products; vehicle title loans; installment loans with an “all-in” annual percentage rate above 36 percent per year involving either an account access device, e.g., checks, automated clearinghouse authorizations, or a vehicle title as security; and open-end lines of credit. The proposal does not cover non-recourse pawn transactions involving taking possession of the pawned item, rather than taking possession of the title. The proposal also excludes credit card accounts, real estate secured loans, student loans, and deposit account overdraft services.

The proposal under consideration includes prevention and protection requirements. Under the prevention requirements, consumers would be required to prove an ability to repay before entering a covered transaction. Under the protection requirements, various restrictions would limit the specific terms of transactions without an ability-to-repay requirement.

The proposal will also delineate between short-term credit and long-term credit. Short-term credit covered by the proposal will involve transactions with a term of forty-five days or less, and such transactions would be governed by either an ability-to-repay requirement or an alternative set of requirements. Long-term credit transactions are those with terms over forty-five days involving an all-in annual percentage rate above 36 percent that include either an

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66. Id.
67. Id. § 54-4-36(1).
70. Id. at 7.
71. Id.
73. See CFPB Outline, supra note 69, at 11–13, 22–23.
74. Id. at 16, 26–27.
75. Id. at 7, 19.
76. Id. at 7.
77. The CFPB Outline states that the CFPB is “considering using an annualized cost of credit measure that would include interest, fees, and the cost of ancillary products such as credit insurance, memberships, and other products sold along with the credit. One possible measure is the military annual percentage rate defined in 32 CFR 232.” Id. at 7 n.10.
account access device or a vehicle title as security. 78 Like the short-term transactions, long-term transactions would be governed by either an ability-to-repay requirement or an alternative set of requirements. 79 The proposals under consideration would also impose collection, recordkeeping, and procedural requirements on all credit types. 80

The proposal states that the CFPB believes that these restrictions would lead to a substantial reduction in the volume of covered loans and fees generated. 81 Noting “a number of sources of uncertainty” 82 and that its figures “should not be taken as lower or upper bounds on the impact” 83 of the proposal, the CFPB nonetheless predicted that storefront short-term payday loan volume would fall by 69 percent to 84 percent. 84 No similar prediction was made for short-term title loan volume or for installment lending volume.

78. Id. at 19–20.
79. Id.
80. Id. at 28–31.
81. Id. at 40.
82. Id. at 41.
83. Id. at 43.
84. Id.
“Abusive” Acts or Practices Under the CFPA’s UDAAP Prohibition

By Laurie A. Lucas, Adam D. Maarec, and John C. Morton*

INTRODUCTION

This survey reviews the Bureau of Consumer Financial Protection’s (CFPB’s) enforcement actions involving allegations of abusive conduct taken under the authority of the Consumer Financial Protection Act of 20101 (“CFPA”), which, among other things, prohibits unfair, deceptive, and abusive acts or practices (“UDAAP”).2 The Federal Trade Commission (“FTC”) has long had the power to prohibit unfair and deceptive acts or practices,3 and there is a well-developed body of precedent defining those terms.4 The CFPA added “abusive” to the statutory list of prohibited acts and practices and vested independent enforcement authority in the CFPB.5 The CFPA also granted UDAAP enforcement powers to state attorneys general and state regulators.6 The CFPB has engaged in a significant number of UDAAP-based enforcement actions and several of those actions have alleged “abusive” practices. While this survey primarily focuses on actions alleging abusive acts and practices, such actions cannot be divorced from the collective UDAAP doctrine. Most enforcement actions that involve claims of abusive acts or practices are based on facts that also serve as the basis for allegations of unfair or deceptive acts or practices. When relevant, allegations of unfairness or deception are included in the discussion below.

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6. Id. § 5552(a).
The New “A” in UDAAP

Under the CFPA, if an “act or practice . . . materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service,” the CFPB has the authority “to declare [that] act or practice [to be] abusive.”7 An act or practice also may be declared abusive if it “takes unreasonable advantage of” a consumer’s “lack of understanding” regarding “the material risks, costs, or conditions” of a consumer financial product or service, a consumer’s “inability” to protect his or her own interests, or a consumer’s “reasonable reliance” on the belief that the “covered person” was acting in “the interests of the consumer.”8 This statutory definition is broad and arguably subjective in nature. As a result, a review of enforcement actions filed by the CFPB is instructive as to how the term “abusive” has been applied in practice and provides insight into the CFPB’s interpretation of the term.

ACE Cash Express, Inc.

In In re ACE Cash Express, Inc.,9 the CFPB entered into a consent order with ACE Cash Express, Inc. (“ACE”) to resolve allegedly unlawful debt collection activities. ACE offered payday loans to consumers through brick-and-mortar retail outlets and the Internet.10 ACE’s loan products typically required repayment within two weeks, but consumers would often “roll over, renew, or refinance their loans,” incurring additional charges.11 If a consumer defaulted, ACE would use either its own in-house collections process or outsource collections to a third-party debt collector.12

The CFPB alleged that ACE’s in-house and third-party debt collectors worked to create a “sense of urgency” on the part of consumers by calling them excessively, disclosed that the debt existed to parties with no liability on the debt, and failed to cease making calls to consumers who were at work, where calls

7. Id. § 5531(d)(1).
8. Id. § 5531(d)(2)(A)–(C).
10. Id. at 3.
11. Id. at 3–4.
12. Id. at 4. ACE apparently ceased using third-party debt collectors in September 2013. Id. This enforcement action also illustrates how the UDAAP provisions of the CFPA may effectively extend the CFPB’s enforcement authority beyond the scope of existing consumer protection laws like the Fair Debt Collection Practices Act, which is generally not applicable to creditors collecting their own debts. See 15 U.S.C. § 1692a(6)(A)–(F) (2012). UDAAP-based enforcement actions also effectively extend the CFPB’s authority to entities historically not subject to financial regulators (like telecommunications companies) but now arguably covered by the CFPA. See, e.g., Stipulated Final Judgment and Order, CFPB v. Celco P’ship, No. 3:15-cv-03268-PHS-LHG (D.N.J. May 12, 2015), http://files.consumerfinance.gov/f/201505_cfpb-cfpb-v-verizon-proposed-order.pdf (finding unfair practices against telecommunications company Verizon Wireless for unauthorized charges to consumers’ bills by third parties); Stipulated Final Judgment and Order, CFPB v. Sprint Corp., No. 14-cv-09931 (S.D.N.Y. May 12, 2015), http://files.consumerfinance.gov/f/201505_cfpb-cfpb-v-sprint-corporation-proposed-order.pdf (same against Sprint Corp.).
were prohibited, or were represented by counsel after being informed of the representation. 13 ACE allegedly engaged in these practices “to induce delinquent borrowers with a demonstrated inability to repay their existing loans” to refinance the loans with new loans and incur the attendant fees. 14 The allegedly abusive act or practice was the creation of a sense of urgency that allowed ACE to take “unreasonable advantage of the inability of [these] consumers to protect their own interests” when choosing whether to enter into another loan. 15 The CFPB also alleged that these same acts and practices were unfair under the CFPA. 16 An act or practice is considered unfair if it “causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and . . . such substantial injury is not outweighed by countervailing benefits to consumers or to competition.” 17

Finally, the CFPB also claimed that other acts and practices engaged in by ACE were deceptive. 18 While not defined in the CFPA, the CFPB has indicated that acts or practices may be considered deceptive if they “are likely to mislead consumers acting reasonably under the circumstances and [such acts or practices] are material.” 19 The CFPB’s allegations of deceptive acts or practices asserted against ACE and its third-party debt collectors included misrepresentations made to consumers about ACE’s ability to prevent the transfer of their debts to third-party debt collectors or what might happen once their debts were transferred; ACE also falsely threatened to sue consumers, to report their debts to credit bureaus, to refer their debts for criminal prosecution, and to add various collection fees to their debts. 20 Among other things, ACE was ordered to pay $5 million in restitution and $5 million in civil money penalties. 21

**College Education Services LLC**

In *CFPB v. College Education Services LLC*, 22 the CFPB made allegations of abusive acts or practices against Coll. Education Services LLC, its owner, and an employee (“CES”). CES was charged with numerous violations of law stemming from CES’s allegedly deceptive telemarketing of student loan debt-relief services

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13. ACE Consent Order, supra note 9, at 10–11.
14. Id. at 11.
15. Id.
16. Id. at 9. An additional act or practice the CFPB alleged as unfair, but not abusive, was ACE’s failure to cease calls after being informed that it was contacting the wrong person. Id.
18. ACE Consent Order, supra note 9, at 10.
20. ACE Consent Order, supra note 9, at 10.
21. Id. at 17, 21.
to consumers. In addition, many of the same practices the CFPB alleged to be abusive also were alleged to be deceptive.

The CFPB’s allegations included charges that CES “targeted” consumers who were “financially distressed” through “sophisticated and expensive Internet-marketing campaigns,” which directed consumers’ searches to CES. Consumers who called a toll-free number or gave contact information on a website were then contacted “within five minutes . . . and twice a day for up to 10 days” until a CES representative made contact with the consumer. CES’s telemarketers contacting these consumers referred to themselves as “counselors and advisors,” followed a script without regard to the consumers’ individual financial situation, and “promised that the result [was] . . . 100% guaranteed,” all while charging advance fees ranging “between $195 and $2,500 . . . with the average fee being about $500.” Despite CES’s guarantees, CES allegedly failed to provide consumers with an individual assessment of their loans and to properly advise them of their options for loan consolidation. In addition, the CFPB alleged that CES misled these consumers about options related to loan forgiveness and made unsubstantiated claims that CES’s services would improve the consumers’ credit scores. The CFPB further claimed that some consumers’ loan payments actually increased as a result of the services.

The CFPB alleged that these actions were abusive because they resulted in CES taking “unreasonable advantage” of these consumers’ “reasonable reliance” on representations that CES was acting in the consumers’ “interests.” Specifically, the CFPB claimed that CES worked to create an “illusion of expertise and individualized advice” in order to “induce consumers to reasonably rely on the company to act in their interests in seeking and selecting student loan debt-relief
plans.” The CFPB further asserted that many of the same acts and practices alleged to be abusive also were deceptive, including CES’s unsubstantiated claims about improvements in consumers’ credit scores and their financial situation and CES’s guarantee that it could quickly achieve results. The company, its owner, and one of its employees were banned from offering any debt-relief services, were ordered to pay the CFPB $25,000, and were ordered to pay the Florida Attorney General $10,000 in civil penalties and $15,000 for investigative and attorney’s fees.

**FORT KNOX NATIONAL CO.**

In *In re Fort Knox National Co.*, Fort Knox National and its subsidiary Military Assistance Company (“Fort Knox”) entered into a consent order with the CFPB to resolve allegedly abusive practices in connection with undisclosed military allotment account fees. Fort Knox managed a program designed to process military payroll deductions, which are referred to as “allotments,” in order to pay servicemembers’ creditors. The CFPB claimed that Fort Knox would routinely charge fees against excess funds in these military allotment accounts that would accumulate after the designated creditors had been paid in full (“residual balances”), and that Fort Knox failed to give adequate disclosure or notification to servicemembers about the practice. The CFPB further claimed that servicemembers did not receive paper or electronic account statements and did not have the capability or option to view charges online when they accessed their accounts. The CFPB alleged that, as a result, Fort Knox’s failure to notify the account holders about the residual balances in their accounts permitted Fort Knox to take “unreasonable advantage of Servicemembers’ inability to protect their interests in selecting or using [Fort Knox’s] allotment product or service.” The CFPB alleged that this practice was abusive and resulted in Fort Knox charging “tens of thousands of Servicemembers [improper] Residual-Balance Fees totaling millions of dollars.”

The CFPB also alleged that these same acts and practices were unfair because they caused “substantial injuries” to account holders without “any countervailing

33. College Education Complaint, supra note 22, at 15.
34. Id.
36. Id. at 6.
37. Id. at 8.
39. Id. at 5.
40. Id. at 5–6.
41. Id. at 6.
42. Id. at 8.
43. Id. at 5.
benefits to Servicemembers or to competition.” Additionally, the CFPB alleged that Fort Knox’s failure to explain the residual balance fees or notify account holders before or after these fees were charged was deceptive because the practices were likely to “mislead consumers acting reasonably under the circumstances” given “that [such] information [was] material to consumers.”

Among other relief, Fort Knox was required to cease such practices and pay nearly $3.1 million to the CFPB for consumer redress.

**PayPal, Inc.**

*CFPB v. PayPal, Inc.* provides another example of acts or practices that the CFPB alleged were both abusive and unfair. PayPal offers consumers using its online payment system a convenient way to make secure payments to third-party vendors. Beginning in 2008, PayPal began offering consumers the ability to use PayPal Credit in addition to the consumers’ preexisting preferred method of payment. The CFPB claimed that PayPal enrolled consumers in, and processed payments through, the credit product without consent or authorization; failed to accept, process, or timely post consumers’ payments; and failed to adequately or timely address billing disputes, including disputes about crediting payments, processing refunds, honoring advertised promotions, unauthorized charges, and double billing.

The CFPB alleged that only some of these practices were abusive. PayPal’s marketing promotions indicated that consumers would be able to control how payments were allocated if the consumer had multiple accounts, particularly accounts marketed as “deferred-interest promotions.” Despite representing to consumers that they could receive and request information about the payment allocation process and specify payment allocations to various outstanding balances by contacting PayPal’s customer service, the CFPB alleged that PayPal’s customer service representatives were often unreachable, provided “misinformation” when they were successfully contacted, and “often ignored” consumers’
specific instructions related to their payment preferences. The CFPB asserted that these practices were abusive because they allowed PayPal to take “unreasonable advantage” of the consumers’ ability to select or use PayPal’s products. PayPal was ordered to pay $15 million in redress to consumers affected by such acts and practices, in addition to a $10 million civil money penalty.

**COLFAX CAPITAL CORP.**

In *In re Colfax Capital Corp.*, the CFPB’s allegations of unfair and deceptive acts or practices again served as the basis for claims of abusive conduct. Colfax Capital offered open-end credit to finance purchases of consumer goods from third-party retailers that marketed to servicemembers. The CFPB alleged that Colfax Capital’s loan agreements unfairly and deceptively included finance charges that were hidden in inflated prices of the retail goods. In addition, the CFPB asserted that when the cost of credit was properly computed, the credit agreements were void under state usury laws and that servicing and collecting these loans was therefore unfair, deceptive, and abusive. Specifically, the CFPB claimed that, since most consumers would be unaware of how state usury and licensing laws might affect their rights, or that their debt obligations were void, Colfax Capital’s collection of the debts was abusive because the practice took “unreasonable advantage of these consumers’ lack of understanding.” Colfax Capital was liquidated in bankruptcy and, according to CFPB Assistant Director Holly Petraeus, “consumers will no longer have to pay on the more than 17,000 outstanding finance agreements, amounting to a total of about $92 million in debt relief for consumers.”

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52. Fort Knox Consent Order, supra note 38, at 15. The CFPB alleged that PayPal’s policy was to apply such payments “proportionately to all deferred-interest promotional balances with the same [interest] rate, . . . regardless of expiration date, unless a promotion was expiring within two billing cycles, in which case excess payments would be applied to that promotion.” Id. at 9
53. Id.
55. Id. at 9.
58. Colfax Consent Order, supra note 56, at 1.
59. Id. at 9.
60. Id. at 8–9.
61. Id. at 12.
CONDOR CAPITAL CORP.

In Lawsky v. Condor Capital Corp.,63 the New York Department of Financial Services (“NYDFS”) was one of the first state regulators to bring allegations of abusive acts or practices under the federal UDAAP authority.64 The NYDFS alleged that Condor Capital, an installment lender, failed to notify borrowers when overpayments on accounts had been made and retained credit balances when accounts were closed, rather than refunding the credit balance to the borrower.65 The NYDFS also alleged that Condor Capital “actively concealed” the existence of these credit balances and “intentionally and deceptively program[ed] its customer-facing web portal” to automatically keep customers from accessing their online accounts immediately after a debt had been paid in full.66 The NYDFS claimed that this practice was “false and misleading,”67 as well as abusive, given that the practice resulted in an “abusive theft of funds from customers.”68

The NYDFS also alleged that Condor Capital engaged in “serious and abusive wrongdoing . . . [with its] reckless endangerment of customers’ personally identifiable information.”69 While statements on Condor Capital’s website indicated that the company had adequate information security systems, it “failed to employ reasonable and appropriate measures to protect the private and confidential personal and financial information of its customers.”70 The NYDFS noted, for example, that Condor Capital “fail[ed] to adhere to the most basic information security policy, known as a ‘clean desk’ policy, which all businesses handling sensitive customer data must follow.”71 Condor Capital’s failure to maintain basic security measures was abusive, particularly given that borrowers had no way of knowing that the representations about security were false and they therefore would be unable “to protect their own interests.”72 The NYDFS also alleged that this practice was unfair because it had “no countervailing benefits to consumers or competition.”73 Other acts that were specifically identified as “abusive” included using “false and inaccurate information” to harass and threaten customers and

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66. Id.
67. Id. at 15.
68. Id. at 3.
69. Id. at 7.
70. Id. at 15.
71. Id. at 8.
72. Id. at 16.
73. Id. at 15.
others, sending inaccurate information to credit agencies, improperly imposing fees and other charges, and making unauthorized charges.\textsuperscript{74}

In a subsequent settlement, Condor Capital was required to pay restitution of more than $6.5 million and a $3 million civil penalty.\textsuperscript{75} It was also required to admit that it violated state and federal laws,\textsuperscript{76} to sell any loans remaining in its portfolio,\textsuperscript{77} and to surrender all of its state licenses to make or acquire consumer loans.\textsuperscript{78}

**Conclusion**

This survey reviews specific facts and circumstances involved in enforcement actions by the CFPB and other regulators under the UDAAP doctrine, especially the few actions to date involving allegations of abusive acts or practices, which may help practitioners better understand this new and rapidly evolving UDAAP standard. Most of these actions were resolved through settlements, without judicial interpretation, and that fact is noteworthy.\textsuperscript{79} When judicial opinions interpreting the UDAAP standard are eventually issued, they may provide helpful precedent that practitioners should monitor closely.

\textsuperscript{74} Id. at 10.
\textsuperscript{76} Id. at 3–6.
\textsuperscript{77} Id. at 7–10.
\textsuperscript{78} Id. at 13–14.
\textsuperscript{79} But cf. CFPB v. ITT Educ. Servs., Inc., No. 1:14-cv-292, 2015 U.S. Dist. LEXIS 28254, at *59–60 (S.D. Ind. Mar. 6, 2015) (denying motion to dismiss on the merits of the claims and also on argument that statutory language defining abusive acts and practices was vague and therefore unconstitutional); Illinois v. CMK Invs., Inc., No. 14-cv-2783, 2014 WL 6910519, at *6–7 (N.D. Ill. Dec. 9, 2014) (rejecting the defendant’s argument that an “account protection fee,” which was the practice alleged to be abusive as well as unfair and deceptive, should not be counted in the calculation of interest charged, and denying defendant’s motion to dismiss); Illinois v. Alta Colls., Inc., No. 14-cv-3786, 2014 WL 4377579, at *3–4 (N.D. Ill. Sept. 4, 2014) (rejecting defendant’s claim that UDAAP standard is unconstitutionally vague).
Consumer Lending to Military Members: The Military Lending Act Final Rule and Servicemembers Civil Relief Act Enforcement

By Nessa Feddis and Robert Savoie*

INTRODUCTION

The past year saw a new rule that dramatically expands the scope of the Military Lending Act (“MLA”)1 and an increase in, and expansion of, the Department of Justice’s (“DoJ’s”) enforcement of the Servicemembers Civil Relief Act (“SCRA”).2 The amendments to the MLA regulation broaden its scope to include many types of credit previously not covered and shifts the responsibility for identifying military status from the applicant to the lender. The increase and expansion of SCRA enforcement extends SCRA liability to assignees, effectively creates new servicing obligations with respect to servicemembers requesting SCRA protections, and emphasizes the need for strict compliance with the SCRA’s requirements. These and other changes are discussed below.

THE MILITARY LENDING ACT FINAL RULE

BACKGROUND AND INTRODUCTION

After the MLA was enacted in 2006, the implementing regulation was adopted in 2007.3 The 2007 final rule limited the MLA to a narrow range of specific products, which included “payday loans, vehicle-title loans, and refund anticipation

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3. Limitations on Terms of Consumer Credit Extended to Service Members and Dependents; Final Rule, 79 Fed. Reg. 50580 (Aug. 31, 2007) (to be codified at 32 C.F.R. pt. 232). The narrow application of the 2007 final rule was based on a 2006 DoD report to Congress that focused specifically on payday loans, vehicle title loans, rent to own products, refund anticipation loans, and military installment loans and identified “characteristics associated with predatory lending.” Id. at 50581 (citing DEP’T OF DEF., REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS 2–3 (Aug. 2006)).
loans.”4 Specifically, the 2007 final rule covered closed-end loans of $2,000 or less with a term of no more than ninety-one days; closed-end credit with a term of no more than 181 days, secured by a vehicle title; and tax refund anticipation loans.5

On July 22, 2015, the Department of Defense (“DoD”) published final amendments to the MLA regulation (“Final Rule”).6 The Final Rule significantly expands coverage to include all consumer credit except for residential mortgages and purchase money loans.7 The Final Rule also revised, and arguably expands, the definition of “covered borrower.”8

Under the Final Rule, lenders making covered loans containing any prohibited terms must determine the military status of all applicants in order to deny the loan or modify the loan terms.9 The Final Rule has been described as limiting the interest rate or rate charged to covered borrowers to 36 percent.10 However, the Final Rule’s rate cap is an “all-in” military annual percentage rate (“MAPR”) that includes all fees, including, in most cases, application11 and participation fees.12 Moreover, the Final Rule includes other, often overlooked prohibitions.13 Finally, the Final Rule modified the disclosure requirements under the MLA, and covered borrowers must receive special oral and written disclosures.14 Compliance is required by October 3, 2016,15 except that for credit cards, the date is October 3, 2017,16 which the Secretary of Defense may extend an additional year.17

**DEFINITION OF COVERED BORROWER**

The Final Rule defines covered borrower as “a consumer who, at the time the consumer becomes obligated on a consumer credit transaction or establishes an

4. Id. at 50585 (“DoD believes that a narrow definition [of consumer credit] will prevent unintended consequences while affording the protections granted by the statute.”).
5. Id. at 50585–86 (explaining and defining these products).
7. Id. at 43579–80.
8. Id. at 43580 (to be codified at 12 C.F.R. § 232.2(g)) (“The Department . . . believes that the definition of ‘dependent’ hereby adopted in the final rule appropriately carries out the intent to simplify the process for determining which family members are covered under 10 U.S.C. [§] 987.”).
9. Id. at 43585 (to be codified at 12 C.F.R. § 232.5).
10. See CFPB Statement on Department of Defense Military Lending Act Final Rule, CONSUMER FIN. PROT. BUREAU (July 21, 2015), http://www.consumerfinance.gov/newsroom/clpb-statement-on-department-of-defense-military-lending-act-final-rule/ (“[T]he law limits the annual rate on an extension of such credit to 36 percent . . . .”); Final Rule, supra note 6, at 43560 (“[T]he MLA limits the amount of interest that a creditor may charge . . . to a maximum annual percentage rate of 36 percent.”).
11. Final Rule, supra note 6, at 43608 (to be codified at 32 C.F.R. § 232.4(c)(1)(iii)(B)).
12. Id. (to be codified at 32 C.F.R. § 232.4(c)(1)(iii)(C)). Some fees may be excluded from the MAPR under limited circumstances. Id. (to be codified at 32 C.F.R. § 232.4(d)).
13. Id. at 43610 (to be codified at 32 C.F.R. § 232.8).
14. Id. at 43610 (to be codified at 32 C.F.R. § 232.6).
15. Id. at 43612 (to be codified at 32 C.F.R. § 232.13(a)).
16. Id. (to be codified at 32 C.F.R. § 232.13(c)(1)).
17. Id. (to be codified at 32 C.F.R. § 232.13(c)(2)).
account for consumer credit, is a covered member . . . or a dependent . . . of a covered member.”18 A “covered member” is a member serving on either active duty or under a call or order that does not specify a period of thirty days or fewer, or active guard and reserve duty; “[d]ependents” includes spouses.19

DETERMINATION OF COVERED BORROWER

To determine military status conclusively, lenders must either use information “obtained directly or indirectly from” the DoD’s database (“MLA database”)20 or use information describing military status, “if any, contained in a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis.”21 While the regulation provides that determination of status is based on the covered member’s status at the time the loan is made,22 if the lender relies on the MLA database or a consumer reporting agency to determine military status, it may make the determination thirty days prior to the time the consumer establishes an account.23 Concerns have been raised about the historical lack of reliability, availability, and accuracy of the MLA database.24 In addition, the three nationwide consumer reporting agencies at this time may not provide military status information.

The safe harbor that had previously permitted lenders to rely on an applicant’s declaration25 also has been eliminated, based on the DoD’s awareness that military personnel and their spouses and dependents were making false statements about their military status.26 The DoD emphasizes that accessing the MLA database or a consumer reporting agency to determine military status is “optional.”27 However, relying on a method not covered by the safe harbor risks violation of the regulation and significant penalties. Curiously, the Final Rule prohibits creditors, including assignees, from directly or indirectly obtaining any historical information from any DoD database “to ascertain whether a consumer had been a

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18. Id. at 43607 (to be codified at 32 C.F.R. § 232.3(g)(1)).
19. Id. (to be codified at 32 C.F.R. § 232.3(g)(2)–(3)).
20. Id. at 43609 (to be codified at 32 C.F.R. § 232.5(b)(1)–(2)).
21. Id. (to be codified at 32 C.F.R. § 232.5(b)(2)(ii)).
22. Id. at 43607 (to be codified at 32 C.F.R. § 232.3(g)(1)).
23. Id. at 43609 (to be codified at 32 C.F.R. § 232.5(b)(3)).
25. 32 C.F.R. § 232.5(a)(1) (2015) (providing an example of language in a “covered borrower identification statement,” which could be used by the lender as a self-identification statement by the borrower).
26. Final Rule, supra note 6, at 43560 (“In this regard [determining whether a borrower is a covered borrower], the Department is aware of misuses of the covered borrower identification statement whereby a Service member (or covered dependent) falsely declares that he or she is not a covered borrower.”).
27. Id. at 43561 (to be codified at 32 C.F.R. § 232.5) (“[I]t [the] rule permits—and does not require—a creditor to use information obtained from the MLA Database or . . . a consumer report obtained from a nationwide consumer reporting agency . . . to conclusively determine whether a consumer-applicant is a covered borrower”).
covered borrower as of the date of that [earlier] transaction or as of the date that [earlier] account was established.”

**DEFINITION OF CONSUMER CREDIT**

The Final Rule defines “consumer credit” to mean “credit offered or extended to a covered borrower primarily for personal, family, or household purposes . . . that is . . . [s]ubject to a finance charge . . . or [is] [p]ayable by a written agreement in more than four installments.” It excludes any transaction that is an exempt transaction under Regulation Z. The DoD stresses that the definition is consistent with the Truth in Lending Act (“TILA”) definition. However, the MLA regulation definition excludes loan products covered by TILA, specifically residential mortgages and purchase money loans.

**RESTRICTIONS ON COVERED LOANS**

The Final Rule also imposes numerous restrictions on covered loans made to military personnel and their spouses and dependents. These restrictions range from pricing limitations to prohibitions against a variety of contractual terms.

The most publicized restriction is the prohibition against providing a consumer loan with an MAPR that exceeds 36 percent. As noted, the MAPR is not an interest rate cap and is different from the APR definition in Regulation Z (which implements TILA) because it includes fees not considered finance charges under TILA. These include application fees and participation fees and fees and premiums for credit insurance, debt cancellation, debt suspension, or any credit-related ancillary products that were sold in connection with the credit.

For open-end credit, the DoD has re-introduced the effective APR concept. This requires a retroactive calculation of the MAPR, based on the periodic rate.
the customer’s actual balance, and the actual fees imposed during the billing period.\textsuperscript{42} If an MAPR cannot be calculated because there is no balance, the creditor may not impose \textit{any} fee or charge during that billing period \textit{except} for a participation fee that is $100 or less.\textsuperscript{43} The $100 limit does not apply if the participation fee is bona fide, as provided in the regulation.\textsuperscript{44}

Fees imposed on credit card accounts may be excluded from the MAPR calculation if they are bona fide, as well as “reasonable for that type of fee.”\textsuperscript{45} Bona fide is not defined, though the rule offers standards to assess whether a bona fide fee is reasonable.\textsuperscript{46} The standard includes comparing “fees typically imposed by other creditors for the same or a substantially similar product or service.”\textsuperscript{47} The Final Rule does not provide definitions for what constitutes a “substantially similar product or service” or for “typically.” The fact that no other creditors charge a fee for the same or substantially similar service or product does not mean that it is unreasonable per se.\textsuperscript{48} If \textit{any} fee is not a bona fide fee, \textit{all} fees (including bona fide fees) must be included in the MAPR calculation.\textsuperscript{49} A participation fee may be reasonable if the “amount reasonably corresponds to the credit limit in effect or credit made available when the fee is imposed, to the services offered under the credit card account, or to other factors relating to the credit card account.”\textsuperscript{50} The interest rate is not listed as a factor in evaluating the reasonableness of a participation fee. The exclusion for bona fide fees does not apply to credit insurance premiums, fees for debt cancellation, or suspension,\textsuperscript{51} or “[a]ny fee for a credit-related ancillary product sold in connection” with the credit.\textsuperscript{52}

The Final Rule also offers a safe harbor for purposes of determining whether a fee is reasonable (but not necessarily bona fide).\textsuperscript{53} Specifically, a bona fide fee is reasonable if it “is less than or equal to an average amount of a fee for the same or a substantially similar product or service charged by 5 or more creditors” with at least $3 billion in outstanding U.S. credit card account balances during the last three years.\textsuperscript{54} A fee higher than average may still be reasonable, “depending on other factors relat[ed] to the credit card account.”\textsuperscript{55}

An application fee also may be excluded from the MAPR calculation for “short-term, small amount loan[s]” provided that it is not charged “more than once in a 12-month period.”\textsuperscript{56} “Short-term, small amount loan” is narrowly defined and,
among other conditions, is limited to loans subject to federal laws that limit the interest rate an insured depository institution or federal credit union may charge, and “is comparable to a limitation of an annual percentage rate of interest of 36 percent.”

The final regulation further prohibits requirements that a covered borrower submit to arbitration or “other onerous legal notice provisions in the case of a dispute[,]” or demands of “unreasonable notice from the covered borrower as a condition for legal action.” These terms are undefined and the Final Rule offers no examples.

Also unlawful is extending credit under which covered borrowers waive their right to legal recourse under state or federal law, including the SCRA. This provision is also unexplained, though the description clarifying the Final Rule notes that the provision does not affect the federal law regarding the interest rate that may be charged.

In addition, covered credit cannot be extended if the creditor requires the borrower to access his or her “deposit, savings or other financial accounts” using “a check or other method of access.” The three exceptions are these: the creditor requires an electronic fund transfer to repay the loan, if permitted by law; the creditor requires the borrower to make direct deposits of the borrower’s salary, if permitted by law, “as a condition of eligibility” for covered credit; or the creditor requires that the borrower allow the creditor to take a security interest in deposited funds “after the extension of credit.” On its face, the restriction appears to prohibit lenders from accepting a check or other payment instrument other than cash or online consumer-initiated bill-pay to repay the loan. The restriction also raises concerns that the regulation may prohibit a covered borrower from using liquid secured credit, such as credit cards secured by a deposit account, which are used to build or rebuild credit history.

Additionally, lenders may not impose prepayment penalties or require that the borrower establish an allotment to repay the loan. The Final Rule also prohibits a creditor from refinancing or renewing credit with proceeds of other covered credit extended by that same creditor to the same covered borrower, if the creditor is subject to laws related to deferred-presentation transactions. This provision does not apply to banks, savings associations, and credit unions.

57. Id. (to be codified at 32 C.F.R. § 232.3(i)).
58. Id. at 43611 (to be codified at 32 C.F.R. § 232.8(c)).
59. Id. (to be codified at 32 C.F.R. § 232.8(d)).
60. Id. (to be codified at 32 C.F.R. § 232.8(b)).
61. Id. at 43581.
62. Id. at 43611 (to be codified at 32 C.F.R. § 232.8(e)).
63. Id. (to be codified at 32 C.F.R. § 232.8(e)(1)).
64. Id. (to be codified at 32 C.F.R. § 232.8(e)(2)).
65. Id. (to be codified at 32 C.F.R. § 232.8(e)(3)).
66. Id. (to be codified at 32 C.F.R. § 232.8(h)).
67. Id. (to be codified at 32 C.F.R. § 232.8(g)).
68. Id. at 43610–11 (to be codified at 32 C.F.R. § 232.8(a)).
69. Id. at 43611 (to be codified at 32 C.F.R. § 232.8(a)).
nally, the rule prohibits using a vehicle title as security for a covered loan. This provision also does not apply to banks, savings associations, and credit unions.

**REQUIRED DISCLOSURES**

Lenders must provide the following disclosures before the borrower becomes obligated on or establishes an account for covered credit: a “statement of the MAPR,” for which the Final Rule provides model language; Regulation Z disclosures; and “a clear description of the payment obligation of the covered borrower.” Disclosures must be provided in writing. The MAPR statement and the payment description also must be provided orally. Creditors may make oral disclosures using a toll-free telephone number.

**PENALTIES AND OTHER REMEDIES**

The penalties for violations may be more severe than those for other consumer protection regulations, and include criminal penalties. First, the Final Rule continues to allow for criminal misdemeanor penalties for creditors knowingly violating the regulation, including fines and imprisonment for up to one year. Second, the Final Rule voids any creditor’s contract that does not comply with the regulation. Third, the Final Rule allows for a private right of action under which violators may be liable for any actual damages (but not less than $500 per violation) and appropriate punitive damages and equitable or declaratory relief, as well as any other relief provided by law, costs, and reasonable attorney’s fees. The Final Rule’s statute of limitations requires that actions be brought no later than two years after a plaintiff discovers the violation or five years after the date of the actual violation. Fourth, the Final Rule allows for administrative enforcement by agencies tasked with enforcing Regulation Z, or any other “applicable authorities” available to those same agencies.

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70. Id. (to be codified at 32 C.F.R. § 232.8(f)).
71. Id.
72. Id. at 43610 (to be codified at 32 C.F.R. § 232.6(a)).
73. Id. (to be codified at 32 C.F.R. § 232.6(a)(1)).
74. Id. (to be codified at 32 C.F.R. § 232.6(c)(3)).
75. Id. (to be codified at 32 C.F.R. § 232.6(a)(2)).
76. Id. (to be codified at 32 C.F.R. § 232.6(a)(3)).
77. Id. (to be codified at 32 C.F.R. § 232.6(a)(2), (d)).
78. Id. (to be codified at 32 C.F.R. § 232.6(d)(2)(i)).
79. Id. (to be codified at 32 C.F.R. § 232.6(d)(2)(ii)(B)).
80. Id. at 43611 (to be codified at 32 C.F.R. § 232.9).
81. Id. (to be codified at 32 C.F.R. § 232.9(a)).
82. Id. (to be codified at 32 C.F.R. § 232.9(c)).
83. Id. (to be codified at 32 C.F.R. § 232.9(e)).
84. Id. (to be codified at 32 C.F.R. § 232.9(e)(5)).
85. Id. (to be codified at 32 C.F.R. § 232.10).
SERVICEMEMBERS CIVIL RELIEF ACT ENFORCEMENT

In addition to the changes under the MLA discussed above, the Department of Justice ("DoJ") and the prudential regulators have increased the frequency and scope of their SCRA enforcement over the last several years. Recent consent orders resulting from these enforcement actions are discussed below.

THE CONSENT ORDERS

In In re Bank of America, N.A.,86 Bank of America, N.A. ("BoA") entered into consent orders with the Office of the Comptroller of the Currency ("OCC"). The OCC alleged that BoA failed to comply with the SCRA, including the requirements related to the 6 percent rate reduction required when servicemembers provide written evidence of active duty.87 BoA also was alleged to have engaged in wrongful repossessions and improper litigation practices related to default judgments, including improper procedures for filing and notarizing affidavits filed in such actions.88 BoA's SCRA policies and procedures, financial commitment to SCRA compliance, training, and self-audit processes were found to be inadequate.89 Accordingly, the order required improvements to each aspect of BoA's SCRA compliance systems to ensure that default judgments are compliant with the SCRA, that servicemembers' property is not repossessed or foreclosed upon in violation of the SCRA, and that 6 percent rate reductions are calculated properly.90 In addition to various remediation and compliance requirements, BoA was also subjected to a $30 million civil money penalty.91

In United States v. Santander Consumer USA Inc.,92 Santander Consumer USA, Inc. ("Santander") entered into a consent order with the DoJ. Santander allegedly violated the SCRA “[b]y failing to obtain court orders before repossessing motor vehicles by protected servicemembers.”93 Santander agreed to pay at least $9.3 million relating to certain SCRA violations.94 Santander also was required to make certain changes to its SCRA policies and procedures relating to the

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89. BoA Consent Order, supra note 86, at 3–4; BoA Cease-and-Desist Order, supra note 86, at 4–5.
90. BoA Cease-and-Desist Order, supra note 86, at 12–19 (outlining details of SCRA compliance plan).
repossession of servicemember motor vehicles pursuant to the SCRA and to provide enhanced training relating to repossessions. The order applied to all loans or contracts held by Santander, regardless of whether a prior holder committed the violation, but imposed a reduced penalty for the violations conducted by entities that later sold the loans or contracts to Santander.

Finally, in United States v. Sallie Mae, Inc., Sallie Mae, Inc. (“Sallie Mae”) entered into consent orders with the DoJ in relation to allegations involving student loans to military members. The orders require that Sallie Mae improve its SCRA compliance systems relating to educational loans to ensure that eligible servicemembers’ interest rates are lowered to 6 percent, as required by the SCRA; to adequately follow up with servicemembers to obtain military orders after the servicemembers have provided notice of their service; to inform servicemembers of their eligibility when the servicemembers provide notification and copies of their orders for other purposes; and to obtain only legally compliant default judgments against servicemembers. The orders provided for civil money penalties of $6.6 million, restitution of approximately $30 million to harmed borrowers, and the funding of a $60 million settlement fund to provide remediation to servicemember borrowers.

THE IMPACT OF THE CONSENT ORDERS ON SCRA COMPLIANCE

The most significant legal theory reflected in the DoJ’s recent enforcement of the SCRA is the extension of liability to assignees. The DoJ’s focus on assignee liability is curious, since Congress did not impose assignee liability under the SCRA, as it did under the Equal Credit Opportunity Act and TILA. Despite this contrast, the U.S. Court of Appeals for the Ninth Circuit’s decision in Brewster v. Sun Trust Mortgage, Inc. does provide support for the position reflected in the consent orders discussed above. In Brewster, the assignee, Nationstar

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95. Id. at 2–13.
98. Sallie Mae Consent Order, supra note 97, at 2–3.
99. Id. at 5–6 (providing for $60 million settlement); Sallie Mae Utah Consent Order, supra note 97, at 19, 27 (providing for $30 million in restitution and $3.3 million civil penalty); Navient Solutions Consent Order, supra note 97, at 21 (providing for $3.3 million civil penalty).
100. See, e.g., Capital One Consent Order, supra note 96, at 2; Santander Consent Order, supra note 92, at 15.
101. Brewster v. Sun Trust Mortg., Inc., 742 F.3d 876 (9th Cir. 2014).
Mortgage, LLC (Nationstar), attempted to collect fees associated with a wrongful foreclosure attempt conducted by the assignor, fees which had not been removed from the account before the assignment. 102 Though Nationstar eventually did remove the fees, the court noted that the SCRA must “be liberally construed” and held that, even though the fees were removed, the attempted collection constituted a violation of the SCRA’s prohibition against a foreclosure without a court order or written waiver. 103 The combination of the Brewster decision and the DoJ’s position in these enforcement actions effectively expands the language of the SCRA to incorporate assignee liability. 104 As a result, any company that purchases loans or retail installment contracts should conduct a thorough SCRA due diligence review.

The consent orders also raise several other issues necessitating carefully designed SCRA compliance systems. These issues include questions regarding what might qualify as effective communication between servicemembers and creditors in relation to providing evidence of military orders. 105 Under the SCRA’s interest rate reduction requirement, a creditor has no obligations until a servicemember provides the creditor with written notice and a copy of his or her military orders. 106 These consent orders effectively expand the SCRA to now require generous follow up by the creditor to ensure that the servicemember understands the requirements of the 6 percent rate reduction and has received repeated notifications if the required orders have not been provided. 107 These consent orders also require effective communication and awareness of the SCRA’s requirements across all aspects of a creditor’s organization and, therefore, a creditor that receives a borrower’s military orders, for any reason, should make that fact widely known. 108 Creditors can no longer rely solely on their SCRA departments to be the sole recipients of military orders. Finally, the consent orders confirm the SCRA’s requirement 109 that a creditor obtain a written SCRA waiver before repossessing or foreclosing upon a servicemember’s collateral, unless a court order is obtained. 110 Creditors also should be careful to ensure that any waivers specifically acknowledge the servicemember’s SCRA rights, as the

102. Id. at 877–78.
103. Id. at 879–80 (noting that “the United States Supreme Court has unambiguously required courts to give a broad construction to the statutory language of the SCRA to effectuate the Congressional purpose of granting active-duty members of the armed forces repose from some of the trials and tribulations of civilian life”).
104. See id.; Santander Consent Order, supra note 92, at 15, 17.
105. See Sallie Mae Consent Order, supra note 97, at 2–3.
107. See, e.g., Sallie Mae Consent Order, supra note 97, at 2–3.
108. Id.
110. See Santander Consent Order, supra note 92, at 6. But cf. Engstrom v. First Nat’l Bank of Eagle Lake, 47 F.3d 1459, 1462 (5th Cir. 1995) (noting that an oral waiver would be allowed, despite the SCRA’s requirements, as the SCRA must be administered in a way that “requires an equitable consideration of the rights of the parties to the end that their respective interests may be properly conserved”).
DoJ’s required disclosures reflect that a generic voluntary surrender or waiver form may not be sufficient.\textsuperscript{111}

**Conclusion**

Lenders are confronting significant new compliance requirements and risk related to the MLA and the SCRA. MLA coverage is expanded to cover significantly more loans and lenders and the responsibility for determining military status has shifted from the borrower to the lender. In addition, technical compliance with the requirements of the SCRA no longer seems sufficient for a creditor to avoid liability. Rather, many of the recent consent orders enforcing the SCRA appear to demonstrate that more is needed, including robust SCRA compliance systems operating across a creditor’s organization. Creditors should review carefully the new MLA requirements, constantly monitor published SCRA consent orders, and regularly update their compliance systems to ensure compliance and avoid enforcement actions.

\textsuperscript{111} See Santander Consent Order, supra note 92, at 29.
Communicating with Bankrupt Mortgage Loan Borrowers: Thorny Issues and Attempts at Clarity

By Ralph Wutscher, Alan Leeth, Eric Tsai, Ryan Hebson, and Andrew Williamson*

INTRODUCTION

For mortgage loan servicers, a borrower’s declaration of bankruptcy can be complicated. A bankruptcy filing generally bars efforts to collect from a borrower. However, the Real Estate Settlement Procedures Act (“RESPA”),1 the Truth in Lending Act (“TILA”),2 and the Fair Debt Collection Practices Act (“FDCPA”)3 have a number of requirements for communicating with mortgage loan borrowers. Some of the disclosures required under these statutes must still be provided when a borrower is in bankruptcy, or when a borrower has received a bankruptcy discharge, even though the disclosures might initially appear to be related to debt collection. This survey addresses several recent developments in the law regarding the thorny issue of communicating with consumer mortgage loan borrowers under these circumstances.

This survey begins with a general overview of the relevant United States Bankruptcy Code (“Bankruptcy Code”)4 provisions that impact borrowers in bankruptcy or borrowers who have received a bankruptcy discharge. Next, the interplay between the FDCPA and the Bankruptcy Code is analyzed. Finally, the survey considers a few specific types of communications required under RESPA, TILA, and the FDCPA; analyzes the Bureau of Consumer Financial Protection’s (“CFPB’s”) current Mortgage Servicing Rules5 and its Official

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Interpretations; and reviews the CFPB’s proposed amendments to the Mortgage Servicing Rules (“Proposed Rule”) addressing some of the issues that affect servicer communications and bankruptcy.

**THE RELEVANT BANKRUPTCY CODE PROVISIONS**

Generally, when a borrower files a bankruptcy petition, the Bankruptcy Code imposes an automatic stay that prevents creditors from attempting to collect any outstanding debts from the borrower. The automatic stay protects the debtor individually, as well as property that is part of the bankruptcy estate. Mortgaged property is generally considered “property of the estate” under the Bankruptcy Code. An individual injured by “any willful violation of the automatic stay may recover actual damages, including costs and attorney’s fees, and, in appropriate circumstances, may recover punitive damages” by suing under the Bankruptcy Code for contempt. However, statements that simply provide “information to a debtor are permissible communications” that do not violate the automatic stay. Confusion over what is simply “information” and what is an attempt to collect a debt has led to much litigation under the Bankruptcy Code and the FDCPA.

At the end of a typical bankruptcy case, the debtor will receive a discharge of all prepetition debts. Once a discharge is granted, the automatic stay is replaced by the discharge injunction, which operates as an injunction against the commencement or continuation of an action to collect any such debt as a personal liability of the debtor. The discharge also protects all community property of the debtor and the debtor’s spouse that was acquired after the commencement of the case. There is a limited exception to the discharge injunction for a creditor that retains a security interest in the principal residence of the debtor where the creditor is permitted to seek periodic payments in lieu of foreclosure.

Like the automatic stay, a creditor may be held liable for contempt under the Bankruptcy Code if it willfully violates the discharge injunction. If a bankruptcy court finds that a party willfully violated the discharge injunction, the

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6. Id. pt. 1024, supp. I.
9. Id. § 362(a).
10. Id. § 541(a).
11. Id. § 362(k)(1).
14. 11 U.S.C. §§ 727(b), 1141(d), 1328(a).
15. Id. § 524(a)(2).
16. Id. § 524(a)(3); Rooz v. Kimmel (In re Kimmel), 378 B.R. 630, 635 (B.A.P. 9th Cir. 2007).
18. Id. § 524(a)(2).
court may award actual damages, punitive damages, and attorney’s fees to the debtor.\textsuperscript{19} Some courts also permit FDCPA lawsuits for violations of the discharge injunction, as discussed below.\textsuperscript{20} The potential exposure of mortgage servicers, therefore, coupled with a lack of clarity as to what constitutes a violation of the stay or discharge injunction, underscores both the importance and the urgency of the developments in the Mortgage Servicing Rules, including the CFPB’s Proposed Rule.

**Overlap of Bankruptcy and the FDCPA**

The FDCPA is a strict liability statute that prohibits debt collectors from engaging in “false, deceptive, or misleading [practices] in connection with the collection of any consumer debt.”\textsuperscript{21} Among other things, debt collectors are also prohibited from using “unfair or unconscionable means to collect [a] debt,” including “[t]he collection of any amount . . . [not] . . . expressly authorized by the agreement creating the debt or permitted by law.”\textsuperscript{22} Complications arise when mortgage servicers are required to communicate with borrowers, either while the automatic stay is in place or after the borrower has received a discharge in bankruptcy. Many of the communications referenced here are not sent to collect a debt. Yet, because they invariably relate to the servicing of a mortgage loan, many consumer litigants may “re-characterize” the communications to bring a cause of action under the FDCPA or an equivalent state law for allegedly violating the automatic stay or the discharge injunction.

Historically, federal courts are split on whether an independent FDCPA claim exists for an alleged violation of a bankruptcy stay or a discharge injunction, or whether the proper remedy is to seek relief under the Bankruptcy Code.\textsuperscript{23} In *Garfield v. Ocwen Loan Servicing, LLC*,\textsuperscript{24} for example, the court recognized that complying with both the Bankruptcy Code and the FDCPA was not so easy.\textsuperscript{25} In that case, the debtor, among other things, alleged that, while a discharge injunction was in place, the servicer violated the FDCPA by failing to communicate as required with the debtor.\textsuperscript{26} Yet, as the court noted, the servicer could not possibly “comply with § 1692e(11) and the Bankruptcy Code’s discharge injunction because . . . sending a § 1692e(11) notice would violate the automatic stay [or injunction].”\textsuperscript{27} Accordingly, the court held that the FDCPA claims were precluded by the Bankruptcy Code, and it dismissed the debtor’s FDCPA claims.\textsuperscript{28}

\begin{footnotesize}
\begin{enumerate}
\item Id. § 105(a).
\item See infra note 23.
\item Id. § 1692f.
\item Compare *Walls v. Wells Fargo Bank, N.A.*, 276 F.3d 502, 510–11 (9th Cir. 2002) (finding that FDCPA claims are precluded by the Bankruptcy Code), with *Randolph v. IMBS, Inc.*, 368 F.3d 726, 730–33 (7th Cir. 2004) (recognizing FDCPA claim for violation of the automatic stay).
\item 526 B.R. 471 (W.D.N.Y. 2015).
\item Id. at 473–74.
\item Id. at 479 (citing 15 U.S.C. § 1692e(11)).
\item Id.
\item Id. at 480.
\end{enumerate}
\end{footnotesize}
This was likely a hollow victory for the servicer. As the Garfield court held, creditors cannot avoid liability entirely because the borrower may still assert a claim under the Bankruptcy Code for any alleged willful violations of the automatic stay or the discharge injunction.  

As previously mentioned, the FDCPA is a strict liability statute, but liability for violations of the Bankruptcy Code requires a showing of willfulness. However, the amount of exposure under the Bankruptcy Code can sometimes be worse than under the FDCPA. Under the FDCPA, if a borrower cannot prove actual damages, statutory damages are capped at $1,000 “per proceeding” and not “per violation.” In contrast, and regardless of actual damages, a bankruptcy court may impose harsher penalties on servicers who “willfully” communicate with debtors without sufficiently tailoring the content of their communications based on the debtor’s circumstances.

COMMUNICATIONS REQUIRED UNDER FEDERAL LAW

Mortgage servicers are required under federal law to send various communications to borrowers but have been sued under the FDCPA, the bankruptcy provisions, and other laws for sending these communications to borrowers in bankruptcy. Some examples are discussed below.

NOTICE OF NEW OWNER

Under TILA, for example, when an entity purchases a mortgage loan, it must provide the borrower with specific information within thirty days after the sale or transfer. The purchaser must disclose, among other things, its contact information, the date of transfer, and contact information for its agent or loan servicer. This notice of new owner is not required in these circumstances: the purchaser subsequently “sells, or otherwise transfers or assigns legal title to the mortgage loan on or before the 30th calendar day following the date that the covered person acquired the mortgage loan”; the purchaser acquires the loan “in connection with a repurchase agreement that obligates the transferor to repurchase the loan”; or the purchaser receives “only a partial interest in the loan” and the contact person for the loan “does not change as a result of the transfer.”

How does the imposition of the automatic stay affect this notice? Cautious persons concerned only with the automatic stay may think that contacting a borrower in bankruptcy would expose them to liability. In some cases, however,

29. Id.
31. See Wright v. Fin. Serv. of Norwalk, Inc., 22 F.3d 647, 651 (6th Cir. 1994).
32. See, e.g., In re Haemmerle, 529 B.R. 17, 31 (Bankr. E.D.N.Y. Apr. 16, 2015) ( awarding punitive damages in the amount of $500 for each violation).
34. 15 U.S.C. § 1641(g).
it is the opposite. TILA’s notice of new owner requirement, for example, does not have an exception for a borrower in bankruptcy. As such, mortgage loan purchasers should send the notice of new owner required under TILA, even if a borrower is in bankruptcy.

**Notice of Service Transfer**

Under RESPA, when a federally related mortgage loan is transferred to a new servicer, both the prior servicer and the new servicer are required to provide the borrower with written notice of the service transfer. The CFPB Official Interpretation of this requirement concerns only where the notice should be sent and does not address borrowers in bankruptcy or borrowers who have received a bankruptcy discharge.

However, the court opinions addressing RESPA servicing transfer notices and FDCPA liability in the bankruptcy context suggest sending them does not violate the automatic stay. For example, one court found that a notice of servicing transfer sent during the pendency of a borrower’s bankruptcy did not constitute a violation of the FDCPA. Although the court did not discuss the automatic stay specifically, the absence of discussion implies that the RESPA notice did not implicate the automatic stay. The RESPA notice, of course, must be adequate.

In contrast, the U.S. Court of Appeals for the Second Circuit held in *Hart v. FCI Lender Services, Inc.* that a notice of servicing transfer was a communication in connection with the collection of a debt. This finding was enough to survive a motion to dismiss on the FDCPA issue. Thus, the mere sending of a notice of servicing transfer as required under RESPA, at least in the Second Circuit, may result in allegations that the notice violated the bankruptcy automatic stay or discharge injunction.

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36. At least one court has allowed a TILA claim against a mortgage loan purchaser for failing to provide a notice of new ownership after the borrower filed bankruptcy. Ahmadi v. CitiMortgage, Inc. (*In re Ahmadi*), 467 B.R. 782, 790–91 (Bankr. M.D. Pa. 2012).
43. *Id.* at *24.
44. *Id.*
PERIODIC PAYMENT STATEMENTS

Payment statements are one of the most confusing bankruptcy issues for creditors and mortgage servicers to navigate. TILA expressly requires that a mortgage loan servicer provide periodic payment statements to borrowers. The statements must include, among other things, the amount due, the payment due date, the amount of any late fees, the date when the late fee will be imposed if payment is not received, the outstanding balance, and the current interest rate.

Despite their best efforts, mortgage servicers may find themselves in FDCPA litigation even when they comply with TILA. For instance, TILA requires that mortgage servicers comply with the payment statement requirements even if the borrower has exercised his or her cease-communication rights under the FDCPA. The CFPB issued an advisory bulletin clarifying that the FDCPA cease-communication option does not generally render servicers liable under the FDCPA if they comply with the relevant TILA requirements. The FDCPA also provides that there is no liability for any act done in good faith in conformity with any advisory opinion of the CFPB. Nevertheless, despite the safe harbor provision in the FDCPA and the CFPB advisory guidelines, servicers should anticipate having to defend lawsuits based on periodic statements sent in compliance with TILA.

Similarly, although a mortgage servicer is exempt from providing periodic statements for a debtor in bankruptcy, it must resume sending payment statements once the case is dismissed or closed, or upon the debtor’s discharge in bankruptcy. Moreover, the Bankruptcy Code expressly permits secured creditors to communicate with discharged debtors in connection with loans secured by the debtor’s primary residence. Nevertheless, periodic statements sent to borrowers post-discharge have led to litigation for alleged unlawful debt collection.

The CFPB’s Proposed Rule also may further complicate communications with borrowers in bankruptcy. The CFPB believes that periodic statements would likely provide borrowers who want to keep their homes better access to

46. 12 C.F.R. § 1026.41(d).
47. Id.
48. CFPB BULL. NO. 2013-12, IMPLEMENTATION GUIDANCE FOR CERTAIN MORTGAGE SERVICING RULES 7 & n.23 (Oct. 15, 2013) (“The CFPB has determined that a servicer acting as a debt collector would not be liable under the FDCPA for complying with these requirements despite a consumer’s ‘cease communication’ request.”).
51. 12 C.F.R. § 1026.41(e)(5).
information about the status of their debt and how much they owe. According
ingly, the Proposed Rule would require mortgage servicers to send modified pay-
ment statements to borrowers under specified circumstances.

For example, under the Proposed Rule, a servicer must send modified pay-
ment statements to a consumer in bankruptcy “if the consumer requests in writ-
ing that the servicer continue . . . [to provide statements] unless a court enters an
order in the consumer’s bankruptcy case requiring the servicer to cease provid-
ing” such statements. The modified statements for consumers in bankruptcy
need not include certain information that is ordinarily required for consumers
who are not in bankruptcy.

The Proposed Rule, however, does require that the modified statements con-
tain additional information specifically required for borrowers in bankruptcy.
First, the first page must include “[a] statement identifying the consumer’s status
as a debtor in bankruptcy or the discharged nature of the mortgage loan.” Sec-
ond, the first page must also include “[a] statement that the periodic statement is
for information purposes only.” Third, there are special requirements for “a
consumer who is a debtor in Chapter 12 or Chapter 13 bankruptcy,” for “mul-
tiple obligors[,]” and for servicers who provide a “coupon book.” If adopted,
the Proposed Rule will require servicers to analyze the specific circumstances
of a borrower’s bankruptcy, and to tailor their communications to comply.

**Loss Mitigation Offers**

RESPA currently requires that mortgage servicers engage in early intervention
with delinquent borrowers to identify options for avoiding foreclosure. Mort-
gage servicers are required to “make good faith efforts to establish live contact
with a delinquent borrower” within thirty-six days “of the borrower’s delin-
quency.” A written notice of any available loss mitigation options must be
given within forty-five days of the borrower’s delinquency. Moreover, servicers
may be required under specific circumstances to provide notices and evaluate
the borrower for loss mitigation options if a loss mitigation application is re-
ceived before a foreclosure sale.

54. Proposed Rule, supra note 7, at 74248–49 (explaining that borrowers “in bankruptcy may
benefit from information regarding the application of their payments to principal, interest, escrow
and fees”).
55. Id. at 74296 (to be codified at 12 C.F.R. § 1026.41(e)(5)) (proposing revising the rule exempt-
ing servicers from payment statement requirements while a borrower is in bankruptcy and allowing
the exemption only for certain consumers who fit a limited number of categories and conditions).
56. Id. (to be codified at 12 C.F.R. § 1026.41(e)(5)(ii)).
57. Id. at 74296–97 (to be codified at 12 C.F.R. § 1026.41(f)(1)).
58. Id. at 74297 (to be codified at 12 C.F.R. § 1026.41(f)(2)(i)).
59. Id. (to be codified at 12 C.F.R. § 1026.41(f)(2)(ii)).
60. Id. (to be codified at 12 C.F.R. § 1026.41(f)(3), (4), (5)). Additional conditions are quite nu-
merous and are not explored in this survey.
62. Id. § 1024.39(a).
63. Id. § 1024.39(b).
64. Id. § 1024.41(b), (c).
Discussing loss mitigation options with a borrower can be a tricky proposition. Bankruptcy courts have found violations of the discharge injunction based upon calls or loss mitigation letters sent to borrowers. However, other bankruptcy courts have held that loss mitigation communications do not violate the discharge injunction because the conduct is expressly permitted under the Bankruptcy Code.

Recognizing this conundrum, the CFPB created an exemption for borrowers in bankruptcy or borrowers who have exercised the cease-communication right under the FDCPA. A catch-all provision was added, exempting servicers from having to engage in any loss mitigation communications with a borrower that would “otherwise be prohibited by applicable law.”

However, the current rules do not contemplate post-discharge loss mitigation communications, or make any distinction among discharges in different types of bankruptcies (i.e., a Chapter 7, 11, 12, or 13). The type of discharge a borrower receives, such as a complete discharge of all personal liability under the mortgage loan, or a discharge of only a portion of the debt, may directly affect the servicer’s loss mitigation efforts and its potential exposure. For example, a debtor is discharged of most unsecured debts in a Chapter 7 bankruptcy, whereas a Chapter 13 debtor generally receives a discharge of only the unsecured debts set forth in the plan of reorganization. Thus, greater clarification is necessary on these issues.

The CFPB’s Proposed Rule seeks “to narrow the scope of the bankruptcy exemption” in the Mortgage Servicing Rules by making the exemption for loss mitigation communications apply only to the borrower “who is the debtor in a Chapter 7 or Chapter 11 bankruptcy case.” The CFPB intends “to maintain the exemption from the live contact requirements” for a “borrower who is in bankruptcy, has discharged personal liability for the mortgage loan, or shares liability on a mortgage loan with a person who is a debtor in a Chapter 12 or Chapter 13 bankruptcy case.”

68. Id. § 1024.39(c).
69. See Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X); Final Rule, 78 Fed. Reg. 10696, 10807 (Feb. 14, 2013) (to be codified at 12 C.F.R. pt. 1024) (“The CFPB has not sought to interpret the Bankruptcy Code, but instead intended to indicate that servicers may take a flexible approach to complying with § 1024.39 in order to provide information on loss mitigation options to borrowers in bankruptcy to the extent permitted by applicable law or court order.” (emphasis added)).
70. 11 U.S.C. § 727(b) (2012).
71. Id. § 1328(a).
72. Proposed Rule, supra note 7, at 74201–02 (to be codified at 12 C.F.R. § 1024.39(a), (b)).
73. Id. at 74203.
Nonetheless, narrowing the exemption could lead to a rise in litigation. Under the Proposed Rule, servicers would have to comply with the written early intervention notice requirements for all borrowers in bankruptcy unless: no loss mitigation options are available, the borrower’s confirmed bankruptcy plan provides for the surrender of the property or avoidance of the lien or does not provide for the payment of pre-bankruptcy arrearages or payments due under the loan; the borrower files a statement of intent to surrender the property; or an order is entered avoiding the lien or lifting the automatic stay. 

**LENDER-PLACED INSURANCE**

RESPA also requires mortgage servicers to send notices before assessing fees to a borrower for lender-placed insurance. An initial notice must be sent to the borrower at least forty-five days before charging the borrower for this insurance, and a second reminder notice must be sent no earlier than thirty days after the first notice. However, the current Mortgage Servicing Rules do not contemplate borrowers in bankruptcy or those who have received a discharge.

The lack of a bankruptcy exemption also has spawned FDCPA litigation based on lender-placed insurance notices sent in compliance with RESPA. Several courts have held that surrendering property in bankruptcy did not force creditors to assume ownership of the collateral and then eliminate a debtor’s post-confirmation obligations, such as property taxes and insurance. At least one court has held that a notice regarding the obligation to purchase insurance was not an attempt to collect a debt. Nevertheless, FDCPA lawsuits are still being filed based on an alleged discharge of all mortgage-related obligations.

The lack of guidance from the CFPB, including in the Proposed Rule, will undoubtedly result in continued litigation based on lender-placed insurance notices.

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74. Id. at 74202.
76. 12 C.F.R. § 1024.37(c), (d) (2015).
77. Id. § 1024.37.
81. See id. at *2–3 (alleging FDCPA violation based on a single notice informing homeowners of their obligation to purchase hazard insurance, though court held that notice was not an attempt to collect a debt and not subject to the FDCPA).
FDCPA Validation of Debts

Finally, the FDCPA also requires a debt collector to communicate with borrowers, as debt collectors are required to send debt validation notices “within five days after the initial communication with a consumer in connection with the collection of any debt.” The notice must contain the amount of the debt, the name of the creditor, and inform the borrower of his or her right to dispute the debt or the debt will be presumed valid. Only mortgage servicers that meet the definition of a “debt collector” under the FDCPA are required to provide the notice. Additionally, the disclosure requirement applies only to a communication sent “in connection with the collection of a debt.” Nevertheless, the absence in some jurisdictions of a bankruptcy exception for the debt validation notice requirements of the FDCPA can be problematic, as the debt validation notice required under the FDCPA might appear as if it were an attempt to collect a debt in potential violation of the automatic stay.

Conclusion

It is unclear whether the CFPB’s Proposed Rule amending the Mortgage Servicing Rules will actually help stem the flow of litigation against mortgage servicers by borrowers in bankruptcy, or will simply add fuel to the fire. Indeed, as case law demonstrates, even seemingly innocent (and often compliant) communications from servicers may still lead to costly litigation. Consequently, it is difficult to see how the CFPB’s Proposed Rule, which requires an increase in communications between mortgage servicers and borrowers in bankruptcy, will not also increase litigation. Accordingly, servicers should continue to exercise great caution when communicating with borrowers in bankruptcy and with those who have received a bankruptcy discharge.

82. 15 U.S.C. § 1692g(a) (2012).
83. Id.
84. Id. § 1692a(6).
85. Id. § 1692g(a).
86. Id. § 1692g.
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