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IT'S NONE OF YOUR BUSINESS: STATE REGULATION OF TRIBAL BUSINESSES UNDERMINES SOVEREIGNTY AND JUSTICE

SAM J. CARTER AND ROBIN M. ROTMAN*

The U.S. Constitution grants the federal government plenary power over American Indian affairs, yet states are increasingly attempting to assert regulatory and tax jurisdiction over tribal businesses. This overreach threatens tribal sovereignty and contravenes the terms of treaties entered between the United States and American Indian tribes. This Article begins by examining the legal foundations of federal, state, and tribal relations. It then examines recent cases across four business sectors—gaming, tobacco sales, petroleum sales, and online lending—in order to illustrate the pervasive jurisdictional challenges faced by courts in cases involving tribal businesses. This Article offers three recommendations. First, it argues that the proper first forum for resolving disputes involving tribal businesses is the tribal court system; federal and state courts should be prepared to consider this issue sua sponte if it is not raised by the parties. Second, this Article calls for periodic, systematic audits of federal compliance with Indian treaties, which should evaluate both the federal government's activities and the federal government's obligation to prevent state interference with tribes' treaty-protected rights. Finally, in light of recent legislative proposals and executive actions, this Article asserts that removing barriers to American Indian participation in the political process at all levels will support economic development and self-determination in Indian Country. We contend that all Americans—indigenous or not—have a stake in seeing the federal government uphold its constitutional and treaty-bound commitments to American Indian tribes.

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I.
Introduction

The heightened discourse of late regarding decolonization and reconciliation with Native Americans[1] has done little to fix the persistent problem of state overreach into tribal lands and businesses. In an era of global and online com-

1. This paper uses the terms "Indian," "American Indian," and "Native American" interchangeably to refer to the indigenous peoples of the mainland United States at the time of European colonization. Given the complex and on-going narratives around indigenous identity and terminology, we chose to utilize the terms found in U.S. federal Indian law for simplicity. This paper focuses on such issues as they relate to Native Americans; these topics are also relevant to Alaska Natives and Native Hawaiians. For more information on the business enterprises of Alaska Native Corporations, see *Alaska Native Corporations*, Resource Development Council of Alaska, https://www.akrdc.org/alaska-native-corporations#Sources. For more information on the legal status of Native Hawaiians, see John Heffner, *Between Assimilation and Revolt: A Third Option for Hawaii as a Model for Minorities World-Wide*, 37 Tex. Int'l L.J. 591 (2002).

merce, states have increasingly attempted to assert regulatory and tax jurisdiction over tribal businesses. In some recent cases, federal courts have upheld principles of self-determination and tribal autonomy. In others, they have allowed states to impose settler norms and values on tribal businesses, impeding economic development, interfering with cultural practices, and undermining sovereignty.[2]

The federal government has long recognized that Native American tribal governments have authority over their members, their lands, and, in certain instances, non-tribal members who enter their lands.[3] However, the federal government has not always acted in accordance with this legal reality.[4] Native American tribes' inherent sovereignty has been confirmed through their status as domestic dependent nations in the U.S. Constitution, two centuries of U.S. Supreme Court rulings, treaties between the federal government and tribes, and generations of customary practices between tribes and their neighbors.[5] As sovereign, domestic dependent nations, the tribes have rights to self-governance, to manage tribal lands, to own and operate tribal businesses, and to regulate non-tribal individuals and businesses operating on their lands.[6]

The status of a sovereign, domestic dependent nation is a unique one, and the relationship between tribes, states, and

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2. Chloe Thompson, *Exercising and Protecting Tribal Sovereignty In Day-to-Day Business Operations: What the Key Players Need to Know*, 49 WASHBURN L. J. 661, 674–75 (2010).

3. *See, e.g.*, Williams v. Lee, 358 U.S. 217, 220 (1959) ("Congress has also acted consistently upon the assumption that the States have no power to regulate the affairs of Indians on a reservation."). *See generally* Matthew L.M. Fletcher, *A Short History of Indian Law in the Supreme Court*, 40 HUM. RTS. 3, 3–6 (2015).

4. *See, e.g.*, Wenona T. Singel, *The First Federalists*, 62 DRAKE L. REV. 775, 856 (2014) ("Yet, despite the ways in which tribal governance is inextricably linked to effective governance, the Supreme Court nearly always neglects this relationship. Instead, the Court frames tribal governance as dangerously divergent, disruptive, and unnecessary. In doing so, the Court paradoxically stymies effective governance and creates unnecessary barriers to the promotion of federalism's values."); Thompson, *supra* note 2, at 674.

5. *See generally* Fletcher, *supra* note 3, at 3.

6. *See* United States v. Wheeler, 435 U.S. 313, 323 (1978); Turner v. United States, 248 U.S. 354, 357–58 (1919); Cherokee Nation v. Georgia, 30 U.S. 1, 17 (1831).

the federal government is complicated.[7] This is progressively true as tribes increase their participation in the national and international marketplaces.[8] As evidenced by the COVID-19 pandemic, national, state, tribal, and local economies are interconnected by national supply chains.[9] It is well-settled that states cannot regulate business activities occurring on Indian reservations.[10] However, this notion has become markedly more complex as more elements of tribal businesses must occur off-reservation. That leaves us to wonder, what does "on-reservation" really mean in an era of expanded national and online commerce? And is the notion that Indian commerce is under the exclusive jurisdiction of tribal governments and the federal government still being upheld if there is space for state integration and interference?

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7. Nathan R. Margold, *Introduction* to FELIX S. COHEN, HANDBOOK OF FEDERAL INDIAN LAW, at viii (1942) ("For more than a century, Supreme Court Justices, Attorneys General, and Commissioners of Indian Affairs have commented on the intricate complexity and peculiarity of federal Indian law.").

8. *See* Erin Tindell, *FAS Programs Help Promote Native American Foods Worldwide,* U.S. DEP'T OF AGRIC. (Feb. 21, 2017), http://blogs.usda.gov/2013/11/26/fas-programs-help-promote-native-american-foods-worldwide. Tribes have promoted economic development projects outside of international agricultural exports, as well, see Robert J. Miller, *Inter-Tribal and International Treaties for American Indian Economic Development,* 12 LEWIS & CLARK L. REV. 1103, 1108–09 (2008) (discussing examples such as the acquisition of Hard Rock Cafe by the Seminole Tribe of Florida, an automotive wiring harness plant owned by the Mississippi Band of Choctaw Indians, and the Navajo Nation's trade agreement with Cuban food purchasing agency Alimport, among others).

9. *See* Elizabeth Hoover, *Native Food Systems Impacted by COVID,* 37 AGRIC. & HUM. VALUES 569 (2020).

10. *See* McClanahan v. Ariz. State Tax Comm'n, 411 U.S. 164, 172 n.7 (1973) (citations omitted) ("The source of federal authority over Indian matters has been the subject of some confusion, but it is now generally recognized that the power derives from federal responsibility for regulating commerce with Indian tribes and for treaty making."); *see also* United States v. Lara, 541 U.S. 193, 200 (2004) (citations omitted); Ramah Navajo Sch. Bd., Inc. v. Bureau of Revenue of N.M., 458 U.S. 832, 837 (1982) (citations omitted); White Mountain Apache Tribe v. Bracker, 448 U.S. 136, 142–43 (1980) (citations omitted); Bryan v. Itasca Cnty., 426 U.S. 373, 376 n.2 (1976) (citations omitted); United States v. Mazurie, 419 U.S. 544, 553–56 (1975) (citations omitted); Morton v. Mancari, 417 U.S. 535, 551–53 (1974) (citations omitted).

Economic development is a critical issue in Indian Country.[11] From a strictly fiscal perspective, American Indians are both the most impoverished race group in the United States[12] and the least likely to be business owners.[13] Historically, federal policies of dealing with tribes and tribal businesses have reflected capitalist values, which may conflict with tribal cultural practices and norms.[14] Although treaties between tribes and the federal government promised to honor tribal rights to self-determination, the contemporary reality is that many tribal businesses must operate within a capitalist framework.[15]

The effects of these policies and pressures affect many facets of tribal business operation today. For example, the remote locations and fragmentation of many Indian reservations, far from potential customers and suppliers, has added to the difficulty of establishing successful tribal businesses.[16] Even though some reservations are rich in natural resources, outside investors are often reluctant to partner with tribal businesses to develop these resources, because they are often reluctant to submit themselves to tribal laws and regulations, and to the jurisdiction of tribal court systems.[17] Even when tribes agree to resolve disputes in state or federal courts, tribal sovereign immunity can raise concerns for business counterparties.[18]

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11. *See* Miller, *supra* note 8, at 1103; Joseph Patterson, *The Native American Struggle Between Economic Growth and Cultural, Religious, and Environmental Protection: A Corporate Solution*, 92 NOTRE DAME L. REV. ONLINE 140 (2016).

12. *See* Naomi Schaefer Riley, *One Way to Help Native Americans: Property Rights*, ATLANTIC (July 30, 2016), https://www.theatlantic.com/politics/archive/2016/07/native-americans-property-rights/492941/ ("The 2 million Natives in the U.S. have the highest rate of poverty of any racial group—almost twice the national average."); *see also What Drives Native American Poverty?*, NW. INST. FOR POL'Y RES. (Feb. 24, 2020), https://www.ipr.northwestern.edu/news/2020/redbird-what-drives-native-american-poverty.html; John Koppisch, *Why Are Indian Reservations So Poor? A Look at the Bottom 1%*, FORBES (Dec. 13, 2011, 7:32 PM), https://www.forbes.com/sites/johnkoppisch/2011/12/13/why-are-indian-reservations-so-poor-a-look-at-the-bottom-1/#19aceb123c07.

13. *See* Robert J. Miller, *American Indian Entrepreneurs: Unique Challenges, Unlimited Potential*, 40 ARIZ. STATE L.J. 1297, 1297 (2008).

14. *See id.* at 1300–01.

15. *See id.* at 1305–06.

16. *See* Patterson, *supra* note 11, at 143 n.19.

17. *See* Miller, *supra* note 13, at 1309–14.

18. *See* Koppisch, *supra* note 12.

There are examples of profitable brick-and-mortar tribal businesses operating on Indian reservations in sectors ranging from gaming operations to convenience stores to renewable energy generators.[19] Tribes are also increasingly seeking to develop online businesses to reach a wider customer base. Online enterprises, primarily in the financial services sector, have helped tribes generate significant revenues to fund tribal services and provide employment opportunities for their members.[20] Yet some Native Americans have observed that these business ventures do not comport with their tribal values and may expose their tribe to predatory schemes from outside actors.[21]

Commensurate with growth of tribal businesses that have an online or off-reservation component are state attempts to assert regulatory and tax jurisdiction over these businesses. Some recent federal cases have rejected state attempts to regulate tribal businesses, whereas others have legitimized them. Treaty interpretation has been at the core of these recent legal decisions. Treaties are not merely reminders of the past. They are contracts that are legally binding in the present day. These bilateral agreements shaped the formation of the United States, and they continue to dictate how land, natural re-

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19. The 500-member Mashantucket (Western) Pequots in southeastern Connecticut generate over one billion dollars a year from their Foxwoods Casino and Resort and are one of the state's highest revenue contributors and largest employers, see *Foxwoods Resort Casino Announces $33.6 Million in Slot Revenue for June 2020, Contributes $8.4 Million to the State of Connecticut*, TRIBAL GAMING AND HOSP. (2020), https://tgandh.com/news/tribal-stories/foxwoods-resort-casino-announces-33-6-million-in-slot-revenue-for-june-2020-contributes-8-4-million-to-the-state-of-connecticut/. The Confederated Salish and Kootenai Tribes have launched numerous enterprises, including S&K Technologies, S&K Electronics, and Energy Keepers, Inc., see *Tribal Enterprises*, CSK TRIBES, https://csktribes.org/home/tribal-businesses (last updated 2021). For examples of Native American entrepreneurs, see Gabrielle Pickard-Whitehead, *8 Native American Entrepreneurs*, SMALL BUS. TRENDS (Oct. 8, 2019), https://smallbiztrends.com/2019/10/native-american-entrepreneurs.html.

20. *See* Mary Jackson, *Tribal Lending Provides More Opportunities for America's Indigenous Peoples*, FORBES (Nov. 26, 2019, 8:00 AM), https://www.forbes.com/sites/forbesfinancecouncil/2019/11/06/tribal-lending-provides-more-opportunities-for-americas-indigenous-peoples/?sh=6ecb84f274ba.

21. Miller, *supra* note 13, at 1300–01.

sources, and other rights are to be effectuated within the context of a nation-to-nation paradigm.

In entering treaties with American Indian tribes, the federal government recognized the inherent sovereignty of tribal nations. We are troubled by ongoing attempts by state governments to infringe the rights of these separate sovereigns, and by the federal government's lackluster efforts to uphold its end of the bargain—a bargain that it made on our behalf. When the federal government allows the constitutional rights of any group of Americans to be systematically disregarded by state governments, or otherwise, this poses a threat to *all* Americans, not just those who are directly impacted. In this Article, we advocate for the restoration of rule of law in the form of honoring treaty commitments and constitutional rights.

This Article argues that the federal government's plenary power over Indian affairs precludes state attempts to assert regulatory and tax jurisdiction over tribal businesses. The United States has a duty, under the Constitution and treaties entered with Indian tribes, to guard against this overreach. Part II begins by examining the legal foundations of federal, tribal, and state relations. Part III then examines recent cases across four business sectors—gaming, tobacco, petroleum, and online lending—to illustrate the pervasive jurisdictional challenges faced by courts in cases involving tribal businesses. Part IV offers three recommendations on how the federal government can uphold its constitutional and contractual duty to tribes. First, this Article argues that the proper first forum for resolving disputes involving tribal businesses or conflicts regarding tribal and state jurisdiction is the tribal court system; federal and state courts should be prepared to consider this issue *sua sponte* if it is not raised by the parties. Second, this Article calls for the enactment of law that would require periodic systematic audits of federal compliance with the terms of Indian treaties, including the federal government's activities and the federal government's obligation to prevent state interference with tribes' treaty-protected rights. Finally, in light of recent legislative proposals and executive actions, this Article asserts that removing barriers to Indian participation in the political process at all levels will support economic development and self-determination in Indian Country. This Article concludes that all Americans—indigenous or not—have a stake in seeing the

federal government uphold its constitutional and treaty-bound obligations to American Indian tribes, and that, as tribes increasingly enter the national and global marketplace, the time to act is now.[22]

II.
Legal Foundations of Federal, Tribal, and State Relations

A. *From Time Immemorial: Indigenous Relationships to Place*

Indigenous peoples have inhabited and thrived in the space we now know as the United States since time immemorial.[23] Tribes had—and continue to have—their own knowledge systems comprised of cultural practices, languages, traditions, spiritual beliefs, and forms of government.[24] However, the formation of federal laws and policies surrounding American Indians and their land have rarely, if ever, been constructed using indigenous knowledge.[25] Few written records exist which document indigenous relationships to the land prior to colonization; what we do know has been passed down through the practice of oral tradition. In *Braiding Sweetgrass*, Robin Wall Kimmerer offers the following depiction of indige-

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22. Before continuing, let us, as authors, explain our interest in this Native American sovereignty and economic development. We do not have a tribal affiliation. We do not purport to speak for any tribe or group. Although we consulted with Native American scholars and attorneys in preparing this manuscript, we do not personally offer a native voice. We felt drawn to write this Article because we are American citizens and, as such, we have an interest in seeing the United States uphold the constitutional and contractual commitments that it made on behalf of all Americans when entering treaties with native peoples.

23. Roxanne Dunbar-Ortiz, An Indigenous Peoples History of The United States 14 (2015).

24. *See generally* Sharon O'Brien, American Indian Tribal Governments 14–33 (1989) ("These governments ranged from highly centralized (Creek Nation) to highly decentralized (Yakama Nation) . . . each tribe, exercising its inherent sovereignty, structured its government according to its special needs, made and enforced its own laws, and conducted relations and trade with other tribes."); Hyojung Cho, *Conservation of Indigenous Heritage in the United States: Issues and Policy Development*, 38 J. Arts Mgmt. L. & Soc'y 187, 188 (2008).

25. *See* Robert J. Miller, *The International Law of Colonialism: A Comparative Analysis*, 15 Lewis & Clark L. Rev. 847, 849 (2011).

nous relationships to place and space and how they differ from settler colonist views of land:

> In the settler mind, land was property, real estate, capital, or natural resources. But to our people, it was everything: identity, the connection to our ancestors, the home of our nonhuman kinfolk, our pharmacy, our library, the source of all that sustained us. Our lands were where our responsibility to the world was enacted, sacred ground. It belonged to itself; it was a gift, not a commodity, so it could never be bought or sold. These are the meanings people took with them when they were forced from their ancient homelands to new places.[26]

As we examine the history of the legal interactions between federal, state, and tribal governments, particularly ones relating to land and place, we must keep in mind that the U.S. legal system has been developed from a singular perspective—the one offered by settler colonialism.[27]

B. *The Colonial Period*

Long before European colonization of what we now know as the Americas, American Indian Tribes existed as independent nations.[28] In the 1600s, at the time of European contact, approximately 12 million Native Americans, from more than 600 tribes, inhabited what is now North America.[29] Tribes often traded with and aligned with European powers, long before the formation of the United States.[30] In these interactions, England followed official governmental policies of deal-

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26. ROBIN WALL KIMMERER, BRAIDING SWEETGRASS: INDIGENOUS WISDOM, SCIENTIFIC KNOWLEDGE, AND THE TEACHINGS OF PLANTS 17 (2013).

27. *See* BRENNA BHANDAR, COLONIAL LIVES OF PROPERTY: LAW, LAND, AND RACIAL REGIMES OF OWNERSHIP (2018); Eve Tuck & K. Wayne Yang, *Decolonization Is Not a Metaphor*, 1 DECOLONIZATION: INDIGENEITY, EDUC. & SOC'Y 1 (2012). *See generally* Cheryl I. Harris, *Whiteness as Property*, 106 HARV. L. REV. 1707, 1757–58 (1993) ("The essential character of whiteness as property remains manifest in two critical areas of law and, as in the past, operates to oppress Native Americans and Blacks in similar ways."); Naomi Mezey, *Law as Culture*, 13 YALE J.L. & HUMAN. 35, 44 (2001).

28. *See* O'BRIEN, *supra* note 24, at 14; Nassima Dalal, *The Impact of Colonial Contact on the Cultural Heritage of Native American Indian People*, 4 DIFFUSION: UCLAN J. UNDERGRADUATE RES. 1 (2011).

29. *See* O'BRIEN, *supra* note 24, at 14.

30. *See id.* at 41.

ing with tribes, and recognized them as distinct, sovereign governmental entities, often making treaties with them.[31] Although it is thought that this may have been out of an effort to minimize legal liability, British law was explicit in its regard for tribal sovereignty.[32] In fact, some Native Americans even allied with the British in the Revolutionary War.[33]

Following the colonists' victory in the Revolutionary War, the newly formed United States inherited modicums of the British legal principles which considered tribes to be foreign nations and continued to recognize tribal possessory rights in western territories.[34] While these inherited principles established some guidance for the young nation, the United States needed to figure out for itself how Indian tribes would be regarded within the federal system.

The U.S. Constitution does not speak to the question of whether tribes are subject to federal regulation, state regulation, or both. The constitutional provisions that most directly address Indian tribes are the Indian Commerce Clause and the two Treaty Clauses, which are discussed in detail below. Federal Indian law is largely judge-made law. The first cases to consider federal–state–tribal relations are known as the Marshall Trilogy.

C. *Marshall Trilogy*

In the 1830s, SCOTUS was called upon to interpret the nature and scope of tribal sovereignty in relation to the controlling constitutional provisions.[35] Through a series of three decisions known as the Marshall Trilogy, SCOTUS accomplished a fundamental shift in federal Indian law, no longer treating tribes as fully sovereign and transitioning them to a

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31. *See* Robert J. Miller, *American Indians and the United States Constitution*, FLASHPOINT MAG. (2006); *see also* Lance F. Sorenson, *Tribal Sovereignty and the Recognition Power*, 42 AM. INDIAN L. REV. 69, 97 (2017).

32. *See* Richard C. Dale, *The Adoption of the Common Law by the American Colonies*, AM. L. REG. 553 (1882); Mark Savage, *Native Americans and the Constitution: The Original Understanding*, 16 AM. INDIAN L. REV. 1, 112–13 (1991).

33. *See* David Jaffee & Megan Mehr, *Native Americans and the American Revolution: Choosing Sides*, NAT'L ENDOWMENT FOR HUMAN. (Nov. 13, 2009), https://edsitement.neh.gov/lesson-plans/native-americans-role-american-revolution-choosing-sides; Savage, *supra* note 32, at 100.

34. Philip J. Smith, *Indian Sovereignty and Self-Determination: Is Moral Economy Possible?*, 36 S.D. L. REV. 299, 311–12 (1991).

35. *Id.* at 311.

unique status of protected domestic dependents within the federalist state.[36]

The first case in the Marshall Trilogy, *Johnson v. M'Intosh,* interpreted the Doctrine of Discovery to mean that land ownership lies with the governments whose subjects explored and occupied that land.[37] This interpretation is based on the idea that when Europeans conquered North America, their claims to the land superseded any Native American claims, and that further, when the United States won the territory from Great Britain in the Revolutionary War, all of the lands that the British purportedly owned were transferred to the United States.[38] However, more importantly, the case established federal supremacy in Indian affairs over that of states and individuals.[39] The ruling was based on the inherently racist logic that "'the superior genius of Europe might claim an ascendancy' over the 'character and religion' of the Natives . . . ."[40] The facts of the case involved a dispute over the ownership of parcels of land in the Ohio River Valley, which two parties claimed to have acquired from Indian nations in the area.[41] The Supreme Court held that Indians could not sell their property or title to anyone except the federal government.[42] This ruling made all previous sales of Indian property to individuals, states, or other nations void.[43]

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36. *See* Cherokee Nation v. Georgia, 30 U.S. 1, 17 (1831) (serving as the second case in the Marshall Trilogy, and summarizing the rationale for this shift in legal policy).

37. Johnson v. M'Intosh, 21 U.S. 543, 567 (1823) ("Not only has the practice of all civilized nations been in conformity with this doctrine, but the whole theory of their titles to lands in America, rests upon the hypothesis, that the Indians had no right of soil as sovereign, independent states. Discovery is the foundation of title, in European nations, and this overlooks all proprietary rights in the natives.").

38. *Id.* at 562 ("The European governments asserted the exclusive right of granting the soil to individuale [sic], subject only to the Indian right of occupancy. . . . The exclusive right of the British government to the lands occupied by the Indians, has passed to that of the United States.").

39. *Id.* at 587–88.

40. M. Jordan Thompson & Chelsea L.M. Colwyn, *Living Sqélix: Defending the Land with Tribal Law*, 51 CONN. L. REV. 889, 899 (2019) (quoting *Johnson*, 21 U.S. at 573).

41. Fletcher, *supra* note 3, at 2.

42. *Id.*

43. *Id.*

The second case in the Marshall Trilogy, *Cherokee Nation v. State of Georgia,* involved the Cherokee Nation seeking an injunction to restrain the State of Georgia from enforcing the laws of the State within Cherokee territory.[44] Before reaching the merits, the issue of federal court jurisdiction had to be addressed. The Cherokee Nation argued that it was a distinct entity from the State of Georgia, capable of managing and governing itself.[45] The Cherokee Nation positioned itself as a foreign nation, therefore claiming the Court had diversity jurisdiction over its dispute with the State of Georgia.[46] But the Court disagreed, holding that the Cherokee were not a foreign nation, but rather a "domestic dependent nation"[47] and therefore did not have legal recourse against the Georgia laws being used to remove them from their land.[48] The classification of tribes and bands as "domestic dependent nations" would be used to justify the removal of indigenous people from ancestral lands, as well as the complete paternalistic authority by Congress over tribes.[49]

The *Cherokee Nation* court recognized that the "domestic dependent nation" concept would be a difficult one to implement, remarking that the "condition of the Indians in relation to the United States is perhaps unlike that of any other two people in existence"[50] but could most closely be analogized to that of a "ward to his guardian."[51] Further in the *Cherokee* decision, Justice Johnson would state in the concurrence "[b]ut I think it very clear that the constitution neither speaks of them as states or foreign states, but as just what they were, Indian tribes; an anomaly unknown to the books that treat of states,

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44. Cherokee Nation v. Georgia, 30 U.S. 1, 1 (1831); Fletcher, *supra* note 3, at 2.

45. *Cherokee Nation,* 30 U.S. at 2–3.

46. *Id.* at 11 ("The bill avers that this court has, by the constitution and laws of the United States, original jurisdiction of controversies between a state and a foreign state, without any restriction as to the nature of the controversy.").

47. *Id.* at 17.

48. *Id.* at 20.

49. *Id.* at 17 ("They look to our government for protection; rely upon its kindness and its power; appeal to it for relief to their wants; and address the president as their great father."); *see* Thompson & Colwyn, *supra* note 40, at 899–900.

50. *Cherokee Nation,* 30 U.S. at 16.

51. *Id.* at 17.

and which the law of nations would regard as nothing more than wandering hordes, held together only by ties of blood and habit, and having neither laws or government, beyond what is required in a savage state."[52]

The final case of the Marshall trilogy, *Worcester v. Georgia*, arose from a Georgia State Court case related to state professional licensure requirements and their application on American Indian lands. In this case, a non-Indian minister, Reverend Worcester, was convicted for ministering without a license. Worcester challenged the conviction on the basis that he was operating solely within the Cherokee Nation lands, and therefore was not bound by the Georgia state licensing requirement.[53] SCOTUS agreed. Unlike the events in *Cherokee Nation v. State of Georgia*, the Court found the Georgia law inapplicable by operation of the Supremacy Clause, concluding that the Cherokee Nation was a "distinct community occupying its own territory . . . in which the laws of Georgia can have no force, and which the citizens of Georgia have no right to enter, but with the assent of the Cherokees themselves, or in conformity with treaties, and with the acts of [C]ongress."[54] Applying its prior holdings in *Johnson* and *Cherokee Nation*, the Court further held that "while the guardian–ward relationship did not extinguish tribal sovereignty, the federal government's assumption of fiduciary obligation towards tribes necessarily requires that tribal powers of self-government are limited by federal statutes, by the terms of treaties, and by restraints implicit within the protectorate relationship."[55]

In summary, the Marshall trilogy established three key principles of federal Indian law: (1) tribal sovereignty existed before the foundation of what we now know as the United States, and with the creation of the new nation it was not extinguished, but needed to be reinterpreted with the federal government holding the power to interpret this relationship; (2) tribes occupy a unique status within the federal structure as a domestic dependent nation; and (3) the status of tribes as domestic dependent nations creates a protectorate relationship in which the tribes' powers of self-government are limited and,

52. Cherokee Nation v. Georgia, 30 U.S. 1, 27–28 (1831).
53. Worcester v. Georgia, 31 U.S. 515, 537–41 (1832).
54. *Id.* at 561.
55. Smith, *supra* note 34, at 311.

thus, the United States has a fiduciary duty to them. Although federal Indian law has evolved and developed in the nearly 200 years since these decisions were issued, the core principles of the Marshall Trilogy are still utilized today.[56]

D. *Treaty Era*

As noted above, the European colonizers largely treated tribes as sovereign governments with authority over their peoples and territories. Generally, European settlers believed they held a right of occupancy of North America under the Doctrine of Discovery, but they did not believe this right was unbounded, and sought to negotiate treaties with Native Americans.[57] "Thus, England, France, and Spain, and later the United States, entered into numerous treaties with tribal governments to purchase land . . ." and secure access to other resources.[58]

Following the Revolutionary War, the United States followed the European model of creating treaties with tribes in the face of westward expansion.[59] The Articles of Confederation authorized the United States government to deal directly with tribes; between 1781 and 1789, the United States government entered into nine treaties with Indian tribes.[60] While the Articles provided Congress with the authority to manage American Indian affairs, the exclusivity of this power was unclear.[61] Thus, states also attempted to intervene.[62]

The early American government's attitude toward tribes can be regarded as one of indifference, reflecting a belief that fighting with tribes was a poor use of time and money that could have been better spent advancing settler colonialism.[63] In 1783, George Washington relayed this attitude to James

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56. *See* Matthew L.M. Fletcher, *The Iron Cold of the Marshall Trilogy*, 82 N.D. L. Rev. 627 (2006).

57. *See* Sorenson, *supra* note 31, at 97.

58. Robert J. Miller, The History of Federal Indian Policies 2 (Mar. 17, 2010) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573670.

59. *See* Miller, *supra* note 31.

60. *See Treaties Between the United States and Native Americans*, Yale L. Sch. (2008), https://avalon.law.yale.edu/subject_menus/ntreaty.asp.

61. *See* Miller, *supra* note 31.

62. *See id.*

63. *See* Miller, *supra* note 58, at 5–6.

Duane, a delegate in the Congress of the Confederation, stating, "[T]he gradual extension of our Settlements will as certainly cause the Savage, as the Wolf, to retire; both being beasts of prey, tho' they differ in shape."[64] But as white American populations grew in the late 1700s and fueled westward expansion, the United States government began to cast off the British legal principles in favor of ones that would advance the interests of settlers at the expense of the Native peoples.[65] The early approach of relative indifference towards tribes was no longer viable. Disputes with tribes became more common, and even erupted into violent clashes in states such as Georgia and South Carolina.[66] Such disputes, caused by states meddling in Indian affairs, demonstrated the need for a stronger federal government, and were therefore one driving force that motivated the adoption of the U.S. Constitution.[67]

Article II, Section II of the U.S. Constitution, also known as the Treaty Clause, gives the President power to enter treaties with Indian tribes and foreign nations: "[The President] shall have the Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur . . . ."[68] Under this provision, all treaties between the federal government and an Indian tribe or foreign nation must be signed by all parties and then ratified by Congress in order to have effect.[69] Article VI, Section II established that treaties carry the same force in effect as an act of Congress and are deemed the "supreme Law of the Land."[70]

Beginning with The Ordinance of 1785, legislation was executed that required the removal of Indians.[71] With the Northwest Ordinance in 1787, the federal government estab-

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64. Letter from George Washington, Commander in Chief of the Cont'l Army, to James Duane (Sept. 7, 1783), https://founders.archives.gov/documents/Washington/99-01-02-11798.

65. *See* Miller, *supra* note 58, at 6.

66. *See* Miller, *supra* note 31.

67. *Id.*

68. U.S. CONST. art. II, § 2.

69. Although the U.S. Constitution vests treaty-making power with the President, it did not entirely devoid states of their voice in the treaty-making process; by requiring Congressional ratification, states continue to have some control over the process.

70. U.S. CONST. art. VI, § 2.

71. THE NORTHWEST ORDINANCE: ESSAYS ON ITS FORMULATION, PROVISIONS, AND LEGACY, at vii (Fredrick D. Williams ed., 1988).

lished the Northwest Territories, which "set the pattern for territorial governance and statemaking that was ultimately applied to thirty-one of the fifty states."[72] In 1790, Congress enacted the Trade and Intercourse Act, which, in pertinent part, asserted federal control over all commercial and other interactions between Indians and non-Indians.[73] As noted above, in *Worcester v. Georgia*, the U.S. Supreme Court had affirmed that the federal, not state, government has control over commerce with Indian tribes.[74]

The period from 1790 to 1830 was marked by relatively good relations between the United States government and American Indian tribes. The Bureau of Indian Affairs ("BIA") was established in 1824 to serve as trustee for all federally recognized Indian tribes through a fiduciary relationship.[75] But, as westward expansion pressed onward with an ever-increasing pace, so did the mounting conflicts between American Indians and non-Indian settlers.

Under pressure from President Andrew Jackson, in 1830, Congress passed the Indian Removal Act.[76] The Act authorized the President to negotiate "treaties" with Indian tribes in order to remove tribes from their homeland and relocate

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72. Denis P. Duffey, *The Northwest Ordinance as a Constitutional Document*, 95 COLUM. L. REV. 929, 930 (1995).

73. Act of June 30, 1834, Pub. L. No. 23-161, § 12, 4 Stat. 729, 730 (codified as amended at 25 U.S.C. § 177 (2006)).

74. *See* Worcester v. Georgia, 31 U.S. 515, 573 (1832) (M'Lean, J., concurring) (quoting ARTICLES OF CONFEDERATION of 1781, art. IX, para. 4) ("[T]he United States, in congress assembled, shall also have the sole and exclusive right and power of regulating the alloy and value of coin struck, by their own authority, or by that of the respective states; fixing the standard of weights and measures throughout the United States; regulating the trade and management of all affairs with the Indians, not members of any of the states: Provided, that the legislative right of any state, within its own limits, be not infringed or violated.").

75. *See* Robert McCarthy, *The Bureau of Indian Affairs and the Federal Trust Obligation to American Indians*, 19 BYU J. PUB. L. 1, 4, 9 (2004); *Mission Statement*, BUREAU OF INDIAN AFFAIRS (Sept. 5, 2021, 5:26 PM), https://www.bia.gov/bia.

76. Ch. 148, 4 Stat. 411 (1830); Adam Crepelle, *Lies, Damn Lies, and Federal Indian Law: The Ethics of Citing Racist Precedent in Contemporary Federal Indian Law*, 44 N.Y.U. REV. L. & SOC. CHANGE 529, 564 (2021) ("Elected in 1828, President Jackson actively worked to ensure the passage of the Indian Removal Act of 1830 which empowered the president to negotiate the removal of tribes from the Eastern United States.").

them to Indian territories located west of the Mississippi.[77] These "treaties" were frequently entered by tribes under duress. Under the Indian Removal Act, tribes were compelled to sign a number of treaties in which they forfeited their homelands in exchange for new lands west of the Mississippi.[78] Throughout the 1830s and 1840s, thousands of Indians migrated west under a program that was "voluntary in name and coerced in fact."[79] The forced migration, termed the "Trail of Tears" by the Cherokee Nation, was ordered by Congress and championed by President Jackson.[80] The program was responsible for the loss of thousands of lives and has come to be regarded as an act of systematic genocide.[81]

With the discovery of gold in California, along with the opening of the Oregon Trail, the 1840s witnessed rapid migration west by non-Indians. In 1851, as removal of all tribes into Indian Territories became impractical, Congress passed the Indian Appropriations Act.[82] This Act introduced the concept of Indian reservations, to be located in Oklahoma and also in other (largely undesirable) locations primarily in the American West.[83] In the "Reservation Era" between 1850 and 1887, nearly 300 reservations were established by tribal governments and the United States.[84]

For the most part, reservations were significantly smaller than the lands that the tribes had originally held, and in some cases, the reservation was in an entirely new location completely unfamiliar to the tribe.[85] This period was marked by a

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77. Ch. 148, 4 Stat. 411 (1830).

78. *See* Miller, *supra* note 58, at 11.

79. William C. Canby, Jr., American Indian Law in a Nutshell 19 (6th ed. 2015).

80. *See* Miller, *supra* note 58, at 11.

81. National Museum of the American Indian, *The "Indian Problem,"* YouTube (Mar. 3, 2015), https://www.youtube.com/watch?v=IF-BOZgWZPE.

82. Ch. 14, 9 Stat. 574 (1851); Miller, *supra* note 58, at 13.

83. *See* Miller, *supra* note 58, at 11; James J. Lopach, Tribal Government Today: Politics on Montana Indian Reservations 1 (2019).

84. *See* Charlene Koski, *The Legacy of* Solem v. Bartlett*: How Courts Have Used Demographics to Bypass Congress and Erode the Basic Principles of Indian Law*, 84 Wash. L. Rev. 723, 728 (2009); Miller, *supra* note 58, at 13.

85. *See* Miller, *supra* note 58, at 13; Michael C. Blumm, *Retracing the Discovery Doctrine: Aboriginal Title, Tribal Sovereignty, and their Significance to Treaty-Making and Modern Natural Resources Policy in Indian Country*, 28 Vt. L. Rev. 713, 763 (2004).

staggering number of deaths as indigenous people struggled to adjust to the practice of farming rather than hunting, as well as the rampant spread of disease by non-Indians.[86] And yet, in the mid-1800s, and even by some people today, reservations were improperly regarded as a gift from the United States government to tribes, rather than a retention of tribes' lands and sovereignty that predates colonization.[87]

Members of the U.S. House of Representatives began to voice opposition to the United States entering treaties with American Indian tribes. The opposition was not grounded in ethical concerns, but, paradoxically, in the notion that after decades of conflicts with settlers, forced migration, and the rampant spread of new disease, the Native American population had dwindled too much to be called a "nation."[88] In 1871, after entering 370 treaties with American Indian tribes,[89] Congress ceased to recognize tribes as independent nations with which the United States could contract by treaty, ending the

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86. *See* Miller, *supra* note 58, at 14; Kyle Whyte, *The Dakota Access Pipeline, Environmental Injustice, and U.S. Colonialism*, RED INK: AN INTERNATIONAL JOURNAL OF INDIGENOUS LITERATURE, ARTS, & HUMANITIES, Feb. 28, 2017, at 154 (describing how tribal lands were broken up "into private property (often 160-acre parcels) for tribal members, an effort intended to force Indigenous peoples to adopt farming lifestyles that would pose less resistance to settlement.").

87. Marilyn J. Ward Ford, *Indian Country and Inherent Tribal Authority: Will They Survive ANCSA?*, 14 ALASKA L. REV. 443, 469 (1997) ("Much of the understanding regarding tribal sovereignty stems from the mistaken idea that it is a gift granted by the federal government to American Indian tribes."); Nicholad Vrchoticky, *The Untold Truth of the Trail of Tears*, GRUNGE (Sept. 2, 2021, 10:56 PM), https://www.grunge.com/135049/the-untold-truth-of-the-trail-of-tears/?utm_campaign-clip (explaining how reservations are now often regarded as stolen land. "American Indian reservations were built on a messed up history of colonization by an invading government. Reservations themselves are a reminder that the United States sits on stolen land through attempted genocide and rose to its heights on the backs of broken treaties. Reservations symbolize the killing of whole traditions and languages; the end of the old Indigenous way of life and the start of a new one controlled by an uninvited force.").

88. Mark Hirsch, *1871: The End of Indian Treaty Making*, MAG. OF SMITHSONIAN'S NAT'L MUSEUM OF THE AM. INDIAN (Summer/Fall 2014), https://www.americanindianmagazine.org/story/1871-end-indian-treaty-making.

89. Hansi Lo Wang, *Broken Promises on Display at Native American Treaties Exhibit*, NAT'L PUB. RADIO (Jan. 18, 2015, 4:57 PM), https://www.npr.org/sections/codeswitch/2015/01/18/368559990/broken-promises-on-display-at-native-american-treaties-exhibit.

tradition of treaty-making.[90] Notably, Congress agreed to continue to honor all existing treaties.[91]

However, in 1903, the Supreme Court confirmed that Congress held the power to "abrogate the provisions of an Indian treaty."[92] In *Lone Wolf v. Hitchcock,* a case was brought against the US government by a Kiowa chief who charged that tribes under the Medicine Lodge Treaty had lost land due to a Congressional action in violation of the treaty.[93] The Court held that the plenary power held by Congress gave it the ability to abrogate, or lessen, treaty responsibilities, or even negate treaties entirely.[94] Since the decision in *Lone Wolf v. Hitchcock*, treaties have been abrogated or broken by Congress in several instances; however, while Congress may terminate tribal and treaty rights, "the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress."[95] Following the end of the treaty-making era, Indian reservations have been established by presidential designation, and federal Indian policy has been made through statutes and executive actions.[96]

Although no new treaties between the federal government and tribes have been entered for the past 150 years, treaties are still one of the primary instruments grounding the recognition of tribal sovereignty.[97] Treaties continue to delineate land borders and define the political relationship between

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90. Indian Appropriations Act of 1871, 25 U.S.C. § 71 ("No Indian nation or tribe within the territory of the United States shall be acknowledged or recognized as an independent nation, tribe, or power with whom the United States may contract by treaty . . . .").

91. *Id.*

92. Lone Wolf v. Hitchcock, 187 U.S. 553, 566 (1903).

93. *Id.* at 564.

94. *Id.* at 566.

95. Menominee Tribe of Indians v. United States, 391 U.S. 404, 412–13 (1968) (citing Pigeon River Improvment, Slide & Boom Co. v. Charles W. Cox, Ltd., 291 U.S. 138, 160 (1934)). *See generally* Jeri Beth K. Ezra, *The Trust Doctrine: A Source of Protection for Native American Sacred Sites*, 38 CATH. U. L. REV. 705 (1989); Robert Laurence, *Thurgood Marshall's Indian Law Opinions*, 27 HOW. L.J. 3 (1984); Catherine M. Ovsak, *Reaffirming the Guarantee: Indian Treaty Rights to Hunt and Fish Off-reservation in Minnesota*, 20 WM. MITCHELL L. REV. 1177 (1994).

96. Michael C. Blumm, *Retracing the Discovery Doctrine: Aboriginal Title, Tribal Sovereignty, and their Significance to Treaty-Making and Modern Natural Resources Policy in Indian Country*, 28 VT. L. REV. 713, 764 n.333 (2004).

97. Frank Pommersheim, *Tribal-State Relations: Hope for the Future*, 36 S.D. L. REV. 239, 242 (1991).

tribes and the federal government today.[98] However, disputes still arise over the interpretation. The U.S. Supreme Court has developed three canons of construction for resolving treaty disputes: treaties are to be construed as the participating Indians understood them at the time of signing, ambiguous expressions are to be resolved in favor of the Indians, and treaties are generally to be construed liberally in favor of Indians.[99]

E. *Separate Sovereigns*

The United States Constitution speaks to the relationship between the federal and state governments, and between the federal government and American Indian tribal governments, but it does not address the relationship between states and Indian tribes. Federal Indian law, therefore, is grounded in the concept that because the Constitution granted plenary power over Indian affairs to Congress,[100] and treaty-making power to the President and the Senate,[101] states have no authority over tribal governments unless expressly authorized by Congress.[102]

Tribes and states are parallel sovereigns, meaning that tribal governments are not subordinate to state governments, and state governments are not subordinate to tribal governments. States and tribes are separate sovereigns with proximal geographic territories that share common citizens.[103] In the modern era, states and tribes have government-to-government relations and cooperate in areas such as taxation, education, and law enforcement.[104]

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98. *Id.*

99. Jill De La Hunt, *The Canons of Indian Treaty and Statutory Construction: A Proposal for Codification*, UNIVERSITY OF MICHIGAN JOURNAL OF LAW REFORM, 17 U. MICH. J. L. REFORM 681, 708–09 (1984).

100. U.S. CONST. art. I, § 8, cl. 3.

101. U.S. CONST. art. II, § 2.

102. Jackie Gardina, *Federal Preemption: A Roadmap for the Application of Tribal Law in State Courts*, 35 AM. INDIAN L. REV. 1, 1 (2010).

103. Tribal citizens who reside on-reservation are citizens of both the Tribe and the State however, non-Indian residents of the reservation are State citizens, but not tribal citizens.

104. SUSAN JOHNSON ET AL., GOVERNMENT TO GOVERNMENT: MODELS OF COOPERATION BETWEEN STATES AND TRIBES 18, 69 (2d ed. 2009).

Questions of federal, state, and tribal jurisdiction persist in the present day.[105] Generally speaking, states do not have authority over tribes unless a federal statute is found to support the contrary.[106] A tribe has authority over its members on its reservation unless a federal statute dictates otherwise.[107] If a tribe asserts authority over non-members on reservation, unless there is a federal statute addressing the issue, authority will be determined on a case-by-case basis, in which the individual or parties affiliation with the tribe is considered, as well as the potential effect upon essential tribal political, economic, or social interests.[108] Until recently, in instances when a State and a tribe asserted the same authority over non-member interests on a reservation, the two-prong *Bracker* test was used to determine who held authority,[109] asking: (1) is the state law preempted by a federal law; and (2) would state authority infringe upon tribal self-government? In recent cases, however, the Court appears to be trending towards upholding state authority over non-Indian activity on reservations.[110]

It should be noted that there are significant exceptions to these general rules in the areas of criminal and family law, which are beyond the scope of this paper. Most notably, Public Law 280 confers—from the federal government to six state governments—criminal jurisdiction over tribal lands located within each respective state; it also contains an option for

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105. *See, e.g.*, Worcester v. Georgia, 31 U.S. 515, 520 (1832) (describing the limits of state authority in Indian Country); United States v. Wheeler, 435 U.S. 313, 319 (1978) (recognizing the plenary authority of the federal government in Indian Country); Plains Commerce Bank v. Long Family Land & Cattle Co., 554 U.S. 316, 336–37 (2008) (defining the limits of tribal jurisdiction); David M. Blurton, *ANCSA Corporation Lands and the Dependent Indian Community Category of Indian Country*, 13 ALASKA L. REV. 211, 227–28 (1996) (describing the shifting policies).

106. *See* United States v. McBratney, 104 U.S. 621 (1881); McClanahan v. Arizona Tax Comm'n, 411 U.S. 164 (1973); Montana v. United States, 450 U.S. 544 (1981); Moe v. Confederated Salish & Kootenai Tribes, 425 U.S. 463 (1976).

107. *See* Montana, 450 U.S. 544.

108. *Id.* The Court subsequently upheld the exclusive authority of tribes over hunting and fishing by members *and* non-members within the reservation. New Mexico v. Mescalero Apache Tribe, 462 U.S. 324 (1983).

109. White Mountain Apache v. Bracker, 448 U.S. 136, 142 (1980).

110. *See* Cty. of Yakima v. Confederated Tribes and Bands of the Yakima Indian Nation, 502 U.S. 251, 257–58 (1992); Strate v. A-1 Contractors, 520 U.S. 438, 452–53 (1997).

other states and tribes to adopt the policy fully or partially.[111] Moreover, the Indian Child Welfare Act created federal minimal standards to justify the removal of an Indian child from their family and placement into foster or adoptive homes.[112]

Further complicating jurisdiction in Indian Country is the fact that many parts of Indian Country are "checkerboarded"—or divided in ownership between indigenous and non-indigenous peoples—as an effect of the allotment policies of the late 1800s and early 1900s. The Dawes Act of 1887 divided Native American tribal communal land holdings into allotments for Native American families, retroactively altering the community traditions of tribes and forcing them to assume a "capitalist and proprietary relationship with property."[113] After parcels of land were allotted to Native American families, the remainder was sold off to non-Indians. Between 1887 and 1934, nearly 100 million acres, or two-thirds of lands held by Native Americans, were forfeited as a result of the Dawes Act.[114]

The 1934 passage of the Indian Reorganization Act prohibited further allotment and restored the rights of American Indians to manage their own land.[115] However, the Indian Reorganization Act still allowed for the fundamentally problem-

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111. 18 U.S.C. §§ 1162, 1360 (2010); *Public Law 280*, TRIBAL LAW AND POLICY INSTITUTE, http://www.tribal-institute.org/lists/pl280.htm.

112. For more information on Public Law 280, *see, e.g.*, *Construction and Application of § 2 of Federal Public Law 280, Codified At 18 U.S.C.A. § 1162, Under Which Congress Expressly Granted Several States Criminal Jurisdiction Over Matters Involving Indians*, 55 A.L.R. Fed. 2d 35 (2011) [hereinafter *Construction and Application of § 2 of Federal Public Law 280*]; for more information on the Indian Child Welfare Act, *see Construction and Application of Indian Child Welfare Act of 1978 (ICWA) (25 U.S.C.A. §§ 1901 et seq.) Upon Child Custody Determinations*, 89 A.L.R.5th 195 (2001); *see also* Kathryn Fort & Adrian T. Smith, *Indian Child Welfare Act Annual Case Law Update and Commentary*, 7 AM. INDIAN L.J. 20 (2019).

113. THE SETTLEMENT OF AMERICA: AN ENCYCLOPEDIA OF WESTWARD EXPANSION FROM JAMESTOWN TO THE CLOSING OF THE FRONTIER 161–362 (James Crutchfield et al. eds., 2d ed. 2015).

114. ENCYCLOPEDIA OF MINORITIES IN AMERICAN POLITICS: VOLUME 2, HISPANIC AMERICANS AND NATIVE AMERICANS 608 (Jeffrey Schultz et al. eds. 2000).

115. Indian Reorganization Act of 1934 ch. 576, §1, 48 Stat. 984. (codified as amended at 25 U.S.C. § 461).

atic parts of the Dawes Act to remain in effect.[116] Since the land base has remained checkerboarded, Indians can no longer assume the same jurisdictional authority that they would have had on a reservation or land entirely populated by tribe members. Because their lands are held in trust by the federal government, Native Americans do not hold typical occupancy or possessory rights to the land, but rather own an interest in the proceeds received from the land.[117] They cannot perform real estate transactions, which, in turn, has stifled their ability to acquire capital.[118]

F. *Tribal Sovereign Immunity*

American Indian tribes retain a right to immunity from suit traditionally provided to other sovereign entities.[119] This right was made apparent in the 1895 case *Thebo v. Choctaw Tribe of Indians,* which further explained the position of tribes as sovereign entities protected from suit by the state without their consent, or in some rare cases, the authorization of the Congress.[120]

Congress initially recognized tribal sovereign immunity because it believed the immunity was necessary to protect Indian tribes from encroachment by the individual states.[121] Tribal sovereign immunity can only be waived by a tribe itself or by an act of Congress.[122] A lawsuit against a sovereign entity

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116. The Act did not change some parts of the General Allotment Act that had made the use of allotments increasingly difficult among Indian people. *See Land Tenure History*, INDIAN LAND TENURE FOUNDATION (Sep. 5, 2021, 4:03 PM), https://iltf.org/land-issues/history/.

117. Patterson, *supra* note 11, at 150.

118. *Id.*

119. Santa Clara Pueblo v. Martinez, 436 U.S. 49, 58 (1978);*S see* United States v. U.S. Fid. & Guar. Co., 309 U.S. 506, 512 (1940) (holding that an Indian tribe should retain the same level of immunity that it possessed when it was considered a separate sovereign); *see also* William Wood, *It Wasn't an Accident: The Tribal Sovereign Immunity Story*, 62 AM. U. L. REV. 1587, 1594 (2013).

120. Thebo v. Choctaw Tribe of Indians, 66 F. 372, 375 (8th Cir. 1895) ("It has been the policy of the United States to place and maintain the Choctaw Nation and the other civilized Indian Nations in the Indian Territory, so far as relates to suits against them, on the plane of independent states. A state, without its consent, cannot be sued by an individual.").

121. *See* Kiowa Tribe v. Mfg. Techs, 523 U.S. 751, 758 (1998).

122. *Id.* at 754 (stating that an Indian tribe can only be sued under federal law if the tribe has waived its tribal immunity, or if Congress has taken an

can be authorized by Congress only if their intent to abrogate immunity is "unequivocal[ ]."[123] The power of sovereign immunity has become extensive because of the growth in economic activity between tribes and states, leading to numerous implications for both parties.[124] In the following section, we will examine recent cases involving disputes between states and tribes regarding business activities.

III.
Recent Legal Developments in Leading Tribal Industries

A. *Gaming*

Tribal gaming may be the industry most thought of by non-indigenous people when discussing on-reservation tribal businesses. Tribal gaming operations generated approximately $105 billion in 2018—nearly half of all gaming revenue generated in the United States.[125] There are more than 400 Indian gaming establishments in the United States, on reservations lo-

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action to authorize the suit); Thebo, 66 F. at 373–74 (explaining that Congress's power to pass acts that authorize lawsuits against Indian tribes has never been in doubt and that Congress has done so numerous times in the past).

123. Kimel v. Fla. Bd. of Regents, 528 U.S. 62, 73 (2000) (describing how the requirement of an unequivocal expression mandates a presumption that Indian tribes possess this tribal sovereign immunity); *see also* White Mountain Apache Tribe v. Bracker, 448 U.S. 136, 143–44 (1980) (explaining that any ambiguity in a federal law is construed in a manner that favors the tribe).

124. *Kiowa Tribe*, 523 U.S. at 758 (1998) (noting that tribal immunity was originally interpretated as a protection of a tribe's ability to self-govern, but now covers a number of off-reservation commercial activities); *see also* Lorie M. Graham, *An Interdisciplinary Approach to American Indian Economic Development*, 80 N.D. L. Rev. 597, 601–02 (2004) (explaining that Indian tribes have begun offering an increasing number of commercial services). The doctrine of tribal immunity has continually come under increased scrutiny. *See* Memphis Biofuels, LLC v. Chickasaw Nation Indus., Inc., 585 F.3d 917, 922 (6th Cir. 2009); *see also* Hunter Malasky, Note, *Tribal Sovereign Immunity and the Need for Congressional Action*, 59 B.C.L. Rev. 2469, 2475, 2481 (2018).

125. *The Economic Impact of Tribal Gaming: A State-By-State Analysis*, Am. Gaming Ass'n (Nov. 8, 2018), https://www.americangaming.org/wp-content/uploads/2018/11/Economic-Impact-of-Tribal-Gaming-Two-Pager-11.5.18.pdf; *The Economic Impact of Tribal Gaming: A State-By-State Analysis*, Am. Gaming Ass'n (Nov. 8, 2018) (Nov. 8, 2018), https://www.americangaming.org/resources/the-economic-impact-of-tribal-gaming-a-state-by-state-analysis-2/.

cated across 28 different states.[126] These businesses have created approximately 676,000 jobs[127] —an impressive feat for communities that are often geographically isolated. While casino-type gaming has become a major modern industry for many tribes, other forms of Native American gaming have existed for centuries.[128] Traditionally, many tribes have used games to redistribute wealth, teach traditional values, and preserve culture.[129]

Yet, gaming is not a panacea. As we explore in this section, the development of gaming compacts between state and tribal governments is often contentious, time-consuming, and expensive for tribal governments. Even when these negotiations are successful, on-reservation casinos sometimes fail due to inexperienced management and/or a lack of customers.[130] While tribal casinos close to urban areas can draw customers and tourists from far and wide, tribal casinos in remote areas often draw heavily on their own tribal membership as a customer base.[131] In this scenario, the prosperity of the tribal casino can come at the expense of the tribe's own members. Further, some casinos have been associated with a rise in drug and alcohol use as well as criminal activity on reservations (though they also generate revenue that supports tribal law enforcement, health care, and other social services).[132]

The merits of the case that got the dice rolling on the now multibillion-dollar Indian gaming industry involved the misapplication of less than $200 in taxes by states. In 1973, Rosalind McClanahan, a Navajo woman who lived on the Navajo Reservation in Arizona, sought to reclaim her withheld state income tax, around $16, from a job she worked on the reservation.[133]

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126. *Id.*

127. *Id.*

128. Eileen M. Luna-Firebaugh & Mary Jo Tippeconnic Fox, *The Sharing Tradition: Indian Gaming in Stories and Modern Life*, 25 WICAZO SA REV. 75, 75 (2010).

129. *Id.*

130. Danielle Slawny, *Taking a Gamble: Considering Potential Problems and Effects on Indigenous Gaming Communities*, BOSTON UNIVERSITY ARTS AND SCIENCE WRITING PROGRAM, https://www.bu.edu/writingprogram/journal/past-issues/issue-10/slawny/.

131. Randall K. Akee et al., *The Indian Gaming Regulatory Act and Its Effects on American Indian Economic Development*, 29 J. ECON. PERSP. 185, 199 (2015).

132. Slawny, *supra* note 130.

133. McClanahan v. Ariz. State Tax Comm'n, 411 U.S. 164, 166 (1973).

McClanahan claimed, and the Supreme Court unanimously agreed, that Arizona did not have the right to tax her because Indian reservations were exempt from state authority.[134] *McClanahan* recognized that, with some exceptions, "state law could have no role to play within the reservation boundaries"[135] which gave way to the notion that tribes would be exempt from state gaming laws.

Two years later, a similar case was presented to the Minnesota court system; however, the case was unique because Minnesota was (and remains) a Public Law 280 state.[136] Broadly, as explained above, Public Law 280 confers criminal jurisdiction over American Indians on reservations from tribes to the state. The Bryan family, members of the Chippewa tribe, brought suit against the state seeking a declaratory judgement that Itasca County (and by extension the State of Minnesota) lacked the authority to levy a personal property tax of approximately $160 on their mobile home, which was located on land held in trust by the United States for members of the Chippewa tribe on the Leech Lake Reservation.[137] In another unanimous decision, the Supreme Court held that Public Law 280 did not grant States the authority to levy taxes against Indians on-reservation because the law was intended to confer state criminal jurisdiction— not to authorize state civil regulatory control over American Indians.[138] While *McClanahan* and *Bryan* were both largely tax cases, the opinions emboldened tribes to take advantage of the federal protections provided to them on their own land—specifically, by beginning gaming operations.[139]

It is important to understand that what made the emerging industry of Indian gaming successful was not federal Indian policy, but restrictive state policy.[140] States maintain strict

134. *Id.* at 179–80.

135. Kevin K. Washburn, *Federal Law, State Policy, and Indian Gaming*, 4 NEV. L.J. 285, 285 (2004) (quoting *id.* at 168).

136. For more information on Public Law 280, *see Construction and Application of § 2 of Federal Public Law* 280, *supra* note 112.

137. *Bryan*, 426 U.S. at 373.

138. "Public Law 280 relates primarily to the application of state civil and criminal law in court proceedings, and has no bearing on programs set up by the States to assist economic and environmental development in Indian territory." *Id.* at 387 (quoting Senator Sam Ervin).

139. Washburn, *supra* note 135, at 285.

140. *Id.* at 286.

restrictions or even prohibitions on commercial gaming, largely for political reasons.[141] However, these restrictions did not prevent states from maintaining an interest in collecting tax revenue from gaming occurring on Indian reservations—even after the opinions in *McClanahan* and *Bryan* had been issued.

The modern Indian gaming movement began with high-stakes bingo operations in California and Florida.[142] While milder forms of bingo were legal at the time in both states, officials began to object to the more successful and lucrative tribal bingo operations.[143] Litigation throughout the Florida and California court systems culminated to the 1987 Supreme Court case *California v. Cabazon Band of Mission Indians*.[144]

Like many tribes in the 1980s, the Cabazon and Morongo Bands of Mission Indians were subject to scrutiny by state and local officials after their small bingo parlors and card clubs began to be frequented by non-Indians visiting the reservations.[145] In 1987, California attempted to minimize, and ultimately shut down, the Bands' gaming operations under the pretense of violating state law.[146] The Cabazon Band fought against California's ordinances and brought suit against the state, arguing that the Band's status as a sovereign nation with civil regulatory authority protected it from state interference. The State of California argued that Public Law 280 had granted broad criminal jurisdiction over American Indians and Indian country to the state, and that gaming should fall into the realm of criminal activity.[147] The Supreme Court in a 6-3 decision determined that because the State of California permitted and even encouraged some forms of gambling throughout the state, that gambling regulations were a type of civil law and were therefore not enforceable on-reservation without express consent from Congress.[148] The Court further elucidated that even though "an otherwise [state] regulatory

141. *See id.* at 289.
142. *Id.* at 287.
143. Steven Andrew Light, *The Cabazon Decision: Opening the Door to Indian Gaming - 20 Years Later*, INDIAN GAMING, Apr. 2007, at 22.
144. California v. Cabazon Band of Mission Indians, 480 U.S. 202 (1987).
145. Light, *supra*, note 143.
146. *Id.*
147. *Id.*
148. *Cabazon Band of Mission Indians*, 480 U.S. at 220–21 (1987).

law is enforceable by criminal as well as civil means does not necessarily convert it into a criminal law" enforceable on an Indian reservation pursuant to Public Law 280.[149]

Ultimately, *Cabazon* signaled that if states with jurisdiction over tribal lands through Public Law 280 did not have the power to impose regulations on on-reservation gaming, then no state did.[150] The decision did leave Public Law 280 states with the theoretical option of passing stricter, criminally enforceable gaming regulations, but states were unwilling to do that, fearing the negative effects to their own gaming industry.[151]

Congress had begun hearings on Indian Gaming issues at the insistence of state and local governments even before the *Cabazon* decision.[152] Intense lobbying from numerous parties led Congress to enact the Indian Gaming Regulatory Act ("IGRA") in 1988 under the claim of providing "a statutory basis for the operation of gaming by Indian tribes."[153] But in reality, the Act was likely an attempt to pacify state governments and roll back the freedom afforded to tribes in the *Cabazon* decision.[154] With the enactment of the IGRA came the creation of the National Indian Gaming Commission ("NGIC"), a federal regulatory body designed to regulate and support on-reservation tribal gaming.[155]

The IGRA also established a three-class structure that sets forth the roles of tribal, state, and federal governments in gaming regulation.[156] Class I gaming includes traditional Native American games of chance that are typically low stake; these games are exclusively regulated by tribal governments.[157] Class II applies to games like bingo, pull-tabs, and non-banked card games, like poker; these games are regulated jointly by the

149. *Id.* at 211.
150. Washburn, *supra* note 135, at 289.
151. *Id.*
152. *Id.*
153. 25 U.S.C. § 2702(1) (2000).
154. Washburn, *supra* note 135, at 289.
155. *About Us*, NAT'L INDIAN GAMING COMM'N, https://www.nigc.gov/ commission/about-us.
156. Indian Gaming Regulatory Act, 25 U.S.C. § 2703(6) ("The term 'class I gaming' means social games solely for prizes of minimal value or traditional forms of Indian gaming engaged in by individuals as a part of, or in connection with, tribal ceremonies or celebrations.").
157. *Id.*

NIGC and tribal governments.[158] Finally, Class III games include all other forms of gaming not mentioned in Class I or II such as blackjack and slot machines.[159] In order to follow the IGRA, Class III games are only legal if: (1) they are authorized by the tribal government; (2) they are located in a state that permits the games for any purpose; and (3) they are performed in compliance with tribal-state gaming compacts.[160]

Compacts for Class III gaming are created in conjunction by the tribe and the state. Compacts may include provisions on:

> (1) the application of state or tribal criminal and civil laws that relate to gaming; (2) who holds jurisdiction between the tribe and the state; (3) payments to the state for their regulation of gaming; (4) taxation by the tribe on gaming activities; (5) remedies for breach of compact; (6) standards of operation for gaming facilities; and (7) any other relevant subjects.[161]

Once compacts are agreed upon by the tribe and the state, they are approved or disapproved by the Secretary of the Interior.[162] Compact negotiation disputes are within the exclusive jurisdiction of federal district courts.[163]

Conflict over compacts can arise when a party tries to use means other than those specified in the compact to settle a dispute. One such example is the Mohegan tribe, whose COVID-19 response measures were challenged by the state of Connecticut when it attempted to reopen the Mohegan Sun casino.[164] At the Federal Bar Association's 2020 D.C. Federal Indian Law Conference, Sarah Harris, the Vice Chairwoman of the Mohegan Tribe, gave a presentation on state pushback that occurred as her tribe attempted to reopen their casino.[165]

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158. *Id.* at cl. 7.
159. *Id.* at cl. 8.
160. Akee, *supra* note 131, at 192.
161. *Id.*
162. *Id.* at 201.
163. *Id.*
164. Sarah Harris, Vice Chairwoman, Mohegan Tribal Council, Mohegan Tribe and COVID-19 address at Federal Bar Association (Nov. 5, 2020).
165. *Id.*

The Mohegan reservation is located near Uncasville, Connecticut and has been federally recognized since 1994.[166] Shortly after receiving federal recognition, in 1996, the Mohegan Tribe opened the Mohegan Sun, a luxury resort and casino.[167] Since its inception, the Mohegan Sun has fallen under the purview of a gaming compact between the Mohegan tribe and the State of Connecticut, which posits that in exchange for the exclusive right to offer Class III gaming, the Mohegan must contribute a portion of their slot revenue to the state.[168] This contribution totaled $8 million in 2019.[169] Pre-COVID, the Mohegan Sun was a robust operation, netting revenues of $251 million in 2019 despite the year being a largely unsuccessful one for the industry.[170] Additionally, Mohegan Sun created immense employment opportunities, employing a staff of 4,500 full time employees and 2,000 part-time and seasonal employees.[171]

It goes without saying that COVID had profound effects on the gaming industry, tribal and non-tribal. Following the first reported case of COVID in Connecticut in early March of 2020, the Governors of Connecticut, New York, New Jersey and Massachusetts announced a regional response plan on March 17th and asked the Mohegan Tribe to join in the effort.[172] On March 17th, the Mohegan Tribe issued a Tribal Council Emergency Declaration, and the Mohegan Sun closed its doors for the first time in twenty-four years.[173]

Promptly following the issuance of the statewide response plan, the Mohegan Tribe invited the governor's office to collaborate on the design of safety protocols for an eventual reopening. But, the governor's office did not respond. Without

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166. *Recognition*, MOHEGAN TRIBE, https://www.mohegan.nsn.us/about/information/recognition.

167. *About Mohegan Sun*, MOHEGAN SUN, https://moheganSun.com/about-mohegan-sun.html.

168. Sarah Harris, Vice Chairwoman, Mohegan Tribal Council, Mohegan Tribe and COVID-19 address at Federal Bar Association (Nov. 5, 2020).

169. *Id.*

170. Joe Cooper, *Mohegan Sun's 3Q profits fall 21% amid declining gaming revenues*, HARTFORD BUS. J. (Aug. 8, 2019), https://www.hartfordbusiness.com/article/mohegan-suns-3q-profits-fall-21-amid-declining-gaming-revenues.

171. Harris, *supra* note 168.

172. *Id.*

173. *Id.*

state direction, the Mohegan Tribe proceeded by establishing a relationship with the advisors to the State of Connecticut to devise their own safety protocols.[174] The Mohegan Sun developed a plan that would reopen the Mohegan Sun on June 1, 2020.[175]

On May 20th, Connecticut Governor Ned Lamont issued a statement in response to the Mohegan Sun's reopening plan, warning that it was too early to reopen and outlining avenues the state might take to force the Mohegan Sun to comply with state law.[176] The Governor mentioned involving the casino workers union or pulling the casino's liquor licenses if the Mohegan Sun were to continue with its plans to reopen.[177] On May 22nd, the Connecticut Consumer Protection Commissioner sent a letter demanding a comprehensive account of the Mohegan Sun's reopening plans by the following day, citing the Mohegan Gaming Compact as a source of state authority.[178]

It is understood that the states' input into the health and safety standards of gaming compacts serves to protect the nonmembers who venture on-reservation to utilize these facilities. However, when disputes occur over the implementation of such standards, the parties should resolve them using means established in the compact, rather than resorting to indirect avenues of pressuring compliance. As states and tribal gaming operations continue to navigate the uncertainty imposed by COVID-19, it is important they both use the established methods of dispute resolution.

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174. These advisors included a Dean of Yale Medical School Occupational Health, the Army National Guard, the Mohegan Chief Medical Officer, the Mohegan Tribal Health Department, and a panel of experts who worked on the SARS epidemic in Macau. *Id.*

175. Harris, *supra* note 168.

176. Pat Eaton-Robb & Susan Haigh, *Tribes Plan to Partly Open Casinos; Lamont Opposes the Move,* US NEWS (May 20, 2020, 6:57 PM), https://www.usnews.com/news/best-states/connecticut/articles/2020-05-20/connecticut-restaurants-can-begin-outdoor-dining-service.

177. *Id.*

178. The Mohegan Tribe – State of Connecticut Gaming Compact § 14(a) ("Tribal ordinances and regulations governing health and safety standards applicable to the gaming facilities shall be no less rigorous than standards generally imposed by the laws and regulations of the State relating to public facilities with regard to building, sanitary, and health standards and fire safety.").

Although contemporary issues surrounding tribal gaming more often surround their operations on and off reservation, in some instances, their very construction is the point of dispute. Such has been the case for the Mashpee Wampanoag tribe, which is engaged in an ongoing legal battle regarding its reservation status that was initiated by the Mashpee's desire to construct a casino.[179]

The Mashpee Wampanoag were a consistent presence in the Massachusetts area for thousands of years, but they were left out of federal recognition during the 1934 Indian Reorganization Act due to their low population and because they had not entered into a treaty with the federal government.[180] In 1976, the Mashpee tribe filed a land ownership claim which would grant them land in trust.[181] "Land in trust" has historically been a mechanism employed by the U.S. government to provide protection to tribal nations who have lost large portions of their traditional lands throughout the 19th and 20th century.[182] In 2007, the tribe was granted federal recognition.[183] They were finally granted land in trust on September 2015, when the Department of Interior took into trust 170 acres of Mashpee, Massachusetts.[184] In 2016, shortly following the receipt of the land, the Mashpee announced their plans to open a gaming complex.[185]

However, tension around the proposed gaming complex arose immediately. The non-indigenous Littlefield family, joined by other members of the town of Mashpee, brought forth a suit with the intention of barring the construction of the casino by seeking federal revocation of the tribe's land in

179. Anna Kate E. Cannon & Maya H. McDougall, *The Mashpee Wampanoag Tribe's Crisis Within a Crisis*, THE HARV. CRIMSON (Apr. 17, 2020), https://www.thecrimson.com/article/2020/4/17/mashpee-wampanoag-scrutiny/.

180. *Id.*

181. Mashpee Tribe v. Town of Mashpee, 447 F. Supp. 940 (D. Mass. 1978), *aff'd sub nom.* Mashpee Tribe v. New Seabury Corp., 592 F.2d 575 (1st Cir. 1979).

182. *Fee to Trust*, US DEPT. OF INTERIOR INDIAN AFFAIRS, https://www.bia.gov/bia/ots/fee-to-trust (last visited).

183. Mashpee Wampanoag Tribe, Mashpee Wampanoag Tribe, https://mashpeewampanoagtribe-nsn.gov/.

184. Cannon & McDougall, *supra* note 179.

185. *Id.*

trust.[186] The litigation against the Mashpee was also funded in part by Neil Bluhm, a developer who had sights on constructing his own casino just 20 miles from the proposed Mashpee casino site.[187]

The case was heard in the United States District Court for the District of Massachusetts, where both parties filed for cross-motions for summary judgement.[188] The plaintiffs brought action against the United States, the Department of Interior, the Bureau of Indian Affairs, and the Assistant Secretary of Indian Affairs, challenging, under the Administrative Procedure Act, the Secretary of Interior's acquisition of the land in trust for the Mashpee pursuant to the Indian Reorganization Act.[189]

Under the Indian Reorganization Act, the Secretary of the Interior has the authority to hold land in trust for American Indians.[190] The plaintiffs argued, and the court agreed, that the Mashpee people failed to meet the definition of "Indian" set forth in the Indian Reorganization Act ("IRA") and that the interpretation of the definition is not up to Secretary of the Interior.[191] Relying on the controversial holding in *Carcieri v. Salazar*, the court held that since the Mashpee people were not federally recognized before 1934, they do not fit the definition of Indian and are thus ineligible for a land in trust.[192] An appeal was filed by the Mashpee Wampanoag tribe (which had joined the case) and the case was heard by the United States Court of Appeals for the First Circuit in February of 2020, where the decision of the lower court was affirmed.[193]

While, on the surface, the casino appears to be the point of contention between the tribe and the town, what is truly

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186. Littlefield v. U.S. Dep't of Interior, 199 F. Supp. 3d 391, 394 (D. Mass. 2016), *aff'd sub nom*, Littlefield v. Mashpee Wampanoag Indian Tribe, 951 F.3d 30 (1st Cir. 2020).

187. Cannon & McDougall, *supra* note 179.

188. Littlefield, 199 F. Supp. 3d at 394.

189. *Id.* at 392.

190. G. William Rice, *The Indian Reorganization Act, The Declaration on the Rights of Indigenous Peoples, and a Proposed Carcieri "Fix": Updating the Trust Land Acquisition Process*, 45 IDAHO L. REV. 575, 583–84 (2009).

191. Littlefield, 199 F. Supp. 3d at 392–97.

192. In the opinion, Justice Thomas clarifies that the phrase "now" refers to the time following the passing of the IRA in 1934. Carcieri v. Salazar, 555 U.S. 379, 380 (2009).

193. Littlefield v. Mashpee Wampanoag Indian Tribe, 951 F.3d 30, 40 (1st Cir. 2020).

being threatened is the Mashpee's ability to act as a sovereign nation, free from the regulations that the town and state had imposed on it for the preceding centuries.[194] The progress the tribe has been able to achieve in the past five years, such as the establishment of a criminal court, a Mashpee preschool where traditional language is taught, and plans to establish new businesses, could be stifled by the loss of their land in trust.[195]

At the time of writing, it is unclear whether the Mashpee tribe will attempt to appeal the case further. It is worth noting, however, that President Biden has backed a congressional "Carcieri fix" of the Supreme Court's 2009 decision, which would allow any federally-recognized American Indian tribe to apply to have land taken into trust, regardless of when the tribe became federally recognized.[196]

Although tribal gaming is a longstanding industry, questions still arise over whether the federal protections of tribal gaming laid out in the IGRA preempt certain state laws. Such was the question explored in the case *Rogers County Board of Tax Roll Corrections v. Video Gaming Technologies*. At issue in the case was whether Video Gaming Technologies ("VGT"), a non-Indian owner of electronic gaming equipment who leased to Cherokee Nation Entertainment, a business entity of the Cherokee nation, was preempted from paying an *ad valorem* tax on the leased gaming equipment used for tribal gaming operations.[197] In 2012, Video Gaming Technologies was charged *ad valorem* taxes on equipment leased to the Cherokee Nation.[198] VGT appealed the tax to the Tax Roll Corrections Board of Rogers County, claiming that electronic equipment leased to a tribal entity for gaming was preempted from taxation under federal law.[199] The Rogers County Tax Roll Board denied re-

194. Olivia Miller, *The Post-Carcieri Struggle For Tribal Land and The Case of the Mashpee Wampanoag*, 73 ADMIN. L. REV. 101, 102–107 (2021).

195. Cannon & McDougall, *supra* note 179.

196. Andrew Westney, *How A Biden Presidency Could Shape Native American Law*, LAW360 (Oct. 30, 2020, 7:49 PM), https://www.law360.com/articles/1322099/how-a-biden-presidency-could-shape-native-american-law.

197. Video Gaming Techs., Inc. v. Rogers Cty. Bd. of Tax Roll Corr., 475 P.3d 824, 826 (Okla. 2019), *cert. denied*, 141 S.Ct. 24 (2020).

198. *Id.*

199. *Id.*

lief from the *ad valorem* tax, finding that VGT was not exempt.[200]

VGT and the Rogers County Tax Roll Board then filed motions for summary judgement to the Rogers County District Court. In its countermotion for summary judgement, the Rogers County Tax Roll Board argued that VGT had not provided evidence that it actually passed through these tax liabilities to the Tribe, and therefore was not preempted by IGRA.[201] The Rogers County District Court, upholding the finding of the Rogers County Tax Roll Board, invoked *Mashantucket Pequot Tribe v. Town of Ledyard ("Mashantucket II")*, which held that the "State of Oklahoma's *ad valorem* tax statutes are not preempted or barred by the Indian Trader Statutes, the Indian Gaming Regulatory Act, or pursuant to the balancing test set forth by the United States Supreme Court in *White Mountain Apache Tribe v. Bracker*."[202] The District Court denied VGT's motion for summary judgment and sustained the Roger County Tax Roll Board's countermotion for summary judgement.[203]

VGT filed an appeal to the Oklahoma Supreme Court. On appeal, VGT argued that the District Court erred in relying on the precedent in *Mashantucket II* and in failing to grant VGT's motion for summary judgement, arguing that the *ad valorem* tax is preempted by IGRA and the Bracker balancing test.[204] The Bracker balancing test is designed to assess the validity of state assertions of authority over "non-Indians engaging in activity on the reservation."[205]

The Oklahoma Supreme Court held that *ad valorem* taxes on gaming equipment are preempted by IGRA.[206] The Oklahoma Supreme Court found the following: "Due to the comprehensive nature of IGRA's regulations on gaming, the federal policies which would be threatened, and County's failure to justify the tax other than as a generalized interest in raising revenue, we find that *ad valorem* taxation of gaming

200. *Id.*
201. *Id.*
202. *Id.* (quoting Mashantucket Pequot Tribe v. Town of Ledyard, 722 F.3d 457 (2nd Cir. 2013)).
203. *Id.*
204. *Id.*
205. White Mountain Apache Tribe v. Bracker, 448 U.S. 136, 144 (1980).
206. *Video Gaming Techs., Inc.*, 475 P.3d at 825.

equipment here is preempted."[207] The Oklahoma Supreme Court reversed and remanded.[208]

The Rogers County Board of Tax Roll filed a petition for writ of certiorari to the United States Supreme Court. The petition was denied but is still noteworthy because Justice Thomas issued a dissent from the denial of certiorari. His dissent took the position that the designation of Oklahoma as tribal land by *McGirt v. Oklahoma* destabilized the governance of eastern Oklahoma and left uncertainty on even basic government functions, like taxation.[209]

McGirt v. Oklahoma is a criminal case that raises broader jurisdictional questions. In 1997, Jimcy McGirt was convicted by the State of Oklahoma for three counts of sexual assault and was sentenced to one thousand years plus life in prison.[210] McGirt appealed to the Oklahoma Court of Criminal Appeals, which affirmed.[211] McGirt then appealed to the U.S. Supreme Court, arguing that the Oklahoma courts lacked the jurisdiction to hear his case because he is a member of the Creek Nation and the alleged crimes occurred on what constituted Indian Country under the Indian Major Crimes Act.[212]

The land in question was designated by Congress as the Creek Reservation in 1833.[213] However, when Oklahoma was granted statehood in 1907, the State of Oklahoma took the position that the Creek Nation had ceded ownership of the land to the state.[214] The Court in *McGirt* critically held that Congress had established a reservation for the Creek Nation and the government's allotment agreement with the Creek Nation did not silently terminate the Creek Reservation.[215]

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207. *Id.* at 834.

208. *Id.*

209. Rogers Cty. Bd. of Tax Roll Corr. v. Video Gaming Techs., Inc., 141 S. Ct. 24, 24 (2020).

210. McGirt v. Oklahoma, 140 S. Ct. 2452, 2482 (2020).

211. *Id.*

212. David K. TeSelle, *Review of McGirt v. Oklahoma – How the Supreme Court and Justice Gorsuch's Revolutionary Textualism Brought America's "Trail of Tears" Promise to the Creek Nation Back From the Dead*, NATI'L L. REV. (Aug. 5, 2020), https://www.natlawreview.com/article/review-mcgirt-v-oklahoma-how-supreme-court-and-justice-gorsuch-s-revolutionary.

213. *McGirt*, 140 S. Ct. at 2461.

214. *Id.* at 2477.

215. *Id.* at 2482.

While the land has been owned and controlled by the State of Oklahoma for over 100 years, this control was based on the assumption that when legislation granted Oklahoma statehood in 1907, the Creek Nation ceded ownership of the land.[216] The U.S. Supreme Court in this case held that only Congress can dissolve an Indian Reservation, and given that it had not dissolved the Creek Reservation, the Reservation exists to this day.[217] Further, the Court held that the potential transformative effects were deemed an insufficient justification to disestablish the Creek Reservation.[218] The decision has revealed that the Muscogee Creek Nation and four neighboring tribal nations have jurisdiction over most criminal cases in eastern Oklahoma, but civil regulatory jurisdiction and taxation authority are unlikely to be affected by the ruling.[219]

In Justice Thomas's view, *McGirt* presents a conflict on an important question: "Does federal law silently pre-empt state laws assessing taxes on ownership of electronic gambling equipment when that equipment is located on tribal land but owned by non-Indians?"[220] In his dissent, Justice Thomas stated that the split between the Oklahoma Supreme Court's ruling in *Video Gaming Technologies* and the Second Circuit Court in *Mashantucket II* warranted review.[221] Further, Justice Thomas stated that the case presented an opportunity to provide clarity to courts on how pre-emption principles should be applied at the intersection of federal law, state law, and tribal land.[222] Time will tell whether the issues identified by Justice Thomas will have implications for tribal gaming going forward.

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216. TeSelle, *supra* note 212.

217. *Id.*

218. McGirt, 140 S. Ct. at 2480 ("In any event, the magnitude of a legal wrong is no reason to perpetuate it.").

219. Katie Bart, *Educational seminar: Debrief of McGirt v. Oklahoma*, SCOTUSBLOG, at 26:55 (May 12, 2020, 9:19AM), https://www.scotusblog.com/2020/05/educational-seminar-debrief-of-mcgirt-v-oklahoma/.

220. Rogers Cty. Bd. of Tax Roll Corr., *supra* note 209 at 24–25.

221. *Id.* at 25.

222. *Id.*

B. *Tobacco and Petroleum Sales*

Smoke shops and gas stations are two of the most common tribal businesses.[223] Both tobacco and gasoline are excise products, which means that the tax questions presented around the two products sold from reservations are often similar. Not surprisingly, states often wish to collect as much tax revenue as possible, and therefore may change their tax codes to extract tax revenue from tribal businesses selling tobacco and petroleum, or at least to level the playing field for on- and off-reservation businesses.[224] In this section, we will begin by discussing the history of disputes between the tribes and states regarding the tobacco industry. Currently, there are no major tobacco cases in litigation, so this section will serve to give an overview of the industry issues broadly. Next, we will explore a fuel tax dispute between the state of Washington and the Yakama tribe that was resolved through a lengthy litigation, finally arriving at the Supreme Court in 2018.

1. *Tobacco Sales*

Historically, Native Americans have used tobacco for ceremonial, spiritual, and medicinal purposes.[225] While the high tobacco usage rates amongst Native American may in part be attributed to customary use, commercial tobacco has also gained prevalence on reservations.[226] Prior to the passage of the Indian Religious Freedoms Act of 1978, many aspects of Native American religious and cultural ceremonies had been prohibited by law, including the use of traditional tobacco.[227] However, some tribes were able to circumvent the law and

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223. Richard D. Pomp, *The Unfulfilled Promise of the Indian Commerce Clause and State Taxation*, 63 TAX LAW. 897, 903 (2010).

224. *Washington's Tax Code is an Untapped Resource to Advance Racial Justice*, PROGRESS IN WASHINGTON (2019), https://budgetandpolicy.org/resources-tools/2019/10/2019-Brief-WA-Tax-Code-is-untapped-resource-for-racial-justice.pdf; Kelly S. Crosman and Jonathan B. Taylor, W*hy Beggar Thy Indian Neighbor? The Case for Tribal Primacy in Taxation of Indian Country* 11–12 (Bureau of Indian Affairs, Working Paper, 2016), www.bia.gov/sites/bia_prod.opengov.ibmcloud.com/files/assets/as-ia/raca/pdf/2016_Croman_why_beggar_thy_Indian_neighbor.pdf.

225. Dina Fine Maron, *The Fight to Keep Tobacco Sacred*, SCI. AM. (Mar. 29, 2018) https://www.scientificamerican.com/article/the-fight-to-keep-tobacco-sacred/.

226. *Id.*

227. *Id.*

hold onto their historical practices by substituting traditional tobacco for commercial cigarettes.[228] Another factor underlying Native Americans' use of cigarettes is the economic reality that reservation gas stations and smoke shops sell tobacco to tribal members for a low price.[229]

Cigarette taxes, which are a form of an excise tax, exist for two primary reasons: (1) as a public health strategy to discourage smoking and (2) to increase state tax revenues.[230] Although any consumer of legal age can purchase tobacco on tribal land, not all consumers are taxed in the same manner. In 1976, a Supreme Court ruling held that states do not have the power to collect cigarette sales taxes on reservation sales by a tribal business to an Indian, or to impose vendor license fees on Indians selling cigarettes on reservation land through tribal businesses.[231] However, the state could require Indian retailers to add the tax on cigarettes to sale prices when the products were sold to non-Indians.[232]

States have tried to address potential jurisdictional conflicts or tax revenue loss from tribes and have developed two strategies for tax enforcement and collection, often used together: negotiating compacts, which legally dictate the behavior on tribal lands through contract law, and codifying laws that function outside of compacts.[233] Additional measures have been incorporated to bridge the gap between compacts and codified laws, although they are used at a lower frequency.

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228. *Id.*

229. Kari A. Samuel et al., *Internet Cigarette Sales and Native American Sovereignty: Political and Public Health Contexts*, 33 J. PUB. HEALTH POL'Y. 173 (2012); Lauren K. Lempert and Stanton A. Glantz, *Tobacco Industry Promotional Strategies Targeting American Indians/Alaska Natives and Exploiting Tribal Sovereignty*, 21 NICOTINE & TOBACCO RESEARCH 940, 942 (2019).

230. Hillary DeLong et al., *Common State Mechanisms Regulating Tribal Tobacco Taxation and Sales, the USA, 2015*, 25 TOBACCO CONTROL i32, i32 (2016) https://tobaccocontrol.bmj.com/content/25/Suppl_1/i32.

231. Moe v. Confederated Salish & Kootenai Tribes of Flathead Rsrv., 425 U.S. 463, 480–81 (1976).

232. *Id.* at 483 ("Such a requirement is a minimal burden designed to avoid the likelihood that in its absence non-Indians purchasing from the tribal seller will avoid payment of a lawful tax, and it does not *frurate* [sic] tribal self-government or run afoul of any federal statute dealing with reservation Indians' affairs.").

233. *See* DeLong et al., *supra* note 230, at i32–33.

These measures include tax stamps, record-keeping, and tax rates.[234]

States do, however, have the power to collect taxes when tribal businesses sell goods to non-tribal members on-reservation.[235] Of the thirty-four states where Indian reservations are located, twenty of these states address tribal tobacco tax collection from non-members.[236] Intergovernmental compacts are the most popular means of addressing tribal tobacco sales to non-members.[237] Compacts function in much the same ways as contracts and are negotiated between state and tribal officials. Compacts allow both parties to protect their interests in tax revenue and self-governance and can be especially effective when tribal lands are near large off-reservation population centers. However, they are often time- and cost-intensive and hinge on a preexisting positive relationship between a state and tribe.[238]

Codified laws, by comparison, exist to diminish the availability of tax-free cigarettes available to the tribes and in the tribal marketplace.[239] One method of reduction is through tax prepayment. Almost two-thirds of all tribal tobacco retailers are required to prepay a tax, collected by the state at a point within the distribution process prior to the ultimate sale to consumers, often using a tax stamp.[240]

While compacts and codified laws have clear applications in instances where the tribal retailer is located on an Indian reservation within the exterior boundaries of the state, when the supply chain extends outside of the state, the matter becomes more complex. Such was the case of Native Wholesale Supply Company ("NWS"). At issue in *Native Wholesale v. California, ex rel. Becerra* was a contract for the purchase of goods and services that was fully performed by Native Wholesale Supply, a tribal tobacco retailer chartered under the laws of the Sac and Fox Nation of Oklahoma and headquartered on the

234. *Id.* at i33.
235. *Id.* at i32.
236. *Id.* at i33.
237. *Id.* at i34.
238. *Id.* at i35.
239. *Id.* at i34.
240. Samuel et al., *supra* note 229; DeLong et al., *supra* note 230, at i35.

Seneca Nation in New York.[241] The U.S. Supreme Court recently denied a petition for writ of certiorari on the case.[242]

In 2008, the State of California sued NWS in the California Superior Court for allegedly violating state laws on cigarette distribution and cigarette fire safety.[243] The complaint challenged NWS's sale of cigarettes to the Band of the Western Mono Indians of the Big Sandy Rancheria, which is located within California, that were not listed in California's Tobacco Directory.[244] The question presented was whether NWS became subject to the personal jurisdiction and tobacco regulations of the State of California when it sold cigarettes to the Band of the Western Mono Indians of the Big Sandy Rancheria, located within California.[245] NWS filed a motion to remove the case to federal court, but the motion was denied.[246] The Superior Court of California granted NWS's motion to quash for lack of personal jurisdiction, finding that the plaintiff had not provided sufficient evidence that sales between the out-of-state corporation and the Indian tribe constituted minimum state contacts sufficient to warrant personal jurisdiction.[247]

The State of California appealed the decision to the California Court of Appeals for the Third District.[248] This court held that California did have personal jurisdiction, because ultimately NWS had derived benefit from California activities under the stream of commerce theory,[249] sufficient to invoke personal jurisdiction of the State of California.[250] NWS ap-

241. People *ex rel.* Becerra v. Native Wholesale Supply Co., 37 Cal. App. 5th 73, 77, 249 Cal. Rptr. 3d 445, 449 (2019).

242. Native Wholesale Supply Co. v. California *ex rel.* Becerra, 141 S. Ct. 233 (2020).

243. People *ex rel.* Becerra v. Native Wholesale Supply Co., 37 Cal. App. 5th at 77, 249 Cal. Rptr. 3d at 449. *Id.* at 363.

244. *Id.* at 78; Native Wholesale Supply Co. v. California ex rel. Becerra, 141 S. Ct. at 262–63.

245. People *ex rel.* Harris v. Native Wholesale Supply Co., 196 Cal. App. 4th 357, 360 (2011).

246. Native Wholesale Supply Co. v. California *ex rel.* Becerra, 141 S. Ct. 233 (2020).

247. People *ex rel.* Becerra v. Native Wholesale Supply Co., 37 Cal. App. 5th at 81, 249 Cal. Rptr. 3d at 451.

248. *Id.*

249. People *ex rel.* Harris v. Native Wholesale Supply Co., 196 Cal. App. 4th 357 at 360 ("We see not just a stream of commerce, but a torrent.").

250. People *ex rel.* Becerra v. Native Wholesale Supply Co., 37 Cal. App. 5th at 84.

pealed this jurisdictional determination to the California Supreme Court which denied review, and the U.S. Supreme Court which denied certiorari.[251]

This case illustrates that jurisdictional uncertainties are still contentious for on-reservation business, particularly when the exchange of goods and services happen outside of a state but still enter its stream of commerce. Given the expansion of online businesses in the global pandemic, it is becoming increasingly likely for conflicts such as with *Native Wholesale* to arise between separate sovereigns. This issue further illustrates that the definition of on-reservation business needs clarification.

2. *Petroleum Sales*

The Yakama Tribe[252] and the State of Washington have a long history of disagreements surrounding taxation and other legal matters relating to state-tribal relations. The latest iteration is a dispute regarding Cougar Den Inc., a fuel importer and distributor operating on the Yakama Reservation. Cougar Den has operated on the Reservation since the 1990s.[253] It buys fuel at wholesale in Oregon and transports it by truck, crossing the border into Washington, and then traveling a further twenty seven miles on public highway in Washington to the Yakama Reservation, where it is sold at retail at an on-reservation gas station.[254] Cougar Den is incorporated under Yakama law and is owned by Kip Ramsey, a member of the

251. *Id.*, *cert. denied*, 141 S. Ct. 233 (2020).

252. Throughout this section, the name "Yakima" will refer to the city and county in Washington. The name "Yakama" will be used when referring to the tribe or reservation of the Yakama people. In 1994, the Yakama Tribal Council voted to change the spelling of the tribe's name from Yakima to Yakama to match the spelling of the 1855 treaty. *See 'Yakamas' Alter Spelling of Tribe*, SEATTLE TIMES, (Jan. 26, 1994), https://archive.seattletimes.com/archive/?date=19940126&slug=1891713.

253. *About*, COUGAR DEN, https://cougardeninc.com/about (last visited Sept. 1, 2021, 2:13:00 PM).

254. Wash. State Dep't of Licensing v. Cougar Den, Inc., 139 S. Ct. 1000, 1004 (2019).

Yakama Nation.[255] Cougar Den employs over 150 employees[256] and generates $770,000 (USD) in sales annually.[257] As discussed further below, Washington State has long desired to extract tax revenue from these sales.

In 1995, the Washington State Legislature enacted Substitute House Bill 1271, which "granted the Department of Licensing the authority to enter into an agreement with any federally recognized Indian tribe regarding the taxation of fuel on the reservation.[258] Certain tribes entered into agreements with the Department of Licensing pursuant to which the on-reservation gas stations would collect state tax on fuel sales, and then the Department of Licensing would remit a portion of those tax receipts to the tribe.[259] The amount to be remitted was based on a formula that accounts for the percentage of on-reservation fuel sales to tribal members versus non-tribal members.[260]

However, disputes arose over this method of fuel tax collection and, in 2003, the Squaxin Island Tribe and Swinomish Indian Tribal Community sued the Department of Licensing after the Department found that the legal incidence of the tax improperly fell on the tribal retailer, rather than non-Indian customers, and therefore was an overreach of the state's au-

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255. Phil Ferolito, *U.S Supreme Court: Yakamas do not have to pay state tax on wholesale fuel*, YAKIMA HERALD (Mar. 20, 2019), https://www.yakimaherald.com/news/local/u-s-supreme-court-yakamas-do-not-have-to-pay-state-tax-on-wholesale-fuel/article_07fd346e-4a7d-11e9-8aaf-eb520011d82d.html.

256. COUGAR DEN, *supra* note 253.

257. *Cougar Den, Inc. – Company Profile*, DUN & BRADSTREET, https://www.dnb.com/business-directory/company-profiles.cougar_den_inc.46a7cb28dedb680a199a05192927f612.html (lasted visited Sept. 1, 2021).

258. WASH. REV. CODE § 82.38.320 (amended 2013); WASH. REV. CODE § 82.38.320 (amended 2013); WASH. STATE DEP'T OF LICENSING, 2018 TRIBAL FUEL TAX AGREEMENT REPORT (2019), https://www.dol.wa.gov/about/docs/leg-reports/2019-tribal-fuel-tax-agreement-report.pdf.

259. *Cougar Den*, 139 S. Ct. at 1008; WASH. STATE DEP'T OF LICENSING, 2012 TRIBAL FUEL TAX AGREEMENT REPORT (2012), https://www.dol.wa.gov/about/docs/TribalFuelTaxAgreementReport.pdf

260. WASH. STATE DEP'T OF LICENSING, 2018 TRIBAL FUEL TAX AGREEMENT REPORT (2019), https://www.dol.wa.gov/about/docs/leg-reports/2019-tribal-fuel-tax-agreement-report.pdf; Washington State Dept. of Licensing v. Cougar Den Inc., No. 16-1498, 2017 WL 3098553, at *10 (Wash. July 17, 2017).

thority.[261] This incident led to the drafting of Senate Bill 5272, An Act Relating to the Administration of Fuel Taxes, in 2007, which provided that the tax would be assessed at the point at which the fuel enters Washington State by ground transportation—in other words, an importation tax.[262] Cougar Den refused to collect or remit the tax.[263] In 2013, the Washington State Department of Licensing assessed Cougar Den owed $3.6 million in back taxes, penalties, and licensing fees for importing fuel.[264]

Cougar Den contested the assessment by the Washington Department of Licensing, based on the legal theory that the 1855 Yakama Treaty between the federal government and the Yakama Tribe shielded the Yakamas from any importation taxes for moving goods in commerce to or from the Yakama Reservation via public highway.[265] The Yakama Treaty expressly provides the tribe "the right, in common with citizens of the United States to travel upon all public highways."[266]

The matter was initially adjudicated by a Department of Licensing Administrative Law Judge, who agreed with Cougar Den that the tax was preempted.[267] However, on October 15, 2014, the Department of Licensing's Director, Pat Kohler, disagreed and overturned the Administrative Law Judge's order.[268] Cougar Den appealed the Department of Licensing decision to the Yakima County Superior Court.[269] The Superior Court reviewed the case de novo and held that the tax as applied to the Yakama was preempted, on grounds that it would

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261. Squaxin Island Tribe v. Stephens, 400 F. Supp. 2d 1250 (W.D. Wash. 2005); WASH. STATE DEP'T OF LICENSING, TRIBAL FUEL TAX AGREEMENT REPORT (2015), https://www.dol.wa.gov/about/docs/leg-reports/2016-tribal-fuel-tax.pdf.

262. WASH. REV. CODE § 82.36.010(4), (12), (16); An Act Relating to the Administration of Fuel Taxes, S.B. 5272, 60th Leg., 2007 Regular Session (Wa. 2007).

263. *Cougar Den*, 139 S. Ct. at 1007.

264. *Id.*

265. *Id.*

266. Treaty between the United States and the Yakama Nation of Indians, art. 3, June 9, 1855, 12 Stat. 951.

267. Cougar Den Inc. v. Dept. of Licensing Yakima County, No. 14-2-03851-7, 2015 WL 13762926, at *1 (Wash. Super. Ct. July 22, 2015).

268. Brief at 9, Cougar Den v. Wash. State Dep't of Licensing, 188 Wash.2d 55 (2017).

269. Cougar Den Inc. v. Dept. of Licensing Yakima County, No. 14-2-03851-7, 2015 WL 13762926, at *1 (Wash. Super. Ct. July 22, 2015).

be impossible for Cougar Den to transport fuel to the reservation without using a highway and, thus, the Yakama Treaty would not have secured a right to travel unless it intended to use it for a purpose such as trade.[270] The Department of Licensing petitioned for direct review by the Washington State Supreme Court, which accepted the case and affirmed the decision of the lower court.[271] The Department, in turn, filed a petition for certiorari with the United States Supreme Court.[272] Certiorari was granted on June 25, 2018.[273] The oral argument was heard on October 30th, 2018.[274]

Before the U.S. Supreme Court, the Washington State Department of Licensing argued that the state tax applied to petroleum, not highway travel.[275] It claimed that the tax was nondiscriminatory, applying to all who import fuel into Washington, and that its legal incidence occurs off-reservation.[276] The state asserted that the tax should apply to Cougar Den unless it is expressly preempted by federal law.[277] Washington State further claimed that the Yakama Treaty did not preclude application of the tax; the state argued that the Treaty guarantees the right of the Yakama to travel in common with others via public highway, but says nothing that would preempt a generally applicable tax on importation of goods.[278]

The Tribe argued that the travel provision of the 1855 Yakama Treaty protected Cougar Den from importation taxes.[279] Since the motor vehicle fuel tax was rewritten in 2007, the law provided that motor fuel licensees pay a per-gallon tax when fuel enters the state via ground transportation.[280] Cougar Den argued, and the lower courts affirmed, that "travel

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270. *Id.* at *2.

271. Cougar Den, Inc. v. Wash. State Dep't of Licensing, 392 P.3d 1014 (Wash. 2017), *aff'd,* 139 S. Ct. 1000 (2019).

272. WASH. STATE DEP'T OF LICENSING, *supra* note 260.

273. *Washington State Department of Licensing v. Cougar Den Inc.*, SCOTUSBLOG, https://www.scotusblog.com/case-files/cases/washington-department-licensing-v-cougar-den-inc.

274. *Cougar Den*, 139 S. Ct. 1000.

275. *Id.* at 1009.

276. *Id.* at 1012, 1014.

277. *Id.* at 1007.

278. *Id.*

279. *Id.* at 1004.

280. WASH. REV. CODE § 82.36.010(4), (12), (16); Washington State Dep't of Licensing v. Cougar Den, Inc., 139 S. Ct. 1000, 1004 (2019).

upon public highways is directly at issue because the tax was an importation tax."[281] While the Department of Licensing argued that the tax would apply as long as the fuel entered by a means other than pipeline or vessel, the lower courts agreed that this was irrelevant because "it was impossible for Cougar Den to import fuel without using the highway."[282] Cougar Den argued that as a question of state law, the Washington Supreme Court's interpretation of the statute is entitled to deference.[283] It also explained that the United States Court of Appeals for the 9th Circuit has interpreted the travel provision of the Yakama Treaty several times and found the Yakama exempt from some state requirements on taxes and fees collected during travel for trade.[284]

The Court received an array of briefs from numerous amici. The Multistate Tax Commission filed a brief in support of the Washington Department of Licensing, emphasizing the importance of developing a uniform tax collection system in the United States, which they expressed would be undermined by a victory for Cougar Den.[285] Twelve other states and the city of New York filed a brief which argued that affirming the decision of the lower court would permit the Yakama and other tribes with similar treaties to evade taxes on a plethora of goods that are imported by highway.[286] The State of Idaho issued a brief in support of the petitioner, as it also has tribes with similarly worded treaty travel provisions within its borders and feared a victory would extend an exemption from state authority to tax on any activity associated with highway use.[287] The Washington Oil Marketers Association, which lobbies for petroleum marketers, and the Washington Association of

281. *Cougar Den*, 392 P.3d at 1019, *aff'd*, 139 S. Ct. 1000 (2019).

282. *Id.*

283. *Cougar Den*, 139 S. Ct. at 1010 (2019).

284. Cree v. Flores, 157 F.3d 762 (9th Cir. 1998) (holding that the Yakama are exempt from logging truck license and overweight vehicle fees); S*ee also* United States v. Smiskin, 487 F.3d 1260 (9th Cir. 2007) (holding that the Yakama are exempt from a requirement to notify the state before transporting unstamped cigarettes).

285. Brief for Multistate Tax Commission and Federation of Tax Administrators as Amici Curiae Supporting Petitioner, Cougar Den, 139 S. Ct. 1000 (No. 16-1498), 2018 WL 3993391, at *7–9.

286. Brief for Idaho et al. as Amici Curiae Supporting Petitioner, Cougar Den, 139 S. Ct. 1000 (No. 16-1498), 2018 WL 3993390 at *1.

287. *Id.*

Neighborhood Stores, which lobbies for convenience stores, jointly issued a brief in support of the petitioner.[288]

The Confederated Salish and Kootenai Tribes and Nez Perce tribes expressed their support for the respondent.[289] As the only other American Indian tribes with an expressly reserved right to travel in their treaty, they wrote to emphasize the historical and modern significance of this right.[290] The Confederated Tribes and Bands of the Yakama Nation filed a brief in support of Cougar Den, as a regulated and licensed business of the nation exercising their treaty right and provided historical context on the tribe's reliance on travel in trade.[291] Additional briefs in support of the defendant were submitted by the National Congress of American Indians and Sacred Ground.[292]

In a 3-2-4 plurality decision, the Court ruled in favor of Cougar Den.[293] It concluded that Washington's fuel tax burdened the treaty-protected right of the Yakama Nation to travel upon all public highways in common with citizens of the United States, and Washington's application of its fuel tax on Cougar Den was preempted by the treaty's reservation of the right to travel on public highways.[294]

Justice Breyer's plurality opinion, joined by Justices Sotomayor and Kagan, concluded that the 1855 Yakama Treaty, which guarantees "the right, in common with citizens

288. Brief for Washington Oil Marketers Association and Washington Association of Neighborhood Stores as Amici Curiae Supporting Petitioner, Cougar Den, 139 S. Ct. 1000 (No. 16-1498), 2018 WL 3969556 at *1.

289. Brief for Nez Perce Tribe and Confederated Salish and Kootenai Tribes as Amici Curiae Supporting Respondent, Cougar Den, 139 S. Ct. 1000 (No. 16-1498), 2018 WL 4808849 at *2.

290. *Id.*

291. Brief for Confederated Tribes and Bands of the Yakama Nation as Amici Curiae Supporting Respondent, Wash. State Dep't of Licensing v. Cougar Den, Inc., 139 S. Ct. 1000 (No. 16-1498), 2018 WL 4739661 at *2.

292. *See, e.g.*, Brief for Nat'l Cong. of Am. Indians as Amicus Curiae Supporting Respondent, Wash. State Dep't of Licensing v. Cougar Den, Inc., 139 S. Ct. 1000 (2019) (No. 16-1498), 2018 WL 4659224; Brief for Sacred Ground Legal Services as Amicus Curiae Supporting Respondent, Wash. State Dep't of Licensing v. Cougar Den, Inc., 139 S.Ct. 1000 (2019) (No. 16-1498), 2018 WL 4405428.

293. Wash. State Dep't of Licensing v. Cougar Den, Inc., 139 S. Ct. 1000 (2019).

294. *Id.*

of the United States, to travel upon all public highways,"[295] preempted the Department's fuel importation tax.[296] Because the tax exempted importation by pipeline or vessel, it was found to be targeting the right to travel by highway with fuel.[297] The plurality's conclusion that the fuel tax is preempted by the treaty rests on three considerations. First, the Court had previously interpreted the Yakama Treaty four times; each time it stressed that the language of the treaty should be interpreted as the Yakama would have understood it at the time of signing.[298] The plurality found that the words "in common with" should be understood in the context of the Yakama's understanding at the time of signing, rather than the colloquial meaning.[299] The second consideration of the plurality is the historical record, which further indicates that the treaty negotiations between the United States and the Yakama would have led the Yakama to believe that the treaty's protection of the right to travel on public highways would include the right to travel with goods for trade.[300] The third and final consideration by the plurality is that to impose a tax upon traveling with certain goods inherently burdens travel.[301] And the right to travel on public highways, without burden, is exactly what the treaty protects from. Therefore, precedent would dictate that the tax is preempted.[302]

In the plurality opinion, the Justices addressed their concerns that the ruling would potentially permit the travel of hazardous goods that threatened health and safety, such as "dis-

295. *Id.* at 1007 (quoting Treaty Between the United States and the Yakama Nation of Indians, art. 3, 12 Stat. 951 (1855)).

296. *Id.* at 1015.

297. *Id.* at 1014.

298. *See* United States v. Winans, 198 U.S. 371, 380–381 (1905); Suefert Bros. Co. v. United States, 249 U.S. 194, 196–198 (1919); Tulee v. Washington, 315 U.S. 681, 684–685 (1942); Washington v. Wash. Com. Passenger Fishing Vessel Ass'n., 443 U.S. 658, 677–678 (1979).

299. *Cougar Den,* 139 S. Ct. at 1012.

300. *Id.* at 1013.

301. *Id.* at 1013.

302. *See, e.g.*, *Tulee,* 315 U.S. at 684 (holding that the fishing right reserved by the Yakamas in the treaty preempted the application to the Yakamas of a state law requiring fishermen to buy fishing licenses. ("Such extraction of fees as a prerequisite to the enjoyment of" a right reserved in treaty "cannot be reconciled with a fair construction of the treaty.")).

eased apples," onto the reservation.[303] The plurality emphasized that "we do not say or imply that the treaty grants protection to carry any and all goods,"[304] or that "the treaty deprives the State of the power to regulate to prevent danger to health and safety."[305] In their emphasis, the plurality suggests that the treaty negotiations may have allowed for state regulation for the purposes of health and safety, but do not explicitly grant this power to the state of Washington,[306] leaving the issue with a sense of ambiguity.

Justice Gorsuch, joined by Justice Ginsburg, issued a concurrence that was even more vehement about the 1855 treaty being interpreted in the manner it would have been understood by the Yakama at the time of signing, and that the court must "give effect to the terms as the Indians themselves would have understood them."[307] As the concurrence notes, the treaty between the Yakama and the United States was drafted in Chinook jargon, a trading language that the Yakama could not read.[308] They suggest, like the plurality, that the language regarding a right to travel would have been understood to provide them "with the right to travel on all public highways 'in common with' without being subject to any licensing and permitting fees related to the exercise of that right while engaged in the transportation of tribal goods."[309] The concurrence asserts that while the treaty supplies the Yakama with special rights to travel with goods to and from market, the language "in common with" indicates that tribal members knew they would have to share the road with non-Indians and accept regulations that would allow the two groups safe coexistence.[310]

The concurrence drew its attention to a counterfactual hypothetical, discussing why the treaty would have allowed the state to regulate Cougar Den in the interest of public safety,

303. *Cougar Den,* 139 S. Ct. at 1021.
304. *Id.* at 1015.
305. *Id.* at 1015.
306. *Id.* at 1015.
307. Minnesota v. Mille Lacs Band of Chippewa Indians, 526 U.S. 172, 196 (1998).
308. Yakama Indian Nation v. Flores, 955 F. Supp. 1229, 1243 (E.D. Wash. 1997).
309. *Cougar Den,* 139 S. Ct. at 1017.
310. *Id.* at 1020.

though that was not actually at issue in the case.[311] The concurrence observed that tribes should have assumed that some concessions to their treaty rights would have to be made in order for peaceful coexistence between the two groups to occur.[312] Using an example of bad apples, the concurrence finds that should the apples somehow pose a threat to safe travel on highways, then it would be within the scope of power for the state to regulate them.[313]

However, the matter of health and safety is not at issue in this case, which leads to the question of why the plurality and concurrence chose to only concur in judgement, rather than opinion. The dissent suggests that while the plurality held that the treaty preempts all laws that attempt to burden travel on highways by the Yakama, the concurrence found the treaty more specifically preempted laws that attempted to burden travel with goods.[314] The contention between the plurality and the concurrence is not explicitly examined in either opinion.

The dissent is authored by Chief Justice John Roberts, joined by Justices Thomas, Alito, and Kavanaugh. The dissent argues that just because a state law affects the Yakamas while they are exercising a treaty right does not mean the law prohibits exercise of the right.[315] Further, the dissent claims that the right to travel with goods is just an application of the Yakama's right to travel and does not ensure them the right to possess whatever goods they want free from taxation and regulation.[316] Because the tax is collected on each gallon of motor vehicle fuel imported, not on the miles traveled over Washington State highways, they take the position that it is a tax on a product, and not an obstruction to travel, like a blockade, toll, or "no trespassing" sign.[317] The dissent argues that the time and place of the imposition of the tax does not change what is being taxed, which, in this case, they believe is the possession of goods.[318] They further assert that the historical context was

311. *Id.* at 1021.
312. *Id.* at 1020.
313. *Id.* at 1021.
314. *Id.* at 1021 (Roberts, C.J., dissenting).
315. *Id.* at 1022.
316. *Id.* at 1022.
317. The dissent refers to issues in *United States v. Winans*, 198 U.S. 371 (1905), and *Seufert Bros. Co. v. United States,* 249 U.S. 194 (1919).
318. *Cougar Den*, 139 S. Ct. at 1023.

wrongfully construed by the plurality, stating, "[n]othing . . . supports the conclusion that the right 'to travel on public highways' transforms the Yakamas' vehicles into mobile reservation, immunizing their contents from any state interference."[319] The dissent is skeptical of the plurality's assertion that the treaty would allow for regulations for the purposes of health and safety.[320]

In the second dissent, Justice Kavanaugh, joined by Justice Thomas, proposes a strict and narrow interpretation of the right to travel clause, arguing that the language "in common with" secured the Yakama only equal rights of travel that are on par with other U.S. citizens.[321] Justice Kavanaugh believes that the tax is nondiscriminatory in nature, and, thus, attempts to interpret the treaty by the judiciary are misplaced and better handled by Congress.[322]

Cougar Den and the Yakama Tribe have experienced no significant changes in operation since the decision. At the time of writing, there have been no changes to the Washington tax code following the decision, as fuel importers that are not owned by the Yakama Nation or its members were unaffected by the ruling. Cougar Den remains in operation and continues to provide fuel to the Yakama reservation.

While few tribes have explicit treaty travel provisions like the Yakama, approximately 368 treaties were made between tribes and the United States.[323] The decision in *Cougar Den* is being used to demonstrate that treaty interpretation must reflect historical context and the understanding of the parties at the time of signing.[324] The decision in *Cougar Den* can be used to prevent narrow interpretations of treaty rights, which would blatantly ignore not only the discrepancies in understanding

319. *Id.* at 1024.
320. *Id.* at 1025.
321. *Id.* at 1026 (Kavanaugh, J., dissenting).
322. *Id.* at 1027.
323. Mark Hirsch, *1871: The End of Indian Treaty Making*, 15 MAG. OF SMITHSONIAN'S NAT'L MUSEUM OF THE AM. INDIAN, https://www.americanindianmagazine.org/story/1871-end-indian-treaty-making.
324. *See, e.g.*, Rosebud Sioux Tribe v. Trump, 428 F. Supp. 3d 282, 293 (D. Mont. 2019); Confederated Salish & Kootenai Tribes v. Lake Cty. Bd. of Comm'rs, 454 F. Supp. 3d 957, 971 (D. Mont. 2020).

for the Indian signees, but also a history of corruption in dealings with American Indians on the part of the United States.[325]

The decision in Cougar Den has been cited as precedent in cases where treaty interpretation is a consideration. In *Confederated Salish and Kootenai Tribe v. Lake County Board of Commissioners,* the Confederated Salish and Kootenai Tribes prevailed in the United States District Court for the District of Montana against the Lake County Board of Commissioners, who had aimed to build a 40 acre RV park on property within the boundary of the Flathead Indian Reservation, when the judge ruled that the tribes were entitled to summary judgement and the defendants did not have jurisdiction to develop.[326] The ruling relied on the United States District Court for Montana's interpretation of the 1855 Hell Gate Treaty.[327] Although the parts of the reservation had been platted and sold in lots in 1913, the court found that this did not remove the lands from tribal control.[328] *Cougar Den* was cited as precedent for the finding that treaty language must be interpreted as it would have been understood by tribes at the time of signing, and all ambiguities should favor the signer of the treaty.[329]

In another case heard by the United States District Court for the District of Montana, *Rosebud Sioux Tribe v. Trump,* the federal court denied the efforts by the United States federal government (Trump) and TransCanada to dismiss the Rosebud Sioux's case against the Keystone XL Pipeline and found that the issuance of the presidential permits to construct the pipeline violated Indian treaties and the tribe's inherent sovereign powers.[330] In *Rosebud Sioux,* Indian tribes brought action against President Trump and various governmental agencies seeking declaratory and injunctive relief for claims that the defendants had violated: the 1851 Fort Laramie Treaty, the 1855 Lame Bull Treaty, the 1868 Treaty of Fort Laramie, the Foreign Commerce Clause of the United States Constitution, the tribes' inherent sovereign powers, and various federal statutes

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325. *See, e.g.*, *Rosebud Sioux Tribe*, 428 F. Supp. 3d at 293; *Salish & Kootenai*, 454 F.Supp. 3d at 971.

326. *Salish & Kootenai*, 454 F. Supp. 3d 957 at 961.

327. *Id.* at 961.

328. *Id.* at 969.

329. *Id.* at 978 n.7.

330. Matthew L. Campbell et al., Keystone XL Pipeline, Native Am. Rts. Fund (Jan. 20, 2021), https://www.narf.org/cases/keystone/.

and regulations when he issued a Presidential Permit in 2019 to TransCanada Keystone Pipeline, LP and TC Energy Corporation for the construction of the oil pipeline known as Keystone XL.[331] In the case, the court focuses their interpretation of treaties "upon the historical context in which it was written and signed," citing *Cougar Den* as precedent.[332] TransCanada announced the termination of the Keystone XL pipeline project on June 9, 2021. Rosebud Sioux Tribe President Rodney M. Bordeaux said of this announcement "this is great news for the Tribes who have been fighting to protect our people and our lands. The treaties and laws guarantee us protections, and we are committed to see that those laws are upheld."[333]

In the case of *Unkechaug Indian Nation v. New York State Department of Environmental Conservation*, the United States District Court for the Eastern District of New York found that the New York State Department of Environmental Conservation's ability to regulate fishing rights in a designated reservation and in customary fishing waters was barred by both the May 24, 1676 treaty entered between the Unkechaug Nation and Virginian Governor Andros as well as the protection of the First Amendment's freedom of religious expression.[334] The court relied on the interpretation canon in *Cougar Den*, which states that "the language of [an Indian] treaty should be understood as bearing the meaning that the [Indian tribe] understood it to have," barring the New York State Department of Environmental Conservation's attempts to regulate the Unkechaug customary waters.[335] *Cougar Den* has already proven to shape decisions that pertain to upholding treaties and protecting the rights of indigenous people.

C. *Online Lending*

Tribes are major players in the rapidly growing online financial services industry. Tribal lending enterprises (TLEs") typically offer small-dollar loans to consumers in need of

331. Rosebud Sioux Tribe v. Trump, 428 F. Supp. 3d 282, 286 (D. Mont. 2019).

332. *Id.* at 293.

333. Campbell et al., *supra* note 330.

334. Unkechaug Indian Nation v. New York State Dep't of Env't. Conservation, No. 18-CV-1132 (WFK), 382 F. Supp. 3d 245, 2019 WL 1872952, at *20, *22 (E.D.N.Y. Apr. 23, 2019).

335. *Id.* at *20.

money quickly or who were turned away by traditional lenders.[336] TLEs now constitute 10% of the online financial services industry—an industry with a current annual origination volume of $20 billion, which is expected to grow to $73.7 billion by 2022.[337]

The growth of online TLEs has relied, at least in part, on the legal premise that tribal lenders are not subject to state usury laws, because the loans are processed on-reservation[338] and consumers typically consent to the application of tribal law, rather than state law, in the loan documentation.[339] Not surprisingly, this view has not been universally accepted. Many TLEs operate in partnership with non-tribal enterprises.[340] In fact, it is common for non-tribal enterprises to perform almost

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336. The primary users of tribal online-lending are "underbanked" customers not adequately serviced by traditional lenders. *See Is Sovereign Immunity for Tribal Lending Coming to an End?*, PYMNTS.COM (June 30, 2015), https://www.pmnts.com/indepth/2015/is-sovereign-immunity-for-tribal-payday-lending-coming-to-an-end/. The 2013 FDIC National Survey of Unbanked and Underbanked Households defines the underbanked as individuals with a checking or savings account who still must rely on alternative financial services such as check-cashing services, payday loans, rent-to-own agreements, or pawn shops. One in five households were underbanked in 2013, consisting of an estimated sixty-eight million people. *See* Susan Burhouse et al., *2013 National Survey of Unbanked and Underbanked Households*, 4 (2014), https://www.fdic.gov/householdsurvey/2013report.pdf. Alternative financial services (AFS) exist to meet the needs of those left behind by traditional banking, and comprise an estimated $144 billion industry in 2016. Gary Davis, *Strong Hearts to the Front Native Financial Services and the New Tribal Economy*, TRIBAL BUS. J. http://tribalbusinessjournal.com/news/financial-services-strong-hearts-front-native-financial-services-new-tribal-economy/.

337. Davis, *supra* note 336.

338. Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 1001-1100H, 124 Stat. 1376, 1955-2113 (2010); Adam Crepelle, *Tribal Lending and Tribal Sovereignty*, 66 DRAKE L. REV. 1, 15–16 (2018) ("Online lending has provided isolated tribes with an opportunity to improve their economies. State law typically does not apply on tribal land, and states are the primary payday-loan regulators. Since the Dodd-Frank Act considers tribes "States," poor and isolated tribes have seen online payday lending as an opportunity to use their sovereignty to promote economic development. Indeed, payday lending provides some tribes with the majority of their budgets.")

339. Adam Crepelle, *Tribal Lending and Tribal Sovereignty*, 66 DRAKE L. REV. 1, 16 (2018).

340. Kate Berry, *CFPB's Mulvaney Shows Lighter Touch with Tribal Lenders*, AM. BANKER (Mar. 19, 2018) (detailing "rent-a-tribe" schemes as non-tribal lender strategies in which lenders establish relationships with tribes to bene-

all the key aspects of the lending operation—from advertising to website design to underwriting to providing the loan capital—all with minimal input from the tribe or its members.[341] In these so called "rent-a-tribe" arrangements, only a small number of tribal members are employed by the TLE, and they perform only basic administrative functions related to loan processing.[342] In some arrangements, tribes are entitled to as little as 1-2% of the profits[343]— all while potentially jeopardizing their sovereign immunity.

However, when done right, TLEs can create professional employment opportunities on reservations, while bringing in significant financial returns to tribes.[344] Revenue that is returned to the reservation allows for continued growth and in-

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fit from their immunity from state usury laws) https://www.americanbanker.com/news/cfpbs-mulvaney-shows-lighter-touch-with-tribal-lenders.

341. James Williams Jr., *Respect Indian Country, Retire "Rent-A-Tribe,"* CAGLE (Aug. 28, 2018), https://www.cagle.com/james-williams-jr/2018/08/respect-indian-country-retire-rent-a-tribe; Nathalie Martin & Joshua Schwartz, *The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?*, 69 WASH. & LEE L. REV. 751, 784 (2012) ("We suspect that many of the current connections between tribes and internet payday lenders are tenuous, and further, that tribes generally receive minimal compensation relative to their non-tribal partners.").

342. Jayne Munger, Student Note, *Crossing State Lines: The Trojan Horse Invasion of Rent-a-Bank and Rent-a-Tribe Schemes in Modern Usury Law*, 87 GEO. WASH. L. REV. 468, 478 (2019) ("It operates similarly to a rent-a-bank scheme, in that the lender markets, advertises, and provides funds for the service, then the tribal entity originates the loan to the borrower, which can be done nation-wide over the internet, and subsequently sells the loan to the lender according to a prior arrangement."). The term "rent-a-tribe" is a controversial one. The term originated in gaming, where attacks started as soon as tribes became a competitive threat to non-tribal casinos. Opponents suggested that tribes' practice of hiring capable vendors to provide services related to casino operations was akin to "renting" sovereignty and detracted from the tribal ownership of the business, even though many non-tribal entrepreneurs engage in identical outsourcing practices when starting a new business in a regulated industry. *See also* Williams Jr., *supra*, note 341.

343. Leslie Bailey, *"Tribal Immunity" May No Longer Be a Get-Out-of-Jail Free Card for Payday Lenders*, THE PUB. JUST. FOUND. (Jan. 2, 2018), https://www.publicjustice.net/tribal-immunity-may-no-longer-get-jail-free-card-payday-lenders/.

344. Mary Jackson, Tribal Lending Provides More Opportunities for America's Indigenous Peoples, Forbes (Nov. 6, 2019, 8:00 AM), https://www.forbes.com/sites/forbesfinancecouncil/2019/11/06/tribal-lending-provides-more-opportunities-for-americas-indigenous-peoples/?sh=104e69c74ba8.

vestment.[345] Although we cannot yet discern the long-term effects of the following examples on tribes, they are currently engaged in employing tribe members and generating revenue.

The Habematolel Pomo of Upper Lake in California and the Lac Vieux Desert in Michigan's Upper Peninsula are two tribes who are seeing growth of tribal economies by providing online loans.[346] Tribal authorities like Sherry Treppa, chairperson of the Habematolel Pomo Tribe, say that the funds generated by lending are important to the lives and livelihoods of the tribes.[347] Treppa says the lending business "has been transformative," providing funds for tribal government services, stipends for seniors and scholarships for students, and that "without tribal lending, these programs would be impossible."[348] In 2018, the Habematolel Pomo TLE was able to open a call center that could provide eighty jobs in the area.[349]

On the Lac Vieux Desert Reservation, approximately 42% of the Nation's General Fund comes from revenue associated with tribal lending operations.[350] The Lac Vieux Desert Reservation's TLE, Castlepay, employs 11 of its 648 tribe members.[351] While the number may not seem significant, the lending operations still brought a handful of decent jobs to one of America's most remote regions, Michigan's Upper Peninsula, where winter temperatures often fall to −20°F.[352] Castlepay loans are funded by a third-party hedge fund.[353] However, Castlepay does not seem to experience the same lopsided benefits some tribes do in their operation with an outside finan-

345. *Id.*

346. *Does Tribal Lending Have a Future?*, PYMNTS.COM (Jan. 16, 2018), https://www.pymnts.com/news/alternative-financial-services/2018/tribal-lending-scott-tucker-racketeering/.

347. *Id.*

348. *Id.*

349. *California Tribe Creates New Jobs with Opening of Call Center*, NATIVE AM. FIN. SERVS. ASS'N. (Dec. 20, 2018), https://nativefinance.org/ news/california-tribe-creates-new-jobs-with-opening-of-call-center.

350. Chico Harlan, *Indian tribes gambling on high-interest loans to raise revenue*, WASH. POST (Mar. 1, 2015), https://www.washingtonpost.com/business /economy/indian-tribes-gambling-on-high-interest-loans-to-raiserevenue/ 2015/03/01/8551642d-e51b-4d3a-89c6-4de0d3bdf385_story.html.

351. *Id.*

352. *Id.*

353. *Id.*

cier.[354] Additionally, the Lac Vieux Desert Band was able to pay off a $30 million loan that financed the construction of their casino with revenues from the tribal lending business.[355]

However, Castle Payday has encountered obstacles from regulators, too. The tribe received cease and desist orders from New York's financial services superintendent, Benjamin Lawsky, who said they and other online lenders were violating New York's 25% annual interest cap by dealing with borrowers in the state.[356] The Lac Vieux Desert Band, along with the Otoe Missouria Tribe of Indians in Oklahoma, together challenged Lawsky's power to regulate the loans.[357] The case was dropped after they lost twice in court.[358] Castlepay no longer issues loans to consumers in New York, Pennsylvania, Arkansas, Vermont, West Virginia, or Colorado—states that either banned high-rate lending or have challenged online lenders.[359] As of January 2021, a class action suit is pending against Big Picture Loans, owner of Castle Payday, by plaintiffs in Virginia.[360] In the complaint filings, the plaintiffs allege that Matt Martorello, a venture capitalist and non-tribal member, used an association with the Lac Vieux Desert Band to establish a rent-a-tribe business model for his own company, Bellicose Capital.[361] Because Castlepay is deeply integrated into the Band's society, the case is one to follow. With much of the Lac Vieux Desert Band's ability to provide services for its members currently contingent on Castlepay, should the court determine

354. *Id.*

355. *Revenues from Tribal Lending Enterprise and Investments into Economic Enterprises Lead Lac Vieux Desert to Historic Milestone: Payment in Full of Casino Debt*, NATIVE AMERICAN FINANCIAL SERVICES ASSOCIATION (Jan. 13, 2020), https://nativefinance.org/news/revenues-from-tribal-lending-enterprise-and-investments-into-economic-enterprises-lead-lac-vieux-desert-to-historic-milestone-payment-in-full-of-casino-debt/.

356. Chico Harlan, *supra* note 350.

357. *Id.*

358. *Id.*

359. *Id.*

360. Emma Whitford, *Borrowers Want Sanctions in Tribe-Linked Lending Row*, LAW360 (Jan. 21, 2021), https://www.law360.com/articles/1346953/print?section=Banking; Frank Green, *Court to consider case involving alleged 'rent-a-tribe' loan operation charging high interest*, RICHMOND TIMES DISPATCH (May 2, 2019), https://richmond.com/news/local/crime/court-to-consider-case-involving-alleged-rent-a-tribe-loan-operation-charging-high-interest/article_01e85a4a-a088-58e2-9879-214f0dc3158d.html.

361. *Id.*

that its arrangement with Bellicose Capital is in some manner predatory, the potential effects on the Lac Vieux Desert Band would be great.

The Habematolel Pomo is another tribe currently experiencing success from their operation. In 2018, the Consumer Financial Protection Bureau under the Trump Administration withdrew a lawsuit against lending companies owned by the Habematolel Pomo of Upper Lake.[362] The tribe views this dismissal as a sign of progress.[363]

However, some TLE arrangements do little to assist tribes and may even damage tribal sovereignty. The prevalence of "rent-a-tribe" arrangements was brought into the public eye in 2018 through the Netflix documentary series *Dirty Money*.[364] This series exposed the activities of Scott Tucker, a non-Indian, professional race car driver, who had amassed a small fortune through his work with TLEs.[365] Starting in 2003, Tucker entered agreements with several Native American tribes, including the Santee Sioux Tribe of Nebraska, the Miami Tribe of Oklahoma, and the Modoc Tribe of Oklahoma.[366] Under these agreements, the tribes became nominal owners of Tucker's online lending businesses, so that when states sought to enforce laws prohibiting the high-interest loans offered by these businesses, the businesses could claim to be protected by sovereign immunity.[367] The Tribes made no payment to Tucker to acquire the portions of the businesses they purported to own.[368]

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362. *Trump administration signals major changes for tribal lending industry*, INDIANZ (Jan. 19, 2018), https://www.indianz.com/News/2018/01/19/trump-administration-signals-major-chang.asp.

363. *Id.*

364. DIRTY MONEY: PAYDAY (Netflix 2018).

365. David Heath, *Payday Lending Bankrolls Auto Racer's Fortune*, CTR FOR PUB. INTEGRITY (Feb. 10, 2016), https://publicintegrity.org/2011/09/26/6605/ payday-lending-bankrolls-auto-racers-fortune; *See* Leslie Bailey, *Payday Lending: Boon or Boondoggle for Tribes?*, THE PUB. JUST. FOUND. (Mar. 5, 2015), https://www.publicjustice.net/payday-lending-boon-or-boondoggle-for-tribes/.

366. *Scott Tucker Sentenced To More Than 16 Years In Prison For Running $3.5 Billion Unlawful Internet Payday Lending Enterprise*, U.S. DEP'T OF JUST. (Jan. 5, 2018), https://www.justice.gov/usao-sdny/pr/scott-tucker-sentenced-more-16-years-prison-running-35-billion-unlawful-internet-payday.

367. *Id.*

368. *Id.*

While Tucker's lending businesses were "owned" by the Miami and Modoc Tribes of Oklahoma as well as the Santee Sioux Tribe of Nebraska, it appeared that the bulk of the operations occurred at his office in Kansas, not on the reservation.[369] Operating under names including Ameriloan, Cash Advance, One Click Cash, United Cash Loans, and 500 Fast-Cash, Tucker's enterprises employed approximately 600 people, only a small fraction of which were tribal members.[370] In order to deceive borrowers into believing that they were dealing with Native American tribes, Tucker directed call center employees to state that they were located on Indian reservations in Oklahoma and Nebraska, when in fact they were working out of Tucker's corporate office in Kansas.[371] In exchange for participating in these arrangements, the tribes received payments, typically 1% of the revenues from the TLEs that they purportedly owned.[372]

The contrast between Tucker's lifestyle and those of the tribes that "owned" the TLEs was stark. Tucker garnered over $380 million in profit from these arrangements, which he spent on a fleet of Ferraris and Porsches, a professional auto racing team, a private jet, and a luxury home in Aspen, Colorado.[373] Meanwhile, even at the height of the lending operations, members of the Modoc Tribe of Oklahoma and Santee Sioux Tribe of Nebraska struggled with continued poverty.[374]

Consumers borrowing from these operations were routinely charged interest rates of 600-700%, and sometimes higher than 1000%.[375] Between 2006 and 2011, the Better Business Bureau of Eastern Oklahoma received more than 2,000 complaints about Scott Tucker's TLEs.[376] And the Federal Trade Commission reported that between 2007 and 2012,

369. *Id.*

370. DIRTY MONEY: PAYDAY, *supra* note 364.

371. Some managers located in Kansas City would insist that employees never reveal that they were located outside of Oklahoma, going as far as sending out weather reports for the state each day. *Id.*

372. U.S. DEP'T OF JUST., *supra* note 366.

373. *Id.*

374. The Miami Tribe have been able to achieve a higher standard of living. In 2010, however, the chief stated in a tribal newsletter that hard times were forcing the tribe to consider layoffs and other budget cutting measures. CTR. FOR PUB. INTEGRITY, *supra* note 365.

375. U.S. DEP'T OF JUST., *supra* note 366.

376. CTR. FOR PUB. INTEGRITY, *supra* note 365.

more than 7,500 other complaints were filed in other jurisdictions throughout the country.[377]

The State of Colorado attempted to sue Tucker' business, Cash Advance, in state courts for violation of state usury regulations and other abusive lending practices.[378] Each of these state courts dismissed the claims on the grounds that the TLEs were protected by the tribes' sovereign immunity.[379] Yet, the tribes held only an indicium of ownership over the TLEs and performed only a small amount of the TLEs' business functions.[380]

In 2011, the Federal Trade Commission filed a Complaint in the U.S. District Court for the District of Nevada against Tucker, his online lending businesses, and several related businesses and affiliated individuals.[381] This was the first federal enforcement action the FTC filed against Tucker.[382] The five-count Complaint alleged that Tucker had violated the Federal Trade Commission Act ("FTC Act"), and the Electronic Funds Transfer Act ("EFTA").[383] Tucker's businesses had allegedly engaged in a number of abusive lending practices such as giving inaccurate loan information to borrowers, requiring borrowers to preauthorize electronic withdrawals from their bank accounts as a condition of obtaining loans, improperly garnishing wages, and threatening borrowers with arrest and lawsuits in debt collection calls.[384] The defendants moved to dis-

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377. *FTC Charges Payday Lending Scheme with Piling Inflated Fees on Borrowers and Making Unlawful Threats When Collecting*, FED. TRADE COMMISSION (Apr. 2, 2012), https://www.ftc.gov/news-events/press-releases/2012/04/ftc-charges-payday-lending-scheme-piling-inflated-fees-borrowers.

378. Cash Advance and Pref. Cash Loans v. State, 242 P.3d 1099 (Colo. 2010); State *ex rel* Suthers v. Cash Advance, 205 P.3d 389, 399 (Colo. App. Ct. 2008).

379. U.S. DEP'T OF JUST., *supra* note 366.

380. *Id.*

381. *FTC Charges that Payday Lender Illegally Sued Debt-Burdened Consumers in South Dakota Tribal Court Without Jurisdiction*, FED. TRADE COMMISSION (Mar. 17, 2012), https://www.ftc.gov/news-events/press-releases/2012/03/ftc-charges-payday-lender-illegally-sued-debt-burdened.

382. *Id.*

383. Complaint for Permanent Injunction and Equitable Relief, Fed. Trade Comm'n v. Payday Financial, LLC (D. S.D. Sept. 6, 2011), https://www.ftc.gov/sites/default/files/documents/cases/2011/09/110912paydaycmpt.pdf.

384. *FTC Charges Payday Lending Scheme with Piling Inflated Fees on Borrowers and Making Unlawful Threats when Collecting*, FED. TRADE COMMISSION (Apr. 2,

miss on the grounds that they were an on-reservation business and were not subject to state jurisdiction.[385] Their motion was denied.[386]

Ultimately, AMG Services entered a Partial Settlement Agreement with the FTC in July 2013, in which Tucker's businesses, AMG Services and MNE Services Inc., agreed to stop these abusive lending practices and to pay $21 million in restitution, with another $285 million waived in charges that were assessed but not collected.[387] In January of 2015, the U.S. District Court for the District of Nevada approved and issued the permanent injunction.[388] The injunction barred the settling defendants from using threats of arrest and lawsuits as a tactic for collecting debts, and from requiring all borrowers to agree in advance to electronic withdrawals from their bank accounts as a condition of obtaining credit.[389] In January of 2016, two of the defendants, Red Cedar Services Inc. and SFS Inc., paid a total of $4.4 million to resolve the case against them.[390]

Finally, in October of 2017, after having engaged with TLEs for close to twenty years, Tucker was found guilty by the United States District Court for the District of Nevada on 14 counts, including racketeering, wire fraud, money laundering, and TILA offenses; he was sentenced to 200 months in prison.[391] In addition to the conviction, the judge ruled that Tucker and his corporate defendants pay a $1.3 billion pen-

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2012), www.ftc.gov/news-events/press-releases/2012/04/ftc-charges-payday-lending-scheme-piling-inflated-fees-borrowers.

385. Fed. Trade Comm'n v. AMG Services, Inc., No. 2:12-cv-00536-GMN-VCF, 2015 WL 10738453 (D. Nev. May 26, 2015).

386. *Id.*

387. *U.S. Court Finds in FTC's Favor and Imposes Record $1.3 Billion Judgment Against Defendants Behind AMG Payday Lending Scheme*, Fed. Trade Commission (Oct. 4, 2016), www.ftc.gov/news-events/press-releases/2016/10/us-court-finds-ftcs-favor-imposes-record-13-billion-judgment.

388. *Online Payday Lending Companies to Pay $21 Million to Settle Federal Trade Commission Charges that They Deceived Consumers Nationwide*, Fed. Trade Commission (Jan. 16, 2015), www.ftc.gov/news-events/press-releases/2015/01/online-payday-lending-companies-pay-21-million-settle-federal.

389. *Id.*

390. Fed. Trade Commission., *supra* note 387.

391. David Heath, *Payday Lending Bankroll's Auto Racer's Fortune*, Public Integrity (Feb. 10, 2016), https://publicintegrity.org/2011/09/26/6605/payday-lending-bankrolls-auto-racers-fortune.

alty, the largest figure ever obtained by the FTC in a litigated case.[392]

Following the 2012 FTC victory against Tucker, the Modoc Tribe agreed to forfeit $2 million to the federal government, the Santee Sioux tribe forfeited another $1 million, and the Miami tribe forfeited $48 million.[393] As of 2018, 25% of the Modocs' 253 members and 25% of the Santee Sioux' 355 members are living below the poverty line.[394] For the Miami tribe, who had a diversified safety net of income from gaming and a handful of other endeavors, 95% of the tribe's ninety-three on-reservation members live above the poverty line.[395]

Tribal lending enterprises have displayed instances of success in creating careers and a source of revenue for impoverished rural tribal communities. Tribal lending has also responded to a demand by underbanked consumers for alternative financial services.[396] In return, tribal lending enterprises have the burden of proving that the majority of the business activity occurs on-reservation.[397] By proving this, tribes not only prevent state infringement on tribal sovereignty, but protect themselves from non-tribal affiliates who intend to use their sovereignty to skirt state usury laws without establishing a meaningful business relationship with the tribe. In proving that tribal business is occurring on-reservation, TLEs might also bar themselves from being challenged by state attorneys general and state agencies in court.[398] However, this is complicated by the fact that federal courts test to determine whether a business is an arm of the tribe vary in complexity and emphases.[399] Until a unilateral test is adopted, TLEs must be pre-

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392. Steve Vockrodt, *American Indian tribes used by convicted payday lender Scott Tucker settle with feds*, KAN. CITY STAR (June 26, 2018), https://www.kansascity.com/article213852304.html.

393. *Id.*

394. *My Tribal Area*, U.S. CENSUS BUREAU, https://www.census.gov/tribal/index.html?aianihh=5740.

395. *Id.*

396. Gavin Clarkson et al., *Online Sovereignty: The Law and Economics of Tribal Electronic Commerce*, 19 VAND. J. ENT. & TECH. L. 1, 9 (2016) ("One in five (or twenty-four million) households were underbanked in 2013.").

397. Adam Crepelle, *Tribal Lending and Tribal Sovereignty*, 66 DRAKE L. REV. 1, 42 (2018); Bree R. Black Horse, *The Risks and Benefits of Tribal Payday Lending to Tribal Sovereign Immunity*, 1 AM. INDIAN L. J. 396, 400 (2013).

398. *Id.*

399. Black Horse, *supra* note 397.

pared to demonstrably prove their affiliation to the tribe on any number of points.

In this Article we have examined on-reservation businesses in four industries: gaming, tobacco, petroleum, and online lending. While the points of contention in each case are varied, the similarity in each is that a tribal business acted under the assumption that their actions were protected by virtue of being an extension of the tribe. Tribes' ability to act as sovereign entities has been confirmed through the U.S. Constitution, treaties, and agreements with the federal government, as well as centuries of case law. In each industry we explored, and in others we did not explore, when a part of a tribal business occurs off-reservation, disputes about the legality of its actions are often challenged by the state or individuals. We now turn our attention to recommendations that address pathways through which these disputes can be resolved in a manner that recognizes the unique position of tribes and tribal businesses in the US legal system.

IV.
Recommendations

The challenges to sovereignty for tribal businesses are numerous and far-reaching, as are the potential solutions to these challenges. In this section, we offer three ideas. First, we argue that federal and state courts must recognize that tribal courts— not state courts—are the appropriate forum for resolving disputes that involve tribal businesses as parties or that address questions of state jurisdiction over tribal businesses. Second, we call for the Government Accountability Office ("GAO") or another independent office to perform a comprehensive audit of the federal government's compliance with treaties with American Indian tribes. Finally, we contend that removing barriers to Native Americans participating in the political process, including certain state election law provisions, is an important step to promoting tribal sovereignty and economic development. Taken together with other efforts, these measures could potentially enhance the self-determination of tribes, in turn enabling tribes to conduct their business operations in a manner consistent with their beliefs and values.

A. *Exhaustion of Tribal Court Remedies*

As evidenced by a number of cases discussed in Section 3, a perennial question is which judicial forum(s) are appropriate for resolving disputes involving tribal businesses. We argue that the proper first forum for resolving disputes involving tribal businesses is the tribal court system. By subjecting tribal businesses to the jurisdiction of state regulatory bodies or state courts, or even federal courts, without first allowing the tribal court to adjudicate the matter, state or federal law improperly displaces tribal law.

The U.S. Supreme Court has recognized the jurisdiction of tribal courts and the development of tribal law is a vital aspect of tribal sovereignty.[400] The Court has acknowledged the "congressional policy promoting the development of tribal courts."[401] The development of tribal courts does not minimize the rights of litigants, as they still preserve their right to seek review of tribal court decisions by the federal courts.[402] Even when a tribal court applies state law, or a tribal court decision is ultimately appealed to a federal court, exhaustion of tribal court remedies allows tribal courts to "explain to [the] parties the precise basis for accepting jurisdiction, and . . . also provide[s] other courts with the benefit of their expertise in such matter in the event of further judicial review."[403] Opponents of tribal courts are quick to allege bias or incompetence, yet these allegations are entirely unsupported.[404] They are a thinly veiled excuse for attempting to circumvent tribal jurisdiction.[405]

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400. B.J. Jones, *Welcoming Tribal Courts into the Judicial Fraternity: Emerging Issues in Tribal-State and Tribal-Federal Court Relations*, 24 Wm. Mitchell L. Rev. 457, 499–500 (1998) (citing Iowa Mut. Ins. Co. v. LaPlante, 480 U.S. 9, 15–16 (1987) which ruled that a tribal court should have the first opportunity to evaluate the facts, and National Farmers' Union Ins. Cos. v. Crow Tribe of Indians, 471 U.S. 845, 857 (1985) which held that a tribal court should have an opportunity to determine its own jurisdiction).

401. Iowa Mut. Ins. Co. v. LaPlante, 480 U.S. 9, 15–16 (1987).

402. Brown v. Washoe Hous. Auth, 835 F.2d 1327, 1329 (10th Cir. 1988).

403. Burlington N. R.R. Co. v. Crow Tribal Council, 940 F.2d 1239, 1246 (9th Cir. 1991).

404. Adam Crepelle, *Tribal Courts, the Violence against Women Act, and Supplemental Jurisdiction: Expanding Tribal Court Jurisdiction to Improve Public Safety in Indian Country*, 81 Mont. L. Rev. 59, 82 (2020).

405. *Id.*

Tribes have a right to "manage the use of [tribal] territory and resources by both members and nonmembers [and] to undertake and regulate economic activity within the reservation."[406] If non-tribal litigants challenge the jurisdiction of the tribal court, the tribal court itself should have the first opportunity to adjudicate its own jurisdiction. The U.S. Supreme Court has remarked that allowing tribal courts this opportunity "encourage[s] more efficient procedures" and promotes judicial economy.[407]

Many of the cases discussed in Section 3 were adjudicated in state court, with hardly a mention of whether exhaustion of tribal court remedies was appropriate. We point to the following examples across three industries to illustrate this question: *People ex. Rel. Becerra v. Native Wholesale Supply Company* (tobacco), *Washington State Department of Licensing v. Cougar Den* (petroleum), and *Littlefield v. Mashpee Wampanoag Tribe* (gaming).

A key issue in *People ex. Rel. Becerra v. Native Wholesale Supply Company* was whether the defendant, a cigarette wholesaler owned by a member of the Seneca Nation and incorporated under the laws of the Sac and Fox Nation, became subject to the regulatory jurisdiction of the State of California when it sold cigarettes to the Band of the Western Mono Indians of the Big Sandy Rancheria, located in California. The issue of whether the state court or the federal court was the appropriate forum for this case was debated over multiple levels of appeal; however, exhaustion of tribal court remedies does not appear to have been raised or considered. While the Big Sandy Rancheria Band of Mono Indians is a small tribe and does not have its own court system, the Seneca and Sac and Fox Nations both have their own courts, which could have provided an appropriate forum to begin proceedings. Particularly given the nature of the case, with questions of both tribal business operation and jurisdiction, exhaustion of tribal courts may have provided an opportunity to gain tribal perspective on Native Wholesale's operation.

The case of *Washington State Department of Licensing v. Cougar Den* addressed whether the Yakama's transport of fuel from Oregon to their reservation within the State of Washington

406. N.M. v. Mescalero Apache Tribe, 462 U.S. 324, 335 (1983).
407. *Crow Tribal Council*, 940 F.2d at 1246.

was protected under the Yakama Treaty and thus exempt from a Washington fuel importation tax. The proceeding began before a Washington State Department of Revenue Administrative Law Judge, and worked its way up through the state court system and eventually to the U.S. Supreme Court.[408] The Yakama tribal court did not have an opportunity to adjudicate the issue, even though the case centered on the understanding and historical context of the Yakama's treaty right, for which the tribe is the utmost authority.

The question of exhaustion of tribal remedies is also relevant to the federal courts. The case of *Littlefield v. United States Department of Interior* (later *Littlefield v. Mashpee Wampanoag Tribe*) illustrates this point. The plaintiffs in that case, the Littlefields, sued the United States Department of Interior (DOI) in federal District Court on grounds that the DOI's designation of land in trust for the Mashpee Tribe was contrary to federal law.[409] One wonders why the Littlefields did not initially include Mashpee Tribe as a defendant—perhaps it was to circumvent the tribal court. In any event, the United States District Court for Massachusetts ruled in favor of the Littlefields. DOI dropped their petition to appeal the decision, but having joined the case, the Mashpee Wampanoag petitioned the U.S. Court of Appeals for review. At such point in time, the Court of Appeals should have considered remanding the case to the Mashpee Wampanoag tribal court.

While the tribal businesses may have waived sovereign immunity and agreed to be sued in state court, or at the least not contested the jurisdiction of the state court on sovereign immunity grounds, we argue that the state and federal courts should have *sua sponte* considered the question of whether the tribal courts would have been an appropriate first forum for resolving the disputes. This is not to say that exhaustion of tribal court remedies should always be required, but rather that the court should at least consider the question.

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408. Washington State Dep't of Licensing v. Cougar Den, Inc., 139 S. Ct. 1000, 1007 (2019).

409. Littlefield v. United States Dep't of Interior, 199 F. Supp. 3d 391, 392 (D. Mass. 2016), *aff'd sub nom.* Littlefield v. Mashpee Wampanoag Indian Tribe, 951 F.3d 30 (1st Cir. 2020).

B. *Treaty Compliance Audits*

Treaties between the federal government and other nations are legally binding documents.[410] History has shown, and the recent cases discussed in Section 3 emphasize, that the federal government does not honor its treaties with American Indian nations to the same extent it honors treaties entered into with foreign nations. The federal government has not upheld its Indian treaty obligations regarding land boundaries, water rights, hunting and fishing rights, rights to engage in commercial activities, as well as many other rights.[411] The federal government has also been complicit in state violations of these rights.[412]

Treaty compliance is important to American Indians, whose nations made significant concessions in exchange for treaty promises. But it is also important—or at least, we argue, it should be important—to nonindigenous citizens of the United States, who became parties to the treaties when they were made on our behalf by the federal government.

As a mechanism of promoting federal government compliance with American Indian treaties, we recommend that Congress pass a law or otherwise adopt a standing request for periodic non-partisan audits of Indian treaty compliance. Regular treaty compliance audits would aid in keeping the federal government (and by extension U.S. citizens) in good relationship with tribal nations and be a logical step in repairing the damage that has been caused by disregarded treaty promises. These audits should review not only the federal government's own actions, but also its (in)actions in allowing states to infringe on tribes' treaty-protected rights.

An organization that is well-poised to conduct treaty audits is the U.S. Government Accountability Office ("GAO"). The GAO is Congress's "watchdog," and it produces non-partisan, objective audit reports on government operations at the

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410. U.S. CONST. art. VI; Seminole Nation v. United States, 316 U.S. 286, 296 (1942) ("[I]n carrying out its treaty obligations with the Indian Tribes the Government is something more than a mere contracting party. . . it has charges itself with moral obligations of the highest responsibility and trust.").

411. *See* Siegfried Wiessner, *American Indian Treaties and Modern International Law*, 7 ST. THOMAS L. REV. 567, 572 (1995).

412. *Id.*

request of the congressional committees.[413] Another potential avenue is the Congressional Research Service ("CRS"). The CRS analyzes policy and law for members of Congress from a non-partisan perspective and drafts frameworks for achieving policy goals.[414] While we believe that the federal government should assume responsibility for (and pay for) this internal audit function, non-government organizations such as the Native American Rights Fund could consider providing technical assistance to tribes that wish to perform an audit of compliance with the treaties that apply to them.

This recommendation is not without issue. The GAO and the CRS are not courts, and their determinations of what actions are and are not compliant with the terms of a treaty would not be legally binding. However, as the reports they produce are often treated as valid and credible, they may create an indirect political pressure for a company, state, or federal government to abandon a practice once it is deemed noncompliant.

C. *Voting Rights and Political Participation*

Voting rights and political participation may not be the first topic that comes to mind when analyzing tribal businesses, but, given the heightened focus on voter rights surrounding the 2020 Presidential election,[415] its inclusion in this article felt timely. In the modern day, Native Americans have the same right to vote as all other American citizens, but social, economic, and geopolitical factors inhibit Native American voters from accessing the polls. While these conditions persist, the interests of the Native American electorate—the interests of tribes and tribal businesses—are underrepresented.

In this section, we briefly examine the historic and current issues facing Native American voters and the federal government's efforts to mitigate these issues. To be clear—we are not suggesting that participation in the U.S. political system is or should be necessary for Native Americans to maintain their

413. *About*, U.S. Gov't Accountability Off., www.gao.gov/about (last visited Sept. 4, 2021).

414. *About CRS*, Libr. of Cong., https://loc.gov/crsinfo/about (last visited Sept. 4, 2021).

415. Andrew Westney, *Justices Open Door to More Restrictive Voting Regs*, Law360 (July 1, 2021, 10:19 AM), https://www.law360.com/nativeamerican/articles/1372410.

culture, practices, treaty rights, or self-determination. Rather, we are arguing that Native Americans who desire to participate in the U.S. political system should not face unique or undue hardships when doing so.

Political disenfranchisement of Native Americans has a lengthy history. The Fifteenth Amendment to the United States Constitution secured that "[t]he right of citizens of the United States to vote shall not be denied or abridged by the United States or by any State on account of race, color, or previous condition of servitude."[416] However, many state constitutions were written prior to the passage of the Fifteenth Amendment and included stipulations that allowed only white citizens to vote.[417] Decades of political and social movements, court cases, and activism eventually led to the right to vote for all Native Americans, when in 1958 North Dakota became the last state to remove its ban on Native American voting.[418]

While voting access has improved substantially for all groups since the 1950s, today only two-thirds of eligible Native Americans are registered to vote, and voter turnout for Native Americans is the lowest of any demographic segment in the country.[419] Between 2008 and 2020, twenty lawsuits were filed on matters relating to Native American access to the polls.[420] Alaska Natives also face barriers in exercising their voting rights.[421]

The isolated nature of many Indian reservations can make it complicated and expensive for residents to visit state licensing offices to obtain approved voter identification and to access post offices to obtain voter registration cards and sample ballots.[422] Even after securing approved identification cards,

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416. U.S. CONST. amend. XV, § 1.

417. James Thomas Tucker et al., OBSTACLES AT EVERY TURN: BARRIERS TO POLITICAL PARTICIPATION FACED BY NATIVE AMERICAN VOTERS, at 11 (2020), https://vote.narf.org/wp-content/uploads/2020/06/obstacles_at_every_turn.pdf.

418. Patty Ferguson-Bohnee, *How the Native American Vote Continues to Be Suppressed*, AM. BAR ASS'N HUM. RTS. MAG., Feb. 9, 2020, www.americanbar.org/groups/crsj/publications/human_rights_magazine_home/voting-rights/how-the-native-american-vote-continues-to-be-suppressed.

419. Tucker et al., *supra* note 417, at 6.

420. Ferguson-Bohnee, *supra* note 418.

421. Zachary R. Kaplan, *Unlocking the Ballot: The Past, Present, and Future of Alaska Native Voting Rights*, 37 ALASKA L. REV. 205, 207, 218 (2020).

422. Ferguson-Bohnee, *supra* note 418.

Native American voters have been turned away at the polls because some poll workers are not familiar with the unique residential addressing systems used on some reservations.[423]

Gerrymandering also contributes to this problem. Malapportioned districting, where Native Americans are placed into districts in a manner that reduces Native voting strength, is a contributing factor in the denial of equal access to representation and government services for many tribal members.[424]

Malapportioned districts may also be a challenge for those tribal citizens who wish to run for office.[425] Despite this, in the 2020 election, six Americans Indians were elected to Congress, and numerous indigenous candidates won state and local elections.[426] This is a sign of progress not only for indigenous individuals whose interests are supported by indigenous representation, but also for tribal businesses whose unique positionality may be best served by representatives who are familiar with the business operations and the tribe's legal rights.

In 2019, U.S. Senator Tom Udall (D-N.M.), vice chairman of the Senate Committee on Indian Affairs, and U.S. Representative Ben Ray Luján (D-N.M) introduced the Native American Voting Rights Act, with the objective of removing barriers to voting and improving access to the polls for Native Americans.[427] The legislation would improve Native American access to voter registration sites and polls, approve the use of tribal IDs for elections in all states, and require jurisdictions to consult with tribes prior to closing voter registration and polling sites on Indian Reservations.[428] The bill would also create a Native American Voting Task Force and a grant program to provide funding towards Native American voting access, as well as requiring the U.S. Department of Justice to consult with

423. *Id.*

424. *Id.*

425. *See* CONG. RSCH. SERV., RS21176, APPLICATION OF CAMPAIGN FINANCE LAW TO INDIAN TRIBES (2007).

426. Erica Belfi, *Historic Number of Native Americans Elected to U.S. Congress*, CULTURAL SURVIVAL (Nov. 17, 2020), https://www.culturalsurvival.org/news/historic-number-native-americans-elected-us-congress.

427. Ferguson-Bohnee, *supra* note 418.

428. *Id.*

tribes on voting issues.[429] However, the bill has been stuck in committee since 2019.[430]

On March 7, 2021, President Biden signed an Executive Order on Promoting Access to Voting.[431] It established a Native American Voting Rights Steering Group to determine the best practices for protecting voting rights of Native Americans; the Steering Group is directed to produce a report by early 2022.[432] The issues for the Steering Group to address are similar to those contained in the proposed Native American Voting Rights Act.[433] While it is promising that the Biden administration has taken steps to mitigate the discrimination faced by Native American voters, real change will likely hinge on implementation of the Steering Committee report.[434]

V.
CONCLUSIONS

Tribal businesses and the markets they serve have evolved over time, but their unique status as tribal entities remains. In an era of global and online commerce, states have increasingly attempted to assert regulatory and tax jurisdiction over tribal businesses. The federal government has, for the most part, sat idly by and allowed this abdication of its exclusive constitutional authority over Indian commerce. In this article, we discussed four industries—gaming, tobacco, petroleum, and online lending—to demonstrate the need for the federal government to live up to the promises it made in Indian treaties and to act in accordance with the principles of sovereignty and self-determination.

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429. Ferguson-Bohnee, *supra* note 418; *see also Native American Voting Rights: Barriers and Solutions Examined by Congress*, AM. BAR ASS'N WASH. LETTER (Feb. 1, 2020), https://www.americanbar.org/advocacy/governmental_legislative_work/publications/washingtonletter/feb-20-washington-letter/medicare-feb-2020/.

430. Native American Voting Rights Act of 2019, H.R. 1694, 116th Cong. (2019).

431. Exec. Order No. 14,019, 86 Fed. Reg. 13,623 (Mar. 7, 2021).

432. *Id.*

433. *Id.*; *see also* Ferguson-Bohnee, *supra* note 418.

434. As evidenced by a recent Supreme Court decision, the strength of certain provisions in the Voting Rights Act is still being contested. *See* Brnovich v. Democratic Nat'l Comm., 141 S. Ct. 2321, 2325 (2021).

We recognize that tribal scholars and attorneys are more than capable of advocating for themselves, and that indigenous individuals have unique insights that are linked to indigenous identity and relationality. Rather, as non-tribal members who strive to be allies of our Native colleagues, we seek to call attention to the continual overreach of state regulation over tribal businesses and to show that the federal government is not living up to its constitutional and treaty-bound obligations. To this end, we offered three recommendations in this Article. First, we argued that tribal courts are the proper forum to first consider disputes in which tribal businesses are parties or which address questions of state jurisdiction over tribal businesses. If the issue of tribal court exhaustion is not raised by the parties, state courts should consider raising it sua sponte. Second, we called for an independent office within the federal government to perform periodic, comprehensive audits of the federal government's compliance with American Indian treaties. Finally, in light of the current national discourse regarding voting rights, we contended that increasing access to the polls for Native Americans is an important step to promoting tribal sovereignty and economic development.

One does not need to be a tribal member or ally to have a stake in these issues. It is in the interest of all Americans for the federal government to prevent unconstitutional state overreach over business enterprises. It is in the interest of all Americans that when promises are made in our name, those promises are kept. In that sense, it's all of our business.

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BASEL III AND THE REGULATION OF MARKET-BASED FINANCE: THE TENTATIVE REFORM

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Since the mid-2010s, with memories of the global financial crisis of 2008 ("GFC") progressively fading, there has been increasing recognition of the potential contributions of market-based finance. This refers to credit intermediation conducted by non-bank entities, effectively what in 2007 was termed "shadow banking." A number of policymakers in the post-crisis years have praised the opportunity to reconcile shadow banking with resilient market-based channels of intermediation. In 2016, the G30 stressed the potential that lies in securitization and other forms of market-based finance. In the process, though, market-based finance is also proposing the re-emergence of a business model that in the pre-crisis years was known as securitized banking.

The post-crisis narrative suggests that the regulatory corrections established since 2008 should contribute to transforming shadow banking into resilient market-based finance. The Basel III framework sits at the heart of the post-crisis regulatory architecture, and its design aims to protect large financial institutions from the risks flowing from market-based channels of intermediation. This general optimism, though, clashed with the economic slowdown caused by the COVID–19 pandemic in the spring of 2020, particularly insofar as it exposed some deep-seated fragilities in the financial system.

Therefore, this Article engages with a critical appraisal of that regulatory edifice, analyzing in particular its capacity to respond to risks associated with pre-2008 securitized banking, as well as the challenges emerging from the more recent morphing of market-based channels of intermediation. The new Basel framework appears to provide the necessary safeguards to guarantee the stable operations of restored capital markets. However, this Article observes that, despite providing much needed regulatory improvements from

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the pre-crisis regime, the current framework still falls short in protecting the financial system from inherent risks generated by the evolution of market-based finance.

Introduction

This Article proposes a critical view of the resurrection of market-based channels of finance, which in the years before 2008 were characterized chiefly by securitization and the repurchase ("repo") market.[1] Halfway through the last decade, with memories of the 2008 debacle slowly fading in public perceptions, policymakers at the global level started to praise the potential economic benefits of market-based finance, and the opportunity to reconcile the shadow banking[2] system, with the idea of resilient market-based finance.[3] As an illustration of this policy trend, the U.K. Financial Conduct Authority ("FCA") stressed the importance of alleviating large banks of the burden traditionally borne as providers of finance as well as the need to lower systemic risk in the banking system by developing alternative market-based channels of intermediation.[4] In a similar vein, the EU Capital Markets Union was chiefly conceived as an opportunity to integrate European capital markets around, primarily, a revived securitization market.[5]

Two specific concerns prompted this Article, both of which materialized in the spring of 2020, when the pandemic-induced economic slowdown unveiled deep-seated fragilities in the financial system. The first one coincided with the downgrade of Collateralized Loan Obligations ("CLO")[6] tranches, caused by defaults in the underlying leveraged loans. Several commentators looked at the post-2008 development in the CLO market as the "ground zero for the next financial crisis."[7]

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1. The combination of securitization and repo is often referred to as securitized banking, especially in the context of pre-2008 practices.

2. The term was coined by economist Paul McCulley at a speech in 2007 by the Kansas City Federal Reserve Bank.

3. *See generally* Matteo Aquilina & Wladimir Kraus, *Market-Based Finance: Its Contributions and Emerging Issues*, Financial Conduct Authority, May 2016, at 1; *EU Commission Green Paper on Building a Capital Markets Union*, COM (2015) 63 final (Feb. 18, 2015); Grp. of Thirty, Shadow Banking and Capital Markets: Risks and Opportunities (2016).

4. Aquilina & Kraus, *supra* note 3.

5. *See EU Commission Green Paper on Building a Capital Markets Union*, *supra* note 3.

6. Collateralized Loan Obligations are a sub-species of pre-2008 securitized debt. For more on this, see discussion *infra* Section I.D.

7. Joe Rennison & Robert Smith, *CLOs: Ground Zero for the Next Stage of the Financial Crisis?*, Fin. Times (May 13, 2020), https://www.ft.com/con-

The second concern has roots in a broader regulatory problem related to increasing levels of private debt creation and leverage coupled with ensuing financial stability concerns.[8] This led to claims that the financial system showed serious fragilities in the spring of 2020 that demanded regulatory intervention.[9]

Notwithstanding the aforementioned concerns, proponents of market-based finance believe that new channels of financial intermediation, outside of the banking system, could represent more efficient avenues of credit transmission, thus achieving the goal of completing financial markets.[10] Moreover, central to this idea is the greater risk-sharing capacity that market-based financial systems have when compared to banking systems.[11] Claims that market-based finance can be reconciled with resilience and sustainability, however, are grounded in the existence of a new regulatory framework, whereby the excesses of securitized banking experienced in the decade pre-

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tent/f10eaaac-0f4e-46bc-8f78-0754028da46a. These alarms were mirrored by the ECB. *See Leveraged Lending: Banks Exposed to Risks amid COVID-19*, SUPERVISION NEWSL. (Eur. Cent. Bank, Frankfurt, Ger.), May 13, 2020, https://www.bankingsupervision.europa.eu/press/publications/newsletter/2020/html/ssm.nl200513.en.html; *see also* Frank Partnoy, *The Looming Bank Collapse*, ATLANTIC, July-Aug. 2020; Vincenzo Bavoso, *Hail the New Private Debt Machine: Private Equity, Leveraged Loans, and Collateralised Loan Obligations*, 14 LAW & FIN. MKTS. REV. 141 (2020).

8. *See* IMF, *Global Corporate Vulnerabilities: Riskier Business*, Global Financial Stability Report (Oct. 2019).

9. Paul Tucker, *Time to Look Again at the Financial System's Dangerous Faultlines*, FIN. TIMES (Jan. 20, 2021), https://www.ft.com/content/0d848d03-7d66-4a76-a4f2-8f09980747fa. The Systemic Risk Council followed up from the events from April 2020, and in October 2020 it issued a statement that looked, among other things, at ways to strengthen the financial system, with some emphasis on the containment of systemic risks from the shadow banking system. *See* Letter from The Systemic Risk Council to the Finance Ministers and Central Bank Governors of the G20, The Financial Stability Board, and the International Standard-Setters (Oct. 9, 2020), http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2020/10/SRC-Reigniting-the-Reform-Debate.pdf.

10. This stance is traditionally associated with the idea of financial deepening and market completion. *See* Peter L. Rousseau & Paul Wachtel, *What is Happening to the Impact of Financial Deepening on Economic Growth?*, 49 ECON. ENQUIRY 276 (2011).

11. Tobias Adrian & Bradley Jones, *Shadow Banking and Market-Based Finance* (Int'l Monetary Fund, Departmental Paper No. 18/14, 2018).

ceding the GFC should be reined in.[12] From a global perspective, Basel III represents the central piece of the post-2008 regulatory architecture, particularly with respect to the interplay between large banks and capital markets as well as the containment of systemic risks from the shadow banking system.[13]

Some of the Basel III provisions need to be understood in connection with the risks that they seek to mitigate. In particular, a revived securitized banking model re-proposes forms of maturity and liquidity transformation[14] conducted outside of the banking system, potentially creating long and opaque intermediation chains that, as it happened before 2008, magnify problems of complexity and leverage. Part I of this Article therefore provides an analytical understanding of the legal and regulatory problems that emerged in connection with non-bank (market-based) financial intermediation, bearing in mind that some of these problems are intrinsic to and inevitable features of the financial system.[15]

While it is now well known that the shadow banking system does not benefit from the same regulatory backstops that apply in the banking sector,[16] the intricate web of interconnectivities that link the two systems together represent the most

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12. GRP. OF THIRTY, *supra* note 3.

13. *See* Andrea Enria, Chair, Supervisory Bd. of the Eur. Cent. Bank, Keynote Speech at the European Commission's DG Financial Stability, Financial Services and Capital Markets Union Conference on the Implementation of Basel III (Nov. 12, 2019).

14. The former is represented by the use of short-term funds to invest in long-term assets, whereas liquidity transformation focuses on the use of liquid liabilities to buy illiquid assets. *See* Laura Kodres, *What is Shadow Banking?*, FIN. & DEV., June 2013, at 42.

15. Asymmetry of information and more general agency problems between sellers of financial products and buyers are inevitable. These agency problems can only be exacerbated by misaligned incentives (such as compensation structures), that in the pre-crisis decades progressively encouraged a culture of risk taking centered on the volume of sales, as opposed to one rooted in more prudential behavior on the part of bankers. Asymmetry of information was further fuelled by the increased complexity of financial products, which created information failures. One such case was that of collateralized debt obligations, which while creating greater appeal to investors, due to the tranched securities, were also concealing underlying loan-level data, leading thus to neglected risks. *See* Joshua Coval et al., *The Economics of Structured Finance*, J. ECON. PERSPS., Winter 2009, at 3; Adrian & Jones, *supra* note 11, at 6.

16. *See* Zoltan Pozsar et al., *Shadow Banking* (Fed. Rsrv. Bank N.Y., Staff Report No. 458, 2010).

problematic aspect of this story. Before 2008, a number of contractual features that connected banks' balance sheets to entities and products in the shadow banking system exemplified these ties. This interconnectedness is precisely the regulatory problem that became crystallized in the events of September 2008, when a run on the repo market quickly propagated through the global financial system. In a sense, regulators aimed post-2008 at insulating the banking system from risks arising in less regulated markets—in other words, at preventing another GFC from recurring. This Article focuses precisely on assessing the capacity of Basel III to achieving that, especially in light of the aforementioned events of March 2020.

As mentioned at the beginning of this Introduction, widespread risk aversion and the threat of new regulatory measures caused the drastic decline in market-based activities after 2008.[17] This trend changed in 2014 when policymakers began brainstorming the idea of a regulatory architecture that could ensure simplicity and transparency in market-based finance, and, thus, achieve some degree of resilience.[18] At the global level, the main tool was the creation of an infrastructure for the system-wide monitoring of systemic risk in the shadow banking system. This is centered on the work of the Financial Stability Board ("FSB") through its Global Shadow Banking Monitoring Report.[19] Two goals represent the Basel III frame-

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17. This trend is best represented by the parallel decline in securitization and repo activities after September 2008, with the slow and consistent restart of these markets after 2010. *See* BONNIE G. BUCHANAN, SECURITIZATION AND THE GLOBAL ECONOMY 115 (2017) (chart on CDO issuance); Barry Ritholtz, *Will Twist Cause Problems for the Repo Market?*, BIG PICTURE (June 26, 2012), https://ritholtz.com/2012/06/will-twist-cause-problems-for-the-repo-market/ (chart on volume of repo transactions).

18. For probably the first concrete policy document in this sense, see Bank of Eng. & Eur. Cent. Bank, *The Case for a Better Functioning Securitisation Market in the European Union* (May 29, 2014); *see also* Tobias Adrian et al., *Liquidity, Leverage, and Regulation 10 Years After the Global Financial Crisis*, 10 ANN. REV. FIN. ECON. 16 (2018); GRP. OF THIRTY, *supra* note 3.

19. *See* FIN. STABILITY BD., GLOBAL MONITORING REPORT ON NON-BANK FINANCIAL INTERMEDIATION 2018 (2019). At the EU level, much progress has been made with the European Systemic Risk Board ("ESRB"), which is also important in the related risk assessment processes and in the implementation of relevant macroprudential policies. At the U.S. level, Title I of the Dodd–Frank Act established the Financial Stability Oversight Council, which represents a functional coordination of the U.S. regulators with respect to the regulation of large systemic financial institutions. *See* ADRIAN BLUNDELL-

work's role in this regulatory effort: a) to recognize the exposure of deposit-taking institutions to the shadow banking system through better capital and risk coverage rules, and b) to foster resilient market-based intermediation by bringing transparency into both the securitization and repo markets, and also by reducing the dependence of banks on wholesale funding channels.[20]

To develop and address the above questions, this Article is divided into six parts, including the present Introduction. Part I provides the background of this research by tracing the evolution of banks and capital markets through the lens of securitization and repos, the two main legs of the securitized banking model. It then draws a picture of the market-based development that occurred over the past decade. Part II engages with a critical analysis of the regulatory and legal origins of market-based developments. This analysis starts by situating the central role of market discipline in the regulation of capital markets, and how it informed more specific regulatory and legal developments in the areas of securitization and repo. The post-2008 evolutions in market-based finance are also explained through the lens of the market discipline orthodoxy. Part III moves the discussion on to the critical analysis of the relevant Basel III measures. It focuses on capital and risk coverage rules, the new securitization framework, the leverage ratio, and the liquidity rules. Outside of Basel III, this Article also discusses the rules on minimum haircuts in repos. The critical review of the new regulatory framework is the basis for an appraisal, conducted in Part IV, of whether and how the post-crisis regulatory framework is likely to respond to the challenges posed by revived market-based finance, and whether shadow banking can be brought within a resilient boundary. The Article then concludes.

WIGNALL ET AL., GLOBALISATION AND FINANCE AT THE CROSSROADS 218 (2018).

20. New rules on liquidity, in particular, and the greater focus on off-balance sheet exposures, generally, illustrate the willingness to strengthen banks' exposure to non-bank channels of intermediation. For a closer examination of this area of the Basel framework, see *infra* Part III.

I.
Framing the Problem: Market Developments and Changes in Banks and Capital Markets

The trajectory of financial development, globally, has been characterized since the 1980s by the expansion of market-based channels of intermediation and the attendant greater availability of market-based financial products.[21] Presently, this trend can be illustrated through a number of policy documents recently produced by the EU Commission in support of the initiative to implement a capital markets union ("CMU") in the EU.[22] Similarly, shifts from more traditional models of credit intermediation to market-based ones have been even more pronounced in other jurisdictions, primarily in the United States and to a degree in the United Kingdom, where regulatory changes between the 1980s and the early 2000s promoted the further development of capital markets.[23]

It is important to clarify that the above shift did not simply rebalance the old textbook distinction between bank finance and capital markets finance. As this Part will illustrate, the development of capital markets was instrumental to the emergence of large banking institutions (so called "dealer banks")[24] due to their increasing interaction with capital markets. The business model of dealer banks progressively relied less on the traditional deposit-based funding channels, and more on wholesale, market-based funding channels.[25] In essence, banks became an integral part of capital markets finance, and their

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21. *See* Niki Anderson et al., *A European Capital Markets Union: Implications for Growth and Stability*, Fin. Stability Paper (Bank of Eng., London, U.K.) Feb. 25, 2015.

22. *See EU Commission Green Paper on Building a Capital Markets Union*, *supra* note 3.

23. *See* Jeffrey N. Gordon and Kathryn Judge, *The Origins of a Capital Market Union in the United States* (Eur. Corp. Governance Inst. Working Paper, Paper No. 395, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3154676.

24. *See* Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 Cornell L. Rev. 1143, 1165 (2017); *see also* Vincenzo Bavoso, *Market-Based Finance, Debt and Systemic Risk: A Critique of the EU Capital Markets Union*, Acct. Econ. & L., Oct. 2018, at 1.

25. *See* Hockett & Omarova, *supra* note 24; Aquilina & Kraus, *supra* note 3.

interplay with capital markets drastically changed the patterns of financial intermediation and credit transformation.[26]

In order to understand the relationship between this new model of financial intermediation and the events of 2007–2008, and beyond, it is necessary to examine the way in which large dealer banks operated within this model. From the early 2000s, large banking institutions had fully expanded their activities into different areas of business, which in previous decades had been kept separate by a number of regulatory constraints.[27] The shift in the banks' business models was dramatic. To appreciate the scale of changes, it is useful to look at the structure of their balance sheets, namely at the items included as assets and liabilities.[28] A simplified overview of a traditional commercial bank's balance sheet would show on the assets side: a) a mix of loans (from more secured mortgages, to other commercial and consumer loans, as well as interbank loans); b) securities, such as government bonds; and c) reserves and cash items. On the liabilities side, one would find: i) deposits of different sizes; ii) borrowings from other banks; and iii) bank capital.[29]

Conversely, dealer banks' balance sheets show their greater interplay with capital markets, and, more specifically, with market-based funding channels. On the assets side, long-term asset-backed securities ("ABS") started replacing the more conventional loan-type assets.[30] This shift necessitated a longer chain of relationships with a number of financial intermediaries, for the purpose of minimizing the risks associated with ABSs held by dealer banks.[31] It is important to em-

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26. *See* Hockett & Omarova, *supra* note 24; Aquilina & Kraus, *supra* note 3.

27. It is beyond the scope of this Article to map the regulatory changes that elicited the emergence of dealer banks. For an overview, see BLUNDELL-WIGNALL ET AL., *supra* note 19, at 1–39.

28. See Perry Mehrling, *Financialization and its Discontents*, 3 FIN. & SOC'Y 1 (2017), bearing in mind that assets refer to promises to pay made by others to the bank, whereas liabilities refer to promises to pay issued by the bank to other parties.

29. *See Assets and Liabilities of Commercial Banks in the United States—H.8*, FED. RSRV. BANK, https://www.federalreserve.gov/releases/h8/current/default.htm (last visited Sept. 22, 2021).

30. Pozsar et al., *supra* note 16, at 10–11.

31. Specifically, risks associated with ABSs were sold off to other capital markets intermediaries. This would occur through different derivative con-

phasize that in the pre-crisis years it was widely believed that these ABSs were virtually risk free (and also more liquid than conventional loan assets) due to the process whereby their risk was being passed to asset managers and other derivatives dealers, who were, in turn, selling these risks (or rather financial products whose value was based on these risks) to capital markets investors. These assets, perceived to be risk free, were eventually used by dealer banks as collateral in a number of other transactions detailed below.[32]

On the liabilities side, dealer banks' balance sheets became even more interconnected with wholesale, market-based funding channels. Instead of traditional deposits, they increasingly funded their operations through repo contracts with money market funds.[33] Perry Mehrling aptly defined this form of financial intermediation as "money market funding of capital market lending."[34] Effectively, dealer banks engaged with what has been referred to as the securitized banking system, whereby they repackaged loans and resold them as ABSs on their assets side, while, on their liabilities side, they mainly relied on repo transactions with money market funds.[35]

Why is this relevant at all? Because the transactions and products that characterize dealer banks' balance sheets, and their relationships with other financial intermediaries, resulted in high levels of interconnectedness with the shadow banking system.[36] In the pre-crisis years, the shadow banking system revolved chiefly around two main channels of credit intermediation: the securitization market and the repo market.[37] Therefore, it is necessary to briefly illustrate how these two seg-

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tracts such as interest rate swaps, foreign exchange swaps, or credit default swaps. *See* Aquilina & Kraus, *supra* note 3, at 13.

32. *Id.* at 14; Adrian & Jones, *supra* note 11, at 3–4.

33. *See* Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on the Repo*, 104 J. FIN. ECON. 425 (2012).

34. *See* Perry Mehrling et al., Bagehot Was a Shadow Banker: Shadow Banking, Central Banking and the Future of Global Finance (Nov. 6, 2013) (unpublished manuscript), http://papers.ssrn.com/abstract=2232016.

35. *See* Gorton & Metrick, *supra* note 33, at 428.

36. *See* Pozsar et al., *supra* note 16, at 4–7 (providing an understanding of shadow banking system as we know it today).

37. *Id.* at 10–11 (explaining the various steps and phases of the shadow system). *See also* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 2010 BROOKINGS PAPERS ON ECON. ACTIVITY 261, 269–70.

ments of capital markets functioned in the pre-crisis period, followed by how they have morphed after 2008.

A. *The Evolution of Securitization Before 2008*

From the early 2000s, the practice of securitizing receivables gathered increasing pace, due chiefly to transactional and technological innovation, but also as a consequence of the regulatory changes that caused the progressive liberalization of financial markets.[38] In the United States and the United Kingdom, this expansion was characterized by new transactional forms, such as collateralized debt obligations ("CDO" and later CDO squared and synthetic CDOs).[39] These facilitated the origination of many more assets, critically, low quality assets.

Typically, the originating bank (or sponsoring bank) transfers a pool of assets to a special purpose vehicle ("SPV"), which, in turn, issues debt securities secured over the asset pool to investors in the capital markets.[40] Traditionally, SPVs issued one type of security against the asset pool, with investors acquiring a pro rata interest in it.[41] With the advent of tranching, SPVs started slicing the security into a number of tranches, each bearing a different level of credit quality and subordination.[42] As each tranche carried a different level of risk and rate of return, this way of pooling assets attracted a wider variety of investors with a more diverse risk appetite.[43] Unlike more traditional securitization structures, tranching fa-

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38. *See* Vincenzo Bavoso, *Financial Innovation and Structured Finance: The Case of Securitisation*, 34 CO. LAW. 3 (2013).

39. A large amount of literature has been written on securitization and its more recent innovations. *See, e.g.*, Sarai Criado & Adrian van Rixtel, *Structured Finance and the Financial Turmoil of 2007–2008: An Introductory Overview* (Banco de España, Documento Ocasional No. 0808, 2008); Gerard Caprio, Jr. et al., *The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats* (World Bank, Dev. Rsch. Grp., Fin. & Priv. Sector Team, Working Paper No. 4756, 2008); Douglas Lucas et al., *Collateralized Debt Obligations and Credit Risk Transfer*, Yale Int'l Ctr. for Fin., Working Paper No. 07-06, 2007).

40. Bavoso, *supra* note 38, at 4.

41. Lucas et al., *supra* note 39.

42. *Id.* (explaining that first losses on the underlying pool are borne by the bottom (equity) tranche of the bond, while the top senior tranches are the most secure, and therefore rated AAA).

43. Coval et al., *supra* note 15, at 5–6.

cilitated the origination of low quality assets.[44] These however, received high ratings from credit rating agencies ("CRA") because CDOs were structured in accordance with complex correlation formulas that underscored the bundling of the asset pool.[45] A variety of credit enhancement mechanisms also had the effect of minimizing the SPV's credit risk, thus facilitating the marketability of securitized bonds to investors.[46]

Innovations in tranching and the way in which assets were pooled together led to the more dramatic emergence of synthetic CDOs. These instruments involved the use of derivatives and, in particular, credit default swaps ("CDS") which helped create an exposure to the credit risk of the asset pool.[47] More specifically, synthetic CDOs did not feature a sale of assets to the SPV. Instead, the originator entered into a CDS with the SPV, whereby the SPV acted as swap counterparty and sold credit protection over the asset pool to the originator.[48] The SPV, in turn, issued credit-linked notes to investors, thus effectively passing the risk of the asset pool (that it did not own) onto investors.[49] This practice was associated with much higher levels of leverage creation[50] and with the increased opacity of the securitization market.[51]

The vast application of securitization allowed banks to remove the loan inventory from the asset side of their balance sheet, leading to what has been referred to as an "originate-to-

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44. In CDO structures, it became common practice to securitize already existing debt securities, such as other "unsold" securitization tranches, giving way to what has been termed securitization squared.

45. Felix Salmon, *A Formula for Disaster*, WIRED, Mar. 2009 (explaining how the Gaussian Copula formula allowed the creation of triple-A securities where none of the underlying assets were worth triple-A).

46. *See* Viral Acharya et al., *Securitization without Risk Transfer*, 107 J. FIN. ECON. 515, 531–32, (2013).

47. *See* Elizabeth Uwaifo, *Key Issues in Structuring a Synthetic Securitisation Transaction—A European Perspective*, 16 J. INT'L BANKING L. 98 (2001).

48. *Id.*

49. *See* Jan De Vries Robbé & Paul Ali, *Synthetic CDOs: The State of Play*, 21 J. INT'L BANKING L. & REGUL. 12, 12–13 (2006).

50. *See* Margaret Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 REV. BANKING & FIN. L. 225 (2010).

51. *See* Vincenzo Bavoso, *Filling the Accountability Gap in Structured Finance Transactions: The Case for a Broader Fiduciary Obligation*, 23 COLUM. J. EUR. L. 369 (2017).

distribute" model of credit intermediation.[52] Under this model, banks could profit from loan intermediation—not only for originating and holding them on their balance sheet, as was traditionally the case.[53] More importantly, moving assets off-balance sheets created regulatory capital, which was instrumental in facilitating the origination of more loans (especially mortgages), in fueling asset expansion not complemented by increases in capital, and, therefore, in huge increases in leverage.[54]

In the context of the securitized banking system, it is also important to remember that the vast amount of securitized bonds, originated and traded by dealer banks, were pledged as collateral for securing financing in repo transactions.[55]

B. *The Interplay with Repurchase Agreements*

As discussed, the practice of tranching facilitated the production of assets that were perceived as super-safe, namely the top tranches of securitized bonds that were receiving triple-A ratings.[56] By virtue of their safety, these senior tranches became very valuable collateral in the pre-crisis years, especially in the context of repurchase transactions.[57] Typically, in repo transactions, a dealer bank (borrower) borrows short-term funds from a money market mutual fund (lender) by transferring the legal ownership of the collateral to the lender. The money market mutual fund engages in a reverse repo as the

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52. Instead of the traditional originate-to-hold, whereby banks would hold the assets they originated on their books until maturity. *See* Vitaly M. Bord & João A.C. Santos, *The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation*, FED. RSRV. BANK N.Y. ECON. POL'Y REV., July 2012, at 21–34.

53. Gorton & Metrick, *supra* note 33, at 434.

54. *See* Jay Cullen, *Securitisation, Ring-Fencing and Housing Bubbles: Financial Stability Implications of UK and EU Bank Reforms*, 4 J. FIN. REGUL. 73 (2018); Emilios Avgouleas, *Bank Leverage Ratios and Financial Stability: A Micro- and Macroprudential Perspective* (Levy Econ. Inst., Working Paper No. 849, 2015).

55. Nicola Cetorelli, *Hybrid Intermediaries* 4–5 (Fed. Rsrv. Bank N.Y., Staff Report No. 705, 2014) (arguing that this model led to the growing centrality of dealer banks and the market for securities lending and repo agreements).

56. This took place at a time when demand for safe and liquid assets was increasing, while low-risk government bonds were becoming scarce. *See* Daniela Gabor & Cornel Ban, *Banking on Bonds: The New Links Between States and Markets*, 54 J. COMMON MKT. STUD. 617 (2016).

57. Gorton & Metrick, *supra* note 33.

dealer bank promises to repurchase the collateral at a later date.[58] Critically, if the dealer bank becomes insolvent and cannot honor its promise, the lender can sell the collateral.[59] Lenders are further protected by haircuts. These refer to the market value of the collateral, which is higher than the value of the loan (also referred to as the margin, which is calculated on the value of the collateral).[60] Similarly, if the collateral falls in value, margin calls are used to ensure that the repo is fully collateralized.[61]

In the context of the securitized banking system, repo agreements became significantly convenient due to two main legal features characterizing pre-crisis practices. First, the collateral was transferred to the lender, enabling the lender to immediately access and sell the assets in the event of the borrower's default.[62] Second, as the assets were transferred to the lender, lenders were free to reuse the same collateral in other similar transactions, a process that has been referred to as rehypothecation, and that gave rise to virtually endless chains of rehypothecations.[63] In this respect, it must be acknowledged that many of the problems associated with rehypothecation (which will be discussed in more detail in Part II) were prerogative of bilateral repos, where collateral and cash were exchanged simultaneously on a delivery-versus-payment basis.[64] Conversely, in tri-party repos, the employment of an

58. *See* Jay Cullen, *The Repo Market, Collateral and Systemic Risk: In Search of Regulatory Coherence, in* RESEARCH HANDBOOK ON SHADOW BANKING 85 (Iris H.-Y. Chiu & Iain G. MacNeil eds., Edward Elgar 2018).

59. *Id.*

60. *See* Gorton & Metrick, *supra* note 37, at 264. Specifically, the haircut represents the difference between the amount of money deposited by the lender and the value of the collateral pledged by the borrower (the latter being higher); whereas the repo rate is the difference between the amount of money deposited by the lender and the amount that the lender receives back with the second leg of the repurchase agreement.

61. In this context a margin call is typically issued by the lender when the value of the collateral falls below the level that is necessary to support the loan. *See* Carolyn Sissoko, The Collateral Supply Effect on Central Bank Policy 19 (Aug. 21, 2020) (unpublished manuscript), https://ssrn.com/abstract=3545546.

62. Cullen, *supra* note 58, at 8.

63. *Id.* at 13.

64. *Id.* at 9.

agent to manage the transaction added much in terms of transparency and stability.[65]

Like securitization, the repo market grew exponentially in the post-liberalization years,[66] and it became the centerpiece of the market-based financial system, where large financial institutions could increasingly tap wholesale funding channels (through repos), instead of deposits, to fund their operations.[67] The centrality of the repo market in the market-based financial system is also represented by the heavy exposure that dealer banks had to it, as opposed to the exposure of traditional commercial banks.[68]

C. *The Rise and Fall of Securitized Banking*

The interplay of securitization and the repo market coincided with what came to be defined as the shadow banking system,[69] which is now more commonly referred to as market-based finance. The main problem attributed to these channels of financial intermediation was the replication of bank-like functions, resulting in maturity transformation and liquidity creation.[70] While maturity transformation is typical of banks as they hold long-term assets (such as mortgages) and issue short-term liabilities (such as deposits),[71] it presents more risky contours in the shadow banking system. This is particularly evi-

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65. *Id.* at 6. However, it must be explained that in some ways the mechanics of tri-party repo added some complexity to the structure of the market. For instance, during the GFC of 2008, repo lenders had to be concerned about other repo lenders exiting the market (and, therefore, leaving them with the burden of holding a larger share of the market together), but above all they were wary of agent banks not being able or willing to complete daily clearing operations, leaving lenders hugely exposed. *See* John Mullin, *The Repo Market is Changing (and What is a Repo, Anyway?)*, ECON FOCUS, First Quarter 2020, at 16.

66. This was particularly the case once the market started accepting as collateral privately issued ABSs as well as securities issued by shadow banking entities. This shift was caused by the scarcity of government bonds which are traditionally the quintessentially safe assets. Daniela Gabor, *The (Impossible) Repo Trinity: The Political Economy of Repo Markets*, 23 REV. INT'L POL. ECON. 967, 982 (2016).

67. *Id.* at 981–84.

68. *See* Gorton & Metrick, *supra* note 33, at 438.

69. Pozsar et al., *supra* note 16, at 1.

70. *Id.* at 1–2.

71. Morgan Ricks, *Regulating Money Creation after the Crisis*, 1 HARV. BUS. L. REV. 75, 98 (2011).

dent in the repo market, where dealer banks were exposed to significant short-term liabilities, often having to roll-over contracts on a daily basis, thus magnifying the maturity transformation.[72] Moreover, liabilities issued in the repo market resulted in money claims due to their liquidity.[73] However, unlike typical money claims (deposits), they were not regulated and, in particular, they were not covered by deposit insurance protection.[74] On this point, it is important to remember that these activities within the shadow banking system fell outside the perimeter of traditional banking regulation.[75]

In particular, two relevant areas of regulation did not apply in the shadow banking system: capital requirements and deposit insurance protection. Traditionally, capital requirements are designed to constrain the level of risk-taking in banks.[76] This is done by imposing a cushion to absorb losses from money claims.[77] The cushion is typically represented by the percentage of equity that banks have to hold against certain assets, which varies according to the riskiness of the assets.[78] Constraining the level of banks' risk-taking in this way should also result in limiting their level of leverage.[79]

There is an important caveat here, because the impact of capital regulation had been severely affected by financial innovation. The way in which the shadow banking system developed meant that banks were allowed to originate assets far beyond the limits of capital requirements, therefore stultifying the function of the cushion mentioned earlier. Most of the shadow banking intermediation was taking place outside the umbrella of regulatory oversight.[80] Specifically, loans or mortgages originated by dealer banks were transferred off-balance sheets and to SPVs, thus freeing up dealer banks' regulatory

72. *Id.* at 86.

73. *Id.* at 97.

74. *Id.* at 120. This was the main cause of the run on the repo market, as documented by Gorton & Metrick, *supra* note 33, at 447–48.

75. Pozsar et al., *supra* note 16, at 7 (highlighting the difference between credit intermediation activities that are respectively receiving direct public enhancement, indirect public enhancement, or are unenhanced).

76. Avgouleas, *supra* note 54, at 2.

77. *Id.*

78. *Id.*

79. *Id.* at 9–10.

80. Pozsar et al., *supra* note 16, at 7 (showing that credit intermediation related to securitized banking activities was unenhanced).

capital to originate more assets.[81] Of course, SPVs were not covered by capital regulation. On the contrary, the capital requirements devised under Basel I and II created an incentive for dealer banks to pursue asset growth strategies by simply moving assets off their balance sheets, with the assurance that the securities issued by the SPV would receive attractive ratings due to the credit enhancement mechanisms in place, and the use of credit derivatives to ensure the creditworthiness of securitized bonds.[82] This widespread practice contributed to the failure to control the amount of credit created by banks (or in other words, the ratio between bank capital and debt), and in turn, the uncontrolled increase in leverage, both firm-wise and system-wise.[83]

To further appreciate the riskiness of credit intermediation conducted in the shadow banking system, it is useful to highlight the different regulatory protection in relation to money claims. As already mentioned, deposit insurance protection regulation represented a non-discretionary support of money claims.[84] Deposit insurance protection was complemented by the discretionary, lender of last resort protection provided by central banks, which was similarly conceived to prevent banks' defaults on money claims.[85] The main difference with protecting deposits was that it constituted an *ex ante* guarantee that depositors' money would be protected (up to a certain amount). The prevention of defaults on money claims was essentially aimed at minimizing the occurrence of bank runs.[86] As was explained earlier in this Article, deposits are not the only money claims, and it has been observed that in the United States, for instance, money claims outside the deposit insurance protection exceed those that fall within the protection.[87] Again, this dynamic is due to money claims being is-

81. Cullen, *supra* note 54, at 81.

82. *See* Perry Mehrling, *Credit Default Swaps: The Key to Financial Reform*, *in* TIME FOR A VISIBLE HAND 185, 195 (Stephany Griffith–Jones, José Antonio Ocampo & Joseph Stiglitz eds., 2010).

83. Margaret M. Blair, *Making Money: Leverage and Private Sector Money Creation*, 36 SEATTLE U. L. REV 417, 434 (2013).

84. Ricks, *supra* note 71, at 83.

85. *Id.* at 117.

86. *Id.* at 119.

87. *Id.* at 121.

sued in the shadow banking system, largely in repo contracts, and therefore outside the system of banking regulation.

Most notably, a run on the repo market aggravated the collapse of Lehman Brothers in 2008.[88] When the value of the securitized bonds that Lehman was pledging as collateral in repo contracts fell, lenders in the repo market either demanded a higher haircut, or simply refused to roll-over those contracts with Lehman.[89] Unlike depositors, money market mutual funds in the repo market had no guarantee of getting their money back, which partly explains the events of September 2008.[90] Moreover, the fact that the repo market remained effectively unregulated until 2015 further increased its vulnerability, due to a fundamental lack of transparency and the ensuing unmonitored level of leverage.

Finally, it is worth reiterating that the intermediation chains developed in the securitized banking system created huge levels of interconnectedness between regulated financial institutions and intermediaries in the shadow banking system.[91] One clear drawback of this interconnectedness was the ensuing fragility of the financial system as a whole, due to its vulnerability to shocks that could be transmitted through the system, causing the sort of domino effect that was eventually experienced with the collapse of Lehman Brothers in 2008.[92] Critically, the homogeneity of dealer banks' balance sheets aggravated this problem of "contagion."[93] The combined application of tranching and CDS created layers of counterparty credit risk, effectively leading to dealer banks holding portfolios of assets (securitized bonds and CDO tranches) that were

88. *See id.* at 126, 126–27 n.116.

89. *See* Gorton & Metrick, *supra* note 33, at 447–48.

90. *See id.*

91. It must be remembered that entities investing in securitized bonds were often other financial institutions, or funds that had borrowed money from financial institutions. Moreover, mechanisms such as credit enhancements and credit default swaps contributed to an overall asset homogenization among financial institutions. *See* Vincenzo Bavoso, *High Quality Securitisation and EU Capital Markets Union—Is it Possible?*, ACCT. ECON. & L., Dec. 2017, at 1.

92. *See* Andrew Haldane & Robert May, *Systemic Risk in Banking Ecosystems*, 469 NATURE 351, 355 (2011).

93. *See* Bavoso, *supra* note 91, at 19.

similar to one another.[94] Homogeneity of portfolio composition and the correlation of the assets therein (and particularly their sensitivity to market movements) were ultimately the factors that heightened problems of systemic risk that emerged in connection with the Lehman downfall.[95]

D. *The Post-Crisis Morphing of Market-Based Finance*

After 2008, the securitization market remained moribund. For example, the U.S. market was chiefly supported by government-backed issues, with private sector securitizations remaining only a small fraction of the market.[96] The post-2008 U.S. market also showed that more problematic segments of structured finance, such as CDOs, were all but defunct between 2008 and 2014.[97] A similar trend can be observed in the repo market,[98] which was affected by the scarcity of collateral that was normally posted in repo contracts. Still, it is well documented that market-based channels of finance slowly restarted in the post-2008 years, and with them the interconnectedness between banks and non-bank entities.[99]

As structured credit markets slowly thawed after 2014, they did so under the new regulatory framework of Basel III (partly implemented, partly to be implemented). While the structure and impact of Basel III is analyzed later in this Article, it can be anticipated that its main focus is on the large financial institutions that emerged as the main culprits after

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94. *See* Frédéric Hache, *A Missed Opportunity to Revive "Boring" Finance?*, FIN. WATCH, Dec. 2014, at 1, 35–36.

95. *Id.*

96. Alper Kara & Solomon Y. Deku, *Securitisation—The Complex Financial Product that Fuelled the Financial Crisis is Making a Comeback*, THE CONVERSATION (Sept. 14, 2018, 8:18 AM), https://theconversation.com/securitisation-the-complex-financial-product-that-fuelled-the-financial-crisis-is-making-a-comeback-93807.

97. *See* Grahame Johnson & Eric Santor, *Central Bank Liquidity Provision and Core Funding Markets*, RSRV. BANK AUSTL., 2013, at 111; BONNIE G. BUCHANAN, SECURITIZATION AND THE GLOBAL ECONOMY 115 (2017).

98. Ritholtz, *supra* note 17.

99. For instance, between the first quarter of 2015 and the first quarter of 2020, banks' cross-border claims on, and liabilities to non-bank entities grew from $4.6 trillion to $7.5 trillion (claims), and from $3.7 trillion to $5.6 trillion (liabilities). Inaki Aldasoro et al., *Cross-Border Links between Banks and Non-Bank Financial Institutions*, BANK FOR INT'L SETTLEMENTS Q. REV., Sept. 2020, at 61, 62–63.

2008.[100] The goal, as stated elsewhere, was to insulate large systemic institutions from risks flowing from the shadow banking system.[101] In light of this regulatory strategy, the more recent developments in the CLO[102] market should come as no surprise.[103] As of 2019, the level of CLO issuance neared $120 billion in the United States. In the EU, it was close to $30 billion.[104] The renaissance of CLOs coincided with the growth of leveraged loans, originated both in the United States and in the United Kingdom, whereby CLOs became the transactional structure that allowed these high risks to be transferred onto capital markets investors.[105]

While this dynamic will sound redolent of pre-2008 themes, it is currently being shaped by new transactional patterns. This is why, notwithstanding warning signs raised by the IMF about the increasing levels of leverage and the ensuing rise of systemic risks,[106] industry experts have been reiterating that the structure of CLOs can "ride out cycles" and keep risks away from systemic institutions.[107]

Compared to more traditional forms of securitization, CLOs are characterized by the central role of private equity firms (instead of dealer banks), acting as both sponsors and managers of the transaction.[108] More specifically, the transaction flow here does not start with the origination and pooling of receivables by a bank. Instead, the transaction hinges on the

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100. Enria, *supra* note 13.

101. *Id.*

102. CLOs were initially conceived as an innovation of plain vanilla asset securitization, and in fact as a subset of the more popular CDOs. *See* Andreas Jobst, *Collateralised Loan Obligations (CLOs)—A Primer* 11 (Ctr. for Fin. Stud., Working Paper No. 2002/13, 2002).

103. In 2013 CLO issues reached a value of $55.41 billion against $88.94 billion in 2007. Tracy Alloway & Nicole Bullock, *CLO Issuance Hits Highest Level Since Before Financial Crisis*, FIN. TIMES, (Sept. 29, 2013), https://www.ft.com/content/a9008c0c-26c1-11e3-9dc0-00144feab7de.

104. *Leveraged Loan Primer*, S&P GLOB., https://www.spglobal.com/marketintelligence/en/pages/toc-primer/lcd-primer#sec8ci (last visited Oct. 20, 2021).

105. FIN. STABILITY BD., VULNERABILITIES ASSOCIATED WITH LEVERAGED LOANS AND COLLATERALISED LOAN OBLIGATIONS 7 (2019).

106. IMF, *Lower for Longer*, Global Financial Stability Report, at 25 (2019).

107. *See* Stephen Foley & Henny Sender, *Private Equity Firms Fuel Demand for CLOs*, FIN. TIMES (Dec. 20, 2012), https://www.ft.com/content/bd0081a8-4ab7-11e2-9650-00144feab49a.

108. Bavoso, *supra* note 7, at 143.

management role of private equity firms. They: a) set up and manage the SPV; b) accomplish functions that are typical of asset managers in ensuring the quality of the asset pool;[109] c) facilitate the issuance of the leveraged loans (either by owning the firms that access the loans, or by engineering the LBOs that stand behind the leveraged loans) that are pooled in the CLO; and d) orchestrate the process of syndication through which leveraged loans are issued by pools of lenders.[110]

From the outset, one key feature of these transactions is the syndication of the origination process which involves a number of lenders, fractionally exposed to the leveraged loans, assigning their portion of receivables to the SPV—a process coordinated by the private equity firm.[111] This also means that individual banks are not directly exposed to the CLO market.[112] However, as will be discussed in the next section, the new shape of CLOs presents a number of legal and regulatory challenges to the application of post-2008 regulation.

The 2008 collapse of securitization, and particularly CDOs, deprived repo agreements of what had become their main source of collateral. Moreover, the new Basel III framework created regulatory costs on dealer banks that drastically reduced their exposure to the repo market.[113] Contextually, repo lenders started to engage with central banks. In the United States, for instance, the Federal Reserve created the Overnight Reverse Repurchase Agreement Facility in 2014, designed to borrow from a number of firms, including mutual

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109. In terms of selection and management of the asset pool. *See* Douglas Long, *Converging Developments in ABCP Conduits and SIV Markets*, *in* ASSET SECURITISATION AND SYNTHETIC STRUCTURES 115, 120 (Rick Watson & Jeremy Carter eds., 2006).

110. *See* Foley & Sender, *supra* note 107 (describing how the private equity industry is fueling demand for leveraged loans, which in turn require CLOs).

111. *See* Bavoso, *supra* note 7, at 143.

112. *Id.* at 144.

113. *See* Sriya Anbil & Zeynep Senyuz, *The Regulatory and Monetary Policy Nexus in the Repo Market,* 30 (Bd. Governors Fed. Rsrv. Sys., Working Paper No. 2018-027, 2018), https://doi.org/10.17016/FEDS.2018.027 (explaining in particular that European dealer banks reduced their exposure to repo borrowing at quarter end (due to quarterly reporting obligations) by around 30%).

funds.[114] In essence, the Fed used its powers in the repo market both as a monetary policy tool (something that is beyond the scope of this Article) and also to promote market liquidity through its credit facility programs.[115]

New regulatory constraints also affected the EU repo market which, after 2008, has been characterized by an increase in centrally cleared transactions.[116] Here, too, monetary policies affected the dynamics of the repo market: Central banks purchasing assets (thus draining the market of necessary collateral) on the one hand, and, on the other hand, making assets available through their securities lending facilities aimed at increasing liquidity in the repo market.[117]

II.
The Regulatory and Legal Origins of Securitized Banking

The developments in market-based finance mapped out in the previous Part point to several legal and regulatory questions. While some were not recognized before the GFC of 2008 and were, thus, at the heart of the Basel III reform process, other regulatory problems emerged in the context of the panic in March 2020.

The fact that much of the securitized banking intermediation was conducted in the shadow banking system, and that the shadow banking system proved to be highly interconnected with dealer banks, was the first concern that clearly emerged after 2008. As explained by much of the post-crisis literature, the collapse in the value of assets that were pledged as collateral in the repo market caused the inability of these

114. With this, the Fed sought to establish a system of interest rate targeting, which had been partly affected by quantitative easing. *See* Mullin, *supra* note 65.

115. *See id.* at 14 (noting in particular that since the outbreak of the COVID–19 pandemic, the Fed has been active through its Primary Dealer Credit Facility).

116. *See* Michael Grill et al., *Recent Developments in Euro Area Repo Markets, Regulatory Reforms and Their Impact on Repo Market Functioning*, *in* Fin. Stability Rev. 158, 160 (Nov. 2017), https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart201711_03.en.pdf?cdc0ecfde7587803e21ae82506a69565 (noting that centrally cleared transactions increased from around 30% in 2019, to more than 60% in 2017).

117. *Id.*

same banks to extend new lines of credit or renew existing ones.[118] This resulted in the well-known credit crunch dynamics that have afflicted the real economy since 2007.[119] Basel III dealt with these problems (as will be explained in Part III) through a new liquidity framework designed to capture banks' exposures to non-bank entities, as well as through new capital requirements and a leverage ratio, both incorporating off-balance sheet exposures.

An attendant issue is that shadow banking in the pre-crisis years consisted chiefly of securitization and repo, and much of the post-crisis regulatory effort has been directed at mitigating risks flowing from those segments of capital markets.[120] However, as was detailed at the end of Part I, the structure of market-based finance has morphed after the GFC, and it is therefore crucial to understand how these changes challenge the efficacy of the Basel III framework. While this question is ultimately addressed in Part III, with the discussion on Basel III, it is important to conceptually explore the legal and regulatory underpinnings of market-based finance and its developments. This analysis is central to the overarching inquiry conducted in this Article, because ultimately Basel III was designed to make market-based finance resilient. This Part is therefore specifically concerned with the reconceptualization of how law and regulation shaped the development of market-based finance, and how Basel III is interplaying with that regulatory trend.

A. *Market Discipline and the Rationale for (Not) Regulating Capital Markets*

Before moving on to the more specific analysis of the legal and regulatory origins of the securitization and repo markets, it is necessary to reconceptualize the foundation upon which market-based channels of finance developed. In particular, it is important to remember that the undisputed application of market discipline underscored capital markets develop-

118. Avgouleas, *supra* note 54, at 21.

119. *See id.* (explaining, among other things, how the macro-prudential perspective, developed after 2008, contributed to understanding the interactions between traditional banking channels and shadow banking intermediation).

120. *See generally* Gorton & Metrick, *supra* note 37.

ment in the last three decades.[121] This regulatory approach rested on the overarching belief that regulation could not improve overall economic welfare; the only exception to that would be the occurrence of a market failure, because the collapse of the market is considered, under this line of thinking, to be more costly than regulatory (government) intervention.[122] This meant that there was an overwhelming prioritization of efficiency goals in policy and regulatory discourses.[123]

In the absence of a strong regulatory oversight, market forces and market players were left free to engineer new structures and products, this being the essence of the process of financial innovation that characterized the period between the 1980s and the early 2000s.[124] As was briefly explained in the Introduction, this process was justified by the belief that a wider and more diversified range of financial products would lead to more efficient and complete markets that would, in turn, ensure a better allocation of resources and risk diversification.[125]

In the process, financial innovation became the engine that enabled financial institutions to engage with excessive levels of risk taking through undesirable increases of lever-

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121. *See* Vincenzo Bavoso, *Regulating Complex Financial Products Post-Crisis: Between the STS Regulation and ESMA Power Intervention Powers*, *in* REGULATION AND THE GLOBAL FINANCIAL CRISIS 101 (Daniel Cash & Robert Goddard eds., 2020); Emilios Avgouleas & Jay Cullen, *Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries*, 41 J.L. & SOC'Y 28, 28–50 (2014).

122. On the broader regulatory debate, see ANTHONY OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY 4 (reprt. 2004).

123. Bavoso, *supra* note 121, at 108–09.

124. *Id.*

125. This ideology found a springboard in the neoliberal orthodoxy disseminated chiefly with the work of Milton Friedman, "Capitalism and Freedom," where the idea of the free market was championed, and particularly the role of the free market for regulatory purposes. *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM (Univ. of Chi. Press 1962). This proposition in turn advanced the concept of rational utility-maximizers who would lead to a state of competitive equilibrium (optimal allocation of resources, or Pareto efficiency) in the context of efficient markets. Attaining this idealized state of competitive equilibrium represented another justification for preferring policies that facilitated the interaction between rational utility-maximizers and the market, with limited regulatory interference in the process. On the idea of competitive equilibrium and Pareto optimality, see Kenneth Arrow & Gerard Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 ECONOMETRICA 265 (1954).

age.[126] This trend was also accepted in pre-crisis years, because mainstream academics and policymakers contended that high levels of leverage were a prerequisite for efficient financial markets. In particular, it was believed that leverage could have a positive impact on banks' allocative efficiency, due to the resulting lower cost of capital.[127] In turn, this would allow banks to extend more credit at cheaper rates, ensuring, according to this line of thinking, broader economic development.[128] Along these lines, it was also contended that regulating leverage would impede financial institutions (chiefly their capacity to extend cheap credit) and create competitive advantages for non-regulated entities in the non-bank sector.[129]

Much of the discourse above underscored the regulatory agenda in pre-crisis years, and still informs some of the critiques made against the new measures introduced under Basel III[130] (discussed in Part III of this Article). One of the problems with the pre-crisis regulatory approach was that market participants assumptively monitored leverage and other risky practices.[131] Under the third pillar of Basel II, in fact, the supervision of the Committee's standards was to be left to mar-

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126. *See* JAMES K. GALBRAITH, A SHORT HISTORY OF FINANCIAL EUPHORIA 19 (Penguin Books 1994) (explaining that "[t]he world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets."). The same type of debt creation was involved within the subsequent innovation which was centered on the use of leverage and the collateralization of assets.

127. Indeed, banks in pre-crisis years did expand their balance sheets chiefly through debt rather than equity. *See* Harry DeAngelo & René Stulz, *Liquid-Claim Production, Risk Management and Bank Capital Structure: Why High Leverage is Optimal for Banks* (Fisher Coll. of Bus., Working Paper No. 2013-03-08, 2014), http://ssrn.com/abstract=2254998.

128. It was contended that a wider extension of credit would ensure that the best projects would be adequately financed, and this would of course contribute to economic growth. *Id.*

129. *See, e.g.*, *id.* at 5.

130. Briefly, it has been observed that the Leverage Ratio and the higher capital requirements under Basel III may limit the ability of banks to extend credit, and this could in turn have consequences in terms of GDP decline. *See* INST. INT'L FIN., THE CUMULATIVE IMPACT ON THE GLOBAL ECONOMY ON CHANGES IN THE FINANCIAL REGULATORY FRAMEWORK (Sept. 2011).

131. *See* Emilios Avgouleas, *The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform*, 6 Eur. Co. & Fin. L. Rev. 440, 458–62 (2009).

ket discipline.[132] For the purpose of the Basel framework, market discipline entailed the development of a set of disclosure recommendations, which were assumed to allow market participants to access and process sufficient information.[133] Information, in turn, was supposed to enable risk assessment procedures and the general risk management related to the capital adequacy of each financial institution.[134]

Furthermore, the Basel framework laid particular emphasis on the importance of banks' internal risk methodologies, which essentially empowered large financial institutions to develop a high degree of discretion in assessing (which will be discussed later in this Part, as "gaming") and applying capital requirements.[135] Again, this system of regulation and supervision was largely justified on the grounds of its cost effectiveness, and on the belief that market participants would be able to police themselves.[136] The hypothesis was grounded on the assumption that depositors and other bank creditors could play a part in monitoring risk taking.[137] Market discipline would then materialize through: a) investors reacting to excessive levels of risk taking (by, for instance, withdrawing funds or demanding higher returns); and b) market reactions that would signal excessive risk taking (such as changes in the value of banks' liabilities).[138]

Beyond the Basel framework, the reliance on market discipline was amplified in the years before 2008 by a fundamental trust in all those supervisory processes that stemmed from market mechanisms and external (non-state) governance ar-

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132. *See infra* Section IV.B, which analyzes market discipline in the context of the Basel framework.

133. For a critique of the disclosure paradigm as a regulatory mechanism, see Avgouleas, *supra* note 131, at 440–75; Martin Hellwig, *Market Discipline, Information Processing, and Corporate Governance* (Max Planck Inst. for Rsch. on Collective Goods, Preprint No. 2005/19, 2005).

134. Basel Comm. on Banking Supervision, Pillar 3—Market Discipline (Sept. 2001) (unpublished manuscript), https://www.bis.org/publ/bcbs_wp7.pdf.

135. *Id.* at 1. See *infra* Part III for more on this point.

136. *See* Avgouleas, *supra* note 131, at 447–48.

137. *See id.* at 448.

138. *See* David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421 (2015).

rangements.[139] It was widely believed that market forces were better at allocating resources through an assessment of the relevant risks and returns, and at exercising discipline across financial institutions.[140]

In a 2001 speech at the Bank for International Settlements, Andrew Crockett (then Head of the Financial Stability Board) noted that notwithstanding the above orthodoxy, there were shortcomings related to market discipline, particularly with respect to its suitability to deal with the evolution of systemic risk.[141] He further pointed out that the presumed effectiveness of market discipline can be hindered by a number of shortcomings that are typically associated with market forces.[142] Primarily, they are related to the difficulty to disclose full information under market mechanisms and the attendant problematic assessment of asset values and risks.[143] Of course, these flaws were worsened by a problematic incentive structure that was already evident at that time and became fully apparent during the following crisis years.[144]

Similarly, market discipline also manifested with an increasing bias towards debt finance, largely because, following the Savings and Loans crisis of the mid-1980s, the perception was that the system of regulation and supervision of banks was not sufficient to curb and monitor banks' risk taking. Instead, it was believed that market discipline should complement the regulation of banks' risk exposure, specifically through the

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139. *See* Andrew Crockett, Gen. Manager, Bank for Int'l Settlements, Speech at the Banks and Systemic Risk Conference: Market Discipline and Financial Stability (May 23, 2001).

140. *See id.* (warning that for it to be effective, market discipline rests upon a number of conditions, namely that market participants have sufficient information to reach informed judgements, that they have the ability to process information, that they have the right set of incentives, and that they have the mechanisms to exercise discipline).

141. *Id.*

142. *Id.*

143. *Id.* Crockett further notes that as opposed to market mechanisms, supervisory authorities can be better placed in a number of situations, given that they have preferential access to information, face a different incentive structure, and may also be better at dealing with risks that affect the system as a whole). *Id.*

144. *See generally* Emilios Avgouleas & Jay Cullen, *Excessive Leverage and Bankers' Pay: Governance and Financial Stability Costs of a Symbiotic Relationship*, 21 COLUM. J. EUR. L. 1 (2015).

role of bondholders, who were thought to be best placed to exert discipline.[145]

Finally, it is useful to note that the development of securitization and repo was also the result of an efficiency rationale upheld within the relevant legislative processes and at common law level. Admittedly, before 2008, the regulation of these two segments of capital markets was at best indirect.[146] At the same time, relevant contractual developments went unfettered and were actually facilitated by a liberal legal and regulatory approach.[147]

The efficiency that securitization provided to originators' balance sheets was facilitated by two commercial law features, namely the transfer of assets from originator to SPV, which was characterized as a true sale,[148] and the bankruptcy remoteness of the SPV from the originator, which prevented the substantive consolidation of the SPV's assets with the originator's estate in the event of its insolvency.[149]

The repo market, too, prospered in the years before 2008, chiefly due to the flexibility that is afforded to lenders and the money-like claims they hold.[150] In a repo transaction, title to the collateral passes to the lender (as if it were effectively a

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145. *See* Robert B. Avery et al., *Market Discipline in Regulating Bank Risk: New Evidence from the Capital Markets*, 20 J. MONEY CREDIT & BANKING 597, (1988).

146. *See* Dan Awrey, *Complexity, Innovation, and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235, 277–78 (2012).

147. *Id.*

148. There is a long-standing academic debate as to whether the transfer of receivables to the SPV should instead be configured as a secured financing, where the assets are pledged as security. This characterization of the transaction would of course be detrimental to the goal of securitization, which is to move assets off the originator's balance sheet. *See* STEVEN SCHWARCZ ET AL., SECURITISATION, STRUCTURED FINANCE AND CAPITAL MARKETS 37–43, 69–70 (2004); *see also* PHILIP WOOD, PROJECT FINANCE, SECURITISATIONS, AND SUBORDINATED DEBT 112 (2d ed. 2007).

149. Again, allowing the creditors of the originator to lodge claims on the assets held by the SPV upon insolvency would defy the purpose of securitization because it would drastically compromise the interests of SPV investors. Moreover, the likelihood of substantive consolidation would highly affect the rating of securitized bonds, thereby hindering investor appetite. *See* SCHWARCZ ET AL., *supra* note 148, at 69–70; *see also* WOOD, *supra* note 148, at 125.

150. *See* Gorton & Metrick, *supra* note 37, at 265–66; *see also* Ricks, *supra* note 71, at 89 (contending that money market instruments possess basic properties of money).

true sale rather than a secured financing), providing greater security to lenders in cases of borrowers' default and also giving them freedom to reuse the same collateral in other transactions.[151] More significantly, in the United States, where title to the collateral does not pass from borrower to lender, transactional efficiency was still preserved due to the "automatic stay" exception under U.S. bankruptcy law.[152] The next two subsections further explore the efficiency rationale that underscored developments in securitization and repo.

B. *Regulatory and Transactional Preconditions of Pre-2008 Securitization*

The abuse of securitization and its uncontrolled development into complex products was widely recognized as one of the main causes of the GFC after 2008.[153] For instance, *The Turner Review* of 2009 mapped the causes of the financial meltdown. Much of its first chapter, titled "What Went Wrong," focused on the role of securitization and financial innovation in advancing problems of leverage and maturity transformation in the shadow banking system.[154] In the United States, *The Financial Crisis Inquiry Report*, finalized in 2011, dedicated its Part II, called "Setting the Stage," to questions related to securitized banking and its genesis.[155] For the purpose of the analysis conducted in this Article, it is useful to

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151. At the EU level this was regulated through Directive 2002/47 of the European Parliament and European Council. *See* Council Directive 2002/47, 2002 O.J. (L 168) 43 (EC).

152. In the United States, an "automatic stay" is imposed during bankruptcy proceedings on the assets of the defaulted party. This means that secured creditors must wait for commencement of the bankruptcy proceedings before being able to seize the relevant assets pledged as security. The "automatic stay," however, does not apply in the context of repo transactions and derivatives, therefore allowing creditors to immediately use the collateral upon debtor's default. *See* Cullen, *supra* note 58, at 95–96 (explaining that reforms in bankruptcy law led to an almost total exception related to all types of repo collateral in 2005).

153. *See* FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 28 (2009).

154. *See id.* at 11–49.

155. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 27–80 (2011) (discussing shadow banking, securitization and derivatives, deregulation redux, and subprime lending).

reconceptualize the pre-crisis development of securitization under two headings: regulatory and transactional.

The regulatory fault lines that spurred the perverse employment of securitization can be primarily reconciled with some unintended consequences of the Basel I and II frameworks. It is rightly contended that Basel represented a regulatory incentive for banks to resort to off-balance sheet finance.[156] In the 1990s, large dealer-banks had started expanding their business to capital markets, completing a functional integration between banking and capital markets activities.[157] The main focus of capital rules was on banks' balance sheets,[158] whereas banks' exposures relating to securitization and other off-balance sheet activities remained outside the scope of Basel capital regulation.

As a consequence, securitization was widely employed for regulatory arbitrage purposes, because it had the effect of creating regulatory capital for banks; banks could increase their asset base (by originating more mortgages, for instance), without having to post capital against those assets at the same time, because the originated mortgages would be moved off-balance sheet and outside the umbrella of capital regulation.[159] This model of financial intermediation proved to be highly profitable for banks. In essence, banks were engaging in asset substitution on the assets side of their balance sheet, moving risks off-balance sheet, while simultaneously originating or investing in high-risk assets.[160] While this increase in risk taking was highly lucrative for bank shareholders and executives—as it was maximizing returns on equity ("RoE")—the resulting increase in leverage was not accompanied by banks setting aside commensurate amount of capital to account for the risk.[161]

The accuracy of its risk weighting process was a connected regulatory problem with the Basel framework, which, in princi-

156. Douglas W. Arner, *The Global Credit Crisis of 2008: Causes and Consequences* 14 (Asian Inst. Int'l Fin. L., Working Paper No. 3, 2009).

157. *See* Hockett & Omarova, *supra* note 24, at 1173.

158. Essentially, the focus of the Basel framework remained fixed on banking activities. *See* discussion *infra* Part III.

159. It will be remembered that the transfer of assets is between the originating bank and the SPV; SPVs were of course not subject to any capital regulation. *See* Arner, *supra* note 156, at 16.

160. *See* Avgouleas, *supra* note 54, at 9.

161. *See* Avgouleas & Cullen, *supra* note 144, at 10.

ple, should have mitigated the issue explained in the previous paragraph. Two specific regulatory gaps affected this process in the pre-crisis years. The first one was represented by the subjective inputs provided by the larger and more sophisticated dealer banks that could resort to the internal ratings-based approach to assess the riskiness of their securitization exposures.[162] This entailed that securitization was employed to circumvent (or rather, to "game") capital requirements and achieve risk-weighted optimization.[163] The deficient measurement of leverage in pre-crisis years represents the second gap. Traditionally, leverage ratios did not incorporate any distinction between different types of assets, and more importantly, did not encompass off-balance sheet exposures.[164] Given the role of securitization (and more generally, of financial innovation as a whole) in shifting leverage across the shadow banking system and outside the perimeter of financial regulation, this resulted in banks increasing the riskiness of their balance sheet, due to both investments in riskier projects and assets and the buildup of leverage system-wide.[165]

The second problem with securitization during the pre-crisis years was related to its transactional development. As analyzed in Section I.A, a number of features of pre-crisis securitization practice can be singled out and will be treated here under three headings: tranching, credit enhancements, and synthetic exposures. The practice of tranching[166] allowed dealer banks to originate assets of poorer quality (higher risk),

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162. BANK FOR INT'L SETTLEMENTS, BASEL III DOCUMENT: REVISIONS TO THE SECURITISATION FRAMEWORK 2 (2016 ed. rev. 2014) ("The IRB approach is aimed at more sophisticated banks and allows for a more granular assessment of the relevant risks associated with the securitisation exposures concerned.").

163. *See* Avgouleas, *supra* note 54, at 14.

164. *See* discussion *infra* Section III.C ("LR's risk insensitivity means that assets with the same nominal value, but different risk levels, are treated equally. . . ."). Basel III introduced the off-balance treatment of the leverage ratio. *See id.*

165. *See* Avgouleas, *supra* note 54, at 12–13 (discussing the argument that leverage ratios may encourage banks to increase the riskiness of their asset portfolios and build up riskier balance sheets). Financial innovation in particular, as will be explained in the next paragraph, allowed the shifting of regulatory promises towards areas of the financial system where they were treated differently, or were not recognized at all.

166. With tranching, instead of issuing one type of security against the asset pool, the SPV issues several types of securities (tranches) of different

which would still receive a high credit rating due to the complex correlation formulas that determined the way in which assets with different risk profiles were bundled in each tranche. In other words, tranching reflected the belief in risk diversification, which was thought to occur thanks to a new transactional design.[167]

The most senior tranches received triple-A ratings from the CRAs due to another contractual device embedded into the securitization chain. It was common practice in pre-crisis years for originators or sponsors to extend a liquidity protection to the SPV, through credit enhancement mechanisms.[168] These mechanisms took the shape of guarantees that were triggered in the event of the SPV's insufficient cash flow from the asset pool.[169] As a result, in spite of the true sale and bankruptcy remoteness, the originator ensured payments to investors by retaining the SPV's credit and liquidity risks.[170] This practice, which was defined as "securitization without risk transfer," had the effect of aggregating risks (instead of efficiently dispersing them as was predicated by the theory) within large dealer banks that were not holding sufficient capital against these risks.[171]

The interconnectedness caused by tranching and credit enhancement mechanisms was further aggravated by the use of CDSs in the most sophisticated synthetic securitization structures. Beyond their use in the context of securitization, CDSs became very common in the early 2000s and were more generally employed in capital markets either to hedge certain exposures or to speculate on certain assets.[172] While CDSs

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credit quality and subordination, whereby each tranche carries a different risk and rate of return. *See* Coval et al., *supra* note 15, at 5–6.

167. The concepts of diversification and financial deepening were consistent with the belief that new products would be conducive to a state of competitive equilibrium. *See* Pozsar et al., *supra* note 16, at 17.

168. *See* Acharya et al., *supra* note 46, at 519–20, 519 n.6 (describing the practice of sponsors providing guarantees to SPVs, resulting in qualification for high credit ratings).

169. *See id.*

170. *Id.* at 516, 519.

171. *Id.* at 521.

172. *See generally* Adrian Blundell-Wignall & Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity,* 2010 ORG. FOR ECON. COOP. & DEV. J.: FIN. MKT. TRENDS 9, 13 (describing the evolution of CDS and the way in which it allowed banks to transform buckets of risk with deriv-

were welcomed as instruments that had the potential to complete and diversify financial markets,[173] dealer banks started employing them to transform their assets' risk profile, thus undermining the function of capital regulation.[174] Before the wave of post-2008 regulation, these derivatives were traded over-the-counter, and there was little or no transparency about counterparty credit risk.[175]

The massive growth in synthetic securitizations in the mid-2000s caused sharp increases in the level of dealer banks' leverage, which was not shifted off-balance sheet.[176] Overall, the combined use of tranching, credit enhancements, and CDSs, created homogeneity among dealer banks' balance sheets, going squarely against what was predicted by proponents of financial deepening—namely that the justification for more financial products and for expanding capital markets was always the opportunity to create more avenues for private risk diversi-

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atives without having to trade as much on the underlying securities on primary markets).

173. *See id.* Associating complex derivatives with concepts such as market completion and financial risk diversification was consistent in the pre-crisis years with the prevailing market discipline orthodoxy, explored in the previous Part. As an illustration of this ideology, Alan Greenspan, former head of the United States Federal Reserve, kept dismissing the threats posed by derivatives including in 2004, when he reiterated their capacity to diversify risks in the financial system, and as ideal risk-management tools. *See* Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, (Oct. 8, 2008), https://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?smid=url-share.

174. As will be observed in the next Part, this resulted in a case of shifting promises in the financial system. *See* Blundell-Wignall & Atkinson, *supra* note 172.

175. Both Dodd–Frank in the United States, and EMIR in the EU (Regulation EU No. 648/2012) established a clearing obligation for derivative contracts, with the aim to enhance transparency and mitigate the problem of counterparty credit risk, by interposing central clearing counterparties and trade repositories between the two derivative counterparties. Before then, it is safe to infer over-the-counter derivatives were not regulated. *See generally* Dodd–Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 8302, (2010) (imposing rulemaking requirements regarding clearing and trade repository reporting); *see also* Commission Regulation 648/2012 of July 4, 2012, OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L 201) 2.

176. *See* FRANK FABOZZI ET AL., INTRODUCTION TO STRUCTURED FINANCE 135–38 (2006).

fication.[177] Homogeneity of balance sheets meant that the assets held by dealer banks were highly correlated (and contagious), thus, increasing the interconnectedness of the financial system, and, critically, the interconnectedness between regulated banks and the shadow banking system. As became evident in September 2008, these dynamics exacerbated problems of systemic risk.[178]

Problems of excessive leverage were also linked to the lack of liquidity that flowed from the use of securitization. This again countered the assumptions of market discipline, which justified leverage as a form of liquidity creation in the financial system.[179] While dealer banks were able to maximize the use of their capital base by securitizing assets, this trend also led to a decrease in liquidity in these banks' balance sheets.[180]

Finally, the transactional innovation of securitization created a level of opacity in capital markets that made it nearly impossible for investors to conduct due diligence on the asset pool. In particular, assessing the riskiness of the underlying portfolio became too costly for investors[181] who increasingly relied on CRAs and the presumption of safety attached to senior tranches.

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177. *See* Hache, *supra* note 94, at 35 (stating securitization and the use of CDS leads to banks having similar global asset portfolios).

178. *See generally id.*, at 35–36 (noting that the resulting increased correlation between balance sheets shifts risk in the tail, creating a challenge from a systemic risk perspective).

179. *See* Ricks, *supra* note 71, at 91 (countering the idea that transaction reserves must be held in a medium of exchange, stating that highly liquid assets can be used to meet transactional needs).

180. It must be noted that liquidity refers mainly to two different aspects, namely funding liquidity and asset liquidity. Funding liquidity is the maturity transformation function that is typical of banks, whereas asset liquidity reflects the types of assets that banks invest in and their ability to convert those assets into cash. It has been observed that the ability of dealer banks to securitize their loan portfolio coincided with a decrease of liquid assets on their balance sheet. In other words, the ability to increase the liquidity of the loan portfolio coincided with a massive decrease of on-balance sheet liquidity. *See* Elena Loutskina, *The Role of Securitization in Bank Liquidity and Funding Management*, 100 J. FIN. ECON. 663, 664 (2011).

181. This was also due to the increased heterogeneity of asset classes in the CDOs. *See* Hache, *supra* note 94, at 39.

C. *The Regulatory Approach to Repo Haircuts and Rehypothecation*

The mechanics of the repo system magnified the creation of leverage in the financial system, particularly in its shadow banking segments. The expansion of the repo market made the new dealer bank business model—which was over-reliant on wholesale channels of funding instead of traditional deposits—possible.[182] Its development remained unfettered in the 1990s because it was believed that an active repo market could ensure liquidity in the financial system (particularly in the market for government bonds).[183] Moreover, dealer banks' reliance on market discipline mechanisms and a risk management framework based on haircuts and collateral was believed to ensure a liquid and well-functioning market.[184]

Wholesale funding channels allowed banks to grow their balance sheet on the assets side beyond their core liabilities and were the main driver of instability. Through the repo market, dealer banks could access large sources of funding where the only limitation was the quantity and quality of collateral that they could post.[185] As explained earlier, collateral in these transactions was represented by senior tranches of securitized bonds, which were either manufactured by the same bank, or purchased from other banks.[186] Effectively, dealer banks were able to expand their asset base, without simultaneously increasing their regulatory capital or reducing existing risks. Unsurprisingly, this model of funding proved to be incredibly profitable. The only constraint on the assets pledged as collateral was represented by the haircut—the risk attributed to those assets.[187]

To understand the dynamics of haircuts and how they can be conducive to financial instability, it is useful to briefly explain how haircuts and initial margins interplay in the repo market. Haircuts represent the difference expressed as a percentage between the value of the collateral pledged by the dealer bank, and the value of the loan extended by the repo

182. *See* Aquilina & Kraus, *supra* note 3, at 11–17.
183. *See* Gabor, *supra* note 66, at 980–81.
184. *Id.* at 981.
185. *See* Hache, *supra* note 94, at 38.
186. *Id.* at 30–32.
187. *Id.* at 38.

lender (also called the purchase price of the repo).[188] The initial margin is the premium that is added to the market value of the security pledged as collateral.[189] The essence of these contractual arrangements is that haircuts provide a form of over-collateralization whereby the lender is hedged against the risks of that collateral.[190] In turn, the collateral is a tool to protect the lender against the borrower's risk of default.[191]

The problems associated with the repo market, and experienced before the GFC, are centered around the pro-cyclicality of haircut spirals. Before 2007, triple-A CDO tranches were considered safe collateral and dealer banks could borrow 90% on the value of these assets.[192] With changes in market conditions, which include dynamics such as leverage cycles, fluctuations in asset prices can be exacerbated by the use of short-term funding channels such as repos.[193] After 2007, with the tightening of credit conditions and the waning optimism surrounding the value of securitized bonds, it became very difficult for dealer banks to rely on these assets as collateral in the repo market. This type of trend tends to quickly become a self-fulfilling prophesy, where bad news concerning the value of certain assets leads market participants to liquidate those assets, causing a further decrease in their value. When a substantial number of lenders experience losses linked to the value of collateral in the repo market, they will either refuse to lend

188. *See* RICHARD COMOTTO, HAIRCUTS AND INITIAL MARGINS IN THE REPO MARKET 4 (2012). A haircut is also referred to as a margin percentage.

189. *Id.* Initial margins are also expressed in percentage points, and can also be called margin ratios (in the GMRA) or independent amounts (in the ISDA Master Agreement). Thus, having a 100% initial margin equates to a 0% haircut (because there will be no difference between the market value of the collateral and the purchase price of the repo).

190. *Id.* at 4–5.

191. *Id.* at 5. It is noted here that in principle the haircut should be a function of market liquidity risk, operational risk, legal risk, and default risk. *Id.* at 5–6.

192. John Geanakoplos, *Solving the Present Crisis and Managing the Leverage Cycle*, 16 FED. RSRV. BANK N.Y. ECON. POL'Y REV., August 2010, at 101, 112 (noting that in fact banks could borrow as much as 98.4 cents on the dollar on AAA assets, which, according to credit rating agencies' valuations, were only supposed to have a risk of default over a ten-year period of 1 in 100).

193. *See, e.g.*, Ana Fostel & John Geanakoplos, *Reviewing the Leverage Cycle* (Cowles Found. for Rsch. in Econ., Discussion Paper No. 1918, 2013) (reviewing the leverage cycle, specifically the feedback properties of leverage, volatility, and asset prices).

against those assets, or demand higher haircuts that dealer banks would not be able to afford.[194] The result of this process is a systemic shock due to the fundamental breakdown of liquidity mechanisms.[195]

The problem with this pro-cyclical trend is that the rapid and sharp swings in the level of haircuts come at the worst time and tend to affect a wider spectrum of market participants, not simply those with over-leveraged positions.[196] In other words, higher haircuts will lead to fire sales, and then to prices further dropping.[197] As prices plummet, and the value of assets become insufficient to collateralize transactions, margin calls issued by repo lenders further reinforce a dynamic that eventually leads to a crisis.[198]

The rehypothecation of collateral is the second problem associated with the repo market. In essence, this is the right that lenders have to reuse the collateral posted by the borrowers under the contract.[199] The problem arises when the process is repeated several times, which is normally the case in most repo agreements.[200] Unless otherwise stated, there is a tacit consent to this practice.[201] The exception to that is represented by tri-party repos (more common in the United States than in Europe),[202] where the collateral cannot be reused, and also by centrally cleared repos, where the collateral is managed by a central clearing counterparty ("CCP").[203] While some limits to rehypothecation did exist in the United States,[204] in Europe and, particularly in the United Kingdom, there were vir-

194. *Cf.* Cullen, *supra* note 58, at 15. It is reminded here that between 2007 and 2009 the haircut on ABSs increased by more than 50%.

195. This is well documented in the work of Gorton and Metrick, who emphasize how a run on the repo market was the ultimate cause of the Lehman Brother's collapse. *See* Gorton & Metrick, *supra* note 33, at 447.

196. *See* Geanakoplos, *supra* note 192, at 104.

197. *See id.*

198. *See* Sissoko, *supra* note 61, at 19.

199. *See* Cullen, *supra* note 58, at 13.

200. *See generally* Manmohan Singh & James Aitken, *Deleveraging After Lehman—Evidence from Reduced Rehypothecation* 3 (Int'l. Monetary Fund, Working Paper 09/42, 2009) (describing the common practice of including blanket consents to rehypothecation).

201. *Id.*

202. *See* Cullen, *supra* note 58, at 9–11.

203. *See id.* at 11.

204. *See* 17 C.F.R. §§ 240.15c2–1, 15c3–3 (2021) (creating rules for hypothecation and customer protection with regard to customers' securities).

tually no regulatory constraints to the unlimited reuse of collateral before the financial crisis.[205]

The belief in market discipline, and the ensuing overarching prioritization of market efficiency[206] ahead of financial stability, led to identifying the reuse of collateral in repo markets as a source of funding liquidity in financial markets.[207] By allowing the same asset to fund a number of other transactions, repo contracts were effectively performing a money multiplier function.[208]

Before 2008, these long chains of rehypothecations led to increased levels of leverage in the financial system. As assets pledged as collateral were being reused, there was an infinite collateral creation fueling the expansion of dealer banks' off-balance sheet positions.[209] As was illustrated in the previous Part with respect to securitization, the repo market became a nexus of interconnectedness between banks and non-bank entities, and a source of systemic fragility given the unmonitored creation of leverage in the shadow banking system.[210] Moreover, the mechanics of collateral reuse further exacerbated the "illusion of liquidity" in the financial system as well as the over-reliance of market participants on liabilities that, despite being money-like, were not receiving any public backstop.[211]

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205. *See generally* Cullen, *supra* note 58, at 14 n.56 ("In European repo markets . . . the lender may use the property in any way it likes, including using it as collateral . . . .").

206. *See* Zoltan Pozsar & Manmohan Singh, *The Nonbank-Bank Nexus and the Shadow Banking System* 7–11 (Int'l Monetary Fund, Working Paper No. 11/289, 2011).

207. *See* Hyejin Park & Charles M. Kahn, *Collateral, Rehypothecation, and Efficiency*, 39 J. FIN. INTERMEDIATION 34 (2019) (observing that rehypothecation increases capital efficiency, because due to the reused collateral, less regulatory capital is needed).

208. *See* Gorton & Metrick, *supra* note 33, at 428.

209. *See generally* Peter Breuer, *Measuring Off-Balance-Sheet Leverage* (Int'l Monetary Fund, Working Paper 00/202, 2000) (describing the ability of highly leveraged institutions to accumulate leverage off the balance sheet).

210. *See* Paolo Saguato, *The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option to Address the Regulatory Void* 36 (London Sch. Econ., Working Paper No. 21/2015, 2015).

211. *See, e.g.*, Ricks *supra* note 71, at 103–04; *see also* Cullen, *supra* note 58, at 14.

D. *The "Efficiency" of Market-Based Finance and the Panic of 2020*

The evolution of capital markets, outlined in Section I.D, is at the heart of some of the problems that arose in the COVID–19-induced economic shutdown in the spring of 2020. This Section builds on that analysis by exploring the legal and regulatory questions that emerged in March 2020, and which will link to the later analysis of Basel III.

The growth of the leveraged loan market is one key factor that contributed to the drastic increase in risk taking in the post-2008 years.[212] The erosion of underwriting standards, caused by changes in loan documentation, explains the market's intrinsic fragility.[213] In particular, covenant-lite loans (referred to as "cov-lite") became, both in the United States and in the United Kingdom, the predominant contractual practice employed to realize loan syndication.[214] These loans are negotiated with a financial incurrence covenant typically associated with bonds, and that requires the issuer to still be in compliance with the underlying covenant in the event they take an action (for instance issuing debt or paying dividends).[215] Because taking on more debt would only be in compliance within that incurrence limit, this type of clause can limit the issuer's debt to, for example, five times its cash flow.[216]

Maintenance covenants instead, where an issuer is required to meet certain financial tests periodically (e.g., on a quarterly basis) regardless of whether the issuer has taken any action, would be more typical, and perhaps appropriate, in the context of loan agreements. In this case, an issuer taking on more debt would have to pass a maintenance test every quarter.[217]

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212. *See* Bavoso, *supra* note 121, at 7.

213. FIN. STABILITY BD., VULNERABILITIES ASSOCIATED WITH LEVERAGED LOANS AND COLLATERALISED LOAN OBLIGATIONS 1 (2019).

214. *See generally* S&P Glob., Syndicated Loans: The Market and the Mechanics 15–16 (2017) (defining covenant-lite loans and noting their proliferation since 2013).

215. *Id.*

216. *See id.* Bearing in mind that the incurrence test does not affect past actions, so if for instance an issuer found itself above the incurrence threshold because of deteriorated earnings, this would not trigger a breach of the covenant.

217. *Id.* at 16.

Of course, investors' demand for high yields in the post-2008 years motivated this practice in the past, which in turn led to a growth in the market for leveraged loans.[218] The problem is that during unforeseen swings in the economic cycle, such as the one experienced in mid-2020, the level of defaults can rise beyond expectations.[219] This dynamic shows that questions of financial stability were downplayed during the euphoric times (mid-2010s), when new transactional forms were shaped in the name of efficiency, in order to boost leveraged loans issuance, and the repackaging of these assets into CLOs.[220] While proponents of this transactional structure reiterated their confidence in the stability of these products,[221] the level of leverage they create and the low credit quality of the underlying assets[222] indicate that this may be a turning point in the leverage cycle.[223]

Another regulatory change that impacted the post-2008 regulatory infrastructure is the recent booming of the CLO market. One regulatory reaction to the GFC was the introduction of a formal "skin in the game" provision aimed at aligning the interest of securitizers and investors, limiting the riskiness of the assets repackaged in securitization-type transactions. The provisions' effect was to impose a retention of the economic risk for all the originated assets, equal to at least 5%.[224] This provision was problematic in the context of CLOs, due to the peculiar structure of these transactions, with private equity firms and a syndicated origination process at their heart.[225]

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218. *See* Bavoso, *supra* note 121, at 2.

219. *See* FIN. STABILITY BD., *supra* note 213, at 1.

220. *See generally id.* at 1 (stating that the syndicated loan market has become dominant due to the efficiency of syndicated loans compared to traditional bilateral credit lines).

221. *See* Rennison & Smith, *supra* note 7.

222. This concern was specifically highlighted by the FSB. FIN. STABILITY BD., *supra* note 213, at 16.

223. For a critical perspective on how the combination of relaxed underwriting standards and innovations in structured finance can interplay with a leverage cycle, see Bavoso, *supra* note 7.

224. This was enshrined in the Dodd–Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78o–11 (2012), and at the EU level in 2013 O.J. (L 176) 1 and the accompanying Council Directive 2013/36, 2013 O.J. (L 176) 338 (EU).

225. The transaction structure of CLO was closely detailed in Section I.D. *See* discussion *supra* Section I.D.

Moreover, the application of this provision seemed to hinder the economic viability of the leveraged loan market, which was perceived in the post-2008 years to be channeling useful sources of finance to the economy.[226] These sentiments led U.S. industry regulators in 2013 to propose a different approach to the risk retention requirement, revolving around a different configuration of risk retention for "open market CLOs." This framing implied a distinction from "balance sheet CLOs"—while the former acquire their assets by trading in the open market, the latter are created by the originator of the underlying assets (thus resembling traditional securitization transactions).[227] In light of this distinction, the loan syndicators and the lead arranger fulfill the risk retention obligation in open market CLOs, rather than the CLO manager.[228]

In 2018, this industry approach was endorsed by the United States Court of Appeals in *Loan Syndications & Trading Ass'n v. SEC*.[229] The court emphasized that Dodd–Frank did not purport to bind open market CLO managers with risk retention requirements, because managers are not securitizers within the meaning of the Act.[230] Specifically, they were not transferors of the assets in the securitization structure.[231] This problematic application of risk retentions flows from the *sui generis* transactional structure of CLOs as well as from the undisputable fact that CLO managers do not own or control assets that are transferred to the SPV.

The EU applied the Capital Requirement Regulation[232] and encountered a similar dilemma, because collateral manag-

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226. *See* Partnoy, *supra* note 7.

227. This distinction was clarified by the United States Court of Appeals in Loan Syndications & Trading Ass'n v. SEC, 882 F.3d 220, 221 (D.C. Cir. 2018).

228. Rob McDonough, *Collateralised Loan Obligations*, GLOBAL FIN. MKTS. INST. (Apr. 9, 2016), https://www.gfmi.com/articles/collateralized-loan-obligations/.

229. *Loan Syndication & Trading Ass'n*, 882 F.3d at 229.

230. *Id.* at 222.

231. *Id.* at 225. The Court reiterated that a party must be a transferor, relinquishing ownership or control of assets to an issuer of securities, in order for that party to be a securitizer within the meaning of § 941 of Dodd–Frank.

232. Commission Regulation 575/2013 of June 26, 2013, Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation 648/2012, 2013 O.J. (L 176) 1.

ers held the retained interest, even where they were not originators or sponsors in the transaction.[233] They then corrected the approach in 2014, and enacted a new rule that collateral managers would only be under a risk retention obligation if they qualified as originators or sponsors.[234]

Critical evolutions in market-based finance also occurred in the repo market. The correlation between an overall reduced turnover in the repo market and the introduction of the leverage ratio, which imposed higher costs on market participants, demonstrates the major effects Basel III had on dealer banks' balance sheets in the period between 2010 and 2015.[235] Dealer banks adjusted to the new regulatory requirements in different ways, depending on how the ratio was implemented across jurisdictions, and how it had to be reported.[236] For instance, the requirement under the leverage ratio[237] was implemented differently for U.S. and European banks.[238] For the latter, the leverage ratio was calculated, and reported, on a quarterly basis; whereas in the United States the equivalent measure (called the Supplementary Leverage Ratio) was calculated on a daily basis.[239]

This difference created incentives for European banks to engage in so called "window-dressing," which entails con-

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233. Latham & Watkins, *EU Risk Retention Rules and CLOs—the Journey's End?*, CLIENT ALERT NO. 1704, 2 (June 26, 2014), https://www.lw.com/thoughtLeadership/LW-EU-CLO-regulatory-technical-standards.

234. See the original broader risk-retention requirement in Council Directive 575/2013, art. 122A, 2013 O.J. (L 176) (EU), which was later narrowed with the *EBA Final Draft Regulatory Technical Standards*, art. 4, 5, 8, EBA/RTS/2013/12 (Dec. 17, 2013). See also Latham & Watkins, *supra* note 233, at 3, for a discussion on how the application of risk retention rules was designed with securitization-type transactions in mind, and how it would remain problematic in the context of CLOs.

235. Andreea Bicu et al., *The Leverage Ratio and Liquidity in the Gilt and Repo Markets* 24 (Bank of Eng., Working Paper No. 690, 2017). While this piece by the Bank of England focused primarily on the leverage ratio, other measures introduced under Basel III (such as the liquidity coverage ratio and the net stable funding ratio) also contributed to increasing costs on dealer banks.

236. Anbil & Senyuz, *supra* note 113, at 9.

237. Namely, a requirement to hold 3% Tier-1 capital of an exposure measure that includes both on- and off-balance sheet assets, thus including repo transactions. *Id.* at 2.

238. Anbil & Senyuz, *supra* note 113, at 9.

239. *Id.* The authors note that U.K. dealer banks moved in 2016 to a reporting based on daily averages. *Id.* at 9 n.4.

tracting their balance sheet in connection with reporting dates, only to expand it again afterwards.[240] As a consequence of this trend, European banks have reduced 30% of their borrowing from the repo market around the end of each quarter, with adjustments mainly taking place in overnight activities.[241] It is also worth noting that, in the context of these adjustments, window-dressing increased by 80%.[242]

The U.S. policy implemented by the Federal Reserve, namely the reverse repo facility ("RRP"), kept repo lenders (chiefly money market mutual funds) lending to the Fed.[243] Effectively, this policy facilitated the implementation of Basel III insofar as it provided money markets with an alternative to the repo borrowers that were withdrawing from the market.[244]

While the combination of the Basel III provisions was envisaged as a way to constrain liquidity spirals in the repo market, particularly by limiting dealer banks' exposure to liquidity risks,[245] the events of March 2020 proved that instability may well be an intrinsic feature in the repo market.[246] Alternatively, one could argue that post-2008 reforms may not have tackled the sources of that instability. However, notwithstanding central banks' efforts to maintain stability by engaging in heavy market-making (that is, huge purchase programs of both government and private label bonds), the fragility of the

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240. *Id.* at 9–10. The authors explain that the measures under the Basel III liquidity framework are subject to daily reporting, therefore there are no implications here for quarter end repo activities nor for window-dressing.

241. *Id.* at 19–20. The authors emphasize here that in the United States there has been no window-dressing pattern, and that the net effect of the implementation of Basel III is near zero. *Id.* at 20.

242. *Id.* at 30.

243. This applied to eligible money market mutual funds, whereas non-eligible ones were still relying on the private market.

244. *See* Benjamin Braun & Daniela Gabor, *Central Banking, Shadow Banking, and Infrastructural Power*, *in* INT'L HANDBOOK OF FINANCIALIZATION (Philip Mader et al. eds., 2020).

245. As will be explained in Part III, Basel III discourages the use of private sector collateral (such as securitized bonds) in the repo market, while favoring more liquid government bonds. *See* discussion *infra* Section III.D.

246. *See* Andrew Bailey, Governor, Bank of Eng., Speech at the ISDA 35th Annual General Meeting: Taking Our Second Chance to Make MMFs More Resilient (May 12, 2021). Bailey stressed that despite some regulatory adjustments post-2008, there remains structural vulnerabilities associated with money market mutual funds, particularly because of the growth of non-bank finance after 2014.

repo market was once again exposed in March 2020. In particular, the economic uncertainty brought by the pandemic again highlighted the mechanics of haircut, margin spirals, and the ensuing liquidity problems.[247] In other words, the same dynamics that had characterized the beginning of the 2008 GFC were being reproposed, suggesting that some fundamental weaknesses in wholesale markets have not been fixed.[248]

Notably, an important mechanism to manage risk exposures, namely total return swaps ("TRS"), facilitated post-2008 market-based finance.[249] TRSs have essentially permitted institutional investors (such as hedge finds) to leverage their balance sheet by gaining exposure to the return of financial assets (such as bonds, loans, equity interests), without owning the underlying assets.[250] Essentially, this has become a way to facilitate risk taking for institutional investors, particularly in the context of risky assets, such as CLOs. Moreover, the problem with TRSs is that as investors are exposed to the assets' credit risk, there is a problematic layer of counterparty risk that these transactions elicit.[251] That risk materializes when investors enter into a number of TRSs on similar (correlated) underlying assets: the decline in the value of such assets would cause a reduced return for investors, who would continue to make payments for those assets under the TRS. Should investors not be adequately capitalized, their risk of default would represent

247. *See generally* Jeanna Smialek, *The Financial Crisis the World Forgot*, N.Y. TIMES (Mar. 16, 2021), https://www.nytimes.com/2021/03/16/business/economy/fed-2020-financial-crisis-covid.html (detailing the economic crisis resulting from the pandemic).

248. For a good account of the events of March 2020, see Smialek, *supra* note 247. The author highlights here how the massive rescue package passed by Congress in the United States managed to save the market.

249. Under a TRS two parties exchange the returns from a financial asset. The contractual structure of this derivative is similar to other swaps (such as credit default swaps), and it sees one party (the investor) making payments based on a set rate, while the other party (say a bank holding the financial asset) makes payments based on the return of the underlying assets. For an illustration, see *What is a Total Return Swap (TRS)?*, CORP. FIN. INST. (last visited Sept. 25, 2021), https://corporatefinanceinstitute.com/resources/knowledge/finance/total-return-swap-trs/.

250. *Id.*

251. *Id.*

a substantial risk on their counterparties too (such as banks).[252]

One of this scheme's critical efficiencies is the opportunity that investors have to maximize their investment capital, because there is no transfer of assets and no substantial use of capital. Furthermore, while derivatives were at the heart of post-2008 regulation, some reforms have not been fully implemented—this is crucially the case for measures aimed at mitigating counterparty credit risk through margin requirements and clearing obligations through central counterparties. This raised criticism, particularly in the United States where Dodd–Frank provided for a number of rules to be finalized in relation to swaps.[253] The SEC, however, was very slow to implement relevant rules on transparency (due only in November 2021).[254] Meanwhile, due to the pandemic, most regulators also pushed back the implementation of margin requirements for non-cleared swaps (to September 2022).[255]

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By analyzing the post-2008 evolution of market-based finance, this Part highlighted the fundamental fault lines in capital markets that emerged again in March 2020. Because the efficiency rationale has informed the way in which capital markets morphed and adapted in response to post-2008 regulation, these can primarily be ascribed to the structure of these markets. We will now turn to the relevant provisions of the Basel III framework that were engineered to make market-based finance resilient.

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252. *Id.*

253. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301 (2010). Under EU law, TRSs are covered under the Securities Financing Transactions Regulation. Commission Regulation 2015/2365 of 25 Nov. 2015, Transparency of Securities Financing Transactions and of Reuse and Amending Regulation 648/2012, 2001 O.J. (L 337).

254. Joe Rennison et al., *US Put Off Derivatives Rules for a Decade Before Archegos Blew Up,* FIN. TIMES (Apr. 12, 2021), https://www.ft.com/content/7819e714-bf9d-4f83-a6e4-497df534f77c.

255. *Id.*

III.
Setting the Test: Basel III and the Regulation of Market-Based Finance

For the purpose of this analysis, the reform package engineered by the Basel Committee after the GFC (Basel III)[256] represents a central piece of the post-crisis regulatory framework and is at the heart of the assessment conducted in this Article. Importantly, despite the visible tightening of the earlier framework and the addition of a number of provisions aimed at strengthening the new one, Basel III represents a development, rather than a restructuring, of the same architecture that was employed under Basel II. It is correct in this sense to say that at the heart of the Bank for International Settlements ("BIS") policymaking remains a belief that the regulatory architecture based on risk models is still valid. This argument is based on a subtle distinction, however, because the method employed for the risk analysis is still considered correct, whereas its application, the underlying statistical risk modeling and the data therein, was deemed incorrect—and this caused the risk regulation's failure before the crisis.[257]

Therefore, that the conceptual foundation of Basel III replicates that of its predecessor is unsurprising. Basel III comprises three pillars for the regulation of capital: Pillar 1 is centered on different capital ratios (including countercyclical buffers and capital conservation buffers), on risk coverage (which embeds counterparty credit risk) and on leverage; Pillar 2 deals with risk management and supervision; Pillar 3 with market discipline.[258] Higher levels of loss absorbency capacity for systemically important financial institutions supplement these three pillars. Moreover, the Basel III framework provides

256. The process of reform can be said to have started in 2010 with Bank for Int'l. Settlements, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (2010) [hereinafter BIS 2010]; this process culminated in 2017 with Bank for Int'l Settlements, Basel III: Finalising Post-Crisis Reforms (2017) [hereinafter BIS 2017].

257. For a discussion, see Simon Gleeson, Gleeson on the International Regulation of Banking 27–33 (3d ed. 2018). The author here provides an interesting insight explaining how the main flaw of risk modeling regulation was related to the use of statistical data and the weakness of historical information related to markets and prices.

258. Bank for Int'l Settlements, Basel III: High-Level Summary of Basel III Reforms (2017).

a new set of liquidity standards that this Part will closely analyze.[259] The rest of this Part discusses the provisions of the new Basel framework that are relevant to the problems highlighted in the previous Part of this Article. The analysis will also extend to the new securitization framework and the regulation of repo haircuts.

A. *Capital Rules, Risk Coverage and the Use of Internal Models*

A number of capital regulation changes have been implemented to reflect a better and more robust quality of capital under Basel III. First, there is a greater focus on common equity as tier-1 capital, which must be 4.5% of risk-weighted assets ("RWA"), phased in at 6% in 2019.[260] Common equity as tier-1 capital enhances the capacity of banks to run on a going concern basis, while tier-2 capital includes instruments issued by consolidated subsidiaries, other instruments issued by banks and not included in tier-1, and loan-loss provisions.[261] The total of tier-1 and tier-2 RWA capital must be no less than 8%.[262]

A new capital conservation buffer of 2.5% of tier-1 RWA, which is designed to be built up in good times, and run down during bad times, complements the capital rules.[263] This buffer involves constraints on the discretion of banks to distribute dividends and/or bonuses when the buffer range is triggered.[264] This requirement tackles problems of pro-cyclicality which are traditionally associated with capital regulation and should contribute to enhancing the capacity of banks to be resilient in times of stress.[265]

The counter-cyclical buffer is more squarely designed to mitigate problems of pro-cyclicality. This buffer focuses on the cyclical development of the whole financial system, thereby in-

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259. An essential map of the new Basel framework is provided in *Basel Committee on Banking Supervision Reforms—Basel III*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/basel3/b3_bank_sup_reforms.pdf (last visited Sept. 25, 2020).

260. BANK FOR INT'L. SETTLEMENTS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 12, 69 (2010).

261. *Id.* ¶ 57.

262. *Id.* ¶ 50.

263. *Id.* ¶¶ 129, 133.

264. *Id.* ¶¶ 124, 129–132.

265. *See id.* ¶ 128.

corporating a macroprudential, systemic perspective.[266] This extra buffer, of up to 2.5% tier-1 RWA, aims to mitigate the cyclical effects of excessive credit growth.[267] It reflects the problems commonly associated with the leverage cycle and the instability that ensues.[268] Importantly, this buffer is triggered at the discretion of the national supervisor based on their observation of growth in the credit market.[269]

Loss absorbency requirements also strengthen capital ratios under Basel III. These aim to allow capital instruments to be written off or converted into equity in the event of the bank becoming nonviable.[270] These requirements are particularly relevant in connection with global systemically important banks ("G-SIB"), which are identified by national supervisors in accordance with five broad criteria, namely: a) size; b) interconnectedness; c) lack of readily available substitutes or financial institution infrastructures; d) global activity; and e) complexity.[271] Together with the aforementioned buffers, loss absorbency requirements should reduce the probability of G-SIBs' failures and their impact. They involve additional capital ranging between 1% and 2.5% tier-1 RWA (depending on how the bank is positioned within the five criteria).[272]

While the overview of these revamped capital ratios shows a more robust framework and a clear focus on higher levels of better capital, they need to be evaluated in close connection with the way in which capital is calculated. Generally speaking, under Basel, the capital ratio is calculated by dividing tier-1 and tier-2 capital of the bank by its risk-based assets.[273] In other words, determining the risk weight of a bank's assets is instrumental in calculating how much capital the bank has to

266. *Id.* ¶¶ 137, 139

267. *Id.* ¶ 139.

268. *Id.* ¶¶ 29–30.

269. *See id.* ¶¶ 139–42, 150.

270. *See* BANK FOR INT'L SETTLEMENTS, GLOBAL SYSTEMICALLY IMPORTANT BANKS: UPDATED ASSESSMENT METHODOLOGY AND THE HIGHER LOSS ABSORBENCY REQUIREMENT (2013).

271. *See id.* ¶¶ 15, 16.

272. *See id.* ¶ 46.

273. *See* Adrian Blundell-Wignall et al., *Assessing the Finalised Basel III Banking Regulation Regime*, *in* GLOBALISATION AND FINANCE AT THE CROSSROADS 201, 212 (2018); *Definition of Capital*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/basel_framework/chapter/CAP/10.htm?inforce=20191215 (last updated June 5, 2020).

post. Risk-weighting has traditionally been problematic under this regulatory model, not only because of the overarching question concerning the weakness of the dataset used, but also, more controversially, because of the freedom that banks have enjoyed in determining risk weights. More specifically, large and more sophisticated financial institutions were traditionally allowed to resort to an internal ratings-based ("IRB") approach[274] which essentially elicited the in-house development and use of internal models for regulatory capital charges.[275] In the aftermath of the GFC, it became apparent that reported risk-weighted capital ratios had become unreliable due to the excessive variability in the RWA calculations conducted by banks.[276]

One key Basel III development is related to the use of bank models. While it appears that post-crisis the Committee accepted that the use of internal models caused uneven capital weights between similar banks and overall problems of regulatory arbitrage, it is altogether clear that internal models are not prohibited under Basel III.[277] Instead, the Committee has chosen to restrict the use of models. More specifically, the advanced IRB approach won't be available for banks' exposure to other banks and financial institutions under Basel III, because exposure to these entities are too difficult for banks to model.[278] Banks will instead be allowed to employ a foundation IRB approach, under which they can still estimate the probability of default, while other risk-weights will be calculated according to parameters determined by the Committee.[279] Banks will still be able to employ the advanced IRB approach in cases where robust estimates are considered more likely. But even in such cases, more conservative outputs will

274. The alternative of the IRB being the standardized approach ("SA"). Under the SA, banks employ a prescribed risk weight for the calculation of the RWA. *See Overview of the Revised Credit Risk Framework—Executive Summary*, BANK FOR INT'L SETTLEMENTS (Feb. 28, 2018), https://www.bis.org/fsi/fsisummaries/rcrf.htm.

275. *See* Blundell-Wignall et al., *supra* note 273, at 48, 208.

276. *See* BIS 2017, *supra* note 256, at 1.

277. *See* Blundell-Wignall et al., *supra* note 273, at 208.

278. *Id.* at 208.

279. Typically, models are used to calculate a wide array of exposure-related risks that flow into the formulas for capital rules, such as the probability of default, the loss given default, the exposure at default, and the effective maturity of exposures. See *id.* for an explanation.

be ensured by applying input floors to parameters for the calculation of probability default, loss given default, and exposure at default.[280]

In other words, banks using internal models for the calculation of capital will be subject to an alternative minimum capital requirement.[281] This represents a limit on the opportunities for regulatory arbitrage that such banks can exploit by using internal models instead of the standardized approach. This approach should lead to a more level playing field between different types of financial institutions.[282]

Notwithstanding these developments, sophisticated banks will still be able to benefit from the use of internal models, given that the probability of default remains a key variable, even in the foundation IRB approach.[283] The overarching problems that emerged in the pre-crisis years with the use of internal models are likely to remain; in fact, the safety and resilience of banks may largely depend on the effectiveness of the leverage ratio, discussed later in this Part.[284]

Beyond the revised approaches for calculating RWA,[285] Basel III tackles some of the regulatory problems that had emerged in the pre-crisis years. Part II of this Article explained how Basel II did not incorporate off-balance sheet exposures into the risk assessment of banks, creating problems of regulatory arbitrage and incentives to expand shadow banking chan-

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280. *Id.* at 209.

281. Essentially where banks use internal models, they are subject to an alternative minimum capital requirement—so called Basel III output floor. This is calculated using the SA, in a way that minimizes the regulatory benefits that banks using internal models would gain, compared to those using the SA. *See* Bozena Gulija, *Basel III Finalisation: Completing the Jigsaw*, INT'L FIN. L. REV. (Aug. 8, 2019).

282. *See* GLEESON, *supra* note 257, at 49. It is noted here that banks using internal models will be subject to minimum capital requirements equal to 72.5% of the requirement that would be applied if they were using the SA. This safeguard was introduced in order to balance risk sensitivity and limit arbitrage opportunities. In this sense it can be said that output floors represent a form of backstop. *See* Enria, *supra* note 13.

283. Blundell-Wignall et al., *supra* note 273, at 209.

284. *See id.*

285. Aside from what was explained in the previous paragraph, the new risk coverage framework introduces a revised output floor, which is designed to limit the regulatory capital benefits that can be obtained by banks using internal models instead of the SA. *See Basel Committee on Banking Supervision Reforms—Basel III*, *supra* note 259.

nels of intermediation. Under the new framework, a number of requirements should contribute to reducing those problems. First, banks need to determine their capital requirements for counterparty credit risk using stressed inputs.[286] These must include capital charges associated with the deterioration of counterparties' creditworthiness.[287] Second, capital charges have to incorporate so called wrong-way risks, namely transactions with counterparties whose probability of default is correlated with the amount of exposure.[288] Third, an asset value correlation ("AVC") is applied for exposures to regulated financial institutions that have assets of at least $25 billion, raising risk weights for this type of exposure.[289] Fourth, with respect to large and illiquid derivative exposure to counterparties, banks are required to apply longer margining periods as a basis for determining regulatory capital.[290] Finally, there are incentives to use centralized exchanges ("CCPs") instead of OTC derivatives, because a zero risk-weight is applied for counterparty risk exposures when the bank deals with a centralized exchange.[291]

B. *The New Securitization Framework and the STC Label*

As part of the risk coverage, Basel III introduced a new securitization framework that seeks to strengthen the capital standards for securitization exposures, particularly in light of the shortcomings associated with the previous framework.[292] This analysis is central to the appraisal of the overall ability of Basel III to mitigate risks arising from a revived securitized banking system.

Generally speaking, securitization exposures need to be risk-weighted under a specific regime that is different from the

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286. *See* Blundell-Wignall & Atkinson, *supra* note 172, at 1, 8.
287. *Id.*
288. *Id.*
289. *Id.* at 9.
290. *Id.*
291. *Id.*
292. In particular, the Committee found that major shortcomings were represented by: 1) mechanistic reliance on external ratings; 2) excessively low risk weights for highly-rated securitization exposures; 3) excessively high risk weights for low rated securitization exposures; 4) cliff effects; 5) insufficient risk sensitivity of the framework. *See* BANK FOR INT'L SETTLEMENTS, *supra* note 162, at 1–2.

ordinary one and also includes exposures from interest rates, currency derivatives, and/or credit protection to a securitization SPV.[293] Essentially, when a securitization exposure arises through an off-balance sheet SPV, that exposure has to be converted into an on-balance sheet SPV.[294] The overall risk-weighting of securitization exposures depends on the type of underlying exposures; in turn, this process follows a hierarchy of approaches, which is detailed in the next paragraph.

This revised hierarchy looks to reduce reliance on external ratings and limit the number of approaches in order to simplify the process.[295] At the top of the hierarchy is the internal ratings-based approach (SEC-IRBA), which employs a capital charge input for the underlying exposures, using either the advanced or the foundation approaches.[296] For the SEC-IRBA to be used, banks must have: a) an IRB model approved by the supervisor for the type of underlying exposures in the asset pool; and b) sufficient information to estimate the capital charge.[297]

Where banks cannot calculate the capital charge for the underlying exposures using the IRB framework, they would have to use the external ratings-based approach (SEC-ERBA), the condition here being that this method is implemented by the competent national regulator.[298] When neither of the above approaches is possible, banks use the standardized approach (SEC-SA), meaning the capital charge input for the underlying exposures is based on the standardized approach for credit risk.[299] This approach, in a more conservative form, is also employed for the risk-weighting of re-securitization exposures.[300]

Overall, the revised hierarchy has the merit of simplifying the approaches and reducing the reliance on external credit ratings, since other risk drivers have been incorporated into

293. *See* GLEESON, *supra* note 257, at 350.
294. This is done through a credit conversion factor of 100%. *Id.*
295. BANK FOR INT'L SETTLEMENTS, *supra* note 162, at 2.
296. *Id.* at 3.
297. *Id.*
298. *Id.*
299. *Id.*
300. *Id.*

the SEC-ERBA.[301] The prudential treatment of securitization has also been improved relative to the previous framework, with an increase in capital requirements. For instance, capital requirements of senior securitization exposures backed by quality pools are subject to risk weights of 15%.[302] The assessment of the new prudential treatment is made against the new STC (Simple, Transparent, and Comparable) criteria for the capital treatment of securitization exposures.

STC partly reflects the definition adopted under the EU STS Regulation.[303] The criteria within this label seek to promote a more sustainable use of securitization, where the parties in the transaction are able to evaluate risks and returns and compare products and asset classes.[304] As is the case with the EU equivalent, the STC aims to foster a more robust securitization market, devoid of the risks that had become prevalent before 2008.[305] Under the Basel III framework, "[s]implicity refers to the homogeneity of the underlying assets, . . . and a transaction structure that is not overly complex."[306] "Transparency" involves providing investors with sufficient information in relation to the underlying assets, the transaction structure, and the parties involved.[307] This criterion is aimed at empowering investors to exercise due diligence and make their assessment. "Comparability" aids investors in understanding differences among comparable securitization products and across jurisdictions.[308] Compliance with the STC criteria attracts a better capital treatment compared to non-STC exposures. For example, STC capital requirements of senior tranches are subject to a 10% risk weight as opposed to 15% for non-STC; capital charges vary similarly across different levels of seniority between STC and non-STC securitizations, with the latter attracting higher charges.[309]

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301. Such as maturity and tranche thickness for non-senior exposures. *Id.* at 5.

302. *Id.*; *see also* GLEESON, *supra* note 257, at 381 tbl.18.7.

303. Commission Regulation 2017/2402, 2017 J.O. (L 347) 36.

304. *See* Bavoso, *supra* note 91, at 7–8.

305. *See id.* at 3.

306. BANK FOR INT'L SETTLEMENTS, *supra* note 162, at 6.

307. *Id.*

308. *Id.*

309. *See* GLEESON, *supra* note 257, at 381, 384 (reproducing tables with securitization risk weights respectively for non-STC and STC securitization exposures).

Regulatory questions about the application of the STC label will arise due to the way the compliance process is designed. Undoubtedly, large financial institutions will seek to optimize their regulatory capital by using the STC risk weights; it is also foreseeable that they would adopt an internal ratings-based approach.[310] Despite STC compliance being attested against specific criteria, it is up to originators to make this claim of compliance, which has to be verified by investors.[311] More specifically, originating banks have to disclose all necessary information to the transaction parties, who would then be able to determine whether the exposure is compliant.[312]

The role of supervisors in this process is ostensibly marginal. Simply, it relates to reviewing the preferential capital treatment self-attributed by the banks that they supervise and taking remedial actions should they not be satisfied with compliance.[313]

The peripheral role of competent national supervisors, not to mention the absence of a transnational regulator in charge of monitoring a market that is inherently cross-border, is a criticism that has also been voiced concerning the similar

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310. The revised framework has clarified in this sense that the IRB top-down approach can be used. *See* BANK FOR INT'L SETTLEMENTS, *supra* note 162, at 3 n.8. A top-down approach entails that correlation effects are taken into account for the valuation, so the risk of default on a portfolio valued in this way will be less than the sum of the risks of default of individual assets in the portfolio; a bottom-up approach, instead, is the sum of the risks of default of all individual components in the portfolio. Therefore, for any portfolio, the top-down risks will be less than the bottom-up risks. The problem with the top-down valuation in the context of securitization is that a bank could well take assets that should be evaluated using the bottom-up approach, it could then securitize those assets, buy back the securitized notes, and thus gain a reduction in capital requirements. *See* GLEESON, *supra* note 257, at 342.

311. While originators assess regulatory compliance with the STC criteria in order to determine the capital treatment of their holding, originators have a duty to disclose sufficient information to allow investors to perform that assessment. *See* BANK FOR INT'L SETTLEMENTS, *supra* note 162, at 7.

312. The determination of compliance follows slightly different processes for short-term securitizations, where the assessment is performed by investors only; whereas for other securitization exposures the assessment is made by the sponsor, or by a third-party support provider. *See* BANK FOR INT'L SETTLEMENTS, CAPITAL TREATMENT FOR SHORT-TERM "SIMPLE, TRANSPARENT AND COMPARABLE" SECURITISATIONS 3 (2018).

313. *See* BANK FOR INT'L SETTLEMENTS, *supra* note 162, at 7.

STS initiative at the EU level.[314] It is important to remember that the role of originators and investors here reflects the unchanged orthodoxy of market discipline in the overall Basel III framework (Pillar 3, in fact).[315] The discussion conducted in Part II of this Article, on the rationale for incorporating market discipline as a regulatory technique, must be remembered here to inform the assessment as to whether the availability of internal models, combined with a strong determination power retained by large banks, will still create opportunities for regulatory arbitrage in the STC context.

C. *The Leverage Ratio*

The introduction of a leverage ratio ("LR") complemented the first pillar of Basel III. This was conceived as a limit to the total amount of leverage banks can achieve.[316] In line with other capital measures, it is designed to avoid the build up of leverage during boom years, and the ensuing deleveraging that becomes inevitable as a consequence.[317] LR requires banks with a large share of high-risk weighted assets to have additional loss-absorbing capacity, capturing both on- and off-balance sheet exposures (through a 100% credit conversion factor).[318] Non-G-SIBs have to operate under a permitted ratio of 3%,[319] whereas for G-SIBs a buffer at 50% of their risk-weighted higher loss absorbing requirement ("HLAR") is in place.[320]

The LR is a non-risk-based capital measure, conceived by the Committee as a backstop to the risk-based capital requirements. It is defined as tier-1 capital over a bank's total exposures.[321] The LR is expected to increase the resilience of large

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314. *See* Bavoso, *supra* note 91, at 14–15, 23–24; *see also* Bavoso, *supra* note 24, at 35–36.

315. *See Pillar 3 Framework—Executive Summary*, BANK FOR INT'L SETTLEMENTS (June 27, 2019), https://www.bis.org/fsi/fsisummaries/pillar3_framework.htm.

316. *See* BANK FOR INT'L SETTLEMENTS, BASEL III LEVERAGE RATIO FRAMEWORK AND DISCLOSURE REQUIREMENTS 1 (2014).

317. *See id.*

318. *See id.* at 1, 19.

319. BLUNDELL-WIGNALL ET AL., *supra* note 19, at 212.

320. *Id.*

321. BIS 2010, *supra* note 256, at 61 (referring to the ratio between a bank's non-risk weighted assets and its tier-1 capital). The ratio between a bank's non-risk weighted assets and its tier-1 capital is essentially designed to

banks as it will provide a measure to contain aggregate risks, and a protection against losses in the financial system.[322] Moreover, it is also conceived as a regulatory tool to limit opportunities for regulatory arbitrage, limiting the capacity of banks to leverage their capital base.[323] In essence the LR plays a central role in containing the system-wide build up of leverage.

Notwithstanding the above, LR's risk insensitivity means that assets with the same nominal value, but different risk levels, are treated equally and face the same capital charge.[324] In other words, moving away from a risk-based approach here may lead to unintended consequences where banks with low risk-weighted assets increase their risk taking beyond a desirable level, offsetting the benefit of holding extra capital under the LR.[325]

A more substantial critique of the LR has been its role as a backstop of capital. Given the ineffectiveness to date of the capital weighing approach, and the opportunities for regulatory arbitrage within it, the LR could have been the main regulatory measure to mitigate risk-taking in the banking system.[326] As a last critique, the leverage ratio is measured in different ways across jurisdictions.[327] This leads to fragmented implementation and supervision as well as potential problems of regulatory arbitrage. Ultimately, the LR operates in a broader context of prudential measures and will have to be evaluated as part of that larger regulatory puzzle.

D. *Liquidity Regulation*

The regulatory fault lines that emerged in connection with the securitized banking system pointed to weaknesses in large financial institutions' liquidity. The GFC of 2008 mani-

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supplement the risk weighted capital ratio. As a result, any bank with an unweighted leverage ratio of less than 3% would be considered undercapitalized.

322. *See* Ross Cranston et al., Principles of Banking Law 53 (3d ed. 2018).

323. *Id.*

324. Smith et al., *The Leverage Ratio, Risk Taking and Bank Stability* 5 (Eur. Cent. Bank, Working Paper No. 2079, 2017).

325. *Id.*

326. *See* Blundell-Wignall & Atkinson, *supra* note 172, at 14–15.

327. Anbil & Senyuz, *supra* note 113, at 9.

fested itself as a rapid dry up of liquidity, where banks' assets became illiquid at any price.[328] Moreover, it is well documented that the liquidity crisis was heavily dependent on banks' over-reliance on wholesale funding channels.[329] This led the Committee to introduce, outside of the three traditional pillars, two liquidity measures under Basel III that are designed to aid supervisors.[330]

The liquidity coverage ratio ("LCR") and the net stable funding ratio ("NSFR") are conceived to improve the ability of banks to absorb shocks arising from financial stress, and—by extension—to reduce the possibility of shocks spilling over from the financial system to the real economy.[331] Traditionally, banks have been free to model liquidity without regulatory intervention, but this led to two main problems: a) subjective models used to calculate liquidity; and b) the uneven playing field created by these subjective calculations.[332]

The LCR requires that banks maintain a minimum amount of unencumbered[333] high-quality liquid assets ("HQLA") that would allow them to meet their liquidity needs during a 30-day stress scenario, surviving a stress scenario for that period.[334] During this timeframe, the stock of HQLA should remain at least 100% of the bank's total net cash outflows.[335] In essence, this is a way to regulate short-term liquidity management. Although the Committee's design of the LCR was based on existing market practices, the adopted definition

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328. *See* GLEESON, *supra* note 257, at 427.

329. *See* Gorton & Metrick, *supra* note 33, at 433.

330. *See* GLEESON, *supra* note 257, at 420 (explaining that the new liquidity ratios represent a move away from modeling, towards a less flexible and less risk-based regulatory architecture).

331. *See* BIS 2010, *supra* note 256, at 8–9.

332. *See* GLEESON, *supra* note 257, at 428 (noting that even before the crisis Bear Stearns maintained a pool of short-term liquid assets to ensure its liquidity—comparable to the new LCR—while Lehman Brothers maintained a portfolio of long-term real estate loans on a funding base—comparable to the NSFR).

333. The term "unencumbered" as used here is intended to mean as not pledged to secure, collateralize, or provide credit enhancement to a transaction. *See* BANK FOR INT'L SETTLEMENTS, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS ¶ 31 (2013).

334. *See id.* ¶ 17.

335. *See id.*

is grounded in two key mechanisms: 1) the definition of liquid assets, and 2) the calculation of expected outflows.

The definition of HQLAs favors government bonds, while it disfavors market-based products such as ABSs.[336] Beyond outlining characteristics that HQLAs should have (e.g., low credit risk, low market risk, certainty of valuation, and low correlation with risky assets),[337] Basel III divides liquid assets into two levels. Level 2 can comprise no more than 40% of the stock of HQLAs.[338] This assumes that cash inflows during the 30-day stress period never exceed 75% of the expected outflows.[339] The outflow is calculated by applying a presumed outflow percentage to the specific type of exposure, also known as run-off rates.[340]

The NSFR is conceived to supplement the LCR as a protection against extended liquidity shortages. It requires banks to maintain a percentage of available stable funding ("ASF") to match the amount of required stable funding ("RSF").[341] In other words, the purpose of this ratio is to limit the way in which banks can finance long-term assets with short-term liabilities—which is exactly one of the phenomena that emerged within the securitized banking model. In particular, the NSFR was designed to limit the exposure that dealer banks had in pre-crisis years to short-term funding on their liabilities side.

The NSFR is grounded in a definition of long-term assets, which, for the purpose of this ratio, are assets with a maturity of more than one year.[342] Long-term sources should fund these long-term assets on the liabilities side of a bank's balance sheet. The requirement forces a bank to hold an available

336. *See id.* ¶ 24.

337. *See id.*

338. The classification includes level 2B assets, which may be permitted by supervisors, and should not amount to more than 15% of the total pool. *See id.* ¶ 46.

339. *See id.* ¶ 69.

340. Stable retail deposits require 5% in the liquidity pool; less stable deposits require 10%; unsecured wholesale funding through operational relationship require 25%; unsecured wholesale funding from non-financial corporates require 75%; unsecured wholesale funding from all other customers require 100%. *Id.*

341. *See* BANK FOR INT'L SETTLEMENTS, BASEL III: THE NET STABLE FUNDING RATIO ¶ 9 (2014).

342. *See id.*

amount of stable funding,[343] established based on its assets and activities over the one year period.[344]

Clearly, the new liquidity measures tackle some of the pre-crisis problems concerning excessive reliance on wholesale funding. The reduced volume of the repo market after 2008[345] is the reflection of a new regulatory architecture that makes it substantially more expensive for dealer banks to engage with short-term funding in the wholesale market.[346] It is altogether evident that the use of classifications under the two ratios, such as stable funding, still inevitably relies on inputs from large banks and on supervisors' ability to monitor the market. This could eventually create scope for arbitrage opportunities, because banks incurring higher costs due to liquidity regulation may seek to increase their risk-taking in other areas.[347]

Notwithstanding the validity of the new framework to regulate liquidity, the panic of 2020 once again revealed liquidity problems in the money market. The Basel III liquidity framework is directed at banks; yet many areas of financial intermediation have migrated towards non-bank entities, and so leverage creation and liquidity oversight remain problematic.[348] This critique is expanded on in Part IV.

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343. ASF is defined as a portion of equity and liability financing that is expected to be a reliable source of funding for a one-year period, under conditions of extended stress. *See id.* ¶ 26 (providing a table of the ASF categories, which correspond to a factor of stability from 0% to 100%—i.e., 100% assigned to tier-1 capital or deposits for instance; 0% assigned to liabilities without a stated maturity). It must be noted that ASF is also required to support potential liquidity calls from off-balance sheet commitments.

344. RSF reflects the liquidity of the assets on the bank's balance sheet, their level of encumbrance and also off-balance sheet exposures. The calculation for the RSF factor is similar to the calculation for the LCR, and it assigns a percentage that reflects the liquidity of the assets—i.e., 0% assigned to coins, banknotes or central bank reserves for instance; 100% assigned to assets that are encumbered for more than one year, or non-performing loans. *See id.* ¶ 44 (providing a table of the RSF factors for various asset categories).

345. *See* Ritholtz, *supra* note 17.

346. Dealer banks have "reduced their balance-sheet commitment to market-making," which some have argued may have detrimental effects on market liquidity. Adrian et al., *supra* note 18, at 9.

347. *See* Blundell-Wignall & Atkinson, *supra* note 172, at 20; GLEESON, *supra* note 257, at 420.

348. *See* Yalman Onaran, *Can We Survive the Next Financial Crisis?*, BLOOMBERG (Sept. 10, 2018), https://www.bloomberg.com/graphics/2018-lehman-anniversary/.

E. *Mitigating Risks from the Repo Market*

Before the collapse of wholesale funding channels in 2008, the regulation of repo markets was thought to be best left to market discipline mechanisms. The EU Securities Financing Transaction Regulation was adopted in 2015 to directly deal with repos.[349] This initiative was specifically aimed at increasing transparency in repo-type transactions and addressing problems of collateral reuse by requiring adequate disclosure among the transaction counterparties.[350] Effectively, the EU Regulation was anchored in a regulatory technique based on market discipline; it relied on market participants' enhanced access to information to limit collateral reuse, or at least mitigate its effects.

The FSB picked up the other pressing issue for repos: minimum haircuts.[351] The FSB framework revolves around two main provisions: a) qualitative factors are incorporated into new or existing methodologies used by repo counterparties to calculate haircuts; and b) the application of *de minimis* through-the-cycle haircut floors to non-centrally cleared repos, where financing against collateral, other than government securities, is provided to non-bank entities.[352]

The first leg of the FSB provision seeks to mitigate procyclical fluctuations of repo haircuts, the uncertainty of which had contributed to instability in the financial system following the credit crunch of 2007.[353] The second leg set limits on the amount that non-bank entities could borrow against different types of securities in bilateral repos. The aim was to limit the build up of leverage outside of the regulated banking system and, by extension, reduce the pro-cyclicality of leverage as a whole.[354] The application of a haircut floor according to the

349. *See* Commission Regulation 2015/2365, *supra* note 253, at 1.

350. *See id.* art. 15(1).

351. *See* FIN. STABILITY BD., TRANSFORMING SHADOW BANKING INTO RESILIENT MARKET-BASED FINANCE 2 (2015). This was aimed at establishing a globally applicable regime for haircuts on non-cleared transactions, among which repos.

352. *See id.* at 9. These provisions are applied with some exceptions, namely, centrally-cleared SFTs to banks and broker–dealers, subject to adequate capital and liquidity regulation; and repos carried out by central banks.

353. *See id.*

354. *See id.* at 9–10.

market risk and historical performance of collateral pledged is another important element of the FSB's framework.[355]

As is the case with the relevant Basel provisions, the FSB framework relies on market participants to establish adequate internal processes and procedures. While reference is made to national supervisors for monitoring haircuts, and to a coordination role of Basel and IOSCO,[356] the strategy adopted to mitigate the problems associated with the repo market relies chiefly on market discipline mechanisms. In particular, the limits on rehypothecation in the context of the EU Regulation simply reflect increased disclosure requirements from market participants. Similarly, the FSB relies substantially on inputs from market participants for the purpose of limiting haircut fluctuations. A more detailed conceptual critique of this regulatory approach will be expanded on in the next Part of this Article.

IV.
How Resilient is the Financial System? A Critique of the Current Regulatory Framework

The new regulatory architecture of global finance has produced a number of positive results, even before its full implementation. One straightforward sign is the safety of large banks, which are better capitalized and less leveraged than they were before 2008.[357] Similarly, these banks' funding structures have shifted towards more long-term and stable funding, in line with the liquidity provisions examined earlier.[358] Moreover, banks' business models seem to have moved away from

355. As an example, short-term corporate debt attracts a 0.5% haircut floor, index equity 6%, while securitized debt would attract a higher haircut. *See* Bank for Int'l Settlements, Haircut Floors for Non-Centrally Cleared Securities Financing Transactions 8 (2015).

356. *See* Fin. Stability Bd., *supra* note 351.

357. There have been clear increases in the level of capital among large banks, especially in the United States. The average capital of the top U.S. banks in 2007 was 2.5%, whereas by 2018 this figure had risen to 6.6%. *See* Onaran, *supra* note 348.

358. *See id.* In 2007 large dealer banks were over-reliant on short-term repos (44%), against 29% of deposits and 6% of equity; in 2018 deposits went up to 47%, equity to 10% while repo agreements went down to 24%. This aggregate data includes the liabilities of JP Morgan, Citigroup, Bank of America, Goldman Sachs, and Morgan Stanley. *Id.*

risky trading to more traditional banking functions.[359] While some of the large European banks may still be affected by non-performing loans ("NPL") on their books, they are also showing increasing levels of capitalization, in line with Basel III requirements and reductions in RWA.[360]

Because some segments of capital markets restarted after 2014[361] and some areas of shadow banking are growing in the process, it is imperative to examine the Basel framework's persistent weaknesses in reining in risks in financial markets. As previously examined, market-based finance is taking on a new shape. With a sharp collapse in the amount of outstanding CDOs since 2008, there has been a contextual increase in the amount of outstanding CLOs, which are essentially bonds backed by leveraged loans. This points to another post-2008 trend: the increasing move of risky leveraged loans away from banks, towards non-bank entities. While banks have become safer, risks have moved to other areas of capital markets and outside the traditional pre-2008 channels of securitization and repos.[362] However, they replicate very similar risks.[363] The turmoil in the spring of 2020 demonstrated the intrinsic fragilities in the mechanics of market-based finance that have endured after 2008.[364]

This Part critiques the Basel III framework from four interrelated perspectives, starting with a macro view of the framework and its place in global financial regulation. The next critique focuses on the Committee's reluctance to depart

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359. *See id.* This needs to be ascribed to both the new capital rules under Basel III and, in the United States, the Volcker Rule. Dodd–Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 1851 (2018).

360. *See* Maheen Khan, *Capital and RWAs of Top European Banks—2017 to 2018*, CLARUS FIN. TECH. (Sept. 10, 2018), https://www.clarusft.com/capital-and-rwas-of-top-european-banks-2017-to-2018/.

361. *See supra* notes 13, 14, 75 and accompanying text.

362. *See* Onaran, *supra* note 348.

363. For instance, against a sharp collapse in the amount of outstanding CDOs since 2008, there is a contextual increase in the amount of outstanding CLOs, which are essentially bonds backed by leveraged loans. This points to another post-crisis trend, which is the increasing move of risky leveraged loans away from banks, towards non-bank entities. So while banks have become safer, risks have moved to the shadow banking sector, even though outside the traditional channels of securitization and repos. *See id.*

364. *See* Tucker, *supra* note 9. Interestingly Tucker stressed that only massive central banks' intervention, in the shape of bond purchasing programs, could rescue financial markets from collapsing. *See id.*

from the orthodoxy of market discipline. Finally, the analysis questions whether the current framework offers market players opportunities for regulatory arbitrage before concluding with an assessment on the safety of the financial system.

A. *Zooming in and Zooming out*

The analysis conducted in Part III offers a rather optimistic view of how Basel III could rein in the excesses of securitized banking, putting market-based finance on a more sustainable footing. Post-crisis regulation seems to create the right incentives for dealer banks to make more efficient use of their capital and liquidity resources, due to the higher costs of providing market and funding liquidity.[365] More specifically, the combination of leverage and liquidity provisions under Basel III creates disincentives for dealer banks to participate in low margin activities while simultaneously incentivizing them to hold more liquid securities and reduce their reliance on short-term funding.[366]

The aggregate of individual provisions creates a regulatory environment where certain activities, such as pre-crisis securitized banking, have become costly for banks. For instance, output floors introduced under Basel III will likely mitigate the degree of RWA variability experienced in the pre-crisis years.[367]

Zooming out though may provide a bigger picture, and a more critical perspective of the impact of the new framework. The reader will recall from the earlier analysis that the new

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365. *See* Nina Boyarchenko & Or Shachar, *Liquidity Effects of Post-Crisis Regulatory Reform*, FED. RES. BANK N.Y.: LIBERTY ST. ECON. (Oct. 16, 2018), https://libertystreeteconomics.newyorkfed.org/2018/10/liquidity-effects-of-post-crisis-regulatory-reform/. It needs to be noted that asset or market liquidity refers to the ease with which an asset is traded, whereas funding liquidity is the ease with which funding can be obtained, see Markus K. Brunnermeier & Lasse Heje Pedersen, *Market Liquidity and Funding Liquidity* (Nat'l Bureau Econ. Rsch., Working Paper No. 12939, 2007).

366. *See* Boyarchenko & Shachar, *supra* note 365.

367. This comes with some caveat though, as it has been observed that banks with capital constraints will still have incentives to game their internal models. Variability is also more likely to persist in banks with a high share of opaque assets. *See* Edson Bastos e Santos et al., *Variability in Risk-Weighted Assets: What does the Market Think?* (Bank for Int'l Settlements, Working Paper No. 844, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3549535.

capital measures still rely on a number of assumptions and classifications. The new capital ratios still leave room for the use of internal models, despite some restrictions.[368] Similarly, the new securitization framework relies on the STC label, which is a form of self-certification by market participants. This may lead to market participants using the label as an arbitrage device.[369] Moreover, under the already mentioned liquidity measures, classifications such as stable funding will leave large banks vying to exploit arbitrage opportunities, given the costs imposed by the regulation and the possibility that banks have to increase risk-taking in other areas.

The crisis of 2020 highlighted Basel's emphasis on banks, and particularly on G-SIBs. This focus fails to capture risk taking in other areas of capital markets, such as private equity firms structuring CLOs. A critical question is the extent to which G-SIBs are sufficiently insulated from risks emanating from other areas of capital markets. It is undeniable that, in the spring of 2020, another global financial crisis was only averted due to massive government interventions (via central banks).[370]

Overall, zooming out presents a landscape where Basel III relies substantially on the fairness of market participants' inputs, and on the role of national supervisors.[371] This should come as no surprise, because the Committee believes in the validity of model-based regulation. Moreover, this regulatory design is still accompanied by the orthodoxy of market discipline. In other words, a macro perspective of Basel III offers a view of the framework that is strikingly similar to its discredited predecessor.

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368. Beyond the restrictions discussed in the previous Part, it is worth also looking at the guidelines by the ECB, see EUR. CENT. BANK, ECB GUIDE TO INTERNAL MODELS (2019).

369. Bearing in mind that infringements would result in penalties.

370. *See* Tucker, *supra* note 9.

371. As we know, there is no global supervisor in international finance, despite some efforts to coordinate supervisory strategies provided by BIS, FSB and IOSCO. It seems to be widely accepted though that Basel III is bound to be implemented in different ways, according to the different economic structure of each jurisdiction and its regulatory arrangements. *See* BLUNDELL-WIGNALL ET AL., *supra* note 19, at 217–18.

B. *The Problem with Market Discipline*

After 2008, former Chairman of the United States Federal Reserve, Alan Greenspan, one of the keenest proponents of market discipline in the pre-crisis heydays of market efficiency,[372] conceded that the intellectual edifice that permeated risk management in the pre-crisis decades was flawed.[373] Richard Posner reached a similar conclusion in his post-crisis book, firmly stating that the financial system had relied too heavily on market forces for the purpose of regulating and monitoring the industry.[374]

While some institutional responses to the GFC emphasized that the failures of market discipline were caused by structural barriers, such as misaligned incentives, moral hazard, or lack of transparency, they insisted the concept was worth preserving.[375] However, this viewpoint does not explain the failure of market discipline to signal excessive risk taking or investor and market reactions.[376] These were conceptual failures, and not merely failures related to the application of market discipline. While it is beyond the scope of this Article to dig into a wider conceptual critique of market efficiency and its tenets, it is difficult to advocate for the merits (or indeed the success) of market discipline.

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372. *See* Alan Greenspan, Chairman, Fed. Reserve. Bd., Remarks Before the American Bankers Association on the Evolution of Bank Supervision (Oct. 11, 1999) (transcript available at https://www.federalreserve.gov/boarddocs/speeches/1999/19991011.htm) ("Heavier supervision and regulation designed to reduce systemic risk would likely lead to the virtual abdication of risk evaluation by creditors of such entities . . . . The resultant reduction in market discipline would, in turn, increase the risks in the banking system, quite the opposite of what is intended.").

373. *See* Edmund L. Andrews, *Greenspan Concedes Errors on Regulation*, N.Y. TIMES (Oct. 23, 2008), http://www.nytimes.com/2008/10/24/business/economy/24panel.html.

374. *See* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2011).

375. *See* INST. INT'L FIN., *supra* note 130; *see also* David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421, 1422 (2015).

376. *See* Min, *supra* note 375, at 1457. Min identifies four more specific failures of market discipline in the context of the GFC: a) liabilities of individual banks failed to timely identify risks; b) interbank borrowing rates failed to timely signal systemic risk; c) market pricing of ABSs failed to timely signal systemic risk; d) clear evidence of bank risks prior to July 2007. *See id.* at 1457–68.

Notwithstanding the limits associated with market discipline,[377] Basel III confirms a firm reliance on this regulatory strategy, with the strengthening of existing disclosure requirements. The effectiveness of disclosure as a regulatory technique is premised on a system of informational efficiency, where information can be timely transmitted to market participants who are able to process it and make rational decisions based on the information disclosed.

This construction is built on a rather feeble foundation. A number of studies have convincingly pointed to the failures of disclosure, especially in the pre-crisis years.[378] One key problem is the increased complexity of financial markets, and of banks' balance sheets. Due to information failures, this combination severely limits the scope of disclosure.[379] Complexity also explains a second problem: the cognitive biases of market participants. Rational decision making is at best an assumption, and investors, even when equipped with all necessary information, suffer a number of "errors of judgement."[380]

Errors of judgement affect not only investors, who under the conventional narrative are assumed to perform a number of monitoring mechanisms,[381] but also shareholders and boards. Shareholders have monitoring powers over the bank's activities and risk taking, while the board steers the bank's strategies. However, questions of complexity and cognitive bias have impacted on the capacity of both shareholders and directors to provide discipline and curb risk taking.[382] This trend has been reinforced by a system of corporate governance mechanisms, whereby market actors in the past have not had sufficient incentives to embark on costly monitoring func-

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377. *See* Simon Kwan, *Testing the Strong-Form of Market Discipline: The Effects of Public Market Signals on Bank Risk* (Fed. Rsrv. Bank of S.F., Working Paper No. 2004–19, 2004).

378. *See, e.g.*, Emilios Avgouleas, *The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy*, 9 J. CORP. L. STUD. 23, 44 (2009); Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 220–23 (2009).

379. *See* Schwarcz, *supra* note 378, at 236–39.

380. Errors of judgement are also called heuristics, cognitive bias, anomalies and so on. *See* Avgouleas, *supra* note 378, at 30–31.

381. These monitoring mechanisms, such as monitoring the value of a bank's securities and trading accordingly, would perform in turn a signalling function that amounts to market discipline. *See* Hellwig, *supra* note 133, at 3.

382. *See* Avgouleas & Cullen, *supra* note 121.

tions.[383] Instead, shareholders' short-term horizons (elicited by the safety net of government bailout in the event of failure), board myopia (magnified by compensation packages that spurred more risk taking), as well as the homogenization of business strategies (facilitated by financial innovation and the myth of risk diversification), have represented huge incentives to neglect the monitoring of risk, stultifying the idea of market discipline.[384]

The insistence on market discipline under Basel III, as well as under related FSB and EU Regulation on repos, repropose a number of regulatory problems—namely the over-reliance on models, and the acceptance of a methodological approach to risk regulation that has proven to be, at best, problematic. At the same time, relying on market discipline preempts mitigating bank risks in different ways, such as through higher capital ratios, structural reforms,[385] or even through a more robust supervisory structure (which is critically still missing in most jurisdictions).[386] The events of spring 2020 again show that excessive leverage through private debt creation, and related liquidity mismatches, have remained an integral part of capital markets[387] because market discipline mechanisms have been insufficient in curbing these tendencies.

C. *Opportunities for Regulatory Arbitrage*

As explained earlier in this Article, Basel II created opportunities for regulatory arbitrage because banks could optimize their regulatory capital by shifting liabilities off-balance sheet. Despite the announced improvements in the new framework, large financial institutions will still be able to characterize credit as capital markets instruments and thus avoid capital

383. *See id.* at 14–15 (further expounding this specific analysis).

384. *See id.*

385. *See, e.g.*, BLUNDELL-WIGNALL ET AL., *supra* note 19, at 216–18. The authors observe, for instance, that the United States has implemented rules that are tougher than the Basel ones.

386. Bavoso, *supra* note 24, at 6.

387. *See* Mike Harmon & Victoria Ivashina, *When a Pandemic Collides with a Leveraged Global Economy: The Perilous Side of Main Street,* VOX (Apr. 29, 2020), https://voxeu.org/article/when-pandemic-collides-leveraged-global-economy.

charges.[388] More specifically, the use of CDSs (e.g., when employed to short a bond exposure) will still allow banks to reduce their capital exposure to a certain debt, attracting a lower risk weight. This will also allow an expansion of bank leverage because banks can shift promises in areas of the financial system where they are treated differently.[389]

Section II.D demonstrates the capacity of market participants to move legal promises and regulatory obligations around the financial system. In particular, the difficulty in applying risk retention rules to CLO transactions is indicative of the problem, namely, the ease with which new transactional designs manage to bypass regulatory constraints. This was precisely the case with securitization and its interplay with Basel II. Moreover, the current structure of CLOs stultifies the new requirements under Basel III.[390] In a similar vein, the employment of TRSs by institutional investors has facilitated risk taking beyond disclosure and margin requirements set after 2008.[391]

This line of critique brings us back to Basel III, namely the ability of dealer banks to manipulate risk weights.[392] Subjective inputs stultify not only capital requirements but also the leverage ratio.[393] In essence, the centrality of RWA as a methodology to calculate risks allows large banks to minimize the impact of new measures such as LR.[394]

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388. Blundell-Wignall & Atkinson, *supra* note 172, at 12. For example, this has happened with the use of TRSs. For a discussion, see Robert Armstrong, *Archegos Debacle Reveals Hidden Risk of Banks' Lucrative Swaps Business*, FIN. TIMES (Apr. 1, 2021), https://www.ft.com/content/fb364689-9b04-47cb-aba9-5eb15d1cea85.

389. Blundell-Wignall & Atkinson, *supra* note 172, at 13. The authors explain that a CDS allows banks to move a promise to a sector that is beyond banking regulation. With respect to the arbitrage opportunity, on a $1000 bond a CDS allows a reduction of the capital required from $80 to $18.6.

390. Bavoso, *supra* note 7, at 145–46. With CLOs, the origination process is syndicated among numerous banks, making it difficult to apply both risk retention rules and, more generally, capital requirements. The key actor in CLOs is not the originating/sponsoring bank but a private equity firm, crucially falling outside the regulatory spectrum of Basel III.

391. *See* discussion *supra* Section II.D.

392. *See generally* Saguato, *supra* note 210.

393. BLUNDELL-WIGNALL ET AL., *supra* note 19, at 215–16, 225 (noting that if banks manipulate the "denominator of the ratio, there is no effective leverage constraint").

394. *Id.* at 228–29.

Of course, this problem brings us back to market discipline and the role attributed to market participants for regulatory inputs. The determination and impact of the LR are likely affected by the G-SIBs' exposure across different jurisdictions. Banks with heavy derivatives exposure will have more direct ways to shift regulatory promises and minimize their risk weight.[395]

D. *Assessing Risks of Interconnectedness and Spill-Overs*

The perennial challenge at the heart of regulatory reforms in the post-2008 years has been protecting large financial institutions from risks emanating from the riskiest segments of capital markets. The Basel III framework sought to achieve this goal and engineer a way to tackle these regulatory problems. As a result, by design, the Basel III framework is a backward looking exercise, ill-suited to deal with recent innovations in capital markets and the new structures of market-based channels of finance.

One key argument made by industry representatives to justify post-crisis innovations suggests that large banks would be well insulated from defaults occurring in other areas of capital markets.[396] This narrative hinges on the idea that post-2014, market-based finance is designed as an efficient risk sharing mechanism that facilitates the origination of credit to the real economy (i.e., through leveraged loans) and then efficiently allocates these risks to those in the financial system better suited to bear such risks (e.g., through the repackaging of leveraged loans into CLOs, sold to institutional investors protected by TRSs). Accordingly, individual banks are not directly exposed to leveraged loans, which are originated through a syndication process.

However, this view may be an over-simplification. The FSB suggested that there may well be a resurgence of excessive risk taking in capital markets (specifically in the CLO market) and that, contrary to what the industry contends, this could have wider spillover effects across the financial systems.[397] The FSB

395. *Id.* at 229.

396. *See* Partnoy, *supra* note 7 (pointing to statements to this effect released by Jerome Powell, Head of the Federal Reserve, and Steven Mnuchin, Treasury Secretary).

397. FIN. STABILITY BD., *supra* note 105, at 1–2.

also specified that different types of bank exposures may arise: a) direct exposure to leveraged loans and other credit facilities, which are easier to map; b) exposure arising in the process of arranging the syndication; c) direct exposure to third parties CLOs; and d) exposure through more indirect functions, such as sponsoring and warehousing facilities.[398] While the capacity of banks to withstand shocks has undoubtedly improved due to the phasing in of Basel III,[399] the exposure to shocks in certain markets may be difficult to monitor, and especially to model, especially where the market is characterized by complex products (e.g., CLOs), and where the interconnectedness between entities and markets is unclear.[400]

To put it bluntly, this scenario replicates a game of cat and mouse, with new regulations coming in that constrain risk taking and leverage and with market participants creating new market structures that bypass the effects of those constraints. And in the spring of 2020, that is precisely what transpired.

The traditional claim of efficiency—efficient risk sharing mechanism, efficient flow of credit to the economy—is the crucial legitimizer behind the continuous innovations in capital markets. This innovation process brings financial regulators into a position far too similar to that of the pre-2008 period. Over the past ten years, market-based finance has shown fragilities very similar to those associated with the old shadow banking system. Namely, excessive levels of leverage creation, liquidity problems, interconnectedness, and the ensuing need for central bank intervention with massive injections of liquidity to stabilize markets. The idea of resilient market-based finance never materialized because, once again, the riskier activities migrated beyond the radar of regulatory oversight. Arguably, the idea of efficiency, coupled with market participants' freedom to shift legal and regulatory obligations in complete financial markets, led to the panic experienced in the spring of 2020.

The panic of 2020 resulted from the revived mechanics of debt capital markets. Excessive leveraging and uncontrolled

398. *See id.* at 18–19.

399. *See* discussion *supra* Part III. Beyond the provisions examined in Part III of this Article, stress testing also contributes to banks' resilience, because the period tests reveal how banks manage exposures to certain risks.

400. FIN. STABILITY BD., *supra* note 105, at 22.

interconnectedness were again the main problems caused by market-based finance. The long and complex transaction chains brought by CLOs have facilitated the origination of low quality credit and have disseminated the related risks to capital markets investors. In the process, some problematic mechanisms common with pre-2008 securitization were maintained and became mingled with new transactional complexities.[401] With respect to tranching, losses were propagated through the financial system more widely because institutional investors, exposed to specific slices of the CLO, leveraged their positions in the CLO market through TRSs[402] or by entering into repo contracts.[403] The net effect is homogeneity in market participants' balance sheets that inevitably reinforces problems of contagion once a shock occurs. That effect is exactly opposite to the claim of risk diversification proposed by the industry.[404]

The interconnectedness attributed to tranching reveals another source of systemic risk, particularly in connection with the downgrades of CLO tranches experienced in the spring of 2020.[405] It became apparent that a diverse range of investors is exposed to risky CLO tranches. This largely occurs through leveraged positions where investors are not adequately capitalized.[406] As a result, investors are exposed to the risks of margin calls when their underlying investment becomes the subject of downgrades. This dynamic creates layers of leverage in the financial system. The first layer is made up of leveraged loans

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401. Tranching not only facilitates the origination and distribution of higher risks among market participants but is also an engine of interconnectedness. *See* discussion *supra* Part I.

402. *What is a Total Return Swap (TRS)?*, *supra* note 249.

403. Satyajit Das, *Opinion: In a Replay of 2008, Toxic Subprime Loans Could Worsen This Financial Crisis*, MKT. WATCH (May 14, 2020, 5:41 PM), https://www.marketwatch.com/story/these-packaged-subprime-loans-could-collapse-on-investors-in-this-financial-crisis-just-like-they-did-in-2008-2020-05-14.

404. STIJN CLAESSENS ET AL., SHADOW BANKING: ECONOMICS AND POLICY 16 (Int'l Monetary Fund, Staff Discussion Note No. 12, 2012) (describing how sensitivity to market movements, similar to pre-2008 dynamics, exposes the whole financial system to systemic risks).

405. Joe Rennison, *Rating Agencies Put 1,000 CLO Slices on Review for Downgrade*, FIN. TIMES (Apr. 23, 2020), https://www.ft.com/content/d6f78895-671f-4ed9-8039-d9595821ffd4.

406. Laurie DeMarco, Emily Liu & Tim Schmidt-Eisenlohr, *Who Owns U.S. CLO Securities? An Update by Tranche*, FED. RSRV. BD. (June 25, 2020), https://www.federalreserve.gov//econres/notes/feds-notes/who-owns-us-clo-securities-an-update-by-tranche-20200625.htm.

issued to indebted businesses; the second layer is the structure of CLOs, which are in itself highly leveraged; and the final layer is investors in CLOs who leverage their positions through total return swaps and the repo market.[407]

This analysis shows that the wave of financial innovation that materialized after 2014 has replicated some of the mechanics observed before 2008, namely the multiplication of leverage and its amplification and unchecked transmission through capital markets. Because the Basel III regulatory framework is geared towards the risks that had manifested at the outbreak of the 2008 GFC, it seems to be falling short in fully capturing the risks currently flowing from market-based finance. This is so for two reasons. First, market participants have retained substantial freedom to innovate in the name of market efficiency, moving regulatory obligations around the financial system and away from the umbrella of regulated activities. An example of this is the evolution of CLOs. While they give the appearance of effective risk diversification, the slicing of risks elicits the exposure to extremely high risks of default in exchange for high yields.[408]

Second, the regulatory technique at the heart of Basel, and its lengthy implementation stages, have made regulatory arbitrage a possibility. For instance, TRSs, typically entered into by banks and hedge funds, have become a huge source of (often hidden and unreported) profit for banks and an avenue for leveraged investments for investors.[409] Partly, this is because they are non-cleared derivatives, and regulators have deferred implementing the related margin requirements.[410]

While banks are safer, the financial system as a whole is still permeated by the same mechanics of excessive debt creation and interconnectedness. To claim that banks are insulated from the shocks that inevitably emanate from the rest of

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407. Das, *supra* note 403 (explaining that investors in senior tranches can more easily leverage their investment, up to ten times).

408. Viral V. Acharya et al., *Private Equity: Boom and Bust?*, 19 J. APPLIED CORP. FIN. 44, 51–52 (2007) (reiterating that a small number of defaults from the more risky tranches can translate into heavy losses).

409. *See, e.g.*, Armstrong, *supra* note 388.

410. *See id.*; Rennison et al., *supra* note 254. For a discussion of margin requirements for non-centrally cleared derivatives, see BANK OF INT'L SETTLEMENTS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES (2020).

the financial system, specifically market-based channels of intermediation, is, at best, optimistic. While zooming in shows a picture of healthier and more resilient banks, zooming out provides a more complex view. Banks are still interconnected with non-bank entities and are likely affected by risks emanating from non-bank channels of intermediation.

Conclusion

Notwithstanding these critiques, the new regulatory framework centered around Basel III provides a sharp improvement to the prudential framework of internationally active banks. There are already signs that banks, both in the United States and Europe, are less risky than before 2008. Despite the dissimilar impact that Basel III will have on different banks across jurisdictions, it is likely that this trend will continue.[411]

Basel, and its attendant regulations, resulted in a voluminous and complex set of rules. This shifts our focus towards the implementation phase and the nature of the supervisory infrastructure. This is an important point: with shocks originating in non-bank market-based channels of intermediation, it is vital that supervisors have the capacity to oversee the macro dimension of the financial system and, particularly, the linkages between banks and non-banks.

While it is difficult to speculate on the degree to which large banks will exploit arbitrage opportunities, it is incontrovertible that there remains a strong emphasis on market discipline. Two problems are likely to arise: 1) large banks having a big input in implementing some key regulatory provisions, and 2) a bias towards market-driven solutions to regulatory problems. The latter phenomenon partly explains the unfettered innovations that have shaped market-based finance after 2008.

Policy trends after 2014 favor the expansion of capital markets segments whose growth inevitably creates risks. One preeminent example is the comeback of opaque forms of securitized debt, which are again employed to repackage high-

411. Onaran, *supra* note 348.

risk assets into tradable securities.[412] The risky assets have now shifted from the pre-crisis subprime mortgages to non-performing loans and high-leveraged loans. These trends are corroborated by the 2019 IMF report on global financial stability highlighting the systemic vulnerabilities arising in the corporate sector due to increasing and unsustainable debt burdens.[413] Of course, these vulnerabilities can easily spread throughout the financial system, particularly through the market-based system.

The capacity of the Basel framework to rein in the risks and instability emanating from the resurgent market-based financial system may soon be tested again, given the increasing levels of debt originated by non-bank financial institutions and the ever-present interconnectedness between banks and non-banks.[414] This Article pointed to several weaknesses that still permeate the architecture of global financial regulation, which may prove decisive in making the financial system resilient. In particular, the Basel framework's capacity to capture vulnerabilities arising in non-bank, market-based channels rests ultimately in the robustness of its macro-prudential focus. It is hard to contend that the lingering faith in market discipline will prove a useful regulatory strategy.

412. ORÇUN KARA, EU MONITOR, SYNTHETIC SECURITISATION MAKING A SILENT COMEBACK 1 (2017). Another example is that of CLOs, discussed in Section II.D of this Article.

413. IMF, *supra* note 8, at 25–36.

414. Pedro Nicolaci da Costa, *The Financial System is Loaded Up with a Lot More Debt Than Wall Street Wants You to Know*, BUS. INSIDER (Apr. 6, 2018), https://markets.businessinsider.com/news/bonds/financial-system-more-debt-than-wall-street-wants-you-to-know-2018-4.

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DISCHARGING THE DISCHARGE-FOR-VALUE DEFENSE

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Despite its massive size, the corporate debt market is often considered a sleepy refuge for the risk-averse. Yet, corporate debt contracts are often mind-numbingly detailed. That complexity—when coupled with the financial stakes in play—can be a recipe for calamity. And in late 2020, calamity struck in the form of an accidental $1 billion payoff sent to Revlon Inc.'s distressed creditors—not by Revlon itself but rather by Citibank, the administrative agent for the loan. When several lenders refused to return the cash, Citibank commenced what many reckoned would be a successful (if embarrassing) lawsuit to claw it back. But in a dramatic 2021 opinion, a New York federal court sided with the creditors, applying an obscure equitable doctrine known as the Discharge-for-Value defense. The lenders could keep their wayward windfall, and Citibank got stuck with a sizeable write-down. Regardless of how it comes out on appeal, the case seems destined to feature prominently in contracts classes and textbooks for years to come.

Against this backdrop, this Article makes three contributions. First, it spotlights several doctrinal and logical irregularities in the district court's opinion. Second, it builds on these inconsistencies to critique the opinion from an economic policy perspective. Third (and most substantially), it presents novel empirical data to analyze how market participants have reacted to the opinion. Consistent with the policy critique, I document a rapid, precipitous trend towards writing and/or amending debt contracts to nullify the Citibank opinion in its entirety, manifested in a variety of "Revlon blocker"

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provisions that have appeared in hundreds of publicly disclosed contracts. The firms that adopt Revlon blockers are systematically the largest and most sophisticated companies in the public markets, and their rejection of Citibank appears to have met with general market approval. Beyond demonstrating how legal theory and empirical evidence can helpfully interact, this analysis underscores the critical role that default rules play in contract law and policy, and the high stakes involved in getting them right.

Introduction

For those seeking watershed moments in contemporary contract law, the area of corporate debt seems an unlikely target. Though gargantuan in size (over $10 trillion in the United States alone),[1] corporate debt markets have a storied reputation as a refuge for the risk averse—those seeking stable returns, low volatility, and few surprises. At the same time, the contracts governing corporate debt are themselves gargantuan—both lengthy and complex.[2] When coupled with immense financial stakes, that complexity can sow seeds of calamity. Vagueness, inconsistency, loopholes, opportunism, and unpredictable interpretations can conspire at times to transform a presumptively languid flotilla of corporate bonds into a tumultuous roller coaster ride.

Perhaps no roller coaster careened more violently than the one Revlon Inc.'s creditors rode from 2020 to 2021. Born of a $1.8 billion loan facility executed with a syndicate of lenders a half-decade earlier, this loan had the honor of attracting heated legal controversy not once, but twice within the year. And the second imbroglio seems destined to cast a long shadow over not only corporate debt markets, but contract law as a whole. The latter dispute occurred after Citibank, acting

1. Andrea Miller, *U.S. Companies Face Record $10.5 Trillion in Debt—Here's What to Know About the Corporate Bond 'Bubble'*, CNBC (Mar. 12, 2021, 2:31 PM), https://www.cnbc.com/2021/03/12/behind-the-corporate-bond-markets-10point5-trillion-debt-bubble.html.

2. *See, e.g.*, Adam B. Badawi, Scott Dyreng, Elisabeth de Fontenay & Robert Hills, *Contractual Complexity in Debt Agreements: The Case of EBITDA* (Duke L. Sch. Pub. L. & Legal Theory Series No. 2019-67, 2021), https://ssrn.com/abstract=3455497.

as administrative agent for the loan, stumbled into a series of fateful mishaps that caused it to make a nearly $1 billion payout to Revlon's unsuspecting creditors—all by accident. Moreover, the transferred funds belonged *not* to Revlon, but to Citibank, for Revlon had neither directed a pay down on the loans nor provided the cash to do so. In yet another delicious coincidence, the lenders who reaped this wayward windfall were themselves hours away from launching a long-shot lawsuit of their own against Revlon and Citibank, seeking to recover the precise sum that had just (miraculously) fallen into their laps. That lawsuit was no longer needed, as the lucky lenders had just won the creditor equivalent of the Powerball lottery.[3]

On discovering its mistake, of course, Citibank promptly and urgently pressed for the return of the funds; but several lenders (representing about $500 million in face value) held fast, daring Citibank to sue if it wished to claw back its missing moolah. Citibank did just that, and the dispute eventually landed in Judge Jesse Furman's courtroom in the Southern District of New York for an animated bench trial in late 2020. The principal legal question was whether—on these facts—Citibank could obtain restitution for unjust enrichment under New York law, or alternatively whether the lenders were entitled to walk away with their fortuitous bounty. Most outside observers at the time (myself included) predicted that the bank would eventually eke out an expensive (if embarrassing) victory.[4] The law of restitution tends to look unfavorably on the recipients of mistaken benefits, and the known facts associated with this case seemingly fit the bill. That said, restitution is a strange and unpredictable bird, and the lenders advanced a full-throated defense, spotlighting a three-decade-old precedent in New York,[5] which they claimed accorded them "finders-keepers" rights. Their legal argument is more formally known as the Discharge-for-Value (DFV) defense, and it states

3. *See About*, POWERBALL, https://www.powerball.com/about (last visited Sept. 19, 2021).

4. *See* Chris Dolmetsch & Katherine Doherty, *Bank Error in Your Favor: Citi's Fight to Reclaim $900 Million*, BLOOMBERG (Dec. 7, 2020) https://www.bloomberg.com/news/articles/2020-12-07/bank-error-in-your-favor-citi-s-fight-to-reclaim-900-million ("Citibank has 'a pretty strong case, said Eric Talley, a professor of corporate law at Columbia Law School, but it's 'not so crystal clear that it doesn't involve a little bit of risk.'").

5. Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189 (N.Y. 1991).

that the recipient of a mistaken payment, lacking knowledge of the error, can keep the funds and "should be able to consider the transfer of funds as a final and complete transaction, not subject to revocation."[6] Animating this principle is a longstanding policy goal of maintaining the finality of bank transactions, especially wire transfers that occur frequently throughout the day.[7]

In a noteworthy opinion issued on February 16, 2021, Judge Furman surprised many and sided with the lenders, holding that their DFV defense was successful and that the recipients were not on constructive notice of Citibank's mistake "at the moment they received the . . . wire transfers."[8] Even though the lenders were promptly notified of Citibank's mistake and had not changed their position in reliance, he held, the "magic moment" of fund transfer had already occurred, and the aforementioned judicial policy favoring finality of payments controlled.[9] The transferred funds could not be clawed back, and the lucky lenders could keep it in satisfaction of their debt claims. For its part, Citibank was left with an expensive write down, as well as the dubious consolation prize of stepping into the lenders' shoes as Revlon's new primary creditor (having effectively "purchased" the notes at a substantial market premium).[10] If Citibank wants to avoid outcomes like this in the future, the court warned, it should beef up its internal controls so as to "eliminate the risk altogether" that Black

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6. *Id.* at 196; *see also* RESTATEMENT (FIRST) OF RESTITUTION § 14 (AM. L. INST. 1937).

7. *See Banque Worms*, 570 N.E.2d at 192–96.

8. *In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 396–97 (S.D.N.Y. 2021).

9. *Id.* at 423.

10. Jennifer Surane, *Citigroup Restates Earnings After Writing Down Revlon Loan*, BLOOMBERG (Feb. 26, 2021), https://www.bloomberg.com/news/articles/2021-02-26/citi-says-regulators-in-asia-probing-equity-sales-trading-desk. In May 2021, the court denied Citibank's motion for a stay on the judgment, finalizing its February opinion notwithstanding the appeal. *See In re* Citibank Aug. 11, 2020 Wire Transfers, No. 20-CV-6539, 2021 WL 1905002, at *7 (S.D.N.Y. May 12, 2021). Citibank may even be forced to re-pay some of the money to recipients who gave the errant payment back. *See* Jennifer Surane, Chris Dolmetsch & Katherine Doherty, *Citi Lawyer Cites Mystery Bank He Says Made Even Bigger Flub*, BLOOMBERG (Apr. 9, 2021), https://www.bloomberg.com/news/articles/2021-04-09/citi-says-it-knows-of-another-bank-making-big-payment-error.

Swan events such as this one will happen again.[11] Citibank has filed an appeal with the Second Circuit, which is pending at the time of this writing.[12]

The reception of Judge Furman's opinion has been spirited, to say the least.[13] On the one hand, for law students, professors, and the legal press, it is hard not to get excited about the *mere existence* of this case. The facts are rich, the dispute newsworthy, and the stakes enormous. Regardless of how the case comes out on appeal, *Citibank* seems destined to find its way into the precedential pantheon of first-year casebooks, enlivening class discussions for years to come. That said, it is equally hard not to channel one's inner Oliver Wendell Holmes in suspecting that juicy cases like this tend to make bad law.[14] Numerous observers expressed significant unease about the outcome, focusing on the reasoning in the decision, its potential to unsettle debt markets, and its inconsistency with fundamental economic intuitions concerning contract design and governance.[15] (In the interests of full disclosure, I was one of these commentators, coordinating an amicus brief on behalf of myself and a dozen contract law professors lodging our concerns.[16])

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11. *In re Citibank*, 520 F. Supp. 3d at 451. *See also* NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007) (popularizing the "Black Swan" terminology to describe rare, highly improbable events).

12. *See* Chris Dolmetsch, *Citi Faces 'Finders Keepers' in Fighting $500 Million Ruling*, BLOOMBERG (Feb. 17, 2021), https://www.bloomberg.com/news/articles/2021-02-17/citi-faces-finders-keepers-law-in-fighting-500-million-ruling.

13. *See, e.g.*, Matt Levine, *Citi Can't Have Its $900 Million Back*, BLOOMBERG OPINION (Feb. 17, 2021, 12:33 PM), https://www.bloomberg.com/opinion/articles/2021-02-17/citi-can-t-have-its-900-million-back.

14. *See* N. Sec. Co. v. United States, 193 U.S. 197, 400 (Holmes, J., dissenting) ("Great cases like hard cases make bad law.").

15. *See, e.g.*, Elisabeth de Fontenay, *The $900 Million Mistake:* In re *Citibank August 11, 2020 Wire Transfers (S.D.N.Y. Feb. 16, 2021)*, CAP. MKTS. L.J. (forthcoming 2021), https://ssrn.com/abstract=3844646; Sneha Pandya & Eric Talley, *How the Litigious Bird Caught the (Banque) Worm*, CLS BLUE SKY BLOG (Feb. 24, 2021), https://clsbluesky.law.columbia.edu/2021/02/24/how-the-litigious-bird-caught-the-banque-worm/.

16. *See* Brief of Professors of L. & Econ. as Amici Curiae in Support of Plaintiff-Appellant, Citibank v. Brigade Cap. Mgmt., LP, No. 21-487-CV (2d Cir. Jul. 23, 2021). This was one of several amicus briefs filed with the Second Circuit, and others similarly criticized the opinion. *See, e.g.*, Brief for Am. Bankers Ass'n et al. in Support of Plaintiff-Appellant's Appeal, Citibank

This Article, however, does not endeavor to dwell on that doctrinal and theoretical pose-down; rather, it uses the *Citibank* opinion as a lens to understand empirically how contract law evolves, both in the courtroom and on the ground. To the extent that critics' skepticism about the outcome has practical merit (and is not merely armchair theorizing), it generates several empirical predictions about how sophisticated market participants would react. The most immediate of these—and my principal target here—is about whether/how private contracting practices responded to Judge Furman's surprise ruling. Notwithstanding the newsworthy outcome of the case (or one's assessment of it), virtually all commentators agree that the ruling still announces a *default* rule—one that can be altered (at some expense) by express contractual provisions.[17] Consequently, if *Citibank* imposed the disruptions and inefficiencies that critics claim, then it follows that sophisticated contracting parties would respond to the opinion *not* by altering their internal controls, but *rather* by changing their contract terms to narrow or negate (a.k.a. "discharge"[18]) the DFV doctrine altogether. And at least some market participants proposed this response, releasing model contractual provisions (popularly dubbed "Revlon blockers") that purportedly would do the job.[19] Anecdotal evidence suggests that at

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v. Brigade Cap. Mgmt., LP, No. 21-487-CV (2d Cir. May 7, 2021); Brief for Amicus Curiae Loan Syndications and Trading Ass'n in Support of Plaintiff-Appellant & Reversal, Citibank v. Brigade Cap. Mgmt., LP, No. 21-487-CV (2d Cir. May 6, 2021).

17. *See* Pandya & Talley, *supra* note 15.

18. As used in this Article, the word "discharge" is intended to play on dual meanings. While people can (and do) debate whether the lenders *legally discharged* their burden of proving the DFV defense, my results suggest that market participants have *functionally discharged* the DFV doctrine by explicitly defanging it through their debt contracts. *See Discharge*, DICTIONARY BY MERRIAM WEBSTER, https://www.merriam-webster.com/dictionary/discharge (last visited Sept. 19, 2021).

19. *See Erroneous Payment Provision*, LOAN SYNDICATIONS & TRADING ASS'N (Mar. 19, 2021), https://www.lsta.org/content/erroneous-payment-provision/; *Blackline of Draft of Erroneous Payments*, LOAN SYNDICATIONS & TRADING ASS'N (June 16, 2021), https://www.lsta.org/content/blackline-of-draft-of-erroneous-payments/. The Loan Market Association ("LMA") also released a template on June 30, 2021. *See* Amanda Montano, *What Happens if You Make a Payment in Error? – The LMA Responds to the Revlon Loan Dispute*, JD SUPRA (July 6, 2021), https://www.jdsupra.com/legalnews/what-happens-if-you-make-a-payment-in-1226386/.

least some new debt contracts embraced such provisions shortly after the decision.[20] If, on the other hand, the *Citibank* opinion did not unsettle expectations or impose inefficient risks and costs, then market participants should not rush the exits; they should instead either do nothing or explicitly *embrace* the outcome in their contractual language.

These empirical questions are the key subject of this Article. Using a hand-collected data set of publicly disclosed debt contracts from January 2020 through the end of July 2021, I isolate the incidence of express contractual provisions related to mistaken payments. This time span allows one to analyze not only the response to the *Citibank* litigation and opinion, but also the practices that prevailed beforehand. I then use a variety of computational text analysis tools to assess the semantic content and structure of such provisions, and I deploy several standard empirical tools from finance to tease out both the drivers of adoption and market reactions.

My analysis yields four key findings. First, a small but detectable trickle of Revlon blocker provisions began to take root right after Citibank's gaffe, just as the litigation was heating up. But that trickle swelled to a veritable flood almost immediately after the opinion issued in February 2021, culminating in *between 150 and 200 Revlon blockers disclosed per month* among publicly listed companies—a trend that substantially continued thereafter. By contrast, I could discern only a *single instance* of a provision that explicitly endorsed the trial court's interpretation of the DFV defense. This pattern is consistent with two of the reactions that disinterested observers widely offered about the opinion: (a) That the holding delivered a surprise result; and (b) that the surprise was an unpleasant one to many market participants.[21] Second, my analysis yields insights about the structure and content of the contractual

20. *See* Jenny Warshafsky, *Revlon Agent Clawback*, XTRACT RSCH. (Mar. 2, 2021).

21. Or, as Bloomberg commentator Matt Levine recently put it (in a piece summarizing this Article), "[t]he [trial court's] message here is something like 'banks need to be more careful with their money, and to teach them a lesson I won't let Citi have its money back.' And the banks responded, rationally, by changing their contracts so they don't have to be more careful." Matt Levine, *Insiders Trade in Outside Companies*, BLOOMBERG OPINION (Aug. 25, 2021, 12:25 PM), https://www.bloomberg.com/opinion/articles/2021-08-25/insiders-trade-in-outside-companies.

provisions that adopters embraced. Using a variety of tools from machine learning, I show that—somewhat surprisingly—Revlon blockers do *not* follow a single "cookie cutter" template, where parties copy and paste identical template language from deal to deal with little variation. While the most prominent *model* provision is also the *modal* provision, my analysis suggests that there have also been at least two other clusters (or "families") of Revlon blockers that market participants have embraced, both of which are distinct from cut-and-paste near-clones of the model. Third, I show that adoption of blockers has been wide ranging across firms. Adoption does not seem limited to a single industry, sector, or incorporation jurisdiction. Adoptions do, however, tend to be more concentrated among firms with more at stake: although firm size is not dispositive per se, adoptions are strongly concentrated in companies with larger absolute and relative debt loads and issuers with high relative profitability (as measured by return on assets). Trading premia, in contrast (as measured by Tobin's Q), are negatively associated with adoption. These findings suggests that adoptions are concentrated among those firms with the largest stakes and with elevated prospects for shareholder-debtholder conflict. Finally, and somewhat more preliminarily, I uncover evidence about the relationship between Revlon blocker adoption and market reception. Using an event study approach, I find a positive (but modest) price response to the mean adopter's first disclosure of a Revlon blocker. In light of the possibility that news of blocker adoption may have leaked prior to its public disclosure, I also consider the effect of the *Citibank* opinion itself (which seems clearly to have been a surprise). Here, I find discernible positive abnormal returns for adopting issuers (as well as for predicted adopters) in the days following the opinion. While this evidence is admittedly partial and incomplete (e.g., it does not measure gains in contractual surplus to all parties), it is suggestive that the market on the whole has approved of Revlon blocker adoption.

My analysis proceeds as follows. Part I describes the colorful background to the *Citibank* case, including the roiling creditor dispute that Revlon (and Citibank) were already contending with by mid-2020. The part concludes with a more detailed description of how the erroneous transfer payment came about. Part II discusses the legal claims at stake in the trial

court, concentrating on the delectably named *Banque Worms* case that established the New York precedent for the DFV defense some three decades ago, and which provided the key authority for the trial court's findings. The part then summarizes a variety of internal and external criticisms of the opinion—criticisms that themselves animate a variety of empirical questions. Part III takes on that empirical analysis, describing and analyzing my Revlon blocker data set, analyzing the textual content of such terms, assessing the characteristics of adopters, and gauging market responses. The Article then briefly concludes.

I.
Setting the Stage

As with many financial calamities, it is important to have a sense of the context against which Citibank's unfolded. Doing so will not only provide an important interpretive lens through which to evaluate the opinion itself, but it will also help frame the empirical analysis that follows. Accordingly, this part touches on the high points, with the most important insight being that the circumstances preceding Citibank's mistaken payment were anything but humdrum. This was no "clear day" blunder that dropped out of nowhere: rather, it occurred at the very peak of an acrimonious kerfuffle between Revlon and several of its major lenders—one that had already implicated Citibank directly.

A. *Revlon's Leveraged Finance*

To get a full sense of the backstory, one must go back to mid-2016, when the syndicated loans at issue were designed, executed and funded.[22] It merits observing that even prior to these loans, Revlon was hardly a stranger to leveraged finance. In fact, the company is widely recognized by corporate lawyers as the poster child and namesake for one of the most famous opinions in Delaware corporate law—one spawned from a debt-fueled hostile takeover of the company in the mid-1980s and successfully engineered by its current controlling share-

22. *In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 397 (S.D.N.Y. 2021).

holder, Ronald Perelman.[23] That takeover was part of a mammoth wave of leveraged buyouts and recapitalizations that typified the decade, maneuvers that sowed the seeds for the large-scale reliance on both public and private debt that countless large companies exhibit today. By the mid 2010s, in fact, Revlon was no longer particularly special in the leveraged finance world—but rather it was just one of myriad companies that were recidivist users of corporate debt to finance their activities, including additional acquisitions.[24]

For Revlon, one such acquisition came in 2016, when the company announced a much-touted $900 million cash purchase of Elizabeth Arden, Inc.—the high-profile cosmetics, skin care and fragrance company. To finance the transaction, Revlon entered into a new $1.8 billion term loan facility with a syndicate of hundreds of lenders,[25] and Citibank was a key underwriter for the loan facility. The term loans were funded and publicly disclosed in early September 2016 (at the same time the Arden acquisition closed).[26] The 180-page term loan agreement[27] spelled out in arduous detail a structure whereby the loans were to be backed by a variety of assets consisting substantially of intellectual property (IP) owned by Revlon's chief operating subsidiary, Revlon Consumer Products Corp. (RCPC).[28] These IP assets included, inter alia, those associated with the newly acquired Elizabeth Arden line.[29]

After it had successfully recruited hundreds of third-party lenders into the syndicate, Citibank remained as a contractual party to the deal, serving as the administrative agent for the loan facility. In such a capacity, Citibank was obliged to pro-

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23. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

24. According to Compustat data, the ratio of Revlon's debt to total assets from 2010–19 was 1.09 on average. The sector wide average (Standard Industrial Code 2844) was 1.54. Data on file with author.

25. Revlon, Inc., Term Credit Agreement (Form 8-K) (Sept. 7, 2016), https://www.sec.gov/Archives/edgar/data/887921/000156761916002919/s001409x1_ex10-1.htm [hereinafter 2016 Agreement].

26. *See* Sharon Terlep, *Revlon Agrees to Buy Elizabeth Arden*, WALL ST. J. (June 16, 2016, 10:37 PM), https://www.wsj.com/articles/revlon-agrees-to-buy-elizabeth-arden-for-870-million-1466110938.

27. 2016 Agreement, *supra* note 25.

28. *See* Complaint at 18, UMB Bank, Nat'l Ass'n v. Revlon, Inc., No. 1:20-cv-06352 (S.D.N.Y. Aug. 12, 2020) [hereinafter UMB Complaint].

29. *Id.*

cess periodic interest payments to the lenders as well as the scheduled retirement of the loan in 2023.[30] In addition, if Revlon chose to pay down the loan early (an option it was free to exercise without penalty), Citibank was contractually required to notify lenders of such a paydown in advance and then to process its execution.[31] Several provisions of the loan facility were restructured in some (relatively modest) ways over the next few years, but it had remained substantially in its original form.

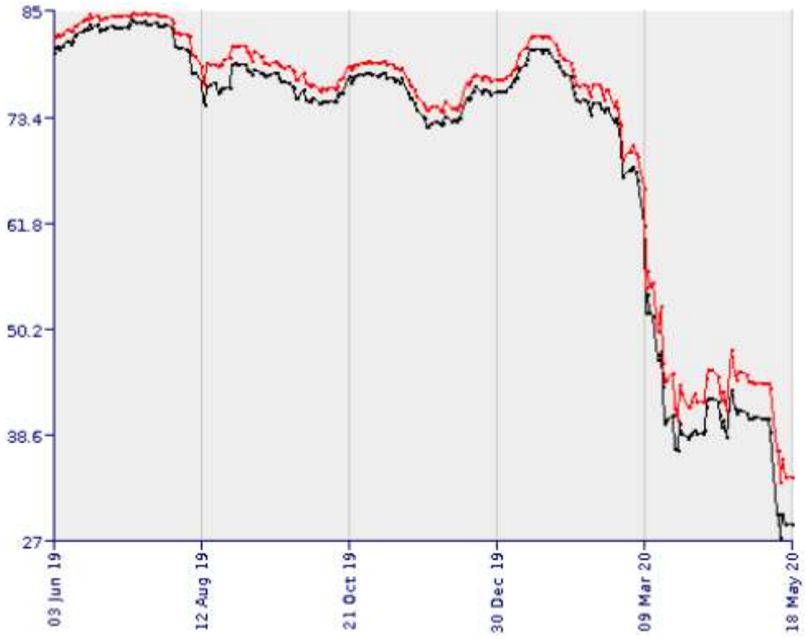

FIGURE 1: TRADING VALUE 2016 TERM LOANS
(FACE VALUE = 100.0)[32]

In the latter part of 2019, Revlon began to experience a flagging cosmetics market—one that would only get worse as the onset of the COVID–19 pandemic set in during early

30. *In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 397–98 (S.D.N.Y. 2021).

31. *See id.* at 398–99; 2016 Agreement, *supra* note 25, § 2.11.

32. The diagram in Figure 1 is reproduced from a complaint by the creditors against Revlon. *See* UMB Complaint, *supra* note 28. Although the complaint is somewhat light on detail, the red and black lines denote the

2020.[33] Revlon's stock price began to tank in response, losing over 50% of its value in the six months between November 2019 and May 2020.[34] Revlon's debt claims also got hammered, and they too began trading at steep discounts. As Figure 1 illustrates, the specific debt claims created by the 2016 term loan facility were no exception. The term loans were trading at around a 25% discount to face value through the end of 2019, and by the end of March 2020 that discount had ballooned to 60%.[35] In short, these numbers were ugly and growing worse. Try as it might, Revlon was hard-pressed to put lipstick on this pig—even with high-end product from the Elizabeth Arden line.[36]

As the spring rolled on, Revlon's financial advisers began considering means by which capital structure could be altered to free up much-needed cash to cope with a business environment that analysts increasingly considered unsustainable.[37] That investigation, in turn, led Revlon right back to one of the company's largest debt burdens: the 2016 term loan facility. Revlon's advisors floated a "solution" whereby the company would transfer the intellectual property assets out of the collateral pools backing the term loans and into the hands of newly created Revlon affiliates, who could then proceed to borrow against the newly unencumbered assets.[38]

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best prevailing offer and bid (respectively) in the secondary market for the 2016 loans.

33. Zoe Wood, *Sleeping Beauty Halls: How Covid-19 Upended the 'Lipstick Index'*, GUARDIAN, (Dec. 18, 2020, 10:34 PM), https://www.theguardian.com/business/2020/dec/18/how-covid-19-upended-the-lipstick-index-pandemic-cosmetic-sales-makeup-skincare.

34. *See, e.g.*, Revlon, Inc. (REV) Historical Prices from Oct. 31, 2019 to May 29, 2020, YAHOO! FIN., https://finance.yahoo.com/quote/REV/history?period1=1572566400&period2=1590796800&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true (last visited Sept. 27, 2021).

35. *See supra* Figure 1.

36. And even if it could, the lipstick was all but certain to be obscured under an N-95 mask anyway.

37. *See Rating Action: Moody's Views Revlon's Transactions as Distressed Exchange, Downgrades Unsecured Notes to C*, MOODY'S INVESTORS SERVICE (May 8, 2020), https://www.moodys.com/research/Moodys-views-Revlons-transactions-as-distressed-exchange-downgrades-unsecured-notes—PR_424166 ("Revlon's operations and restructuring actions have consumed a large amount of cash (over $150 [m]illion) over the past year, and Moody's expects the company to be free cash flow negative in the year ahead.").

38. *See* UMB Complaint, *supra* note 28, at 3–4.

To pull off the proposed restructuring, however, Revlon would need to alter several contractual covenants from the 2016 indenture that appeared to prohibit this type of collateral shifting. In order to do that, it was going to need the consent of a majority of lenders (tabulated through a vote tied to principal loan balance held).[39] Most rational lenders, of course, would be reluctant to approve the removal of collateral unless offered some type of incentive. Here, Revlon borrowed a well-worn page from the playbook of strategic debt restructuring: as part of the deal, consenting creditors would be afforded the opportunity to exchange their claims for newly-issued debt securities that had less attractive financial terms but a higher-priority claim on the relocated IP collateral—effectively pushing them ahead of the 2016 term loan claims they were leaving behind.[40] In other words, creditors who voted to approve the restructuring were going to be permitted to "cut the line" to collect ahead of any hold-outs. While not an uncommon refinancing tactic, such proposals frequently rankle incumbent creditors, who feel (often justifiably) that they have been pitted against one another in a Hunger-Games-worthy battle royale over scarce resources,[41] each frantically attempting to backstab others so as to move up in line through their vote.[42] Of course, the great irony of such situations is that if *all* creditors responded in such a way, they would *all* cut the line simultaneously, and in the end no one would have moved up (in a relative sense) from where they all started.[43]

Typically, when debt is held by a large number of investors (as was Revlon's), the collective action problem described above is difficult to counteract, and a restructuring proposal like this one has a good chance of succeeding—even as it causes the assenting bondholders to be grumpy about their

39. *See* 2016 Agreement, *supra* note 25, § 10.1(a)(E).

40. UMB Complaint, *supra* note 28, at 43.

41. avadaakadavra, *The Hunger Games – Cornucopia Bloodbath [HD],* YouTube (Sept.7, 2012), https://www.youtube.com/watch?v=C7EIW_C0-9c.

42. Within the world of publicly traded debt, this type of aggressive restructuring is sometimes called an "exit exchange" offer, and it has been a staple of refinancing since it was upheld as presumptively valid in the 1980s. *See generally* Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. 1986).

43. For more on the strategic aspects of this type of restructuring, *see* Antonio E. Bernardo & Eric L. Talley, *Investment Policy and Exit-Exchange Offers Within Financially Distressed Firms,* 51 J. Fin. 871 (1996).

predicament. Indeed, several of Revlon's lenders reluctantly acquiesced to the restructuring proposal. But in something of a surprise, several large creditors managed to coordinate with one another, executing a mutual cooperation agreement in which they collectively agreed to vote against the planned May 2020 restructuring.[44] With mounting opposition (and negative votes) from a large bloc of lenders, Revlon now faced a far steeper challenge to restructuring the term loans in the manner it had planned.

Facing this burgeoning creditor rebellion,[45] Revlon began counter-mobilizing.[46] In late spring of 2020, the company entered into several new revolving lines of credit, all with existing term lenders who supported the restructuring plan. As observers at the time widely noted, it was an open secret that this new borrowing had little to do with Revlon's capital needs.[47] It had a lot to do with ginning up votes, however: for hidden within the original 2016 term loan agreement was a provision that bestowed additional votes on new "Revolving Commitments" extended by any term lender—votes that the lenders were entitled to cast alongside their existing claims for purposes of consenting to a restructuring.[48] By entering into such (allegedly "sham") arrangements with a curated coterie of confederates, critics contended, Revlon was rigging the vote in its favor. It evidently worked, for when the dust finally settled in May 2020, the majority of 2016 term loan creditors (joined by the new votes tied to the revolvers) narrowly approved the restructuring proposal by a bare *half of one percent*,[49] thereby enabling

44. UMB Complaint, *supra* note 28, at 27.

45. *Id.* at 5–6.

46. *See, e.g.*, Revlon, Inc., Current Report (Form 8-K) (Apr. 14, 2020), https://www.sec.gov/Archives/edgar/data/0000887921/000095014220001109/eh2000629_8k.htm.

47. *See, e.g.*, *Predatory Priming: How Can Investors Protect Their Priority?*, O'Melveny: Alerts & Publications (Sept. 9, 2020), https://www.omm.com/resources/alerts-and-publications/publications/predatory-priming-how-can-investors-protect-their-priority.

48. 2016 Agreement, *supra* note 25, § 1.1. The terms of the restructuring required Revlon to procure the consent of the "Required Lenders," defined under the 2016 Credit Agreement as "holders of more than 50% of . . . the sum of (i) the aggregate unpaid principal amount of the Term Loans then outstanding, (ii) the Revolving Commitments then in effect, if any . . . ."

49. UMB Complaint, *supra* note 28, at 40.

the collateral removal and significantly undermining further the remaining value of the 2016 Term Loans.

As one might surmise, the dissenting "hold-out" lenders were fit to be tied, and several proceeded to draft a complaint alleging: (a) that the refinancing had breached the 2016 term loan agreement, (b) that the new revolvers also abrogated the agreement, (c) that the restructuring was invalid, (d) that all of this had been done with Citibank's active assistance and encouragement; and (e) that the principal balance on the term loans was immediately due and payable. UMB Bank—a purported assignee of several objecting lenders—filed its 117-page complaint detailing their objections on August 12, 2020.[50] Even today, as one reads the lenders' complaint (and understands it as such), the sheer degree of acrimony between the parties captured in the rhetoric is notable.[51]

Just as the legal fracas between Revlon and its creditors was in its ultimate pre-launch countdown, fate famously intervened. Unbeknownst to the attorneys finalizing and filing the UMB complaint, the prior 24 hours had been a doozy, both for Revlon and (especially) for Citibank. For it was on August 11, 2020—just a day before the creditors sued—that Citibank's employees lapsed into one of the most infamous "fat finger" faux pas in financial history, erroneously sending a face-value payoff of the bonds to all the hold-outs.

B. *Citibank's Historic Blunder*

Although the details of Citibank's blunder have been documented in detail by now,[52] it is worth briefly noting what transpired at a high level. As mentioned above, several of the term lenders were *not* holdouts, but instead had acceded both to approve the restructuring and to exercise the right to exchange their existing debt contracts with "new" debt contracts with higher priority claims against the shifted IP collateral. The mechanics for making the change required Citibank (as administrator) to round up the various consenting creditors

50. *Id.* UMB Bank also claimed to be the new Administrative Agent on the Term Loans, but principally brought its suit pursuant to an assignment of rights from several Term Lenders that opposed the 2020 restructuring. *Id* at 12.

51. For example, the complaint uses the term "theft" six times and some form of the verb "steal" eight times. *Id.*

52. *See, e.g.*, Levine, *supra* note 13.

and "migrate" their accounts over into the new debt securities.[53] Such measures—conventionally called "roll ups"—are common during corporate refinancings. But executing such migrations can often be cumbersome, since (a) the consenters and the holdouts must now be treated differently and (b) the migrations typically occur at an interim point between scheduled interest payments, so that the borrower must generally make good on whatever partial interest has accrued as of the date of the roll-up. The process of executing a roll-up is cumbersome enough that in practice, it has become routine to simplify step (b) by making the partial interest payment to *all* lenders, even the holdouts who are not migrating their claims. Such categorical interest payments usually concede a small benefit to these holdouts, but they do so in the name of administrative ease.

Consequently, in order to execute the roll-up, Citibank planned to make an interim interest payment to all of the term lenders, but then "rapture" the consenting lenders out of the population and into their new claims.[54] To do this, however, Citibank's internal systems required a series of manual acrobatics to override the system's hard-wired instructions that all debtholders must receive identical treatment in all matters.[55] The most efficacious way to coax the software system into performing this feat was evidently to treat *all* creditors (even the holdouts) as if their position was being liquidated, moving holdouts' balances out of the account, and parking it temporarily in a shadow (or "wash") account.[56] Once the consenters had migrated out to their new positions, the wash account balance could simply be shifted back as part of a "rebuild" of the holdouts' original position.[57] The process for orchestrating these maneuvers evidently involved several manual overrides made in less-than-intuitive locations in Citibank's software program. Through a series of mishaps and crossed wires (documented at greater length in court proceedings), these manual entries were mis-entered, the errors went undetected by the triple-layer Citibank review process, and a nightmare scenario

53. *See In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 399 (S.D.N.Y. 2021).

54. *Id.* at 400.

55. *Id.* at 400–01.

56. *Id.*

57. *Id.* at 401.

ensued: at the close of business on August 11th, Citibank not only paid out the partial interest (around $7.8 million) to all lenders as planned, but it also inadvertently released the balance of the wash account to the holdouts—returning to them the face value of their loans (around $900 million all told)—the full sum they were hoping to recover in their imminent lawsuit.[58] Making matters worse (for Citibank), Revlon had neither authorized nor bankrolled an early liquidation of the holdouts' claims. Citibank had made the mistaken transfer with its own money.[59]

On the morning of August 12th, some thirteen hours later (and just as the lawyers for the holdouts were preparing to file their own complaint), Citibank employees discovered the erroneous transfer and sent several (progressively panicked) notices to the hold-out creditors, informing them of the mistake and urgently requesting the return of the wayward payments.[60] Although several lenders cooperated, ten of them—representing around $500 million in principal—dug in, refusing to return the cash.[61] From their perspective, their litigious prayers had just been unexpectedly and miraculously answered, and they were not about to return anything. If Citibank wanted to claw back its ill-fated transfer, it would have to file a lawsuit of its own.

And that's just what Citibank did.

II.
THE *CITIBANK* LITIGATION AND ITS AFTERMATH

Though already expecting to become a co-defendant in the term lenders' breach of contract lawsuit, Citibank now found itself as the sole plaintiff in a much more pressing claim, seeking to recover a half-billion-dollar misguided payment of its own cash. Citibank filed suit within a week of the error, and

58. *See id.* at 396, 400–05; UMB Complaint, *supra* note 28, at 116. The creditors were also seeking prejudgment interest and costs. *Id.*

59. *See In re Citibank*, 520 F. Supp. 3d at 404.

60. *See id.* at 405.

61. *See id.* at 397–98 (Those refusing to return the mistaken payments were Brigade Capital Management, LP; HPS Investment Partners, LLC; Symphony Asset Management LLC; Bardin Hill Loan Management LLC; Greywolf Loan Management LP; ZAIS Group LLC; Allstate Investment Management Company; Medalist Partners Corporate Finance LLC; Tall Tree Investment Management LLC; and New Generation Advisors LLC.).

the consolidated cases eventually landed in U.S. District Court Judge Jesse Furman's courtroom in the Southern District of New York. Trial took place in December 2020, over the (then) unconventional platform of Zoom, with most witnesses appearing via affidavit.[62]

While Citibank asserted several claims against the defendants (including restitution, unjust enrichment and conversion), the central legal issue in the case was simple: whether the equitable principles of New York state law would allow Citibank to claw back the mistaken payment, or whether the lucky lenders were entitled to keep their unexpected bounty.[63] In garden-variety restitution actions that involve mistaken payments, Citibank appeared to stand a strong chance for success. Like most states, New York law "generally treats a failure to return money that is wired by mistake as unjust enrichment or conversion and requires that the recipient return such money to its sender."[64] Moreover, equitable considerations typically cut even *more* decisively in the transferor's favor when the recipient has not changed its position due to the payment.[65] These principles were at the core of Citibank's affirmative claims, and the court held that they shared substantially "overlapping elements",[66] requiring that the plaintiff (Citibank) prove that the defendant (the lenders) mistakenly received a benefit from the plaintiff; if they did so, then equity would or-

62. *Id.* at 410.

63. *Id.* at 396.

64. *Id.* In a similar vein, New York law holds that an unlawful conversion occurs "when someone, intentionally and without authority, assumes or exercises control over personal property belonging to someone else, interfering with that person's right of possession." *Id.* at 413–14 (quoting Colavito v. N.Y. Organ Donor Network, Inc., 860 N.E.2d 713, 717 (N.Y. 2006)). "To establish conversion, a plaintiff must show (1) its 'possessory right or interest in the property' and (2) 'defendant's dominion over the property or interference with it, in derogation of plaintiff's rights.'" *Id.* (quoting Chefs Diet Acquisition Corp. v. Lean Chefs, LLC, No. 14-CV-8467, 2016 WL 5416498, at *7 (S.D.N.Y. Sept. 28, 2016)); *accord* Colavito, 860 N.E.2d at 717.

65. *See, e.g.*, Nat'l Bank of Com. v. Nat'l Mechs.' Banking Ass'n., 55 N.Y. 211, 213 (1873).

66. *In re Citibank*, 520 F. Supp. 3d at 414 (first citing Briarpatch Ltd. v. Phoenix Pictures, Inc., 373 F.3d 296, 306 (2d Cir. 2004) (unjust enrichment); then citing Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, Nat'l Ass'n, 731 F.2d 112, 125 (2d Cir. 1984) (money had and received); and then citing United States *ex rel.* Ryan v. Staten Island Univ. Hosp., No. 04-CV-2483, 2011 WL 1841795, at *5 (E.D.N.Y. May 13, 2011) (payment by mistake)).

dinarily dictate that the benefit should be returned. Most commentators at the time (including this one) conjectured that while the lenders had some colorable claims, they would eventually be required to give back the errant bounty.[67]

All that said, the area of restitution is notoriously strange and unpredictable; no doubt appreciating this predilection, the lenders scoured New York case law for authority that would enable them to assert a "finders-keepers" equitable right to keep the cash. And lo and behold they stumbled on a doozey, in the form of the Discharge-for-Value (or DFV) doctrine, an affirmative defense stating that the recipient of a mistaken payment may lawfully retain the funds in satisfaction of a payment that is owed so long as the recipient is unaware of the error.[68] The real-world application of this principle is relatively uncommon, but when invoked it is typically buttressed by a subsidiary policy goal of maintaining the finality of bank transactions, especially wire transfers that occur frequently throughout every single day.[69] They repeatedly pointed to the DFV defense as the principal principle to govern the mis-paid principal.

A few months after trial concluded, Judge Furman issued a February 2021 opinion that surprised many observers, finding that the lenders had successfully asserted a DFV defense and holding accordingly that the wayward windfall was theirs to keep.[70]

A. *Digging up (Banque) Worms*

So how did the Lenders manage to secure their victory? To answer this question, it is necessary to dig a little deeper into the restitution wormhole. The DFV doctrine—a longstanding component part of the law of restitution[71]—had

67. *See, e.g.*, Dolmetsch & Doherty, *Bank Error in Your Favor: Citi's Fight to Reclaim $900 Million*, *supra* note 4 ("Citibank has 'a pretty strong case,' said Eric Talley, a professor of corporate law at Columbia Law School, but it's 'not so crystal clear that it doesn't involve a little bit of risk.'").

68. *See* Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 192 (N.Y. 1991); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 cmt. d (AM. L. INST. 2011).

69. *See Banque Worms*, 570 N.E.2d at 196.

70. *In re Citibank*, 520 F. Supp. 3d at 451.

71. *See, e.g.*, RESTATEMENT (FIRST) OF RESTITUTION § 14(1) (AM. L. INST. 1937).

been last on prominent public display in New York during the early 1990s, in a 30-year-old precedent delectably known as *Banque Worms v. BankAmerica International*.[72] Though seen only intermittently in the years since its publication, *Banque Worms* remained good law, lurking in the doctrinal waters of New York (possibly awaiting—not unlike the fabled Norse serpent Jörmungandr—its own jurisprudential Ragnarök). And by spotlighting *Banque Worms*, the lenders found a sympathetic ear in Judge Furman, who found the factual "fit" between its stated facts and the Citibank gaffe sufficiently close to compel the same outcome.

In many ways, the district court was onto something with the analogy: similar to the Citibank dispute, *Banque Worms* involved an agent who—ostensibly acting on behalf of a borrower—erroneously sent full payment of an outstanding corporate debt to a creditor, who then fought to keep the money (successfully).[73] The agent in that case was the then-prominent West Coast bank Security Pacific,[74] which had contracted with a debtor—an Australian company named Spedley Securities, Inc.—to act as Spedley's agent for executing payments on various line of credit (LOC) arrangements.[75] One of Spedley's principal LOCs was with the French financial firm Banque Worms, and by 1989 the balance on the loan hovered at around $1.9 million.[76] Under the terms of the LOC, the debt matured (and thus became due and payable) every three months, but Banque Worms also enjoyed a recurring option to "roll over" the debt at the conclusion of each three-month term (an option it had previously exercised multiple times).[77]

In spring of 1989, however, Spedley appeared to be on the brink of financial distress, and its creditors (Banque Worms included) grew antsy about being stiffed on their claims. Seeking an escape hatch, Banque Worms informed Spedley that it would not exercise its option to roll over its

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72. *See Banque Worms*, 570 N.E.2d 189.

73. *See id.* at 190–191.

74. At around the same time as the litigation, Security Pacific was acquired by Bank of America. Maya Blackmun, *Merger Will Cut 100 Jobs at Banks*, OREGONIAN (Portland, Ore.), May 27, 1992, at D06.

75. *See Banque Worms*, 570 N.E.2d at 190.

76. Banque Worms v. BankAmerica Int'l, 928 F.2d 538, 539 (2d Cir. 1991).

77. *Id.*

LOC when the then-current term expired in early April, and it demanded repayment of the outstanding principal balance.[78] On the date of LOC's expiry, Spedley appeared to flip-flop about whether it would release the money. At first, it sent the requisite funds to Security Pacific along with instructions to pay off the balance; but hours later, it sent a countermanding instruction, directing Security Pacific instead to send the payment to a different creditor.[79] Key Security Pacific employees failed to read the countermand, and the full principal balance was transferred to Banque Worms, thereby—at least from its perspective—zeroing out the balance on the expiring LOC.[80] At about the same time, a different group of key Security Pacific employees—who *did* see the countermand—directed the same payment to the substitute creditor per Spedley's revised instruction, even though Spedley had not provided sufficient capital to make both transfers.[81]

A familiar-sounding dispute ensued, with Banque Worms refusing (after some back-and-forth) to relinquish the payment. And when Security Pacific thereafter sought satisfaction from Spedley itself, it was met with the unpleasant news that Spedley had filed for bankruptcy.[82] With no other options, Security Pacific sought restitution from Banque Worms in the Southern District of New York (under diversity jurisdiction). The district court held for Banque Worms, noting that although the mistaken transfer of benefits is ordinarily recoverable in restitution, Banque Worms had successfully asserted the DFV defense.[83] The trial court predicated its analysis on the language from the First Restatement of Restitution, which states (in relevant part):

> **§ 14 Discharge for Value:** (1) A creditor of another or one having a lien on another's property who has received from a third person any benefit in discharge of the debt or lien, is under no duty to make restitution therefor, although the discharge was given by mistake of the transferor as to his interests or duties,

78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.* at 539–40.
82. *Id.* at 540
83. *Id.*

> if the transferee made no misrepresentation and did not have notice of the transferor's mistake.[84]

Because Banque Worms (a) had not misrepresented its position, and (b) had demanded (and received) full payment of the expiring LOC in good faith, the district court held the creditor's receipt of funds from Security Pacific did not put them on notice of a mistake, and the payment was theirs to keep in satisfaction of the debt.[85] The holding was promptly appealed to the Second Circuit, which found itself somewhat at sea, doctrinally, given the dearth of prior case law in New York related to the DFV defense. Rather than spit-balling a way out of the conundrum, the Second Circuit instead took the unusual step of certifying the case to the New York Court of Appeals, asking whether the Discharge-for-Value defense was valid under state law based on the adjudicated facts.[86] In a separate opinion, the Court of Appeals came back with an affirmative answer, holding "that the 'discharge for value' rule as set forth at section 14 of the Restatement of Restitution, should be applied in the circumstances in this case."[87] The court moreover held that the recipient's detrimental reliance (or lack thereof) was not an explicit factor in applying the doctrine.[88] Banque Worms' victory at the trial court was thereby sealed, and a lodestar in New York law took its place in the jurisprudential universe. The *Banque Worms* precedent, in turn, sat ready for another spotlight, which it received in Judge Furman's decision.

B. *District Court Opinion*

Over 105 sweeping pages, and after citing to the *Banque Worms* precedent nearly 100 times, the court explicitly shot down each key assertion that Citibank proffered in opposition to the DFV defense.[89] First, Judge Furman reaffirmed that the

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84. *Id.* (quoting RESTATEMENT (FIRST) OF RESTITUTION § 14(1) (AM. L. INST. 1937)).

85. *Id.* at 541.

86. Banque Worms v. BankAmerica Int'l, 928 F.2d 538, 541 (2d Cir. 1991)

87. Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 198 (N.Y. 1991)

88. *Id.* at 191.

89. *See In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390 (S.D.N.Y. 2021).

defense (according to his reading of *Banque Worms*) does not require the recipients to have changed their position in reliance on the mistaken payment.[90] Next, he rejected Citibank's categorical argument that the debt in question must be "due and payable" at the time of the mistake (which it was not here). It is sufficient, he opined, for the recipient to be "bona fide creditor."[91] Third, the court held that the "magic moment" from which to assess the defendant's knowledge in a DFV defense is the moment that the payment is received by the payee, not at some later moment when the recipient treats the debt as discharged (as Citibank had argued).[92]

The court thereupon turned its attention at length to a critical issue: formulating the appropriate test for whether a recipient of a mistaken benefit "knows" that an error has occurred, which would bar the DFV defense. Here, Judge Furman sided (at least nominally) with Citibank, holding that the "actual notice" requirement advocated by the lenders was too narrow, and that the doctrine should permit a more lenient "constructive notice" standard, whereby one imputes to the recipient whatever inferences a reasonable person would make upon receipt of a mistaken payment in similar circumstances.[93] The court observed that a constructive notice requirement was not only consistent with the Restatement, but also gleaned support from a long trail of New York law predating and postdating *Banque Worms*. Furman further observed that under New York law, constructive notice is often governed by an *inquiry notice* standard: that is, was the recipient aware of facts that would cause a reasonably prudent person to inquire whether a mistake was made?[94]

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90. *Id.* at 454 n.26.

91. *Id.* at 421.

92. *Id.*

93. *Id.* at 430–31.

94. *Id. See also* Marshall v. Milberg LLP, No. 07 Civ. 6950, 2009 WL 5177975, at *3 (S.D.N.Y. Dec. 23, 2009) ("Whether a [party] has such 'inquiry notice' or 'constructive notice' is judged under an objective standard . . . ."); Hicksville Props., LLC v. Wollenhaupt, 711 N.Y.S.2d 729, 729 (App. Div. 2000) (question of notice must examine "whether [defendant] 'had knowledge of facts that would lead a reasonably prudent person to make an inquiry' "). The Restatement also bears this point out:

> While imputed knowledge is described in practice under such various headings as "statutory notice," "record notice," "constructive notice," and "inquiry notice," or by reference to a person's "duty of

Having ratified Citibank's proffered knowledge standard, however, the court proceeded to hold that the facts and circumstances surrounding the mistaken payment were insufficient to put the lenders even on constructive notice of the error. To the contrary, Judge Furman observed, not only had the mistaken sums matched the total principal amount due each lender "to the penny," but the lenders had testified (persuasively, in his view) that they were utterly unsuspicious that the payment might be a mistake until Citibank sent formal recall notices several hours after the transfer closed (i.e., well after the "magic moment" of receipt).[95] In an effort to underscore this point, the court held that sophisticated banks like Citibank can be reasonably expected to have procedures in place to prevent the incidence of clerical mistakes like the one here.[96] Consequently, Judge Furman concluded, no reasonable person in the lenders' shoes would deduce that an unscheduled, unannounced full payment of nearly $1 billion could be a mistake.[97] Inferring a clerical error in this context would be, as Furman wrote (plausibly channeling the *Princess Bride* character Vizzini), nothing short of "inconceivable."[98]

Citibank fared no better with several additional policy arguments it advanced. Judge Furman, in fact, categorically cast aside these arguments, reasoning that although one might—on first principles—be sympathetic to several of Citibank's policy arguments in the absence of a controlling precedent, here "the Court does not write on a blank slate."[99] Finding the core facts of the case to be functionally indistinguishable from *Banque Worms*, the court held that the prior precedent was controlling, and no amount of legal policy wonkery could alter that conclusion.

> inquiry," the different labels attach to what is essentially a common idea. In particular circumstances, and for a variety of reasons, the law will treat a person as knowing a fact without requiring that such knowledge be proven directly.

RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 69 cmt. a (AM. L. INST. 2011).

95. *In re Citibank*, 520 F. Supp. 3d at 431–32.

96. *Id.* at 444.

97. *See id.* at 451.

98. *Id.* at 444; *see also* aqulia2sax, *The Princess Bride Inconceivable Clips*, YOUTUBE (July 12, 2012), https://www.youtube.com/watch?v=QHXjcZdk5QQ.

99. *In re Citibank*, 520 F. Supp. 3d at 451.

C. *Appeal and Reception*

Shortly after the opinion issued in February 2021, Citibank filed its appeal,[100] and the Second Circuit now has the ball (almost literally) in its court to determine whether *Banque Worms* controls as to the outcome of the case, or, instead, whether the restitution worm has turned. Given the fundamental aspects of New York contract law that are at stake, we may be in for a lengthy process: it would not be surprising if—like in *Banque Worms*—the panel were once again to certify the question to the New York Court of Appeal for refinement of and elaboration on when/how the DFV defense under New York law applies in the factual context present here.

In the meantime, there is by now no shortage of discussion among academics and practitioners about the Citibank holding—much of it critical and virtually all concentrating on a mixture of doctrinal and policy arguments.[101] As noted above, I have participated several times myself in that chorus of critics. The aim of this Article, however, is not to rehash those arguments, but rather to relocate the debate to the realm of empirical inquiry. Nevertheless, it is still necessary to understand the core conceptual criticisms of the case, since they in turn deliver empirically testable implications.

1. *Internal Critiques*

A key area of concern in the case relates to the internal reasoning in the opinion itself, and in particular its treatment of constructive notice. A few preliminary observations may help bear this point out. First consider the role of "inquiry" notice in cases like this one. As Judge Furman (correctly) noted, constructive notice is an important doctrinal cornerstone of the DFV defense. To assert it, a recipient typically must establish its "good faith" by proving that it had neither actual notice nor constructive notice of the transferor's mistake.[102] In turn, in most jurisdictions (including New York),

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100. At the time of this writing, oral argument has been scheduled for later in the fall. Jon Hill, *2nd Circ. Expedites Citi Appeal in $500M Revlon Transfer Fight*, LAW360 (Mar. 18, 2021, 9:21 PM), https://www.law360.com/articles/1366328/2nd-circ-expedites-citi-appeal-in-500m-revlon-transfer-fight.

101. *See supra* notes 12–13.

102. *See* Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 192 (N.Y. 1991) (quoting RESTATEMENT (FIRST) OF RESTITUTION § 14(1) (AM. L. INST.

the concept of constructive notice typically manifests as an *inquiry notice* litmus test: that is, was the asserting party aware of facts and/or circumstances that would cause a reasonably prudent person to inquire whether a mistake was made?[103] Because constructive/inquiry notice is a thoroughgoing objective standard, the asserting party's subjective beliefs, inferences, assumptions or deductions are not pertinent. Rather, the test turns on whether a *reasonable person,* in the position of the recipient and faced with the same facts, would have inquired whether the transfer was a mistake. If so, the recipient is charged with the knowledge it would have gained through the exercise of good faith and ordinary diligence, regardless of what it subjectively believed and irrespective of the steps it actually took.[104]

A second preliminary observation is about the role of *good faith.* Although already baked into the DFV defense, the con-

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1937); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 cmt. g (AM. L. INST. 2011) ("A payee's lack of notice is the essence of 'innocence' or 'good faith' in this context . . . ."); United States v. Orozco-Prada, 636 F. Supp. 1537, 1542 (S.D.N.Y. 1986) (the "burden of proof rests" with defendants asserting a bona fide purchaser defense "to establish that," inter alia, they "had neither actual nor constructive knowledge" of the rights of others in the transferred property); *accord In re* Calumet Farm, Inc., 398 F.3d 555, 560 (6th Cir. 2005); Qatar Nat'l Bank v. Winmar, Inc., 650 F. Supp. 2d 1, 10 (D.D.C. 2009).

103. *See, e.g.*, Marshall v. Milberg LLP, No. 07 Civ. 6950, 2009 WL 5177975, at *3 (S.D.N.Y. Dec. 23, 2009) ("Whether a [party] has such 'inquiry notice' or 'constructive notice' is judged under an objective standard . . . ."); Hicksville Props., LLC v. Wollenhaupt, 711 N.Y.S.2d 729, 729 (App. Div. 2000) (question of notice must examine "whether [defendant] had 'knowledge of facts that would lead a reasonably prudent person to make an inquiry'"); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 69 cmt. a (AM. L. INST. 2011) ("While imputed knowledge is described in practice under such various headings as 'statutory notice,' 'record notice,' 'constructive notice,' and 'inquiry notice,' or by reference to a person's 'duty of inquiry,' the different labels attach to what is essentially a common idea. In particular circumstances, and for a variety of reasons, the law will treat a person as knowing a fact without requiring that such knowledge be proven directly.").

104. *See* Booth v. Ameriquest Mortg. Co., 881 N.Y.S.2d 152, 153 (App. Div. 2009) ("[I]f a purchaser or encumbrancer knows facts that would 'excite the suspicion of an ordinarily prudent person' and fails to investigate, the purchaser or encumbrancer will be chargeable with that knowledge which a reasonable inquiry, as suggested by the facts, would have revealed." (quoting Miner v. Edwards, 634 N.Y.S.2d 306, 307 (App. Div. 1995)).

cept of good faith perhaps looms *especially* large in this case. Recall that in *Banque Worms*, Security Pacific was acting solely as an agent for the borrower (Spedley); the creditors who received the mistaken payments had no contractual relationship to Security Pacific whatsoever, other than indirectly in its capacity an agent of the original debtor.[105] For the Revlon loans, in contrast, all of the relevant parties—the lenders, Revlon and Citibank—were parties to (and signatories of) the credit agreement.[106] As such, they are not only bound to the express terms of the contract, but they also are bound by affirmative duties of good faith and fair dealing to one another—which adhere to all parties to a contract.[107] Consequently, even though the good faith of a mistaken payment recipient already animates the DFV defense in a limited way (when asserted), its importance is magnified here by dint of the pre-existing good faith duty of the lenders and Citibank in all their interactions.

Against this backdrop, this subpart highlights three aspects of the district court opinion that seem especially suspicious: (i) its treatment of the burden of proof; (ii) the logic behind its application of the constructive notice standard in the light of that burden; and (iii) the important role played by the fact that the debt here was not only far short of maturity, but also deeply discounted. I consider them in turn.

a. Burden Allocation

The first oddity about the court's reasoning is its treatment of how to allocate the burden of proof under the DFV doctrine. Under well-settled law (and as was stipulated in trial itself),[108] DFV is an "affirmative defense."[109] Consequently, the burden rests on the party asserting the defense (here the lend-

105. *See Banque Worms*, 570 N.E.2d at 190–91.

106. *See In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 397 (S.D.N.Y. 2021).

107. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS, § 205 (AM. L. INST. 1997) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.").

108. *See In re Citibank*, 520 F. Supp. 3d at 428.

109. *See, e.g.*, Awal Bank, BSC v. HSBC Bank USA (*In re* Awal Bank, BSC), 455 B.R. 73, 93 (Bankr. S.D.N.Y. 2011) ("[T]he discharge for value rule is an affirmative defense to be asserted by answer, and a plaintiff 'does not bear the burden of raising and refuting this defense . . . .'") (quoting T.D. Bank, N.A. v. JP Morgan Chase, N.A., No. 10-CV-2843, 2010 U.S. Dist. LEXIS 109471 at *40 (E.D.N.Y Oct. 14, 2010)).

ers) to establish its elements; the plaintiff bears no duty to disprove them.[110] Yet, the district court's opinion is decidedly indecisive about how it allocated the burden. In fact, the court mused (somewhat oddly) that there was a "strong argument" to be made that Citibank (and not the lenders) should carry the burden of proving *bad* faith "if only because it would not involve proving a negative."[111] This declaration is both analytically dubious and doctrinally curious. As a matter of pure analytic logic, there is simply nothing especially vexing about "proving a negative" versus an affirmative proposition.[112] Nor is the concept terribly meaningful in probabilistic settings.[113]

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110. *See, e.g.*, Krueger v. United States, 246 U.S. 69, 78 (1918) ("The defense of bona fide purchaser is an affirmative one, and the burden was upon [defendant] to establish it . . . ."); Leopold v. Baccarat, Inc., 239 F.3d 243, 245 (2d Cir. 2001) ("It is well-established that a defendant . . . bears the burden of proving its affirmative defense.").

111. *In re Citibank*, 520 F. Supp. 3d at 454 n.32.

112. As a matter of logic, the aphorism "you can't prove a negative" falls prey to several well-known parlor tricks of semantic deconstruction. Most whimsically, the aphorism itself is a negative, and thus if one were to ever to assert it provably correct, that assertion alone would be self-refuting. More seriously, the statement makes little sense as a proposition of deductive reasoning, since virtually any analytic proposition can be restated as a negative. Suppose, for example, that there were only two states of the world, "A" and "B", which are mutually exclusive and exhaustive. The set {"A is true", "B is true"} is thus a collection of affirmative propositions that fully partition the state space. Now suppose further (for the sake of argument and consistent with the aphorism) that both affirmative propositions are provable. An equivalent—indeed identical—partition of the state space is {"¬B is true", "¬A is true"}, which clearly consists solely of negative propositions. By hypothesis, each must also be provable as well. More generally, several accepted theoretical insights (such as Arrow's impossibility theorem) are typically articulated and proven as negative propositions. *See* Kenneth J. Arrow, *A Difficulty in the Concept of Social Welfare,* 58 J. POL. ECON. 328 (1950). In any event, to the extent that the court was befuddled by the prospect of asking the lenders to prove their lack of bad faith (a negative), it could have simply recast the inquiry as asking them to prove the presence of good faith (an affirmative). Problem solved.

113. Concerns over "proving a negative" are arguably on stronger ground when it comes to assessing *absolute empirical claims* that can be tested only through induction/observation. Consider the statement "green rubies don't exist." This absolute proposition can be disproven empirically by finding a single green ruby; but it can never be proven definitively by observing a consecutive, homogenous sequence of red rubies, no matter how many. Beyond absolutist statements, however, the aphorism once again tends to break down. Consider, for instance, the probabilistic statement that "no more than 1% of rubies in existence are green." This is an empirical claim about fre-

As a matter of practice, courts regularly assign the burden of proof to the proponent of a claim or defense that has lack of notice as an element.[114] In a seeming overture to preempt these difficulties, Judge Furman's opinion declares that "the Court need not and does not decide the question of burden because even if the burden is on Defendants to prove lack of notice by a preponderance of the evidence, the Court finds that they have met that burden."[115] This reasoning is acceptable as far as it goes (even if facially a little sketchy); but it *should* follow that the opinion would then proceed to err consistently on the side of stating (at least for consistency's sake) that the burden was the lenders' to carry. And yet, the opinion frequently strays from that perspective, both implicitly and explicitly placing the burden of proof as to notice on Citibank.[116] Such lapses create suspicions that the court was at the very least inconsistent in its application of the burden of proof. Such jurisprudential flip-flopping could well sow the seeds of a reversal if the Second Circuit (or New York's Court of Appeals) proclaims more clearly that the burden is on the party asserting the DFV defense.

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quencies that lends itself to the tools of statistical inference. "Proving" it to be absolutely true or false may well be impossible, but one can generate statistical tests of this hypothesis, which trade off the likelihoods of false positives and false negatives (at arbitrarily high confidence levels with sufficient data). Burdens of proof generally share this probabilistic characteristic. *See, e.g.*, Antonio Bernardo, Eric Talley & Ivo Welch, *A Theory of Legal Presumptions*, 16 J.L. ECON. & ORG. 1 (2000); Eric L. Talley, *Law, Economics, and the Burden(s) of Proof*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF TORTS (Jennifer Arlen ed., 2013).

114. *See, e.g.*, Brooks v. Am. Centennial Ins., 327 F.3d 260, 268 (3d Cir. 2003) ("[L]ack of notice is an affirmative defense to be plead and proved by the insurer."); Bartlett v. Dep't of the Treasury (I.R.S.), 749 F.3d 1, 11 (1st Cir. 2014) ("[Plaintiff] has not carried her burden of showing a lack of constructive knowledge of the filing requirements.").

115. *In re Citibank*, 520 F. Supp. 3d at 454 n.32.

116. For instance, the court (1) held that that Citibank's arguments were "not enough to *establish* . . . that Defendants were on notice of the mistake," *id.* at 446 (emphasis added); (2) "challenged counsel for Citibank *to identify any evidence* of Defendants describing the August 11th wire transfers as mistakes prior to receiving the Recall Notices," *id.* at 438 (emphasis added); and (3) devoted a substantial portion of its decision to whether Citibank's "red flag" arguments were sufficient to "*persuade*," *id.* at 440–51 (emphasis added).

b. Logical Coherence

Going beyond questions of burden (at least for the moment), a second quandary stems from the opinion's application of logical/probabilistic reasoning as to the lenders' reasonable beliefs upon receiving a sudden paydown. Recall that the court concluded that "it would be virtually inconceivable" for a reasonable lender to believe that Citibank had wired a full paydown by mistake.[117] Here, a key observation that Judge Furman makes several times to substantiate this conclusion is that a mistake of this type and magnitude was historically unprecedented. Judge Furman writes, "not one witness, on either side of this case, could recall a single example in which a bank accidentally paid the exact amounts owing on outstanding loans."[118] Consequently, the court deduces, a reasonable lender receiving a surprise paydown would functionally place zero weight on the prospect that the payment was made in error.[119]

This reasoning seems curious on several fronts. Foremost, it is hard to ignore the internal inconsistency in the opinion's analysis: earlier in the opinion (as discussed above), Judge Furman lamented the impossibility of "proving a negative" when it comes to assigning the burden. Yet here, he proceeds to do just that: in essence, the court advances the absolute negative proposition that *accidental early paydowns never occur*—one that it evidently deems to be "proven" by a sequence of witnesses testifying they had not observed one before. But in any event, one need not venture far into recent financial history to uncover a veritable data set of other mistaken transfers, involving sums that dwarfed even Citibank's gaffe.[120] Add to that

117. *Id.* at 444

118. *Id.*

119. *See id.* at 433.

120. In 2018, for example, Deutsche Bank mistakenly transferred $35 billion to derivatives counterparties through human error, notwithstanding a purportedly "fail-safe" error detection system it had installed after the bank experienced a similar blunder just four years earlier. *See* BLOOMBERG, *'This Was an Operational Error.' Deutsche Bank Accidentally Transferred $35 Billion It Didn't Owe*, YAHOO! FIN. (Apr. 20, 2018), https://yhoo.it/3aWTrtn; Staff, *Deutsche Bank Mistakenly Transferred $24 Billion in 2014*, REUTERS (May 24, 2018, 11:53 AM), https://reut.rs/3aSzbJy.) Additional instances abound regarding analogous gaffes that were *publicly disclosed* (holding aside those never made public).

data set the fact that an accidental payment *actually did occur in this case*, and the proposition that a reasonable person should place *zero* weight on a mistake seems all the more questionable. Consistent with this reasoning, in fact, several of the lenders appear to have internally discussed explicitly the very possibility of a mistake when the funds first appeared without notice.[121] Plus, a large fraction of lenders *were* evidently convinced that there had been a mistake, and they returned the principal payments to Citibank when requested. Thus, while it seems plausible that a reasonable lender in these circumstances might assess the ex ante probability of mistake to be low (maybe even *very* low), the reasoning in the opinion does not convincingly posit that a mistake was functionally impossible.

Of course, even if the reasonable likelihood of a mistake was merely "low" (but not zero), might that still be enough to justify the court's conclusion that the lenders were not on constructive notice of a mistake? Perhaps. But to engage this issue persuasively, Judge Furman would have had to consult a different set of laws—the laws of probability—in the form of the infamous Bayes rule.[122] From a Bayesian perspective, the constructive notice part of the opinion boils down to formal proposition about the probability that Citibank might have committed an error (or a "Mistake") that caused the full paydown of the lenders' claims. For clarity, let us denote this as Pr{*Mistake*}. Although it seems almost certain that this probability is not identically zero (see discussion above), it is still plausible to presume that this probability is small—and indeed well south of 50 percent.

This *unconditional* probability alone would not be sufficient, however, for a reasonable Bayesian to conclude Citibank's surprise payment was more likely than not a mistake under the facts and circumstances prevailing. To do that, one still must condition on those other facts and circumstances. Among such facts, for example, was that the payment was not

121. *See In re Citibank*, 520 F. Supp. 3d at 404–09.

122. *See generally*, *Bayes' Theorem*, WIKIPEDIA, https://en.wikipedia.org/wiki/Bayes%27_theorem [https://perma.cc/F3GA-F874] (last visited Sept. 27, 2021) ("Bayes' theorem . . . describes the probability of an event, based on prior knowledge of conditions that might be related to the event."). *See also* Pandya & Talley, *supra* note 15, for an analysis of the court's Bayesian reasoning similar to this one.

preceded by the contractually required notice by Citibank to lenders that a full paydown was about to arrive.[123] That is, the facts on the ground were that the lenders had received an "Unannounced Full Paydown" (or UFP). Viewed in this sense, the key probabilistic measure that would relate to a recipient's inferences in the circumstances would be the conditional probability Pr{*Mistake* | *UFP*}. And here, Bayes rule implies the following relationship:

$$\Pr\{Mistake|UFP\} = \frac{\Pr\{Mistake\} \times \Pr\{UFP|Mistake\}}{\Pr\{UFP\}} \qquad (1)$$

Note the three right-hand-side terms comprising this probability: (a) Pr{*Mistake*}, the unconditional probability of a mistake (discussed above); (b) Pr{*UFP* | *Mistake*}, the probability of a full paydown conditional on type of clerical error; and (c) Pr{*UFP*}, the unconditional probability that a borrower such as Revlon would, in the circumstances then-prevailing, decide to spring an unannounced full payment on unsuspecting lenders. Let's consider ingredients (b) and (c) in turn:

- Start with Pr{*UFP* | *Mistake*}—the probability that an unannounced payment would occur conditional on making the type of clerical error that occurred here. Given the nature of the error as described in the opinion, it would seem that this probability is close (if not equal) to 100 percent.[124]
- Now consider the denominator, Pr{*UFP*}—the unconditional probability of an unannounced full paydown on the loans. As noted multiple times in the opinion, a notification from the agent to the recipients generally precedes full payments such as this; and, the 2016 term loans contractually required just such an "an-

123. Beyond Citibank's failure to notify lenders of an early paydown, there are several other observable facts that also constitute valid conditioning events, including the litigious backstory described above, the deep discount on the debt, and the prior refusals of Revlon to accede to the lender's demands for repayment. *See supra* Part I. Each provides additional relevant framing to the factors highlighted in the text.

124. While different types of clerical errors might result in actions other than a full paydown, it was this specific type of error that the opinion fixates on. *See In re Citibank*, 520 F. Supp. 3d at 396.

> nouncement."[125] Yet, Citibank did not issue and the lenders did not receive notice. To the contrary, throughout the contentious backstory described above, the only real notice that the hold-out lenders had received from Revlon was that it intended to fight their claims, and it had no intention whatsoever of caving.[126] Given the steep market discount on debt claims,[127] it seems even more implausible that Revlon would suddenly have a 180-degree change of heart, fully capitulating with neither notice nor settlement conditions. While it is certainly true that "early paydowns do happen,"[128] large accidental payments happen too—with a surprising frequency.[129] All told, the history and context of *these parties'* relationship made the prospect of unconditional surrender by Revlon exceedingly unlikely; if the probability is not exactly zero, it would seem to be quite close.

Aggregating the above observations, the Bayesian formulation stated in equation (1) can be simplified conceptually as follows:

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125. 2016 Agreement, *supra* note 25, § 2.11(a) ("Upon receipt of [written prepayment notice by Revlon] the Administrative Agent shall promptly notify each relevant Lender thereof. If any such notice is given, the amount specified in such notice shall be due and payable on the date specified therein . . . .").

126. *See, e.g.*, Katherine Doherty, *Revlon Lenders Allege Default with New Debt Deal Nearing Close*, BLOOMBERG (May 1, 2020), https://www.bnnbloomberg.ca/revlon-lenders-allege-default-with-new-debt-deal-nearing-close-1.1430217 (quoting a letter from Revlon's counsel asserting that the "objecting lenders [have] made one baseless accusation after another to try to block the company from securing financing" and "[t]heir disgraceful tactics are intended to hurt the company and its employees and their accusations are misleading and without basis"); Becky Yerak, *Revlon Overcomes Holdout Creditors, Securing $65 Million Rescue Loan*, WALL ST. J. (Apr. 30, 2020, 7:06 PM), https://www.wsj.com/articles/revlon-overcomes-holdout-creditors-securing-65-million-rescue-loan-11588287841 (quoting an anonymous Revlon lawyer who "warned that anyone opposing the borrowing would face 'potential liability' "). Revlon appears to have maintained this position up to and after the date of the mistaken payment. *See* Revlon Inc., Press Release: Revlon to Seek Dismissal of Flawed UMB Bank Litigation Claim (Form 8-K) (Aug. 14, 2020).

127. *See supra* Figure 1 and accompanying text.

128. *In re Citibank*, 520 F. Supp. 3d at 433.

129. *See, e.g.*, *supra* note 120.

$$\Pr\{Mistake|UFP\} \approx \frac{\Pr\{Mistake\} \times 1}{\Pr\{UFP\}} \leftrightarrow \frac{Small\ \#}{Small\ \#} \tag{2}$$

To carry their burden of proof under a preponderance standard, the lenders would minimally have to prove that the likelihood (2) fell below 50 percent. Equivalently, they would have to demonstrate that the denominator—the probability of a deliberate, unannounced full paydown in these circumstances (Pr{*UFP*})—was at least twice the size as the remaining term in the numerator—the likelihood of a clerical error (Pr{*Mistake*}). Given the parties' history, the market discount on the debt, and contemporaneous statements by Revlon (among other facts), this seemed to many to be a difficult hill to climb. And it does not appear from Judge Furman's opinion that the lenders surmounted it (nor, it appears, that they were even required to try).

c. Significance of "Due and Payable" Claims

Finally, and related to the analysis above, consider the fact that the lenders' notes bore a maturity date three years *after* the mistaken payment was made. That is, Revlon was not obliged to repay the principal until the loans were due and payable in September 2023.[130] As noted above, the district court rejected Citibank's argument that the DFV doctrine should be categorically limited to situations where the debt is "due and payable" at the moment of the error, holding instead that any "bona fide creditor" has access to the defense, whatever the maturity of its claim.[131] This conclusion seems somewhat in tension with at least some of the key reasoning

130. *In re Citibank*, 520 F. Supp. 3d at 398.
131. *Id.* at 421.

from the *Banque Worms* precedent,[132] as well as subsequent case law interpreting the DFV defense.[133]

But holding that doctrinal point aside, the lengthy remaining tenor of the Revlon debt still bears significantly on a reasonable Revlon lender's assessment of the likelihood of an unannounced early paydown (or Pr{*UFP*} in the formulations above). Recall that by March of 2020, the term loans were trading at around 40% of their face value.[134] In effect, the rate of interest the market imposed on Revlon borrowing now far exceeded the contract rate of the term loans. The *last* thing Revlon (or *any* rational borrower in its shoes) would want to do is to pay them off at face value. To be sure, Revlon possessed a contractual *option* to repay the loans early at face value, and at least according to the court, a reasonable lender receiving the unannounced transfer would have inferred the option was being exercised.[135] But Revlon's option was so far out of the

132. Recall that in *Banque Worms*, the lender extended a short-term line of credit that expired every three months, and it had announced that it was not going to renew the LOC at expiration of the current contract. Banque Worms v. BankAmerica Int'l, 928 F.2d 538, 539 (2d Cir. 1991). On the due date, Security Pacific mistakenly delivered the full balance to Banque Worms, notwithstanding Spedley's pending instructions to stop payment to Banque Worms and to direct payment instead to a different bank. *Id.* There was no question that the debt was due and payable at the time of the disputed transfer and no party argued otherwise. And the Court of Appeals opinion in that case seems to acknowledge the importance of this point (at least implicitly). Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 196 (N.Y. 1991) (stating that the Discharge-for-Value defense is available where a person "*is* entitled" to the money) (emphasis added).

133. *See, e.g.*, Carlisle v. Norris, 109 N.E. 564, 569 (N.Y. 1915) (restitution unavailable where defendants credited payment in good faith, without notice, and "on an indebtedness due them"); A.I. Trade Fin., Inc. v. Petra Bank, No. 89 CIV. 7987, 1997 WL 291841, at *4 (S.D.N.Y. 1997) ("The discharge for value rule contemplates that at the time of the erroneous transfer the transferee/beneficiary have some present entitlement to the funds."); Credit Lyonnais N.Y. Branch v. Koval, 745 So. 2d 837, 841 (Miss. 1999) (for Discharge-for-Value defense to apply, recipient "must be entitled to receive money in payment of a debt").

134. *See supra* Figure 1.

135. *See In re Citibank*, 520 F. Supp. 3d at 433 ("Given that early paydowns do happen, and a mistaken total paydown had perhaps never happened before, it was natural and reasonable for Defendants and their clients to conclude that the August 11th wire transfers were an intentional early paydown by Revlon").

money by mid-2020[136] that no rational party would even consider exercising it. Even if Revlon had wished to cash out existing term lenders in August 2020, it would have been far cheaper to buy their notes in the secondary market, enjoying an approximate 60% discount to face value.[137] Given that the lenders here had no immediate right to payment, and that their claims traded at a steep market discount, it is difficult to fathom why Revlon would suddenly decide to pull the liquidation trigger in a patently *cost-maximizing* way.[138]

d. Synthesis

One could easily criticize the arguments above as little more than speculative, academic, and armchair pondering. That criticism is probably correct in certain ways (I am an academic armchair ponderer, after all). However, that is also the point: because the DFV doctrine is an affirmative defense, the *lenders* must carry the burden to prove it. It should have been up to the lenders to show that the ratio above satisfies the evidentiary standard. Unclear facts, armchair speculation, or evidentiary "ties" should have been resolved in Citibank's favor. To be sure, carrying this burden would be heavy sledding for the lenders, and, in fairness, it might be prohibitively difficult for *anyone* in the lenders' shoes to adduce evidence satisfying equation (2) above, at least given the facts known at the time of the mistaken payment. Yet, that is how burdens are designed to work.

Beyond these points, it merits observing that the lenders still had a tool in their arsenal for injecting greater precision into their Bayesian calculus: they could simply have asked Revlon and/or Citibank about the nature of the unexpected payment. Such an inquiry would have immediately revealed the mistake, and lodging it seemingly costs very little. Moreover, such an action is consistent with the *inquiry notice* standard that typically chaperones constructive notice tests. That is, a *reason-*

136. *See supra* Figure 1.

137. *See supra* Figure 1.

138. Recall that the lenders were launching their lawsuit alleging that Revlon and Citibank had breached the agreement through the refinancing transaction, and if they succeeded in that claim they would be entitled to a return of principal. But even that outcome was far from certain, and the value of the bonds in the secondary market certainly did not betray much optimism about its prospects.

able person in the position of the recipient and faced with the same facts, could (and by this reasoning should) have inquired whether there had been a mistake.

2. *External Critiques*

Building on the "internal" objections raised above, the outcome of the *Citibank* opinion also raises troubling "external" questions about whether the default it purports to enshrine is even desirable to most parties. There has been an explosion of academic research on the law and economics of contract design over the last two decades, and the *Citibank* opinion touches on several of those.[139] These include (i) the constructive use of "information forcing" rules; (ii) the importance of catalyzing and facilitating collaborative contracting; (iii) the efficient allocation of risks and costs; (iv) the relationship of factors (i)–(iii) to the concept of "commercial reasonableness," and (v) the minimization of transaction costs. I briefly consider each in turn.

a. Information Forcing

A key policy consideration for contract design involves the way that contracts govern how information is allocated and distributed between the parties. All else constant, it is neither fair nor efficient to give contract parties an incentive to withhold information about an imminent hazard, particularly when speaking up may help avoid or remediate it. Such principles are well established in legal doctrine too: as noted above, core concepts such as "inquiry notice" work specifically to help ensure that parties will communicate such valuable information to one another. More generally, concepts such as inquiry notice serve the dual purposes of (a) furnishing a practical

139. This literature has even analyzed contractual situations that involve mistaken payments. *See, e.g.*, Dhammika Dharmapala & Nuno Garoupa, *An Economic Analysis of Restitution for Mistaken Payments* (U. Chi. Coase-Sandor Inst. for L. & Econ, Rsrch. Paper No. 931, 2021), https://ssrn.com/abstract=3902607 (reviewing literature and positing a thought experiment that involves damages decoupling in the mistaken payment context); Saul Levmore, *Explaining Restitution*, 71 VA. L. REV. 65 (1985) (suggesting an economic framework for analyzing restitution); *see also* Maytal Gilboa & Yotam Kaplan, *The Mistake About Mistakes: Rethinking Partial and Full Restitution*, 26 GEO. MASON. L. REV. 427 (2018) (advocating full restitution for mistaken payors as a means to stem problems with excess precautions).

"means of establishing a party's prior knowledge, where direct proof is difficult or impossible," and (b) incentivizing "reasonable means of self-protection before seeking the protection of legal rules."[140] So understood, the Discharge-for-Value defense "helps those . . . who help themselves,"[141] but it does not ride to the rescue of those who prefer to ignore/conceal information: "one who has notice . . . is not 'innocent' in the matter."[142]

These doctrinal principles underlie a fundamental precept of contract theory: default legal duties can (and often should) serve an "information forcing" function. All else constant, a well-designed contract would tend to reward parties who—in a critical moment—disclose relevant information about impending hazards (and penalize those who do not).[143] This point is particularly important in contexts where mistakes are difficult to detect. As discussed above, while Citibank's protocols succeeded in unearthing the mistaken payments the morning after the transfer, several lenders had become aware of an irregularity much sooner, even deliberating internally whether the payments were a mistake.[144] The facts and circumstances surrounding the payment quite plausibly raised suspicions that something was afoot, and the lenders were well-suited, at little if any cost, to flag their suspicions for Revlon and Citibank. Indeed, if the lenders knew that they faced an inquiry duty to confirm the bona fides of the payment, they would have no incentive to remain silent about it.

In contrast to this logic, the trial court in this case effectively absolved lenders of any such inquiry duty, placing the risk (and cost) of mistake solely on Citibank. This all but ensures that errors of this type are likely to persist uncorrected

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140. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 69 cmt. f (AM. L. INST. 2011).

141. *Id.*

142. Nationwide Merch. Bank Ltd. v. Star Fire Int'l, 889 F. Supp. 124, 127 (S.D.N.Y. 1995).

143. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989). In some ways, the concept of inquiry notice rules as applied here (along with affiliated settings) may provide a serviceable example of "penalty" default rules that some have argued do not generally exist. *See, e.g.*, Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563 (2006).

144. *See In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 404-09 (S.D.N.Y. 2021).

far longer than is necessary. Going forward, nothing about the opinion would change this outcome in future cases: the lenders would have no incentive to do anything other than stay quiet, cordoning away valuable information from other contract parties until it was too late to fix the error. This incentive is wholly inconsistent with the information allocation goals that animate efficient contract design.

b. Collaborative/Rational Contracting

A second policy concern from the district court's holding relates to the goal of encouraging collaborative contracting among parties in long-term relationships, well documented among contracts scholars. In many settings (this one included), contracts serve as critical governance institutions for long-term commercial relationships rather than one-off transactions. The design of such "relational contracts" necessarily must take into account the fact that the parties will develop a broad set of informal norms and understandings as their relationship plays out.[145]

These norms are critical in long-term, relational settings, since it is precisely such contexts where unexpected contingencies can (and invariably do) arise—including exigencies that cannot possibly be planned for ahead of time, or easily allocated ex ante. In value-creating contractual relationships, moreover, such exigencies require collaboration and cooperation by all sides to resolve. Concrete contract terms (and default rules for interpretation) provide an important (albeit incomplete) backdrop for such collaborative interactions.[146] Perhaps consequently, a robust contract theory literature posits that any sensible contract design in such contingencies must intertwine (or "braid") both the formal mechanisms of enforcement and more informal norms of collaborative dispute resolution to account for unexpected contingencies and uncertainty.[147] Arising from this literature is a consensus that,

145. *See, e.g.*, Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); Ian R. MacNeil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974).

146. *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text* and *Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23 (2014).

147. *See, e.g.*, Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doc-*

as a general matter, one should take care to avoid default legal enforcement rules that unduly dampen, discourage, or otherwise "crowd out" the possibilities for collaborative cooperation among contractual parties.[148]

By corollary, it is anathema to the goal of collaborative contracting for contract provisions to give parties an incentive to kneecap one another through strategic and/or non-collaborative behavior. Many contracts, in fact, implicitly recognize this fact by having provisions that preclude the most egregious forms of such self-interested opportunism.[149] Similarly, the default rules that govern contractual parties (which apply in contingencies where written contractual terms are silent) should typically play a similar role, mirroring the collaborative provisions that the parties would have embraced had they expended efforts to anticipate and bargain over the relevant contingency.[150] Nevertheless, the district court's holding in this case—if taken to its logical ends—would seem to do the opposite, failing to penalize parties for non-cooperative, non-collaborative, and strategic behavior in the face of unexpected contingencies. In fact, the district court's holding goes a step fur-

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trine, 110 COLUM. L. REV. 1377 (2010); Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848 (2010).

148. The value of collaboration in relational settings is far more than hypothetical; evidence of it can be found across markets with sophisticated parties. In high-stakes financial contracting markets (the syndicated loan market being one of them), evidence abounds that contracts critically augment collaboration and settle expectations in the face of unforeseen events. For example, there is a robust secondary trading market for syndicated loans, and this secondary trading occurs even in the context of distressed debt. This market is critical because it provides liquidity to lenders holding distressed debt. While the interests of par holders and distressed purchasers, for example, may differ to some degree, cooperation among lenders and the borrower is critical and should be encouraged. It is common to find provisions governing amendments to a credit agreement (here, § 10.1 of the 2016 Agreement, *supra* note 25) that flexibly permit changes to or waivers of covenants if supported by the sufficient collaborative consent of the various loan parties (i.e., the borrower and the administrative agent) and a simple majority of creditors.

149. For example, credit agreements typically have pro rata sharing provisions which provide that if a lender receives more than it is entitled to, it must turn over the excess. The Credit Agreement at issue in this dispute also had such a provision. *See* 2016 Agreement, *supra* note 25, § 2.18.

150. Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1592, 1597 (1999).

ther by *punishing* collaboration: the lenders who returned the mistaken transfers after Citibank's recall notice, in furtherance of the value enhancing practices of cooperation and collaboration, ended up playing the suckers. For it was the non-collaborators—those who held out defying Citibank to sue—who made serious bank.

c. Efficient Allocation of Costs and Risks

The reader likely will have noticed an important omission in the policy discussion thus far: it largely presumes the mistaken payment to be an "exogenous" event, and it concentrates instead on steps the parties (and particularly the lenders) might have taken to mitigate and/or dampen the consequences of the error. While instructive in some ways, the approach sidelines whatever underlying actions/omissions that sowed the seeds of the erroneous transfer to begin with. Such considerations are potentially critical: for as important as information forcing, collaboration, and relational contracting might be in the face of *exogenous* harms and risks, they might never have come into play at all had Citibank not made the error to begin with. Indeed, the trial court itself thought this a key factor in the case, positing (inter alia) that a sophisticated bank like Citibank would be expected to have extensive quality control measures in place, so that mistakes of this type would be "virtually inconceivable."[151] Indeed, Judge Furman categorically concluded that "there is *no doubt* that the party best positioned to avoid the error that occurred was Citibank."[152]

On its face, this reasoning has tremendous appeal, and it seems to align well with familiar tropes from law and economics about placing risks and duties on the shoulders of parties who, in the circumstances, can most easily avoid the calamity.[153] As the controller of its own internal protocols for booking payments, Citibank was no doubt in a unique position to design quality control processes that might prevent the mistake from occurring. The lenders, in contrast, had essentially

151. *In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 444 (S.D.N.Y. 2021).

152. *Id.* at 450 (emphasis added).

153. *See, e.g.*, GUIDO CALABRESI, THE COST OF ACCIDENTS 312 (1970) ("Such a system could begin by allocating accident costs to those categories that can avoid accidents most cheaply but are sufficiently broad to spread the costs adequately enough to meet our secondary cost avoidance goals.").

no control over Citibank's processes, and did not even know about the particulars of the roll up until the errant transfers landed in their accounts. To the extent that such a claim holds water, sticking Citibank with the tab on this mistake might seem like little more than forcing the bank to eat its own (defective) cooking.

But as one thinks deeper about the issue, the reasoning above seems shortsighted for a variety of reasons. First, the expected social cost of a mistake (to the extent there is one[154]) need not turn wholly on whether a mistake is made to begin with. Rather, it is the *combined product* of the incidence of a mistake and its unavoidable consequences. Reducing either one of them—or giving parties the incentives to do so—would presumably be important to value maximizing contract design. Second, when different parties have comparative advantages in controlling the incidence versus the consequences of mistakes, it seems unlikely that an efficient set of incentives would fixate on a single factor while ignoring the other.

The *Citibank* facts exhibit many of the markers of that circumstance. It seems relatively evident that Citibank had the best (if not sole) control over how to design its protocols ex ante to reduce the likelihood of a mistake. However, as the discussion above suggests, the lenders were also in a particularly strong (if not sole) position to take steps ex post to detect and mitigate the consequences of a mistake immediately after it occurred. An efficient contract (or default rule) would attempt to strike a balance across both activities. The interaction of these two elements of control is critically important in efficiency calculus.

154. The discussion below presumes (for argument's sake) that there is a social loss from uncorrected mistaken payment even though the payment alone is a mere transfer payment (which generally is not considered a welfare loss). To the extent that there is no direct social loss from mistakes (or their correction), then the costs of ex ante precautions and ex post detection/remediation become the sole efficiency considerations; here, the arguments developed below not only still apply, but they grow even stronger.

FIGURE 2: WHAC-A-MOLE[155] (Arcade Version)

To better illustrate the point, consider a riff on the popular arcade game "Whac-a-Mole™." (Figure 2 offers a highly technical visualization to refresh the memories of readers who—dubiously—protest their unfamiliarity.) The game features five "mole holes" cut from a flat melamine playing surface, each ensconcing a cuddly plastic garden mole that is pneumatically powered to ascend and descend intermittently. The game proceeds by iteration: in each iteration, a random process selects a hole, and its occupant emerges to taunt the player for a brief interval of time.[156] The player endeavors to pinpoint the surging creature and—before it can submerge again—to "whack" it with a cartoonish foam mallet, scoring points and dispatching the battered rodent back into its subterranean lair. Once the mole recedes (on its own, or by dint of a whacking), the next iteration begins, and a random pro-

155. For marketing purposes, the game's U.S. originators (who themselves lifted the concept from a Japanese inventor) omitted the "k" from the word *whack*. When used as part of the title of the game, I will retain this convention. *See generally* Brian VanHooker, *An Oral History of Whac-A-Mole: The Surprisingly Contentious Story of the Beloved Family Game About Bludgeoning Small Rodents,* MEL (July 2020), https://melmagazine.com/en-us/story/whac-a-mole-oral-history.

156. Adding to the tension, this interval progressively shrinks as the game proceeds.

cess once again selects a hole. The iterations repeat until a countdown clock expires.

Each iteration of Whac-a-Mole™ represents a surprisingly serviceable framework for considering the interactions between ex ante precautions and ex post mitigation measures. The Citibank lenders can be thought of as akin to the game player, acting as a "sentry" who can sound the alarm ex post when a mole emerges (i.e., a suspicious payment occurs), thereby enabling a quick and definitive whacking (i.e., correcting the mistake). Suppose that whacking moles is socially valuable, so that whenever a rising mole is dispatched it saves society $10 worth of costs. Serving as sentry, of course, may be neither costless nor 100% effective. To reflect these possibilities, suppose that (a) the sentry's cost of time is worth $1 during each iteration;[157] and (b) her ability to detect moles declines in the number of holes she must monitor: if the sentry is watching "N" holes she will successfully spot the creature only 1/N of the time.[158]

Against this backdrop, assume the key policy objective is to maximize the total *net* expected benefits. Is it economically worthwhile to have a sentry serve the mitigating role as described above? Given these parameters, the answer is absolutely yes. Without the sentry, a $10 harm occurs with certainty in each iteration. But with the sentry, the parties avoid that loss 20% (=1/5) of the time, giving rise to an expected benefit of $2, justifying the $1 cost of the sentry's time. While far from perfect, utilizing the sentry to engage in ex post mitigation efforts is a discernible improvement.

Now, add another twist in the form of ex ante precautions. Suppose that the arcade owner could—by incurring some up-front costs—seal up selected holes to prevent the mole from emerging whenever the game's random process chooses that hole. (The owner's actions are akin to anticipating future problems ex ante and modifying the contract/protocols to circumvent them.) Note that plugging holes can benefit the sentry, too, since it reduces the number of remaining

157. This sum could, for example, represent the cost and delay associated with screening payments as they arrive to assess whether they may have been executed erroneously.

158. Thus, for 5 open holes she will successfully pinpoint the rising mole 1/5 = 20% of the time.

holes that require monitoring. In the extreme, the owner could even decide to seal up *all* the holes (again at an incremental cost for each), thereby rendering the sentry wholly superfluous. Let's suppose that it costs $X to seal each hole during an iteration.

Against this new backdrop, continue to assume our key objective remains to maximize total expected *net* benefits, but now through the best possible combination of ex post mitigation (mole whacking) and ex ante precautions (hole sealing). We now have even more design questions: should the owner seal *any* holes, or continue to rely solely on the sentry? If the owner seals up holes, *how many*? And given *that* choice, does it still make any sense to retain a sentry at all?

The answers to these questions, as one might conjecture, turn critically on the value of X. Consider the extreme case where it costs $0 to seal up each hole. In that case, the owner could seal up all five holes at no cost, creating an immediate expected benefit of $10 (with certainty). With all holes sealed, the sentry becomes superfluous. This solution remains the most cost effective *so long as* the hole-sealing cost remains relatively cheap (less than $1/hole in this example).

Once the cost of sealing holes exceeds $1.00, however, relying solely on ex ante precautions is no longer commercially reasonable. The left panel of Figure 3 demonstrates this point with an assumed per-hole cost of X=$1.50. Here, the most efficient solution involves the owner sealing up 4 of the 5 holes, but then relying on a sentry to monitor the last.[159] Effectively, the best solution combines both ex ante precautions and ex post mitigation measures. This type of solution continues to be cost-effective so long as the hole-sealing cost stays south of $2.00. Once the cost exceeds $2.00, however, the efficient solution shifts again, this time towards depending wholly on the sentry. The right panel of Figure 3 demonstrates this last case with an assumed cost of X=$2.50. Here, even though ex ante precautions remain available, they are no longer cost-effective to pursue.

159. With a single hole left to monitor, the sentry will detect and dispatch the mole 1/1 = 100% of the time.

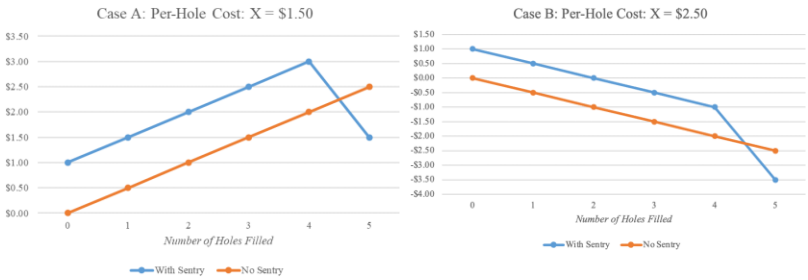

FIGURE 3: WHAC-A-MOLE EXPECTED NET BENEFITS; X=$1.50 (LEFT) & X=$2.50 (RIGHT)

While admittedly simplified, this example demonstrates some general insights for contract design. First, when mistakes can potentially be addressed through both ex ante precautions (hole sealing) and ex post mitigation (mole whacking), there typically is no one-size-fits-all prescription for how best to allocate harm-avoidance duties. Much turns on the structure of the problem, the *relative* cost effectiveness of the two types of activities, and the degree of complementarity between different types of risk-reduction measures. The district court opinion never attempted to conduct this holistic comparison.[160] Indeed, nowhere does it endeavor to assess how costly it would be for the lenders (our sentry in this example) to remain watchful for mistakes, or what the division of labor should be. By neglecting this type of comparison, Judge Furman misses much of the nuance that accompanies multi-sided precautions.

Second, it is frequently optimal to deploy a combination of efforts, and not to embrace a "corner solution" that imposes all the risks and costs on a single party. In Figure 3A, for example, the most efficient solution is for the owner to seal some but not all the holes at random, relying on the sentry to watch the remainder. Even with this optimal solution, and after considerable work by the owner (arbitrarily sealing up say, holes 1 through 4), there remains a chance that the mole will emerge from hole 5. Were that to happen, the owner will no doubt have made an *unlucky* set of precautions *ex ante*, but it would still have behaved reasonably given the sentry's complementary role. Accordingly, it would be disingenuous for the sen-

160. Sorry—hard to resist using that phrase.

try—having fallen asleep on the job at hole 5—to argue that she is not to blame for an un-whacked mole, since the owner could always have decided to seal up that final hole, too (but didn't). Such retrospective reasoning misses the point: by hypothesis, it would not have been cost-effective to do so ex ante, and accordingly a commercially reasonable contract would not have called for it.

Citibank's protocols appear to bear a strong resemblance to this situation. As the opinion observes, Citibank's internal protocols were already highly detailed and had evidently tackled many (but not all) contingencies successfully.[161] Still, the fact that *this* hole remained unplugged does not imply that Citibank was derelict or defective in its efforts. *In particular*, another technology (a mole-whacking sentry in this example) could detect and remediate remaining hazards. Understanding these tradeoffs is a critical piece of assembling efficient default rules by courts (or at least it should be).[162]

On a somewhat related point, the sleeping sentry's spurious protest—not unlike the district court's opinion—runs perilously close to collapsing into *hindsight bias*, a cognitive bias whereby observing an objectively unlikely event causes someone to believe that the event was (or should have been) much more foreseeable ex ante and thus should have been given far more consideration in advance.[163] Such reasoning is akin to

161. *See In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 450 (S.D.N.Y. 2021) ("The bank took that role seriously in adopting the six-eye approval process for wire transfers of the kind made here. And while that process obviously failed in this instance, the unprecedented nature of the mistake in this case suggests that it has generally been successful.").

162. The example could be made richer even still through a variety of extensions not covered here. For example, the arcade owner may not know the number or location of the holes, and would have to learn about them ex ante by making incremental expenditures on search. Each such expense would—at some cost—reveal information about the location of the next unsealed hole (if one exists). Because search is costly, an optimal contract may skew even further towards using a sentry for ex post mitigation, even if the cost of sealing a discovered hole is relatively small.

163. *See, e.g.*, Baruch Fischhoff & Ruth Beyth, *I Knew It Would Happen: Remembered Probabilities of Once—Future Things*, 13 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 1 (1975) (documenting the phenomenon in subjects updated predictions about political events). Hindsight bias is also closely related to the (so-called) availability heuristic, which posits that people change their probabilistic assessment of possible events and give exceedingly high weights to events that are immediate in their memories. *See* Amos Tversky &

insisting that the arcade owner possesses a crystal ball to predict the hole from which the mole will emerge. To be sure, if the owner possessed such a crystal ball, the most cost-efficient solution would usually be to rely solely on its prophetic powers alone and seal up the hole that is foreordained to be chosen.[164] Nonetheless, we don't live in a world of crystal balls (or at least most of us don't), and contract designers should not be held to such a standard either.

d. Policy Arguments and "Commercial Reasonableness"

As noted above, Judge Furman largely stiff-armed the policy arguments offered by Citibank, concluding that as compelling as such arguments might be in the abstract, the existing *Banque Worms* precedent rendered most/all of them inapposite.[165] While it is certainly true that categorical rules frequently trump policy arguments, the issue clouds considerably when the underlying doctrine is more "standard-like" than "rule-like." When such a case-by-case standard is in play—as it was here—policy concerns can (and should) most certainly guide its application.

First, much of the efficiency analysis above relates directly to maximizing the net value of the gains to trade in contracting. Such intuitions often square explicitly with doctrine, because several important contract doctrines (including the DFV defense) hinge on and are cabined by the standard of *commercial reasonableness*. Indeed, the *Banque Worms* holding itself was predicated on the view that the administrative agent had at its disposal commercially reasonable security protocols to minimize the chance of an error.[166] In contrast, if the mistake could only be prevented by having the administrative

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Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCH. 207 (1973).

164. Relying on the mystical powers of the crystal ball continues to be best solution even when the cost of sealing a single hole grows extremely high (as high as $9.00).

165. *See In re Citibank*, 520 F. Supp. 3d at 451 ("Were the Court writing on a blank slate, it is far from clear that it would reconcile these principles in a way that allowed the [hold-out] Lenders to keep the money that Citibank indisputably transferred by mistake . . . . But the Court does not write on a blank slate.").

166. *See* Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 197 (N.Y. 1991).

agent take on exorbitant, *commercially un*reasonable precautions ex ante, then such measures would place an unacceptable expectation on the administrative agent, and the agent should not bear the risk of omitting them.[167]

Similarly, commercial reasonableness necessarily requires a comparison of the alternative means of error avoidance and/or correction: if several low-cost types of ex ante precaution or ex post detection were available, it would imply by necessity that all such technologies should be considered in applying the doctrinal standard. The efficiency-oriented spirit of commercial reasonableness is particularly salient in *Citibank*, because there *was* a readily available form of ex post technology for mitigating mistakes: the recipient of a suspicious payment could simply make an inquiry about why it has just arrived, a gesture that imposes trivial (if any) costs. In contrast, the complexity of payment systems in the financial markets, including the payments at issue here, likely makes ex ante elimination of *all* mistakes prohibitively difficult if not impossible. Going forward, under the district court's holding, it would seemingly be insufficient simply for Citibank to prevent the kind of mistake that *did* happen in this case. Because the next mistake—even if highly unlikely ex ante—would also be part of the agent's responsibility, plausibly magnified through hindsight bias in its importance. The logical end of this reasoning suggests that administrative agents might have to anticipate and negate all *prospective* payment risks—including (by definition) novel types of mistakes that are exceedingly unlikely.

This point bears repeating. Under the District Court's interpretation, a party in Citibank's position evidently would not be required merely to anticipate and circumvent *known* or *reasonably likely* mistakes; it also would have to anticipate and ad-

167. *See* Payne v. Jones, 711 F.3d 85, 94 (2d Cir. 2013) ("The threat of excessive damages . . . encourages overspending on 'socially excessive precautions' that 'cost[ ] more than the reduction of harm produced by [them].'") (quoting Mitchell Polinksy & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869, 879 (1998)); Rockwell Graphic Sys., Inc. v. DEV Indus., Inc., 925 F.2d 174, 180 (7th Cir. 1991) ("Obviously [plaintiff] could have taken more precautions. But at a cost, and the question is whether the additional benefit in security would have exceeded that cost.").

dress exceedingly rare hazards—true "Black Swan" events[168] that are highly unlikely ex ante. Taking that instruction to its logical end would seem to require one to aggregate the costs of providing for all unanticipated (and even unanticipat*able*) contingencies—a near absurdity in its own right. And if not absurd, most certainly exorbitant: for even if it were possible to anticipate every unanticipatable Black Swan event, and even if the cost of doing so were small for each individual event, there are (by definition) infinitely many of them. The judge's instruction would thus appear to impose an obligation on the agent to bear that cost (however modest) *infinitely* many times over. This is a major problem. Yet the opinion appears—insouciantly—to double down on it:

> In short, although the mistake that gave rise to this case may be the proverbial Black Swan event, and the risk of a reoccurrence may therefore be small, the banking industry could—and would be wise to—*eliminate the risk altogether* by taking these or similarly modest steps.[169]

To be sure, participants in the syndicated loan market could try to adapt—as best they could—to this new (seemingly absurd) legal standard. However, doing so would entail a substantial proliferation of quality control protocols and personnel. In the steady state, Citibank and its brethren would almost certainly pass on the added costs to borrowers/lenders in some proportion.[170] Any way one cuts it, however, this allocation of default duties (covering even the remotest of risks) seems highly inefficient from a policy perspective, particularly in the face of an alternative: one that deputizes the lenders as Whac-a-Mole sentries, imposing on them a good-faith obliga-

168. *See* TALEB, *supra* note 11.

169. *In re Citibank*, 520 F. Supp. 3d at 451 (emphasis added).

170. As a matter of theory, the precise proportion of cost pass through turns on the competitiveness of the industry. For perfectly competitive industries, industry-wide cost increases are passed through completely; but even for monopolies, cost pass through is still substantial. *See* Paul R. Zimmerman & Julie A. Carlson, *Competition and Cost Pass-Through in Differentiated Oligopolies* 3 (U.S. Fed. Trade Comm'n, MPRA Paper No. 25931, 2010). The syndicated loan market seems somewhere in the middle. *See Are Loan Syndications Anti-Competitive? Not as Simple as You Think*, LSTA (Feb. 21, 2017), https://www.lsta.org/news-resources/are-loan-syndications-anti-competitive-not-as-simple-as-you-think/.

tion to *inquire* about possible mistakes before any party relies on the payment received. As discussed above, the cost of complying with such a duty would be minimal, and it need not be committed to ahead of time (in contrast to anticipating and plugging myriad contractual holes). In many (perhaps most) contexts, then, it would pale in comparison to the agent's responsibility under *Citibank* to untangle the evident Gordian Knot of anticipating unanticipatables.

e. Transaction Costs and the Importance of Default Rules

If the internal and external critiques articulated above have legs, they also deliver a crucial prediction—one that undergirds the empirical analysis in the next part. Rather than adapting to Judge Furman's proclamation that administrative agents must anticipate and "eliminate . . . altogether" every Black Swan event,[171] sophisticated parties could alternatively respond in a different way: by opting out of the *Citibank* holding altogether. Most observers agree that a key aspect of the DFV defense (and Judge Furman's interpretation of it) is that it constitutes a *default rule:* parties are free to contract around it if they so choose.[172] Consequently, if—as I have argued—the court's interpretation of the DFV doctrine was both (a) a surprise to market participants and (b) a commercially unreasonable allocation of costs and risks, then parties should be anxious to contract around it.

It warrants noting that even though default rules *can* be altered through contract, that fact alone does not render such rules uninteresting or trivial: indeed, how default rules are set is critically important.[173] It is not costless to contract around default rules. If a rule were set inefficiently, in a manner that most parties would disfavor ex ante, then at the very least the default rule imposes immediate and non-contingent costs on

171. *In re Citibank*, 520 F. Supp. 3d at 45.

172. *See, e.g.*, U.C.C. § 4A-501(a) (Am. L. Inst. & Unif. L. Comm'n 1989). ("Except as otherwise provided in this Article, the rights and obligations of a party to a funds transfer may be varied by agreement of the affected party."); Regatos v. N. Fork Bank, 257 F. Supp. 2d 632, 640 (S.D.N.Y. 2003).

173. This point is perhaps underappreciated by many commentators. *See, e.g.,* Levine, *supra* note 21 ("But the fact [the *Citibank* opinion] is a bad *rule* doesn't matter that much for *future* cases, because it is a default rule, and syndicated lenders are big and sophisticated and can just change their contracts to opt out of the rule").

most (or all) parties to bear the costs of either (a) living with the undesirable rule, or (b) negotiating, drafting, performing, and then possibly testing in court a set of express provisions designed to sidestep the rule.[174] Failing to set a default rule in a majoritarian fashion thus tends to increase transaction costs on the whole.

The costs of "contracting around" unattractive default rules grows substantially when the sweep of such rules also includes surprise judicial interpretations that were themselves unexpected ex ante. Prospectively, such a scenario may well require parties to anticipate and draft around not only the shock in question, but also other unexpected future interpretations, which (as discussed above) is a near absurdity. Even retrospective adaptation to the new landscape can be challenging, particularly for existing "legacy" deals that were executed under the prior regime. With the jurisprudential ground having shifted beneath them, such legacy parties may be forced back to the bargaining table to crack open their deals, wrangle anew, and reprice and/or amend myriad existing credit agreements. In a market well in excess of $1 trillion of active loans,[175] this effect on legacy deals may be impracticable or unduly costly to pull off. (And in this sense, the "default" rule set by the district court's judgment may be the functional equivalent of an immutable rule.)

Adding to these costs is the specter (if not likelihood) that new express terms will themselves be *generically* uncertain, since one cannot know how courts of the future will react to language that purports to upend the default rule. Will it be judicially negated as insufficient? Interpreted too narrowly? Too broadly? Will it spawn other unforeseen legal battles? These are typically open questions at the time of a contractual innovation, and each adds uncertainty and cost to the prospect of contracting around a default rule. To the extent that parties still wish to take the transaction-cost plunge in the face

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174. *See* Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1114 (2017); Sarath Sanga, *Choice of Law: An Empirical Analysis*, 11 J. EMPIRICAL LEGAL STUD. 894, 923 (2014).

175. *See, e.g.*, Miguel Faria-e-Castro & Asha Bharadwaj, *Syndicated Loans in the U.S.*, FED. RSRV. BANK OF ST. LOUIS: ST. LOUIS FED ON THE ECONOMY BLOG (Oct. 8, 2019), https://www.stlouisfed.org/on-the-economy/2019/october/syndicated-loans-us.

of an improvident default rule, their actions are far from a freebie (and clearly not a "wash" from a broader cost-benefit perspective).

III.
The Birth of the Revlon Blocker

The prior parts have described the backstory, content, and immediate reception of the *Citibank* opinion, ultimately delivering empirical predictions about contracting behavior in the shadow of the holding. In this part, I turn to that empirical question in earnest, asking whether/how parties to debt contracts have responded to *Citibank*. Recall that the written opinion itself speculated that lending communities and their trade associations would potentially alter their practices, for example by effectuating broad changes to compliance staffing, reforms to industry standards, and enhancements to quality control protocols, so as to further reduce (or in the words of the court, "eliminate") the possibility of unanticipated mistakes.[176]

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176. Explicitly, Judge Furman spit-balled a few possible reforms toward the end of his opinion:

> Moreover, banks could—and, perhaps after this case, will—take other relatively costless steps to both minimize the risk of errors and increase the probability of clawing back erroneous payments. For example, banks could, either on their own, or through an industry association like the LSTA, create clear standards governing the content and timing of payment notices. If a payment notice akin to the Calculation Statements here *always* preceded an actual payment by some specified interval (and banks adopted security procedures, akin to the six-eyes process, to ensure that they did), then the absence of such a notice would indeed raise a red flag that the payment was erroneous. So too, if such notices *always* unambiguously and explicitly described the size and nature of the payment, the recipient of a payment that deviated from the notice would plainly be on notice of the mistake. For example, one could imagine payment notices that stated something like: "You will shortly receive a wire payment of $X. This payment is for interest only; it does not include any payment of principal. If you receive more than $X, any excess would be the result of an error and you would not be entitled to keep it." Suffice it to say, had the Calculation Statements in this case included simple and clear language along these lines, this costly litigation would almost surely have been avoided. In short, although the mistake that gave rise to this case may be the proverbial Black Swan event, and the risk of a reoccurrence may therefore be small, the banking industry could—and

Such wholesale reforms of protocol are not the only possible means by which parties might respond to *Citibank*. Another response might be simply to waive and/or nullify the DFV doctrine altogether (or at least Judge Furman's interpretation of it). Notably, shortly after the opinion issued, a variety of industry participants began to recommend just that, even offering contractual language intended to negate the opinion.[177] The most prominent of such efforts, undertaken by the Loan Syndications and Trading Association (LSTA), resulted in several draft model terms that the Association designed for the purposes of sweeping aside the opinion.[178] The LSTA's (so-called) "Revlon Blocker" provisions were merely the most visible of several organized efforts in which parties actively advocated contractual terms intended not to adopt—but to nullify—the *Citibank* opinion. Even before introduction of the LSTA model language, according to one commentator, at least four occurrences of Revlon blockers appeared in large syndicated loan agreements.[179]

These anecdotal observations raise the important question of how parties on the aggregate have responded to the opinion. Such responses are unlikely to be homogenous: in some cases, new contractual language diffuses quickly through a market, but in others it can tend to die out, languish, or settle into a steady state in which it is embraced by only certain

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> would be wise to—eliminate the risk altogether by taking these or similarly modest steps.

In re Citibank, 520 F. Supp. 3d 390, 450–51 (S.D.N.Y. 2021).

177. *See* Warshafsky, *supra* note 20.

178. *See Erroneous Payment Provision*, *supra* note 19; *see also Blackline of Draft of Erroneous Payments*, *supra* note 19. The Loan Market Association (LMA) also released a template on June 30, 2021. *See* Amanda Montano, *What Happens if You Make a Payment in Error? – The LMA Responds to the Revlon Loan Dispute*, JD SUPRA (July 6, 2021), https://www.jdsupra.com/legalnews/what-happens-if-you-make-a-payment-in-1226386/. More information about the two versions of the LTSA model provision, as well as a subsequent model provision of the Loan Market Association (LMA) is available in Online Appendix A.

179. *See* Warshafsky, *supra* note 20; Lisa Lee & Katherine Doherty, *Citi's $900 Million Mistake Prompts Banks to Seek New Safeguards*, BLOOMBERG LAW (Mar. 3, 2021, 7:10 AM), https://www.bloomberg.com/news/articles/2021-03-03/citi-s-900-million-mistake-prompts-banks-to-seek-new-safeguards?sref=IGLJ0u0Y.

segments of the market.[180] Which (if any) of these trends is at play here has at least four important implications for how we think about the Citibank opinion, and the direction that contract law is taking. First, it is suggestive of the extent to which Judge Furman's decision surprised the markets, extending the DFV doctrine to factual domains that participants had not anticipated. Second, it sheds light on whether syndicated lending communities were disposed to adapt to *Citibank* or mobilized instead to escape it with Revlon blockers. Third, for those who mobilized, it tells us something about their size, industry, profitability, and capital structures. Finally, we can learn something about whether markets rewarded—or at least did not heavily punish—efforts to contract around the opinion. Each of these inquiries lends itself to investigation with empirical data about contracting practices.

To address these questions, this part makes use of EDGAR, the vast database supported by the Securities and Exchange Commission.[181] EDGAR contains the lion's share of publicly filed documents made by SEC-reporting companies (a population that includes all companies whose securities trade in public US markets). Within EDGAR, Revlon blockers are typically found in unscheduled periodic findings detailing material changes or contracts (usually within Form 8-K filings). However, issuers may sometimes disclose the content of a blocker in other contexts as well, such as a quarterly filing (10-Q), an annual filing (10-K), or a proxy solicitation (14A). In order to avoid excluding any such filing, I accessed the "full text" search tool on EDGAR, which gives twenty years' worth of filings and permits users to input a Boolean search for phrases and words. As a first stage of the process, I constructed a deliberately broad search meant to capture any document (regardless of filing type) that conceivably contained language related to a Revlon blocker.[182] This search—covering January 1, 2020, through July 31, 2021—yielded nearly 1,200 candidate docu-

180. Matthew Jennejohn, Julian Nyarko & Eric Talley, *Contractual Evolution,* 89 U. CHI. L. REV. (forthcoming 2022).

181. *See* U.S. Sec. & Exch. Comm'n, EDGAR Company Filings Search Page, https://www.sec.gov/edgar/searchedgar/companysearch.html.

182. Specifically, the search (conducted in early August 2021) considered all filings from January 2020 through July 2021 with the following provisions: "erroneous payment" OR "erroneous payments" OR "mistaken payment" OR "mistaken payments" OR "discharge for value" OR "erroneous distribution"

ments, from which I and a research assistant manually checked the text of the document to determine whether it was, in fact, a Revlon Blocker.

To constitute a Revlon blocker, the provision was required to have three features. First, it had to be part of a contractual provision (rather than, say, a general discussion of the Revlon case in an annual report or a description of a contract whose text is not provided). Second, it had to pertain to payment of a debt, loan, or some other type of credit obligation, either through an agent or on a first-party basis. (Payments made under a regulatory scheme such as ERISA were excluded to the extent I could definitively determine such.) Third, the provision had to make an express statement relating to whether the recipient of a mistaken or erroneous payment had the right to keep the payment or instead must return it to either the borrower or the administrative agent. After applying these criteria, I successfully identified 765 Revlon blockers from the original list of 1,193. I then manually extracted the pertinent language of the blocker from the larger document for analysis.

A. *Diffusion and Semantic Content of Blockers*

Consider first the raw incidence of disclosed Revlon blockers, pictured in Figure 4. This Figure is, in many ways, the key take-away from this study. Although blocker-like terms were not completely new to the industry prior to *Citibank*, the number of disclosed blockers remained miniscule for the first six months of 2020, and then hovered at around 5–10 per month through the end of the year and into 2021. This relatively modest uptake is pictured to the left-hand side of Figure 4. However, the February 2021 arrival of the district court's opinion (marked by the red dashed line) sent shockwaves through the industry. By March, the number of disclosed blockers had increased by an order of magnitude over the pre-opinion levels, and by June of 2021 the increase was nearly twenty-fold.

OR "erroneous distributions" OR "payment in error" OR "payments in error" OR "incorrect payment" OR "incorrect payments".

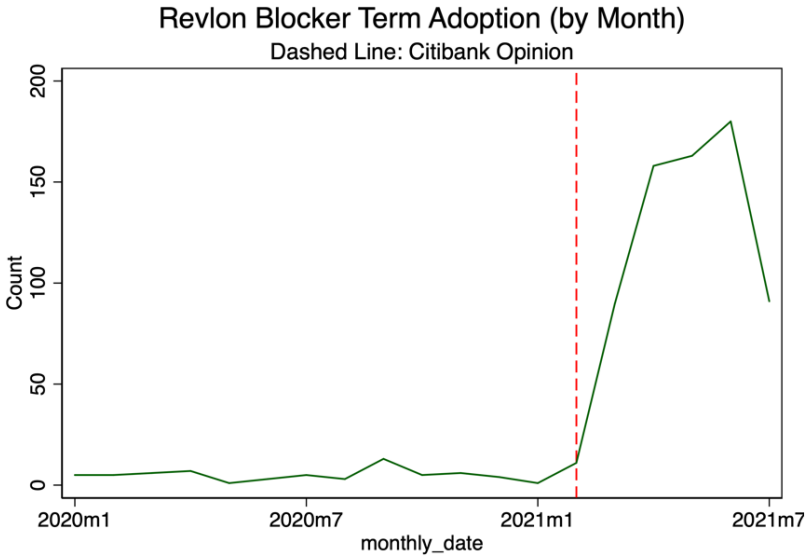

FIGURE 4: UPTAKE OF REVLON BLOCKER PROVISIONS (BY MONTH)
Red dashed line: Month of opinion (2/2021)

Interestingly, July 2021 saw a slight decline in disclosures, but that may be in part an "inventory effect" that reflects the vast stock of provisions that had already been disclosed in the first half of 2021 (and still an order of magnitude larger than the pre-*Citibank* era). In contrast, I was able to find *a single case* of a provision that explicitly imposed the risk of error on the borrower and/or agent—in a document filed six months before the Citibank error occurred.[183]

While the raw incidence of Revlon blockers is itself interesting, drilling into what such provisions contain is even more revealing. To investigate the semantic structure of blockers, I utilized standard machine learning/computational text analysis techniques to process the text of the extracted provisions.[184] After stemming all the words and eliminating com-

183. *See* Digirad Corp., Current Report (Form 8-K) (Jan. 31, 2020).

184. For a general review of these techniques, *see* Jens Frankenreiter, Cathy Hwang, Yaron Nili and Eric Talley, *Cleaning Corporate Governance*, 170 U. PENN. L. REV. (forthcoming 2021); Eric Talley, *Is the Future of Law a Driverless Car? Assessing How (or Whether) the Data Analytics Revolution Will Transform Practice,* 174 J. INST. & THEORETICAL ECON. 183 (2018).

mon "stop" words, an algorithm distilled a global vocabulary from the resulting terms and, then, reduced each document into a "bag of words" (unigrams) representing raw frequency counts of each term. Those counts were then rescaled by their ratio of term frequencies to document frequencies (tf-idfs)—a measure commonly used to emphasize unique terms. This process thereby reduced each provision to a "vector" whose components corresponding rescaled counts of each unique (stemmed) term in the full corpus vocabulary. Such vectors are often informative, but extremely long and sparse. Therefore, it is common practice to reduce the dimensionality of the adjusted vocabulary counts through singular value decomposition (a generalized principal components analysis), extracting a sequence of artificial variables ("components") that embody the semantic content of the underlying term counts. Each successive component captures a decreasingly significant degree of variation in the text. Accordingly, it is often possible to summarize much of the linguistic heterogeneity in a corpus using only a modest set of principal components.

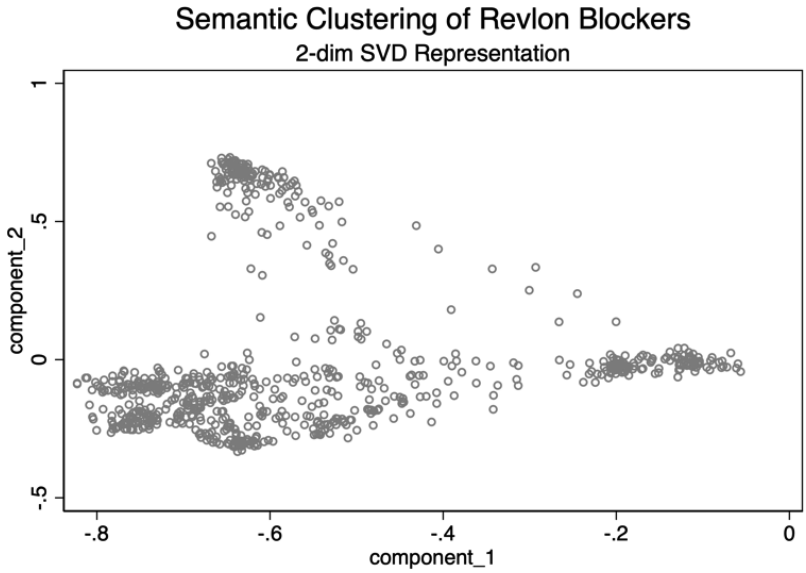

FIGURE 5: 2-DIMENSION LATENT SEMANTIC REPRESENTATION OF REVLON BLOCKERS

Figure 5 illustrates graphically the first two such components for Revlon blocker provisions. Each gray dot in the figure represents a single disclosed Revlon blocker provision, embodied by its coordinates from the first two dimensions in principal component space. As noted above, the informational content of each sequential component is decreasing in its explanatory power, and, thus, the first component (on the horizontal access) corresponds to the first "rotation" of the data and distinguishes amongst texts on the most basic of levels, while the second component (on the vertical axis) endeavors to tackle the "errors" that the first component could not distinguish. The pattern continues down the line for all components (though the Figure displays only the first—and most informative—two for the ease of illustration). Even with just two dimensions, an important pattern is evident from Figure 5: there appear to be at least three discernible "clusters" of blockers, each with significant within-cluster similarities but evident divergence from members of other clusters.

To investigate this pattern more fully, the two panels of Figure 6 reproduce Figure 5 but color-code according to two alternative criteria. Panel A subdivides the blockers into three topical clusters (or "families") according to semantic similarity, superimposing the language of the three most prominent model provisions (two from the LSTA and one from the LMA). This figure more clearly reveals that there are three basic types of Revlon blocker provision that are semantically discernible from one another. Note that the two LSTA provisions (which are also reproduced in Online Appendix A) are extremely close to one another, and both lie within "Family 2," denoted with red markers. The LMA provision, in contrast, clearly falls within "Family 1." In Figure 6B, the color coding is by temporal era, distinguishing between blockers that predated the *Citibank* opinion (red) and after it (lavender). Note that the early blockers are uniformly located in a single cluster (Family 1)—and that cluster continues to persist after the opinion, even as two additional clusters emerge.[185] Indeed, the LMA model provision released at the end of June 2021 appears itself to be fashioned after the Family 1 blockers.

185. Note that the lavender markers in Figure 6B are set in the background and thus slightly obscured by the red markers in the foreground.

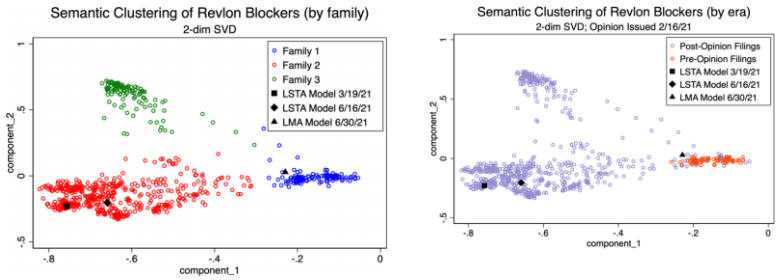

FIGURE 6: COLOR-CODED REPRESENTATIONS, BY FAMILY (6A: LEFT) AND ERA (6B: RIGHT)

It is also evident from Figure 6B that a strong majority of blockers since *Citibank* have gravitated to the LSTA model language, particularly the March version (which has had longer to diffuse). But not all of them. In addition to the Family 1 blockers that continue to persist, there is also another discernible cluster ("Family 3") that emerged wholly in the post-opinion era—one that is distinguishable from both the preexisting cluster and the LSTA-inspired family. Family 3 provisions are relatively similar to one another, and they typically contain what appears to be distilled/condensed principles present in the LSTA provision compressed into a single paragraph and shorn of lengthy procedural instructions. (On this score, note, that along the first principal component represented by the horizontal axis, Family 2 and Family 3 provisions are virtually indistinguishable from one another, reflecting a rough degree of similarity between them.) Table 1 provides a summary of each family type, offering representative examples (which are reproduced in Online Appendix B).

TABLE 1: REPRESENTATIVE REVLON BLOCKER PROFILES; THREE SEMANTIC FAMILIES

	Incidence	Word Ct.	Description	Example
Family 1	Prior and subsequent to SDNY's *Citibank* opinion; 17.5% of disclosures	Mean: 307.1 Median: 244 St. Dev: 262.1	General limitation / exclusion of liability, typically protecting administrative agents for all actions / omissions taken in good faith. Close proximity to LMA model provision. May also include express provision requiring recipients of mistaken payment to return it. Typically does not explicitly waive the Discharge-for-Value defense by name.	Appendix B1: Aptevo Therapeutics Inc. (APVO) 10-Q EX-10.6 (Credit and Security Agreement, filed 10 Nov. 2020)
Family 2	Subsequent to SDNY's *Citibank* opinion; 65.0% of disclosures	Mean: 769.1 Median: 746.5 St. Dev: 551.4	Highly detailed; close proximity to the LSTA's model provisions; explicitly obligates lenders to return any mistaken payments to the administrative agent; requires lenders to presume a mistake when an unexpected payment occurs without notification; may also require the recipient of a presumptively mistaken payment to expend efforts to confirm whether the payment was mistakenly made. Lays out a detailed process for notice of a mistaken payment as well as subrogation rights. Typically explicitly waives the Discharge-for-Value defense by the lender to the extent permissible by law.	Appendix B2: Netflix Inc. (NFLX) 8-K EX-10.1 (Second Amended Credit Agreement, filed 17 June 2021)
Family 3	Subsequent to SDNY's *Citibank* opinion; 17.5% of disclosures	Mean: 257.2 Median: 234 St. Dev: 79.2	Concise provision that distills central substantive rights and obligations from the LSTA template(s); generally thin on procedural protocols. May also explicitly waive the Discharge-for-Value defense.	Appendix B3: Asbury Automotive Group Inc (ABG) 8-K EX-10.1 (Credit Agreement, filed 20 May 2021)

B. *Who Adopts Blockers?*

Given the discernibly rapid diffusion of Revlon Blockers, a logical next question is what types of companies are executing them. Are geographic concentrations, industry concentra-

tions, or capital-structure tendencies related to uptake? What about profitability or market valuation? To tackle this question, I merged the hand-collected Revlon Blocker data with Compustat—an EDGAR-derived dataset that tabulates a variety of industry and financial data.[186] The Compustat database is also vast, and it contains data covering tens of thousands of distinct issuers (most traded in the United States, or cross-listing foreign issuers), taken from their most recent annual filings. (Compustat does not directly track Revlon Blockers, which is what necessitates the hand collection.) A sizable majority (around 80%) of the Revlon blockers in the hand-collected data were successfully matched with at least one issuer in the Compustat database. The results below compare those matched firms to the overall Compustat universe.

Consider first the extent to which Delaware-incorporated firms are more likely to adopt Revlon blockers. Within the overall Compustat universe of issuers (with U.S. and foreign-incorporated entities), Delaware incorporated firms comprise just over 41% of the population. Among blocker adopters, Delaware firms represent a larger 47.83% of the sample. In contrast, the relative proportion of U.S.-incorporated firms among adopters is roughly consistent to the overall average (72.53% of blocker-adopting firms versus 71.8% overall).

186. Specifically I merged my contractual database with Compustat using the Central Indexing Key (CIK) identifier that the SEC assigns issuers. (When a Revlon Blocker was associated with multiple CIKs, I treated each company as a distinct observation.)

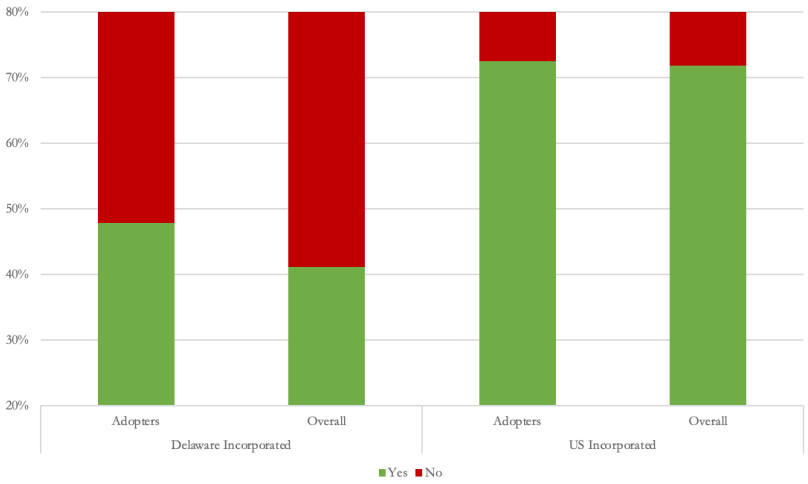

FIGURE 7: INCORPORATION JURISDICTION AND REVLON BLOCKER ADOPTION

A variety of other firm-level attributes are significantly more predictive of blocker adoption, as Figure 8 demonstrates. For each of five standard financial measures (discussed below), I split the Compustat universe up into population terciles corresponding to low, medium and high bins along each measure. The Figure describes the distribution of blocker adopters, according to which population tercile they belong to. As a benchmark, if issuers adopted blockers at random, then the frequency bars should all rise to around 33.33%. As the Figure shows, however, firm-level financial characteristics are highly predictive of adoption. Revlon Blockers are nearly twice as likely to be adopted by the largest Compustat terciles (as measured by both assets and liabilities, corresponding to 60.43 and 60.81 percent respectively); they are more than five times *less* likely to come from the lowest tercile (5.76 and 4.47, respectively). Higher leverage companies (by D-E ratio) are also over-represented by the top two terciles (37.61 and 46.54 for the middle and high terciles, respectively), as are companies at the upper range of ROA measures (37.79 and 50.39). The upper tercile of Tobin's Q firms, in contrast, are discernibly *under*-represented among adopters (23.04).

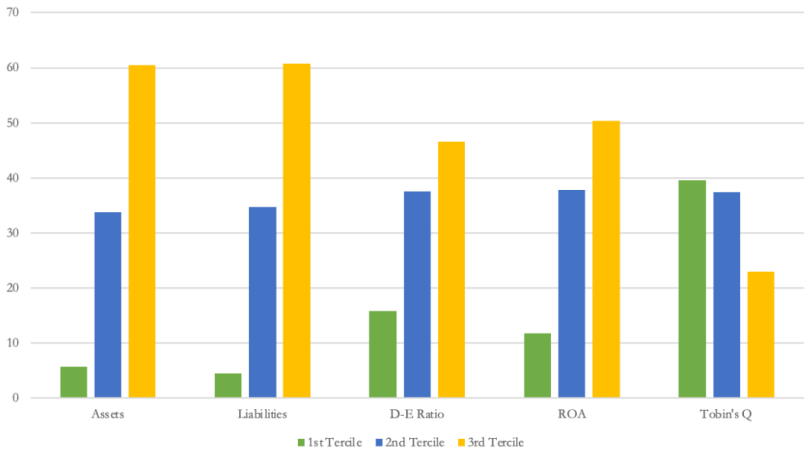

FIGURE 8: FINANCIAL METRICS & ADOPTION
(IN %, BY COMPUSTAT TERCILE)

Using regression analysis, it is possible to distill a slightly more nuanced picture of the adoption proclivities. Table 2 reports on a representative set of logistic regressions where the adoption of a Revlon blocker is the dependent variable.[187] Several of the measures underlying the figures above are included as controls, as well as a variety of industry-related characteristics. Each successive column in the table represents a different regression specification controlling for a mix of different variables; the overall message, however, is remarkably consistent across specifications.

While firm size continues to be highly predictive of adoption (as in Figure 8), total liabilities bear a much stronger relationship to adoption than do total assets. Indeed, controlling for (logged) assets, the more highly leveraged issuers are more likely to report Revlon blockers. This of course makes intuitive sense, since blockers are principally pertinent for debt contracts, which highly leveraged firms have more exposure to by definition.[188] U.S.-incorporated firms (and of those Delaware

187. Because the dependent variable is binary, it is typically appropriate to employ qualitative models (such as logit or probit) that are specifically adapted to such settings (even though linear probability can often be instructive as well). While Table 2 reports solely on a logit specification, the results are qualitatively identical using these alternative models.

188. Debt-equity ratio is not included as a control variable, in view of its close relationship to the liabilities-to-assets ratio, as well as the fact that the

firms) are also statistically more likely to disclose blockers, which is not wholly surprising but still interesting given the frequency of New York choice of law provisions even for foreign corporate borrowing. Highly profitable firms (reflected in ROA) are also systematically more likely to report blockers. But as in Figure 8, predicted reporting proclivity declines in Tobin's Q (a popular measure of market-to-book value). This last result is also not entirely surprising given that most large and established firms tend to have more modest market-to-book ratios.

TABLE 2: PREDICTORS OF REVLON BLOCKER ADOPTION

Logistic regressions with robust standard errors. Dependent variable is the Adoption of a Revlon Blocker provision in a contractual document filed with the SEC. Data reflect all EDGAR-reporting issuers that are linkable to Compustat. Data observed at the issuer-provision level. T-statistics in parentheses. Significance: + = 0.10 level; * = 0.05 level; ** 0.01 level; *** = 0.001 level.

	[1]	[2]	[3]	[4]	[5]
Ln(Assets)	0.058	-0.019	0.02	-0.03	-0.035
	(0.83)	(-0.21)	(0.20)	(-0.30)	(-0.34)
Ln(Liabilities)	0.240***	0.342***	0.325***	0.393***	0.397***
	(3.63)	(4.03)	(3.51)	(4.05)	(4.01)
DE Incorp.	0.433***	0.400***	0.527***	0.343**	0.350**
	(3.55)	(2.96)	(3.83)	(2.43)	(2.45)
US Incorp.	1.549***	1.555***	0.615*	0.811***	0.832***
	(6.10)	(5.91)	(2.26)	(3.03)	(2.89)
ROA		0.150**	0.155***	0.192***	0.190***
		(2.37)	(2.89)	(3.75)	(3.73)
Tobin Q			-0.002+	-0.002***	-0.002***
			(-1.88)	(-2.84)	(-2.62)
Finance				-1.149***	
				(-5.24)	
Constant	-5.756***	-5.798***	-5.209***	-5.229***	-4.658***
	(-20.11)	(-19.33)	(-18.18)	(-18.83)	(-7.24)
Industry FEs	N	N	N	N	Y
chi-2	337.36	345.662	315.814	349.249	373.356
p	0.00	0.00	0.00	0.00	0.00
N	6714	6053	5038	5038	5025

natural log of liabilities/assets ratio is a linear combination of ln(Assets) and ln(Liabilities), each of which is already included across all specifications from Table 2.

One seeming anomaly in Table 2 is in column [4], which includes a control variable designating whether the issuer is a finance-related entity (according to its 2-digit SIC code). Interestingly, firms in finance-related industries appear *less* likely to disclose Revlon blockers than virtually all other industries—indeed, finance firms are far and away the least likely to make such disclosures. This result seems peculiar in first blush, since banks and financial institutions overwhelmingly serve as administrative agents in syndicated loans. Some resolution of this quandary may come in understanding that blockers are usually culled from disclosures in issuers' Form 8-K filing. The filing of an 8-K, in turn, is triggered upon the occurrence of a material event (including a contract) for the reporting firm. When a bank or financial institution enters into a contract solely as administrative agent for a third-party loan facility, that limited role is likely insufficient to meet the materiality threshold to force a disclosure by the bank. In contrast, the financial firm would be far more likely to disclose the terms of a debt contract for its own corporate debt, and it is these disclosures that are being picked up in Table 2. Thus, it appears that even as banks and financial institutions seem perfectly willing to embrace Revlon blockers for third-party contracts designating them as agents (thereby working to their own advantage), they seem less interested in the provisions for their own corporate borrowing.

In sum, not only have Revlon blockers been embraced widely since the Citibank opinion, but the firms embracing them have been some of the largest, most profitable companies in the world with large debt portfolios. This response is consistent with the proposition that the new turn the district court took in the DFV defense is viewed with disapprobation, particularly among the firms with the most at stake.

C. *Market Response to Blocker Adopters*

Although the adoption of Revlon blockers (discussed above) captures a critical and direct market reaction to the *Citibank* opinion, there are other, less direct responses that perhaps warrant some attention. In particular, it is possible to gain some limited traction of market reception by analyzing securities market reactions. This final subpart offers a few preliminary insights along these lines, in the form of tentative

event study analysis on market reception to Revlon blockers and the firms that adopted them.

Before proceeding, it is important to note that in addition to their well-known vulnerabilities, stock-based event studies may not be an especially clean way to measure economic gains from the adoption of a specific contractual term in a debt contract—even one that is publicly disclosed in an SEC filing. Contracts and amendments thereto frequently have many moving parts and may inject multiple types of conflating news into the market. In addition, such contracts bind many parties, only some of whom are likely to have observable securities prices for an event study. Revlon's term loans, for example, involved a contract between Revlon, hundreds of members of a lending syndicate, and Citibank acting as administrative agent. Citibank, moreover, was not a principal to the contract and thus was not under a materiality obligation to disclose the contract. If a blocker creates *joint* value for the parties, that value would presumably be divided among them, and not just concentrated with the observable security. Finally, for a variety of reasons, event studies are typically best positioned to study shocks in thickly traded *equity* markets, and not debt. Equity values may present a reasonable proxy for shareholder value, but they do not capture other attributes of overall firm value for the borrower (such as employees, customers, suppliers, and the like). Thus, it is important not to read too much into stock market reactions related to the *Citibank* case.

With these caveats in mind, there are two potentially interesting events that would lend themselves to an event study here. The first is the first date at which an issuer announces the inclusion of a Revlon blocker in its debt contracts. (Additional such disclosures after that date are less likely to be newsworthy.) The second is the effect of the *Citibank* opinion on returns of blocker-adopting firms (or those likely to become one). I discuss each briefly in turn.

1. *Revlon Blocker Adoption*

Consider first an event study that hinges on the adoption of a Revlon blocker, based on the first disclosure made by an adopting firm. Figure 9 plots mean cumulative abnormal returns for adopting firms where the date is normalized so that "Date 0" corresponds to the calendar date on which the issuer made its first disclosure. Abnormal returns represent the

deviation of a security's percentage return from its predicted return on the same date. In all the results below, I utilize the well-known Fama-French 3-factor model[189] as a benchmark to generate predicted returns, and, from there, generate abnormal returns. The solid line represents the mean cumulative abnormal return for disclosers, cumulated over the ten trading days after disclosure. The dotted lines represent the 95-percent confidence interval around that mean. As can be seen from the Figure, the initial disclosure of a Revlon blocker is associated with mild positive abnormal return for disclosing issuers over the first few days after disclosure. The magnitude of the abnormal return, however, is mild relative to estimation noise and not statistically significant at over any window. The mean abnormal return also tends to erode on average after about a week, converging to zero at the end of two weeks.

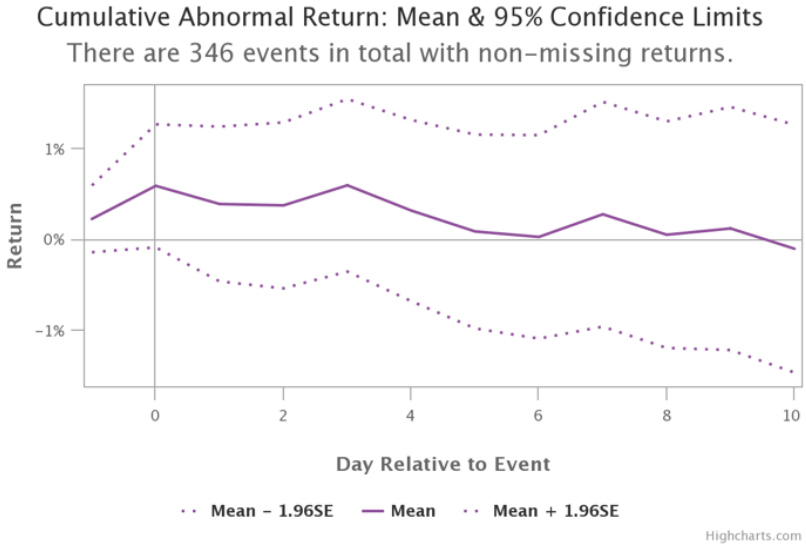

FIGURE 9: MEAN CAR AFTER BLOCKER DISCLOSURE
Predicted Returns Generated from Fama-French 3-Factor Model

Under conventional social science interpretations, the results of Figure 9 suggest not much of a story to be told in either direction: while there may be a modest market uptick as-

189. *See* Eugene F. Fama & Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. FIN. ECON. 3 (1993).

sociated with an announced Revlon blocker, there also does not appear to be a significant market penalty for the adoption of such a provision.

A complicating factor in this interpretation, however, is the fact that an issuer's initial disclosure of a contractual blocker may not be the first time that market participants learn of its adoption. Such provisions have to be negotiated after all, and in many cases must first be approved by incumbent creditors (who are themselves market participants). Moreover, as noted above, shortly after the *Citibank* opinion issued, several commentators, scholars, professional associations, and (significantly) a host of borrowers voiced criticism, announcing that they would likely attempt to nullify the outcome contractually. By the time their contractual provisions finally saw the light of day (and were thus captured in my data set), the news might have already grown stale. Viewed in this sense, the first disclosure of a blocker may have been a nonstory because its news had leaked far ahead of the disclosure itself.

2. *Release of Citibank Opinion*

The information "leakage" shortcoming of disclosure-based event studies suggests that it would be more profitable to concentrate on something that was a "true" surprise. On this topic, one candidate stands above all: the *Citibank* opinion itself, which (as the arguments above demonstrate) struck most observers as a newsworthy shock. At the time of the opinion's release, there were only a handful of firms that had adopted blockers. However, one potentially informative inquiry would be to run the event study with a retrospective twist, assessing the abnormal returns of firms that had or were destined to adopt a Revlon blocker upon the announcement of the opinion. (Such an approach effectively embraces the possibility of information leakage—presuming that the adopting firms began to discuss and reveal intentions shortly after the opinion came out—as many did.[190])

Figure 10 presents this analysis, normalizing "Date 0" to be the release of Judge Furman's opinion, and plotting mean abnormal returns for issuers that either had adopted or would adopt a Revlon blocker of any form by the end of July 2021. As

190. *See* Warshafsky, *supra* note 20.

can be seen from the Figure, mean abnormal returns among adopters appear non-trivially positive after the opinion's release, and move progressively upwards over the ten-business-day span that followed. To the extent that eventual blockers were "outed" in the days following the opinion, this suggests that the market approved of their intentions.

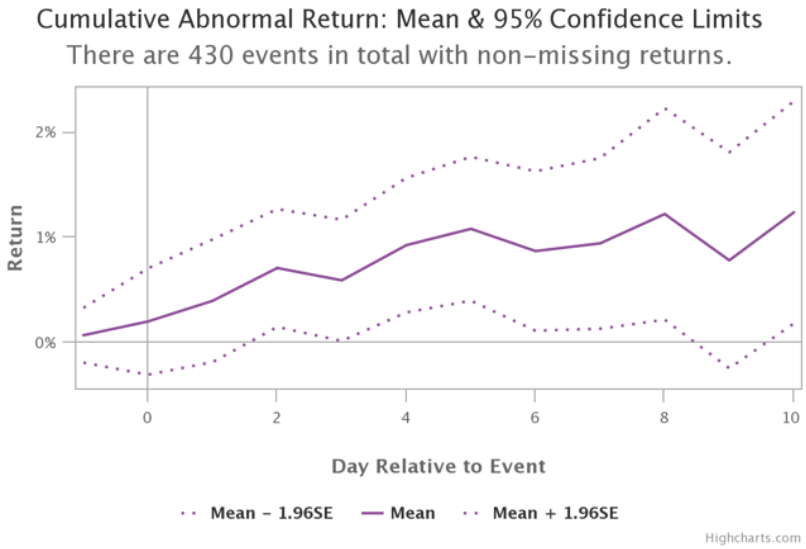

FIGURE 10: MEAN CAR AFTER *CITIBANK* OPINION RELEASE
Treatment Group: Revlon Blocker Adopters by 7/31/21
Predicted Returns Generated from Fama-French 3-Factor Model

Event studies are often overinterpreted, and in this case great care is especially warranted not to overinterpret these findings. Indeed, it simply may not be easy to tell *when* market participants became aware of an issuer's undertaking to adopt a blocker. Without such information, event studies lose much of their punch. However, it is worth noting that similar (albeit slightly more attenuated) results as Figure 10's emerge if one conducts an event study on *expected* adopters (i.e., firms whose various attributes would predict statistically that they would embrace an adopter—a group that includes most of the adopting firms and many others who ended up not adopting[191]). On balance, then, this evidence seems confirmatory of the asser-

191. Results on file with author.

tion that adopting firms do not appear to have been penalized by market participants, and they plausibly were rewarded.

Conclusion

The 2021 *Citibank* mistaken-payment opinion has all the right ingredients to launch lively discourse in lecture halls, faculty lounges, and lawyerly conference rooms. Accordingly, the dispute seems well poised to become a modern chestnut of contract law (perhaps regardless of its disposition on appeal). To be sure, pundits and commentators of all stripes have taken their shots at the opinion along doctrinal, logical, and policy lines. But these criticisms are in many ways cheap talk: give thoughtful people enough time and space, and they can capably criticize anything.

That said, the dramatic and surprising nature of the opinion also represents an invitation to use empirical tools that go beyond cheap talk. Indeed, the holding provides a unique occasion to witness—and to measure—how private parties respond to surprise doctrinal shocks in real time, not just through rhetorical remonstration, but through the content of their commercial relationships. Using a novel data set of publicly disclosed contracts, this Article has documented a rapid, precipitous trend to negate the *Citibank* opinion through contractual Revlon blocker provisions, manifested through several distinct families of provision and promulgated overwhelmingly by the largest and most sophisticated companies in the public markets. Their rapid rejection of *Citibank,* moreover, appears to have been mildly endorsed (and certainly not penalized) by market participants. As such, this exercise injects a needed form of concrete evidence allowing us better to assess and evaluate the holding.

As of this writing, of course, *Citibank*'s ultimate fate rests with the Second Circuit. Given the extensive factual findings that undergird Judge Furman's opinion, the appellants are likely to face an uphill battle.[192] That said, should the Second Circuit choose to reverse, there are multiple alternative roads available (all flowing from the analysis above). It might, for example, challenge the district court's reasoning that a reason-

192. *See* Pandya & Talley, *supra* note 15 ("Citi's road to a successful appeal will therefore have to overcome the deference that is traditionally accorded to the judge's interpretation of the facts . . . .").

able, Bayesian, lender acting in good faith—and under the distressed and litigious conditions then prevailing—would fail to suspect an error had occurred. It might hold that the district court waffled impermissibly in allocating the burden of proof for the DFV defense—a burden that should have remained squarely with the lenders throughout. Alternatively, it might find that the district court failed to consider the commercial reasonableness of imposing all burdens on Citibank for ex ante *error prevention*, ignoring whether that allocation is reasonable when compared to the costs of ex post *error detection* by the lenders. Instead, the Second Circuit might categorically cabin the DFV defense to cases where the debt in question is due and payable at the time of the transfer (as was the case in *Banque Worms*). Most dramatically, the appellate panel might simply conclude on broader policy grounds that the *Banque Worms* precedent drove us into an unproductive dead end and warrants rethinking.[193] Given this broad menu of choices and the important state law issues at play, it would be surprising if the New York Court of Appeals were not called upon once again (as it was three decades ago[194]) to issue further guidance. Under each of these scenarios, however, the market's response to the *Citibank* holding—as documented empirically in the analysis above—would be highly relevant inputs.

Beyond the specifics of this case, however, the analysis presented above helps demonstrate how legal doctrine, legal theory and empirical evidence can (and should) helpfully interact. Courts and policy makers would do well to assess how the legal shocks that they create affect market behavior.[195] Such empirical field-testing can be enormously helpful as a means to assess prudent course corrections in contract law, including doctrinal experiments that prove unsuccessful: for the task of establishing fair and efficient default rules in short order is tricky, and judicial actors frequently lack enough information to make the judgment confidently—often because

193. Some commentators, for example, have advocated adopting a good-faith reliance requirement for DFV claimants. *See, e.g.*, Gilboa & Kaplan, *supra* note 139.

194. Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189 (N.Y. 1991).

195. An Appendix providing more detailed information about various model Revlon blocker provisions, as well as typical examples of real-world Revlon blockers, is available at the following link: https://drive.google.com/file/d/1VC3iRdUQcKQVX7TXmU2TNCMVkwOiQq3C/view?usp=sharing.

such information simply does not exist at the time they must render decisions. Field testing new innovations to legal doctrine may be the best (and sometimes the only) way to assess their relative virtues, providing a lodestar for either plunging forward or reversing course. Ignoring such feedback, in contrast, would constitute much more than a $1 billion mistake.

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THE BREAKDOWN OF THE PUBLIC–PRIVATE DIVIDE IN SECURITIES LAW: CAUSES, CONSEQUENCES, AND REFORMS

GEORGE S. GEORGIEV*

As a regulatory scheme, U.S. securities law has traditionally been designed around a set of lines—the "public–private divide"—which separate public companies, public capital, and public markets, from private companies, private capital, and private markets. Until the early 2000s, the lines were successful in establishing two largely coherent legal realms—a highly regulated public realm and a lightly regulated private realm. A series of bold and often-inconsistent reforms between 2002 and 2020, however, have transformed this longstanding regime into a low-friction system wherein public capital flows to both public and private companies, private capital is ever more abundant, and firms can effectively eschew public company status, which is both more costly and much less essential to firm success than ever before. This Article contends that, taken together, these developments have led to the breakdown of the public–private divide: in effect, the boundaries between the regulated and unregulated realms have been removed and the public–private distinction has lost its descriptive and explanatory power as an organizing principle of securities law. The Article contributes to the literature by (1) putting forward a novel and comprehensive analytical account of the breakdown of the public–private divide (up through the completion of the deregulatory cycle), (2) identifying the consequences of these developments with respect to specific firm constituencies and on a systemic level,

* Associate Professor, Emory University School of Law. For helpful comments and discussions, I thank Steven Bank, Jennifer Fan, Kristin Johnson, Kay Levine, Jonathan Nash, Mariana Pargendler, Joanna Shepherd, Verity Winship, and participants in presentations at Emory University School of Law and the 2021 National Business Law Scholars Conference. This project has also benefitted from many conversations over the years with other members of the corporate and securities law academy and the feedback of several securities lawyers. I am grateful to the *N.Y.U. Journal of Law & Business* team for superb editorial assistance. I welcome comments and reactions via email and retain responsibility for any errors or omissions.

and (3) investigating possible reforms and their expected effectiveness in returning securities law to a state of conceptual coherence. The scale of the problems suggests that the necessary reforms are likely to be foundational. Given past experience with hasty and crisis-driven legislation enacted by Congress, the Article urges the SEC to commence a broad deliberative process involving multiple stakeholders to rethink the appropriate structure of securities law. The outputs from this process will be particularly valuable whenever the next window of opportunity for change arises.

Introduction

The first two decades of the 21st century were a busy and turbulent time for securities law. The regulatory regime, which had grown in a slow and adaptive fashion since its inception during the 1930s, was transformed in fundamental ways by three landmark bills—the Sarbanes–Oxley Act of 2002, the Dodd–Frank Act of 2010, and the 2012 JOBS Act—and a series of related rulemakings by the Securities and Exchange Commission (SEC).[1] Many of these reforms were decidedly pro-regulatory and served to heighten the disclosure and governance obligations of public companies in the name of "investor protection"—the original mainstay of securities law—alongside looser, public-regarding goals such as transparency and accountability.[2] But just as many of the reforms were deregulatory, seeking to change securities law in order to promote

1. *See infra* Sections II.A–B.
2. *See infra* Section I.C.

"capital formation," a more recent mainstay.[3] Comparing securities law in 2021 to securities law in 2001, prior to the Sarbanes–Oxley Act, one cannot help but observe that there is a lot more regulation today than there was two decades ago, but that this regulation covers fewer firms and is easier than ever to avoid.

As a regulatory scheme, U.S. securities law has traditionally been designed around a set of lines—the "public–private divide"—which separate public companies, public capital, and public markets, from private companies, private capital, and private markets. The divide has always been imperfect and, its foundational role notwithstanding, somewhat undertheorized.[4] Until the early 2000s, however, it was successful in establishing two largely coherent legal realms—a highly regulated public one and a lightly regulated private one.

A wide-lens analysis of the myriad of changes in securities law over the past two decades reveals that the public–private divide is no more. Even though the law still distinguishes between public and private companies, capital, and markets, the two coherent legal realms have been supplanted by a low-friction system in which public capital flows to private companies, private capital is ever more abundant, and firms can effectively eschew public company status, which is both more costly and much less essential to firm success than ever before.

Consider the following regulatory paradox: it is possible today for two firms that are *identical* in virtually every respect—business model, size and scope of operations, enterprise value, access to capital, number of shareholders, number of employees, and so on—to have *widely different* regulatory obligations. The firm that is a public company (Firm A) would need to provide public disclosure on a regular basis about its results of operations, financial condition, trends and risks affecting the business, executive compensation, corporate governance arrangements, and various other topics. It would need to estab-

3. *See infra* Section II.B.

4. *See infra* Section I.A. For the first and now-classic analysis of securities law reforms with respect to a "public–private divide" and the introduction of the term to the literature, see Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013); *see also* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public–Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013).

lish and maintain robust internal controls and procedures over financial reporting. Its board of directors would need to have specially designated committees with strict qualification requirements for those serving on them.[5]

By contrast, the firm that is a private company (Firm B) would have to do none of that. It could operate in secrecy, avoid public scrutiny, and eschew the internal governance structures required of public companies.[6] And while both firms would be covered by the anti-fraud provisions of SEC Rule 10b-5, Firm A would still be much more likely to face an enforcement action.[7] There are even spillover effects beyond securities law.[8] The key to understanding the paradox is that (1) public company regulation generally kicks in only if a firm elects to finance itself on the *public* capital markets instead of the *private* capital markets, and (2) that private markets are now just as abundant, which renders public company status virtually irrelevant from an access-to-capital point of view. The public company regulatory paradox is a direct consequence of the breakdown of the public–private divide in securities law described in this Article.

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5. The Sarbanes–Oxley Act requires public companies to have an audit committee and disclose whether the committee has a member who is a financial expert. The Dodd–Frank Act requires public companies to have a compensation committee comprised of independent directors. The New York Stock Exchange listing requirements, which are, in effect, mandatory for public companies, add an overlay by requiring public companies seeking a listing to have a nominating or corporate governance committee. *See infra* Section I.C.1.

6. To be sure, the two firms will be subject to the entity laws of their respective states of organization. If both are corporations incorporated in Delaware, for example, they would be subject to the Delaware General Corporation Law. State corporate codes, however, are consciously designed to be "enabling"; as a result, they generally avoid mandatory rules and instead rely primarily on default rules and opt-in rules. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1417 (1989).

7. *See, e.g.*, Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663, 724–29 (2020) (presenting data on SEC enforcement actions against private companies, which remain rare).

8. As an "issuer" of securities, Firm A would be subject to all provisions in the Foreign Corrupt Practices Act (FCPA), whereas Firm B would be subject to a limited subset and would, again, face less scrutiny and less enforcement. *See* Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1–3, 78m(a) (distinguishing the categories of "domestic concern" and "issuer of securities").

In addition to being illogical, the new regulatory reality is deeply problematic for the way it thwarts core goals of the modern administrative state. Congress enacted the original securities laws to protect investors from the types of market abuses that precipitated the stock market crash of 1929 and the ten-year Great Depression that followed. Much of the complex and costly infrastructure of securities regulation was built to protect investors by placing conditions on firms' access to capital, as well as restrictions on ordinary investors' ability to invest in non-public companies.[9] This expansive investor protection framework notwithstanding, another element of the regulatory paradox is that an investor today can invest with the same ease in *both* Firm A and Firm B—benefitting from investor protections in the first case but not in the second. Even more bizarrely, both firms would likely be contained in the broadly diversified portfolios that have become a staple of standard 401(k) retirement plans and other popular investment vehicles. Accordingly, it would be difficult for an investor to avoid putting money in the unregulated firm (Firm B), even if this were an express goal based on an informed choice. Today's investors, in other words, are routinely exposed to both regulated and unregulated firms, which undermines the logic of investor protection.[10]

What this Article calls *the public company regulatory paradox* has been a creeping phenomenon taking shape over a number of years. The idiosyncratic architecture of U.S. corporate law, with responsibility for regulation effectively shared by the federal government and the states, and with built-in regulatory competition among the states, has always been predisposed to some degree of inconsistency.[11] However, the present moment represents an inflection point of singular import, which requires us to recognize the paradox and reckon with it head-on. There are at least three reasons for this. First, a fuller picture is starting to emerge of the far-reaching consequences of a deregulatory cycle in the area of capital markets, which began with the 2012 JOBS Act, continued with the 2015 FAST Act,

9. *See infra* Section I.A.

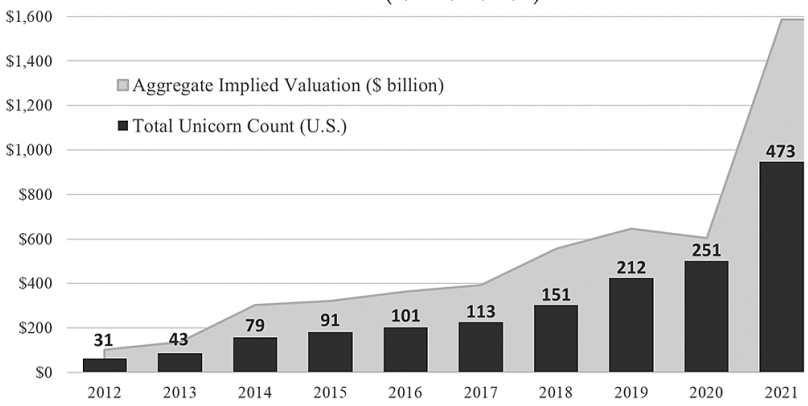
10. *See infra* Section III.C.

11. *See, e.g.*, John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531 (2001); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

and was completed in November 2020 during the last days of the Trump administration.[12] Second, there is now a growing appetite for developing targeted solutions to various problems in the capital markets; any new reform proposals, however, should be cognizant of the breakdown of the public–private divide and the changed metastructure of securities law. Third, and relatedly, the sheer scale of the trends suggests that the existing framework needs to be rethought.

Consider, for example, the dramatic rise of "unicorns"—private firms with an implied market valuation of at least $1 billion; such once-rare firms are among the most prominent manifestations of the deregulation of capital raising during the 2010s. Figure 1 presents relevant data.

FIGURE 1: NUMBER AND AGGREGATE VALUATION OF U.S.-BASED UNICORNS (2012–2021)[13]



Whereas there were approximately 43 unicorn firms in the United States when the term was coined in 2013, at the end of December 2020 their number stood at 251. Just eleven months later, at the start of December 2021, it had nearly doubled to 473. The aggregate implied valuation of U.S. unicorns now stands at $1.58 trillion, which is an eleven-fold in-

12. *See infra* Section II.B. For a summary of the expansive November 2020 reforms, see *infra* notes 165–66 and accompanying text.

13. This data has been compiled by the author from the current and historical editions of the unicorn list maintained by CB Insights. *See The Complete List of Unicorn Companies*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies. The data for 2021 is as of December 3, 2021.

crease since 2013, and a nearly three-fold increase in 2021 alone.[14]

The tectonic shifts in capital markets are by no means limited to the arrival and proliferation of unicorns. The annual number of initial public offerings (IPOs) in the United States has fluctuated considerably over the past 30 years, from a peak of over 500 IPOs per year for much the late 1990s, to fewer than 100 IPOs per year for parts of the 2000s, to over 400 IPOs in 2020 and over 900 in 2021.[15] Whereas the number of U.S. public companies exceeded the number of U.S. private equity-owned companies by a considerable margin in 2000, two decades later these positions have been reversed.[16] Assets under management in the U.S. buyout industry, a key source of private capital, have grown steadily—and more than ten-fold—between 1990 and 2019.[17] While data on capital raising in the opaque private markets is incomplete, it still shows that during the 2010s more capital was raised on the private markets than on the public markets.[18] Today's unicorns rely on the private markets for the growth-intensive stages of their lifecycle, whereas older-generation tech companies, such as Amazon, Google/Alphabet, and Facebook, relied predominantly on the public markets.[19] The typical age of tech firms going public was 7.8 years between 1980 and 2011; since 2012, the year of the passage of the JOBS Act, it has increased to 11 years.[20]

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14. In considering this data, it is important to bear in mind that the number of unicorns is a function of both entry and exit. The total number of unicorns increases each time a private startup reaches a $1 billion valuation, and it decreases when a startup goes public via an IPO (thereby losing its unicorn status) or gets acquired by another unicorn or by a public company. As a result, at any given point in time the total number of unicorns and the aggregate valuation of all unicorns depend on macroeconomic factors, private capital-raising conditions, the state of the public markets (which provide a reference point for private company valuations), IPO conditions, M&A activity, and other factors. Because of its symbolic nature, the $1 billion benchmark has not been adjusted for inflation; the valuation data is presented in current-year dollars.

15. *See infra* Appendix, Figure A–1.

16. *See infra* Appendix, Figure A–2.

17. *See infra* Appendix, Figure A–3.

18. *See infra* Appendix, Figure A–4 and Figure A–5. A global comparison of the growth of public market capitalization and private equity net asset values over time reveals a similar trend. *See infra* Appendix, Figure A–6.

19. *See infra* notes 198–200; *see also infra* Appendix, Figure A–7.

20. *See infra* note 59 and accompanying text.

The headline story that emerges from these datapoints is clear: not only have U.S. capital markets been in a state of flux, but the balance between the *public* and *private* sides has shifted for companies, capital, and markets. As we will see, regulatory policy (*both* regulation and deregulation) is an inextricable part of understanding and explaining this transformation: many of the trends have been driven, at least to some degree, by regulatory policy; many of them have served as a justification for significant changes in regulatory policy, and, today, these trends have implications for regulatory policy.

A seminal article on contemporary securities regulation written by Donald Langevoort and Robert Thompson in 2013 opens by observing that "[s]ecurities regulation is under extraordinary stress today."[21] Langevoort & Thompson's article was prescient about many of the effects of the JOBS Act and spurred an extensive literature; its framing observation is true today more than ever. Writing in 2017, Elisabeth de Fontenay highlighted the deregulation of private capital and linked it to the decline of the public company, ultimately concluding that the existing legal arrangements likely are not sustainable.[22] In analyzing emerging developments, a number of other scholars touched on the broader theme of the eroding distinction between the public and private sides of securities regulation, as did financial and legal commentators.[23] All the while, the SEC continued to shift the foundations of securities law—a process that concluded only at the start of 2021 with the arrival of a new administration.

This Article contributes to the literature in three primary ways. First, it puts forward a novel and comprehensive analytical account of the breakdown of the public–private divide. This account includes an analysis of the full deregulatory cycle, including the major changes to the capital raising framework adopted in late 2020. The account goes further in its assessment of the nature and extent of the changes—the use of "breakdown" as opposed to merely "erosion" is intentional—and it identifies the public company regulatory paradox as a major manifestation of the breakdown. The analytical account

21. Langevoort & Thompson, *supra* note 4, at 337.

22. *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 447 (2017).

23. *See* sources cited in Parts I–IV.

also weaves in extensive evidence about the history, political economy, and capital market impact of the regulatory developments. Second, the Article contributes by analyzing the consequences from the breakdown of the public–private divide on specific firm constituencies (investors and employee-investors) and on a systemic level; the systemic consequences in particular are surprising but heretofore unexamined. Finally, the Article contributes to the literature by investigating possible reforms, including a proposal likely to show up on the SEC's regulatory agenda, and by assessing these proposals' expected effectiveness in returning securities law to a state of conceptual coherence. In this regard, the Article intentionally avoids making substantive recommendations and instead proposes a deliberative process whereby the SEC and relevant stakeholders can arrive at the most appropriate substantive solutions.

The Article proceeds in four main parts, each of which is previewed below.

Part I begins by describing the classic public–private divide in the securities law. More than anything, the public–private divide is a convenient device for conceptualizing the structure of securities law. The locus and nature of the public–private divide has traditionally been a function of the two regulatory spheres established on either side of it: a heavily regulated "public realm" where public companies raise capital from the investing public on the public markets, and a lightly regulated (and often unregulated) "private realm" where private companies raise private capital from special classes of investors on non-public markets. After defining the public–private divide, Part I discusses the various mechanisms for becoming a public company, the evolving rationales for making this choice, and the ever more complex framework regulating the disclosure and governance obligations of public companies.

Part II focuses on the road to the breakdown of the public–private divide. The story starts with the 2002 Sarbanes–Oxley Act, adopted in the aftermath of massive accounting fraud at Enron, WorldCom, Tyco, and elsewhere, which I argue served as the system shock that set into motion many of the developments that followed. By imposing new substantive and disclosure mandates on public companies, Sarbanes–Oxley represented a signal step in the "federalization" of corporate governance, a much-criticized development.

The 2010 Dodd–Frank Act, adopted in the aftermath of the financial crisis and massive taxpayer-funded corporate bailouts of 2008–2009, imposed additional regulation and deepened the role of the federal government in corporate law. The transformative changes put in place by Sarbanes–Oxley and Dodd–Frank coincided with a growing sense of alarm over the apparent decline of U.S. public capital markets at the time, as evidenced by the declining annual number of IPOs and the overall number of public companies, which in turn raised concerns about a loss of global competitiveness.[24]

The two contemporaneous developments were quickly bundled together to suggest that there was a causal relationship: (over)regulation as the cause of economic trouble. Although subsequent research revealed other, more plausible explanations for the decline in public capital markets, and although the decline in IPOs proved to be a temporary phenomenon, the overregulation narrative had already taken hold in the media and among policymakers.[25] The result was the JOBS Act, passed with bipartisan support in 2012, which set off what this Article calls a deregulatory cascade: a cycle of deregulatory measures aiming to facilitate firms' capital raising, which continued through 2020. As we will see, some of these measures exacerbated the very problems they set out to address, which, in turn, became the rationale for yet more deregulation.[26] Two figures included in this Part provide a simplified visual representation of the shifting trends in the flows of capital among public and private firms, and public and private markets since the early 2000s due to the various deregulatory developments. Ultimately, these developments have led to the breakdown of the foundational public–private divide in securities law and the full realization of the present-day public company regulatory paradox.[27]

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24. *See infra* Section II.A.

25. *See infra* Section II.A.

26. *See infra* Section II.B. The deregulatory cascade entailed the following six developments, some of which are mutually-overlapping: enabling the rise of unicorns; emphasizing private markets over public markets; enabling the dramatic rise of private equity; allowing public capital into private companies; transforming public capital into private capital; and promoting regulation-lite regimes. *See infra* Section II.B.

27. *See infra* Section II.C.

Part III shifts the focus from causes to consequences. It finds that the consequences of the breakdown of the public–private divide have been profound both on a conceptual and practical level and that they implicate multiple constituencies within and outside the firm. Four broad themes emerge. First, the federalization of corporate governance, much criticized in academic and policy circles over the past two decades, today looks more like *quasi-federalization*: the regulatory provisions at issue are tied to public capital raising and can now be easily avoided or circumvented by raising capital on the private markets instead. This is a backdoor, market-based "issuer choice" regulatory regime, whose merits remain contested in the academic literature and have never been seriously considered, much less endorsed, by policymakers.[28] Second, and relatedly, the breakdown of the public–private divide has undermined the regulatory capacity of securities law: firms can avoid important disclosure and governance mandates by delaying or never going public, by going private, or by selling off "bad" assets to a private company. Since public company regulation has come to fulfill important roles in ensuring corporate transparency and accountability—and to the extent this development is a desirable one—the breakdown of the public–private divide is a problem not just for capital market participants, but for society as a whole.[29]

The third and fourth sets of consequences relate to mainstream investors and employee-investors, respectively. As regards mainstream investors, there has been a decoupling of the exclusive relationship between public companies and mainstream investors and, consequently, an attenuation of the logic of investor protection upon which much of securities regulation rests. The investor protection issues concern both efficient pricing, i.e., the most basic term of any securities transaction, and matters such as the difficulties in maximizing risk-adjusted returns within an investment portfolio due to information asymmetries, suboptimal corporate governance, and inadequate access to appropriate investment opportunities.[30]

In addition, the breakdown of the public–private divide compounds the problems faced by a special class of inves-

28. *See infra* Section III.A.
29. *See infra* Section III.B.
30. *See infra* Section III.C.

tors—employees of startup companies who usually receive a considerable amount of their total compensation in illiquid and hard-to-value private company stock and stock options and who are incapable of mitigating through diversification the firm-specific risk associated with their investment of both financial and human capital via the employment relationship. Unlike in the past, these problems are no longer capped in size or duration, because startups can now raise unlimited amounts of private capital (with larger private startups having more employees and, accordingly, more employee-investors), and because startups can remain private, and thus untouched by federal corporate governance regulation, virtually indefinitely.[31]

Part IV considers possible avenues for reform. One set of options relates to *rebuilding the public–private divide*—either by filling various regulatory gaps in the lightly-regulated private realm, or by adjusting regulation to expand the size of the public realm.[32] As an example of the latter, SEC Commissioner Allison Herren Lee recently put forward a simple, yet bold proposal: The SEC should revise the concept of "shareholder of record" used in existing legislation to more accurately capture the true number of beneficial owners—a change that will automatically push a number of large private companies into the heavily-regulated public realm. An analysis of this proposal suggests that it will be an effective tool for rebuilding the original public–private divide—and a blunt one at that, which, somewhat counterintuitively, puts its feasibility into question. While Commissioner Lee's proposal will address most of the problems stemming from the breakdown of the public–private divide, it does not solve, and will likely exacerbate, problems related to employee-investors.[33]

A second set of reform options entails *circumventing the public–private divide* rather than rebuilding it. This can be done by shifting some of the economic regulation that currently operates through securities law to other regulatory domains, in effect lowering the distinction between public and private companies.[34] These options are not mutually exclusive but

31. *See infra* Section III.D.
32. *See infra* Section IV.A.
33. *See infra* Section IV.A.3.
34. *See infra* Section IV.B.

they are likely to be difficult and costly to implement. Given historical patterns of regulation, as well as the political and logistical roadblocks to reform, the Article posits that securities law may well need to wait until the next big market crisis—or its next "critical juncture"—before the public company regulatory paradox can be addressed.[35]

Despite its unspecified timing and outcome, this conclusion need not be viewed as defeatist. There is much that the SEC, capital market participants, and other corporate governance stakeholders can do now to ensure that when the opportunity for reform arises, it will be used to optimize the regulatory landscape. The recent history of securities regulation is replete with examples of hastily implemented reforms that did not enjoy broad support,[36] making careful deliberation all the more important. The recent breakdown of the public–private divide around which securities regulation has been organized since the 1930s puts the field in disarray but it also offers opportunities for blue sky thinking. In order to be able to seize on these opportunities for innovation, it is crucial to understand exactly where we are today and how we got here—a key goal of this Article.

Before proceeding with the main exposition, a brief note about scope, approach, and nomenclature. While the Article touches on all *major* trends and regulatory developments in U.S. capital markets since the early 2000s that are relevant to the topic, it does not catalog every rule change; indeed, to do so in this context would be impossible. In addition, while the Article contains extensive technical detail, it ultimately seeks to translate and analyze discrete legal developments on a conceptual level—in line with the fact that the public–private divide is a conceptual device for thinking about the regulation of capital raising and capital markets. This makes it necessary to balance generality and specificity, with all the attendant trade-offs. To facilitate the translation process, the Article also

35. *See infra* Section IV.C.

36. The 2012 JOBS Act is the most prominent recent example. As discussed in Section II.B, the JOBS Act was heavily influenced by industry lobbyists. Even though some of its provisions dealt with highly-technical aspects of securities law, and even though the SEC (as the competent administrative agency) expressed skepticism about some of the bill's provisions, the SEC's objections barely registered and failed to prevent passage of the bill. *See infra* notes 161–63 and accompanying text.

purposefully avoids various specialized terms from the securities law rulebook unless their use is required by context,[37] and, where the context permits, it uses other, more general terms, which have a commonly-understood meaning in the legal and policy community, but no statutory definition.[38] Finally, the Article identifies various trends with the help of available data, and analyzes their legal and economic determinants as well as their policy implications. It is worth keeping in mind, of course, that in certain circumstances data is limited or imperfect, and that causal inferences are always open to contestation.[39]

I.
The Architecture, Goals, and Means of the Regulatory Regime

To set the stage for the analytical core of the Article, this Part provides an overview of the structure and scope of securities law as it pertains to public and private companies, public and private investor capital, and public and private markets. It does so by discussing the legal provisions that serve to construct the public–private divide, the reasons for and mechanics

37. This includes using "public company" in lieu of specialized terms such as "issuer," "registrant," and "reporting company," unless those are required in order to draw a meaningful distinction.

38. These terms include "public capital" (generally, capital raised or traded on the public capital markets and/or capital raised from or traded by investors not subject to qualification restrictions), "private capital" (generally, capital raised or traded on private capital markets and/or capital raised from or traded by qualified investors in line with specific regulatory exemptions), "public investors" (generally, mainstream investors whose access to investment opportunities is regulated and, traditionally, has been more limited), and "private investors" (investors who qualify for special and less-regulated investment opportunities in addition to the opportunities available to public investors).

39. The following quote from John Coates applies to many of the matters discussed in this Article: "[C]orporate governance is not rocket science—in fact, it is much more complicated than rocket science. . . . [T]here are few consensus views among researchers about any non-trivial topic . . . and evidence tends to emerge slowly, is rarely uncontested, and is subject to constant (and often dramatic reevaluation)." *Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urb. Affs.*, 111th Cong. 45 (July 29, 2009) (statement of John C. Coates IV, Professor, Harvard Law School).

of becoming a public company, and the far-reaching regulatory consequences of taking on public company status.

A. *The Public–Private Divide*

The public–private divide is a useful conceptual device for making sense of much of the original design of U.S. securities law.[40] Each of the securities law statutes, including the Securities Act, the Securities Exchange Act, and the Investment Company Act, covers certain economic actors or economic activities while exempting other economic actors or economic activities from regulation; in other words, each of the statutes draws lines. In the aggregate, these lines create two regulatory spheres: a heavily-regulated "public realm" where public companies raise capital from the investing public on the public markets, and a lightly-regulated (and often unregulated) "private realm" where private companies raise private capital from special classes of investors on non-public markets. The *public–private divide* is what separates the public and private—regulated and unregulated—realms. The "breakdown of the public–private divide," then, refers to the removal of the boundaries between these two realms and the notion that, functionally, the public–private distinction has lost both its descriptive and its explanatory power as an organizing principle of securities law.

The genesis of the public–private distinction is Congress' observation in 1933 that the Securities Act, the first of the modern securities laws, should not regulate transactions "where the public benefits are too remote."[41] The Securities Act put this principle in practice by distinguishing between public (or "registered") offerings, which are subject to extensive disclosure requirements and communication restrictions,[42] and "transactions by an issuer not involving any public

40. *See* Langevoort & Thompson, *supra* note 4, at 339 (2013) (conceptualizing the public–private divide and noting that it "has long been an entirely under theorized aspect of securities regulation").

41. Comm. on Interstate & Foreign Com., House Report on Securities Act of 1933, H.R. Rep. No. 73–85, at 5 (1933).

42. The disclosure requirements at the offering stage under the Securities Act are a subset of the disclosure requirements described in Section I.C.1 *infra*; the publicity restrictions relate to gun-jumping and other communication prohibitions. *See* LATHAM & WATKINS LLP, U.S. IPO GUIDE (2021), https://bit.ly/3rCzt0m.

offering," which are exempt from registration.[43] Since the term "public offering" was left undefined in the statute, it fell to the SEC, with a subsequent assist from the Supreme Court, to map out the public–private line in the Securities Act.

Early on, the SEC focused on a multi-factor approach that reflected an expansive understanding of publicness.[44] In 1953, the Supreme Court held that an offering to investors who can "fend for themselves" was not a public offering.[45] In 1982, the SEC issued Regulation D, which largely codified existing practice and anchored the public–private divide with reference to factors such as aggregate offering price, number and status of investors, and publicity.[46] Significantly, Regulation D placed heavy reliance on the category of "accredited investors"—sophisticated investors who can "fend for themselves" and who are allowed to participate in private offerings because they do not need the full protections of the Securities Act.[47] Institutions fit easily within the logic of this concept. In the case of individual investors, however, sophistication was much more difficult to capture and the SEC used high income and high net worth as proxies.[48] Issuers could avoid registration—and the bulk of securities regulation—as long as they conducted a

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43. *See* Securities Act of 1933 (Securities Act) § 4(a)(2), 15 U.S.C. § 77d(a)(2). Even though private offerings fall inside the unregulated private realm, private offerings must still comply with various procedures in order to attain and retain their "private" status.

44. *See* Letter of General Counsel, Securities Act Release No. 285, 1935 WL 27,785 (Jan. 24, 1935). The release covered the following considerations with respect to whether or not an offering constituted a "public offering": "(1) [t]he number of offerees and their relationship to each other and to the issuer[,] . . . (2) [t]he number of units offered[,] . . . (3) [t]he size of the offering," and "(4) [t]he manner of offering." *Id.*

45. SEC v. Ralston Purina Co., 346 U.S. 119, 120 (1953).

46. *See* Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Release No. 33–6389 (Mar. 8, 1982), 47 Fed. Reg. 11,251.

47. It is a less-known fact that the "accredited investor" concept was created by Congress, not the SEC, pursuant to the Small Business Incentive Act of 1980. *See id.*, at 11,251–52.

48. Among other criteria, Regulation D defines as accredited investors individuals with an annual income over $200,000 or net worth of at least $1 million. 17 C.F.R. §§ 230.501(a)(5)–(6). Because this definition has never been updated to account for inflation, these thresholds are much lower in real terms today than they were in 1982. In other words, it takes significantly less wealth today than it did in 1982 for an investor to be deemed sophisticated. *See infra* note 183 and accompanying text. The changes implemented

small offering, to a limited number of sophisticated investors, and without engaging in general solicitation and general advertising.[49] As we will see in Section II.B, the deregulatory cascade of the 2010s has had a particularly erosive effect on these categories, which has contributed to the breakdown of the public–private divide.

The Exchange Act also helps structure the public–private divide. For one, it defines the content of public company regulation (discussed in Section I.C.1), since it sets out the requirements for "reporting companies"—this is the content of the regulation in the regulated public realm.[50] In addition, the Exchange Act draws the line between public and private companies: As discussed in more detail in Section I.B, public companies are those that have conducted a registered offering of securities, elected to list securities on a national securities exchange, or fall above certain size thresholds pertaining to number of investors and value of assets.

The Exchange Act complements the Securities Act, but also reflects a different and somewhat inconsistent approach: Whereas the focus of the Securities Act is on *investor qualification*, as determined by wealth and sophistication, the Exchange Act generally focuses on the *funding choices and size attributes* of the issuer.[51] (The JOBS Act introduced further inconsistency by importing the concept of accredited investor into Section 12(g) of the Exchange Act;[52] because Section 12(g) has become largely irrelevant, however, the significance of this change is more symbolic than practical.)

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in November 2020 expanded the definition by adding indicators of financial literacy as qualifying factors. *Id.*

49. Regulation D, Rules 504–06, 17 C.F.R. §§ 230.504–06.

50. *See infra* Section I.C.1.

51. The inconsistency in the public–private lines under the Securities Act and the Exchange Act was first discussed in works by Donald Langevoort & Robert Thompson, and Adam Pritchard. *See* Langevoort & Thompson, *supra* note 4 (noting a "gross inconsistency in how the two main securities statutes—the Securities Exchange Act of 1934 and the Securities Act of 1933—approach [the public–private] divide"); A.C. Pritchard, *Revisiting "Truth in Securities" Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1000 (2013) ("Both the Securities Act and the Exchange Act reflect a public–private divide, but they take very different approaches to drawing that line.").

52. *See infra* note 77 and accompanying text.

The final building block of the public–private divide relates to the regulation of *pools of capital*. The basic distinction here is between registered investment companies, such as mutual funds and money-market funds, which are subject to stringent regulation under the Investment Company Act of 1940, and private investment companies, including private equity funds and hedge funds, which are generally exempt from registration.[53] As we will see in Section II.B, the deregulation of this sphere has increased the supply of private capital; this increased supply has been able to satisfy the increased demand for private capital, which has been driven by the deregulation of matters governed by the Securities Act and the Exchange Act.

B. *Becoming a Public Company*

All mainstream business entities in the United States are organized under state law. Among those, corporations incorporated in Delaware are the most common type of entity that chooses to become a public company by following one of the pathways established by federal securities law.[54] An entity that has not chosen to become a public company is referred to as a private company. The sections that follow discuss two key background matters: why firms become public companies, and how they go about doing it. Despite the seeming continuity of U.S. capital markets, the answers to both questions have evolved in

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53. For a comprehensive and original analysis of the public–private divide as it pertains to investment companies, see Cary Martin Shelby, *Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency*, 69 S.M.U. L. Rev. 405 (2016). For an insightful analysis of the historical origins of the distinctive public–private line in this area, see John D. Morley, *Collective Branding and the Origins of Investment Management Regulation*, 6 Va. L. & Bus. Rev. 341 (2012).

54. Note that while the corporation is the most common type of public company, limited partnerships, limited liability companies, and other entity types may also opt into the public company category established by federal law. Foreign business entities, somewhat confusingly referred to as "foreign *private* issuers," may also opt into all or, more commonly, a subset of U.S. public company regulation. Delaware's dominance as the preferred jurisdiction of incorporation for public companies is illustrated by the fact that in 2020 nearly 68% of Fortune 500 companies were registered in Delaware and approximately 93% of new U.S. IPOs were conducted by Delaware-registered entities. *See* Del. Div. Corps, 2020 Annual Report Statistics (2020), https://bit.ly/317nqNq.

recent years as a result of market developments and in response to regulation.

1. *Motivations for Going Public*

On a conceptual level, becoming a public company entails a bargain: a heretofore private company gains access to large and highly liquid pools of public capital, which enables it to raise funds quickly, efficiently, and at low cost, but, in return, the company becomes subject to an extensive federal regulatory regime. The foundational rationale for this regime's existence is the need to protect the "investing public"—the investors, i.e., suppliers of capital, who buy and sell securities on the public markets.[55]

The access-to-capital justification for going public has always had the greatest currency, but it increasingly fails to account for the observed market reality. The expanded supply of *private capital* due to the deregulatory cascade of the 2010s makes access to *public capital* much less of a growth imperative.[56] Tech firms such as Uber, Airbnb, and Dropbox were able to support their growth with private capital for years before they chose to go public, in each case reaching a previously-unimaginable scale and attaining the status of "unicorns" (private valuation of at least $1 billion), and, subsequently, "decacorns" (private valuation of at least $10 billion).[57] With so much private capital on offer, the process of going public—and becoming subject to federal corporate governance regulation—can be put off for a long time: the median age of U.S.

55. *See, e.g.,* Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 221–22 (2013); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 19, 50 (1982).

56. *See infra* Sections II.B–C.

57. *See, e.g.*, George S. Georgiev, *Securities Laws are Speed Bumps that Prevent Uber-Sized Wrecks*, HILL (June 29, 2017), https://bit.ly/3D3b5aa [hereinafter Georgiev, *Uber-Sized Wrecks*] (discussing the rise of unicorns and associated regulatory issues). The most recent additions to the unicorn nomenclature are the terms "hectocorn" and "centicorn," which refer to a private company with an implied valuation of over $100 billion. While unicorns are now commonplace, hectocorns or centicorns do remain rare. *See* Michael Sheetz, *Elon Musk's SpaceX Hits $100 Billion Valuation After Secondary Share Sale*, CNBC (Oct. 8, 2021), https://cnb.cx/3rhq3XD (noting that SpaceX has become the first, and so far the only, U.S.-based company to reach an implied private valuation over $100 billion).

tech firms going public in 1999 was 4 years, whereas in 2020 it was 12 years.[58] Based on 40 years of data, the pre-JOBS Act (1980–2011) average median was 7.8 years (notwithstanding the dot-com bust and the global financial crisis, both of which delayed many IPOs and skew this number upwards), whereas the post-JOBS Act (2012–2020) average median had increased considerably to 11 years.[59]

Beside public versus private capital, another relevant distinction for explaining the changed market realities relates to the increased importance of *non-financial capital* relative to financial capital. Evidence suggests that firms in certain industries have more difficulty attracting human capital than financial capital, and, simultaneously, that human capital has become more important than financial capital to many firms' success.[60] A recent study observed that "[p]ossibly for the first time in history, we're talent-constrained instead of [financial] capital-constrained."[61]

The increase in the relative importance of human capital as a result of changes in the economy has impacted the IPO calculus: At many firms, the going-public decision, ostensibly about raising new financial capital, has become subordinate to concerns about attracting and keeping human capital, i.e., the skills and knowledge embodied in the firm's employees. Startups often use their own equity to cover part of the compensa-

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58. *See* JAY R. RITTER, INITIAL PUBLIC OFFERING: UPDATED STATISTICS 12 tbl. 4a (2021), https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf [hereinafter *Ritter's IPO Database*].

59. Author's calculations based on data contained in *Ritter's IPO Database*. A prominent discontinuity in the trend occurred in 2008: In the period 1980–2007, the median IPO age ranged between 4 and 9 years; in the period 2008–2020, it ranged between 9 and 14 years. *Id.* Ritter's annual data is reported as a median; my calculations for multiple-year periods take the average of the annual median figures, hence the references to "average median."

60. *See, e.g.*, Vijay Govindarajan et al., *Why We Need to Update Financial Reporting for the Digital Era*, HARV. BUS. REV. (June 8, 2018), https://bit.ly/3rxRpJn (noting that "[f]inancial capital is assumed to be virtually unlimited, while certain types of human capital are in short supply").

61. Eric Ries, *Foreword* to SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT, at xi (2019). *See also* George S. Georgiev, *The Human Capital Management Movement in U.S. Corporate Law*, 95 TUL. L. REV. 639 (2021) [hereinafter Georgiev, *Human Capital Management*] (discussing firms' adaptive responses to the increased significance of human capital).

tion packages for executive and non-executive employees.[62] Doing so has considerable advantages: saving on salary expenses, managing liquidity, and aligning performance incentives. However, by the time a firm has a sizeable workforce and/or has been in existence for some time, there is also a sizeable (and often vocal) group of stakeholders—the firm's employees—who have a vested interest in the firm going public.[63] Employees prefer for the stock they receive as part of their compensation to be publicly traded because public company stock is free of trading restrictions, has greater liquidity, and may command a premium over otherwise-identical private company stock.[64] The human capital justification for going public does not apply consistently across the economy; instead, it is a consideration predominantly at tech firms that have a substantial need for professionals whose skills are scarce.

To be sure, any IPO decision is unlikely to be driven by a single factor. Beside human capital, there are a number of other ancillary considerations and explanations that do not revolve around the need to raise new equity capital.[65]

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62. *See, e.g.,* Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019) (describing the process and associated legal challenges).

63. *See, e.g.*, Erin Griffith, *Inside Airbnb, Employees Eager for Big Payouts Pushed It to Go Public*, N.Y. TIMES (Sept. 20, 2019), https://nyti.ms/3HXxdqd (noting tensions among Airbnb's 6,000-person workforce due to delays in the IPO process).

64. For an overview of the relevant considerations, see Eric D. Schoenborn, *Equity Compensation at Private Firms: How to Compete for Executive Talent*, SOC'Y FOR HUMAN RES. MGT. (Jan. 15, 2009), https://bit.ly/31b9D8s.

65. For example, going public gives firms opportunities to adjust their capital structure. For one, it enables firms to *return equity capital* to existing investors by making it possible to borrow more efficiently on the *public debt markets*. Alternatively, it enables them to replace one set of investors (venture capital and private equity funds) with another set of investors (those investing through the public markets). Separately, firms may pursue an IPO because public companies are widely covered in the financial and general press and enjoy a significant amount of free publicity relative to private companies; this is of particular value to consumer-facing businesses. Public company stock can also serve as an acquisition currency, meaning that an acquisitive firm would benefit from public company status. Finally, going public may send a positive signal about a firm's maturity and the quality of its corporate governance: the decision to go public can function as a bonding mechanism, which might yield real benefits in terms of the cost of capital. *See, e.g.,* John C. Coffee, Jr., *The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, *in* GLOBAL MARKETS, DOMESTIC INSTITUTIONS 437 (Curtis J. Milhaupt ed., 2003) (discussing the benefits of

2. *Pathways to Going Public*

Whereas the justifications for taking on public company status come from the realm of business strategy, the process of doing so is driven by law. Becoming a public company generally involves a carefully choreographed, multi-stage process that requires financial advisors (underwriters), legal advisors, auditors, public relations experts, and others. By far, the most common and most well-known scenario involves conducting an IPO under the Securities Act of 1933 by issuing new securities as a means of raising additional equity capital.[66] Traditional IPOs involve a great degree of intentionality, planning, and expense,[67] all of which have contributed to recent deviations from the default approach.

Another path to going public involves listing already-existing securities on a national stock exchange; this process triggers public company status through the registration requirements contained in the Securities Exchange Act of 1934.[68] While relatively uncommon until recently, this avenue for taking on public company status gained more prominence after Spotify's direct listing transaction in 2018 and the New York Stock Exchange's subsequent efforts to amend its listing requirements to facilitate such transactions.[69] Spotify's direct listing resulted in a near-instantaneous $30 billion public com-

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U.S.-style public company regulation in terms of access to capital); Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L L. 141 (2003) (discussing the nexus between listing on the regulated public markets and enhanced access to capital).

66. *See* Securities Act § 5(c), 15 U.S.C. § 77e(c) (2012) (prohibiting the sale of any security unless a registration statement is effective); *id.* § 77d(a)(2) (declaring that the prohibition does not apply to "transactions by an issuer not involving any public offering"). The specific prescriptions of the Securities Act, as well as the liability provisions that apply to issuers, their directors and officers, and to underwriters have made the traditional IPO process both structured and standardized.

67. *See, e.g.*, LATHAM & WATKINS LLP, *supra* note 42 (providing a detailed guide to the mechanics of the traditional IPO process).

68. *See* Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78l(d) (2011).

69. *See* Marc D. Jaffe et al., *Spotify Case Study: Structuring and Executing a Direct Listing*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 5, 2018), https://bit.ly/3FZO8GN (discussing Spotify's innovative direct listing transaction). Other companies that have taken advantage of this route include Slack, Palantir, Asana, and Thryv Holdings. *See* Anna T. Pinedo et al., *Primary Direct Listings: A Hybrid Approach to a Traditional IPO Alternative*, HARV. L. SCH. F. ON

pany valuation.[70] One considerable advantage to direct listings is the cost saving. Whereas companies pursuing traditional IPOs pay as much as 7% of the IPO proceeds in fees to their underwriters and often deliberately underprice the stock to ensure an "IPO pop" on the first day of public trading, companies going public through direct listings can avoid these costs.[71] Relatedly, removing underwriters from the process also removes the risk of misaligned incentives in IPO pricing.[72]

Mergers, acquisitions, and spin-off transactions are also used to create public companies, or take on public company status, without conducting a traditional IPO. SPAC transactions—controversial but booming—involve the public listing of a shell company (a special-purpose acquisition vehicle), which uses the IPO proceeds to acquire an existing operating company; the upshot is that the operating company attains public company status without going through the disclosure and due diligence process associated with a traditional IPO.[73] As illustrated by Figure A–1 in the Appendix, such transactions have experienced a dramatic resurgence since 2017, having previously enjoyed a brief spell of popularity immediately

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CORP. GOVERNANCE (Jan. 24, 2021), https://bit.ly/3leYdYc (discussing precedent transactions and the SEC's evolving approach to direct listings).

70. *See* Katie Roof, *Spotify Opens at $165.90, Valuing Company at Almost $30 Billion*, TECHCRUNCH (Apr. 3, 2018), https://tcrn.ch/3rejoh7.

71. *See* Matt Levine, *How to Disrupt the IPO Pop*, BLOOMBERG OP. (Oct. 4, 2019), https://bloom.bg/3D1uxE0. Evidence suggests that the average IPO is underpriced by approximately 20% to ensure that the stock price rises on the first day of trading, which benefits large institutional investors that received initial allocations. *See Ritter's IPO Database*, *supra* note 58, at 4 (reporting that "money left on the table" for all IPOs conducted between 1980 and 2020 averaged 20.1% of proceeds on a proceeds-weighted basis); *see also* John C. Coffee, Jr., *The Irrepressible Myth That SEC Overregulation Has Chilled IPOs*, COLUM. L. SCH. BLUE SKY BLOG (May 29, 2018), https://bit.ly/3pbqa4j (discussing IPO mechanics and associated costs).

72. *See, e.g.*, Patrick M. Corrigan, *Footloose with Green Shoes: Can Underwriters Profit from IPO Underpricing?*, 38 YALE J. ON REG. 908, 914 (2021) (noting that "[g]reen shoe options break the incentive alignment of underwriters and issuers to price IPOs as high as possible, since underwriters maximize the value of green shoe options by pricing the IPO as *low* as possible").

73. *See, e.g.*, John Detrixhe, *IPOs Are Popping Like It's 1999, and Executives Are Fed Up*, YAHOO (Sept. 3, 2020), https://yhoo.it/3E7kYF1. The securities law liability implications of both SPACs and direct listings are as-yet uncharted territory. *See* John C. Coates, *Statement by Acting Director Coates on SPACs, IPOs and Liability Risk Under the Securities Laws*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 9, 2021), https://bit.ly/3D30FaD.

prior to the 2008 financial crisis.[74] Using somewhat similar mechanics, reverse mergers are another non-conventional (and similarly controversial) way to gain public company status.[75] Though largely overlooked in the literature, spin-off transactions in accordance with SEC Staff Legal Bulletin No. 4 are another means of creating a public company. In a spin-off, an already-existing public company carves out business assets, bundles them into a new company, and distributes the shares of this new company as a tax-free dividend to its existing public shareholders.[76]

The final mechanism for going public is very important for purposes of this Article, but it is largely irrelevant for capital market participants; indeed, it is important here precisely because it has grown to be irrelevant. Under Section 12(g) of the Exchange Act, if a private company reaches a certain number of public "shareholders of record" and a certain minimum asset size (jointly, an imperfect proxy for firm size), the company automatically becomes subject to the reporting requirements of the Exchange Act and, thus, a public company. In effect, a business entity could become a public company without taking any affirmative steps to raise capital or improve secondary market liquidity. Congress initially set the registration trigger at 500 shareholders of record in 1964. In 2012, it raised the overall registration trigger to 2000 shareholders of record, added an additional registration trigger at 500 non-accredited investors, and expressly excluded employee-investors from the

74. The SPAC trend may be curtailed if litigation filed by law professors John Morley and Robert Jackson in 2021 is successful. Morley and Jackson have argued that SPACs should be regulated as investment funds (and not merely as operating companies), which would result in stricter oversight under the Investment Company Act of 1940. *See, e.g.*, Andrew Ross Sorkin et al., *A SPAC Counterattack*, N.Y. TIMES (Aug. 30, 2021), https://nyti.ms/3lAv61K.

75. *See, e.g.*, Thompson & Langevoort, *supra* note 4, at 1588–98 (discussing the law and economics of reverse mergers). Definitionally, reverse mergers are transactions whereby "a private company directly or indirectly merges into a shell company that has established itself as a public issuer under the [Exchange] Act." *Id.* at 1589.

76. *See* SEC Staff Legal Bulletin No. 4 (CF) (Sept. 16, 1997). On the governance implications of spin-offs, see Young Ran (Christine) Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-Offs*, 10 U.C. IRVINE L. REV. 1 (2019).

count.[77] (Arguably, the legislative change was initiated to accommodate Facebook, which, at the time, was on course to reach the 500-shareholder threshold before it was ready to go public.[78])

The higher threshold for mandatory registration post-2012, the exclusion of employee-investors from the count, and the evolution of technologies that artificially deflate the count, have rendered this provision essentially meaningless. The original rationale behind it, however, is worth bearing in mind: in 1964, Congress determined that firms of a certain size (and, implicitly, societal footprint) should be subject to federal regulation irrespective of those firms' capital raising needs and irrespective of their preferences regarding public company status.

There are certain other categories of companies that can be described as semi-public: because of various characteristics—most notably small size, infancy, and foreign status—they are subject to a subset of public company regulations, either permanently or, as in the case of emerging growth companies, for up to five years.[79] The level of heterogeneity and complex-

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77. Section 12(g) of the Exchange Act, as amended by the JOBS Act, requires a company to register its securities under the Exchange Act if it has $10 million or more in total assets and a class of equity securities "held of record" by 2000 or more persons (or 500 or more persons who are not "accredited investors"). *See* Exchange Act § 12(g)(1)(A), 15 U.S.C. § 78l(g)(1)(A) (2012). Importantly, both numbers exclude shareholders who received the securities through an employee compensation plan exempt from registration. *Id.* § 781(g)(5).

78. *See* Richard Waters, *Effects of the JOBS Act Are Hard to Predict*, FIN. TIMES (Apr. 4, 2012), https://on.ft.com/3E2gsaZ. *See also* Langevoort & Thompson, *supra* note 4, at 355–59 (discussing the issue of Facebook's pre-IPO capital raising in the context of the Exchange Act).

79. For example, "smaller reporting companies," which generally have a public float of less than $250 million, are required to disclose less historical financial information. They also receive exemptions from certain provisions of the Sarbanes–Oxley and Dodd–Frank Acts, and have more time to file their reports. Additionally, the JOBS Act created the category of "emerging growth company" (EGC) for firms with gross annual revenue of less than $1 billion (indexed to inflation and subject to periodic update). EGCs enjoy substantially reduced disclosure requirements, both under the Securities Act as part of the IPO process, and under the Exchange Act for purposes of their ongoing reporting obligations (for up to five years). Regulation A and Regulation CF (Crowdfunding) enable firms to raise small amounts of capital without complying with the full disclosure regime. Foreign companies issuing securities in the United States also benefit from certain exemptions. *See*

ity in the securities laws has expanded considerably as a result of the developments discussed in Section II.B. This Article focuses on the paradigmatic public company, which is subject to all the public company regulations described in Section I.C.

C. *Regulatory Means and Ends*

Public company regulation—the public realm of securities law—comprises a set of interwoven SEC rules and regulations,[80] various liability provisions,[81] stock exchange listing rules,[82] and public company accounting standards.[83] Taken together, these are most accurately described as a loosely-coordinated system of federal corporate governance, which sits atop the corporate governance provisions contained in applicable state law statutes.[84] Because of its accretive nature and the absence of a single legislative or administrative instrument containing all relevant provisions, public company regulation is sometimes dismissed as merely a system of investor-oriented disclosure rules and procedural shareholder voting rules that are flawed or, at best, ineffectual. Such descriptions, however, are both reductive and incomplete: certain provisions framed as disclosure rules extend beyond the dissemination of information and shape internal governance arrangements or corporate behavior; other provisions directly impose substantive mandates.

George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. Rev. 602, 614–16 (2017) [hereinafter Georgiev, *Too Big to Disclose*].

80. This includes rules and regulations promulgated by the SEC pursuant to specific mandates in federal legislation, such as the Sarbanes–Oxley and Dodd–Frank Acts, as well as the SEC's broad authority over disclosure.

81. *See generally* Thomas Lee Hazen, Treatise on the Law of Securities Regulation §§ 7.0–7.17, 12.1–13.2, Westlaw (database updated 2021).

82. Stock exchange listing rules are commonly viewed as an integral part of public company regulation. Some of these rules stem from the Sarbanes–Oxley and Dodd–Frank Acts, whereas others do not but have the same effect in practice. *See generally* Geeyoung Min & Kwon-Yong Jin, *Relational Enforcement of Stock Exchange Rules*, 47 BYU L. Rev. (2021).

83. *See, e.g.*, Corporate Accounting Practices: Is There a Credibility GAAP?: Hearing Before the H. Subcomm. on Cap. Mkts., Ins., and Gov't Sponsored Enters., Comm. on Fin. Servs., 107th Cong. 152–64 (2002) (statement of Robert K. Herdman, Chief Accountant, U.S. Sec. & Exch. Comm'n).

84. *See* Marc I. Steinberg, The Federalization of Corporate Governance 19–20 (2018).

The overview that follows pays special attention to these points because they are vital to appreciating the full range and depth of the regulatory regime. It is also worth emphasizing that this regime represents a significant difference between private companies, which are subject only to state law rules, and public companies, which are subject to the comprehensive federal regulatory scheme described here *in addition to state law rules*. The overview highlights the deeply problematic nature of firms' ability to treat this regime as elective and the resulting public company regulatory paradox described in the Introduction. The question about the goals of the regulatory regime is discussed at the end of this section.

1. *The Public Company Regulatory Regime*

The majority of public companies, as well as the paradigmatic public company, are subject to the full range of public company regulation.[85] The requisite information, including, in the case of substantive requirements, confirmations of compliance, is disclosed publicly according to timelines devised by the SEC.[86] The regulatory requirements are backed up by an elaborate liability and enforcement regime, which includes private enforcement by shareholders (and, in certain cases, bondholders), public enforcement by the SEC (and, in certain cases, the DOJ), and a regime of sanctions maintained by the stock exchanges.[87] Enforcement of state law claims often bene-

85. Recall, however, that firms that fall in certain categories are exempt from some of the rules, either generally or for a limited time. *See* Georgiev, *Too Big to Disclose, supra* note 79 and accompanying text.

86. Depending on the rule in question, disclosure may be called for periodically (yearly or quarterly), on a current basis (promptly upon the occurrence of significant corporate events), or episodically, in connection with certain major transactions. See DIV. CORP. FIN., U.S. SEC. & EXCH. COMM'N, FINANCIAL REPORTING MANUAL 19, 36 (2008). For example, the SEC's Form 10-K sets out information to be disclosed on an annual basis, Schedule 14A sets out information required to be filed in connection with matters subject to a shareholder vote (usually at the annual general meeting), and Form 10-Q sets out information to be disclosed on a quarterly basis. *Id.* The current reporting requirements are set out in Form 8-K, which must be filed within four business days of the occurrence of the relevant event. *Id.* at 38. As an example of episodic disclosure, a tender offer would necessitate the filing of information required under Schedule TO. *Id.* at 349–50.

87. As part of enforcement proceedings, the SEC routinely enters into one-off settlement agreements with public companies whereby the companies voluntarily undertake to make substantial changes to their governance

fits substantially from information disclosed as a result of regulatory requirements under federal law.[88] The public nature of disclosure also guarantees that firms will be subject to public scrutiny from the media, academics, public interest organizations, politicians, and others.

The most familiar elements of public company regulation require the reporting of historical information about a firm's business activities, financial condition, and results of operations, as well as more forward-looking information about material trends and uncertainties, risks facing the business, and exposure to legal proceedings, among other business and operational issues.[89] The shareholder meeting process is also regulated through a set of requirements that put in place procedural safeguards and mandate disclosure of additional information in connection with matters subject to a shareholder vote. Such matters include the election of board members, amendments to the firm's organizational documents, approval of certain types of transactions, non-binding resolutions contained in shareholder proposals, and non-binding approval of executive compensation arrangements.[90]

Financial reporting is another heavily regulated area. The relevant rules implicate both the nature and format of information required to be disclosed and, importantly, the internal procedures and oversight mechanisms within public companies. As a basic matter, public companies are required to file audited financial statements with the SEC.[91] These statements, which often include lengthy expositions in the form of "notes," provide a wealth of information in a standardized for-

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practices that go beyond what the law requires. *See* STEINBERG, *supra* note 84, at 142–45.

88. *See, e.g.*, *In re* Clovis Oncology Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188 at *5, *7, *9 (Del. Ch. Oct. 1, 2019) (relying on required periodic disclosure filings to support review of duty of oversight claim under Delaware law).

89. These requirements are contained, respectively, in the following provisions of SEC Regulation S-K: Item 101, Item 303, Item 503(c), Item 305, and Item 103. *See* 17 C.F.R. § 229 et seq.

90. *See* Schedule 14A, 17 C.F.R. § 240.14a-101 (2020). The votes on shareholder proposals and executive compensation arrangements are advisory to the board. *See* Rule 14a-8, 17 C.F.R. § 240.14a-8 (2020); Regulation S-K Item 402, 17 C.F.R. § 229.402 (2020).

91. *See* Regulation S-K Item 302, 17 C.F.R. § 229.302 (2020); Regulation S-X Rule 10-01, 17 C.F.R. § 210.10-01 (2020).

mat.[92] The process for promulgating accounting standards, administered by the Financial Accounting Standards Board (FASB) and overseen by the SEC, also amounts to a form of public company regulation.[93] A separate regulatory body, the Public Company Accounting Oversight Board (PCAOB), sets and oversees standards for preparing audit reports.[94]

The regulation of public company financial reporting covers not just the outputs but also the process. The CEO and CFOs of public companies are required to certify in periodic reports filed with the SEC that the financial statements and other disclosures contained in such reports are accurate, and fairly and accurately present the company's operations and financial condition.[95] In connection with making this certification, the officers are responsible for establishing and maintaining "disclosure controls and procedures"[96] and "internal control over financial reporting."[97] Guidance on how to meet these mandates is extensive and fairly prescriptive.[98] Relatedly, companies are required to assess and report on the effectiveness of their internal control structure and, if material weaknesses are identified, disclose those to shareholders.[99] The internal controls must also be inspected and reported on by an

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92. *See* Regulation S-X Rule 10-01, 17 C.F.R. § 210.10-01.

93. *See Standard-Setting Process*, FIN. ACCT. STANDARDS BD., https://bit.ly/2ZAfqny.

94. Sarbanes–Oxley Act of 2002 § 101, 15 U.S.C. § 7211 (2012); *Public Company Accounting Oversight Board (PCAOB)*, INVESTOR.GOV, https://bit.ly/3xzMxVe. While the PCAOB is independent, its members are appointed by the SEC. *Id.*

95. Sarbanes–Oxley Act of 2002 § 302.

96. Exchange Act Rule 13a–15, 17 C.F.R. § 240.13a-15 (2020).

97. Exchange Act Rule 15d–15, 17 C.F.R. § 240.15d-15 (2020). The CEO and CFO certification requirements in respect of these matters are contained in Regulation S-K Items 307 & 308, 17 C.F.R. § 229.307–308 (2020).

98. *See, e.g.*, PROTIVITI, GUIDE TO THE SARBANES–OXLEY ACT: INTERNAL CONTROL REPORTING REQUIREMENTS (4th ed. 2007), https://bit.ly/3o0hnTC. On the difference between SOX sections 302 and 404, see Shanna Nasiri, *The Differences Between SOX 302 and 404 Requirements*, RECIPROCITY (Dec. 5, 2019), https://bit.ly/3pazMwd.

99. Sarbanes–Oxley Act of 2002 § 404(a). The results of the testing must be reviewed by management, and all control testing failures identified must be categorized as a deficiency, significant deficiency, or material weakness. The company is required to report on deficiencies to the Audit Committee and the Board of Directors, and material weaknesses must be disclosed in the company's annual 10-K filing with the SEC. *See* PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, AUDITING STANDARDS (AU) Section 325: COM-

external auditor.[100] In short, the provisions related to financial reports and the financial reporting process are complex and extensive.

Certain SEC rules and practices have the effect of imposing higher standards of conduct upon public companies than what is required under state law. For example, an SEC rule requires disclosure of any transactions amounting to more than $120,000 between a public company and any of its executive officers or directors (and their affiliates),[101] which serves to discourage self-dealing and the suboptimal use of corporate resources. Another SEC rule requires a public company that is undertaking a transaction whereby existing public shareholders are cashed-out to disclose whether it "reasonably believes that the [relevant] transaction is fair or unfair" to such shareholders, and the "material factors" upon which this belief is based.[102] Because disclosing that the transaction is "unfair" (or disclosing fairness without an adequate basis) would subject the company to litigation, this rule in effect requires public companies to ensure the fairness of such transactions. To safeguard the economic rights of the shareholders of the acquisition target, the SEC has also engaged in extensive rulemaking in the context of acquisitions via a tender offer.[103]

Public company regulation is particularly expansive in the areas of board structure and composition as well as executive

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MUNICATIONS ABOUT CONTROL DEFICIENCIES IN AN AUDIT OF FINANCIAL STATEMENTS, https://bit.ly/3d43lKd.

100. Sarbanes–Oxley Act of 2002 § 404(b).

101. Regulation S-K Item 404, 17 C.F.R. § 229.404 (2020). The extension of this rule to affiliates substantially expands its scope due to the broad definition of affiliate under federal law. *See* Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 11 (2011); *see also Statement of Financial Accounting Standards No. 57: Related Party Disclosures*, FIN. ACCT. STANDARDS BD. 10 (1982), https://bit.ly/3E2vygH (defining "affiliate"). On the interaction between state and federal law, see Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663 (2014).

102. Regulation M-A Item 1014, 17 C.F.R. § 229.1014 (2020); *see* Rule 13e-3, 17 C.F.R. § 240.13e-3 (2020); Schedule 13E-3 Item 8, 17 C.F.R. § 240.13e-100 (2020).

103. *See Information for Certain Types of Transactions and Filers*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/corpfin/omalinks (last visited Oct. 30, 2021); STEINBERG, *supra* note 84, at 140–42. In so doing, the SEC has gone beyond what is strictly required by the relevant federal statute (the Williams Act of 1968). *Id.* at 141 n.150.

compensation. The relevant provisions are of fairly recent vintage: virtually all stem from Sarbanes–Oxley, Dodd–Frank, stock exchange listing requirements adopted in the early 2000s, and independent (i.e., not congressionally-mandated) SEC rulemaking from the 1990s and 2000s. These provisions have also been subject to the most criticism because they lock in place arrangements in areas that had theretofore been subject to private ordering due to the lack of state law requirements.[104] The net result of the various federal regulatory provisions is a fairly standardized public company governance model, which is described in a stylized fashion below. By contrast, there is no standardized governance model for private companies.[105]

Some of the defining features of the public company governance model pertain to board structure and composition. Public company boards are comprised of a majority of independent directors and usually have three major committees in common: an audit committee (with at least one person who qualifies as a "financial expert"), a compensation committee, and a nominating committee.[106] Each of these committees has specified responsibilities.[107] Public companies are required to provide detailed information about the skills and qualification

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104. *See, e.g.*, Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731 (2013). *See also* sources cited in Section II.A *infra*.

105. *See, e.g.*, Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165 (2017). Private companies that are seeking to go public, however, would eventually conform to the public company model. *Id.* at 167, 170–71. Some private companies have also adopted elements from the public company governance model in the wake of scandals. *See* Georgiev, *Uber-Sized Wrecks*, *supra* note 57 (highlighting Uber's voluntary adoption of governance structures that mirror the SEC's corporate governance requirements).

106. *See* Martin Edwards, *Expert Directors*, 90 U. COLO. L. REV. 1051, 1052, 1060–61 (2019); *see also* STEVEN M. BAINBRIDGE & M. TODD HENDERSON, OUTSOURCING THE BOARD: HOW BOARD SERVICE PROVIDERS CAN IMPROVE CORPORATE GOVERNANCE 160–61, 165–66 (2018).

107. The audit committee oversees internal and external financial reporting; the compensation committee determines executive compensation and prepares a compensation discussion and analysis (CD&A) report for inclusion in the company's proxy statement; the nominating committee is tasked with selecting new board members. *See* NYSE LISTED CO. MANUAL, §§ 3.03A.07, 303A.05 & 3.03A.04, https://bit.ly/3xWySre.

of directors,[108] as well as information about individual board members' meeting attendance records.[109] The relevant rules also require information about the board's leadership structure, and, in particular, whether the CEO also serves as the chair of the board.[110] There is also a requirement to disclose whether or not the company has adopted a code of ethics.[111] Again, disclosure is a significant—but by far not the only—way to effectuate public company regulation. In the area of executive compensation, for example, both Sarbanes–Oxley and Dodd–Frank mandated so-called "clawback" provisions in respect of erroneously-awarded incentive-based compensation.[112]

Controversially, the public company regulatory regime also contains disclosure requirements pertaining to various miscellaneous matters. Mainly stemming from the Dodd–Frank Act, these specialized rules require public companies to disclose information about the pay received by their median worker and the ratio between median worker pay and CEO pay;[113] information on the use within their supply chains of "conflict minerals" originating in the Congo and adjoining countries;[114] information about payments made to a foreign government or the U.S. federal government for the purpose of commercial development of oil, natural gas, or minerals

108. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,343 (Dec. 23, 2009); Regulation S-K Item 401(e), 17 C.F.R. § 229.401(e) (2020).

109. Regulation S-K Item 407(b), 17 C.F.R. § 229.407 (2020).

110. *See* Dodd–Frank Act § 972, 15 U.S.C. § 78n-2 (2010). In the case of CEO/Board Chair duality, the stock exchange rules require the appointment of an executive director and the holding of executive board sessions (without the CEO present). *See* NYSE LISTED CO. MANUAL, § 303A.03 & Commentary, https://bit.ly/31wyggj; *see also* NASDAQ REG., 5605(b)(2), https://bit.ly/3DpL8Sf.

111. Sarbanes–Oxley Act of 2002 § 406. The stock exchange listing rules elevated this provision from a disclosure to a substantive mandate by requiring that listed public companies adopt a code of ethics meeting certain standards.

112. *See* Steven A. Bank & George S. Georgiev, *Paying High for Low Performance*, 100 MINN. L. REV. HEADNOTES 14, 23-27 (2016). The Sarbanes–Oxley clawback rule is in effect but can be enforced only by the SEC; the Dodd–Frank clawback rule has not been finalized as of this writing.

113. Dodd–Frank Act § 953(b).

114. *Id.* § 1502.

(known as "resource extraction payments");[115] information about mine health and safety (if applicable);[116] and information on whether they have engaged in activities covered by the Iran Sanctions Act.[117] These specialized disclosure rules have been subject to criticism among academic commentators and even by individual members of the SEC.[118] Many were targeted for legislative repeal[119] and two were challenged in court,[120] but, with very limited exception, the rules survived and are in force today.[121]

The expansive regulatory framework discussed here has often been described critically as the "federalization of corpo-

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115. Section 1504 of the Dodd–Frank Act added Section 13(q) to the Securities Exchange Act of 1934. The original rule promulgated by the SEC was invalidated by Congress in 2017 pursuant to the Congressional Review Act. The SEC adopted a revised version of the rule in December 2020. *See* Disclosure of Payments by Resource Extraction Issuers, Exchange Act Release No. 34–90,679, Dec. 16, 2020, https://www.sec.gov/rules/final/2020/34-90679.pdf.

116. Dodd–Frank Act § 1503.

117. *See* Iran Threat Reduction and Syria Human Rights Act of 2012 (ITRA), Pub. L. No. 112-158, 126 Stat. 1214. Section 219 of the ITRA added a new Section13(r) to the Securities Exchange Act of 1934. *Id.*

118. *See, e.g.*, Michael S. Piwowar, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at the 34th Annual Current Financial Reporting Issues Conference (Nov. 16, 2015), https://www.sec.gov/news/speech/piwowar-current-financial-reporting-issues-conference.html (criticizing the SEC's adoption of congressionally-mandated pay ratio and conflict minerals disclosure rules and arguing that "[t]he focus on non-material, special interest disclosure provisions is a deplorable corruption of our mission to protect investors, to ensure fair, orderly, and efficient markets, and to facilitate capital formation").

119. Between 2011 and 2017, at least five distinct House bills targeted various Dodd–Frank provisions; none of these bills became law. *See* H.R. 10, 115th Cong. (2017); H.R. 5983, 114th Cong. (2016); H.R. 414, 114th Cong. (2015); H.R. 1135, 113th Cong. (2013); H.R. 1062, 112th Cong. (2011).

120. *See* Nat'l Ass'n of Mfrs. v. SEC, 956 F. Supp. 2d 43, 46 (D.D.C. 2013) (ruling on a challenge to the conflict minerals rule on First Amendment and APA grounds by the National Association of Manufacturers, the Chamber of Commerce, and the Business Roundtable); Am. Petroleum Inst. v. SEC, 953 F. Supp. 2d 5, 8 (D.D.C. 2013) (ruling on a challenge to the resource extraction payments rule).

121. The D.C. Circuit struck down part of the conflict minerals rule but upheld most of it. *See* Nat'l Ass'n of Mfrs. v. SEC, 800 F.3d 518, 170 (D.C. Cir. 2015). For the sake of completeness, it should be noted that even though the Dodd–Frank disclosure mandates discussed here ultimately survived, the SEC did suffer a significant loss at the D.C. Circuit in connection with a different Dodd–Frank rule. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1146 (D.C. Cir. 2011) (striking down the SEC's proxy access rule).

rate governance."[122] This is true, but only up to a point. Because "public company" has become a truly elective category, a more apt characterization would be "*quasi*-federalization": there is indeed a federal regulatory regime, but firms now have a meaningful choice about whether to opt into federal regulation, with all the attendant obligations, or whether to avoid those obligations and remain subject only to state corporate law. This argument is explored in more detail in Section III.A.

2. *Investor Protection, Capital Formation, and Beyond*

After describing the means of public company regulation, it is worth considering its goals. Unfortunately, due to the size and scope of the regulatory framework, as well as its age and the haphazard patterns through which it has evolved, there is no absolute consensus about these goals as a positive matter—and even less so as a normative matter. The original statutes and the extensive lore of securities law focus repeatedly on investor protection. The term, however, is left undefined and open to interpretation.[123] The putative objects of protection—investors—have been growing ever more heterogeneous over time.[124] This suggests that not only do they need different types of protection but also that their interests may be in direct

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122. STEINBERG, *supra* note 84. *See also* STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 21, 27–28 (2012).

123. *See, e.g.*, Guttentag, *supra* note 55, at 210 (outlining four distinct conceptions of "investor protection" consistent with legislative history and regulatory practice: protecting investors from fraud; protecting investors from informational asymmetries; protecting investors from tunneling of resources; and protecting investors from making irrational or harmful investment decisions). Separately, if investors' interests are taken to encompass non-financial goals, alongside traditional financial ones, then the scope of investor protection expands considerably and approaches total societal welfare. When investors are fully-diversified "universal owners" holding a slice of the broad economy, they would be rationally interested in maximizing the aggregate value of that slice rather than the value of any individual firm within the investment portfolio. For a modern interpretation and a novel normative framework, see Jeffrey N. Gordon, *Systematic Stewardship* (Eur. Corp. Governance Inst., Working Paper No. 566/2021), https://ssrn.com/abstract=3782814.

124. *See, e.g.*, Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461 (2015) (presenting a typology of heterogeneous investors).

conflict.[125] Even after these matters are settled, there is still the difficult question about the effectiveness of particular regulatory interventions in achieving the investor protection goal.

Since 1996, the securities law statutes also include a triad of additional goals: "promot[ing] efficiency, competition, and capital formation."[126] Among these, the SEC, Congress, and the policy community have focused almost exclusively on capital formation, which is often presented as a foil to investor protection.[127] The concept of capital formation, however, is also undefined; far from having any deep meaning that can guide policymaking, in securities law the term is usually used simply as a stand-in for firms' ability to raise capital.[128] For our purposes, we can ponder whether the goal should be capital formation on the *public* markets or the *private* markets, and what is the *efficient level* of capital formation. From a total welfare point of view, one goal of economic regulation should be allocative efficiency—allocating resources, in this case capital, to their most productive use. Unconstrained capital formation can be in direct conflict with this goal.[129]

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125. *See id.*; *see also* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561 (2006) (discussing heterogeneity in investor profiles and interests).

126. *See* Securities Act of 1933, 15 U.S.C. § 77b(b) (2012); Exchange Act of 1934, 15 U.S.C. § 78c(f) (2012). In 1999, the same provision was added to the Investment Company Act of 1940 and applies to rulemaking thereunder. Investment Company Act of 1940, 15 U.S.C. § 80(a)-2(c) (2012).

127. For a discussion of the relevance and importance of competition to the SEC's mission, see Georgiev, *Too Big to Disclose*, *supra* note 79, at 658–62.

128. Curiously, the term "capital formation" was imported into mainstream securities regulation discourse *as recently as the 1990s*, without any elaboration. The term was embedded into law by the National Securities Markets Improvements Act of 1996 via the amendments cited in note 126 *supra*. In macroeconomics and neoclassical growth theory, the areas of inquiry where the term has been theorized, capital formation refers to long-term investment as a function of intertemporal choices about saving and consumption. A report to Congress from 1980 that discussed "federal actions that could promote capital formation" only lists macroeconomic and public finance policies, such as reducing the size of the federal deficit, changing various aspects of the tax system, stabilizing the regulatory environment and inflation, and assessing the availability of federal credit. *See* U.S. Gov't Accountability Office, PAD-80-24, An Analytical Framework for Federal Policies and Programs Influencing Capital Formation in the United States v (1980), https://www.gao.gov/assets/pad-80-24.pdf.

129. This point is not merely academic. The rise of private capital has led to very significant losses at firms such as Theranos and many unicorns do not

Increasingly, securities law spills over beyond investor protection and capital formation. Some of the specific public company disclosure rules, particularly rules stemming from Sarbanes–Oxley and Dodd–Frank, are difficult to square with traditional notions of investor protection and capital formation, which suggests that Congress may have had in mind other goals, even if it did not clearly articulate them.[130] Writing in 2013, Langevoort & Thompson noted that "the extent to which—purely as a descriptive matter—securities regulation is about social, political, and economic interests, in addition to investor protection and capital formation, has been seriously underestimated" and characterized securities regulation as "a joint project of experimentation in investor protection coupled with a public-driven demand for more transparency, voice, and accountability . . . as to systemically significant business enterprises."[131] Though this trend continues to meet heavy resistance,[132] it is descriptively accurate, and a further complication to the ambiguities that bedevil both investor protection and capital formation.

Based on the foregoing discussion, one way to summarize the goals of securities law is by thinking about a regulatory scheme that enables investors to maximize risk-adjusted returns on invested capital and firms to maximize funding opportunities (including by minimizing the cost of capital). The question of whether securities law should focus on minimizing societal externalities remains subject to debate, as do questions about allocative efficiency and the proper balance among the various goals. As we will see in the following Part, these definitional and conceptual issues have made it easier to justify different types of legislation, thereby contributing to the breakdown of the public–private divide; unless resolved, these same definitional and conceptual issues are also likely to pre-

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turn a profit. *See infra* note 176 and accompanying text. On the financial performance of unicorns, see *infra* notes 225 & 235 and accompanying text.

130. *See, e.g.*, Ann M. Lipton, *Beyond Internal and External: A Taxonomy of Mechanisms for Regulating Corporate Conduct*, 2020 WIS. L. REV. 657, 658–61 (2020) (noting a tendency to frame regulatory interventions with reference to shareholder/investor protection even when the subject matter does not justify this).

131. Langevoort & Thompson, *supra* note 4, at 372–73.

132. *See, e.g.*, Piwowar, *supra* note 118.

sent a challenge to repairing the public–private divide and securities law more generally.

II.
The Road to the Breakdown of the Public–Private Divide

This Part examines the numerous, often confounding regulatory and market developments related to public companies since the early 2000s. In the aggregate, these developments have led to the breakdown of the public–private divide. This was a gradual process, whose roots can be traced back to the Sarbanes–Oxley Act in 2002; it gained traction due to the decline in the number of public companies in the 2000s, and ultimately culminated with a long series of deregulatory measures between 2012 and 2020. Because those measures have been self-reinforcing, this Article refers to them as a deregulatory cascade. These developments are described thematically in Section II.B and illustrated by two figures in Section II.C. The bottom line is that the capital raising process in 2021 looks nothing like the capital raising process just two decades prior.[133]

A. *SOX as Shock . . . and Scapegoat*

The Sarbanes–Oxley Act of 2002 (known colloquially as "SOX") was the most ambitious federal law pertaining to public companies since the 1930s. It resulted from the financial scandals in the early 2000s that involved accounting fraud at well-known firms such as Enron, WorldCom, Global Crossings, Tyco, Adelphia, and others.[134] The scandals resulted in bankruptcies, the loss of approximately $1.5 trillion in market

133. Based on a close reading of the available evidence, this Article makes the case that the most consequential changes that ultimately transformed securities regulation can be traced back to the 2002 Sarbanes–Oxley Act. To be sure, even though securities regulation was more stable during the prior decades, it was certainly not static. There were several developments that expanded private markets and the availability of exemptions in primary offerings, such as the initial adoption of Regulation D in 1982 and subsequent amendments. On this and other points, a different telling of the deregulation story that follows is certainly possible.

134. *See generally* Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes–Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 Wash. U. L. Q. 329 (2003).

value, and hundreds of thousands of jobs.[135] It also contributed to a general unease about the state of U.S. capitalism at the turn of the 21st century. Thus, SOX sought to restore financial disclosure transparency and revitalize investor confidence in the integrity of U.S. financial markets. As described in Section I.C, for example, SOX requires the CEO and CFO to certify the company's financial statements, and to establish and maintain "disclosure controls and procedures" and "internal control over financial reporting."[136] The Act also focused on the boards of directors of public companies, putting in place various provisions related to director independence and requiring that public companies establish audit committees, with certain membership requirements.[137]

In effect, SOX acted as a shock on the regulatory framework and increased the compliance costs of maintaining public company status. There was widespread skepticism about the Act's benefits among practitioners and prominent academics, one of whom notoriously labeled the legislation "quack corporate governance."[138] This epithet stuck and was applied again when the Dodd–Frank Act came around just eight years later.[139]

The Sarbanes–Oxley Act's provisions were not self-executing but, instead, required implementation through lengthy SEC rulemaking. During this process, many of them were debated and heavily contested.[140] The SEC enjoys broad exemptive authority,[141] so it had the power to delay the effectiveness

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135. *See* Catherine Valenti, *A Year After Enron, What's Changed?*, ABC NEWS (Nov. 27, 2002), https://abcnews.go.com/Business/story?id=86817 (describing the economic toll of Enron's downfall). For an academic analysis, see generally William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

136. *See supra* notes 96–97 and accompanying text.

137. Sarbanes–Oxley Act of 2002 § 301, 18 U.S.C. § 1350.

138. Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005).

139. *See* Stephen M. Bainbridge, *Dodd–Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1781, 1821 (2011).

140. *See, e.g.*, Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1818–19 (2007).

141. In 1996, Congress added Section 36 to the Exchange Act (under which the relevant rules fall), providing the SEC with sweeping general exemptive authority in respect of the Act's provisions "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." 15 U.S.C. § 78mm(a)(1).

of some of the Act's provisions and to water down others considerably. As part of the notice-and-comment rulemaking process at the SEC, which lasted for more than half a decade, the Act's opponents focused repeatedly on the high compliance costs imposed by the new rules. This period also saw greater competition from international capital markets; notably, London gained attention by promoting its light-touch regulation approach.[142] Two prominent working groups were formed to examine the competitiveness of U.S. capital markets. The resulting reports highlighted the high compliance costs associated with Sarbanes–Oxley's prescriptive mandates,[143] particularly as contrasted with the well-branded "principles-based regulation"[144] approach in the United Kingdom.[145]

The narrative about compliance costs was bolstered by an easily observable and troubling phenomenon: a substantial decline in new IPOs, which was rationally (though still hastily)

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142. *See, e.g.*, Roel C. Campos, Comm'r, U.S. Sec. & Exch. Comm'n, SEC Regulation Outside the United States (Mar. 8, 2007), https://www.sec.gov/news/speech/2007/spch030807rcc.htm (criticizing the "light touch" regime in the United Kingdom).

143. A 2007 McKinsey and New York City Economic Development Corporation report, which came to be known as the Bloomberg–Schumer Report, considered New York's and the United States' role within global financial markets. One of its headline findings was that "recent legislative and regulatory actions are hurting America's financial competitiveness." *See* McKinsey & Co. & N.Y.C. Econ. Dev. Corp., Sustaining New York's and the US' Global Financial Services Leadership ii, 86–87 (2007), https://on.nyc.gov/3D6zMSR. A contemporaneous report by the Committee on Capital Markets Regulation concluded that "[b]y any meaningful measure, the competitiveness of the U.S. public equity market has deteriorated significantly in recent years." Comm. on Cap. Mkts. Regul., The Competitive Position of the U.S. Public Equity Market 1 (2007), https://bit.ly/3xEn5Ob.

144. The term "principles-based regulation" in corporate law and financial regulation has long functioned as a means of encouraging deregulation. *See, e.g.*, Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of 'Principles-Based Systems' in Corporate Law, Securities Regulation and Accounting*, 60 Vand. L. Rev. 1411 (2007).

145. The perception of stagnation in the United States at the time was also driven in part by the significant openness to experimentation in capital markets in other jurisdictions. *See, e.g.*, Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 Stan. L. Rev. 475 (2011) (discussing capital market innovations in the European Union and Brazil).

attributed to the increased costs of being a public company.[146] Another element of this narrative was the "going dark" phenomenon, where public companies delisted their securities and thus exited the public company regulatory sphere.[147] By the start of the 2010s, the total number of public companies in the United States had shrunk by half, from a peak of 8,025 in 1996 down to 4,101 in 2012; the U.S. decline ran counter to international trends and was taken as evidence of a significant "listings gap."[148] The scale and persistence of this phenomenon gave further credence to the over-regulation narrative, which had always appeared intuitive. The business press regularly ran articles about the death or decline of the public com-

146. *See, e.g.*, *The Lure of the Private Firm*, ECONOMIST (Nov. 17, 2004), https://econ.st/3dUF6yy ("The Sarbanes-Oxley legislation . . . has imposed on public companies much onerous corporate-governance compliance—a source of constant complaint from bosses in America and beyond."); Russ Garland, *Fixing Public Markets' "Systemic Dysfunction,"* WALL ST. J. (Nov. 9, 2009), https://on.wsj.com/3I5JUzk (reporting "evidence of a serious and systemic dysfunction" in public markets and asserting that Sarbanes–Oxley rules are "the main scapegoat") (internal quotations omitted); *Uncuffing Capitalism*, ECONOMIST (Mar. 31, 2012), https://econ.st/3xvT439 (noting that "onerous regulations" such as Sarbanes–Oxley and Dodd–Frank are to blame for an "IPO drought").

147. The "going dark" phenomenon did not occur spontaneously. Regulatory changes from the mid-2000s greatly facilitated the process of delisting, i.e., the exit of public companies from the regulated public realm. Some of those changes were overdue and much needed. But they may have been overbroad in that they created a rush to the exits, which became known as "going dark." This decreased the overall size of public markets and may have resulted in the delisting (and thus, deregulation) of firms that should have remained public. *See* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 140–43 (2009) (describing the delisting process); *see also* Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 123 n.33 (2013). This also routinized "going private" transactions, which involve one investor (or a group of investors), such as a private equity fund, acquiring the publicly held stock of a company, whether through a merger or tender offer; some firms have used this process—traditionally thought of as a once-in-lifecycle transaction—with some frequency and in value-destroying ways. *See, e.g.*, David Scigliuzzo et al., *How Private Equity Works, and Took Over Everything*, BLOOMBERG BUSINESSWEEK (Oct. 3, 2019), https://bloom.bg/3p5Urlf.

148. *See* Craig Doidge et al., *The U.S. Listing Gap* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 21,181, 2015) ("The number of U.S. listings fell from 8,025 in 1996 to 4,101 in 2012, whereas non-U.S. listings increased from 30,734 to 39,427.").

pany, public capital markets, and IPOs.[149] Commentators and policymakers began to consider measures to reverse these phenomena by decreasing the subset of companies to which Sarbanes–Oxley, and the rest of public company regulation, applies.[150] In short, Sarbanes–Oxley catalyzed the erosion of the public company regulatory sphere and, for a long time, market data provided the oxygen to keep this process going.

Well over a decade after Sarbanes–Oxley's adoption, it turned out that the over-regulation narrative was not just oversimplified but also wrong. High-quality empirical studies found that other factors caused the decline in IPO activity and the number of public companies. One study showed that the decline in small-firm IPOs started in 1998, well before the adoption of Sarbanes–Oxley and Dodd–Frank, and is attributable to a decrease in demand by institutional investors rather than to supply-side factors such as the cost of being a public company.[151] Another study noted that "market forces *independent of regulation*" (including increased M&A activity, greater availability of private capital, and changes in investment patterns) explained the decline in IPOs.[152] The study also highlighted the fact that the decline in IPOs was primarily a de-

149. *See, e.g.*, Jason Zweig, *The Demise of the IPO—and Ideas on How to Revive It*, WALL ST. J. (June 25, 2010), https://on.wsj.com/3D39mlc (analyzing various challenges to IPO activity and stating that the IPO market is in "suspended animation"); Alix Stuart, *Missing: Public Companies – Why is the Number of Publicly Traded Companies in the U.S. Declining?*, CFO MAG. (Mar. 22, 2011), https://bit.ly/3xEnCj9 (discussing data on the decrease in the number of public companies and new IPOs and advocating for "a completely different market model" (quoting Edward Kim, capital markets senior advisor at Grant Thornton)); Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, BLOOMBERG BUSINESSWEEK (Apr. 21, 2011), https://bloom.bg/3E7ep5m (noting that "[o]wing to the Sarbanes-Oxley Act and other regulatory changes to capital markets over the past decade, the IPO is no longer an attractive goal for many companies"); Andrew Ross Sorkin, *C.E.O.s Meet in Secret over the Sorry State of Public Companies*, N.Y. TIMES (July 21, 2016), https://nyti.ms/3xFzf9G (asserting that "[p]ublicly listed companies in the United States have become something of a dying breed").

150. *See supra* note 141 and accompanying text.

151. *See* Robert P. Bartlett III, Paul Rose & Steven Davidoff Solomon, *The Small IPO and the Investing Preferences of Mutual Funds*, 47 J. CORP. FIN. 151, 163, 165 (2017).

152. *See* Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone: The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83, 87 (2016) (emphasis added).

cline in small-firm IPOs, not IPOs across the board.[153] A third empirical study similarly rejected the "regulatory overreach" hypothesis.[154] Neither the findings of these studies, which never truly penetrated the policymaking community,[155] nor the recovery in the annual number of IPOs during much of the 2010s,[156] were successful in stopping the deregulatory cascade, which at that point was well underway. As we will see, the 2012 JOBS Act and the SEC's concerted push to deregulate capital raising during the tenure of Chairman Jay Clayton scrambled the internal logic of securities regulation and set off a process of regulatory line-drawing, re-drawing, and, ultimately, erasure.

Another point, discussed in more detail in Section III.B, deserves mention here. The high compliance costs of Sarbanes–Oxley and Dodd–Frank were blamed for causing the demise of the "public company" as a type of business entity. Yet, "public company" is merely a regulatory category that captures certain entities if they meet a set of pre-defined characteristics.[157] As we will see, Sarbanes–Oxley and Dodd–Frank may have caused the near-demise of "public company" as a regulatory category by feeding into the over-regulation narrative and instigating the deregulatory cascade of the 2010s.

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153. *Id.* at 87, 120.

154. *See* Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANT. ANALYSIS 1663, 1669–71 (2013) (rejecting a "regulatory overreach" hypothesis for the decline in the number of small-firm IPOs in favor of an "economies of scope" hypothesis that focuses on the advantages enjoyed by large firms). As I have discussed in prior work, these large-firm advantages also stem from the application of a key tool of securities regulation—the *TSC Industries* materiality standard embedded in a number of disclosure rules, which does not take into account firm size. *See* Georgiev, *Too Big to Disclose*, *supra* note 79, at 652–62 (suggesting that materiality functions as a "regulatory subsidy for bigness" since it often enables large firms to disclose less information than small firms).

155. Congress continued to hold hearings themed around solving the purported problem of regulatory overreach. *See, e.g.*, *The Cost of Being a Public Company in Light of Sarbanes Oxley and the Federalization of Corporate Governance: Hearing Before the Subcomm. on Cap. Mkts, Sec., & Inv. of the H. Comm. on Fin. Servs.*, 115th Cong. (July 18, 2017).

156. *See infra* Appendix, Figure A–1.

157. *See supra* Section I.B.1.

B. *The Deregulatory Cascade*

The public model of financing, whereby a growing company needs to go public in order to access additional capital and, as part of this process, commits to public company regulation, was the dominant model for much of the 20th century and at the dawn of the 21st century. Just two decades later, in 2021, this is no longer the case. The transformation of the capital raising ecosystem has been the product of numerous actions taken by Congress and the SEC, mostly during the 2010s, that have touched and altered virtually every aspect of the regulatory system governing firms' capital raising activities: the types of capital, the types of investors, and types of markets that firms of different kinds can access in exchange for undertaking certain legal obligations.

This section starts by analyzing the political economy of the deregulatory cascade and then thematically sets out the many technical deregulatory developments that have occurred, primarily since the passage of the JOBS Act in 2012. The figures in Section II.C provide a schematic illustration of these developments. At the outset, I should note that not every individual development that is part of the deregulatory cascade is problematic as a matter of policy; indeed, some were well-advised and overdue. But their execution—and the combination of sensible changes and changes hastily put in place to serve ideological goals—render the deregulatory cascade a negative development as a whole.

After the Dodd–Frank Act was signed into law in July 2010, many in the media and policy establishment in Washington, D.C. assumed that the mission of preventing a repeat of the 2008 financial crisis had been accomplished and moved on to other hot-button issues. Others immediately shifted their attention to the fraught process of agency rulemaking needed to implement the Act's provisions.[158] But less than two years later (and working in Dodd–Frank's shadow), Congress hastily passed another important piece of financial legislation, which

158. *See, e.g.*, Steven A. Bank & George S. Georgiev, *Securities Disclosure As Soundbite: The Case of CEO Pay Ratios*, 60 B.C. L. Rev. 1123, 1128–29, 1139 (2019) (discussing the protracted process of implementing the pay ratio disclosure mandate contained in the Dodd–Frank Act).

received relatively little popular attention: the strategically-titled JOBS Act of 2012.[159]

The JOBS Act contained a smorgasbord of provisions related to equity crowdfunding, amendments to various securities offering rules, the creation of a new, time-limited regulatory category—the "emerging growth company" (EGC), and a directive to the SEC to study further changes to the securities disclosure regime. The only broad themes that can be discerned in the JOBS Act are *laissez-faire* capital formation and an attempt to reverse the supposed regulatory overreach of Sarbanes–Oxley and Dodd–Frank.[160] It likely would have been impossible to sell this grand deregulatory design politically if it had been clearly reflected in the JOBS Act. Instead, the JOBS Act proceeded piecemeal through a series of small and easy-to-overlook rule amendments, exemptions, and efforts to "modernize" the regulatory framework.

The political economy of the JOBS Act is worth noting because it challenges the view of securities regulation as a technocratic enterprise—a special and highly-specialized type of economic regulation that is relatively free of interest group lobbying and political influence. The JOBS Act was heavily supported by tech companies in Silicon Valley during an era of unbridled tech optimism among policymakers and the media;[161] shortly after, Amazon, Facebook, Google/Alphabet, Microsoft, and Apple joined the ranks of the world's largest companies, which they hold to this day. The Obama adminis-

159. The Act's awkward full title—the Jumpstart Our Business Startups Act—illustrates the linguistic gymnastics its drafters employed to arrive at the palatable acronym "JOBS." Though very little, if anything, in the Act was substantively related to boosting jobs and employment, the JOBS moniker made it more difficult to oppose the bill during a period of high unemployment and the lagging recovery from the 2008 financial crisis.

160. The SEC's approach in implementing congressional mandates and amending its own rules during the 2010s, at least as exemplified by the rhetoric of a number of SEC Commissioners and senior staff, has focused on capital formation, with more always being better. This basic premise is flawed when viewed from the point of view of financial economics and management science. To mention just a few possibilities, firms can easily become overleveraged, capital may be misallocated, and too much capital may lead to corporate waste and inefficiencies.

161. *See* James Freeman, *Kate Mitchell: How Silicon Valley Won in Washington*, WALL ST. J. (Apr. 6, 2012), https://on.wsj.com/3lCsQaz (discussing the role of tech firm lobbying in generating bipartisan political backing for the JOBS Act).

tration was firm in its support of the JOBS Act,[162] even though investors, other stakeholders, academics, and the Obama-appointed SEC Chair raised a series of concerns.[163] Even the name of the legislation, meant to evoke job creation, was a brilliant stroke of Silicon Valley marketing. A link between the JOBS Act's provisions and actual jobs was never demonstrated and has not materialized. In fact, to the extent the JOBS Act contributed to the rise of the gig economy exemplified by firms such as Uber and DoorDash where workers are independent contractors instead of employees and do not benefit from various worker protections, the JOBS Act may have contributed to the destruction of conventional jobs.

By facilitating the raising of capital on the *private* markets, certain JOBS Act provisions resulted in decreased *public* capital formation. Recall, however, that public capital formation was the problem, whether real or imagined, that the JOBS Act was supposed to solve. When the solutions did not come, Congress doubled down by adding provisions deregulating capital formation (dubbed JOBS Act 2.0) in the infrastructure-focused FAST Act in 2015.[164] The SEC quickly implemented the provisions of the FAST Act, even though the agency still had a back-

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162. The genesis of many of the specific ideas contained in the JOBS Act can be traced back to a report prepared by the IPO Task Force, an ad hoc group dominated by Silicon Valley entrepreneurs, venture capitalists, and the bankers, lawyers and accountants representing them. *See* IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH (2011), https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf; *see also* Freeman, *supra* note 161 (noting how a Democratic venture capitalist shepherded the JOBS Act); *see also* Pritchard, *supra* note 51, at 1008–09 (noting that President Obama signed the bill into law because he was "anxious to portray himself as 'pro-growth' while facing an economy still plagued by high levels of unemployment").

163. *See* 158 Cong. Rec. 1698–99 (2012) (letter of SEC Chairman Mary L. Schapiro) (expressing the SEC's concern with various provisions in the draft version of the bill, which ultimately became law). Academic commentators also raised concerns. *See* John Coates & Robert Pozen, *Bill to Help Businesses Raise Capital Goes Too Far*, WASH. POST (Mar. 14, 2012), https://wapo.st/3FVm6fv; *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the S. Comm. on Banking, Housing, & Urb. Affs.*, 112th Cong. 13 (2011) (statement of John C. Coffee, Jr., Professor, Columbia University Law School).

164. *See* Stacy Kanter, *FAST Act: Capital Formation Changes and Reduced Disclosure Burdens*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 29, 2015), https://bit.ly/3HZ2Yz5. The FAST Act included technical changes, such as

log of unfinished, congressionally-required rulemakings under the Dodd–Frank Act from five years prior. Thus, the SEC continued to prioritize the deregulation of the *private* markets in the name of *public* capital formation.

The deregulatory cycle was completed just a day before the November 2020 presidential election, with the looming prospect of a new administration, new composition of the SEC, and a policy reversal. On a split 3–2 vote, the agency adopted extensive rule amendments ostensibly seeking to "harmonize and improve" the "patchwork" private offering framework.[165] In reality, however, the SEC retained the "patchwork" and merely increased the size of the constitutive exemption "patches." Among other matters, the amendments changed existing limits on the timing and size of private offerings.[166] In effect, they permitted larger and more frequent private offerings to be offered more widely to the general public. Notably, the SEC was also tasked by Congress with taking some steps that modernized the regulatory framework by updating rather than eroding it. Updating Form D to make it more informative and updating the wealth thresholds under the definition of "accredited investor" are a case in point.[167] The SEC

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codifying the informal Section 4(a)(1½) exemption for private resales and it also expanded further the accommodations provided to EGCs. *Id.*

165. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework (Nov. 2, 2020), https://www.sec.gov/news/press-release/2020-273 [hereinafter Summary of November 2020 Amendments]; *see also* Adam Fleisher et al., *SEC Harmonizes Regulation and Improves Access to Capital in Private Markets*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 8, 2020), https://bit.ly/3rA1HIZ (describing amendments and noting the 3–2 vote).

166. *See* U.S. Sec. & Exch. Comm'n, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Final Rule, Rel. No. 33-10,884 (adopted Nov. 2, 2020), 86 Fed. Reg. 3496 (Mar. 15, 2021) (including amendments to: raise offering limits for certain exempt offerings; relax investment limitations for certain investors; shorten the integration safe harbor period from six months to 30 days; expand the use of test-the-waters communications across all exempt offerings and for all types of investors; reduce disclosure requirements under Regulation D; and permit the creation of a crowdfunding special purpose vehicle, among other matters).

167. The SEC has failed to finalize its 2013 proposal to amend Form D to enhance investors' ability to evaluate offerings under Regulation D. *See* Amendments to Regulation D, Form D, and Rule 156, 78 Fed. Reg. 61,222 (proposed July 10, 2013). In addition, it has failed to adjust the accredited

placed these low on its priority list and, as of this writing, has not completed the required rulemakings.

The late stages of the deregulatory cascade of the 2010s were also characterized by a curious shift in rhetoric. Previously, lobbyists had used "capital formation" as the primary justification for deregulation; while poorly defined, the term "capital formation" is part of the SEC's mission.[168] In light of the growth of private markets, the rise of unicorns, and the recovery of the IPO market, however, it is becoming increasingly difficult to argue that firms are having a difficult time raising capital. To account for this, lobbying efforts leading up to the November 2020 amendments focused on giving retail investors appropriate investment opportunities, which included giving them access to the unregulated private markets.[169] The SEC enthusiastically picked up on the "investor opportunity" leitmotif in the proposing and adopting releases pertaining to the November 2020 amendments. This was done with little regard for the risks inherent in such opportunities and traditional notions of investor protection.[170] Another way to frame this set of initiatives that similarly conceals their prob-

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investor wealth thresholds to account for inflation. *See infra* note 183 and accompanying text.

168. *See, e.g., What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/Article/whatwedo.html (last modified Nov. 22, 2021) (stating the SEC's mission as "protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation"). *See also* discussion *infra* Section I.C.2.

169. *See, e.g.*, COMM. ON CAP. MKTS. REGUL., EXPANDING OPPORTUNITIES FOR INVESTORS AND RETIREES: PRIVATE EQUITY (2018), https://bit.ly/3y1mK8C (advocating for a number of deregulatory changes which were subsequently adopted, with reference to "expanding opportunities").

170. *See, e.g.*, Press Release, Allison Herren Lee, Comm'r, U.S. Sec. & Exch. Comm'n, Public Statement on Amendments to the Exempt Offering Framework (Nov. 2, 2020), https://www.sec.gov/news/public-statement/lee-harmonization-2020-11-02. SEC Commissioner Hester Peirce has defined "investor opportunity" as "the chance for investors to try new products and services, to include in their portfolios new types of assets, to use the latest technologies, to get in on the ground floor of new opportunities, to experiment and learn from investment successes and failures." *See* Hester M. Peirce, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at Meeting of Investor Advisory Committee (Sept. 9, 2021), https://www.sec.gov/news/public-statement/peirce-iac-090921.

lematic nature has been as an effort to "democratize" capital markets.[171]

Zooming out, the developments that made up the deregulatory cascade were not only highly technical but also piecemeal. The discussion that follows organizes these developments around themes. The thematic approach adopted here and in the two figures in Section II.C offers a big-picture overview of how the many individual developments from the 2010s have transformed the legal framework for capital raising. The deregulatory cascade is defined by decisions from Congress, the SEC, and, in one instance, the Department of Labor, along the following six overlapping dimensions: (1) enabling the rise of unicorns; (2) emphasizing private markets over public markets; (3) enabling the dramatic rise of private equity; (4) allowing public capital into private companies; (5) transforming public capital into private capital; and (6) promoting regulation-lite regimes.

(1) Enabling the Rise of Unicorns: Perhaps the most visible development in capital markets during the 2010s has been the rise of "unicorns": firms with valuations over $1 billion that have not (yet) conducted an initial public offering and are not public companies. Fast-growing firms like SpaceX (private valuation: $100.3 billion), Stripe ($95 billion), Instacart ($39 billion), Juul Labs ($12 billion), Ripple ($10 billion), Reddit ($10 billion), and MasterClass ($2.75 billion) are just some of the more familiar names that currently fall in this category; Uber, Lyft, Box, Dropbox, Airbnb, Doordash, Spotify, and Robinhood, among many others, are ex-unicorns.[172] As noted in the Introduction, the growth in the number and implied market value of unicorns has been staggering: from 43 unicorns when the term was first coined in 2013 to 473 unicorns

171. *See, e.g.*, Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 87 TENN. L. REV. 983, 994–1000 (2020) (discussing "democratization" of private markets). The benign-sounding rhetoric of democratizing markets echoes the marketing efforts of ill-fated fintech startups, such as Robinhood. *See, e.g.*, Jared Dillian, *Robinhood Is Not About the Democratization of Markets*, BLOOMBERG OP. (Aug. 11, 2021), https://bloom.bg/3q592xB (discussing Robinhood's marketing rhetoric and noting that "[r]etail trading of meme stocks is just a massive transfer of wealth from the unsophisticated to the sophisticated").

172. *See The Complete List of Unicorn Companies*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Dec. 3, 2021).

in early December 2021, reaching an aggregate implied valuation of $1.58 trillion, which is an eleven-fold increase since 2013, and a nearly three-fold increase in 2021 alone.[173] These developments are not limited to the United States, as shown by Figure A–8 in the Appendix, but extend to capital markets in China and the rest of the world.

Though private, unicorns look and behave like public companies in terms of market capitalization, number of employees, global reach, and potential for inflicting externalities. They have been able to raise capital and sustain their growth without tapping the public markets. The previous generation of fast-growing tech companies, such as Google, Amazon, and others, had to conduct an IPO much earlier in their lifecycle and, correspondingly, achieved the bulk of their present-day market capitalization in the public markets (as shown by Figure A–7 in the Appendix). Today, unicorn companies are so ubiquitous in the U.S. economy that the unicorn label seems like a misnomer.

The rise of unicorns was a regulatory development due to the much wider availability of "private capital."[174] In addition, the JOBS Act raised the mandatory registration thresholds contained in Section 12(g) of the Exchange Act, enabling companies to acquire a much larger investor base before mandatory registration (and federal corporate governance regulation) is required.[175] As discussed below, the SEC has also adopted various rules that encourage private placements, which permit unicorns to raise substantial capital without trading unicorn status (and the associated freedom and secrecy) for public company status (and the associated regulatory compliance obligations and transparency). The SEC and Congress failed to anticipate and account for the informational

173. *See supra* Figure 1 & notes 13–14 and accompanying text.

174. *See* de Fontenay, *supra* note 22, at 447.

175. Recall that Section 12(g) of the Exchange Act, as amended by the JOBS Act, requires a company to register its securities under the Exchange Act if it has $10 million or more in total assets and a class of equity securities "held of record" by 2000 or more persons (or 500 or more persons who are not "accredited investors"). *See supra* note 77 and accompanying text. The question about the reach of Section 12(g) is not a simple one. Usha Rodrigues, for example, has argued that the rule was irrelevant even before the JOBS Act. *See* Usha R. Rodrigues, *The Once and Future Irrelevancy of Section 12(g)*, 2015 U. ILL. L. REV. 1529 (2015).

problems raised by unicorns, and these problems quickly morphed into governance problems, as illustrated by the multiple scandals at WeWork, Uber, Theranos, and elsewhere.[176]

(2) Emphasizing Private Markets Over Public Markets: The expansion of exemptions from public registration, most prominently under Rule 506,[177] has made it easier and easier for firms to attain scale solely based on the investment of accredited investors. Rule 701 has made it easier for private companies to pay employees in stock and stock options; while the rule has been around since the 1980s, the growth in the number of unicorns and their total employee headcount during the 2010s, as well as the doubling of relevant offering limits in 2018, has amplified the rule's significance.[178] New, creative ways of doing the same have been under consideration;[179] these would, for instance, allow private platform companies, like pre-IPO Uber and Airbnb, to pay non-employee drivers and hosts, respectively, with stock. These private transactions further undermine the need for public markets, from the per-

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176. *See, e.g.*, Rani Molla & Shirin Ghaffary, *The WeWork Mess, Explained*, VOX (Oct. 22, 2019), https://bit.ly/3rf663J (discussing governance problems at WeWork); Georgiev, *Uber-Sized Wrecks*, *supra* note 57 (discussing Uber); John Carreyrou, *SEC Charges Theranos CEO Elizabeth Holmes With Fraud*, WALL ST. J. (Mar. 14, 2018), https://on.wsj.com/3lgMYyN (discussing Theranos).

177. 17 C.F.R. § 230.506 (2021). Though the availability of aggregate data is limited, the SEC's Concept Release suggests that most private capital is raised using the exemptions provided in Rule 506(b) and Rule 506(c). *See* U.S. Sec. & Exch. Comm'n, Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460, 30,466 (June 26, 2019).

178. SEC Rule 701, adopted in 1988, allows private companies to offer and sell securities as part of compensatory arrangements without the need to register the securities. *See* Compensatory Benefit Plans and Contracts, Securities Act Release No. 33–6768, 53 Fed. Reg. 12,918–19 (Apr. 20, 1988). While this provision is not new, its use increased considerably in the post-JOBS Act capital markets ecosystem. In addition, as directed by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, the SEC increased from $5 million to $10 million the 12-month offering threshold in excess of which firms are required to deliver additional information to employee-investors. *See* U.S. Sec. & Exch. Comm'n, Press Release, SEC Adopts Final Rules and Solicits Public Comment on Ways to Modernize Offerings Pursuant to Compensatory Arrangements (July 18, 2018), https://www.sec.gov/news/press-release/2018-135.

179. *See* Concept Release on Compensatory Securities Offerings and Sales, Exchange Act Release No. 33–10,521, 83 Fed. Reg. 34,958–59 (July 24, 2018).

spective of both firms and investors. The so-called Regulation A+ enables firms to raise certain amounts of capital from public investors without becoming subject to public company regulation.[180]

The November 2020 amendments to the securities laws changed existing limits on the timing and size of private offerings. For example, the SEC raised the offering limit in Regulation Crowdfunding from $1.07 million to $5 million, while at the same time removing the cap on the amounts accredited investors can invest in each offering.[181] This affected both the supply and demand sides of these transactions. Similarly, the SEC doubled the limit for offerings under Rule 504 of Regulation D, from $5 million to $10 million.[182]

One notable feature of the November 2010 amendments is that even though the SEC raised the offering limits, presumably, at least in part, to account for inflation, it did not raise the thresholds under the definition of "accredited investor." Recall from Part I that this category seeks to capture certain wealthy investors, who are presumed to be less sensitive to financial losses, and/or more financially-sophisticated investors. Failing to update qualification requirements for inflation has led to a 550% increase in the percentage of households qualifying as accredited investors since 1983 (from 2% of all U.S. households to 13% of all U.S. households).[183] In practice, this means that there has been a 550% increase in the share of households that can be exposed to unregulated (and often risky) financial instruments.

(3) Enabling the Dramatic Rise of Private Equity: Private assets under management have grown more than five-fold since

180. Adopted in April 2015, the rules referred to as Regulation A+ revise Regulation A to create two separate tiers of exempt securities offerings not exceeding $20 million and $50 million, respectively, in any 12-month period. *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, Trust Indenture Act Release No. 2501, 80 Fed. Reg. 21,806 (Apr. 20, 2015). These limits were raised through the November 2020 amendments discussed below. The market performance of firms taking advantage of these provisions has been dismal. *See infra* note 226 and accompanying text.

181. *See* Summary of November 2020 Amendments, *supra* note 165.

182. *Id.*

183. *See* Amending the "Accredited Investor" Definition, Securities Act Release No. 10,824, Exchange Act Release No. 89,669 (Aug. 26, 2020).

2000: from less than $1 trillion in 2000 to more than $5 trillion in 2017.[184] The existence of this sizeable pool of private capital has gradually undermined the essential nature of public markets to capital raising.[185] The rise of private equity has resulted from a combination of active deregulation and abstention from regulating new types of transactions that are functionally equivalent to transactions that had been regulated in the past.

(4) Allowing Public Capital into Private Companies: The SEC permits mutual funds to invest up to 15% of their assets in the stock of private companies.[186] Mutual funds represent trillions in capital that originates from prototypical "public" investors, i.e., unsophisticated investors who should get protection from the securities laws. For example, in 2018, the 12th-largest investment in Fidelity's $25 billion Blue Chip Growth Fund was a $438 million stake in Juul (a private company that does not seem to fit the "blue chip" label in the fund's name); the fund's investment in unicorn Juul was greater than its investment in true "blue chip" firms like MasterCard and Netflix.[187] The investor protection concerns associated with this development are many and varied.[188] The expansion of the offering exemptions discussed under item (2) above represents another mechanism through which more and more public capital can flow into private companies.

(5) Transforming Public Capital into Private Capital: In addition to allowing public capital into private companies directly, there are now multiple other, indirect ways for public capital to end up in private companies. A 2020 rule change from the Department of Labor allowed defined contribution plans to

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184. Frank Partnoy, *The Death of the IPO*, ATLANTIC (Nov. 2018), https://bit.ly/3rf677N.

185. *See id.*; *see also infra* Appendix, Figure A–3 (showing growth in assets under management for the U.S. buyout industry) & Figure A–6 (showing global growth of the private equity industry).

186. *See* U.S. Sec. & Exch. Comm'n, Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18,612 (Mar. 12, 1992) (setting out 15% limit on holdings of restricted securities or other assets not having readily available market quotations, an increase from the 10% limit previously in effect).

187. *See* Partnoy, *supra* note 184.

188. For a normative analysis of this phenomenon, see Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341 (2017).

offer private equity as an investment option.[189] In effect, this allows public investors to route retirement savings into private equity funds; those funds can, in turn, invest freely in private companies. This move was endorsed by SEC Chairman Jay Clayton and fit with the agency's broader agenda at the time of allowing "main street" investors to access the private markets.[190] This development was foreshadowed by legal changes from 2006, which narrowed the scope of ERISA restrictions and gave more public pension plans access to private equity.[191]

(6) Regulation-Lite Regimes: The JOBS Act also created a new, time-limited category, the Emerging Growth Company, which is subject to what the SEC calls "scaled" regulation, in an effort to induce companies to go public.[192] If they qualify based on certain thresholds, newly-public companies in the first five years of their lifecycle are subject to less regulation.[193] Separately, the "smaller reporting company" category allows certain companies that are publicly traded to avoid public company regulation based on size thresholds related to shares outstanding and revenues.[194] Regulation A+ IPOs, discussed under item (2) above, are another prominent example. The SEC has been raising the applicable qualification thresholds during the 2010s, thereby increasing the number of companies subject to such regulation-lite regimes.

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189. U.S. Dep't. of Labor, Div. of Fiduciary Interpretations, Opinion Letter (June 3, 2020), https://bit.ly/3o1Eflz.

190. *See* Press Release, U.S. Dep't. of Lab., U.S. Department of Labor Issues Information Letter on Private Equity Investments (June 3, 2020), https://bit.ly/3xwLncQ. The press release quotes SEC Chairman Jay Clayton praising the move because it would "provide our long-term Main Street investors with a choice of professionally managed funds that more closely match the diversified public and private market asset allocation strategies pursued by many well-managed pension funds as well as the benefit of selection and monitoring by ERISA fiduciaries." *Id.*

191. *See* Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780 (codified as amended in scattered sections of 29 U.S.C.).

192. *See Emerging Growth Companies*, U.S. Sec. Exch. & Comm'n., https://www.sec.gov/smallbusiness/goingpublic/EGC (last modified July 24, 2019). For an academic analysis, see Jeff Schwartz, *The Law and Economics of Scaled Equity Market Regulation*, 39 J. Corp. L. 347 (2014) (discussing the mechanics and effects of scaled securities regulation).

193. *See* 15 U.S.C. § 77g(a)(2) (setting out registration requirements for EGCs); JOBS Act, Pub. L. No. 112–106, 126 Stat. 306, §§ 102–104 (2012).

194. *See Smaller Reporting Companies*, U.S. Sec. & Exch. Comm'n, https://www.sec.gov/smallbusiness/goingpublic/SRC (last modified Mar. 15, 2021).

C. *Capital Raising in 2021 vs. 2000: An Illustration*

Taken together, the changes discussed in Section II.B have transformed the capital raising regulatory regime. Figures 2 and 3 provide a graphic illustration by showing the functional changes between the applicable regulatory framework before the 2000s and the applicable regulatory framework in 2021.

FIGURE 2: SIMPLIFIED OVERVIEW OF THE CAPITAL RAISING REGULATORY REGIME BEFORE THE 2000S

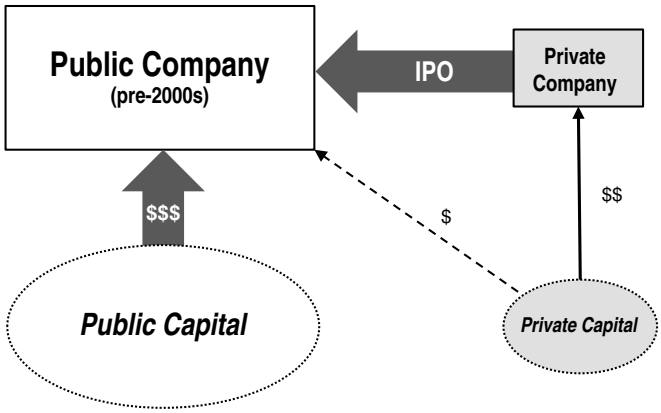
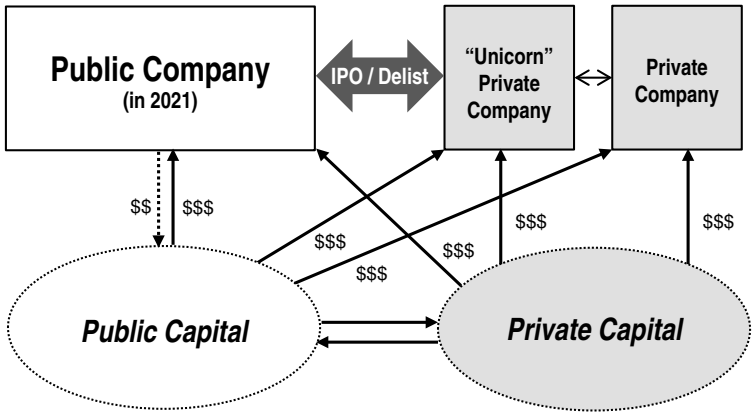


FIGURE 3: SIMPLIFIED OVERVIEW OF THE CAPITAL RAISING REGULATORY REGIME IN 2021



As illustrated by Figure 2, before the 2000s, public companies sat at the center of the capital markets. Most capital was public capital (invested through the public markets). The public markets were also the primary way public companies financed themselves. The private (i.e., unregulated) markets were small and underdeveloped. Public companies could finance themselves through private capital in very limited circumstances.[195] Moreover, public capital generally could not flow to private companies. Private companies had to finance themselves with private capital, but the smaller size of the private capital pool made this a limited option. If a private company wanted to grow, it had to gain access to public capital by going through the traditional IPO process discussed in Section I.B.2. And, once public, it was virtually impossible for a public company to revert to private company status. As shown in Figure 2, going public was a one way street.

Figure 3, which illustrates today's capital raising regulatory regime, paints an altogether different picture. As a result of the deregulatory cascade of the 2010s discussed in Section II.B, the pool of private capital is substantially expanded, and, in addition, public capital can easily morph into private capital. Private companies can benefit from this expanded pool of private capital and, in addition, can now also receive public capital. This makes the need to go public—and enter the regulated realm—much less urgent and may indeed obviate it. By raising ever-greater amounts of private capital, private companies can take on "unicorn" status and look very similar to public companies, but without the attendant regulatory obligations. When unicorns do decide to go public, they can do so via an IPO (or direct listing), but, importantly, this decision is now much easier to reverse through a delisting: going public is a two-way street. Moreover, the flow of capital between public markets and public companies is also bidirectional because of the buyback phenomenon, whereby significant amounts of capital are returned to shareholders.[196] There is another

195. So-called PIPE (Private Investment in Public Equity) transactions represent the most prominent example. For a description of PIPE transactions, see Thompson & Langevoort, *supra* note 4, at 1598–1601.

196. *See* Matt Phillips, *This Stock Market Rally Has Everything, Except Investors*, N.Y. TIMES (Feb. 25, 2019), https://nyti.ms/3o04fOc; *see also infra* Appendix, Figure A–9 (showing the substantial rise in stock buybacks in the United States during the 2010s).

prominent source of capital for private firms, which is not shown in Figure 3: private firms' own equity, which they use to cover more and more of their labor costs. As discussed in Section I.B.1, unicorns pay for human capital by granting employees stock and stock options. Their ability to do so further diminishes the importance of public markets as a source of capital.

Compare the two figures: The streamlined nature of Figure 2 highlights the fact that before the 2000s, there was a divide between public and private capital (even if it was somewhat porous). By contrast, no such divide can be observed in Figure 3. Public capital flows freely into both public and private companies; private capital, which is now greater in size due to deregulatory developments, can also flow freely into both public and private companies. In effect, public and private capital and public and private markets have now become fungible for a large subset of firms seeking financing.

D. *The Fungibility of Public and Private Capital*

In response to the changes in capital formation practices in recent years, the widely-followed financial commentator Matt Levine has observed that "the private markets are the new public markets."[197] One way to interpret this statement is that public capital and private capital have become fungible. But recall that the structure of the current public company regulatory regime is premised on the separation, or non-fungibility, of public and private capital.

The regulatory cascade has facilitated the flow of capital among public and private investors, public and private companies, and public and private markets. Functionally, capital is now free-flowing: what used to be hard regulatory prohibitions are now merely compliance items. A private company can enjoy the same access to finance as a public company by hiring bankers and lawyers to structure capital raising transactions in ways that comply with a complex set of exemptions, carve-outs, and capital raising formalities. Problematically, this state of affairs is actually worse than a universe where capital truly flows freely, since the vestigial regulations are mere formalities that can be avoided, but at the cost of hiring investment bankers

197. *See* Matt Levine, *Private Markets Might Be Too Nice*, BLOOMBERG (Oct. 31, 2019), https://bloom.bg/3CVM4O4.

and lawyers. In other words, for a firm determined to avoid public company regulation, the securities laws have come to be little more than transaction costs.

Unsurprisingly, public capital raised on public markets is becoming increasingly irrelevant; instead, public markets are more important for the purpose of providing liquidity and adjusting the investor base than for raising new capital. Consider again the contrast between newer- and older-generation tech companies. The implied valuation of Uber in the private market was significantly higher than the total value created in the IPO.[198] For a long time, the company's actual market capitalization was below what its initial IPO price indicated.[199] In other words, Uber was built on the private markets, and the public markets were not a part of Uber's growth story. By contrast, as of August 2020 virtually none of Amazon's $1.3 trillion in market capitalization was raised in the private markets, and only 3% of the value created by Alphabet/Google, and 17% of the value created by Facebook, was raised in the private markets.[200]

III.
Consequences of the Breakdown of the Public–Private Divide

In the aggregate, the myriad of legal interventions described in Part II have led to the breakdown of the foundational public–private divide in securities law. But the fact that the transformation of the legal framework for capital raising has been dramatic does not automatically suggest that the resulting regulatory landscape is problematic. This Part makes the case that it is. As we will see, the breakdown of the public–private divide and the resulting public company regulatory paradox have had significant adverse consequences along four dimensions. The first two are primarily conceptual: Securities law has gone from a mandatory regulatory scheme to one that is largely elective and subject to "issuer choice," which, in turn,

198. *See* Mike Isaac et al., *How the Promise of a $120 Billion Uber I.P.O. Evaporated*, N.Y. Times (May 15, 2019), https://nyti.ms/32IjFP5.

199. *See* Annie Palmer, *Uber Falls to All-Time Low as Investors Grow More Skeptical*, CNBC (Aug. 12, 2019), https://cnb.cx/3xxhmJQ.

200. Matt Levine, *Public Markets Don't Matter Like They Used To*, Bloomberg (Aug. 5, 2020), https://bloom.bg/3E4Szzh.

has diminished the federal government's ability to regulate certain types of economic activity through securities law. The third and fourth sets of consequences pertain to important constituencies: The breakdown of the public–private divide has led to the fragmentation of investor protection across the capital markets and, in addition, it has increased the vulnerability of employee-investors. Whereas prior manifestations of the latter two developments have received attention in the academic literature, the first two developments have largely escaped notice.

A. *Elective Regulation, Quasi-Federalization, and "Issuer Choice"*

The mandatory nature of securities regulation, particularly following the 1964 expansion of the Exchange Act through the addition of Section 12(g), has long been subject to critical scrutiny in the legal and finance literature. At its core, the classic case in favor of mandatory disclosure is based on a market failure argument: in the absence of a government mandate, firms cannot be expected to reveal the information, *both positive and negative*, that investors need in order to make investment decisions.[201] Law-and-economics scholars have countered by arguing that capital market efficiency obviates the need for the mandatory disclosure regime, since market forces, notably the competition for scarce investor capital, will induce firms to provide the requisite information.[202] Researchers have conducted numerous empirical studies seeking to assess the relative benefits of public company regulation via mandatory disclosure requirements.[203]

Some of the most concerted and well-known arguments against mandatory securities disclosure are associated with

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201. *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 747 (1984).

202. *See* Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 928 (1994).

203. *See, e.g.*, George J. Benston, *An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, 41 LAW & CONTEMP. PROBS. 30, 42 (1977) (expressing skepticism about the benefits of mandatory securities disclosure); Christian Leuz & Peter D. Wysocki, *The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research*, 54 J. ACCT. RSCH. 525 (2016) (reviewing a large sample of empirical studies of disclosure regulation).

Roberta Romano, who made a forceful case against regulation in a 1998 article. Romano found that "little empirical evidence suggests that the federal [securities regulation] regime has affirmatively benefited investors," which led her to argue in favor of investor empowerment via "issuer choice"—a system whereby there are a variety of different regulatory frameworks on offer and firms decide whether or not to opt into securities regulation.[204] Romano's article gave rise to one of the most prominent academic debates in securities regulation, which in essence was a debate about the very need for such regulation.[205] Even though the vast majority of scholars have been supportive of some form of mandatory securities regulation,[206] this debate was never settled. The issuer choice idea, however, fell by the wayside in the early 2000s as a result of new market developments that were both unexpected and inconvenient: the dot-com crash and the accounting scandals of the early 2000s.

These market developments stymied whatever interest there may have existed in scaling back securities regulation. Instead of regulatory retrenchment, the federal response to

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204. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2372 (1998).

205. For a direct rejoinder to Romano, see Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (arguing in favor of mandatory disclosure and interpreting empirical evidence as supportive of this position). The debate between Romano and Fox continued over the next few years. *See* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387 (2001); Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563 (2001). Many other scholars wrote about this debate or some aspect of it. *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 282–84 (2000) (proposing a system allowing sophisticated investors to decide what, if any, disclosure they require); Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1034 (2000) (criticizing securities regulation via the mandatory disclosure regime on behavioral grounds); Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002) (updating the case in favor of a mandatory securities disclosure regime).

206. *See, e.g.*, Reinier H. Kraakman, *Disclosure and Corporate Governance: An Overview Essay*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 95, 96 (Guido Ferrarini et al. eds., 2004) (reporting a "consensus" among most academics and regulators, premised on disclosure's benefits for the efficient pricing of securities, and "practical concerns associated with the governance and regulation of public companies").

the accounting scandals was the Sarbanes–Oxley Act, which represented the most significant expansion of federal securities regulation since the 1930s. The reigning debate in securities law soon became about the new regulatory reality—described as the "federalization" of corporate governance—and its merits and demerits.[207] The passage of another ambitious federal bill, the Dodd–Frank Act, less than a decade later expanded federal corporate governance even further and reinforced these concerns.[208]

Today's regulatory reality, epitomized by the breakdown of the public–private divide, is different and it disrupts the federalization narrative. While it is certainly true that Sarbanes–Oxley and Dodd–Frank "federalized" a number of matters of corporate governance that had previously been within the exclusive purview of state corporate law, it is important to remember that these laws' provisions have always applied *only* to public companies. At the time when public company status (and the access to public capital via the plentiful public markets it provided) was essential to corporate success, the federalization label was accurate as a descriptive matter. With very limited exceptions,[209] the choice to go public was not much of a choice, since access to public capital was a prerequisite for growth.

As described in Section II.B, however, the deregulatory cascade of the 2010s has transformed the funding landscape for U.S. firms. The virtually-unlimited availability of private capital, and the new rules allowing public capital to flow into private firms, renders "going public" truly a *choice* rather than

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207. *See* Romano, *supra* note 138; Langevoort, *supra* note 140; John C. Coates IV, *The Goals and Promise of the Sarbanes–Oxley Act*, 21 J. ECON. PERSPS. 91 (2007).

208. *See* Bainbridge, *supra* note 139. While the larger point about the federalization effects of Sarbanes–Oxley and Dodd–Frank still stands, it is also useful to remember that most of the provisions in these statutes did not *displace* or *override* already-existing state corporate law rules; rather, the provisions sought to *fill* regulatory gaps in state corporate law.

209. The relevant exceptions are a few large, mostly family-owned firms that never went public, including Cargill, Koch Industries, Albertsons, and Mars. Professional firms, such as Deloitte, PricewaterhouseCoopers, and Ernst & Young have also been private traditionally. *See* Chloe Sorvino, *Silent Giant: America's Biggest Private Company Reveals Its Plan To Get Even Bigger*, FORBES (Oct. 22, 2018), https://bit.ly/3cXfuAH (listing the largest private companies other than unicorns).

an *imperative*. As private companies, unicorns are not subject to federal corporate governance notwithstanding their size, large investor base (which increasingly includes retail investors), and societal footprint. The federalization label, therefore, is no longer apt. Instead, it is more accurate to speak about Sarbanes–Oxley and Dodd–Frank as causing *partial* or *quasi-federalization*: These laws have added a federal corporate law layer on top of the state law provisions for *some* firms in the economy, but definitely not for *all* firms. What is more, the subset of firms to which the federal layer applies is driven by private ordering, not mandatory regulation.[210] Despite the considerable time and effort Congress and the SEC have devoted to developing the federal corporate governance regime over the course of almost nine decades, the federal government has no means to force a firm into the regime.

The latter observation takes us back, and full circle, to the notion of issuer choice and the academic debates related to it before the advent of Sarbanes–Oxley. Even though the merits of the issuer choice model remain contested in the academic literature, the breakdown of the public–private divide has brought about, quietly but surely, the realization of Roberta Romano's intellectually-ambitious vision for *elective* federal securities regulation. In effect, the provisions of the federal securities laws are *mandatory*, but only after an issuer has *elected* to opt into the regime by taking on public company status. Whether to do so is—to echo Romano's phrase—the issuer's choice.

The suggestion that changes in federal securities law over the past two decades have brought about an issuer choice model is an important but overlooked point in the assessment of securities law's recent trajectory. To be sure, issuer choice is not an implausible model and one can imagine a set of circumstances under which it could garner political support and become formally embedded in law. What is notable here, however, is that issuer choice was never mentioned in debates over the JOBS Act and the initiatives that comprised the deregu-

210. Recall that there is only one provision that "forces" a firm into public company status, Section 12(g), which has little practical effect. *See supra* notes 77–78 and accompanying text. As discussed in Section IV.A.3, one of the most clearly fleshed out reform proposals coming out of the SEC focuses on reforming this very provision.

latory cascade detailed in Section II.B. In other words, the issuer choice model was not subjected to democratic scrutiny and did not win a battle of policy ideas. Instead, the issuer choice outcome is simply an unintended consequence of the breakdown of the public–private divide in securities law.

B. *Securities Law's Diminished Regulatory Capacity*

As discussed in Section I.C, over the years, securities regulation has come to fulfill important roles in ensuring corporate transparency and accountability, in addition to investor protection and capital formation.[211] Firm-specific information released pursuant to the requirements of the mandatory securities disclosure regime provides a window into corporate activity that is useful not just to investors but also to employees, customers, suppliers, competitors, and society at large.[212]

From the vantage point of federal lawmaking, securities law via disclosure mandates provides a relatively easy channel for adopting general economic regulation: the "public company" regulatory category is already in existence, as is the disclosure regime and the powerful regulator in charge of it, the SEC. Accordingly, and as we saw in Section I.C, Congress has used the securities laws to require disclosure pertaining to various miscellaneous topics, such as conflict minerals, extractive payments, mine safety, corporate pay equity, and corporate activity in countries under economic sanctions, such as Iran.[213] Proposed legislation would use the public company category to impose a variety of disclosure obligations pertaining to ESG topics.[214] Nevertheless, the optimal volume of disclosure obligations and the scope of the disclosure regime are heavily contested,[215] and usually hinge on one's policy preferences.

Irrespective of the policy choices on the latter points, the breakdown of the public–private divide has undermined the

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211. *See supra* notes 131–32 and accompanying text.

212. *See, e.g.*, Georgiev, *Too Big to Disclose*, *supra* note 79, at 652–54.

213. *See supra* notes 113–17 and accompanying text.

214. *See* Corporate Governance Improvement and Investor Protection Act, H.R. 1187, 117th Cong. (2021).

215. *Compare* Jill Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L. J. 923 (2019) (arguing in favor of securities disclosure mandates on sustainability-related topics), *with* Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821 (2021) (arguing against the expansion of the disclosure regime to cover ESG topics).

regulatory capacity of securities law: young firms can now avoid important disclosure and governance mandates by never going public, whereas already-public firms can go private or sell "bad" assets off to a private company. As long as the public company category is elective, the federal government cannot use it to effectively regulate business activities and practices it has deemed undesirable.[216]

Climate change regulation provides a case in point. There has been a powerful push in the Biden administration to mobilize all federal administrative agencies, including the SEC, to address climate change.[217] In the case of the SEC, this will likely entail adopting new disclosure rules concerning firms' activities that might contribute to climate change and the risks firms face due to climate change—rules that are subject to considerable controversy.[218] Importantly, under the current regulatory framework any new SEC disclosure rules would apply *only* to public companies. This fact would not be problematic if all the biggest polluters were public companies, but it turns out that the opposite is the case. According to a recent report, small, non-public oil and gas drilling companies have become the biggest polluters in the United States in terms of methane and other greenhouse gases.[219] The report notes that these firms' pollution is "wildly large relative to their production" and that the firms have escaped the type of public scrutiny leveled on large oil and gas companies, even though in

216. The manifestations and implications of this phenomenon deserve more detailed treatment, which I provide in related work. *See* George S. Georgiev, *Is "Public Company" Still a Viable Regulatory Category?*, 13 HARV. BUS. L. REV. 1 (forthcoming 2022) (draft on file with author) [hereinafter Georgiev, *Regulatory Category*].

217. *See* Exec. Order No. 14,030, 86 Fed. Reg. 27,967 (May 25, 2021) (announcing a policy to "advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk"); *see also* Exec. Order No. 14,008, 86 Fed. Reg. 7619 (Feb. 1, 2021) (announcing a "government-wide" approach to climate change mitigation).

218. *See, e.g.*, Rose, *supra* note 215 (opposing climate change disclosure rules on materiality and institutional competency grounds). For arguments in favor of climate change disclosure mandates on the grounds that they are consistent with the SEC's mission, including investor protection and the unjustifiably-neglected goal of promoting competition, see George S. Georgiev, Comment Letter to the SEC on Climate Change and Other ESG Disclosure (June 22, 2021), https://ssrn.com/abstract=3874186.

219. *See* Hiroko Tabuchi, *Here Are America's Top Methane Emitters. Some Will Surprise You*, N.Y. TIMES (June 2, 2021), https://nyti.ms/317ur0t.

many cases the small private polluters have bought their high-polluting assets from larger public companies.[220] This reallocation of high-polluting assets is a win–win proposition for the firms, if not for the public. In effect, the large public companies are "cleaning up" their investor- and public-facing disclosure reports by offloading the problematic assets and freeing up financial capital. The small private companies, in turn, get to exploit the same assets with little public oversight, without incurring reputational harm, and, most likely, without paying a higher cost of capital.

The upshot of this example is that private firms like the smaller high-polluting firms can avoid important climate change disclosure rules at the federal level by simply avoiding the public capital markets and public company status.[221] As we saw in Part II, the deregulatory cascade of the 2010s and the wide availability of private capital make this a feasible option. The negative implications are twofold. First, government regulation by way of SEC disclosure mandates fails to capture a significant segment of entities across the economy. In this regard, the ready opportunities for regulatory arbitrage result in an adverse selection problem—the rules fail to cover precisely the types of firms to which they are most relevant. Second, because a growing number of public investors can now invest in private firms not subject to SEC disclosure obligations, those public investors would not obtain disclosure in respect of their pri-

220. *Id.* This trend is projected to continue and intensify over time. The report notes that by the end of the 2020s, "the world's largest oil and gas companies will divest from more than $100 billion of assets as they adjust to the [clean] energy transition." *Id.*

221. To be sure, other federal agencies have the power to require disclosure of all firms, not just public companies. The point here is about the diminished regulatory capacity of securities law, which in recent years has been a preferred vehicle for seeking to impose new economic regulation. During the 116th Congress, between 2019 and 2021, there were 18 unique bills that sought to regulate various aspects of general economic activity via the public company regulatory category. These bills pertained to matters such as employee representation in corporate governance and disclosure concerning diversity in corporate leadership, human capital management, the value of digital assets, corporate political spending, outsourcing practices, internal compensation trends, ESG metrics, cybersecurity risk and internal cybersecurity expertise, financial dealings with firearms manufacturers, measures taken to address illegal activities in the supply chain, and various other topics. *See* Georgiev, *Regulatory Category*, *supra* note 216 (manuscript at 13–17).

vate company investment and would not reap the investor protection benefits of the rules. The latter point illustrates the fragmentation of investor protection due to the breakdown of the public–private divide, a topic to which we turn next.

C. *Fragmented Investor Protection*

Perhaps the most immediate question raised by the changes in public and private markets relates to the impact of these changes on investor protection. Accordingly, scholars who have written about the underlying developments have considered their implications for investor protection rigorously and from different perspectives.[222] The analysis that follows builds upon this fine work, but it takes a somewhat different conceptual approach. As a point of departure, I inquire into the systemic impact of the breakdown of the public–private divide on investor protection (rather than the impact of specific private capital developments). I also assess investor protection at the *portfolio level* under the assumption that mainstream investors' portfolios today include a mix of public and private firms as a result of the various deregulatory measures discussed in Part II.

Viewed systemically and at the portfolio level, the impact of the breakdown of the public–private divide on investor protection can be described as the *fragmentation* of investor protection. Fragmentation is an apt label because different components of the portfolio are subject to different degrees of investor protection: whereas public companies (whose securities would still comprise the largest share of a capitalization-weighted fully-diversified portfolio) are subject to the expansive regulatory scheme described in Section I.C.1, private companies (whose securities would comprise a smaller but steadily increasing share of the portfolio) remain unregulated. As noted in Section I.C.2, there are different ways to define investor protection,[223] but, notably, the point about fragmentation applies regardless of the chosen definition. As long as legal interventions applying to public companies offer a degree of protection that has been deemed *necessary* for the protection

222. *See, e.g.*, Elizabeth Pollman, *Private Company Lies,* 109 GEO. L.J. 353 (2020); Winship, *supra* note 7; Alon-Beck, *supra* note 171; *see also* sources cited in Section IV.A *infra*.

223. *See supra* notes 123–25 and accompanying text.

of mainstream investors, then exposing these investors to both public and private firms diminishes the overall level of investor protection within the portfolio.

Despite the rhetoric about "investor opportunity" which is usually tied to a quest for higher returns,[224] it is at best unclear that mixing public and private firms in the portfolio contributes to higher returns. Empirical evidence shows that private markets, on average, do not outperform public markets in terms of investor returns.[225] Relatedly, the track record of unregulated IPOs under Regulation A+ has been dismal.[226]

Expanding investor opportunity should not occur at the expense of overriding investor choice, but this may be one unintended consequence of the breakdown of the public–private divide. Because private company securities are finding their way into the diversified funds that comprise a majority of 401(k) retirement savings, it would be very difficult (or, in the very least, it would be burdensome) for an investor to *exclude* private companies from the portfolio even if this were a deliberate strategy based on an informed choice. The entry of private company securities into the investments of "public" investors is not a remote possibility but a reality. The big-three asset managers already invest in private companies and the biggest of them, BlackRock, has recently indicated plans for further expanding its investment in private company equity.[227] (While

224. *See supra* note 169.

225. *See* Erik F. Gerding, *The Cost to Retail Investors and Public Markets of "Harmonizing" Securities Offering Exemptions*, COLUM. L. SCH. BLUE SKY BLOG (Oct. 1, 2019), https://bit.ly/3Ix9n4D (providing a detailed overview of relevant studies and concluding that "[t]he best evidence suggests that, on average, *even institutional investors may be doing no better in the private markets than they would investing in a broad index of public securities*") (emphasis in original).

226. *See, e.g.*, Leo Imasuen, *Most Regulation A+ IPOs Are Outright Uninvestable*, SEEKING ALPHA (Oct. 31, 2017), https://bit.ly/3qlupv5. Crowdfunding represents a relatively similar method of capital raising, but data on profitability is more limited. Because of the relatively modest amounts raised, both Regulation A+ IPOs and crowdfunding fall outside the scope of this Article. Conceptually, crowdfunding also has implications for the public–private divide. *See* Joan MacLeod Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 503 (2014) ("An analysis of the regulation of [crowdfunded] offerings of securities . . . exposes new and emerging complexity in distinguishing between public and private offerings . . . and between public and private companies . . . .").

227. *See, e.g.*, Simon Jessop & Ross Kerber, *Insurers Plan to Ramp Up Private Market Investments, BlackRock Says*, REUTERS (Nov. 15, 2021), https://reut.rs/

there is an academic case to be made for diversification along related lines, it assumes legitimate variation in legal arrangements rather than what is in effect regulatory arbitrage.[228])

What are the harms of allowing investors who, in the words of the Supreme Court, "cannot fend for themselves," to invest in public firms? The classic story with respect to the merits of public markets as opposed to private markets relates to the advantages of public markets in terms of price discovery, liquidity, and information quality.[229] The harms of holding both private and public company securities are many, but perhaps the most significant one relates to private markets' reduced capacity to value firms accurately compared to public markets. The price at which an investor buys or sells a security is the most important term in a securities transaction, which makes stock price accuracy a key element of investor protection.[230] Private markets are inferior in pricing to public markets. According to Jesse Fried and Jeff Gordon, structural features of private markets, particularly tech startups in Silicon Valley, contribute to valuation and governance bubbles.[231] They note that "[a] market that makes it difficult and costly to express negative sentiments is prone to a bubble and thus an abrupt collapse when negative fundamentals finally become too pervasive to ignore."[232]

3EB8JAG; *see also supra* note 187 and accompanying text (discussing Fidelity's investment in Juul).

228. Kelli Alces has made such an argument, though her approach does not call for mixing public and private companies, but, rather companies with different legal arrangements. *See* Kelli A. Alces, *Legal Diversification*, 113 COLUM. L. REV. 1977, 1977 (2013) (explaining that "[l]egal diversification protects investors from the risk that a particular method of minimizing agency costs will prove ineffective").

229. *See, e.g.*, Coffee, *supra* note 201, at 747.

230. *See, e.g.*, Merritt B. Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 370–81 (2003); *see also* Allen Ferrell, *Measuring the Effects of Mandated Disclosure*, 1 BERKELEY BUS. L.J. 369, 372 (2004) (providing an assessment of the various empirical studies and noting that "[t]he concept of stock price accuracy is well accepted and commonly employed in the accounting and finance literature"); *see also* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992).

231. *See* Jesse M. Fried & Jeffrey N. Gordon, *The Valuation and Governance Bubbles of Silicon Valley*, COLUM. L. SCH. BLUE SKY BLOG (Oct. 10, 2019), https://bit.ly/3rk1glU.

232. *Id.*

Empirical evidence bears this out. According to a Morgan Stanley report, "[v]aluing young companies is an inherently tricky task."[233] The same report notes the results of a 2020 survey of venture capitalists on unicorn valuations: more than 90% of the respondents believed that unicorns were "'significantly' overvalued," even though 40% of them had themselves invested in unicorns.[234] On an aggregate level, the report also notes that in the period between 2011 and 2019, "about one-third of the companies that went public had a valuation below that implied by the final round of private financing."[235]

At a most basic level, accurate asset prices are key to investor protection and without a public listing, asset prices cannot be guaranteed to be accurate.[236] Relatedly, the rise of private markets inhabited by private firms that do not produce public disclosure reduces the overall level of firm-specific information that is available to market participants, which has the potential to affect the accuracy of securities prices for *public* firms.[237] The investor protection harms, in other words, are not limited to investors in private firms, but, rather, extend systemically across all capital markets. As a result, the diminished availability of information about private firms due to the rise of private capital has significant implications for allocative efficiency in the overall economy.

There is also the potential for investor losses due to poor corporate governance, inadequate information, and poor monitoring, as illustrated by the cases of WeWork, Uber, Theranos, and others.[238] At each of these companies, there were

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233. *See* MICHAEL J. MAUBOUSSIN & DAN CALLAHAN, MORGAN STANLEY, PUBLIC TO PRIVATE EQUITY IN THE UNITED STATES: A LONG-TERM LOOK 48 (2020), https://mgstn.ly/31CaMpV.

234. *Id.* at 47–48.

235. *Id.* at 47.

236. *See* James J. Park, *Investor Protection in an Age of Entrepreneurship*, HARV. BUS. L. REV. (forthcoming 2022), https://ssrn.com/abstract=3911454; Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings* (Eur. Corp. Governance Inst., Working Paper No. 594/2021), https://ssrn.com/abstract=3707249.

237. *See* de Fontenay, *supra* note 22.

238. *See supra* note 176 and accompanying text; *see also* discussion *infra* Section IV.A. For an additional analysis of the investor protection implications, see Ann Lipton, *The Eroding Public/Private Distinction*, BUS. L. PROF. BLOG (Feb. 1, 2020), https://bit.ly/3DukFTw. For a contrarian analysis, see Platt, *infra* note 247.

governance failures despite the involvement of sophisticated venture capital and other institutional investors. Contrary to what we might expect by simply analyzing those investors' incentives, they did not bargain for information or exercise oversight in an effective manner. It appears likely that these firms' private status contributed to their governance problems. As is so often the case in corporate law, however, the counterfactual, whether public company status would have prevented the associated scandals, cannot be proven. But on balance, it does appear that, at least for large firms, public company status is more conducive to better governance (with all the associated benefits in terms of mitigating fraud and waste) than private company status.

There are two additional considerations. First, public markets may provide firms with greater resilience in times of crisis. The availability of private capital is more cyclical and private markets remain smaller overall; they are less liquid even during the best of times. Therefore, a regulatory policy that encourages firms to take on public company status may offer systemic benefits in terms of firms' ability to access capital when they experience distress. The second consideration relates to diversification. Diversification is key to maximizing risk-adjusted returns. Yet, it is considerably more difficult for individual investors constructing an individual portfolio to diversity effectively with private securities, because there is significantly less information available about private companies and because of the diminished liquidity of private company securities.

D. *Increased Vulnerability of Employee-Investors*

In addition to mainstream investors, the breakdown of the public–private divide compounds the problems faced by a special class of investors—employees of startup companies who usually receive a considerable amount of their total compensation in illiquid and hard-to-value private company stock and who are incapable of mitigating through diversification the firm-specific risk associated with their investment of both financial and human capital.[239] As discussed in Parts I and II, changes to industry practices as well as various economic and

239. *See, e.g.*, Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867 (2019).

regulatory changes from the past two decades have complicated the economic relationship between certain firms and their employees, giving rise to a hybrid economic actor: the employee-investor.

In the case of unicorns, stock options are a source of significant and well-documented problems relating to valuation, tax, contracting, lack of liquidity, and other matters.[240] Comprehensive data on employee ownership stakes in unicorns is lacking, but it is generally assumed that in late-stage startups approximately 15% of the market capitalization is reserved for employees.[241] An examination of headcount data from the current cohort of U.S.-based unicorns shows that 112 of them have 1000 or more employees, and a further 141 have between 500 and 999 employees.[242] Applying the general rule of thumb that approximately 80% of startup employees receive stock options, it stands to reason that there are hundreds of thousands of startup employees who are exposed to the stock of their employers. From a firm's point of view, trading equity capital for human capital is an attractive financial proposition, because it diminishes the need to seek external financing and delays the going-public decision, as discussed in Section I.B.1. Moreover, as discussed in Section I.B.2, employee-investors do not count for purposes of the mandatory registration thresholds under Section 12(g).

Unlike in the past, these problems are no longer capped in size or duration, because startups can now raise unlimited amounts of private capital (larger private startups tend to have more employee-investors) and because they can remain private, and unregulated from an investor-protection point of view, virtually indefinitely. As a result, the unique problems faced by employees investing in the stock of their employer are compounded. In the case of an employee receiving stock options as part of their compensation, the employee repeatedly has to make at least three types of difficult and highly conse-

240. *See, e.g.*, Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107 (2019).

241. *See* Alexander Davis, *IPO Bonanza Leaves Out Some Tech Workers Over Unexercised Stock Options*, PITCHBOOK (Dec. 17, 2020), https://bit.ly/3dton5h (quoting an estimate from a compensation expert).

242. Author's calculations based on data from PitchBook as of December 5, 2021. Aggregate data on unicorn headcount and the evolution of unicorn headcount over time is not available publicly.

quential investment decisions: (1) trading their human capital for stock options (a process which implicitly assigns a net present value to the stock option investment); (2) holding on to the stock options by continuing their employment at the company, or, if they decide to terminate their employment, either forfeiting the stock options or paying an exercise price plus applicable taxes within a limited period post-termination; and (3) deciding whether to exercise the options prior to their expiration date. The more human capital an employee trades in for stock options, the more consequential and risky the latter two decisions become. And, for each of these three types of decisions, an employee needs sufficient information about the firm's long-term prospects, which is not always available or forthcoming.[243]

It is important to keep in mind that all of the harms pertaining to investors discussed in Section III.C apply here as well. Moreover, the issue is not limited to the missed benefits of public company regulation and diversification. To the extent that there is a greater incidence of fraud at private companies, such fraud harms employee-investors disproportionately.[244] In short, employee-investors are exposed to both the harms faced by a firm's employees and the harms faced by a firm's investors.

IV.
Reforms: Conceptual Approaches and Roadblocks

As documented in Part II, the regulatory system governing firms' capital raising activities—the types of capital, types of investors, and types of markets that different types of firms can access if they undertake certain legal obligations—is in a state of flux. This stands in contrast with the ordered nature of the original system described in Part I: public firms raising public capital from public investors on the public markets, and private firms obtaining private capital from a narrow class of qualified investors through the much-smaller private markets. As we saw in Part III, the implications of this change,

243. *See* Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 Va. L. & Bus. Rev. 613 (2017).

244. *See, e.g.*, Urska Velikonja, *The Cost of Securities Fraud*, 54 Wm. & Mary L. Rev. 1887 (2013) (discussing the significant and idiosyncratic costs of corporate fraud for non-investor constituencies, including employees).

heretofore largely unacknowledged, are far-reaching and impact multiple constituencies both within and outside the firm.

Regulatory flux and incoherence can be lasting conditions, though hopefully not permanent ones. Even though some observers believe that the capital markets are over-regulated,[245] whereas others believe that they are under-regulated,[246] both groups are likely to agree that capital markets today are mis-regulated.[247] If and when change becomes possible, what might it look like? What are the roadblocks to reform and can they be overcome? The discussion that follows outlines two conceptual approaches—rebuilding the public–private divide and lowering the stakes in capital raising decisions by circumventing the public–private divide and shifting some of the economic regulation that currently operates through securities law to other regulatory domains.

Instead of endorsing a specific proposal or set of proposals, this Article analyzes the preconditions for reform and then argues in favor of new deliberative mechanisms for determining the optimal structure of securities regulation in the wake of the breakdown of the public–private divide.

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245. *See, e.g.*, Center for Capital Market Competitiveness, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193319-192490.pdf (urging substantial further deregulation consistent with the Chamber of Commerce's "longstanding effort to examine how SEC regulatory burdens may diminish access to capital and to remove those barriers").

246. *See, e.g.*, Elisabeth D. de Fontenay, Erik Gerding, et al., Securities Law Professor Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193340-192501.pdf (criticizing the rise of private capital and arguing against further deregulation by way of capital raising exemptions).

247. There is also a case for avoiding reforms in either direction. Some academics have recently pushed back against the prevailing critical views of the rise of private capital, and of unicorns in particular. *See, e.g.*, Alexander I. Platt, *Unicorniphobia*, HARV. BUS. L. REV. (forthcoming 2022), https://ssrn.com/abstract=3915793 (expressing skepticism about arguments that unicorns pose investor protection and other problems, as well as about the expected efficacy of the policy interventions proposed by other scholars); Abraham J.B. Cable, *Time Enough for Counting: A Unicorn Retrospective*, YALE J. ON REG. (BULLETIN), Sept. 21, 2021, https://bit.ly/3D0BCF7 (analyzing the investment outcomes of 32 "original" unicorns and suggesting that "private ordering by founders, employees, and investors is proving an effective alternative to ambitious regulatory reform").

A. *Rebuilding the Public–Private Divide*

While a complete picture of the breakdown of the public–private divide, along with its causes and consequences, is just emerging, a number of observers have analyzed the various changes in capital markets occurring during the 2010s and offered a range of discrete reform recommendations. From the vantage point of the public–private divide, these reform proposals can be classified into two general categories: (1) increasing regulation in the private realm in order to solve various investor-protection problems resulting from the changes in the capital markets ecosystem discussed in Part II; and (2) changing regulation to expand the public realm. One idea in the latter category—the "shareholders of record" solution proposed in October 2021 by SEC Commissioner Allison Herren Lee—deserves special attention both because of its sweeping nature and because the SEC can implement it fairly easily by acting on its existing authority, without the need for additional congressional action.

1. *Regulating the Private Realm*

As a point of departure, the analyses that fall within this rubric do not take a categorical stance against the rise of private capital markets and the expansion of the private realm, along with the key underlying phenomena: the rise of unicorns, the greater equity stakes held by private company employee-investors, and the expanded opportunities for retail investor participation in private company capital raising. Recognizing various problems caused by these phenomena, however, commentators have offered proposals for increasing the regulation of the newly-expanded private realm.

The reforms in respect of regulation of the private realm include the creation of special disclosure regimes for unicorns,[248] requiring additional disclosure for the benefit of em-

248. *See* Jennifer Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. Rev. 583, 585 (2016) (arguing that "once a private company reaches unicorn status, it should be subject to some of the same reporting obligations as public companies to provide greater transparency and protect minority stockholders"); *see also* Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 Ind. L.J. 151 (2013) (arguing for expanded disclosure requirements for certain large private companies). For an early and prescient analysis of emerging problems in private markets, see Elizabeth Pollman, *Informa-*

ployee-investors in private companies,[249] whistleblower protections for private company employees,[250] more stringent enforcement of the anti-fraud provisions of the securities laws, which apply to private companies,[251] facilitating trading of private company securities in order to improve stock price accuracy,[252] and placing regulatory restrictions on trading in the absence of adequate disclosure.[253]

The key advantage of these proposals is that they offer one or more targeted solutions, which facilitates both assessment and implementation; a potential downside is that they each focus on a subset of the problems caused by the breakdown of the public–private divide and that the suggested interventions, while targeted, are not systemic. These proposals merit careful consideration during future policymaking rounds and should form a core part of the broad deliberative process envisioned by Section IV.C.

2. *Expanding the Public Realm*

Instead of regulating the private realm directly, it is also possible to intervene by expanding the size of the public realm, which will, in turn, shrink the private realm. Under this approach, the number of entities subject to the already-existing regime for regulating public companies would increase, while the number of entities that fall in the unregulated private realm would decrease. To achieve this, commentators have suggested, for example, to require or nudge late-stage private companies to take on public company status.[254] Changing the definition of the term "shareholder of record," a pro-

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tion Issues on Wall Street 2.0, 161 U. PA. L. REV. 179, 222 (2012) (discussing the rise of secondary markets for private company securities and arguing that the SEC should require "a specified minimum level of disclosure" for trading in such markets).

249. *See* Aran, *supra* note 239; Alon-Beck, *supra* note 171.

250. *See* Winship, *supra* note 7.

251. *See* Pollman, *supra* note 222; Winship, *supra* note 7.

252. *See* Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. (forthcoming 2021), https://ssrn.com/abstract=3801131.

253. *See* Jones, *supra* note 105, at 186–87 ("Policymakers can act by restricting trading in Unicorn shares in the absence of adequate disclosure.").

254. *See* Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 TEX. L. REV. 1347, 1382 (2021); Amy Deen Westbrook, *We'(re) Working on Corporate Governance: Stakeholder Vulnerability in Unicorn Companies,* 23 U. PA. J. BUS. L. 505, 570 (2021).

posal discussed in detail in Section IV.A.3 below, offers a blunt and automatic solution to expanding the public realm; these attributes work both in the proposal's favor and against it. Apart from the "shareholders of record" solution, the mechanics associated with expanding the public realm are complex and uncertain. Moreover, implementation would require congressional action, which is highly unlikely absent a crisis (as discussed further in Section IV.C below).

A report from the Global Financial Markets Center at Duke Law School published in February 2021 offers an illustration of various possible ways to expand the public realm.[255] The report suggests that "all large companies [ought to be] public," and lists the following triggers for imposing public company status:

- revenues above a threshold (e.g., $100 million annually);
- a "market cap" above a threshold (e.g., $1 billion) based on private market valuations;
- a "public float" in a private trading venue above a threshold (e.g., $75 million);
- a number of beneficial owners of "securities" above a threshold (e.g., 500), irrespective of "accredited investor" status; [. . .]
- a threshold number of employees (e.g., 250 full-time equivalents); [and]
- receiv[ing] more than a certain dollar amount in revenues directly from government contracts or funds (e.g., $25 million).[256]

The menu of options offered by the report reflects the evolving indicators of what it means to be a public company and deserves careful consideration. While the proposed thresholds are merely indicative, it is worth noting that they are set at relatively low levels and that, as presented, exceeding any one of them would be sufficient to push a firm into public company status. As a practical matter, then, this would subject most firms across the economy, except the smallest firms, to

255. *See* TYLER GELLASCH & LEE REINERS, FROM LAGGARD TO LEADER: UPDATING THE SECURITIES REGULATORY FRAMEWORK TO BETTER MEET THE NEEDS OF INVESTORS AND SOCIETY (Glob. Fin. Mkts. Ctr. at Duke L., 2021), https://bit.ly/31cXO1H.

256. *Id.* at 11.

federal corporate law. It is also important to acknowledge again that adopting these recommendations would require congressional action, which appears unlikely as of this writing. By virtue of the way they change the regulatory treatment of private firms, the recommendations themselves will be disruptive to capital market participants, even with a phase-in period. Finally, international regulatory competition is another likely barrier to adoption. Forcing large and medium-sized U.S. private companies into public company status, and the full complement of public company regulation discussed in Section I.C.1, is a significant and costly step that might lead at least some of them to consider changing their domicile of incorporation. The rise of private capital is a global phenomenon and so is the proliferation of unicorns, as illustrated by Figure A–6 and Figure A–9, respectively.

3. *The "Shareholders of Record" Solution*

In an October 2021 speech, SEC Commissioner Allison Herren Lee offered an important and relatively easy-to-implement proposal for expanding the public realm.[257] Commissioner Lee focused on the "shareholders of record" trigger for public company status and made the case that the concept should reflect the *actual* number of investors, which would push many now-private firms beyond the threshold for registration and thus "create" a number of new public companies.[258]

Recall that under Section 12(g) of the Exchange Act, issuers of equity securities with at least $10 million in assets and more than 2000 shareholders of record (or more than 500 shareholders of record who are not accredited investors) are required to register the securities under the Exchange Act and thereby become subject to the periodic reporting requirements for public companies.[259] In other words, private compa-

257. *See* Allison Herren Lee, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at The SEC Speaks in 2021, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021), https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12.

258. *Id.*

259. *See supra* note 77 and accompanying text. Note that the technical term is "equity securities . . . held of record by . . . persons"; in line with other commentators, I refer to "shareholders of record" for the sake of clarity.

nies must become public companies upon exceeding the asset and shareholder-base thresholds. The definition of "shareholders of record," which dates back to the 1960s, does not account for the fact that shares are held predominantly in "street name" accounts, i.e., in the names of the intermediaries through which they were purchased or institutions where they are held, and not in the name of the underlying beneficial owners.[260] The SEC has estimated that "over 85% of the holders of securities in the U.S. markets hold through a broker-dealer or a bank that is a Depository Trust Company participant."[261] For this reason, at public companies and, importantly, at private companies that have gone through several funding rounds, the shareholders of record number *significantly understates* the number of beneficial owners. The SEC's original proposal for Rule 12g5-1 in 1964 contained a "look through" provision (looking through the street name holder to get to, and count, the customers who hold the underlying economic interest), but the final rule opted not to require this.[262] Today, redefining "shareholders of record" to reflect a firm's actual investor base would automatically push many private companies into public company status. According to Commissioner Lee, doing so would be desirable in light of market developments and justifiable in light of the legislative history of Section 12(g).[263]

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260. *See* Lee, *supra* note 257.

261. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12G5-1 AND SUBSECTION (B)(3) 8 n.26 (Oct. 15, 2012), https://www.sec.gov/files/authority-to-enforce-rule-12g5-1.pdf [hereinafter SEC Rule 12g5-1 Study]. The same SEC Staff Report concluded that "issuers with more than 2000 beneficial owners, but less than 2000 holders of record, can be actively traded in the over-the-counter markets or in private secondary markets, without triggering the threshold requirements to report under the Exchange Act." *Id.* at 11.

262. *See* Langevoort & Thompson, *supra* note 4, at 356. The authors also note that even though Rule 12g5-1 does not require look-through, other SEC rules do provide for look-through under various circumstances; in other words, look-through is not outside the norm. *Id.* They explain that "[t]he absence of a look through widens the range of trading that can occur without 1934 Act regulation because beneficial owners can, and do, make individual decisions to sell their stock, so that one broker-dealer as record owner may reflect the reality of hundreds of investors trading." *Id.*

263. *See* Lee, *supra* note 257. (Commissioner Lee's speech appeared as this Article was being finalized and the present analysis is not intended to be comprehensive.)

Even though the notion of "shareholders of record" has long attracted criticism,[264] and even though it was subject to some scrutiny in connection with Congress' consideration of the JOBS Act,[265] all without any resolution, Commissioner Lee's recent focus on this issue is noteworthy. Unlike most of the other proposals for rebuilding the public–private divide, changing the "shareholder of record" definition can be done by the SEC acting on its existing authority and without the need for congressional authorization.[266] Given the need to address problems in the public markets reflected in Commissioner Lee's speech and the very low likelihood of cooperation from Congress, the "shareholders of record" solution is one of the few available avenues for reform.

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264. *See, e.g.*, Petition from Institutional Investors for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3, 2003), https://www.sec.gov/rules/petitions/petn4-483.htm (noting, inter alia, that "Rule 12g5-1 fails to properly effectuate the Congressional intent expressed in Section 12 or the policy goals of the Exchange Act" and making a detailed case for reform); GELLASCH & REINERS, *supra* note 255, at 11 (noting that "the SEC's curious definition of 'shareholder of record' permits issuers, executives, and other interested parties to easily avoid the Section 12(g) trigger by simply aggregating owners into ownership vehicles or at a small number of broker-dealers" and arguing for reform).

265. *See* Letter from North American Securities Administrators Association, to Senator Jack Reed (Mar. 22, 2012), https://bit.ly/31csG2l (asserting that "[t]he current 'holder of record' definition creates confusion and threatens investor confidence in the marketplace"); *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 16 (2011) (statement of Mary L. Schapiro, Chair, U.S. Sec. & Exch. Comm'n) (noting that "since the definition of 'held of record' was put into place, a fundamental shift has occurred in how securities are held in the United States"). In addition, Section 504 of the JOBS Act required the SEC to undertake a narrowly-focused study in respect of the anti-evasion provisions applicable to the concept of "shareholders of record"; because most of the problems associated with the concept stem from its underinclusive nature (rather than from active efforts to evade the rules), however, those problems fell outside the study's narrow scope. *See* SEC Rule 12g5-1 Study, *supra* note 261.

266. *See* Lee, *supra* note 257 ("[T]he Commission can and should act now within our existing authority to restore transparency in capital markets. That means, at a minimum, it's time to revisit how we define shareholders of record under [Section] 12(g)."); *see also* GELLASCH & REINERS, *supra* note 255, at 11 (asserting that "adopting a rule revising [the SEC's] interpretation of the 'shareholder of record' to reflect the actual owners of securities" represents a "change [that] can be made without legislation").

The expected impact of any proposal would depend on the nature of the proposal; since no detailed proposal exists at present, specific predictions can easily miss the mark. Nevertheless, we can observe with some certainty that moving the concept of "shareholder of record" closer to the idea of "beneficial owner" would be a highly effective, albeit blunt and controversial, tool for reversing the breakdown of the public–private divide. Doing so will push many, and possibly most, unicorns into public company status. Notably, it would do so not by incentivizing them to undertake an IPO, but by subjecting them to public company regulation automatically and as a result of the size of their investor base.

The "shareholders of record" move is likely to be controversial for at least two reasons. First, the differences between public and private company status and the associated costs and obligations have grown to be very substantial, as illustrated in Section I.C.1; any change in regulatory treatment, therefore, will be highly-consequential for day-to-day operations and regulatory obligations. Second, even though the change to the SEC rulebook would be fairly minor (simply amending the definition of "shareholder of record"), the consequences from it would be profound: the resurrection of a now-forgotten mechanism for forcing emerging companies into public company status, and, correspondingly, the sudden end of the "issuer choice" regime described in Section III.A. Therefore, it should not be a foregone conclusion that the SEC would be willing to take on, or, indeed, be equipped to withstand, the likely pushback from market participants. Whereas the deregulatory cascade described in Section II.B unfolded over the course of almost a decade, piecemeal and with little fanfare, the re-regulation of private companies by amending the "shareholder of record" definition is likely to be abrupt and highly-visible, no matter the implementation approach.

How would the "shareholders of record" solution fare with respect to the four concerns identified in Part III? As noted already, it will eliminate the current "issuer choice" regime under which firms are able to acquire a broad investor base and still avoid public company regulation by raising capital on the private markets. Resurrecting the Section 12(g) triggers for public company status will diminish the relative importance of the markets on which shares are sold, since the size of the investor base, measured by the number of beneficial own-

ers of shares, will push a number of firms into public company status. Like before, special circumstances may still allow a limited number of firms to achieve scale without the need to raise capital from a broad investor base.[267]

Relatedly, the "shareholders of record" solution will also restore most of securities law's diminished regulatory capacity, the second major consequence of the breakdown of the public–private divide. By using the true size of the investor base as a regulatory trigger, public company regulation will capture a larger number of firms, including smaller and younger firms.[268] At the same time, if the goal is to use parts of securities law to regulate firms with a large societal footprint—or firms characterized by "publicness"[269]—the size of a firm's investor base would be a less-than-perfect proxy, since this metric fails to take into account a firm's impact on non-shareholder constituencies, such as employees, customers, suppliers, communities, and the environment. In addition to being imprecise, zeroing in only on a firm's investors when assessing its overall societal footprint is normatively objectionable.[270]

The "shareholders of record" solution is likely to be effective, albeit indirectly, in addressing the fragmented nature of investor protection, which was the third major consequence of the breakdown of the public–private divide discussed in Part III. Forcing private firms to become public companies upon acquiring an investor base of a certain size would do nothing to foreclose the many new mechanisms through which main-

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267. *See supra* note 209 and accompanying text (noting the existence of a limited number of large private companies that pre-date the rise of unicorns during the 2010s).

268. As discussed in Section I.C.2 and Section III.B, the extent to which securities regulation should be used to advance goals beyond classic investor protection is open to debate. The point here is simply that imposing regulation through the "public company" regulatory category would become much more effective, since the "shareholders of record" solution would cause many more firms to fall within the definition of "public company."

269. *See infra* notes 273–77 and accompanying text.

270. *See, e.g.*, Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REG. 499 (2020) (criticizing the use of the investor-focused disclosure regime as a means of supplying important information to non-investor audiences); Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1671–73 (2018) (noting that analyzing the harms caused by sexual harassment through the lens of corporate law can create additional, "discursive harms").

stream, non-accredited investors can invest in both *private* and *public* companies, which were discussed in Section II.B; it will, however, reduce the overall supply of private company stock because it will reduce the number of private companies. As a result, the share of private company securities in the portfolios of mainstream investors will decrease, which, in turn, will mitigate the investor protection harms stemming from the breakdown of the public–private divide.

Finally, the "shareholders of record" solution would be unable to address, and may in fact exacerbate, the increased vulnerability of employee-investors—the fourth major consequence discussed in Part III. Recall that pursuant to the JOBS Act, employee-investors are expressly excluded from the "shareholders of record" count.[271] Even though the SEC has the authority to amend the definition of "shareholders of record," it cannot amend it in a way that captures employee-investors, since this will be in direct conflict with congressional intent to exclude employees from the count. Moreover, a world in which investors cannot be bundled together through the existing definition of "shareholders of record" is a world in which *every* individual investor counts for purposes of the 2000 shareholder-of-record threshold *except for* employee-investors. As a result, employee-investors would become the only source of private capital that does not trigger Exchange Act registration and regulation. We can expect that as firms approach the 2000 shareholders-of-record threshold for registration, they would place greater reliance on sourcing capital from employee-investors, with all of the attendant problems discussed in Section III.D.

In sum, the "shareholders of record" solution would not resolve all the consequences from the breakdown of the public–private divide in securities law discussed in this Article. It would, however, represent a bold step toward rebuilding the original public–private divide by making it impossible for firms to acquire a sizeable investor base while maintaining private company status, which, in turn, would automatically increase the number of public companies. The blunt nature of this solution raises questions about its practical feasibility, even if the SEC's authority to pursue it is beyond question. Importantly, the "shareholders of record" solution will not address the

271. *See supra* note 77 and accompanying text.

problems faced by employee-investors and may exacerbate them. Ultimately, the limits of the "shareholders of record" solution highlight the difficulties the SEC is likely to encounter if it sets out to rebuild the public–private divide in securities law without comprehensive assistance from Congress. (Whether and when such assistance might be forthcoming is a question I take up in Section IV.C below.)

B. *Circumventing the Public–Private Divide*

The fact that the breakdown of the original public–private divide has caused a series of problems does not automatically suggest that the only way to solve these problems is by rebuilding the divide. Another conceptual approach to addressing the problems identified in this Article may be to reduce the regulatory stakes of the public–private distinction in securities law. The two approaches are not mutually exclusive—it is possible to both reduce the stakes of the public–private distinction and to rebuild a version of the public–private divide.

Why might lowering the regulatory stakes of the public–private company distinction be desirable? As illustrated by the public company regulatory paradox discussed in the Introduction, otherwise-identical firms can inhabit entirely different regulatory universes depending on their public or private company status. Importantly, the regulatory universe in which a firm finds itself now hinges solely on the firm's capital raising choices. As we saw in Section I.C, public companies are heavily regulated in respect of various disclosure and corporate governance matters, whereas private companies are not. Moreover, the volume of regulation at issue has increased dramatically over the past two decades, as has the range of matters covered by such regulation. This, in turn, has heightened the compliance costs and the overall stakes of being a public company. Many of the deregulatory reforms described in Section II.B can be viewed as reforms aimed at extending to private firms benefits previously available only to public firms.

The difference between the regulatory treatment of public and private companies can be reduced by (1) narrowing the scope of securities regulation to matters most closely related to financial investors' buy/sell and voting decisions, and (2) making aspects of what is now public company regulation applicable to all business entities that meet certain criteria,

without regard to public company status. This approach would represent a substantial expansion of the role of the federal government in the regulation of business entities, but it would also reduce the weight of any individual firm's decision with respect to becoming a "public company" and make it possible to rationalize the regulatory regime for capital raising.

Take disclosure regulation as an example. If all firms, whether public or private, that meet certain pre-defined criteria *unrelated to capital market activity* become subject to a new stakeholder-focused mandatory disclosure regime, then the going-public decision is less likely to be affected by the perceived costs of the existing investor-focused mandatory disclosure regime. Ann Lipton has made the case for just such a new stakeholder-focused mandatory disclosure regime on the grounds of the social utility of providing stakeholders with firm-specific disclosure and the inadequacy of existing investor-focused disclosure for non-investor audiences.[272] Lipton's proposal for a separate stakeholder-focused disclosure regime has the important additional benefit of removing the secrecy advantage enjoyed by private firms vis-à-vis public firms and streamlining the regulatory calculus embedded in the going-public decision.

The insight motivating this conceptual approach is a reaction to the public company regulatory paradox: a firm's capital raising choices should not determine, in a binary fashion, whether or not it is subject to the extensive public company regulatory regime that today covers many matters that are only loosely-related to investor protection and may be better described as regulation in the service of business accountability, transparency, efficiency, and other goals. Relatedly, even if there is a robust public–private line for capital raising purposes, a firm's obligations in respect of general economic regulation should not be determined by the side of this line on which the firm finds itself.

Shifting federal economic regulation that currently operates through the public company category outside the realm of securities regulation would require the creation of new, alternative regulatory categories that are not tied to a firm's access-to-capital choices. Such alternative regulatory categories could encompass metrics such as number of employees, revenues, as-

272. *See* Lipton, *supra* note 270.

sets, and other indicators of a firm's societal footprint, i.e., a firm's potential to generate societal externalities that ought to be disclosed and/or regulated regardless of the firm's financing choices. Hillary Sale has developed a theory of "publicness" that links federal economic regulation to a firm's overall societal footprint.[273] Regulating on the basis of publicness can be done with or without reference to a firm's financing activities.[274]

Consider two specific examples, one concerning legislation from outside the United States and one concerning proposed U.S. legislation. The United Kingdom introduced a new regulatory regime in 2018 requiring large private companies to provide certain disclosures and comply with the substantive provisions of its new Corporate Governance Code.[275] While the public–private divide in the United Kingdom was never as pronounced as that in the United States, the new U.K. Corporate Governance Code circumvents the public–private divide entirely and imposes regulation that had previously applied on the basis of a company's status as a stock-exchange listed entity to all companies that meet certain criteria.[276] Contemporaneous amendments to other parts of U.K. corporate law require all companies (both public and private) with more than 250 U.K.-based employees to provide a statement describing any employee empowerment initiatives pursued by the company and summarizing "how the directors have engaged with employees" and "how the directors have had regard to employee interests, and the effect of that regard, including on the princi-

273. *See* Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 137–38 (2011); Hillary A. Sale, Essay, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 BROOK. L. REV. 1629, 1630–31 (2014); Hillary A. Sale, *The Corporate Purpose of Social License*, Geo. L. Fac. Pubs. No. 2171 (2019), https://scholarship.law.georgetown.edu/facpub/2171.

274. *See, e.g.*, Onnig H. Dombalagian, *Principles for Publicness*, 67 FLA. L. REV. 649 (2016); Guttentag, *supra* note 248.

275. *See Corporate Governance for Private Companies: Restoring Trust in Big Business*, LINKLATERS, https://bit.ly/3o36jFu.

276. The Code's corporate governance reporting requirements apply to non-listed U.K. companies that meet one of two thresholds: (1) have more than 2000 employees globally, or (2) have annual turnover over £200 million and a balance sheet over £2 billion. *Id.*

pal decisions taken by the company during the financial year."[277]

In the United States, the Accountable Capitalism Act proposed by Senator Elizabeth Warren in 2018 constructs a new regulatory category, "large entity," defined as any domestic entity engaged in interstate commerce with more than $1 billion in annual gross receipts.[278] Defined this way, the category captures both public and private companies. Under the Act's proposal, large entities would be subject to a variety of corporate governance regulations; previous proposals in respect of some of these regulations were limited to public companies only.[279]

The purpose of this discussion is to outline an alternative conceptual approach with respect to the future of the public–private divide in securities law rather than to analyze or endorse any of the specific proposals that have been mentioned. The more work the public–private divide is asked to do (and, particularly, work beyond the regulation of capital raising), the more pressure there is on the public–private distinction. If there are new regulatory categories that circumvent the public–private distinction, the effectiveness of the regulations employing those categories would likely be enhanced; such an approach would also make it easier to recalibrate the existing investor protection standards for public capital markets.

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277. *See* The Companies (Miscellaneous Reporting) Regulations 2018, SI 2018/860 (UK); *see also* Georgiev, *Human Capital Management*, *supra* note 61, at 658–59 and sources cited therein. The same category of companies are also required to disclose the gender pay gap on an annual basis. *See* Aleksandra Wisniewska et al., *Gender Pay Gap: How Women Are Short-Changed in the UK*, FIN. TIMES (Sept. 25, 2020), https://ig.ft.com/gender-pay-gap-UK.

278. Accountable Capitalism Act, S. 3348, 115th Cong. § 2 (2018). Aggregation rules based on the IRS Code safeguard against evading regulation by splintering entities to fall beneath the $1 billion threshold. *Id.* Large entities would be required to obtain a charter as a "United States corporation" from a newly-created Office of United States Corporations within the Department of Commerce. *Id.*

279. For example, whereas the Accountable Capitalism Act would require that employees of *large entities* (i.e., registered "United States corporations") be given the power to elect at least 40% of the board (*Id.* at § 6(b)(1)), the Reward Work Act, proposed by Senator Tammy Baldwin, would give employees of *public companies* (but not private companies) the power to elect one-third of directors. *See* Press Release, Off. of Sen. Tammy Baldwin, U.S. Senator Tammy Baldwin Reintroduces Legislation to Rein in Stock Buybacks and Give Workers a Voice on Corporate Boards (Mar. 27, 2019), https://bit.ly/3rhFaR7.

C. *Reform Preconditions and Process*

The reform options discussed above are likely to be difficult and costly to implement. Given historical patterns of regulation,[280] as well as the political and logistical roadblocks to reform,[281] securities law may well need to wait until the next big market crisis before the public company regulatory paradox can be addressed.

What are the preconditions for change? Using a "critical junctures" framework, a recent paper by Steven Bank and Brian Cheffins suggests that a stock market crash may not be a sufficient condition for corporate law change.[282] Bank & Cheffins find that, in addition to a stock market crash, major reforms require "a lengthy period of depressed share prices and a perception amongst contemporaries that business wrongdoing precipitated or was otherwise integrally related to the slump."[283] If these patterns hold, it may well be a long time before there is a window of opportunity to return securities law to a state of conceptual coherence. As significant as they are, the immediate consequences of the breakdown of the public–private divide are not guaranteed to result in a stock market crash, a lengthy bear market, and a turn in public opinion connecting market problems to business wrongdoing. A market calamity of such proportions is much more likely to be caused by macroeconomic imbalances, financial engineer-

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280. *See* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L. Q. 849, 855 (1997) (asserting that regulatory surges do not occur randomly and that the catalyst is a crash).

281. *See* Lucian Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1799–1816 (2006); John C. Coffee, Jr., *The Political Economy of Dodd–Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019 (2012).

282. *See* Steven A. Bank & Brian R. Cheffins, *Corporate Law's Critical Junctures*, BUS. LAW. (forthcoming 2022), https://papers.ssrn.com/id=3877329. The authors explain that "[i]n the social sciences context, a critical juncture is an historical moment during which substantially greater change is possible than during the preceding and subsequent periods of stability." *Id.* at 3.

283. *Id.* at 4. The authors further note that "the prolonged downturn and the discrediting of the status quo provide an opening for major change absent under normal circumstances," which includes strong investor and public interest in regulation and, importantly, the inability of "incumbent financial and business interests" to stave off major reform due to their temporarily weakened position. *Id.* at 4–5.

ing gone awry, a natural disaster, or a "black swan"-type event. Of course, none of this can be predicted.

Recognizing that urgent reform may be impossible even if it seems necessary allows the luxury of time to reconsider the institutional design of securities regulation—the allocation of responsibility amongst the SEC, Congress, and courts, as well as the liability structure of securities law.[284] This deliberative approach may resemble the foundational debates around the adoption of the original securities laws during the 1930s. As we saw in Section I.C, both the means and the ends of public company regulation have grown more uncertain and more controversial over time. Questions such as the appropriate scope of the public company regulatory regime, the meaning of the statutory goals of "investor protection" as well as "efficiency, competition, and capital formation," the relevance of unstated-yet-manifested goals such as business transparency and accountability, the allocation of regulatory responsibility between state and federal law, among others, can all benefit from considered examination.

It is often said that "a crisis is a terrible thing to waste"[285]—but so is the time before a crisis. There is a lot that the SEC can do today to ensure that when the next opportunity for change arises, it will be ready to contribute to the legislative process drawing upon its authority and technical expertise. Specifically, the SEC should as soon as possible initiate a broad deliberative process involving multiple stakeholders to come up with a blueprint for capital market regulatory reform to address the breakdown of the public–private divide. Even if this blueprint is not put into immediate use due to congressional inaction, having such a blueprint will help the agency navigate the next occasion when Congress is focused on financial and capital market regulation. It will also make it more difficult for special interests to take over the regulatory process; as we have seen, in the absence of an SEC blueprint, pri-

284. Scholars have made the case for examining securities law's institutional design due to a variety of different concerns. *See, e.g.*, Zachary J. Gubler, *Reconsidering the Institutional Design of Federal Securities Regulation*, 56 WM. & MARY L. REV. 409 (2014); MARK I. STEINBERG, RETHINKING SECURITIES LAW (2021); DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION (2016).

285. *See* Jack Rosenthal, *A Terrible Thing to Waste*, N.Y. TIMES MAG. (July 31, 2009), https://nyti.ms/3yreIpG (discussing the history of the quote).

vate actors supply their own blueprints which often turn into a regulatory agenda.[286]

A change of approach on a more procedural level may also be advisable. Notice-and-comment rulemaking in respect of specific proposals is not an effective means of surveying a wide range of regulatory options or considering foundational regulatory questions such as those listed in the preceding paragraphs; the SEC's use of "concept releases" as a step-zero in notice-and-comment rulemaking, which grew more widespread during the 2010s, is a minor improvement at best. The SEC has used special committees comprised of internal and external experts in prior decades and it should renew this practice. Each of the policy proposals discussed in Sections IV.A and IV.B above deserves careful consideration. In addition, the SEC should focus on data gathering and analysis of private capital raising, most of which still occurs in the shadows. Finally, the SEC should use its authority to engage in investor testing in connection with major policy proposals, which Congress reaffirmed in 2010 through Section 912 of the Dodd–Frank Act.[287] Drawing on the outputs of a well-designed deliberative process and armed with adequate evidence, the SEC can steer the policy conversation with respect to the public–private divide at securities law's next critical juncture, whenever it might occur.

CONCLUSION

This Article started by identifying a public company regulatory paradox, which motivated the present inquiry: it is possible today for two virtually identical firms to be subject to widely different regulatory obligations, which depend solely on the firms' financing choices. Public companies must comply with

286. *See supra* note 161 and accompanying text (noting the wholesale adoption of deregulatory proposals contained in the IPO Task Force Report through the JOBS Act) & *supra* note 169 and accompanying text (noting the wholesale adoption of deregulatory proposals advocated in a 2018 report from the Committee on Capital Markets Regulation).

287. *See* Dodd–Frank Act § 912, 15 U.S.C. § 77s(e) (providing that the SEC may "(1) gather information from and communicate with investors or other members of the public; (2) engage in such temporary investor testing programs as the Commission determines are in the public interest or would protect investors; and (3) consult with academics and consultants, as necessary . . . .").

an extensive and elaborate disclosure and governance framework related to investor protection, transparency, and accountability, whereas private companies are free to operate without disclosure and governance oversight at the federal level. As we saw, the present-day regulatory paradox is a manifestation of the breakdown of the longstanding public–private divide in securities law.

The Article then presented an account of how the public–private divide has lost its descriptive and explanatory power as an organizing principle of securities law. The breakdown of the divide has been a function of numerous, often-incremental deregulatory policies in the service of capital formation during the 2010s, which were, in turn, spurred by significant evolutionary shifts in capital markets and justified with reference to the massive expansion of public company regulation through the Sarbanes–Oxley Act of 2002 and the Dodd–Frank Act of 2010. In addition to highlighting the breakdown of the divide, the Article identified serious systemic and stakeholder-specific consequences: the now-elective nature of public company regulation, the diminished regulatory capacity of securities law, the fragmentation of investor protection, and the increased vulnerability of employee-investors. Addressing these problems, by rebuilding the divide, circumventing it, or through other means, will likely require foundational changes to the regulatory regime. It will also require policymakers and regulators to update the notions of investor protection, capital formation, efficiency, competition, and, more generally, what it means to regulate capital markets in the public interest.

The Article's focus on the public–private divide should not obscure several analytical points. First, private capital certainly has a role to play in the modern economy; *small*, *early-stage* private companies are often a source of significant innovation, which results in benefits to society. There is, for example, much hope that startups focused on clean energy will help with the transition to a greener economy. Nothing here suggests that securities law should treat such firms in the same way as their mature counterparts; as noted throughout, the focus is on larger private companies, such as unicorns, that have been in existence for some time and that have acquired a substantial footprint in terms of implied valuation, investor base, number of employees, and various other metrics. Second, while the public (regulated) vs. private (unregulated) markets dichot-

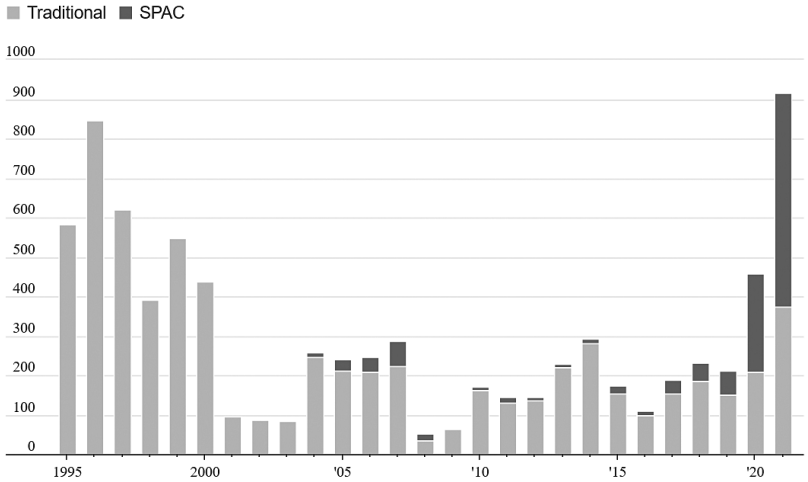
omy is helpful, it does not imply that public markets are perfect; certain specific aspects of the regulation of public markets are the subject of lively academic and policy debates, which lie outside the scope of this Article. Finally, as a factual matter, most large private firms do eventually elect to transition to public company status. One could therefore posit that intervention is unnecessary, because the problems identified here resolve themselves over the long run and at the level of individual firms. This Article has shown that the problems that arise over the short- and medium-run, as well as on a systemic level, are serious enough to warrant regulatory attention.

Zooming out, it is worth noting that because financial capital is both highly mobile and highly morphable, regulating it has never been easy. Political, macroeconomic, technological, and even epistemological challenges abound. More so than in other areas, law here plays a dual rule: not only to proscribe harmful activities, but also to actively enable beneficial ones. In 2021, there are various capital market phenomena that straddle the line between harmful and beneficial, including SPACs, stablecoins, other cryptocurrencies, and certain stock trading platforms. There are also various phenomena that are clearly problematic, such as unaccounted for risks (including climate and cybersecurity), asset valuation issues pertaining to human capital, data assets, and other intangibles, and, as always, issues related to fraud, capital market microstructure, and international competition.

The SEC's ability to solve these problems and future ones, as well as the nature of the solutions, will in large part turn on the renegotiation of the public–private divide. The regulatory future is uncertain, but it is safe to say that securities law's most interesting and challenging years lie ahead.

Appendix:
Selected Data on Trends in Capital Markets

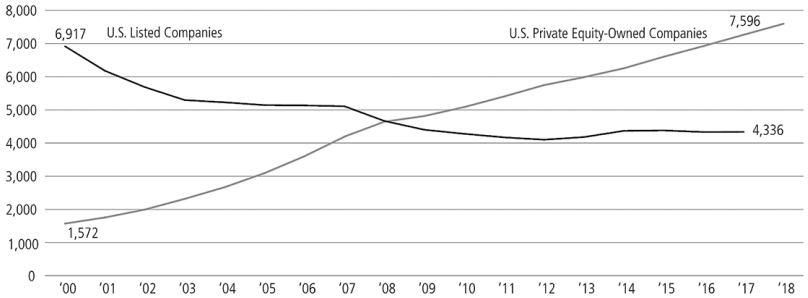
Figure A–1: Number of U.S. Listed IPOs (1995–2021)



Note: 2021 data through Nov. 16

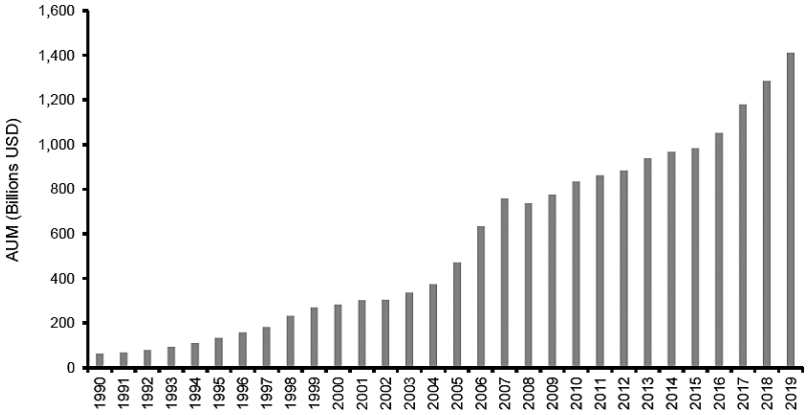
Source: Corri Driebusch, *IPOs Keep Jumping Higher. How Long Will the Ride Last*, Wall. St. J. (Nov. 19, 2021), https://on.wsj.com/3lkKAHj (reporting data from Dealogic).

FIGURE A–2: NUMBER OF U.S. LISTED AND U.S. PRIVATE EQUITY-OWNED COMPANIES (2000–2017)



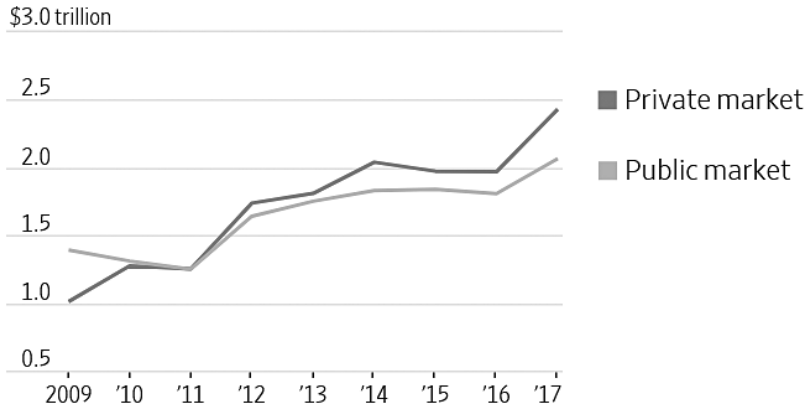
Source: *Capital Raising Goes Back to the Future*, NEUBERGER BERMAN, https://bit.ly/32M3IYc (last visited Nov. 30, 2021) (reporting data from World Bank, World Federation of Exchanges, PitchBook, Credit Suisse).

FIGURE A–3: ASSETS UNDER MANAGEMENT FOR U.S. BUYOUT INDUSTRY (1990–2019)



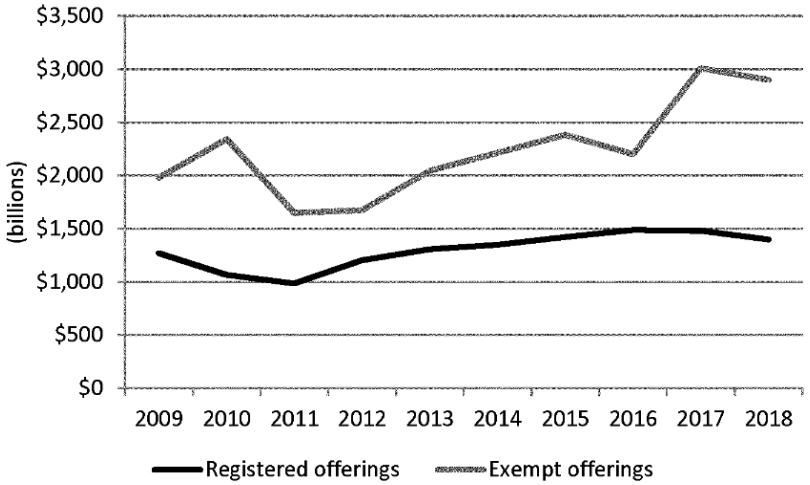
Source: MICHAEL J. MAUBOUSSIN & DAN CALLAHAN, MORGAN STANLEY, PUBLIC TO PRIVATE EQUITY IN THE UNITED STATES: A LONG-TERM LOOK 34 (2020), https://mgstn.ly/31CaMpV (reporting data from PitchBook, NVCA, and Counterpoint Global).

FIGURE A–4: VOLUME OF CAPITAL RAISED BY U.S. COMPANIES IN PUBLIC AND PRIVATE MARKETS (2009–2017)



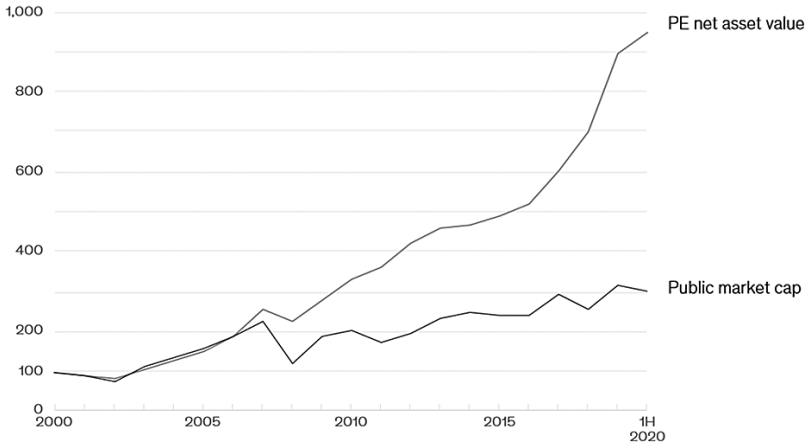
Source: Jean Eaglesham & Coulter Jones, *The Fuel Powering Corporate America: $2.4 Trillion in Private Fundraising*, WALL. ST. J. (Apr. 3, 2018), https://on.wsj.com/3xz1B5m (reporting data from Dealogic and an analysis of SEC filings).

FIGURE A–5: VOLUME OF CAPITAL RAISED BY U.S. COMPANIES IN EXEMPT AND REGISTERED OFFERINGS (2009–2018) (SEC)



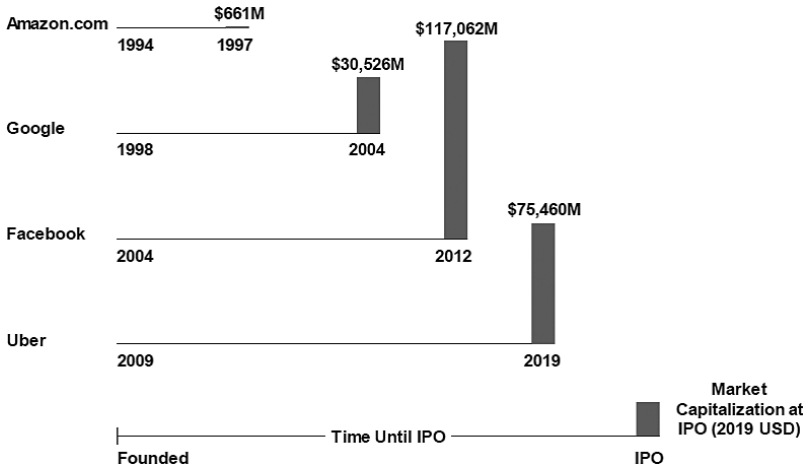
Source: U.S. Sec. & Exch. Comm'n, Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 33–10,649, 84 Fed. Reg. 30,460, 30,465 (proposed June 26, 2019) (reporting data from the SEC Division of Economic and Risk Analysis).

FIGURE A–6: GROWTH OF GLOBAL PRIVATE EQUITY AND PUBLIC EQUITY (%) (2000–2020)



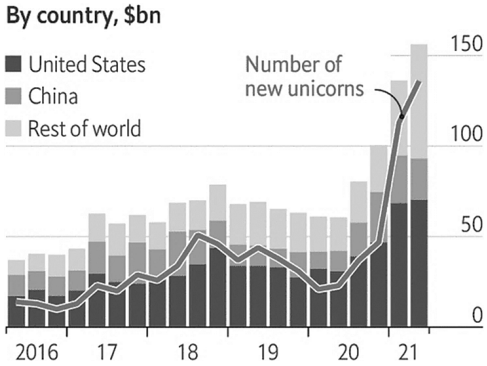
Source: MCKINSEY, MCKINSEY'S PRIVATE MARKETS ANNUAL REVIEW 19 (2021), https://mck.co/3o6olXp (reporting data from World Federation of Exchanges and Preqin).

FIGURE A–7: TIME TO IPO AND MARKET CAPITALIZATION AT IPO: AMAZON, GOOGLE, FACEBOOK, UBER



Source: MICHAEL J. MAUBOUSSIN & DAN CALLAHAN, MORGAN STANLEY, PUBLIC TO PRIVATE EQUITY IN THE UNITED STATES: A LONG-TERM LOOK 49 (2020), https://mgstn.ly/31CaMpV (reporting data from company SEC filings and Counterpoint Global).

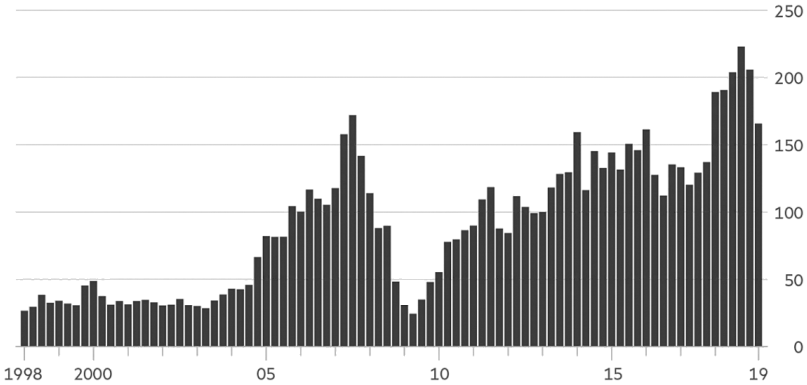
FIGURE A–8: NUMBER OF UNICORNS AND TOTAL CAPITAL RAISED BY UNICORNS IN UNITED STATES, CHINA, AND REST OF THE WORLD (2016–2021)



(Data reported on a quarterly basis.)

Source: *Technology Unicorns Are Growing at a Record Clip*, ECONOMIST, Jul. 24, 2021, https://econ.st/3IxkXwT (reporting data from CB Insights).

FIGURE A–9: QUARTERLY STOCK BUYBACKS BY S&P 500 COMPANIES (1998–2019)



(Data shown in billions of U.S. dollars.)

Source: Richard Henderson, *Fall in Share Buybacks Poses Threat to US Stocks*, FIN. TIMES (Aug. 23, 2019), https://on.ft.com/3ox4Ln8 (reporting data from S&P Dow Jones Indices).