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FOREWORD

EMILIANO M. CATAN*, ROBERT J. JACKSON**
& EDWARD B. ROCK***

In the opening episode of the 2000s television show Ed, a hotshot New York lawyer is fired after drafting a contract with a misplaced comma that ends up causing his firm a significant financial loss.[1] This fictional anecdote—though dramatized for entertainment—serves as a lighthearted reminder of a stark reality in corporate law: words matter. For corporate lawyers and judges alike, the meaning of even the smallest words—"and," "a," or a carefully placed parenthetical—can determine the outcome of disputes involving millions or even billions of dollars.[2] In her Distinguished Jurist Lecture, Justice Karen Valihura offers a fascinating, practical exploration of how Delaware courts interpret corporate documents, charters, bylaws, and statutes through the lens of "plain language."

Drawing on her extensive experience as a Justice on the Delaware Supreme Court, where she has served for over a decade, and her time as a practicing corporate lawyer, Justice Valihura provides a masterful analysis of the interpretive principles

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1. *Ed: Pilot* (NBC television broadcast Oct. 8, 2000).

2. In *SR International Business Insurance Co. v. World Trade Center Properties*, for instance, the litigation turned on the meaning of the word "occurrence" in an insurance policy, with billions of dollars at stake following the tragic events of September 11. SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props., 467 F.3d 107 (2d Cir. 2006).

that guide Delaware's courts. Delaware law adheres to the objective theory of contracts, under which the construction of a contract is determined based on what an objective, reasonable third party would understand the language to mean.[3] If the language of a contract is clear and unambiguous—that is, it conveys an unmistakable meaning and is reasonably susceptible of only one interpretation—Delaware courts will enforce it as written, and will not resort to extrinsic evidence to interpret the contract, vary its terms, or create ambiguity where none exists.[4] At the same time, Delaware law requires courts to read contracts as a whole, ensuring that each provision is given meaning and that no part is rendered superfluous.[5] These principles reflect the Delaware courts' commitment to preserving the parties' bargain while ensuring consistency and coherence in the interpretation of commercial agreements.

Justice Valihura's lecture examines how these broad principles are applied not only to contracts but also to the interpretation of bylaws and statutes. Under Delaware law, corporate bylaws are contractual in nature, and courts apply the same interpretive tools to bylaws as they do to commercial agreements.[6] Drawing from its approach to statutory interpretation, Justice Valihura highlights Delaware's adherence to plain language while acknowledging the role of legislative intent. In cases such as *Activision Blizzard,*[7] the courts interpreted statutory provisions governing the board's role in mergers and stockholder approval of mergers by focusing on both the text of the statute and the legislative purpose behind it. Justice Valihura's lecture analyzes how Delaware courts approach statutes as part of an integrated system, interpreting individual provisions in a way that preserves the integrity of the broader legislative scheme.

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3. BitGo Holdings, Inc. v. Galaxy Digital Holdings, Ltd., 319 A.3d 310, 322 (Del. 2024).

4. Eagle Indus., Inc. v. DeVilbiss Health Care, Inc., 702 A.2d 1228, 1232 (Del. 1997).

5. Weinberg v. Waystar, Inc., 294 A.3d 1039, 1044 (Del. 2023).

6. BlackRock Credit Allocation Income Tr. v. Saba Cap. Master Fund, Ltd., 224 A.3d 964, 977 (Del. 2020) (citing Hill Int'l, Inc. v. Opportunity Partners L.P., 119 A.3d 30, 38 (Del. 2015)).

7. Sjunde AP-fonden v. Activision Blizzard, Inc., et al., 2024 WL 863290 (Del. Ch. Feb. 29, 2024).

Justice Valihura's remarks also raise an important question about the role of market practice in contractual interpretation. Delaware courts are often asked to consider industry norms and commercial expectations when interpreting language. In *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co.,*[8] for instance, the Delaware Supreme Court considered market practice in evaluating whether certain post-closing adjustments were consistent with the parties' intent. Justice Valihura's analysis highlights the tension between honoring market expectations and maintaining fidelity to the text of an agreement or a statute. Courts must strike a careful balance, ensuring that commercial realities inform their analysis without allowing market practice to override clear contractual or statutory language.[9]

The cases Justice Valihura discusses reveal the challenges inherent in contract interpretation. In *Cox Communications, Inc. v. T-Mobile US, Inc.,*[10] for example, the Delaware Supreme Court split over whether a settlement agreement's terms were unambiguous—with three Justices concluding that the language had a single clear meaning, while the remaining two Justices found multiple reasonable interpretations. Justice Valihura's analysis of this and other decisions illustrates how Delaware courts navigate ambiguity without losing sight of their central commitment: to respect the intent of sophisticated parties who choose their words carefully—or even, at times, imperfectly.

Justice Valihura's lecture also prompts deeper reflection on the realities of the drafting process. As lawyers, we know that not every ambiguity is a failure of skill or diligence. For what benevolent reasons would sophisticated parties, assisted by expert counsel, include provisions whose meaning they might later dispute? Sometimes, ambiguity arises because a provision addresses a contingency too unlikely to justify exhaustive negotiation. In other cases, ambiguity reflects a practical

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8. Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co., 166 A.3d 912, 913–14 (Del. 2017).

9. *See, e.g.,* West Palm Beach Firefighters' Pension Fund v. Moelis & Co., 311 A.3d 809, 816 (Del. Ch. 2024) ("What happens when the seemingly irresistible force of market practice meets the traditionally immovable object of statutory law? A court must uphold the law so the statute prevails."); *Activision*, 2024 WL 863290 at *4 ("[w]here market practice exceeds the generous bounds of private ordering afforded by the DGCL, then market practice needs to check itself.").

10. 278 A.3d 752 (Del. 2022).

compromise, deferring difficult decisions to future negotiations or preserving deal momentum when time is short.[11]

Justice Valihura's lecture does not directly address these dynamics, but her analysis of Delaware's case law invites us to consider their implications. If ambiguity stems from strategic compromises or practical constraints, should courts interpret those provisions flexibly, with an eye toward commercial reasonableness? Conversely, if ambiguity results from poor drafting or intentional vagueness, should courts enforce the language strictly to encourage greater care in the future? And how should the court, in attempting to interpret contractual language, account for the fact that future contracting parties may be able to contract around the court's proposed interpretation—or, on the contrary, for the possibility that drafting practices may prove too sticky for the judge's interpretation to be undone? These questions, while not answered in Justice Valihura's lecture, are inspired by her reflections.

In a similar vein, although Justice Valihura's lecture does not say it in so many words, bylaws occupy a unique place in corporate governance, as they are typically unilaterally adopted or amended by boards. As a result, their interpretation requires courts to go beyond standard canons of contractual interpretation and balance the rights of stockholders with the authority of directors. In *Kellner v. AIM ImmunoTech, Inc.,* for example, although the Delaware Supreme Court ultimately upheld the Chancery Court's validation of certain advance notice bylaw provisions, it also held that one "unintelligible" bylaw adopted by a board in the face of an activist campaign was invalid, and that the board had acted inequitably in adopting other bylaws for the primary purpose of interfering with the challenger's nomination.[12]

Justice Valihura concludes her lecture with a forward-looking discussion of the role of artificial intelligence in contract drafting and interpretation. As AI tools become increasingly prevalent in corporate practice, they offer the promise of efficiency and consistency. Yet Justice Valihura cautions that

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11. *See, e.g.*, Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 U. CHI. L. REV. 917, 927 & n.35 (2002) (citing B. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity,* 88 AM. ECON. REV. 902 (1998)).

12. Kellner v. AIM ImmunoTech, Inc., 320 A.3d 239, 246 (Del. 2024).

machines cannot replace the human judgment required to navigate context, ambiguity, and intent. Her reflections remind us that the art of drafting—like the art of interpretation—is ultimately a human endeavor, one that requires care, precision, and an understanding of the relationships and realities that contracts are meant to govern.

Justice Valihura's Distinguished Jurist Lecture is the latest in a series that celebrates the contributions of leading jurists to corporate law and governance. This series began in 2018 with Chief Justice Leo Strine's criticism of corporate political spending;[13] and was followed by Chancellor Bouchard's analysis of *Corwin*,[14] *Trulia*[15] and their progeny;[16] Chief Justice Collins J. Seitz Jr.'s reflections on independence;[17] Chancellor Kathaleen McCormick's discussion of the centrality of the specific performance remedy in M&A disputes;[18] and, most recently, Vice Chancellor Travis Laster's examination of the fiduciary duties of controlling shareholders.[19] Justice Valihura's lecture continues in the tradition of thoughtful engagement with the principles that shape corporate and business law.

We are grateful to Justice Valihura for sharing her insights and for continuing this important dialogue. Her reflections offer a skillful blend of practical wisdom and doctrinal clarity, reminding us that the work of interpreting contracts—like the work of drafting them—requires attention, care, and a deep respect for the role of language. For lawyers, judges, and scholars alike, Justice Valihura's lecture serves as both a guide and an inspiration, underscoring the enduring importance of plain language in the law.

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13. Leo E. Strine, Jr., *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007 (2020).

14. *In re* KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980 (Del. Ch. 2014).

15. *In re* Trulia, Inc. S'holder Litig., 129 A.3d 884 (Del. Ch. 2016).

16. NYU School of Law Institute for Corporate Governance and Finance, *2019 Distinguished Jurist Lecture: Chancellor Andre Bouchard*, YOUTUBE (NOV. 13, 2019) https://www.youtube.com/watch?v=YLO2knjEM5.

17. Collins J. Seitz Jr., *A Declaration of Independence: Committees, Conflicts, and the Courts*, 19 N.Y.U. J.L. & BUS. 467 (2022).

18. Kathaleen St. Jude McCormick & Robert Erikson, *Delaware's Approach to Specific Performance in M&A Litigation*, 20 N.Y.U. J.L. & BUS. 7 (2023).

19. J. Travis Laster, *The Distinctive Fiduciary Duties that Stockholder Controllers Owe*, 20 N.Y.U. J.L. & BUS. 461 (2023).

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"PLAIN LANGUAGE" IN DELAWARE CORPORATE LAW

KAREN LYNN VALIHURA*

* Karen Lynn Valihura is a Justice on the Delaware Supreme Court. The views expressed are solely those of the author and not those of any other judicial officer or of the Delaware Supreme Court. Justice Valihura acknowledges the assistance of certain of her present and former law clerks, namely, Alex MacLennan, Jillian Patterson, Caitlin Hawkins, Theodore Kotler and Francesca D'Agostino, as well as Wolcott Fellows, Benjamin W. Byerly, and Patrick Tkacik and summer interns, Lauren Young, Dylan Kirton and Jett Meek. Nothing herein is intended to express any view on how any future appeal might or should be resolved.

Introduction

In this article, I explore the role of "plain language" as an interpretative guide for Delaware courts construing corporate agreements, charters, bylaws, and statutes. This is not a rigorous scientific or linguistic study. Rather, it is a collection of my observations and musings based upon some of my experiences from my past decade on the Delaware Supreme Court.

I examine several recent decisions by the Delaware Supreme Court and the Delaware Court of Chancery to illustrate certain points. One key point is that discerning the meaning of words is no simple task. Judges can rely upon dictionary definitions, the context of the words within the document and common usage. But my experience has shown that, parties, judges and courts often disagree on the "plain meaning" of words.

The separate opinion in the Delaware Supreme Court's decision in *Cox Communications, Inc. v. T-Mobile US, Inc.*[1] questions whether language is truly plain and unambiguous if jurists reading the same language disagree on its meaning. There, our *en banc* Delaware Supreme Court divided over how to interpret a provision in a settlement agreement between the corporate entities.[2] In a 3-2 split, the Majority declared the provision to be an unambiguous Type II preliminary agreement that merely obligated the parties to negotiate open items in good faith.[3] The Vice Chancellor had also found the provision to be unambiguous, but concluded that it meant something different. The separate concurring and dissenting opinion maintained that both readings were reasonable and, as a result, the provision was ambiguous. Thus, in *Cox*, of the six judicial officers who examined the provision, three Justices saw it one way and three (the other two Justices and the Vice Chancellor) saw another reasonable reading.[4] One might legitimately question, under these circumstances, the strength of the argument that there is only one reasonable way to read the provision. Although the separate opinion acknowledged that the law is well-established that the parties' disagreement over the meaning of a provision does not render it ambiguous, it cited to case law suggesting that when members of a judicial panel disagree, there is more than one reasonable reading.

This article explores the importance of the words corporate drafters use and how those words can either achieve the drafters' goals or lead to findings of ambiguity and unintended results. It raises the question of what the appropriate role is, if any, of "corporate practice" and settled commercial expectations in the analytical process. It also explores how prolixity and complexity in drafting has been perceived by courts as an attempt to create uncertainty or "tripwires" for strategic corporate advantage. Finally, the article comments on the downsides of boilerplate models in corporate instruments, briefly explores one federal judge's recent foray into the use

1. 278 A.3d 752 (Del. 2022).
2. *Id.*
3. *Id.* at 760–61.
4. *See Cox Commc'ns, Inc.*, 278 A.3d at 768, 772 (Valihura, J., concurring in part, dissenting in part, joined by Montgomery-Reeves, J.) ("Although there is authority to the contrary, we are not, here suggesting that a divided panel — where one or more members contend that there is another reasonable interpretation — automatically 'creates' an ambiguity.").

of artificial intelligence and large language models as an interpretive aide, and comments on the challenges lawyers now face in the corporate drafting exercise as a result of the increasing "commoditization" of the practice of law. My end goal, with hopefully a bit of levity at times, is to show that when drafters carefully choose clear, simple plain language to craft corporate documents, they are more likely to achieve their clients' goals.

I.
Examples of General Principles As Applied in Different Contexts

A. *Construing Contracts and Transaction Agreements*

1. *General Principles*

Recently, in *BitGo Holdings, Inc. v. Galaxy Digital Holdings, Ltd.*,[5] our Delaware Supreme Court commented that the basic principles that guide us when we review a trial court's interpretation of a contract are well-settled. We summarized these principles as follows:

> Delaware courts read the agreement as a whole and enforce the plain meaning of clear and unambiguous language. Delaware law adheres to the objective theory of contracts, *i.e.*, a contract's construction should be that which would be understood by an objective, reasonable third party. The true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant. If a contract is plain and clear on its face, *i.e.*, its language conveys an unmistakable meaning, the writing itself is the sole source for gaining an understanding of intent. Stated differently, clear and unambiguous language is reasonably susceptible of *only one* interpretation. Language from a contract need not be perfectly clear for an interpretation of it to be deemed as the only reasonable one.[6]

Other principles are also well-settled, such as the principle that courts seek to give each provision of corporate instruments

5. 319 A.3d 310 (Del. 2024).
6. *Id.* at 322 (citations and quotations omitted) (emphasis in original).

meaning.[7] "If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract or to create an ambiguity."[8] Courts should read specific provisions of the contract in light of the entire contract.[9]

Delaware is a contractarian state.[10] When Delaware courts refer to themselves as "contractarian," they refer to the tradition in Delaware law that protects the freedom enjoyed by sophisticated parties to contract.[11] Beyond Delaware courts and Delaware case law, the Delaware General Assembly has reinforced this principle in certain statutes.[12] The Delaware Revised Uniform Limited Partnership Act ("DRUPLA"), for example, gives "maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." Such provisions provide business entities like LLC's and Partnerships with greater freedom to contract, thereby allowing them to "structure their relationship in the way they believe best suits them and their business."[13]

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7. *See* Manti Holdings, LLC v. Authentix Acquisition Co., 261 A.3d 1199, 1208 (Del. 2021) (explaining that contracts should be read as a whole to "enforce the plain meaning of clear and unambiguous language" and, in doing so, the Court should strive to "'give each provision and term effect' and not render any terms 'meaningless or illusory'").

8. Eagle Indus., Inc. v. DeVilbiss Health Care, Inc., 702 A.2d 1228, 1232 (Del. 1997).

9. *See* Weinberg v. Waystar, Inc., 294 A.3d 1039, 1044 (Del. 2023) (quoting Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co., 166 A.3d 912, 913–14 (Del. 2017)) ("[I]n giving sensible life to a real-world contract, courts must read the specific provisions of the contract in light of the entire contract."); Lorillard Tobacco v. Am. Legacy Found., 903 A.2d 728, 740 (Del. 2006) ("A court must accept and apply the plain meaning of an unambiguous term in the context of the contract language and circumstances, insofar as the parties themselves would have agreed *ex ante*.").

10. *See, e.g.*, Stream TV Networks, Inc. v. SeeCubic, Inc., 279 A.3d 323, 355 (Del. 2022) ("Delaware is a contractarian state."); Huatuco v. Satellite Healthcare, No. CV 8465-VCG, 2013 WL 6460898, at *1 (Del. Ch. Dec. 9, 2013), *aff'd*, 93 A.3d 654, tbl., 2014 WL 2566155, (Del. 2014) ("Delaware law with regard to limited liability companies is contractarian . . . .").

11. *See, e.g.*, NAF Holdings, LLC v. Li & Fung (Trading) Ltd., 118 A.3d 175, 180 n.14 (Del. 2015) (quoting NACCO Indus., Inc. v. Applica Inc., 997 A.2d 1, 35 (Del. Ch. 2009)) ("Delaware upholds the freedom of contract and enforces as a matter of fundamental public policy the voluntary agreements of sophisticated parties.").

12. *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-1101 (West 2024) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.").

13. Touch of Italy Salumeria & Pasticceria, LLC v. Bascio, No. CIV.A. 8602-VCG, 2014 WL 108895, at *1 (Del. Ch. Jan. 13, 2014).

In *Cantor Fitzgerald, L.P. v. Ainslie*,[14] our Court emphasized this freedom of contract when it diverged from the common law on forfeitures and chose to uphold a forfeiture provision attached to a limited partnership agreement.[15] The Court relied upon both the DRUPLA and Delaware case law.[16] The Court highlighted the fact that the "sophisticated" party voluntarily entered into the partnership agreement and by its own actions assumed the risk of triggering the forfeiture provision.[17] However, the Court in *Cantor Fitzgerald*, also acknowledged that this freedom is not without limits as "it is conceivable that a public-policy interest or inequitable outcome could, under some circumstances, outweigh the interest in freedom of contract enshrined in DRULPA. . . ."[18] In this regard, our Court stated:

> When parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract.
>
> Such public policy interests are not to be lightly found, as the wealth-creating and peace-inducing effects of civil contracts are undercut if citizens cannot rely on the law to enforce their voluntarily-undertaken mutual obligations.[19]

But some interpretative principles may appear to be counter-contractarian. In *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co.*,[20] this Court stated that "[t]he basic business relationship between parties must be understood to give sensible life to any contract."[21] This suggests the overall business context

14. 312 A.3d 674 (Del. 2024).
15. *Id.* at 692.
16. *Id.* at 688–89, 692.
17. *Id.* at 692.
18. *Id.*
19. *Id.* at 689 (quoting RSUI Indem. Co. v. Murdock, 248 A.3d 887, 903 (Del. 2021)).
20. 166 A.3d 912 (Del. 2017).
21. *Id.* at 927. *See also* Heartland Payment Sys., Inc. v. InTEAM Assocs., 171 A.3d 544, 557 (Del. 2017) (considering the "spirit of the overall transaction").

matters also.[22] This "big picture" notion was not new. Our Supreme Court, in 1988 stated in *E.I. duPont de Nemours v. Shell Oil Co.*, that "the meaning which arises from a particular portion of an agreement cannot control the meaning of the entire agreement where such inference runs counter to the agreement's overall scheme or plan."[23] But discerning the purpose is still grounded in the text.[24]

In *BitGo Holdings*, our Court reversed the trial court, finding the merger agreement to be ambiguous as to whether the seller's financial statements had to comply with an SEC Staff Accounting Bulletin (SAB 121, issued one day after the agreement was signed) when those financials were submitted to the buyer, or later when the buyer submitted them to the SEC.[25]

The Court did not refer to *Chicago Bridge* in its analysis, but it did comment that "Galaxy's interpretation accords with a common sense reading of the definition's 'file-ready' requirement."[26] It found the definition of "Company 2021 Audited Financial Statements" to be ambiguous and remanded so that the trial court could consider extrinsic evidence to resolve the ambiguity.[27] BitGo's failure to submit the financial statements to Galaxy on time would provide Galaxy with a termination right. Thus, although the Court noted that a "common sense reading" of the "Company 2021 Audited Financial Statements" definition in the merger agreement would support Galaxy's interpretation of the provision, the Court did not find that common sense approach controlling. Instead, it held that there were two reasonable interpretations of the language and that the provision was ambiguous.[28]

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22. *See* Lorillard Tobacco v. Am. Legacy Found., 903 A.2d 728, 740 (Del. 2006) ("A court must accept and apply the plain meaning of an unambiguous term in the context of the contract language and circumstances, insofar as the parties themselves would have agreed *ex ante*.").

23. 498 A.2d 1108, 1113 (Del. 1985).

24. *See* Sunline Com. Carriers, Inc. v. CITGO Petroleum Corp., 206 A.3d 836, 846 (Del. 2019) ("To determine what contractual parties intended, Delaware courts start with the text.").

25. BitGo Holdings, Inc. v. Galaxy Digital Holdings, Ltd., 319 A.3d 310, 314 (Del. 2024).

26. *Id.* at 328.

27. *Id.* at 314. The financial statements were to be "in a form that complies with the requirements of Regulation S-X for an offering of equity securities pursuant to a registration statement on Form S-1 for a nonreporting company." *Id.* at 315.

28. *Id.* at 328.

Most recently, this Court affirmed the Court of Chancery's decision in *Soleimani v. Hakkak and White Oak Healthcare Finance LLC*[29] on the basis of the opinion below, which reinforced Delaware's contractarian principles described above. The Court of Chancery relied upon these principles to interpret a termination provision in a series of identical LLC agreements, namely, "provided that the Company has satisfied," as creating a condition precedent that payment obligations in a term sheet must be satisfied *before* the plaintiff could be removed as an employee and manager.[30] The Court of Chancery opinion reasoned that because other provisions of the LLC agreements used a different future construction, namely, "provided . . . shall," the principle that "[t]he use of different language in sections of a contract indicates that the distinction is intentional" applied. Based upon that principle, the court concluded that the parties intended the different terms to have different meanings.[31]

Accordingly, the Court of Chancery held that "provided . . . has satisfied" was a condition precedent, and that meant that the employee had to be paid for his equity stake before he could be removed.

The Appellants argued that the Court of Chancery's interpretation was contrary to the entire deal structure and led to an absurd result where the terminated founder was allowed to remain in his position until the payments provided for in the agreement were made. Ultimately, the Court concluded that "[e]nforcing the plain language of the contract does not create an absurd or commercially unreasonable result" because the plaintiff negotiated for a fully vested equity stake if he devoted five or more years to the company.[32] As the Court of Chancery noted, and the Supreme Court affirmed, Section 6.1 "says what

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29. No. 2023-0948-LWW, 2024 WL 1593923 (Del. Ch. Apr. 12, 2024), *aff'd*, 2024 WL 4235006, tbl. (Del. Sept. 19, 2024).

30. *Id.* at *5. Section 6.1 of the LLC agreements at issue states in relevant part: "Mr. Soleimani may be removed by the Company as an employee in accordance with the provisions of the Term Sheet, *provided that the Company has satisfied its obligations under the Term Sheet relating to a Specified Termination Event* (as defined in the Term Sheet)." *Id.* (emphasis added by lower court).

31. *Id.* at *6 (citing Williams Cos., Inc. v. Energy Transfer LP, No. 12168-VCG, 2020 WL 3581095, at *12 n.123 (Del. Ch. July 2, 2020) ("One principle of contract interpretation in Delaware is that the use of different language in different sections of a contract suggests the difference is intentional–*i.e.*, the parties intended for the sections to have different meanings.")).

32. *Id.* at *10.

it means and means what it says," and although the defendants "may find this outcome unpalatable[,] . . . it is not [the] court's job to relieve sophisticated parties of the burdens of contracts they wish they had drafted differently. Parties have a right to enter into good and bad contracts, the law enforces both."[33]

2. *Illustrative Cases*

Moving from "big picture" principles to the exact opposite end of the plain language spectrum, the next several cases illustrate that a court's interpretation of even small words like "and," "a," and "the" can be outcome determinative in significant corporate disputes. In these cases, the Delaware courts were required to wade into the minutiae of grammar and punctuation rules.

a. *Weinberg v. Waystar* — "And"

The plain language of even the smallest and most common words can have significant consequences for the parties to a contract. In Weinberg v. Waystar,[34] for example, the Delaware Supreme Court was asked to construe the meaning of a surprisingly controversial word—"and"—in three separate stock option agreements executed by Waystar, Inc. ("Waystar") and its then-employee Tracy Weinberg ("Weinberg") (the "Option Agreements"). The answer to the question would determine whether Waystar had validly exercised a call right to repurchase approximately $1.8 million worth of company units from its former employee, Weinberg.[35]

In Waystar, the divisive "and" was located in a call right provision contained in each Option Agreement (the "Call Right Provision"). The Call Right Provision provided that:

> The Converted Units shall be subject to the right of repurchase (the "Call Right") exercisable by Parent, a member of the Sponsor Group, or one of their respective Affiliates, as determined by Parent in its sole discretion, during the six (6) month period following (x) the (i) the Termination of [Weinberg's] employment with the Service Recipient for any reason

33. *Id.* (cleaned up).
34. (*Waystar II*), 294 A.3d 1039 (Del. 2023).
35. *Id.* at 1042, 1046.

> (or, if later, the six (6) month anniversary of the date of the exercise of the [Substitute] Options in respect of which the Option Stock was issued, ***and*** (y) a Restrictive Covenant Breach. The Call Right shall expire on the earlier of (i) an Initial Public Offering or (ii) a Change of Control.[36]

The question was whether Waystar could exercise its call right after either the "Termination of [Weinberg's] employment" or "a Restrictive Covenant Breach," or only after both events had occurred. At the time of litigation, Waystar had exercised its call right, but the parties agreed that only one event—Weinberg's termination—had occurred.[37]

The Court of Chancery determined that the "and" in the Call Right Provision was unambiguous.[38] In doing so, the court did not deny that "and" was being used in the conjunctive sense, as opposed to a disjunctive sense, as Weinberg argued.[39] Instead, the court found that in the context of the Option Agreements, and considering that the Call Right Provision was "permissive," the "and" was being used in its "several" sense.[40] This meant that Waystar had the option of exercising its call right after Weinberg's termination, or her breach of a restrictive covenant, or both.

Moreover, the Court of Chancery found that Waystar's interpretation was the only interpretation that gave effect to all of the terms in the first two of the three option agreements.[41] Specifically, the court found that Weinberg's interpretation would render a provision in the first two option agreements, which determined the price which Waystar would pay to repurchase Weinberg's units, surplusage.[42] That provision provided that, upon the occurrence of certain enumerated events, including a Restrictive Covenant Breach, the repurchase price would be calculated differently than if such event had not occurred. Accordingly, if Weinberg were correct that the call right was

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36. *Id.* at 1042.
37. *Id.*
38. Weinberg v. Waystar, Inc. (*Waystar I*), No. 2021-1023-SG, 2022 WL 2452141 (Del. Ch. July 6, 2022).
39. *Id.* at *3 ("According to Weinberg, the Defendants' interpretation would transform the conjunctive 'and' into a disjunctive 'or.').
40. *Id.* at *4.
41. *Waystar II*, 294 A.3d at 1056.
42. *Waystar I*, 2022 WL 2452141, at *5.

only triggered upon the occurrence of both termination and a Restrictive Covenant Breach, then only one repurchase price would ever apply, leaving the other repurchase price clause meaningless.

Weinberg appealed from the Court of Chancery's decision, arguing that the trial court had erred in failing to give "and" its plain meaning as a conjunctive word.[43] Citing case law from many jurisdictions, including Delaware, she argued that courts construe "and" according to its ordinary, conjunctive meaning, absent an absurd result.[44] In Weinberg's view, to construe "and" disjunctively would be tantamount to finding that "and" means "or."[45] At the least, she argued, the Call Right Provision was ambiguous, and should be construed against Waystar as the drafter of the Option Agreements.[46]

Reviewing Weinberg's appeal, the Delaware Supreme Court began by affirming that it would apply its well-established principles of contract interpretation.[47] In other words, it would give "and" its plain meaning if it determined the word was unambiguous, as informed by context, as the Court of Chancery had done in its trial opinion.[48] Ultimately, it agreed with the Court of Chancery that "and" in the Call Right Provision was unambiguous: it provided Waystar the option to exercise its call right after either condition had occurred.

Regarding the meaning of "and," the Delaware Supreme Court observed that "two avenues of interpretation — the 'conjunctive or disjunctive' path and the 'joint or several' path — have emerged from the, at times, lively debate."[49] As to the

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43. *Waystar II*, 294 A.3d at 1043.
44. *Id.* n.5.
45. *Id.* at 1047 n.29.
46. *Id.* at 1061.
47. In doing so, the Court rejected Weinberg's contention that in Delaware, courts would construe an "and" conjunctively, absent a finding that such a construction would produce an absurd result. *Id.* at 1043 n.5.
48. Specifically, the Court stated "[w]e will read the contract as a whole and 'enforce the plain meaning of clear and unambiguous language.' In doing so, we endeavor 'to give each provision and term effect' and not render any terms 'meaningless or illusory.' Moreover, '[i]n giving sensible life to a real-world contract, courts must read the specific provisions of the contract in light of the entire contract.'" *Id.* at 1044 (first quoting Manti Holdings, LLC v. Authentix Acquisition Co., Inc., 261 A.3d 1199, 1208 (Del. 2021), then quoting Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co. LLC, 166 A.3d 912, 913–14 (Del. 2017)).
49. *Id.* at 1044–45.

first path, the Court noted that "although 'and,' typically bears a conjunctive meaning, that presumption can be overcome by context."[50] As to the second path, the Court observed that "when confronting whether 'and' is several or joint, we will look to 'the context of the sentence, and what we externally know about the conjoined elements.'"[51] It emphasized that, although courts "often conflate[] the two issues," "the determination between joint and several is distinct from the determination between conjunctive and disjunctive."[52]

In illustrating this point, the Court explored the federal circuit court of appeals cases interpreting an "and" in a federal criminal statute known as the First Step Act.[53] As the Court

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50. *Id.* at 1045.

51. *Id.* at 1046 (quoting OfficeMax, Inc. v. United States, 428 F.3d 583, 600 (6th Cir. 2006) (Rogers, J., dissenting)).

52. *Id.* at 1046–47.

53. *Id.* at 1047. The Court examined then-recent decisions from: the Ninth Circuit, *see* United States v. Lopez, 998 F.3d 431, 435 (9th Cir. 2021), *reh'g en banc denied*, 58 F.4th 1108 (9th Cir. 2023), *abrogated by* Pulsifer v. United States, 601 U.S. 124 (2024); the Eighth Circuit, *see* United States v. Pulsifer, 39 F.4th 1018 (8th Cir. 2022), *aff'd*, 601 U.S. 124 (2024); the Seven Circuit, *see* United States v. Pace, 48 F.4th 741 (7th Cir. 2022), *reh'g en banc denied*, 2022 WL 17254332 (7th Cir. 2022), *cert. denied*, 144 S. Ct. 1092 (2024); the Fifth Circuit, *see* United States v. Palomares, 52 F.4th 640 (5th Cir. 2022), *cert. denied*, 144 S. Ct. 1092 (2024); the Sixth Circuit, *see* United States v. Haynes, 55 F.4th 1075 (6th Cir. 2022), *cert. denied*, 144 S. Ct. 1093 (2024); the Fourth Circuit, United States v. Jones, 60 F.4th 230 (4th Cir. 2023), *judgment vacated*, 144 S. Ct. 1091 (2024), and *abrogated by* Pulsifer v. United States, 601 U.S. 124 (2024); and two decisions (one panel and one en banc) from the Eleventh Circuit, *see* United States v. Garcon, 997 F.3d 1301 (11th Cir. 2021), *opinion vacated*, 23 F.4th 1334 (11th Cir. 2022), *reh'g en banc*, 54 F.4th 1274 (11th Cir. 2022) and United States v. Garcon, 54 F.4th 1274 (11th Cir. 2022), *abrogated by* Pulsifer v. United States, 601 U.S. 124 (2024) (en banc). The Supreme Court resolved this circuit split in Pulsifer v. United States, 601 U.S. 124 (2024). Justice Kagan, writing for the six-justice majority, held that although the conjunctive and disjunctive reading are both grammatically permissible, the disjunctive reading is the only plausible statutory construction. *Id.* at 141–42. The Safety Valve functioned as a checklist with three necessary conditions for relief. *Id.* at 139–49. Because there was only one plausible statutory construction, the majority held the rule of lenity did not grant the appellant relief. *Id.* at 152–53. Justice Gorsuch dissented, joined by Justice Jackson and Justice Sotomayor, arguing the "and" should be given its conjunctive meaning because "an ordinary reader would naturally understand that a defendant is eligible for individualized sentencing if he does not have' trait A, trait B, *together with* trait C." *Id.* at 162 (Gorsuch, J., dissenting). Justice Gorsuch characterized the provision as unambiguous but would have applied lenity where there was still reasonable doubt about the best interpretation. *Id.* at 184–85. Thus, even the Supreme Court could not agree on whether "and" was conjunctive or disjunctive.

observed, the federal circuit courts divided on which avenue of interpretation to venture down and on which canons of interpretation were relevant to the issue. Notwithstanding their different interpretations, each circuit court found that the "and" was unambiguous.[54]

Turning to the context in which the Call Right Provision's "and" appeared, the Delaware Supreme Court agreed with the Court of Chancery that Waystar's interpretation—"and" as having a several sense—was the only interpretation that gave effect to all terms in the Option Agreements.[55] Moreover, it agreed with the Court of Chancery that the Call Right Provision was a "permissive" sentence, *i.e.*, it permitted Waystar to take action, and, accordingly, the "several" sense of "and" "aligns with our understanding of common, ordinary usage."[56]

The Delaware Supreme Court also determined that the "several" "and" aligned with what a reasonable third party would expect from the Option Agreements.[57] Further, Weinberg's suggested joint "and" would produce an illogical result, depriving Waystar of the ability to repurchase its equity in certain scenarios (*i.e.*, a Restrictive Covenant Breach), but not in others (*i.e.*, an employees' commission of a felony).[58] Finally, the Court found that Waystar's interpretation was the only interpretation that accorded with the purpose of a call right, both as that right is generally understood and as stated in the company's equity incentive plan documents.[59] Thus, the Call Right Provision was unambiguous and Waystar had validly exercised its call right to repurchase Weinberg's units after her termination, despite the absence of a restrictive covenant breach.

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54. *Waystar II*, 294 A.3d at 1048.

55. *Id.* at 1054–55. Not only did the Delaware Supreme Court agree with the Court of Chancery that Weinberg's interpretation would render a repurchase price provision surplusage, but it also found that an "if later" clause elsewhere in the Option Agreements would be rendered surplusage under Weinberg's reading. *Id.* at 1055.

56. *Id.* at 1058.

57. *Id.* at 1059 ("[T]he nature of a Call Right and the plain language of the Call Right Provision in each Option Agreement suggest that a reasonable third party would expect that Appellees retained a broad right to repurchase Weinberg's Converted Units.").

58. *Id.*

59. *Id.* at 1060–61.

b. *ION Geophysical Corp.* — "A" and "The"

Another example of small words having big consequences is *ION Geophysical Corp. v. Fletcher International, Ltd.* There, the Delaware Court of Chancery was asked to interpret the plain language of Section 6(b) found in the preferred stock purchase agreement between ION Geophysical Corp. ("ION") and Fletcher International, Ltd. ("Fletcher"). ION sought a declaration that a notice provision found in that section of the stock purchase agreement permitted Fletcher to issue only one notice, rather than multiple notices.[60] That notice provision enabled Fletcher to increase the total number of ION common shares into which it may convert its preferred shares.[61] One method in which Fletcher could increase its liquidity under the Agreement was to convert its Series D Stock into ION common stock.[62] Upon the occurrence of certain events, Section 6(b) gave Fletcher the right to increase the Maximum Number from 7,669,434 shares by giving a 65-Day Notice of the increase to ION stock.[63] Section 6(b) established this right and provided:

> (b) The aggregate number of shares of Common Stock issued, as of a particular date, upon conversion or redemption of, or as dividends paid on the Series D Preferred Shares owned by Fletcher and issuable pursuant to this Agreement shall not exceed the Maximum Number as of that date. The "Maximum Number" shall initially equal seven million, six hundred sixty-nine thousand, four hundred thirty-four (7,669,434), or, in the event of a Change of Control, shall equal nine and three-fourths percent (9.75%) of the outstanding common stock of the Acquiring Person as of immediately after the consummation of the Change of Control, and may be increased upon expiration of a [*8] 65-Day Notice period (***the*** "Notice Period") after Fletcher delivers ***a*** notice (***a*** "65-Day Notice") to the Company designating a greater Maximum Number. ***A*** 65-Day Notice may be given at any time. From time to time following the Notice Period,

60. ION Geophysical Corp. v. Fletcher Int'l, Ltd., No. 5050-VCP, 2010 WL 4378400, at *1 (Del. Ch. Nov. 5, 2010).
61. *Id.*
62. *Id.* at *2.
63. *Id.*

> Common Stock may be issued to Fletcher for any quantity of Common Stock, such that the aggregate number of shares of Common Stock issued hereunder is less than or equal to the Maximum Number.[64]

In November 2008, the 20-day volume-weighted average from the previous 20 trading days of the common stock fell to less than the Minimum Price.[65] On that day, Fletcher delivered a 65-Day Notice, increasing the Maximum Number by two million shares.[66] Then, about a year later, on September 15, 2009, Fletcher delivered another 65-Day Notice to increase the shares by another two million.[67] They were now up four million shares. ION received the second notice but decided not to honor that one.[68] ION filed a complaint against Fletcher seeking a declaration that the second notice was invalid under the Agreement. ION claimed that the plain language of the Agreement gave Fletcher the right to issue only one 65-Day Notice to raise the Maximum Number of shares.[69] This is because Section 6(b) referred to "a notice" and "the notice period" in the singular tense.[70] On the other hand, Fletcher argued that the plain language showed that they had the right to issue multiple 65-Day Notices. [71] This is because "a" is indefinite and should be read as one or more.[72]

The Delaware Court of Chancery determined that "the plain language of Section 6(b) is unambiguous and that the only reasonable interpretation is that Fletcher is entitled to issue to ION one or more 65-Day Notices" and, even if the section were considered ambiguous and extrinsic evidence were necessary, the interpretation would be the same.[73] The Court explained that an article is "definite" if "it provides distinct and certain limits to the noun it precedes" but "indefinite" when the article "does not designate an identified or immediately identifiable person or thing or fails to give exact limits to the noun it modifies."[74]

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64. *Id.*
65. *Id.* at *3.
66. *Id.* at *4.
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.* at *6.
71. *Id.*
72. *Id.*
73. *Id.* at *5.
74. *Id.* at *7.

"The" is used as a function to indicate the following noun is definite whereas "a" is indefinite and used "as a function word before singular nouns when the referent is unspecified."[75] "A" does not, according to the Court, limit the frequency or duration of that noun.[76]

The court explained that in Section 6(b), "a" was placed before the noun "65-Day Notice" and put indefinite and definite articles to modify the noun "Notice Period."[77] This, according to the court, "places no limitation on the number of 65-Day Notices that may be issued."[78] The court used an example and explained that once a Notice is issued and the 65 day period is up, that new share number becomes the Maximum Number and, once that time limit passes and the other party were to deliver a second Notice specifying an increase, the Maximum would once again increase.[79] This was contradictory to ION's interpretation, where it would be fixed at the first Notice number increase.[80] However, "[n]otably, under Fletcher's interpretation, one could determine the Maximum Number on any particular date and the dates of the governing Notice Period."[81]

Furthermore, the Court recognized that ION cited cases where "a" referred to a single event or item; the Court responded by stating that the interpretation can depend on both context and grammar laws.[82] Moreover, even though those cases use "a" in the singular form, ordinary usage is often in the plural form.[83] Therefore, given the context and the ordinary usage notion, the court reached the conclusion that "a" should generally be read in the plural sense.[84] The fact that the article "the" is used to modify "Maximum Number," and "a" is later used in the same sentence to modify "a 65-Day notice period" and "a notice" is contextual evidence that "a" is plural.[85] The court explained that "[t]he use of the indefinite article 'a' in the second sentence of §6(b), especially in contrast to the use

75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.* at *8.
83. *Id.*
84. *Id.*
85. *Id.*

of the definite article 'the' in the same sentence, supports the interpretation that Fletcher was not limited to issuing a single 65-Day Notice."[86]

Moreover, even though ION attempted to focus on "the" in the fourth sentence, the analysis was deemed weak as "[t]he parties used the definite article 'the' in the fourth sentence to signify that once a 65-Day Notice is issued, a particular Notice Period of 65 days in length begins to run."[87] The court explained further that, "the fourth sentence describes what happens once a 65-Day notice is issued; it does not prescribe how many such notices may be issued."[88] In terms of the third sentence, the court found that the phrase "at any time" concerned when a Notice may be issued, not how many notices may be issued.[89] Furthermore, taking "at any time" with the rest of Section 6(b), the phrase does not limit Fletcher to a single issuance of a 65-Day Notice.[90] Therefore, when taking Section 6(b) within its own confines, the court found that it was unambiguous.

In terms of analyzing Section 6(b) in light of the other sections of the Agreement, the court further concluded that it was unambiguous. Even though other sections used language like "one or more" to indicate multiple or plural words — rather than "a" — this did not mean that Section 6(b) was ambiguous.[91] The Court cited to other sections that used the plural "a" form and stated that "ION's reliance on other provisions in the Agreement and the Certificate to support its position that the parties intended the indefinite article 'a' in Section 6(b) of the Agreement to mean there could be one and only one 65-Day Notice is unavailing."[92] Overall, the plural phrases are used to achieve the same purpose as using "a."[93] "[N]one of the other provisions in the Agreement or the Certificate clearly indicates that the article 'a' in §6(b) should not be read in its usual, plural sense."[94] Therefore, the court held that the only "reasonable interpretation" was to conclude that you could bring one or more 65-Day Notices.

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86. *Id.* at *9.
87. *Id.*
88. *Id.*
89. *Id.* at *10.
90. *Id.*
91. *Id.* at *11.
92. *Id.* at *12.
93. *Id.*
94. *Id.*

c. *SeaWorld Entertainment* — The Use of Parentheticals

In *SeaWorld Entertainment, Inc. v. Brad Andrews, et al.*, the Court of Chancery was asked to interpret the plain language of separation agreements entered into between former executives of SeaWorld Entertainment, Inc. ("SeaWorld"), and SeaWorld, at the time that the executives were terminated as employees of the company.[95] During the course of each executives' employment at SeaWorld, each entered into an equity agreement with the company pursuant to which they were granted unvested equity awards. The equity agreements conditioned the vesting of the awards on both the performance of the company in the event of a sale (the "Performance Condition"), and the continued employment of the employee receiving the award (the "Employment Condition"). Later, upon the executives' termination from SeaWorld, each executive entered into a separation agreement with the company, which "amended" the equity agreements.[96] Each separation agreement provided that the executives' unvested equity awards: "shall not be forfeited on the Termination Date and shall continue to be eligible to vest (as if the Participant had remained continuously employed with the Company) in accordance with the provisions of [the Equity Agreements.]"[97]

Following the executives' termination from SeaWorld, in connection with a sale of the company that did not meet the Performance Condition, SeaWorld amended the equity agreements of current employees and incumbent management.[98] That amendment, the "60% Amendment" provided that, despite the failure of the sale to meet the Performance Condition, 60% of those employees' unvested equity awards would vest. Specifically, the 60% Amendment provided: "Notwithstanding the foregoing [conditions], subject to Participant's continued employment with the Company through the Closing [of the Sale] . . . sixty percent (60%) of the [Unvested Awards] . . . shall [vest] upon the Closing."[99]

95. SeaWorld Ent., Inc. v. Andrews, 2020-0955-NAC, 2023 WL 3563047, at *1 (Del. Ch. May 19, 2023).
96. *Id.*
97. *Id.* (alteration in original).
98. *Id.* at *2.
99. *Id.* (alteration in original).

Despite the fact that SeaWorld did not modify the separation agreements of the departed executives, the executives demanded that SeaWorld issue them 60% of their unvested awards. SeaWorld responded by filing suit in the Court of Chancery to declare that the executive defendants were not entitled to any vested equity awards. In a letter opinion, the Court of Chancery granted SeaWorld's motion to dismiss and motion for judgment on the pleadings, because "the Company has offered the only reasonable interpretation of the Separation Agreements."[100]

First, the Court of Chancery observed that the purpose of the equity incentive plan, was "to offer incentive compensation to Company personnel."[101] Thus, the equity agreements contained the Employment Condition, which tied the vesting of the equity awards to the continued employment of the employee receiving the award. The separation agreements the executives entered into upon their termination untied the vesting of the awards from their employment. In other words, "the Separation Agreements were designed solely to remove the Employment Condition."[102]

The Court of Chancery found that "neighboring provisions reinforce this conclusion."[103] Moreover, the separation agreements "reflect[ed] the Company's broad discretion to amend the Equity Agreements."[104] Ultimately,

> The Separation Agreements amended the Equity Agreements of *Defendants*, *i.e.*, certain former employees, to remove the *Employment Condition*. In contrast, the 60% Amendment amended the Equity Agreements of *current* employees to remove the *Performance Condition*. The 60% Amendment caused 60% of the Unvested Awards to vest in the Sale, "subject to Participant's continued employment . . . through the closing" of the Sale, even though the Sale did not satisfy the Performance Condition. The 60% Amendment did not mention, let alone amend, the Separation Agreements.[105]

100. *Id.* at *4.
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.* at *5.

In response, the defendant executives argued that the contracts were ambiguous.[106] They argued, in part, that the parenthetical in the separation agreements — "(as if the Participant had remained continuously employed with the Company)" — "deputized them as current employees for all vesting purposes."[107] Thus, "[b]ecause the 60% Amendment applies to current employees (including executives), the 60% Amendment must apply to them too."[108] In rejecting the defendants' interpretation as "unreasonable," the Court of Chancery stated:

> Words do not exist in isolation. So contracts cannot be construed in isolation either. Quite the opposite: In upholding the intentions of the parties, a court must construe the agreement as a whole, giving effect to all provisions therein. A particular word or phrase cannot be read to pollute the larger linguistic sea in which it swims. Put doctrinally, [t]he meaning from a particular provision cannot control the meaning of the entire agreement if such an inference conflicts with the agreement's overall scheme or plan.[109]

Specifically, the Court of Chancery found that the parenthetical clause modified the preceding clause "shall continue to be eligible to vest."[110] Thus, the parenthetical clause "did not establish a right to the Unvested Awards that did not previously exist under the Equity Agreements. Instead, the Parenthetical Clause means that Defendants would have been entitled to their Unvested Awards — "(as if they had remained continuously employed)" — if the Sale had satisfied the Performance Condition. It did not."[111]

The Court of Chancery then concluded with what can be read as a parting warning to drafters thinking of using parenthetical clauses: "Delaware courts have described contracts that place terms in parentheticals as 'poorly drafted,' 'sloppy,' less than 'careful,' 'potentially puzzling,' and in some cases, 'an

106. *Id.* ("Defendants do not respond with a plain reading of their contracts. Instead, they try to create ambiguity. Those efforts fall short.").
107. *Id.*
108. *Id.*
109. *Id.* (internal footnotes omitted) (internal quotations omitted).
110. *Id.*
111. *Id.*

obvious blunder.' Although the Parenthetical Clause may not reflect model drafting, it does not support Defendants' interpretation."[112]

B. *Construing Charters and Bylaws*

Let us now turn our attention to some specific types of corporate instruments — charters and bylaws.

1. *General Principles*

"Because corporate charters and bylaws are contracts, our rules of contract interpretation apply."[113] "If [a contract] is unambiguous, then there is no room for judicial interpretation and 'the plain meaning . . . controls.'"[114] A court is bound by the principles of contract interpretation when construing a corporation's bylaws.[115] Words must be "given their commonly accepted meaning unless the context clearly requires a different one or unless legal phrases having a special meaning are used."[116] If the language of a bylaw is unambiguous, a "court need not interpret it or search for the parties' intent."[117] Moreover, "'the construction or interpretation of a corporate certificate or by-law is a question of law subject to *de novo* review by [the Delaware Supreme Court].'"[118]

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112. *Id.* at *6 (internal footnotes omitted) (internal quotations omitted).

113. BlackRock Credit Allocation Income Tr. v. Saba Cap. Master Fund, Ltd., 224 A.3d 964, 977 (Del. 2020) (quoting Hill Int'l Inc. v. Opportunity Partners L.P., 119 A.3d 30, 38 (Del. 2015)); *see also* Stream TV Networks, Inc. v. SeeCubic, Inc., 279 A.3d 323, 336 (Del. 2024) (quoting Alta Berkeley VI C.V. v. Omneon, Inc., 41 A.3d 381, 385 (Del. 2012)) ("'Certificates of incorporation are regarded as contracts between the shareholders and the corporation, and are judicially interpreted as such.'").

114. PHL Variable Ins. Co. v. Pure Dawe 2006 Ins. Tr., 28 A.3d 1059, 1070 (Del. 2011) (quoting LeVan v. Indep. Mall, Inc., 940 A.2d 929, 933 (Del. 2007)).

115. Brown v. Matterport, No. 2021-0595-LWW, 2022 WL 89568, at *3, *aff'd* 282 A.3d 1053 (Del. 2022) (citing *Saba*, 224 A.3d at 977 ("Because corporate charters and bylaws are contracts, our rules of contract interpretation apply.")).

116. *Id.* at *3 (quoting *Hill*, 119 A.3d at 38).

117. *Id.* (quoting *Saba*, 224 A.3d at 977).

118. Stream TV Networks, Inc. v. SeeCubic, Inc., 279 A.3d 323, 336 (Del. 2022) (quoting Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 926 (Del. 1990)).

2. *Illustrative Cases*

a. *Kellner v. AIM ImmunoTech, Inc.*

On July 11, 2024, our Supreme Court reaffirmed, in *Kellner v. AIM ImmunoTech, Inc.*, that "[u]nder Delaware law, bylaws are 'presumed to be valid' and must be interpreted 'in a manner consistent with the law.'"[119] "A facially valid bylaw is one that is authorized by the Delaware General Corporation Law (DGCL), consistent with the corporation's certificate of incorporation, and not otherwise prohibited."[120] When a bylaw is challenged facially in court, "it is insufficient for a plaintiff to simply assert that under some circumstances, a bylaw might conflict with a statute or operate unlawfully."[121] Instead, the plaintiff must demonstrate that the bylaw cannot operate lawfully under any set of circumstances.

In *Kellner*, a group of Aim ImmunoTech, Inc. stockholders thought that the board of directors was mismanaging the company. The insurgents included two felons convicted of wire fraud, insider trading, and other crimes. The campaign escalated into two attempts to nominate directors to the AIM board.

The board rejected both nomination notices under its existing bylaws, which led to a lawsuit over the second notice. The Court of Chancery denied the insurgents' request for a mandatory preliminary injunction to place their nominees on the annual meeting ballot. The court held that factual disputes about the veracity of the insurgents' disclosures precluded temporary mandatory injunctive relief.

The insurgents persisted and reshuffled their membership, with Ted D. Kellner leading a third attempt to nominate three new directors to the AIM board. The board amended its bylaws to include sweeping new advance notice provisions that required detailed disclosures by Kellner and his nominees. Many of the amendments were approved in direct response to the insurgents' campaign.

Again, the AIM board rejected Kellner's nominations for failing to comply with the new advance notice bylaws. Kellner sued. Following a trial, the Court of Chancery invalidated four

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119. Kellner v. AIM ImmunoTech, Inc., 320 A.3d 239, 258 (Del. 2024) (quoting Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985)).

120. *Id.* (citations and quotations omitted).

121. *Id.* (citations and quotations omitted).

of the six main advance notice bylaws and reinstated the 2016 version of one of the invalidated bylaws. In the end, the court upheld the board's rejection of the third nomination notice because it failed to comply with the two advance notice bylaws left standing, including the reinstated 2016 bylaw.

Kellner argued on appeal that the trial court erred in rejecting his notice based upon the 2016 bylaw because the AIM board did not rely on that bylaw in rejecting his notice. He also contended that the 2016 bylaw had been repealed when the board enacted the amended bylaws. According to Kellner, the court erred when it held that two of the amended bylaws withstood enhanced scrutiny when, at the same time, it had determined that many others were preclusive and had been adopted for an improper purpose. Finally, he argued that the court erred in finding that the notice failed to comply with the remaining bylaws left standing.

The defendants filed a cross-appeal challenging the trial court's invalidation of four of the amended bylaws. They contended that the court confused a "facial" challenge with an "as-applied" challenge and that Kellner had raised only an "as-applied" challenge. Thus, according to defendants, the court should not have invalidated the four amended bylaws which they asserted withstand enhanced scrutiny in any event.

In resolving the issues on appeal, we first established the framework for evaluating the issues as follows:

> In a challenge to the adoption, amendment, or enforcement of a Delaware corporation's advance notice bylaws that is ripe for judicial review, the court should consider the following: first, if contested, whether the advance notice bylaws are valid as consistent with the certificate of incorporation, not prohibited by law, and address a proper subject matter; and second, whether the board's adoption, amendment, or application of the advance notice bylaws were equitable under the circumstances of the case.[122]

In applying this framework, our Court held that: (1) one "unintelligible" bylaw was invalid; (2) the remaining advance notice bylaws at issue were valid because they were consistent

122. *Id.* at 246.

with the certificate of incorporation, not prohibited by law, and address a proper subject matter; and (3) the AIM board had acted inequitably when it adopted the amended bylaws for the primary purpose of interfering with, and ultimately rejecting Kellner's nominations. As a result, the remaining bylaws challenged on appeal were unenforceable. We also noted that, according to the Court of Chancery, Kellner had submitted false and misleading responses to some of the requests. Given the trial court's countervailing findings about Kellner's and his nominees' deceptive conduct, no further action was warranted, and the case was closed. We discuss other aspects of this case later in this article in the section on linguistic "tripwires."[123]

b. *Hill International Inc. v. Opportunity Partners, L.P.*

In *Hill International Inc. v. Opportunity Partners, L.P.*,[124] our Court reinforced that "[t]he bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers and stockholders formed within the statutory framework of the Delaware General Corporation Law."[125] "'Words and phrases used in a bylaw are to be given their commonly accepted meaning unless the context clearly requires a different one or unless legal phrases having a special meaning are used.'"[126]

There our Court determined, in construing an advance notice bylaw, that the plain meaning of "the date" (in a provision referring to "notice or prior public disclosure of the date of the annual meeting") meant a specific day — not a range of possible days. The proxy statement's reference to "on or about June 10, 2015" did not refer to "the date" of the company's annual meeting.[127] Rather, "on or about" referred to an approximate, anticipated, or targeted time frame that was intended to encompass more than one "date."[128] Thus, the proxy statement did not provide "prior public disclosure" of the company's annual meeting.

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123. *See infra* pp. 56–58.
124. 119 A.3d 30, 38 (Del. 2015).
125. *Id.*
126. *Id.* (quoting Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1188 (Del. 2010).
127. *Id.* at 39–40.
128. *Id.* at 40.

C. *Construing Statutes*

Now, let us turn to some examples of plain language principles applied in the context of construing statutes.

1. *General Principles*

Our Court reviews the interpretation of statutes *de novo*.[129] We have summarized some of the relevant principles of statutory interpretation as follows:

> The principles of statutory interpretation under Delaware law are clear. "When interpreting a statute, the Court's priority is to 'determine and give effect to the legislative intent.' The starting point is the language of the statute. The 'most important consideration for a court in interpreting a statute is the [language] the General Assembly used in writing [the statute].' If a statute is unambiguous, there is no need for judicial interpretation, and the plain meaning of the statutory language controls. "The fact that the parties disagree about the meaning of the statute does not create ambiguity." Statutory language is ambiguous when it is reasonably susceptible to different conclusions or interpretations. "When statutory language is ambiguous, it should be interpreted in a way that will promote its apparent purpose and harmonize it with the statutory scheme."[130]

2. *Illustrative Cases*

a. *Fox/Snap*

In the recent decision of *In Re Fox Corporation/Snap, Inc. Section 242 Litigation* ("*Fox/Snap*"), the Supreme Court grappled with the plain meaning of the word "power" as it appears in 8

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129. Stream TV Networks, Inc. v. SeeCubic, Inc., 279 A.3d 323, 336 (Del. 2022) (quoting Salzberg v. Sciabacucchi, 227 A.3d 102, 112 (Del. 2020)) ("'Statutory interpretation is a question of law, which we review *de novo*.'").

130. Protech Minerals, Inc. v. Dugout Team, LLC, 284 A.3d 369, 375 (Del. 2022) (citations omitted); *see also* State v. Barnes, 116 A.3d 883, 888 (Del. 2015) ("The starting point for the interpretation of a statute begins with the statute's language."); Freeman v. X-Ray Assocs., P.A., 3 A.3d 224, 227 (Del. 2010) (citing Coastal Barge Corp. v. Coastal Zone Indus. Control Bd., 492 A.2d 1242, 1246 (Del. 1985)) ("We must give effect to the legislature's intent by ascertaining the plain meaning of the language used.").

Del C. § 242(b)(2).[131] Following a new amendment of Section 102(b)(7) of the Delaware General Corporation Law ("DGCL"), both Fox Corporation ("Fox") and Snap Inc. ("Snap") (f/k/a/ Snapchat Inc.) sought to amend their corporate charters and expand liability protections for their officers.[132] The new amendments would exculpate officers from duty of care damages.[133] Both Fox and Snap (together, the "Companies") had a multi-class stock structure with homonymous "Class A" common stockholders (collectively the "Class A Stockholders" or "Class A") that enjoyed no voting rights except to the extent stated in the Companies' certificates of incorporation or as required by the DGCL.[134]

In both instances, each company's voting class (or classes) voted to approve the exculpation amendments. Neither company solicited a vote from the Class A Stockholders.[135] Believing that they were entitled to a class vote, the Class A Stockholders filed separate class action complaints in the Court of Chancery which were consolidated against Fox and Snap.[136] The Class A Stockholders sought a declaration that the Company's decision to vote on the amendments without their input violated Section 242(b)(2), which states, in part, that:

> The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, *or alter or change the* ***powers****, preferences, or special rights of the shares of such class so as to affect them adversely.*[137]

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131. *In re* Fox Corp./Snap, Inc. Sec. 242 Litig., 312 A.3d 636 (Del. 2024) [hereinafter *Fox-Snap*].

132. *Id.* at 639.

133. *Id.*

134. *Id.* Fox has a dual-class stock structure consisting of Class B common stockholders with one vote per share and Class A common stockholders who enjoyed no voting rights, except to the extent stated in Fox's certificate of incorporation or as required by DGCL. Snap has a three-class stock structure which consists of Class A common stock with no vote, Class B common stock with one vote per share, and Class C common stock with ten votes per share.

135. *Id.*

136. *Id.*

137. Del Code Ann. tit. 8, § 242(b)(2) (2024) (emphasis added).

According to the Class A Stockholders, the amendments to the Companies' charters adversely diminished Class A's power to sue the Companies' officers for breach of their duty of care, and thus, the language of Section 242(b)(2) "unambiguously required a class vote before adopting the exculpatory charter provisions."[138]

The Court of Chancery acknowledged the merit in the Class A Stockholders' contentions, but ultimately determined that "the officer exculpation amendment does not require a class vote of the company's non-voting stock because the officer exculpation amendment does not affect a power, preference, or special right that appears expressly in the charter."[139] The Court of Chancery advanced four main reasons for its decision.

First, textual overlap between Sections 242(b)(2), 151(a), and 102(a)(4) suggested that powers must be explicitly outlined in the corporate charter to qualify for the protection of Section 242(b)(2).[140] Second, two cases, namely, *Hartford Accident & Indemnity Co. v. W.S. Dickey Clay Mfg. Co.* ("*Dickey Clay*"),[141] and *Orban v. Field* ("*Orban*"),[142] demonstrated that "power" only referred to "peculiar, or special characteristic of a class of

138. *Fox/Snap*, 312 A.3d at 639. The Class A Stockholders' arguments to the Court of Chancery were essentially fourfold. First, they contended that stockholders have three "fundamental" powers which are to vote, sell, and sue, because the dictionary definition of "power" includes "[t]he ability to act or not act[.]" *Id.* at 640 (quoting *Power*, Black's Law Dictionary (11th Ed. 2019)). Second, Class A asserted that a change between previous iterations of Section 242 and the current form, which modified the pertinent phrase from "preferences, special rights or powers" to "powers, preferences, or special rights[,]" foreclosed any ambiguity and evinced that "powers" did not refer to special powers unique to the voting class, but general powers including the power to sue. *See id.* Third, Class A claimed that the greater context of the DGCL supported a reading of power which associated the term with ability to sue or be sued. *Id.* at 640. Finally, Class A argued that two cases relied upon by the Companies (and later the Court of Chancery), *Hartford Accident & Indem. Co. v. W.S. Dickey Clay Mfg. Co.*, 24 A.2d 315 (Del. 1942), and *Orban v. Field*, No. 12820, 1993 WL 547187 (Del. Ch. Dec. 30, 1993), were inapposite because they addressed changes to a capital structure and not, as here, the elimination of a personal power. *Id.*

139. *Id.* at 641 (quoting Transcript of Record at 61, 69, Elec. Workers Pension Fund, Local 103, I.B.E.W. v. Fox Corp., No. 2022-1007-JTL (Del. Chl. Mar. 29, 2023) [hereinafter "*Fox Corp.*"] (internal quotation marks omitted).

140. *Id.*

141. 24 A.2d 315.

142. 1993 WL 547187.

shares rather than rights incidental to share ownership[.]"[143] Third, no commentators supported Class A's interpretation of powers.[144] And fourth, practitioners of Delaware law had long interpreted *Dickey Clay* to support the Companies' reading.[145]

The Class A Stockholders appealed. The Supreme Court affirmed the Court of Chancery's decision.[146] First, the Supreme Court agreed with the Companies' textual argument.[147] Sections 242(b)(2), 151(a), and 102(a)(4) all included similar usage of the words "powers," "privileges," and "special rights."[148] The similar usage in each of these sections indicated they ought to be read together,[149] and when read together, the Sections

143. *Fox/Snap*, 312 A.3d at 641–42 (internal quotation marks omitted). In other words, the power to sue, although a power inherent in all classes of shares, was not expressly reiterated in the description of Class A shares in the Companies' charters, and thus was not a "power" contemplated by Section 242(b)(2). *See Fox Corp.*, C.A. No. 2022-1007-JTL at 69 ("Accordingly, under *Dickey Clay* and *Orban*, the officer exculpation amendment does not require a class vote of the company's non-voting stock because the officer exculpation amendment does not affect a power, preference, or special right that appears expressly in the charter.").

144. *Fox/Snap*, 312 A.3d at 642.

145. *Id.*

146. *Id.* at 651.

147. *Id.* at 645–46.

148. Looking at the language of each statute in turn, Section 102(a)(4) stated that: "The certificate of incorporation shall also set forth a statement of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, which are permitted by § 151 of this title in respect of any class or classes of stock or any series of any class of stock of the corporation . . . ." DEL CODE ANN. tit. 8, § 102(a)(4) (2024) (emphasis added). Section 151(a), as referenced in 102(a)(4) then states: "Every corporation may issue 1 or more classes of stock . . . and which classes or series may have such voting *powers*, full or limited, or no voting powers, and such designations, *preferences* and relative, participating, optional or other *special rights*, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto . . . ." DEL CODE ANN. tit. 8, § 151(a) (2024) (emphasis added). Finally, Section 242(b)(2) extends this right to vote on amendments to non-voting shares under specific circumstances. It states, in pertinent part: "The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the *powers, preferences, or special rights* of the shares of such class so as to affect them adversely." DEL CODE ANN. tit. 8, § 242(b)(2) (2024) (emphasis added).

149. *See Fox/Snap*, 312 A.3d at 646 ("it was not by accident that the same sequence of words was used in Sections [242(b)(2)], 151(a), and 102(a)(4)").

showed that the power to sue an officer for breach of their duty of care was not a "power" under Section 242(b)(2).

First, Section 151 allows for the creation of different classes of stock with different characteristics including "voting powers," "preferences," and "special rights." For these characteristics to be validly attached to a certain class of stock, they must be made express in the corporate charter as required by Section 102(a)(4).[150] Thus, the Supreme Court reasoned that the specific prescriptions of Sections 151(a) and 102(a)(4) imparted a particular meaning to the "powers, preferences, and special rights" referred to in the statutes which distinguished them from general powers incidental to stock ownership.[151] It is to these expressed "powers, preferences, and special rights" that Section 242(b)(2) specifically refers when setting the conditions allowing typically non-voting stock to vote,[152] and because the power to sue a director for breach of fiduciary duty was not expressed in either of the companies' charters, it was not one of the preconditional express "powers" which triggers section 242(b)(2).[153]

The Supreme Court's conclusion with respect to the textual argument dove-tailed with the Court's subsequent analyses of the *Dickey Clay* and *Orban* cases, which the Court found applicable and instructive.[154] The upshot of the analysis was that *Dickey Clay* "held that '[t]he *peculiar, or special quality* with which [the class shares] are endowed . . . serves to distinguish them

150. *See* DEL CODE ANN. tit. 8, § 102(a)(4) (2024).

151. *See Fox/Snap*, 312 A.3d at 647 ("The word 'powers' in Section 242(b)(2) refers to specific class powers under Section 151(a), made express in the corporate charter as required by Section 102, and not to general powers incidental to stock ownership").

152. *Id.* at 650.

153. The Supreme Court rebuffed counterarguments by the Class A Stockholders. For example, the Court rejected a dictionary definition argument, referring to it as a "stilted approach" that "ignores the context in which 'powers' is used and how Section 242(b)(2) interacts with other sections of the DGCL employing the same words." *Id.* at 647. Additionally, the Court rejected an argument that different DGCL provisions supported Class A's reading by describing "power" as the authority to file suit. *Id.* at 648. All provisions cited by Class A that supported such a reading spoke to a different subject matter than stockholder powers, and further defined power within the context of their own statute. *Id.*

154. *See Fox/Snap*, 312 A.3d at 649 ("According to the Class A Stockholders, Dickey Clay 'merely [held] that the relative position of stock in the capital structure is not a "power, preference, or special right" under Section 242(b)(2)' . . . . But a court's ruling is rarely limited to the specific facts before it.").

from shares of another class[.]"[155] *Orban*, for its part, "makes clear that [Section 242(b)(2)] affords a right to a class vote when the proposed amendment adversely affects the peculiar legal characteristics of that class of stock."[156]

The "peculiar" characteristics referred to in *Dickey Clay* and *Orban* are the same as the "powers, preferences, and special rights" referred to in Section 242(b)(2).[157] "Powers, preferences, and special rights" as contemplated by Section 242(b)(2) must be expressed in the charter as the textual argument demonstrated,[158] and as *Dickey Clay* supports.[159] The power to sue an officer for breach of duty of care was, again, not expressed in the Companies' charter so it was not a "peculiar or special quality," but a right incidental to stock ownership.[160] As *Orban* explained, Section 242(b)(2) only provides the right to vote when "peculiar" legal characteristics are adversely affected.[161] Therefore, an amendment affecting Class A's incidental right to sue directors does not implicate Section 242(b)(2) since it does not affect a peculiar or special quality of Class A stock.

As a final point, the Supreme Court commented on the Court of Chancery's conclusions that the plain meaning of "powers, preferences and special rights" was consistent with the long-standing expectations of commentators and practitioners:[162]

> The Court of Chancery determined that this evidence [of corporate practice] fit its understanding that 'in the nearly 40 years since 1986 and the adoption of Section 102(b)(7) for directors, no one has taken the position until this case that an exculpation amendment requires a class vote." Although the Class A

155. *Id.* at 650 (quoting *Hartford Accident*, 24 A.2d at 318–319).

156. *Id.* (quoting Orban v. Field, No. 12820, 1993 WL 547187, at *8 (Del. Ch. Dec. 30, 1993)) (internal quotation marks omitted).

157. *Id.*

158. *See id.* at 646.

159. *Id.* at 650 ("For three quarters of a century, *Dickey Clay* has stood for two points: 1) that rights incidental to stock ownership are not a peculiar characteristic of the shares of a class of stock, and 2) that Section 242(b)(2) should be read considering other provisions of the DGCL.").

160. *See id.* at 647. *Dickey Clay* showed "that rights incidental to stock ownership are not a peculiar characteristic of the shares of a class of stock." *Id.* at 650.

161. *Orban*, 1993 WL 547187, at *8.

162. *Fox/Snap*, 312 A.3d at 650–51.

> Stockholders argue otherwise, the Court of Chancery did not make practitioner experience central to its ruling. Instead, it simply observed that a statutory interpretation which deviated from the historical understanding would conflict with the stability of our corporate law.[163]

This observation regarding the "historical understanding" of a statute raises the interesting question as to what extent "long-standing expectations of commentators and practitioners" should factor into the interpretive exercise. Several recent decisions wrestle more directly with this precise issue.

b. *Moelis*

One such decision is *West Palm Beach Firefighters' Pension Plan Fund v. Moelis & Co.*[164] where the Court of Chancery began with the following question:

> What happens when the seemingly irresistible force of market practice meets the traditionally immovable object of statutory law? A court must uphold the law so the statute prevails.[165]

Because this case is on appeal, my discussion of it herein will be limited strictly to reporting on the decision issued by the Court of Chancery. Nothing herein is intended to suggest how any member of our Court (including myself) would view any issue that might be raised by the parties on appeal.

The "immovable object" referred to by the Vice Chancellor was Section 141(a) of the DGCL which provides that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[166] As the Court of Chancery observed, "Section 141(a) is the source of Delaware's board-centric model of corporate governance."[167]

In *Moelis*, the plaintiff challenged the facial validity of various provisions in a stockholder agreement that provided

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163. *Id.*
164. 311 A.3d 809 (Del. Ch. 2024).
165. *Id.* at 816.
166. DEL CODE ANN. tit. 8, § 141(a) (2024).
167. *Moelis*, 311 A.3d at 816.

Moelis' eponymous founder, CEO and Chairman, Ken Moelis, with certain veto rights or "pre-approval" rights over various corporate actions and over the composition of Moelis' board of directors and board committees. The types of corporate actions that required Mr. Moelis' pre-approval included "the entry into any merger, consolidation, recapitalization, liquidation, or sale of the Company or all of substantially all of the assets of the Company or consummation of a similar transaction involving the Company."[168]

The Court of Chancery held that the stockholder agreement was void because the requirement that the board obtain Mr. Moelis' prior approval for significant corporate actions effectively and improperly delegated managerial authority to him and restricted the board's ability to exercise its independent judgment. The trial court observed that, "[t]he presence of a stockholder who controls the corporation does not alter the board-centric framework,"[169] and that:

> Internal corporate governance arrangements that do not appear in the charter and deprive boards of a significant portion of their authority contravene Section 141(a). The Delaware courts have regularly considered challenges to contractual governance arrangements under Section 141(a) and have frequently invalidated arrangements that improperly constrain a board's authority.[170]

The plaintiff's argument was simple:

> Under Chancellor Seitz's seminal decision in *Abercrombie v. Davies*, governance restrictions violate Section 141(a) when they 'have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters' or 'tend[] to limit in a substantial way the freedom of director decisions on matters of management policy.

168. *Id.* at 825. The Vice Chancellor described the stockholder agreement as a "new wave" agreement that "does not involve stockholders contracting among themselves to address how they will exercise their stockholder-level rights." *Id.* at 817. The pre-approval requirements "encompass virtually everything the Board can do," and because of them, "the Board can only act if Moelis signs off in advance." *Id.* at 818.

169. *Id.* at 817.

170. *Id.*

> . . .' The Delaware Supreme Court has repeatedly endorsed the *Abercrombie* test. This court has repeatedly applied it.[171]

The Court of Chancery rejected the defendants' "one-size-fits-all response" which was that "[a] contract is a contract is a contract."[172] Delaware corporations possess the power to contract, and contracts necessarily constrain a board's freedom of action. Defendants argued that a court cannot differentiate between an internal governance arrangement and an external commercial contract.

In resolving the dispute, the Court of Chancery reasoned that the challenged provisions were part of an internal governance arrangement. The court observed that the only parties to the stockholder agreement are the Company, Moelis, and the three entities he controls. The provisions "resemble the type of governance rights associated with preferred stock" and are part of "an indefinite agreement that the Board cannot terminate."[173] As such, they were subject to Section 141(a).

The question then became whether the provisions violated the *Abercrombie* test.[174] The court held that they did:

> Taken together, the Pre-Approval Requirements force the Board to obtain Moelis' prior written consent before taking virtually any meaningful action. With the Pre-Approval Requirements in place, the Board is not really a board. The directors only manage the Company to the extent Moelis gives them permission to do so. This decision need not consider whether some lesser combination of rights might pass muster under Section 141(a). The Pre-Approval Requirements go too far.[175]

In short, "[b]ecause of the Pre-Approval Requirements, the business and affairs of the Company are managed under the direction of Moelis, not the Board."[176] As such, the Court

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171. *Id.* at 818–19.
172. *Id.* at 819.
173. *Id.* at 820. The parties entered into the agreement just before the Company's shares started trading publicly. *Id.*
174. *Id.*
175. *Id.*
176. *Id.* at 821.

of Chancery held that the Pre-Approval Requirements "violate Section 141(a)."[177]

The trial court also rejected the Company's public policy arguments finding that the case did not call for a public policy analysis. That was because "[w]hen the General Assembly has enacted a statute, that statute embodies Delaware's public policy."[178]

In addressing the Company's observation that other corporations had entered into similar stockholder agreements, the court observed that "the number of companies using this structure remains low relative to the total number of companies in the market."[179] But that "[i]n any event, market practice is not law."[180] Rather,

> Delaware courts consider market practice, because market practice can reflect the judgments of experienced counsel about what is possible under Delaware law. But corporate lawyers are marvelous mimics. And clients pay corporate lawyers to push the envelope. When the General Assembly has enacted a statute, a court's job is to enforce the statute, even if that has implications for market practice.[181]

The Court of Chancery concluded by reiterating that "[w]hen market practice meets a statute, the statute prevails,"[182] and that unless and until the General Assembly acts, the statute controls.

That is exactly what happened next. The General Assembly and Governor enacted statutory amendments to legislatively override the Court of Chancery's decision at least as it might apply prospectively and retrospectively, but not to the *Moelis* case or other cases pending at the time of the enactment of the amendments. In response to the *Moelis* decision,[183] the Delaware

177. *Id.*
178. *Id.* at 877.
179. *Id.* at 878.
180. *Id.*
181. *Id.* at 878–79.
182. *Id.* at 881.
183. *See* Marcel Kahan & Edward B. Rock, *Proposed DGCL § 122(18), Long-term Investors, and the Hollowing Out of DGCL § 147(a)*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 21, 2024) ("The opinion has caused considerable consternation among a group of transactional lawyers because it raises doubts about the validity of a current market practice in which significant

General Assembly added DGCL Section 122(18) in the 2024 Amendments to address the conflict between common market practice and statutory language that was highlighted in that decision. Section 122(18) provides as follows:

Every Corporation created under this chapter shall have the power to:

> (18) Notwithstanding § 141(a) of this title, make contracts with one or more current or prospective stockholders (or one or more beneficial owners of stock), in its or their capacity as such, in exchange for such minimum consideration as determined by the board of directors (which may include inducing stockholders or beneficial owners of stock to take, or refrain from taking, one or more actions); provided that no provision of such contract shall be enforceable against the corporation to the extent such contract provision is contrary to the certificate of incorporation or would be contrary to the laws of this State (other than § 115 of this title) if included in the certificate of incorporation. Without limiting the provisions that may be included in any such contracts, the corporation may agree to: (a) restrict or prohibit itself from taking actions specified in the contract, (b) require the approval or consent of one or more persons or bodies before the corporation may take actions specified in the contract (which persons or bodies may include the board of directors or one or more current or future directors, stockholders or beneficial owners of stock of the corporation), and (c) covenant that the corporation or one or more persons or bodies will take, or refrain from taking, actions specified in the contract (which persons or bodies may include the board of directors or one or more current or future directors, stockholders or beneficial owners of stock of the corporation).[184]

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governance provisions are apparently included in stockholder agreements rather than in the certificate of incorporation.") https://corpgov.law.harvard.edu/2024/05/21/proposed-dgcl-%C2%A7-12218-long-term-investors-and-the-hollowing-out-of-dgcl-%C2%A7-141a/.

184. DEL CODE ANN. tit. 8, § 122(18) (2024).

Section 122(18) permits corporations to enter into agreements with stockholders or beneficial owners concerning corporate governance matters in exchange for minimum consideration that is determined by the board. Thus, Section 122(18) authorizes corporations to take (or not take) certain actions listed in a stockholders' agreement. The only explicit limitation is that the stockholders' agreement's provisions cannot violate the corporation's certificate of incorporation or other provisions of the DGCL. Section 122(18) also provides a non-exclusive list of provisions that a corporation may agree to in a stockholders' agreement.

Commentators have observed that the new amendments raise many issues, including whether counterparties to such agreements will be deemed "controllers," and what happens when control rights obtained via Section 122(18) clash with a board's fiduciary obligations?[185] These questions will have to await further developments in the law. Other commentators, referring to the amendments as "market practice amendments," have questioned whether the amendments "signal a change in approach for how Delaware corporate law will be evolved, shaped, and clarified."[186] Again, only time will tell.

c. *Activision*

In another recent case, *Sjunde AP-fonden v. Activision Blizzard, Inc., et al.*,[187] the Court of Chancery again wrestled with the plain meaning of statutory provisions and an apparent conflict with the long-standing expectations of legal commentators and practitioners as well as common market practices. This case stems from Microsoft's 2022 acquisition of Activision, Blizzard Inc. ("Activision") — a developer and publisher of

185. *Id.*

186. *See* Keith Gottfried, *Proposed DGCL Amendments Depart from Delaware's Historical Approach to Activism and Takeover Defense*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 1, 2024) (observing that "[t]he approach taken by the Council and the Delaware General Assembly to quickly amend the DGCL in response to the *Moelis* decision, rather than allow the Delaware Supreme Court the opportunity to weigh in and possibly either overturn or clarify, shape, and evolve the *Moelis* decision, appears to be at odds with historical practice.") https://corpgov.law.harvard.edu/2024/07/01/proposed-dgcl-amendments-depart-from-delawares-historical-approach-to-activism-and-takeover-defense/.

187. No. 2022-1001-KSJM, 2024 WL 863290 (Del. Ch. Feb. 29, 2024).

interactive entertainment content and services — for $95 per share.[188]

In January 2022, the Activision Board of Directors (the "Board") received and approved a draft of the merger agreement (the "Draft Merger Agreement"). The board neither approved nor reviewed any subsequent version of the merger agreement, including the final and complete execution version.[189] The draft contained several omissions: (i) the company disclosure letter and the disclosure schedules; (ii) the certificate of incorporation of the surviving corporation; and (iii) the amount of consideration paid as well as Activision's name as the target (placeholders were used for both).[190] The Court of Chancery found that these items needed to be included "[a]t bare minimum."[191] The Draft Merger Agreement also omitted any reference concerning Activision's future dividends while the deal awaited regulatory approval — a process that could take years.[192] Activision later filed a proxy statement (the "Proxy Statement") seeking stockholder approval.[193] The Proxy Statement omitted the disclosure letter, the disclosure schedules, and the surviving company's charter.[194] At a special stockholder meeting on April 28, 2022, the stockholders approved the merger with more than 98% of stockholders present voting in favor.[195]

In November 2022, the plaintiff — an Activision stockholder — filed suit in the Court of Chancery, alleging that the defendants had violated Sections 251 and 141 of the DGCL by failing to include in the merger agreement approved by the

188. *Id.* at *1. Activision is perhaps most famous for its production of video games, including the highly-successful "Call of Duty" franchise. *See About Us*, ACTIVISION, https://www.activision.com/company/aboutus (last visited July 2, 2024).

189. *Activision*, 2024 WL 863290, at *2. The parties executed the merger agreement (the "Merger Agreement") on January 18, 2022. In its final form, the Merger Agreement contained multiple changes from the Draft Merger Agreement. *Id.*

190. *Id.* at *1.

191. *Id.* at *7.

192. *Id.* at *1. The board had delegated this matter to a committee to negotiate and resolve.

193. *Id.* at *2.

194. *Id.* Specifically, "[t]he Proxy Statement purported to attach the Merger Agreement as Annex A. But Annex A did not contain the Disclosure Letter, Disclosure Schedules, or the Survivor's Charter." *Id.*

195. *Id.*

Board items required by statute.[196] The Court of Chancery denied the defendants' motion to dismiss as to some of the claims.

In its analysis, the court first focused on the statutory language. Section 251(b) requires that when a corporation desires to merge or consolidate, its board must approve an "agreement of merger."[197] Section 251(b) lists the information that must be included in an agreement of merger, such as the "terms and conditions of the merger[.]"[198] The plaintiff argued that the Board violated Section 251(b) because the Draft Merger Agreement did not include all of the statutorily required terms and, thus, the Board failed to approve the final executed version of the merger agreement.[199]

The defendants responded that this narrow interpretation of Section 251(b) was not required by the statutory language and would also conflict with common corporate practices: "[g]iven the practical realities of negotiating merger agreements, boards commonly adopt resolutions approving a merger agreement in draft or near-final draft form and declaring its advisability before the agreement has been finalized, and this is especially true with respect to ancillary documents, including disclosure schedules."[200] The defendants also emphasized that the plaintiff's interpretation of Section 251(b) would create "uncertainty" about the validity of mergers; would create uncertainty for third parties dealing with Delaware corporations; and would "disserve" Delaware's long-standing public policy of encouraging mergers.[201]

The Court of Chancery rejected the defendants' arguments. Instead, it determined that the plaintiff's interpretation found support in the "plain language of Section 251(b); the unique status of mergers within the DGCL; the essential role of the agreement of merger within Section 251; a board's nondelegable authority with respect to mergers; and the aura of mandatory provisions and strict adherence that engulfs the statutory scheme."[202]

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196. *Id.* The defendants were the Board, Microsoft, Microsoft's Board of Directors, and the merger subsidiary (collectively, the "defendants"). *Id.*

197. DEL CODE ANN. tit. 8, § 251.

198. *Id.*

199. *Activision*, 2024 WL 863290, at *4.

200. *Id.* at *5 (quoting Activision Defendants' Opening Brief at 32).

201. *Id.* at *6.

202. *Id.* at *5 (internal citation omitted).

Although the court recognized that the plaintiff's interpretation did not "square with norms of market practice," it held that "[w]here market practice exceeds the generous bounds of private ordering afforded by the DGCL, then market practice needs to check itself."[203] Moreover, the court added that:

> At bare minimum, Section 251(b) requires a board to approve an essentially complete version of the merger agreement (the "essentially complete interpretation"). This is so because, absent an essentially complete draft, the board-approval requirement of Section 251(b) would make no sense.
>
> . . . .
>
> Nor does Defendants' policy argument work in the face of the essentially complete interpretation. In fact, it is unclear what room there is for a policy analysis on this point. To again quote *Moelis*: "When the General Assembly has enacted a statute, that statute embodies Delaware's public policy. A court is not free to disregard it." Here, the statute reflects public policy. The court is not free to disregard it.
>
> It is reasonably conceivable that the Board failed to satisfy the minimal requirements of Section 251(b) by failing to approve an essentially complete version of the Merger Agreement. Plaintiff alleges that the Draft Merger Agreement omitted the consideration, the Disclosure Letter, the Disclosure Schedules, the Survivor's Charter, and the Dividend Provision. There was a lot of important stuff missing from the Draft Merger Agreement. The consideration was essential. The Disclosure Letter was referenced 45 times in the Merger Agreement and contained information that was important to the agreement. Section 251(b) specifically calls out the Survivor's Charter in the list of six statutorily mandated items. The Dividend Provision was a "key open" issue. Perhaps the Disclosure Schedules were not essential, as Defendants argue. Reasonable minds could reach different conclusions on this point.

203. *Id.* at *5–6.

> The court need not drill down that deep at the pleading stage. Wherever the line in this context is drawn, the Draft Merger Agreement inferably crossed it.[204]

According to the Court of Chancery, no matter how one looks at it, the Draft Merger Agreement omitted information required by statute, and accordingly, it denied the motion to dismiss. The court also found the notice defective because (i) although the proxy statement contained a summary of the merger agreement, the notice did not, and (ii) the merger agreement annexed to the proxy statement, did not include a copy of the surviving corporation's charter.

Following the *Activision* decision, multiple amendments to the DGCL were proposed and adopted. Notably, the amendments include a new Section 147 of the DGCL which states that when a board is required to "approve or take other action with respect to any agreement, instrument or document, such agreement, instrument or document may be approved by the board of directors in final form *or in substantially final form*."[205] According to the amendments' accompanying synopsis, Section 147 "is intended to enable a board of directors to approve an agreement, instrument or document if, at the time of board approval, all of the material terms are either set forth in the agreement, instrument or document or are determinable through other information or materials presented to or known by the board." Thus, Section 147 relaxes the *Activision* court's interpretation of DGCL Section 251(b) — which held that boards must approve the final execution version of a merger agreement — to better conform with common corporate practice.

The amendments also include a new Section 268 of the DGCL. Section 268(a) details the limited contexts in which an agreement of merger need not include "any provision regarding the certificate of incorporation of the surviving corporation."[206] The accompanying legislative synopsis adds that this "this amendment will provide flexibility to a buyer in a typical 'reverse triangular merger' to adopt the terms of the certificate of incorporation of the corporation that, following the effectiveness of the merger, will be wholly owned and controlled

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204. *Id.* at *7–8 (internal citations omitted) (quoting *Moelis*, 311 A.3d at 877).

205. DEL CODE ANN. tit. 8, § 147 (emphasis added).

206. DEL CODE ANN. tit. 8, § 268(a).

by the buyer."[207] Section 268(b) further adds that, unless stated otherwise in the agreement of merger, disclosure letters, disclosure schedules, or any similar documents or instruments will not be considered part of the merger agreement.[208] According to the accompanying legislative synopsis, this provision "reflects the fact that disclosure schedules and similar documents frequently operate as extrinsic facts incorporated by reference into the agreement but are not themselves part of the agreement and, as such, may be negotiated and prepared by officers and agents at the direction of the board of directors without the need, as a statutory matter, for formal approval by the board of directors."[209] Also new Section 232(g) was amended to provide that materials attached to and included with a notice to stockholders were deemed to be part of the notice of DGCL compliance purposes.

The DGCL amendments became effective on August 1, 2024. They apply to (a) all contracts made by a corporation; (b) all agreements, instruments or documents approved by the board of directors; and (c) all merger and consolidation agreements entered into by a corporation — in each case — whether approved or entered into on or before August 1, 2024. Notably, they do not apply to or affect any civil action or proceeding completed or pending on or before August 1, 2024. In those cases, the law pre-dating the amendments applies.[210]

d. *Stream TV Networks, Inc. v. SeeCubic, Inc.*

In another case involving the interpretation of a charter and a statute, *Stream TV Networks, Inc. v. SeeCubic, Inc.*,[211] the Delaware Supreme Court addressed whether approval of a corporation's Class B stockholders was required to transfer pledged assets to secured creditors in connection with what was, in essence, a privately structured foreclosure transaction (the "Omnibus Agreement"). Stream TV Networks, Inc. ("Stream"), along with its founders, argued that the agreement authorizing

207. S.B. 313, 152d. Gen. Assem. (Del. 2024).
208. § 268(b).
209. S.B. 313.
210. The Court of Chancery's decision in *Moelis* has been appealed and the new amendments do not apply to it. *See, e.g.*, Seavitt v. N-Able, Inc., 321 A.3d 516, 556 (Del. Ch. 2024) (stating that, "[t]his case falls into the donut hole, as do *Moelis*, *Wagner*, and a handful of other pending actions.").
211. 279 A.3d 323 (Del. 2022).

the secured creditors to transfer Stream's pledged assets was invalid because Stream's unambiguous certificate of incorporation (the "Charter") required the approval of Stream's Class B stockholders. Stream contended that the court erred in applying a common law insolvency exception to 8 Del. C. § 271 in interpreting the Charter, and that the enactment of Section 271 and its predecessor superseded any common law exceptions. It further argued that, in any event, such a "board only" common law exception never existed in Delaware.[212]

The Delaware Supreme Court agreed that a majority vote of Class B stockholders was required under Stream's Charter. In reversing, the Court based its holding on "the plain and ordinary meaning of the term 'disposition'" as used in the Charter.[213] Under Stream's Charter, an affirmative vote of the holders of a majority of the then-outstanding shares of Class B stock was necessary to consummate an Asset Transfer. The Charter defined "Asset Transfer" as:

> [A] sale, lease or other disposition of all or substantially all of the assets or intellectual property of [Stream] or the granting of one or more exclusive licenses which individually or in the aggregate cover all or substantially all of the intellectual property of [Stream].[214]

The parties agreed that the Omnibus Agreement was not a sale or lease of Stream's assets. Rather, the question was whether it was a "disposition" within the meaning of the Charter. By comparison, Section 271 uses the phrase "sell, lease or exchange."[215]

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212. The "board only" insolvency exception would allow directors of an insolvent (or "failing") corporation to transfer all the assets of the company without stockholder approval.

213. *Stream TV Networks*, 279 A.3d at 337.

214. *Id.* at 338.

215. *Id.* Section 271(a) provides:

Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets, including its goodwill and its corporate franchises, upon such terms and conditions and for such consideration, which may consist in whole or in part of money or other property, including shares of stock in, and/or other securities of, any other corporation or corporations, as its board of directors or governing body deems expedient and for the best interests of the corporation, when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon or, if the corporation is a nonstock corporation, by a majority of the members having the right to vote for the election of the members of the governing body and any other members entitled to vote thereon under the certificate

Further, the Charter contained express reference to "intellectual property" and the granting of "exclusive licenses." The Supreme Court observed that the Charter could have simply tracked the language of Section 271, but it did not. The Supreme Court concluded that "the Charter's use of the phrase 'other disposition' has a meaning that is different, and broader, than the term 'exchange.'"[216] Because the Supreme Court disagreed with the Court of Chancery that the relevant language of the Charter tracked the text of Section 271, it declined to look at Section 271 as an interpretive guide in construing the Charter.[217]

That determination then led the Court to the key inquiry — the meaning of "other disposition" which was not defined in the Charter. It began its analysis with the observation that:

> The Court must first attempt to ascertain the parties' intent from the language of the contract. Words or phrases used in a bylaw or charter are to be given their commonly accepted meaning, and this Court often looks to dictionaries to ascertain a term's plain meaning.[218]

The Court reviewed various dictionary definitions of "disposition" and ultimately concluded that the term "other disposition" included the transfer of assets contemplated by the Omnibus Agreement.

Although the Court did not need to further consider Section 271 (and whether, for example a stockholder vote was required under Section 271), it clarified that a common law insolvency exception, if one ever existed in Delaware, did not survive the enactment of Section 271 and its predecessor.[219] The Supreme Court concluded that a "board only" insolvency exception was inconsistent with a statutory default majority vote rule.[220] It relied on "the plain language of Section 271, which contains no exceptions and is not ambiguous."[221]

The Court of Chancery had found that there was a common law exception to the long-established requirement of

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of incorporation or the bylaws of such corporation, at a meeting duly called upon at least 20 days' notice. The notice of the meeting shall state that such a resolution will be considered. DEL CODE ANN. tit. 8, § 271.

216. *Stream TV Networks*, 279 A.3d at 339.
217. *Id.*
218. *Id.* at 339 (quotations omitted).
219. *Id.* at 343.
220. *Id.* at 353.
221. *Id.*

stockholder approval for the directors of a corporation to transfer away substantially all the assets of the business.[222] This exception would allow directors of an insolvent (or "failing") corporation to transfer all the assets of the company without stockholder approval.[223] For evidence of the exception, the Vice Chancellor relied primarily upon several treatises and a Court of Chancery opinion from 1915 citing two of these treatises for a related proposition.[224] Section 271 and its statutory predecessor, Section 64a, did not supersede this common law exception either, the Court of Chancery reasoned, because there is no indication the General Assembly intended to restrict the authority of directors at common law.[225]

Stream TV Networks, appellant and plaintiff below, argued on appeal that 8 Del. C. § 271 superseded any common law insolvency exception.[226] Moreover, it argued "that the ruling, as a matter of public policy, would upset Delaware's contractarian focus and the predictable application of Section 271."[227] The Delaware Supreme Court agreed stating that "Section 271 was intended to occupy the field and that no such insolvency exception survives, assuming *arguendo*, that it existed in the first place."[228] Still, the Court went on to note:

> As a matter of policy, unearthing a "board only" insolvency exception cited only decades ago, and never by any Delaware court, would foster uncertainty and potential inconsistency in a context where predictability is crucial for corporations that have availed themselves of Delaware law. "Our General Assembly has [] recognized the need to maintain balance, efficiency, fairness, and predictability in protecting the legitimate interests of all stakeholders, and to ensure that the laws do not impose unnecessary costs on Delaware entities." Promoting stability in our DGCL is and remains of paramount importance.[229]

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222. Stream TV Networks, Inc. v. SeeCubic, Inc., No. 2020-0766-JTL, 2021 WL 5816820, at *6–13 (Del. Ch. Dec. 8, 2021).
223. *Id.* at *13.
224. *Id.* at *6–13.
225. *Id.* at *13.
226. *Stream TV Networks*, 279 A.3d at 336.
227. *Id.*
228. *Id.* at 353.
229. *Id.* at 353–54 (alteration in original) (footnote omitted).

The Court stated that, "[i]nstead, we think, the focus should be on the statute's plain language."[230] As the Court stated that, "[s]tability and predictability are not advanced by reading Section 271 to embody a common law exception that was never the basis of a single holding by any Delaware court nor by other courts, according to the parties, for decades."[231] The Court clarified that there is no insolvency exception today, emphasizing the Court's "policy of seeking to promote stability and predictability in our corporate laws, and with recognition that Delaware is a contractarian state."[232]

D. *Irrevocable Proxies — Daniel v. Hawkins*

In *Daniel v. Hawkins*, the Delaware Supreme Court construed an irrevocable proxy and recognized that "Delaware public policy and law require that the terms of an irrevocable proxy be clear and unambiguous."[233] Accordingly, when confronted with an ambiguity in an irrevocable proxy, Delaware courts do not look to extrinsic evidence.[234] "Rather, they construe the irrevocable proxy in favor of the rights of the beneficial owner of the shares."[235]

The Delaware Supreme Court explained that this rule is rooted in the presumption Delaware courts afford to

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230. *Id.* at 354.

231. *Id.* (alteration added).

232. *Id.* at 355 (footnote omitted). On August 1, 2023, following the Delaware Supreme Court's *Stream TV* holding, the Delaware General Assembly amended DGCL Section 272. The amendment made two notable changes. First, it permits a secured party to effect a sale, lease, or exchange of a corporation's mortgaged/pledged assets without the approval of stockholders if the secured creditor exercises this right under applicable law — such as UCC Article 9. Second, the amendment also provides a safe harbor permitting a corporation to sell, lease, or exchange pledged/mortgaged assets without holding a stockholder vote in certain situations. Specifically, a board may sell, lease, or exchange pledged/mortgaged assets to satisfy a corporation's obligations to a secured party without soliciting stockholder approval if: (i) the value of the assets is less than or equal to the total amount of the corporation's liabilities/obligations being eliminated or reduced (the "Asset Value Test"); and (ii) the sale, lease, or exchange is not prohibited by the law governing such mortgage or pledge. *See* DEL CODE ANN. tit. 8, § 272(b). This amendment was proposed following the *Stream TV* decision and addresses the constraints of Section 271 that were highlighted in that decision.

233. (*Daniel II*), 289 A.3d 631, 645 (Del. 2023).

234. *Id.*

235. *Id.* at 648.

stockholders that they "vote in their economic interest."[236] It observed that "[t]his presumption underlies our Delaware courts' preference to defer to the vote of disinterested stockholders."[237] And because "[t]he legitimizing influence of a stockholder vote is premised upon the alignment of the economic and voting interests of stockholders," early Delaware courts were suspect of arrangements that split economic interests in shares from the voting interests of shares.[238] The Court then recognized that "by its very nature, a proxy, which temporarily splits the power to vote from the residual ownership claim of the stockholder, has the potential to create misalignment between the voting interest and the economic interest of shares."[239] And the risk of misalignment is enhanced where the proxy is irrevocable, and even more so when the proxy runs with the shares in a subsequent sale.[240]

Although the Court noted that Delaware courts' approach to such arrangements have liberalized over the years,[241] the Court agreed with the Court of Chancery's statement in *TR Investors, LLC v. Genger* that proxies "[h]istorically have been interpreted narrowly and when there is an ambiguity, read as not restricting the right to vote the shares."[242] With this Delaware rule in mind, the *Daniel* Court turned to the question posed by the *Daniel* litigants.

The question before the Court was whether an irrevocable proxy, which gave appellant W. Bradley Daniel ("Daniel")

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236. *Id.* at 645 (quoting Hawkins v. Daniel (*Daniel I*), 273 A.3d 792, 808 (Del. Ch. 2022)).

237. *Id.* at 646; *see also* Corwin v. KKR Fin. Hldgs. LLC, 125 A.3d 304, 313–14 (Del. 2010); *In re* Lear Corp. S'holder Litig., 926 A.2d 94, 114–15 (Del. Ch. 2007).

238. *Daniel II*, 289 A.3d at 646. Other such arrangements include vote-buying arrangements and voting trusts. *See* Shreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982); Crown EMAK Partners LLC v. Kurz, 992 A.2d 377, 389 (Del. 2010).

239. *Daniel II*, 289 A.3d at 648.

240. *Id.*

241. *Id.* (citing Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 7 (Del. 1981)).

242. *Id.* (quoting (*Genger Trial*), No. 3994-VCS, 2010 WL 2901704, at *20 (Del. Ch. July 23, 2010), *aff'd,* 26 A.3d 180 (Del. 2011)). In *Genger Trial*, the Delaware Court of Chancery confronted the same question: whether an irrevocable proxy had run with the underlying shares in a sale to a third party. The Court of Chancery held that the plain language of the irrevocable proxy there indicated that it did not run with its underlying shares. The Delaware Supreme Court affirmed. *See* Genger v. TR Invs., LLC (*Genger*), 26 A.3d 180, 190 (Del. 2011).

voting power over all 100 shares of N.D. Management, Inc. ("Danco GP") (the "Irrevocable Proxy"), would bind a third-party buyer of such Danco GP Shares. The appellee, Mrs. Sharon Hawkins ("Mrs. Hawkins"), wished to purchase the underlying Danco GP shares (the "Proxy Shares") free and clear of the Irrevocable Proxy, and, accordingly, filed suit against Daniel requesting a declaratory judgment that the Irrevocable Proxy would terminate upon a sale.[243]

The Court of Chancery, relying on *Genger* and *Genger Trial*, found that the plain language of the Irrevocable Proxy did not unambiguously provide that it would survive a sale of the Proxy Shares to an unaffiliated third party.[244] On appeal, Daniel did not dispute the Delaware rule that irrevocable proxies are construed narrowly. Instead, he argued that the Court of Chancery erred in interpreting the Irrevocable Proxy by erroneously relying on the Restatement (Third) of Agency instead of the Irrevocable Proxy's plain language, which he argued unambiguously provided that the Irrevocable Proxy would run with the shares in a sale.

The Delaware Supreme Court ultimately agreed with the Court of Chancery, at least to the extent that the Irrevocable Proxy was ambiguous, and accordingly construed the Irrevocable Proxy against the proxyholder, Daniel.[245] Instead of relying on the Restatement (Third) of Agency as an interpretive guide, the Delaware Supreme Court relied on the Court of Chancery's three unchallenged findings about the Irrevocable Proxy's plain language, which supported an interpretation that the Irrevocable Proxy *did not* run with the underlying shares.

First, the definitions of "Stockholder" and "Shares" in the Irrevocable Proxy "cabin[ed] the applicability of the Irrevocable Proxy" to shares owned by persons agreeing to be bound by the Irrevocable Proxy.[246] *Second*, by its plain language, the

243. The facts of the case are complex, primarily due to a convoluted corporate governance structure. Importantly, whoever controlled Danco GP would control two sub-entities, including the operating entity that distributed profits to Danco GP and its owners. Danco GP was 75% owned by another entity, MedApproach, L.P., in which Mrs. Hawkins owned an 88% interest. The litigation in the Court of Chancery was spurred by the dissolution of MedApproach, L.P., which gave Mrs. Hawkins the opportunity to purchase its assets in the winding up process, including the 75% interest in Danco GP.

244. *Daniel I*, 273 A.3d at 832–33.

245. *Daniel II*, 289 A.3d at 656–57.

246. *Id.* at 650.

provision appointing the proxy holders only did so with respect to the Proxy Shares owned by someone agreeing to be bound by the Irrevocable Proxy at the time of a stockholder vote.[247] *Finally*, the Irrevocable Proxy contained an addendum that expressly bound a subsequent owner to the Irrevocable Proxy, which the Delaware Supreme Court found indicative of an intent for the Proxy Shares to run free and clear of the Irrevocable Proxy upon their sale.[248]

On the other hand, none of the provisions that Daniel argued supported his interpretation, including the provision governing termination of the proxy and the provision governing assignment of rights under the proxy, overcame the foregoing plain language and unambiguously stated the proxy shall run with the shares in a sale.[249] Accordingly, the Delaware Supreme Court affirmed the Court of Chancery's judgment. In doing so, it reaffirmed the principal stated in *Genger Trial*: In Delaware, irrevocable proxies will be construed narrowly, and absent plain and unambiguous language to the contrary, will be construed in favor of the beneficial owner of the shares.

II.
Deviations from Plain Language

In certain discrete areas, our Delaware courts have indicated a willingness to depart from a strong focus on a corporate instrument's plain language. I identify a few next.

A. *The Reasonable Expectations Doctrine — Ferrellgas*

In *Ferrellgas Partners, L.P. v. Zurich American Insurance Co.*,[250] our Court considered whether a run-off exclusion in an insurance policy barred coverage. In the course of affirming the Superior Court's determination that it did, we considered the appellant's contention that even if the policy were not ambiguous, it should be construed in a way that permits coverage consistent with the Reasonable Expectations of the Insured ("REI") doctrine. We observed that "[b]ecause an insurance

247. *Id.* at 651.
248. *Id.* at 651–52.
249. *Id.* at 645, 653.
250. 319 A.3d 849 (Del. 2024).

policy is an adhesion contract and is not generally the result of arms-length negotiation, courts have developed rules of construction which differ from those applied to most other contracts."[251] "A fundamental premise of the doctrine is that 'the policy will be read in accordance with the reasonable expectations of the insured so far as its language will permit.'"[252] We noted that our own case law was unclear as to whether the doctrine applies only after a determination that the insurance contract is ambiguous.[253] But because the appellant's theories could not prevail under any of the proffered interpretations of the doctrine, we did not reach that issue.[254]

B. *Boilerplate in Bond Indentures*

Courts addressing bond transactions have sometimes deviated from plain language interpretations. These courts' willingness to do so generally revolves around efficiency concerns for capital markets. On some occasions, courts have interpreted the plain language of bond transactions in ways surprising to those regularly practicing in the area. Lawyers are no strangers to boilerplate — defined as "ready-made or all-purpose language that will fit in a variety of documents"[255] — and boilerplate can have its virtues. It may be cheaper than crafting agreement-specific language for each transaction and it may already have meanings well-defined by the courts. But boilerplate's vices have occasionally wreaked havoc in significant ways, as they did in the sovereign bond markets after an unexpectedly influential court case.

1. *The Three and a Half Minute Transaction*

In *The Three and a Half Minute Transaction*, authors Mitu Gulati and Robert E. Scott sought to unearth the history

251. *Id.* at 869.
252. *Id.* (internal quotation omitted).
253. *Id.* at 869–70.
254. *Id.* at 869 n.140 ("We need not today definitively resolve the unsettled state of our Delaware case law because even applying *Hallowell's* arguably broader formulations, as opposed to *Stom's* narrower formulation, *Ferrellgas* would not prevail.").
255. Bryan A. Garner, Garner's Dictionary of Legal Usage 115 (3d ed. 2011).

and understanding of *pari passu* clauses in sovereign bond transactions.[256] *Pari passu* clauses are examples of sticky boilerplate — "standardized clauses that have been used by rote over long periods of time — often remain[ing] unchanged, even when a court decision has created uncertainty regarding the clauses' meaning."[257] And in 2000, a Belgian court granted just such a decision.

That year, Elliott Associates, in *Elliott Associates v. Peru*,[258] sought an *ex parte* injunction in a Belgian court in an effort to obtain payment on Peruvian sovereign bonds.[259] Elliott had purchased the bonds at a deep discount and refused to participate in a settlement agreed to by other bondholders.[260] Because of this refusal, Peru sought to pay the settling bondholders, but not Elliott.[261] Elliott pointed to the bonds' *pari passu* clause[262] to argue that Peru could not selectively pay its bondholders and that the court should grant an injunction preventing Peru from paying its other bondholders through Belgium-based Euroclear.[263] In a decision that shocked the legal community and threw sovereign bond markets into chaos, the court granted the injunction and, before it could be appealed, political instability led the Peruvian president to settle the case.[264] Thus, this decision continued to stand as the leading persuasive authority on *pari passu* clauses and capital markets were left to process its chaotic effects.[265]

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256. MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION (2013). As for the title of the book, the authors explain that:

"Three and a half minutes" is one explanation that was candidly offered to us by a lawyer who sought to explain the trade-off between the time it took to "draft a new contract" and the effort costs of redesigning boilerplate that was widely used and had been part of the standard-form contract for many years. But "three and a half minutes" is also a metaphor for a business model that relies on herd behavior, fails to provide incentives for innovation and thus rises and falls on volume-based, cookie-cutter transactions. *Id.* at 6.

257. *Id.* at 10–11.

258. General Docket No. 2000/QR/ 92 (Ct. App. Brussels, 8th Chamber, Sept. 26, 2000).

259. GULATI & SCOTT, *supra* note 256, at 12.

260. *Id.* at 13.

261. *Id.* at 12–13.

262. *Pari passu* is defined as "with equal pace; equally; at the same time." GARNER, *supra* note 255, at 654.

263. GULATI & SCOTT, *supra* note 256, at 12.

264. *Id.* at 12–16.

265. *Id.* at 16–17.

This interpretation of *pari passu* clauses lead to widespread concerns about market stability.[266] Until 2000, sovereigns were strongly positioned to resist creditors' demands. Collecting on judgments against sovereigns was difficult and sovereigns were well-positioned to force settlements on creditors by only paying creditors who agreed.[267] But *Elliott* threw this into doubt. Although seizing sovereign property remained difficult, *Elliott* held that creditors could attack the payments made to other creditors of the sovereign, potentially nullifying sovereigns' abilities to create effective settlements of sovereign bonds.[268] If this decision gained traction, sovereigns may no longer be able to force holdout creditors' hands, giving holdout creditors the power to throw a wrench in the gears of sovereign debt reorganization.

Yet, the presence of the chaos-threatening *pari passu* clauses in sovereign bond transactions did not change. Gulati and Scott's research showed that even after *Elliott*, *pari passu* clauses could be found in well over ninety percent of sovereign bonds.[269] These clauses had been in low and growing usage since 1871,[270] but they spiked to include a majority of sovereign bonds in the post-war era.[271] As of the book's writing, such clauses were virtually universal in sovereign bond transactions and often featured on the front-page of the document.[272]

With such standard usage of these clauses, Gulati and Scott figured they could track down the origin and meaning of them by interviewing the lawyers who regularly used them in sovereign bond transactions.[273] But this assumption proved false. The authors interviewed hundreds of lawyers in the field but could not find a consistent story that explained the clause.[274] Instead, the authors found many theories but few definite facts regarding the clauses' history and understanding.[275]

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266. *Id.*
267. *Id.* at 12.
268. *Id.*
269. *Id.* at 122.
270. *Id.* at 118.
271. *Id.* at 122.
272. *Id.* at 2–3.
273. *Id.* at 5–6.
274. *Id.* The authors observed, after speaking with a sample of New York lawyers who worked on sovereign debt contracts that, "[i]nstead of a straightforward agency problem or other market failure explanation, these hardnosed Wall Street lawyers told us stories about rituals, talismans, alchemy, the search for the Holy Grail, and Zeus." *Id.* at 5.
275. *Id.* at 178.

Explanations for the clauses' persistence varied. Some were based on institutional factors, including the refrain that associates working on the transactions did not have the power to remove them as lawyering has become increasingly commoditized.[276] Others were based on the risk that changing the clause would implicitly accept *Elliott*'s view of the existing clause.[277] But, regardless of the reason, these boilerplate *pari passu* clauses remained sticky with the key lawyers involved having little understanding of their meaning.[278]

The ghost of *Elliott* came back to haunt the market in *NML Capital, Ltd. v. Republic of Argentina*.[279] NML Capital, an Elliott subsidiary, had acquired Argentine sovereign bonds with *pari passu* clauses and refused to participate in Argentina's exchange offer.[280] To induce creditors to accept the exchange, Argentina refused to make payments on non-exchanged bonds, including those acquired by NML.[281] At the district court, NML sought and obtained an injunction requiring Argentina, through its New York agents, to pay the non-exchanged bonds on a "ratable" basis.[282] In reaching its decision, the district court cited the *pari passu* clause.[283]

Argentina appealed to the Second Circuit which affirmed the district court.[284] The Second Circuit rejected Argentina's argument that customary usage of the clause weighed in Argentina's favor writing "the preferred construction of *pari passu* clauses in the sovereign debt context is far from general, uniform and unvarying[.]"[285] After citing several commentators demonstrating a lack of agreement on what the clauses meant, the court analyzed it under New York contract law and affirmed the injunction.[286]

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276. *Id.* at 91 (observing that, "[m]ultiple respondents told stories of their frustration with the increased commoditization of the contract-drafting process in the modern era of the big law firm.").

277. *Id.* at 90.

278. *Id.* at 178.

279. 699 F.3d 246 (2d Cir. 2012); *see also* GULATI & SCOTT, *supra* note 256, at 170–77.

280. GULATI & SCOTT, *supra* note 256, at 170–71.

281. *NML Capital*, 699 F.3d at 252; *see also* GULATI & SCOTT, *supra* note 256, at 171.

282. *NML Capital*, 699 F.3d at 254; *see also* GULATI & SCOTT, *supra* note 256, at 175.

283. *NML Capital*, 699 F.3d at 254.

284. *Id.*

285. *Id.* at 258 (internal quotation omitted).

286. *Id.* at 258–60.

2. *Interpreting Debenture Boilerplate Language in Delaware*

In *Bank of New York Mellon Trust Co. v. Liberty Media Corp.*,[287] the Delaware Supreme Court faced the challenge of applying plain-language principles to boilerplate language. In that case, Liberty Media sought to split off part of its assets as part of a plan to create a new publicly traded company.[288] This attempted split off followed three others as Liberty sought to reorganize its holdings.[289] But Liberty faced a challenge: its outstanding indentures contained a Successor Obligor Provision that risked creating an event of default if Liberty transferred "substantially all" of its assets.[290] Indeed, an anonymous Liberty bondholder sent Liberty a letter alleging that the split off would trigger the Provision because "Liberty has pursued a 'disaggregation strategy' designed to remove substantially all of Liberty's assets from the corporate structure against which the bondholders have claims, and shift those assets into the hands of Liberty's stockholders."[291]

The boilerplate at issue was the "series of transactions" language in the Successor Obligor Provision. The Trustee argued that this language allowed a court to aggregate transactions to meet the definition of splitting off "substantially all" of Liberty's assets.[292] Liberty contended that this language required either a single transaction or a series of *integrated* transactions.[293] To support its position, Liberty cited *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*[294] — a Second Circuit case interpreting the "substantially all" language in debentures as requiring a single transaction or a series of integrated transactions.[295] Although, *Sharon Steel* did not use the "series of transactions" language, Liberty pointed to the *Revised Model Simplified Indenture*'s commentary and reference to *Sharon Steel* to support its argument.[296]

In an opinion written by Justice Holland, the Court accepted Liberty's argument giving weight to a uniform interpretation of boilerplate. The Court wrote that "[s]uccessor obligor

287. 29 A.3d 225 (Del. 2011).
288. *Id.* at 227.
289. *Id.*
290. *Id.*
291. *Id.*
292. *Id.* at 228.
293. *Id.* at 242.
294. 691 F.2d 1039 (2d Cir. 1982).
295. *Bank of N.Y. Mellon*, 29 A.3d at 237–38.
296. *Id.* at 241–42.

provisions in bond indentures consist of market-facilitating boilerplate language. Courts endeavor to apply the plain terms of such provisions in a uniform manner to promote market stability."[297] Next, the Court accepted that "boilerplate provisions in indentures are not the consequence of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties to an indenture."[298] Finally, the Court emphasized the uniform interpretation of boilerplate provisions in indentures writing that "in interpreting boilerplate indenture provisions, 'courts will not look to the intent of the parties, but rather the accepted common purpose of such provisions.'"[299]

In ruling for Liberty, the court looked to the interpretation of the "substantially all" boilerplate in *Sharon Steel*. There, the Second Circuit held that the transactions had to be integrated to trigger the "substantially all" provision of indentures.[300] In alignment with *Sharon Steel*, Justice Holland's opinion held that because Liberty's splitoffs were separate — not integrated — transactions, they did not trigger the "substantially all" provision.[301] Accordingly, the Successor Obligor Provision was not triggered and Liberty could proceed with the splitoff without causing an event of default.

3. *Boilerplate Beyond Debentures*

Delaware courts have also addressed the issue of boilerplate disclaimers, occasionally treating them differently than transaction-specific disclaimers. But should courts treat boilerplate disclaimers differently and does it matter if the parties are well-counseled and sophisticated? Treating boilerplate differently is not new. Professor Llewllyn contrasted boilerplate with bargained-for terms noting that consent to boilerplate is "on the implicit assumption and to the full extent that (1) it does not alter or impair the fair meaning of the dickered terms when read alone, and (2) that its terms are neither in the particular

297. *Id.* at 241.
298. *Id.* (internal quotations omitted).
299. *Id.* (citing Dennis J. Connolly & William Hao, *X Marks The Spot: Contractual Interpretation of Indenture Provisions*, 17 J. BANKR. L. & PRAC. 6 ART. 1, 12 (2008)).
300. *Id.* at 238 (discussing Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039 (2d Cir. 1982)).
301. *Id.* at 241–43.

nor in the net manifestly unreasonable and unfair."[302] And, as Gulati and Scott's research shows, even sophisticated parties may be unaware of the history and meaning of boilerplate.[303]

The Delaware Supreme Court addressed the validity of boilerplate disclaimers for unsophisticated party transactions in *Norton v. Poplos*.[304] In *Norton*, a buyer attempted to rescind a real estate purchase contract by alleging seller misrepresentation and the seller defended by invoking a boilerplate disclaimer.[305] The Court rejected this use of the boilerplate disclaimer noting that "[w]e see no reason why a court of equity should enforce a standard 'boiler plate' provision that would permit one who makes a material misrepresentation to retain the benefit resulting from that misrepresentation at the expense of an innocent party."[306]

But sophisticated parties have found little success with citing *Norton* in Delaware courts. In *Great Lakes Chemical Corp. v. Pharmacia Corp.*, the Delaware Court of Chancery distinguished *Norton* noting that *Great Lakes Chemical Corp.* involved "two highly sophisticated parties, assisted by industry consultants and experienced legal counsel, entered into carefully negotiated disclaimer language after months of extensive due diligence."[307] Further, "[i]n limiting *Norton* to its facts, Delaware courts have held since [*Norton*] that 'such disclaimer provisions are enforceable when the parties to the agreement are sophisticated entities that carefully negotiated its provision.'"[308] Thus, *Norton*'s applicability to boilerplate appears limited and sophisticated parties have struggled to extend it beyond the unsophisticated party context.

Aside from boilerplate in bond indentures, there are decisions by the Delaware courts where the courts have considered custom and practice in ascertaining the meaning and purpose

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302. Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 371 (1960); *see also* Russell A. Hakes, *Focusing on the Realities of the Contracting Process — An Essential Step to Achieve Justice in Contract Enforcement*, 12 Del. L. Rev. 95, 114 (2011).

303. Gulati & Scott, *supra* note 256, at 122.

304. 443 A.2d 1 (Del. 1982).

305. *Id.* at 4.

306. *Id.* at 7.

307. 788 A.2d 544 (Del. Ch. 2001).

308. Transdigm Inc. v. Alcoa Global Fasteners, Inc., No. 7135–VCP, 2013 WL 2326881, at *10 (Del. Ch. May 29, 2013) (quoting Progressive Int'l Corp. v. E.I. Du Pont de Nemours & Co., No. 19209, 2002 WL 1558382, at *7 n.36 (Del. Ch. July 9, 2002).

of provisions that have become standardized in transaction agreements, at least to the extent past practices are reflected in model transaction agreements. In *HControl Holdings LLC v. Antin Infrastructure Partners S.A.S.*, the Court of Chancery observed that "'[i]n an M&A transaction, agreements are not created from scratch. Instead, they are based on provisions negotiated in prior deals and past practices' and lawyers 'negotiate provisions with knowledge of these past practices.'"[309] It is not uncommon for the Delaware courts to refer to model transaction agreements and related commentary in ascertaining the purpose of certain provisions.[310]

C. *Strategic Use of Proxlity, Complexity and Vagueness ("Tripwires")*

1. *Advance Notice Bylaws — Kellner*

Now we return to *Kellner* and to the notion of linguistic "tripwires."[311] To the extent the defendants in *Kellner* argued to the Court of Chancery that the 2023 amendments to the AIM

309. No. 2023-0283-KSJM, 2023 WL 3698535, at *24 (Del. Ch. May 29, 2023) (quotation omitted).

310. *See, e.g.*, Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824, 831 n.29 (Del. 2021) (citing ABA Mergers & Acquisitions Comm., Model Stock Purchase Agreement with Commentary 302–03 (2d ed. 2010)) (analyzing the indemnification section of a Stock Purchase Agreement and how the inclusion of one undefined term alters the mental state required for fraud); Manti Holdings, LLC v. Authentix Acquisition Co., Inc., 261 A.3d 1199, 1241 (Del. 2021) (Valihura, J., dissenting) (citing the National Venture Capital Association's Model documents when discussing policy concerns with using stockholder agreements to effect *ex ante* waivers of appraisal rights for common stockholders); AB Stable VIII LLC v. Maps Hotels and Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *91 (Del. Ch. Nov. 30, 2020) (citing ABA Mergers & Acquisitions Comm., Model Stock Purchase Agreement with Commentary 212 (2d ed. 2010)); Lou R. Kling & Eileen T. Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions § 13.06, at 13–47 (2020 ed.)) (analyzing whether a party breached a Reasonable Efforts Covenant); Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *46–49 (Del. Ch. Oct. 1, 2018) (citing ABA Mergers and Acquisitions Comm., Model Merger Agreement for the Acquisition of a Public Company (2011)) (determining what is "material" regarding a material adverse effect clause); Fortis Advisors LLC v. Johnson & Johnson, No. 2020-0881-LWW, 2024 WL 4048060, at *22 (Del. Ch. Sept. 4, 2024) (citing ABA Mergers & Acquisitions Comm., Model Stock Purchase Agreement with Commentary 213 (2d ed. 2010)) (holding that variations of efforts clauses—particularly those using the term "reasonable"—are largely interchangeable).

311. Kellner v. AIM ImmunoTech, Inc., 320 A.3d 239 (Del. 2024).

advance notice bylaws comported with "market practice,"[312] the opinion offers guidance in finding that several of them operated unreasonably and one was "unintelligible."

Notably, our Court affirmed the invalidity of an "ownership" provision which was a 1,099-word run-on sentence with 13 subsections directed to disclosure interests in AIM and "any principal competitor" of AIM. The Court of Chancery commented that it "cannot say whether the Ownership Provision would choke a horse," but that "it has certainly flummoxed this judge."[313] Further, although the trial court "tried to read and understand it, the bylaw — with its 1,099 words and 13 subparts — is indecipherable."[314] As the Court of Chancery found, "[a] provision requiring a stockholder to disclose such information seems perfectly legitimate[,]" but the problem for AIM was that "the Ownership Provision as drafted sprawls wildly beyond this purpose."[315]

With regard to the as-applied challenge to the adoption of the bylaws, our Court credited the trial court's findings the AAU (Agreement, Arrangement and Understanding) provision "functioned as a 'tripwire' rather than an information-gathering tool and 'suggest[ed] an intention to block the dissident's effort.'"[316] We agreed that the Consulting/Nomination Provision was unreasonable because it imposed "ambiguous requirements" across a lengthy term.[317] And we agreed that the Known Supporter Provision "'impedes the stockholder franchise while exceeding any reasonable approach to ensuring thorough disclosure.'"[318]

2. *Rights Plans — Williams*

In *Williams Companies Stockholder Litigation,* the Court of Chancery considered several challenges to a stockholder rights plan. The plan, adopted during the COVID-19 pandemic, was, at the time, "unprecedented in that it contain[ed] a more extreme combination of features than any pill previously evaluated by this court—a 5% trigger threshold, an expansive definition of

312. Kellner v. AIM ImmunoTech, Inc, 307 A.3d 998, 1034 (Del. Ch. 2023) (referring to similar provisions as "very common").
313. *Id.*
314. *Id.*
315. *Id.*
316. *Kellner*, 320 A.3d at 265.
317. *Id.* at 266.
318. *Id.*

'acting in concert,' and a narrow definition of 'passive investor.'"[319] The Court of Chancery, in describing the plan's key features as "extreme," found, for example, that the plan's definitions of "beneficial ownership" and "acting in concert" went well beyond default federal definitions.[320] The "acting in concert" provision, in the court's view, was the "primary offender" because its "broad language sweeps up potentially benign stockholder communications 'relating to changing *or influencing* control of the Company.'"[321] The provision's language "encompasses routine activities such as attending investor conferences and advocating for the same corporate action.'"[322] This broad language gave the Board discretion to determine whether mundane action such as "exchanging information, attending meetings, [or] conducting discussions" could trigger the Plan.[323]

The Court of Chancery quoted a 2019 analysis by Professors Marcel Kahan and Edward Rock who had expressed concerns over the breadth of some acting-in-concert provisions:[324]

> In their 2019 doctrinal and policy analysis of anti-activist poison pills, Professors Marcel Kahan and Edward Rock express concerns over the breadth of a nearly acting-in-concert provision. In their view, "wolfpack provisions suffer from two fatal flaws, each of which would on its own be sufficient to render them invalid." First, they "do not clearly specify what activities would result in aggregation." Key terms like "parallel," "relating to," and "influencing" are hard to apply, and "plus factors like 'exchanging information' and 'attending meetings'" are quite broad. "Because triggering a pill would have severe adverse consequences, such vague provisions would have a chilling effect on an activist's ability to communicate with other shareholders.

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319. Williams Cos. S'holder Litig., No. 2020-0707-KSJM, 2021 WL 754593, at *1 (Del. Ch. Feb. 26, 2021), *aff'd sub nom.* Williams Cos., Inc. v. Wolosky, 264 A.3d 641, tbl., No. 2020-0707, 2021 WL 5112495 (Del. Nov. 3, 2021).

320. *Id.* at *35.

321. *Id.* at *37.

322. *Id.* (Moreover, "it gloms on to this broad scope the daisy-chain concept that operates to aggregate stockholders even if members of the group have no idea that the other stockholders exist.").

323. *Id.* "In sum, the plan increases the range of Williams' nuclear missile range by a considerable distance beyond the ordinary poison pill." *Id.* at *35.

324. *Id.* at *38 (quoting Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. Rev. 915 (2019)).

> Second, "the very purpose of wolf-pack provisions — to make illicit parallel actions that are not the product of an agreement — is based on a fundamental misconception of how shareholders *ought* to interact." Expounding on this last criticism, the authors explain that "[t]hese sorts of provisions threaten to chill the sort of shareholder interaction upon which sound corporate governance depends and that decades of reform have sought to encourage."[325]

Further, the court described the Passive Investor Definition in the plan as "another easily activated tripwire."[326] Specifically, the court noted that a representative of a major stockholder criticizes Williams for failing to be fully transparent concerning the adoption of the Plan. The court surmised that such communication could be seen as "exercising the power to direct or cause the direction of the management and policies of the Company," thus excluding the major stockholder from the Passive Investor Definition.[327] The court noted that while the Board would likely exempt this major stockholder, other stockholders may not be so fortunate.[328]

The Court of Chancery ultimately declared the plan to be unenforceable, finding that Defendants failed to show that the plan's "extreme, unprecedented collection of features" bore a reasonable relationship to their stated corporate objective.[329] Our Supreme Court summarily affirmed.

III.
New Frontiers for "Plain Language" in the World of AI

I will conclude this article with some musings about potential "new frontiers" in the "plain language" arena.

A. *Judge Newsom's Concurrence in Snell*

At first glance, *Snell v. United Specialty Insurance Co.*[330] seems like a typical case. United Casualty Insurance Company

325. *Id.* at *38 (citations and quotations omitted).
326. *Id.* at *39.
327. *Id.*
328. *Id.*
329. *Id.* at *40.
330. 102 F.4th 1208 (11th Cir. 2024).

("United") refused to defend James Snell, a landscaper, in a civil lawsuit alleging that Snell had negligently installed a ground-level trampoline in a client's backyard.[331] Snell sued, contending that United had breached its insurance contract with him in bad faith and sought a declaratory judgment that United had a duty to defend and indemnify him.[332]

The district court granted summary judgment for United, holding that the accident did not arise from Snell's "landscaping" work within the meaning of his commercial general liability policy.[333] In reaching this conclusion, the district court noted that the policy did not define "landscaping," and that the "common, everyday meaning of the word" did not include trampoline installation "even [under] the definitions submitted by Snell in his briefing."[334] The Eleventh Circuit affirmed.[335]

Snell could have ended there, but a concurrence by Judge Newsom made this case stand out from the pack of plain language insurance disputes. Rather than being content with the traditional plain language tool of the dictionary, Judge Newsom offered a "modest proposal."

> Those, like me, who believe that "ordinary meaning" is *the* foundational rule for the evaluation of legal text should consider – *consider* – whether and how AI-powered large language models like OpenAI's ChatGPT, Google's Gemini, and Anthropic's Claude might – *might* – inform the interpretive analysis.[336]

Judge Newsom noted that "many will reflexively condemn [it] as heresy" and recognized that "having thought the unthinkable, I've said the unsayable."[337]

Judge Newsom then took a fresh approach using large language models to review the definition of "landscaping" as used in the insurance policy and how it fit with the in-ground trampoline. He admitted that his instinct cut against this. Midway through the analysis, he asked: "*Is it absurd to think that ChatGPT might be able to shed some light on what the term "landscaping"*

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331. *Id.* at 1211.
332. *Id.*
333. *Id.*
334. *Id.* at 1213.
335. *Id.* at 1211.
336. *Id.* at 1221 (Newsom, J., concurring) (emphasis in original).
337. *Id.*

means?"[338] His immediate answer was that it was "positively absurd."[339] But after thinking more deeply on it, he considered it less absurd than it seemed.[340]

Judge Newsom's method may be new, but his philosophy of using plain language is not. He describes himself as "unabashedly a plain-language guy — firmly of the view that '[t]he ordinary meaning rule is the most fundamental semantic rule of interpretation' and that it should govern our reading not only of 'constitutions, statutes, [and] rules,' but also, as relevant here, of 'private instruments.'"[341] And he used the LLMs for the plain language purpose of discerning the ordinary meaning of "landscaping."[342]

Judge Newsom's concurrence will undoubtedly inspire a plethora of more in-depth articles on AI and plain language interpretation, but I wish to briefly address a few points here.

First, the LLM search obtained results and notably, they differed from the conclusions reached by the Majority. His research into dictionary definitions revealed that Webster's defined "landscaping" as "to modify or ornament (a natural landscape) by altering the plant cover." Merriam-Websters defined it to mean, as did Oxford, "improv[ing] the aesthetic appearance of (an area) by changing its contours, adding ornamental features, or by planting trees and shrubs."[343] After "languishing in definitional purgatory," Judge Newsom found no single discerning criterion. That is when he turned to ChatGPT. Upon asking ChatGPT "Is installing an in-ground trampoline 'landscaping?'", ChatGPT answered that it was and briefly explained its answer.[344] According to ChatGPT:

> **Response:** Yes, installing an in-ground trampoline can be considered a part of landscaping. Landscaping involves altering the visible fixtures of an outdoor area for aesthetic or practical purposes, and adding an in-ground trampoline would modify the appearance

338. *Id.* at 1222.
339. *Id.*
340. *Id.*
341. *Id.* at 1222–23 (quoting ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 69 (2012)).
342. *Id.* at 1222.
343. *Id.* at 1223 (citing MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 699 (11th ed. 2014); OXFORD DICTIONARY OF ENGLISH 991 (3d ed. 2010)).
344. *Snell*, 102 F.4th at 1225.

> and function of the space. It's a deliberate change to the outdoor environment, often aimed at enhancing the overall landscape and visibility of the area.[345]

And Google's Bard (since replaced by Gemini) returned a similar result to Judge Newsom's question.[346]

Second, Judge Newsom's concurrence also sketched out his view of the benefits and risks of using LLMs. Notably, this was done with the assumption that LLMs would not replace other sources, but would be "one implement among several in the textualist toolkit[.]"[347] As Judge Newsom wrote, the benefits of LLMs include that they train on ordinary language inputs, can "understand" context, are accessible, and have relatively transparent research.[348] Finally, Judge Newsom credited the wide-ranging surveying ability of LLMs that could give judges and lawyers a resource to effectively poll ordinary citizens in a way not possible with traditional methods.[349]

Judge Newsom also addressed several potential drawbacks of LLMs. These drawbacks included LLM's potential to "hallucinate," their failure to capture offline speech and usages of underrepresented populations, concern over manipulation by interested parties, and the potential for LLMs to create a dystopia of algorithmic "robo-judges[.]"[350] Judge Newsom took these concerns seriously but concluded they could be mitigated by keeping the traditional tools in the interpretation toolkit alongside LLM datapoints.[351]

No doubt, there are a host of issues raised by judicial officers and lawyers using generative AI. These range from ethical issues, data security issues and technical competence, among many others.[352] Some uses by judicial officers may be acceptable

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345. *Id.*
346. *Id.*
347. *Id.* at 1226.
348. *Id.* at 1226–30.
349. *Id.* at 1230.
350. *Id.* at 1230–32.
351. *Id.* at 1232.
352. A number of ethics opinions have addressed the use of AI. *See, e.g.*, The Fla. Bar, Florida Bar Ethics Opinion 24–1, at 4 (Jan. 19, 2024), https://www.floridabar.org/etopinions/opinion–24–1 (last visited Apr. 23, 2024). Responsible use of generative AI technology also requires an understanding of how it operates and a solid understanding of best practices. *See* National Center for State Courts, *Interim Guidance: Developing an Internal Use Policy* (April, 2024), https://ncsc.org/__data/assets/pdf_file/0042/99978/ncsc-ai-rrt-developing-policies-april-2024.pdf (last visited Jan. 11, 2025).

to achieve certain efficiencies. However, judicial officers should not use AI services to reach a decision or determine the outcome of a case or disputed issue. Guidelines on the assessment and procurement of AI technology are also essential as is training if courts determine to permit certain limited uses by judicial officers.[353]

B. *AI in Drafting Agreements*

The reality is that the legal marketplace may force lawyers to use AI to increase their efficiency in drafting agreements, whether they want to or not.[354] In addition, it will likely significantly affect how judicial officers do their work.[355] Gulati and Scott noted in *The Three and a Half Minute Transaction* that the legal industry is becoming increasingly commoditized with clients not necessarily willing to pay for extra billable hours spent on finessing the nuances of an agreement.[356] Currently, this leads to pre-existing forms and clauses being used for routine transactions.[357] One may question whether clients will be willing to pay for the billable hours necessary to draft certain agreements without the assistance of AI. The result may be agreements with less thought given to their individual clauses – much as the meaning of the *pari passu* clause remained mysterious to the lawyers who used it.[358] The private implementation of technology in the legal field carriers both promises and pitfalls. New technologies have made the legal profession and the judiciary evolve before and the growth of AI will, no doubt, lead to many changes in the way lawyers and judges work.[359]

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353. The Delaware Commission on Law and Technology is an arm of the Delaware Supreme Court charged with providing Delaware lawyers and judges guidance and education relating to technology and best practices for its use. On October 14, 2024, the Commission approved an Interim Policy on the Use of GenAI by Judicial Officers and Court Personnel.

354. *See, e.g.*, RICHARD SUSSKIND, TOMORROW'S LAWYER (Oxford Univ. Press, 3d ed. 2023).

355. *See* CHIEF JUSTICE ROBERTS, 2023 YEAR-END REPORT ON THE FEDERAL JUDICIARY 6 (stating, "I predict that judicial work—particularly at the trial level—will be significantly affected by AI," and that, "[t]hose changes will involve not only how judges go about doing their job, but also how they understand the role that AI plays in cases that come before them.").

356. GULATI & SCOTT, *supra* note 256, at 89–93.

357. *Id.*

358. *Id.*

359. *See generally*, SUSSKIND, *supra* note 354.

IV. Conclusion

I will end my musings about plain language in Delaware corporate law by stating that I continue to be impressed with the quality of lawyering we are so fortunate to have in our Delaware courts. I am confident that our Bar and judicial branch will continue to address new developments promptly and adeptly. Even with the challenges posed by new technologies and increased commoditization, I am confident that there will continue to be a demand for talented lawyers who are willing and capable of addressing difficult issues that arise in drafting and interpreting corporate documents.

In sum, as you have seen, although the interpretative exercise remains anchored in well-established general principles and rules of grammar, there is much room for good-faith differences of opinion on what words mean. It is my sincere hope that those who read this article might benefit in some small way, even if it is to make readers more focused on the importance of the words selected in the corporate drafting exercise. I hope you have enjoyed my foray into the world of "plain language."

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EVOLVING CORPORATE PHILANTHROPY

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With the rise of corporate ESG initiatives and public benefit corporations, corporate philanthropy is evolving from an emphasis on cash contributions (contributional philanthropy) to an emphasis on adjusting operations to advance the public good (operational philanthropy). All forms of corporate philanthropy are controversial, but this article evaluates the impact of this evolution on the relative benefits and concerns of corporate philanthropy, arguing that the shift in emphasis towards operational philanthropy increases the comparative advantage of corporate philanthropy, increases agency costs, both simplifies and complicates shareholder primacy concerns, and increases the difficulty of prescriptively regulating corporate philanthropy through the tax code or otherwise. This article goes on to argue that accurate and transparent disclosure is the key to minimizing the costs and maximizing the benefits of the now ascendant operational philanthropy and concludes by offering a few observations on disclosure-based regulation of operational philanthropy.

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Introduction

The corporate philanthropy landscape is slowly being transformed. As a fraction of profits, corporate cash contributions (contributional philanthropy) have declined significantly over the last forty years.[1] Countering this, however, has been the recent rise of hybrid profit-seeking and philanthropic entities, such as public benefit corporations (PBCs), and, more significantly, the surging phenomenon of traditional corporations embracing environmental, social, and governance (ESG) missions on top of

1. *Infra* note 13 and accompanying text.

their profit seeking role.[2] While PBCs and ESG-embracing firms often engage in contributional philanthropy, these movements are really about companies adjusting their operations to advance the public good (operational philanthropy).[3]

Both contributional and operational philanthropy are controversial. From a corporate governance perspective, each raises shareholder primacy concerns. In the view of many commentators, if corporate profits are to be sacrificed for the public good, these decisions should be made by shareholders, individually, rather than collectively by corporate management.[4] To be sure, neither contributional nor operational corporate philanthropy is necessarily profit sacrificing. For many firms, contributional philanthropy is akin to advertising, generating income that partially or even fully offsets the expenditure. Similarly, some firms embracing ESG missions expect to do well financially by doing good.[5] Almost inevitably, however, some fraction of both forms of corporate philanthropy is profit sacrificing.

A second governance concern is that corporate philanthropy of all varieties increases managerial agency costs. Managers may advance their own interests through corporate philanthropy, whether that be the attainment of a personal warm glow, greater job security, or other personal benefits, rather than solely advancing corporate or societal interests. Countering these concerns and imparting a more positive spin, some commentators have argued that in some circumstances corporations may have a comparative advantage over shareholders or other stakeholders in engaging in philanthropy.

Corporate philanthropy also raises tax issues. Some commentators have lamented the existence of a tax preference favoring corporate, over individual, largess or simply the existence of an uneven tax playing field depending on the channel through which corporate profits are contributed to the public good.[6]

This article reassesses the governance and tax issues surrounding corporate philanthropy in light of the transformation

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2. *Infra* notes 20-24, 28-30 and accompanying text.
3. *Infra* notes 20-24, 28-30 and accompanying text.
4. *Infra* notes 66-68 and accompanying text.
5. Robert P. Bartlett, III & Ryan Bubb, *Corporate Social Responsibility Through Shareholder Governance* 11 (Eur. Corp. Governance Inst., L. Working Paper No. 682, 2023) (using similar language as shorthand for the enlightened shareholder value perspective on corporate governance).
6. *See* discussion *infra* Parts II.C, III.F.

noted above, reaching a number of general conclusions about corporate philanthropy and its current direction. First, the shift from contributional to operational philanthropy is likely to increase the comparative advantage of corporate philanthropy relative to shareholder or other stakeholder philanthropy. Unlike traditional contributional philanthropy, corporate operational philanthropy often cannot be replicated by individual stakeholders of profit maximizing firms. Oil company shareholders, for example, cannot directly opt to leave recoverable oil reserves unrecovered. To be sure, stakeholder cash donations can advance similar goals, but in many cases direct corporate action is likely to be more effective and efficient.[7]

Second, the shift in emphasis from contributional to operational philanthropy likely increases managerial agency costs. Relative to profit-maximizing companies engaging in limited contributional philanthropy, PBCs and ESG-embracing firms countenance greater deviations from shareholder wealth maximization. In addition, operational philanthropy often involves numerous operational and financial decisions that are opaque to outside observers and difficult to monitor. Each of these factors tends to increase the scope for managerial appropriation. Finally, boards are increasingly tying executive pay to ESG performance, which complicates executive pay and adds further scope for managerial value appropriation.[8]

Third, the shift towards operational philanthropy both simplifies and complicates shareholder primacy concerns. By explicitly adopting a social mission separate from shareholder value maximization, PBCs address shareholder primacy directly, and limit it. ESG-embracing companies, on the other hand, often appear to deviate from shareholder primacy, but by embracing a capacious, not exclusively financial, view of shareholder utility and taking into account investor portfolio impacts of externality reductions it is possible to reach reconciliation. Critical to reproachment, however, is the ability of investors and other stakeholders to sort themselves based on individual company and investment fund social priorities.[9]

Fourth, turning to tax, although costs of operational and contributional philanthropy are deductible under different sections of the federal income tax code and subject to different

7. *See* discussion *infra* Part III.C.
8. *See* discussion *infra* Part III.D.
9. *See* discussion *infra* Part IV.

limitations, in practice the tax treatment of the two is largely the same. Corporate philanthropy is deductible at the effective marginal tax rate applicable to the company. The more important takeaway from a tax perspective is that the shift from contributional to operational philanthropy increases the difficulty of taxing gains and losses from corporate charitable activities differently than gains or losses from profit-seeking activities. In other words, the shift makes it increasingly difficult to discourage corporate philanthropy through the tax code, if doing so was desired, and suggests that any leveling of the tax playing field should target the tax treatment of individual, rather than corporate, philanthropy.[10]

In sum, the major concerns arising from the shift from contributional to operational philanthropy are potentially heightened agency costs and conflict with shareholder primacy. Interestingly, the most effective response to both concerns is likely to be the same — accurate and transparent disclosure which helps mitigate agency costs and facilitates sorting by investors (and other stakeholders) based on the social priorities of firms and investment funds.[11] While both the PBC and ESG movements emphasize transparent disclosure of pro-social missions and accomplishments, at present these commitments seem unlikely to significantly mitigate these two concerns. With respect to ESG, however, the SEC has jumped into the fray, issuing proposed or final rules adopting mandatory disclosure regimes related to climate change; diversity, equity, and inclusion; and human capital management. This Article concludes by offering a few observations on disclosure-based regulation of operational philanthropy.[12]

The remainder of this article is organized as follows. Part I describes the ongoing transformation of corporate philanthropy from a focus on charitable contributions to operational adjustments in the public interest. This Part also briefly considers whether corporate philanthropy is profit-sacrificing, concluding that in some cases it is. Part II lays out the issues and concerns

10. *See* discussion *infra* Part IV.C.

11. This article embraces the view that investor autonomy interests are adequately served as long as there exists a set of public corporations with varying financial and social missions, including a set of firms seeking to maximize shareholder value. As a result, the primary corporate governance issues with corporate philanthropy are managerial agency costs and investor sorting, not inconsistency with shareholder primacy, per se.

12. *See* discussion *infra* Part IV.

associated with corporate philanthropy generally, including shareholder primacy, agency costs, comparative advantage, and federal tax subsidization. This Part also discusses the "incidence" of corporate philanthropy asking who bears the cost when corporate philanthropy is profit sacrificing. Part III provides the reassessment that is the heart of this Article, asking how the transformation in corporate philanthropy impacts its comparative advantage, as well as the shareholder primacy, agency cost, and tax concerns of critics. Part IV turns to mitigation of concerns with operational philanthropy offering a few tentative observations with respect to the ongoing project of ensuring that disclosures minimize agency costs and facilitate investor and other stakeholder sorting based on companies' philanthropic efforts and achievements. A conclusion follows.

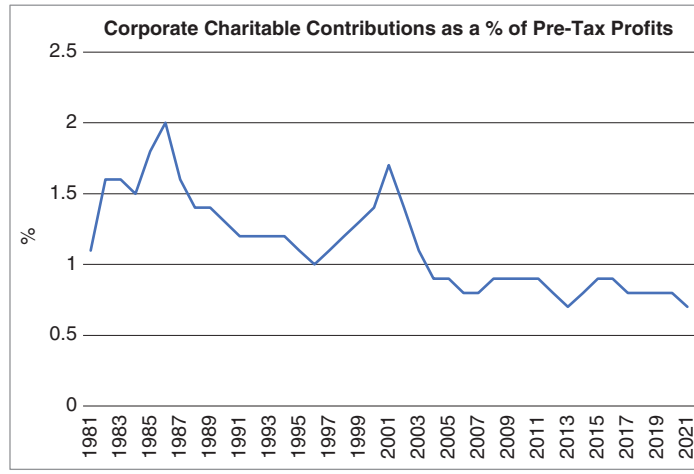
I.
An Evolving Landscape for Corporate Philanthropy

Corporate philanthropy, writ large, is slowly being transformed. As a fraction of corporate profits, traditional "contributional" philanthropy, consisting of cash and some property, such as inventory, has been trending down for decades. Countering this trend, however, has been the recent rise of hybrid entities, such as Public Benefit Corporations (PBCs), that explicitly adopt a social as well as a financial mission and, more significant economically, the adoption of ESG objectives by traditional for-profit corporations. PBCs and ESG-embracing corporations may engage in contributional philanthropy but what sets them apart are their commitments to operate their businesses in ways that promote social objectives (operational philanthropy). Neither contributional nor operational philanthropy are necessarily profit sacrificing. Each can potentially build goodwill and shareholder value over time. But almost certainly some of this philanthropy comes at a cost to shareholders, and even when it does not, philanthropy may shift value between stakeholders. This Part briefly describes these trends and transformations.

A. *Corporate Charitable Contributions*

According to Giving USA, between 2020 and 2021 U.S. corporate charitable giving (contributional philanthropy) increased by a whopping 24% to $21.1 bn, but as a fraction

of pretax profits, contributions slipped from 0.8% to 0.7%.[13] These figures reflect long-term trends. Although corporate giving is somewhat volatile, increases in giving have outpaced inflation over the past 40 years, but, as detailed in the figure below, the fraction of profits contributed has declined from an average of about 1.4% between 1981 to 2000 to about 0.9% between 2001 and 2021.[14] From the perspective of investors, corporate charitable giving has declined in significance over time.



Large corporate donors routinely funnel their charitable giving through separate foundations.[15] Of 230 Fortune 500 firms that reported their charitable giving for 2020, 80% utilized foundations.[16] Direct cash contributions to end-use charities and cash contributions funneled through foundations account for just over three quarters of corporate charitable contributions with the balance coming in various non-cash forms.[17]

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13. Giving USA Found., Giving USA 2022 350, 358 (2022).

14. *Id.*

15. Corporate foundations are not necessarily independent of the corporations that fund them. Executives are not precluded from being involved in these foundations. Brown, Helland, and Smith report that CEOs were involved in foundation management at 42% of firms that channeled charitable giving through foundations. William O. Brown et al., *Corporate Philanthropic Practices*, 12 J. Corp. Fin. 855, 861 (2006).

16. Chief Executives for Corporate Purpose, Giving in Numbers 28 (2021 ed. 2021).

17. *Id.* at 15 (reporting that in 2020, cash contributions accounted for 78% of corporate philanthropy and non-cash accounted for 22%).

In 2020, non-cash giving consisted of product donations (63%), pro bono (15%), and other non-cash contributions including used office equipment, use of facilities, real estate, and patents (21%).[18] In-kind gifts by corporations are tax advantaged in some circumstances.[19]

B. *The ESG Movement*

One factor offsetting the decline in charitable giving by traditional corporations in recent years has been their increasing focus on environmental, social, and governance (ESG) objectives. The ESG movement represents an exceptionally large tent, and what "counts" as ESG is in flux.[20] ISS's ESG database, for example, tracks over 800 indicators for more than 8,000 companies.[21] While the corporate governance prong of ESG, e.g., initiatives aimed at improving board processes and independence, executive pay policies, or shareholder rights, is not directly related to corporate philanthropy, the environmental and social prongs certainly are.[22] Depending on industry and firm-specific factors, corporations embracing "E" or "S" prongs of ESG might pledge, for example, to reduce carbon or other harmful emissions, to forego "fracking" or other environmentally harmful oil extraction practices, to improve diversity within their labor force or executive ranks, or to improve labor standards within their supply chains.[23] What these efforts have in common is a focus on the public interest in addition to providing returns to investors and on benefitting society through changes in corporate operations rather than dispensing cash in support of charitable endeavors. Although most ESG efforts

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18. *Id.*

19. Linda Sugin, *Encouraging Corporate Charity*, 26 VA. TAX REV. 125, 156–57 (2006) (describing generous tax rules applicable to certain corporate gifts of scientific equipment or other inventory).

20. *See* Elizabeth Pollman, *The Making and Meaning of ESG* 17 (Eur. Corp. Governance Inst., L. Working Paper No. 659, 2022).

21. *ESG Ratings and Rankings: Product Guide* ISS GOVERNANCE, https://www.issgovernance.com/esg/ratings/ (last visited Dec. 26, 2024).

22. I will continue to refer to these initiatives as ESG, as is conventional, despite the fact that my focus is on E&S.

23. In a guide to ESG for businesses, consulting firm KPMG includes the following among key E&S topics: climate change, greenhouse gas emissions, waste and pollution, working conditions, health and safety, and employee relations and diversity. KPMG, ESG: ENVIRONMENTAL, SOCIAL, AND GOVERNANCE: AN INTRODUCTORY GUIDE FOR BUSINESSES 2 (2020).

are focused on operational philanthropy, there could potentially be a link between ESG and contributional philanthropy. One consultant expects corporate charitable giving to trend upwards as firms increasingly emphasize ESG.[24] Thus far, however, it is difficult to see any such spillover effects in the aggregate data.

ESG reporting by public companies is now ubiquitous. According to the Governance & Accountability Institute (G&A), 92% of S&P 500 firms issued a report in 2020 highlighting their achievement or compliance with ESG, corporate social responsibility, or sustainability goals, up from 20% of S&P 500 firms that published such a report in 2011.[25] These disclosures are currently voluntary and the quality varies,[26] but G&A reports that 52% of Russell 1000 firms that published disclosures utilized a reporting standard promulgated by the Global Reporting Initiative, a standard that was first developed following the 1989 Exxon Valdez spill and has evolved to be a de facto standard for sustainability reporting.[27]

C. *PBCs*

Although thus far lacking the broad reach of the ESG effort, a more explicitly philanthropic movement afoot in the business sector is the advent of hybrid entities devoted to improving social welfare as well as delivering returns to investors. Several hybrid types exist including low-profit limited

24. Derric Bakker, *Six Trends Likely to Impact Charitable Giving in 2022*, Dickerson Bakker (Dec. 23, 2021), https://dickersonbakker.com/six-trends-likely-to -impact-charitable-giving-in-2022/.

25. Governance & Accountability Inst., Inc., 2021 Sustainability Reporting in Focus 3 (10th ed. 2021).

26. *See, e.g.*, Jessica Ground, *ESG Global Study 2022* (June 17, 2022), Harv. L. Sch. Forum on Corp. Governance, https://corpgov.law.harvard.edu/2022/06/17/esg-global-study-2022/ ("Difficulties with the quality and accessibility of data and inconsistent ratings are hampering the ability of investors to adopt, incorporate and implement ESG.").

27. Governance & Accountability Inst., *supra* note 25, at 13.

The strength of the ESG movement is also evidenced by rising institutional investor interest in ESG. Gillan, Koch, and Starks report that in 2019, 300 mutual funds with ESG mandates received $20 billion in net investment in-flows and that more than 3,000 institutional investors and their service providers representing $86 trillion in assets under management have signed on to the ESG friendly Principles of Responsible Investment. Stuart L. Gillan et al., *Firms and Social Responsibility: A Review of ESG and CSR Research in Corporate Finance*, 66 J. Corp. Fin. 1 (2021).

liability companies, benefit LLCs, certified B corporations, special purpose corporations, and flexible purpose corporations,[28] but the most commonly encountered to date are various forms of benefit corporations, which I will refer to generically as public benefit corporations or PBCs. As of September 2020, over 10,000 U.S. businesses had organized as PBCs,[29] although one recent study could identify only four publicly traded PBCs as of April 2021.[30]

As a creature of state law, the contours of PBCs vary based on jurisdiction, but Delaware's statute is typical. A Delaware PBC must in its charter identify itself as a PBC and identify "one or more specific public benefits to be promoted by the corporation."[31] "Public benefit" is defined as "a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature."[32] Delaware PBCs are also required to report at least every other year on "success in meeting [established PBC] objectives and promoting [their PBC] public benefit."[33]

Although the Delaware PBC statute requires the identification of a "specific" public benefit, Professors Fisch and Solomon criticize the current PBC regime as not requiring sufficient specificity and thus vesting excessive discretion with officers, directors or shareholders.[34] They also criticize the existing regime for lacking meaningful enforcement mechanisms.[35]

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28. Dana Brakman Reiser & Steven A. Dean, Social Enterprise Law: Trust, Public Benefit, and Capital Markets 61–66 (2017) (discussing hybrid entity alternatives to benefit corporations).

29. Frederick Alexander et al., From Shareholder Primacy to Stakeholder Capitalism: A Policy Agenda for Systems Change 3 (2020).

30. Jill E. Fisch & Steven Davidoff Solomon, *The "Value" of a Public Benefit Corporation* 5 (Eur. Corp. Governance Inst., L. Working Paper No. 585, 2021).

31. Del. Code Ann. tit. 8, § 362 (2024). Professor David Yosifon has considered whether Delaware's creation of the PBC option might lead judges to require firms wishing to support social missions to adopt the PBC form, but he argues that this is not the best interpretation of the Delaware PBC statute. David G. Yosifon, *Opting out of Shareholder Primacy: Is the Public Benefit Corporation Trivial?*, 41 Del. J. Corp. L. 461, 462–463 (2017).

32. Del. Code Ann. tit. 8, § 362 (2024).

33. Del. Code Ann. tit. 8, § 366 (2024).

34. Fisch & Solomon, *supra* note 30, at 2, 10.

35. *Id.*

Nonetheless, at least some PBCs appear to operate more in the public interest than traditional corporations.

For example, crowdfunding platform Kickstarter reincorporated as a PBC in 2015.[36] Its avowed mission is quite general: "to help bring creative projects to life."[37] But the company has made several specific public-spirited commitments, including a commitment to donate 5% of after-tax profits to arts and music education in underserved communities and to organizations fighting to end systemic inequality.[38] Kickstarter also promises not to sell customer data and not to employ "loopholes" to reduce its tax burden.[39] Kickstarter reported paying a combined federal, state, and local effective income tax rate of 24% in 2021, well above the average rate of U.S. corporations.[40]

Insurance company Lemonade went public as a PBC in 2020.[41] Its quite general mission is to "transform insurance from a necessary evil to a social good." This is accomplished through the Lemonade Giveback, a program through which the excess of premiums over claims — beyond a fixed amount per policy — is directed to charities selected by policy holders. Lemonade's total "giveback" increased from $53,000 in 2017 to $2.3 million in 2021.[42] As these examples suggest, the philanthropy engaged in by PBCs may be contributional, operational, or both.

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36. Kickstarter PBC, Annual Benefit Statement 2021 3 (2022).

37. *Id.* at 4.

38. *Id.* at 5–6.

39. *Id.* at 4.

40. *Id.* at 17. This is a slightly apples to oranges comparison since the U.S. average rate cited in the Kickstarter report (11.3%) is federal only. Moreover, effective corporate tax rates vary widely depending on industry and other factors. It is not clear that this is a meaningful comparison, although it is a step in favor of transparency.

41. *The Lemonade Giveback*, Lemonade, https://www.lemonade.com/giveback (last visited Jan. 27, 2023). Lemonade received a B Corp certification in 2016 prior to going public. Nonprofit organization B Lab certifies B Corporations, "which are companies that meet high standards of social and environmental performance, accountability, and transparency." *About B Lab*, B Lab, https://www.bcorporation.net/en-us/movement/about-b-lab (last visited Dec. 11, 2024). According to B Lab, there are currently more than 9,200 Certified B Corporations in the US. *Looking for a B Corp?*, B Lab, https://www.bcorporation.net/en-us/find-a-b-corp?refinement%5Bcountries%5D%5B0%5D=United%20States (last visited Feb. 1, 2023).

42. Lemonade, *supra* note 41; *Time to Giveback! Lemonade's 2017 Social Impact Report*, Lemonade, https://www.lemonade.com/blog/time-to-giveback/ (last visited Oct. 23, 2024); *The 2021 Lemonade Giveback*, Lemonade, https://www.lemonade.com/giveback-2021 (last visited Oct. 23, 2024).

D. *Is Corporate Philanthropy Profit Sacrificing?*

A common question for all of these forms of corporate philanthropy is whether public-spirited endeavors run counter to the interests of investors. Corporate finance researchers have produced thousands of studies on these questions[43] without resolving them.[44] Almost undoubtedly the answer is "it depends."

From a theoretical point of view, there are three broad possibilities. First, philanthropy in any of these forms — cash donations by traditional companies, adjustments to operations in pursuit of ESG goals, or organizing as a PBC — could increase a corporation's cash flows sufficiently to offset any costs, thus augmenting investor returns. Such philanthropy could increase cash flows if, for example, customers were willing to pay more for the products of socially responsible producers. Obviously, in this case value would be transferred from consumers to investors. Second, such philanthropy might reduce a corporation's net cash flows, but investors who value their association with socially responsible companies might nonetheless enjoy a net increase in utility.[45] Finally, such philanthropy might reduce aggregate investor utility.[46]

These are empirical issues. Professors Ronald Masulis and Syed Reza examine stock market reaction to announcements

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43. Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. & INV. 210, 210 (2015).

44. *See, e.g.*, Ronald W. Masulis & Syed Walid Reza, *Agency Problems of Corporate Philanthropy*, 28 REV. FIN. STUD. 592, 592 (2015) (finding "no clear evidence in the literature" as to whether corporate charitable contributions have "positive effects on firm revenues or performance or on shareholder wealth").

45. *See* M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 582 (2009) (arguing that, contrary to the view of Milton Friedman, investors derive utility from the warm glow of socially responsible corporate activities, not just from financial returns); *see also*, Bartlett & Bubb, *supra* note 5, at 38 (noting that "shareholders' social preferences are, at least in important part, *associative*") (emphasis in original). Investor utility could also be augmented if costly reductions in the externalities produced by some firms are more than offset by reductions in costs at other firms held by the same investor, that is, by portfolio effects. Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 6 (2020) ("[I]f a subset of firms in a portfolio impose costs on the broader portfolio through the generation of negative externalities, a portfolio-wide owner should be motivated to curtail those externalities at the source.").

46. Gillan et al., *supra* note 27, at 10.

of corporate charitable contributions and find negative reactions, on average,[47] which, as Professors Stuart Gillan, Andrew Koch, and Laura Starks note, suggests that investors do not tend to value contributional philanthropy.[48] Gillan, Koch, and Stark report that 90% of more than 2000 studies find a positive relationship between ESG activities and corporate financial performance, but they caution that causation could run either way.[49] ESG activities could boost cash flows, or firms with strong performance could invest more in ESG. Researchers have attempted to deal with the causation problem, but Gillan, Koch, and Stark conclude that the causal evidence on the ESG/corporate performance relationship is mixed.[50]

Evidence concerning PBC profitability is scant. Professor Ronald Colombo notes that the degree to which PBCs sacrifice shareholder value for public benefits is untested, but he argued that "it stands to reason that the board of a benefit corporation would feel less constrained to prioritize the financial interests of its shareholders as compared to the board of a typical, non-benefit corporation."[51] With their emphasis on "giving back", the few examples of PBCs highlighted above would seem to support Colombo's prediction, but this could just be marketing. Perhaps, for example, policy holders are willing to pay significantly more for Lemonade's socially responsible insurance than for traditional insurance products.

II.
Conventional Corporate Philanthropy — Issues and Concerns

Are corporate operational and contributional philanthropy comparable? Might the former substitute for the latter in a meaningful fashion? I think the answers are yes and yes. As just discussed, each type of corporate philanthropy likely involves the creation of a mix of public and private benefits. Moreover, as developed in this Part and the next, both raise similar issues and concerns regarding shareholder primacy, agency costs,

47. Masulis & Reza, *supra* note 44, at 622.
48. Gillan et al., *supra* note 27, at 11.
49. *Id.* at 10.
50. *Id.* at 13.
51. Ronald J. Colombo, *Taking Stock of the Benefit Corporation*, 7 Tex. A&M L. Rev. 73, 100–01 (2019).

comparative advantage, incidence, and tax subsidies. This Part focuses primarily, but not exclusively, on conventional contributional corporate philanthropy. Part III will consider specifically how these perspectives should be modified given the gradual evolution from corporate contributional to operational philanthropy. For a variety of reasons, many previous commentators have been skeptical of corporate philanthropy, but there have been exceptions.

A. *Corporate Governance Concerns*

Corporate philanthropy — at least of the profit-sacrificing variety — has long been controversial. From a corporate governance perspective, corporate philanthropy can be seen as antithetical to the long-standing norm of shareholder primacy and as exacerbating the agency problems associated with the separation of ownership from control of large, publicly traded corporations.[52] Milton Friedman was perhaps the

52. The shareholder primacy norm holds that the sole objective of the corporation is to advance shareholder interests. This may be contrasted with a stakeholder primacy norm that would expand the objective function to include advancing the interests of other stakeholders including, e.g., employees, creditors, customers, and the communities in which business operate. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 549 (2003) ("At one end of the spectrum are models contending that corporations should be run so as to maximize shareholder wealth. At the other end are stakeholderist models arguing that directors and managers should consider the interests of all corporate constituencies in making corporate decisions."); *see also* Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467, 1478 (2021) ("A central debate in corporate governance concerns whether corporate leaders-directors and top executives-when making business decisions, should consider only the interests and welfare of shareholders ('shareholder primacy') or should also consider the interests of nonshareholder constituents, such as employees, customers, suppliers, local communities, and society at large ('stakeholderism')."). Professors Michael Jensen and William Meckling famously described the managerial agency problem that arises from the separation of ownership from control in large publicly held corporations. In short, the personal interests of executives, who hold a relatively small economic stake in the enterprise, will often diverge from those of shareholders, and, given a lack of transparency, monitoring executive actions to ensure that they are advancing shareholder interests will be costly. Agency costs include the cost of monitoring by shareholders, the cost of executives binding themselves to advancing shareholder interests, and the residual loss arising from executives failing to prioritize shareholder interests. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

most well-known proponent of this view. In a widely read New York Times Magazine article[53] and earlier book,[54] Friedman famously argued that the social responsibility of executives was to "make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom" — leaving philanthropical decisions to the shareholders.[55] Friedman's objections to corporate spending in the public interest were both normative and practical. From a normative perspective, Friedman embraced the orthodox view that executives are agents of shareholders,[56] charged with advancing their interests, which, as Judge Richard Posner argued, coalesce primarily in the shareholders' desire to increase the share price.[57] From a practical perspective, Friedman asked how executives charged with advancing societal interests were to determine the amount of profit they should sacrifice and exactly which interests should be advanced.[58] Numerous commentators have echoed Friedman's argument that if corporate profits are to go towards philanthropy, these decisions should be made by shareholders, not corporations, because otherwise shareholders will be forced to support causes they do not embrace.[59]

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53. Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business is to Increase Its Profits*, N.Y. Times Mag. (Sept. 13, 1970), https://timesmachine.nytimes.com/timesmachine/1970/09/13/223535702.html?pageNumber=379.

54. Milton Friedman, Capitalism and Freedom 133 (40th Anniversary ed. 2002).

55. Friedman, *supra* note 53. Friedman recognized that executives of eleemosynary institutions, such as those running schools or hospitals, would have a different objective function.

56. Friedman, *supra* note 53.

57. Richard A. Posner, Economic Analysis of Law 575 (8th ed. 2011) (noting that "[o]ne person's charity is another person's deviltry," and so the issue "becomes whether the shareholder would like his corporation to make a modest contribution to uncontroversial charities").

58. Friedman, *supra* note 53.

59. Friedman, *supra* note 54, at 135; Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 4 (1991) (arguing that stockholders invest in corporations seeking financial returns); *see also* Leo E. Strine & Nicholas Walter, *Conservative Collision Course: The Tension between Conservative Corporate Law Theory and Citizens United*, 100 Cornell L. Rev. 335, 351 (2015) (summarizing these arguments).

To be sure, the shareholder primacy concern is premised on the assumption that investors bear the cost of corporate philanthropy, an assumption that may not always hold and may be increasingly suspect in an age in which ESG- and PBC- based philanthropy is of growing importance. The incidence

Friedman's concerns with corporate philanthropy can really be divided into two main threads — a question of who, between the owners and managers, should control the disposition of philanthropy in terms of the amounts and beneficiaries of charitably directed corporate profits and, though less obvious on the surface, will management discretion to sacrifice profits for the public good exacerbate agency problems within firms? A third issue highlighted by commentators more sympathetic to corporate philanthropy is comparative advantage.

1. *Shareholder Primacy and Sorting*

Although shareholder primacy has often been equated with maximizing shareholder wealth,[60] Friedman did not rule out the possibility that non-financial interests of investors might be considered as well,[61] and some modern commentators conceive of shareholder primacy more broadly, encouraging directors to consider both financial and non-financial interests of shareholders.[62] As Professors Henderson and Malani argue, the increasing strength of the corporate social responsibility movement suggests that some shareholders have a taste for corporate philanthropy, as well as monetary returns, and gain utility from corporate support for social missions.[63] To be sure, some of the investors in pro-social investment funds may be motivated by an expectation that the funds will outperform the broader market, but survey and experimental evidence suggests that individuals generally are willing to sacrifice some financial returns in

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question is considered at length in Part II.C. below. For now, I will assume that shareholders do indeed bear these costs.

60. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. Rev. 733, 745 (2005) (arguing that this equation conflates two separate issues).

61. Friedman, *supra* note 53.

62. Elhauge, *supra* note 60, at 745, 783 (noting that shareholders have nonfinancial interests and that "maximizing shareholder welfare is not the same as maximizing shareholder profits"); Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L., Fin., & Accт. 247, 248 (2017) (arguing "that it "[I]t is too narrow to identify shareholder welfare with market value."). Note that this re-conceived shareholder primacy is not equivalent to stakeholderism, which would have managers consider non-shareholder interests even when in conflict with the financial and non-financial interests of investors.

63. Henderson & Malani, *supra* note 45, at 582–83.

order to advance social interests.[64] Broadening the concept of shareholder value maximization to include non-financial interests allows directors to address this investor demand as well as to exploit any comparative advantage that corporations might enjoy in delivering philanthropy.[65]

In the context of large, dispersely held public companies, however, this broader shareholder maximization norm raises several difficulties. In addition to potentially increasing agency costs, a point which is discussed below, there is the question of how to operationalize the inclusion of non-financial investor interests in corporate decision making — how to determine, in other words, which social missions to support and to what degree. As Professors Scott Hirst, Kobi Kastiel, and Tamar Kricheli-Katz's experimental evidence indicates, individual preferences with respect to sacrificing investment returns in the public interest are far from uniform.[66] Professors Hart and Zingales suggest the use of polling to determine and aggregate investor non-financial interests, but the more common approach is to assume that investors will sort themselves based on the degree and direction of pro-social activities embraced by corporations or investment funds.[67] While sorting is possible and perhaps likely, it is not inevitable or costless.[68] By contrast, the task of maximizing corporate financial returns alone is simpler, both conceptually and practically.

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64. *See* Scott Hirst et al., *How Much Do Investors Care About Social Responsibility?* 2023 Wis. L. Rev, 977, 989–90, 1009 (2023) (summarizing survey evidence and providing original experimental evidence that the average individual is willing to sacrifice some investment gains to advance social interests).

65. Henderson & Malani, *supra* note 45, at 571; *see generally* Elhauge, *supra* note 60; Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 Cornell L. Rev. 1195, 1203 (1999).

66. Hirst et al., *supra* note 64, at 1015 (finding that 32% of experimental subjects were unwilling to sacrifice even small amounts to advance social interests).

67. *See, e.g.*, Henderson & Malani, *supra* note 45, at 589 (observing market segmentation into socially responsible and profit maximizing funds).

68. Hirst et al., *supra* note 64, at 1032–33 (discussing several obstacles to sorting including insufficient information regarding investment fund policies, fiduciary duty constraints on investment policies, and lack of variation among portfolio companies with respect to approaches to socially responsible operations).

2. *Agency Costs and Comparative Advantage*

Agency costs arise, inevitably, when the interests of agents (e.g., directors, officers, and employees) diverge from those of principals (e.g., shareholders).[69] One concern on the corporate agency cost front is that executives will direct a corporation's philanthropy towards "pet" charities that advance their personal interests in one way or another. As Professors Michael Porter and Mike Kramer put it, corporate charitable "contributions often reflect the personal beliefs and values of executives and employees" rather than being tied to business objectives.[70] Going further, Professors William Brown, Eric Helland, and Janet Smith argue that corporate philanthropy exacerbates agency costs whether managers use corporate funds to support their own "pet" charities or whether managers simply act under a belief, not shared by all investors, that corporations have a social responsibility beyond profit maximization.[71]

Another potential agency cost associated with corporate charitable contributions is increased executive entrenchment. In a study of corporate charitable contributions by Fortune 500 companies, Professors Masulis and Reza find that CEOs "appear to use corporate giving strategically to support charities in which independent directors have affiliations, possibly strengthening the CEO's social bonds with these directors and thereby weakening board independence."[72]

To be sure, other commentators are more optimistic about corporate philanthropy, minimizing the agency cost concern and highlighting the potential comparative advantage that corporations may have in engaging in philanthropy. Professors Henry Butler and Fred McChesney argue that corporate philanthropy is like any other corporate agency problem.[73] They note

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69. Jensen & Meckling, *supra* note 52, at 308.

70. Michael E. Porter & Mark R. Kramer, *The Competitive Advantage of Corporate Philanthropy*, HARV. BUS. REV., Dec. 2002, at 6. An extreme example of this phenomenon might be Texaco's sixty-year sponsorship of the Metropolitan Opera's radio broadcasts which reportedly was prompted by a Texaco executive attempting to placate his opera-loving spouse after she learned of his extramarital activities. *Texaco and the Metropolitan Opera Broadcasts*, W. STATES MUSEUM OF BROAD., http://westmb.org/Exhibits/E_Texaco-Met.html (last visited Oct. 17, 2024).

71. William O. Brown et al., *Corporate Philanthropic Practices*, 12 J. CORP. FIN. 855, 856 (2006).

72. Masulis & Reza, *supra* note 44, at 631.

73. Butler & McChesney, *supra* note 65, at 1197.

that corporate philanthropy can generate value-adding goodwill for the firm.[74] Shareholders could donate individually in the name of the firm and create this goodwill, but donations emanating from the corporation may reduce transaction costs and combat free riding, thus creating a comparative advantage for corporate philanthropy.[75] Butler and McChesney accept that there will be agency problems and managerial slack,[76] but given the usual story about the limitations of judicial oversight,[77] they argue that it makes sense to give managers discretion in this realm as in so many others.[78] In a similar vein, Professors Todd Henderson and Anup Malani argue that corporate philanthropy likely reflects a mix of profit-seeking expenditure and agency slack, but they go on to argue that in certain cases corporations have a comparative advantage in delivering philanthropy given economies of scope and other benefits and that corporations should only engage in philanthropy when they have a cost or quality advantage.[79]

Going even further, Professor Einer Elhauge has argued that the agency cost concern with corporate philanthropy is overblown, that managerial discretion to sacrifice profits in the public interest is unlikely to increase the total amount of agency slack within a corporation, and thus that managerial decisions to sacrifice profits in the public interest must substitute for other, more personally beneficial forms of agency slack, such as excessive self-compensation.[80] Elhauge's argument is rooted in the idea that corporate philanthropy decisions generally are subjected to business judgment review like other operational decisions and thus that the cost of shareholder monitoring is

74. *Id.* at 1203.

75. *Id.* at 1205.

76. "Slack" in this context refers to the divergence between an agent's actual, partially self-interested behavior and the behavior that would optimally serve the interests of the principal. *See, e.g.*, Junxiong Fang et al., *The CEO Horizon Problem and Managerial Slack in China*, 14 MGMT. & ORG. REV. 343, 345 (2018) (noting that "managerial slack promotes personal utility of managers at the expense of shareholders").

77. *See, e.g.*, Kenneth B. Davis Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 580 (2000) (highlighting the "expertise" rationale for judicial deference to corporate directors as embodied in the business judgment rule, i.e., "business judgments are for the business experts – the directors and management – and judges and juries are ill-equipped to review them").

78. Butler & McChesney, *supra* note 65, at 1205.

79. Henderson & Malani, *supra* note 45, at 579, 590, 604.

80. Elhauge, *supra* note 60, at 805–07.

unaffected by rules or norms that allow corporate philanthropy.[81]

Several commentators, however, have questioned Elhauge's "fixed agency slack" view. For example, I have argued that increasing the possible channels of agency slack, e.g., by adding corporate philanthropy to the list of permissible managerial decisions, likely increases the cost of shareholder monitoring and thus the total amount of agency slack.[82] Professor Roy Shapira has argued that corporate philanthropy can be used to co-opt directors and other potential monitors, thus exacerbating agency costs.[83] In the broader context of stakeholderism, Professors Lucian Bebchuk and Roberto Tallarita have argued that stakeholderism would lead to greater managerial slack and agency costs by insulating managers from shareholder discipline and reducing accountability to shareholders.[84] This remains an important open and largely empirical question.[85]

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81. *Id.* at 807 (arguing that "[E]exercises of latent profit-sacrificing authority simply reflect the degree of agency slack managers enjoy under the business judgment rule; they do not increase it.").

82. David I. Walker, *The Manager's Share*, 47 Wm. & Mary L. Rev. 587 (2005). As I argued there, the impact of additional channels of agency slack on total agency costs may depend in part on the mechanism that determines managerial appropriation, which is contested. Under an optimal contracting model of the executive pay setting process, the key question would be whether shareholder monitoring costs would increase with the addition of a channel. Under the managerial power view of the pay setting process the question would be whether the investor outrage constraint is loosened with the addition of a channel of slack. It seems likely that under either model allowing executives to sacrifice corporate profits in the public interest would increase total agency costs, but this is largely an empirical question.

83. Roy Shapira, *Corporate Philanthropy as Signaling and Co-optation*, 80 Fordham L. Rev. 1889, 1919 (2012) (arguing that corporate philanthropy "can be used by managers as mechanisms to co-opt independent directors, influence politicians, and entrench themselves by allying with activist stakeholders.").

84. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 Cornell L. Rev. 91, 165 (2020) (suggesting that stakeholderism would insulate managers and reduce accountability by inducing institutional investors to be more deferential and by inducing policy makers to adopt legal reforms with the same effect); *see also* Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 Notre Dame L. Rev. 1431, 1465 (2006) (arguing that a socially responsible corporate governance scheme could lead to increased managerial slack as managers freed from a duty to account to shareholders might serve themselves rather than serving society).

85. John J. Donohue, *Comment on Elhauge: Does Greater Managerial Freedom to Sacrifice Profits Lead to Higher Social Welfare?*, *in* Environmental Protection and the Social Responsibility of Firms: Perspectives from Law,

B. *Is/When Is Corporate Philanthropy Legally Permissible?*

While corporate philanthropy may have been considered *ultra vires* at one point,[86] today most if not all corporate philanthropy is legally permissible under state and federal law. In all fifty states, traditional corporations are permitted by statute to make charitable contributions.[87] Moreover, despite some authority embracing shareholder primacy,[88] the caselaw of Delaware, far and away the most important jurisdiction for corporate America, explicitly authorizes charitable contributions.[89] Federal law plays a supporting role in this story authorizing deductions for certain charitable contributions by corporations in an amount capped at 10% of corporate profits each year.[90]

ECONOMICS, AND BUSINESS 77, 83 (Bruce L. Hay et al. eds., 2005) (questioning Elhauge's fixed agency slack claim and describing it as an empirical question).

86. Brown et al., *supra* note 71, at 859 ("[P]rior to the mid-1950s, the prevailing legal view was that corporate philanthropy was 'ultra vires.'").

87. Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 602–03 (1997); *see also* DEL. CODE ANN. tit. 8, § 122(9) (2024) ("Every corporation created under this chapter shall have power to: Make donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof.").

88. Delaware caselaw authority embracing shareholder primacy is scant and mostly old. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("[I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders it would not be the duty of the courts to interfere."); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) ("The corporate form . . . is not an appropriate vehicle for purely philanthropic ends . . . . Having chosen a for-profit corporate form . . . directors are bound by the fiduciary duties and standards that accompany that form. These standards include acting to promote the value of the corporation for the benefit of the shareholders. The 'Inc.' after the company name has to mean at least that. Thus, I cannot accept as valid . . . a corporate policy that specifically, clearly and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders . . . .").

89. *See, e.g.*, Theodora Holding Corp. v. Henderson, 257 A.2d 398, 404 (Del. Ch. 1969) (applying a reasonableness test in upholding the validity of a charitable contribution by a Delaware corporation).

90. Generally, corporations may deduct charitable contributions not in excess of 10% of taxable income. I.R.C. § 170(b)(2). Certain short-term exceptions are noted *infra* notes 130, 132. The federal tax code played a supporting role in some state court analyses of corporate philanthropy by providing a measure of reasonableness. *See, e.g.*, Theodora Holding Corp., 257 A.2d

The exact scope of a traditional corporation's power to engage in philanthropy remains subject to some debate but is of little practical significance. Professors Victor Brudney and Allen Ferrell divide corporate charitable contributions into three categories — gifts that are intended to produce "imminent, visible corporate operating gains" (clearly permissible), contributions that are intended to create corporate goodwill (also permissible), and gifts "for which absolutely nothing is received and that would be unauthorized [under state law] unless approved unanimously by the stockholders," in other words, *ultra vires*.[91] Professor Elhauge goes further arguing that managers of traditional corporations "have never had an enforceable legal duty to maximize profits, and that all state statutes authorize "unprofitable corporate donations." [92] Whether Elhauge's expansive view of corporate power in this realm is exactly right or not, surely he is correct in stating that "the law gives corporate managers considerable … discretion to sacrifice profits in the public interest."[93]

C. *Who Bears the Cost of Corporate Philanthropy?*

To the extent that corporate philanthropy is profit sacrificing, who bears the cost? We know that entities, such as corporations, cannot be the ultimate bearer of such costs, only individuals can. Elhauge argues that the managers bear the costs of profit-sacrificing corporate philanthropy. This is the upshot of his view that total agency costs are unaffected by corporate philanthropy.[94] Some commentators implicitly or explicitly assume that shareholders bear the cost of corporate philanthropy.[95] Tax scholars have devoted a great deal of effort

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at 398 (IRC deduction limitations provide a "helpful guide" in determining the reasonableness of a corporate charitable contribution).

91. Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. CHI. L. REV. 1191, 1192–94 (2002); *see also* Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1417–18 (2020) ("It has long been accepted that directors and officers do not violate their fiduciary duties by devoting funds to a social cause, as long as the company explicitly states that it expects some benefit to flow back to it, however indirectly.").

92. Elhauge, *supra* note 60, at 738.

93. *Id.* at 733.

94. *Id.* at 805–07.

95. *See, e.g.*, Kahn, *supra* note 87, at 585 ("Because corporate contributions are funded from corporate profits, they are paid for–and therefore of special concern to–corporate shareholders.").

to an analogous question of who bears the cost or "incidence" of taxes, and so this seems a fruitful place to begin.

The extensive literature on the incidence of the corporate income tax suggests that while shareholders bear the burden or benefit of changes in corporate taxes in the short term, over the long haul the incidence of corporate taxes is shifted to a significant degree to non-corporate capital and to labor as investors move their capital in search of maximum after-tax returns.[96] However, while corporate philanthropy has sometimes been described as a "tax" on investors,[97] traditional contributional corporate philanthropy differs in important ways from corporate taxes, and this impacts incidence. Unlike corporate tax rates that apply systematically, corporate philanthropy is largely firm specific and endogenously determined. As a result, the cost of corporate philanthropy cannot be shifted outside the firm, and at least the cost of mid-course increases or decreases in corporate philanthropy generally is borne by current investors.[98] To be sure, there may be cases in which corporate philanthropy can be anticipated when a firm goes public, in which case a portion of the cost would likely be borne by the founders.[99] In addition, corporate philanthropy is sometimes directed at particular stakeholders, such as consumers or employees. In these cases, the cost of the corporate philanthropy may be borne in part by the targeted constituency. In general, however, it seems reasonable to assume that the bulk of the cost of conventional contributional corporate philanthropy is borne by investors.

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96. *See, e.g.*, Cong. Budget Off., The Distribution of Household Income, 2018, at 43 (2021) (noting the lack of consensus among researchers as to the proper allocation of the corporate income tax and noting that the CBO allocates 75% of the burden to owners of capital in proportion to capital income and 25% to workers in proportion to labor income). I have argued elsewhere that systemic corporate agency costs, such as systemically excessive executive compensation, are analogous to corporate taxes and have similar incidence. *See* David I. Walker, *Who Bears the Cost of Excessive Executive Compensation (and Other Corporate Agency Costs)?*, 57 Vill. L. Rev. 653 (2012).

97. Friedman, *supra* note 53 (analogizing profit sacrificing corporate activities to a tax imposed on shareholders by executives).

98. David P. Baron, *Corporate Social Responsibility and Social Entrepreneurship*, 16 J. Econ. & Mgmt. Strategy 683, 695 (2007) (arguing that investors bear the cost of corporate philanthropy "surprises"). Of course, disgruntled investors can sell their shares but only at a lower price that reflects the markets assessment of the excess of the cost of the new philanthropic program over any additional investor utility arising from the philanthropy.

99. *Id.*

D. *Is Corporate Philanthropy More Heavily Subsidized than Stakeholder Philanthropy?*

Several commentators have raised concerns that corporate philanthropy may be more greatly subsidized than individual philanthropy, encouraging firms to contribute directly in lieu of distributing funds to stakeholders and letting the stakeholders manage their own philanthropy. Comparing direct corporate philanthropy to an alternative scenario in which a corporation distributes a dividend to a shareholder who then makes a charitable contribution, Professor Linda Sugin determined that, based on 1997 tax rates and rules, the funds available to the charity through the corporate philanthropy channel were 54% greater than those available via the shareholder philanthropy channel.[100] In 2009, Professors Henderson and Malani repeated and extended Sugin's analysis to include more scenarios and channels of philanthropy including the purchase of corporate altruism through shareholding, consumption of green goods, and employment by pro-social firms.[101] They concluded that the tax treatment of corporate versus stakeholder philanthropy was inconsistent and incoherent.[102]

In a separate Article, I further extend these analyses and update them for the 2017 enactment of the Tax Cuts and Jobs Act (TCJA) which significantly reduced the tax subsidy for corporate philanthropy but which also resulted in a 63% cut in the fraction of individuals who itemize tax deductions, which favors direct corporate philanthropy.[103] I find that the degree of subsidy or the tax "efficiency" of corporate relative to individual philanthropy is highly variable and depends on which stakeholder "pays" for the corporate philanthropy and how, tax rates (of course), and whether individuals itemize deductions and whether corporations have net operating losses.[104] At current tax rates, however, outsized subsidies for corporate philanthropy result to a large degree from the constriction in itemizing that followed from the TCJA.[105] And many would

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100. Linda Sugin, *Theories of the Corporation and the Tax Treatment of Corporate Philanthropy*, 41 N.Y. L. Sch. L. Rev. 835, 857 n.103 (1997).

101. *See* Henderson & Malani, *supra* note 45, at 625–27.

102. *Id.* at 612.

103. David I. Walker, *Reassessing Corporate Philanthropy from a Tax Perspective*, 28 Fla. Tax Rev. (forthcoming 2024) (manuscript at 5) (on file with author).

104. *Id.* at 22–26.

105. *Id.* at 27.

view the effective restoration of deductions for what would be individual charitable contributions by non-itemizers as a positive feature of the system rather than as a bug. Moreover, from a tax policy perspective, corporate philanthropy is shown to provide numerous advantages over individual philanthropy that have not been discussed or emphasized in the literature. Corporate philanthropy mitigates the "upside-down" effect of the individual deduction for philanthropy[106] and the windfall arising from stakeholder contributions of appreciated securities,[107] is highly responsive to tax incentives, often provides utility to multiple stakeholders, and even transfers some of the cost of U.S. philanthropy to non-U.S. stakeholders.[108]

III.
The Shift to Operational Corporate Philanthropy — Issues and Concerns

This Part considers how the evolution in corporate philanthropy impacts the corporate governance, tax and other concerns discussed in the previous Part. In short, while the shift from contributional to operational philanthropy that is associated with the rise of the ESG movement and advent of PBCs likely increases the comparative advantage of corporate philanthropy, it is also likely to heighten agency cost concerns, add complexity to the incidence analysis, and increase the difficulty of regulating corporate philanthropy via taxation or otherwise. The impact of the shift towards operational philanthropy on shareholder primacy concerns is nuanced.

A. *Operational Philanthropy Incidence*

As an initial matter, by appealing to more stakeholders or constituents, the PBC and ESG movements add complexity to

106. *Id.* at 30. The "upside-down" effect refers to the fact that tax benefits structured as deductions more greatly subsidize activity, here, philanthropy, by high bracket individuals than by lower bracket individuals. The upside-down effect is particularly important in this setting because the types of charities supported by higher and lower income individuals differ systematically. *Id.* at 11.

107. *Id.* at 30. High income individuals often use appreciated securities in fulfilling philanthropic commitments thus avoiding tax on gains. Corporations that contribute appreciated securities can take advantage of the same opportunity, but I can find no evidence that they routinely do so. *Id.* at 9.

108. *Id.* at 25–30.

the corporate philanthropy incidence analysis. Of course, corporations have always used philanthropy to appeal to workers and consumers, but it seems likely that the cost of conventional contributional philanthropy beyond the financial return was largely absorbed by investors. Today, the net cost of a new firm committing to PBC status or of a traditional firm embracing ESG initiatives may be borne by a cluster of stakeholders in idiosyncratic fashion depending on the firm and its particular philanthropic mission.

Consider the following examples of operational philanthropy:

- An established oil company commits to forgoing hydraulic fracking or other environmentally harmful extraction techniques reducing potential profits. Unless oil consumers are willing to pay more for marginally greener fuel or employees are willing to accept less pay, both of which seem unlikely, shareholders of this company are likely to bear the cost of this commitment.
- An established auto manufacturer incurs increased production costs to replace some gas fueled vehicles with electric cars. It is conceivable that consumers concerned with global warming and/or wishing to project such a concern would bear most or all of the increased cost through higher prices. Investors would bear the rest. It is unlikely that employees of an established automaker would receive sufficient utility from this shift to cause them to accept less pay or other benefits.
- A newly formed manufacturer sells nothing but high production cost electric cars. The incidence here would be similar to the case just above except that the founders might bear some of the cost, employees who gain utility from working for a green manufacturer would be more likely to bear a portion of the cost, and investors, particularly those who gain utility from supporting green manufacturers, would bear a portion of the cost.
- An established company commits to improving DEI and expends funds on work-force training.

> It is conceivable that consumers and employees might bear some of this cost if they can be convinced to pay more for the products of such a company or accept lower compensation to work there. More likely, investors will bear this cost.

I do not want to overstate the difference between the incidence of operational and contributional philanthropy. Certain factors tend to homogenize the incidence question. Employment relationships, for example, are sticky. While ESG efforts may appeal to some workers, they may hold little or no appeal for others. But the difference may be insufficient to cause many workers to change jobs. Investors may sort themselves based on their ESG preferences but the driving force to do so and thus bear some of the costs of operational philanthropy may be insufficient to cause them to abandon their S&P 500 index fund. Despite these caveats, the bottom line is that, as a result of the shift in approach to corporate philanthropy, it is increasingly difficult to determine who bears the cost.[109]

B. *Isolating Operational Philanthropy*

It is also more difficult to distinguish between profit-seeking and profit-sacrificing behavior with respect to operational than contributional philanthropy. To be sure, it may be difficult to discern whether a corporate cash gift is expected to produce a near immediate financial return, a long-term financial return, or little or no financial return at all, but it is relatively easy to at least isolate the contribution. Costs associated with operational philanthropy share this difficulty, but those costs may not be distinguishable at all from profit-seeking expenditures. Compare, for example, Acme Corp. which contributes $10,000 to a public charity that provides job training for inner city youths, with Beta Corp. that increases spending on training its own work force from $40,000 to $50,000. Or, moving beyond expenditure, perhaps Acme contributes $1 million to a charity that

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109. It is even possible that that the incidence of operational philanthropy might approach that of the corporate tax. Imagine a scenario in which virtually all publicly traded U.S. firms were compelled to divert resources to charitable missions as a result of institutional investor pressure. The incidence in this hypothetical is much less clear. Systemic, essentially exogenous pressure may be analogous to a corporate income tax. Current thinking suggests that the cost may be shifted to some degree to non-corporate capital and labor.

seeks to advance and secure online privacy while Beta rejects, on privacy grounds, an opportunity to sell its customers' data for $1 million. The analyst following Beta will not only have to determine whether the cost/revenue loss was profit-sacrificing, she will, in all likelihood, have to estimate the magnitude of the cost/revenue loss, unless Beta opts to estimate and disclose the information itself.

With these differences in mind, we now reassess the comparative advantage, agency costs, and other features of corporate philanthropy with a focus on operational philanthropy.

C. *Comparative Advantage*

For a variety of reasons, corporations may enjoy an advantage in engaging in philanthropy directly vis-à-vis leaving philanthropical initiatives and decisions with stakeholders. Consider first purely disinterested philanthropy. Professors Henderson and Malani suggest that a corporate philanthropy comparative advantage could arise from, inter alia, taking advantage of economies of scope to reduce the cost of providing public goods, bundling philanthropy with other goods or services to limit free-riding, or tailoring philanthropy to satisfy the demands of investors, consumers, or employees.[110] In addition, multiple firm stakeholders may enjoy a warm glow from a corporation's disinterested philanthropy while the warm glow associated with stakeholder philanthropy would generally stop with the stakeholder.

To be sure, purely disinterested contributions may be the exception. In many cases, even profit sacrificing corporate philanthropy may serve some business purpose, akin to advertising, and to this extent corporations enjoy a comparative advantage in making these contributions. Also, firms undoubtedly have a comparative advantage with respect to non-cash contributions of company property. Except for the last, however, each of these sources of corporate philanthropy comparative advantage would apply equally to conventional contributional philanthropy as to PBC or ESG-based operational philanthropy.

But the comparative advantage of corporate operational philanthropy is likely to be quite different and often much greater than that of traditional contributional philanthropy.

110. Henderson & Malani, *supra* note 45, at 590–97.

Individual shareholders simply cannot replicate operational adjustments undertaken to advance many social missions, and, in at least some cases, individual cash contributions by stakeholders will not provide the same impact on society as these operational adjustments. Consider, for example, an oil company committing to leave recoverable oil reserves in the ground, a manufacturing company deciding to keep a marginally unprofitable factory open in a rust belt city in lieu of shuttering the plant and sending the work overseas, or any company investing in employee training to heighten awareness of DEI issues within the workplace. The comparative advantage of corporate operational philanthropy in cases like these could be many times that of individual philanthropy.[111]

D. *Agency Costs*

At the same time, however, the agency costs of operational philanthropy are likely to be larger than those of contributional philanthropy. To begin, all of the agency costs concerns associated with contributional philanthropy—donations to executives' pet charities, executives' tastes for corporate philanthropy exceeding that of stakeholders generally, and increased executive entrenchment—apply equally to operational philanthropy.

However, the agency costs associated with operational philanthropy could be significantly greater than those associated with operational philanthropy for several reasons. First, as noted above, compared with cash contributions, it may be more difficult to identify operational philanthropy and distinguish it from profit-seeking expenditures.[112] It may be less clear, in other words, that there is or potentially is an agency problem. Second, operational philanthropy will often involve a great many operational and financial decisions that would be opaque to investors and simply more difficult to monitor. Third, given less clarity regarding the incidence of operational philanthropy, investors may have less of an incentive to monitor

111. Professors Hart and Zingales argue that corporate contributions are separable from profit generation and generally should be determined by stakeholders, but that ethical activities of corporations often are inseparable. They use the example of Walmart selling high-capacity weapons and suggest that "transferring profit to shareholders to spend on gun control might not be as efficient as banning the sales of high-capacity magazines in the first place." Hart & Zingales, *supra* note 62, at 249.

112. *See supra* Part III.B.

corporate operational philanthropy. Fourth, both the ESG and PBC movements countenance more significant deviations from profit maximization than one would associate with traditional contributional philanthropy of otherwise profit maximizing firms. Fifth, boards are increasingly tying a portion of executive compensation to operational philanthropy in the guise of ESG,[113] complicating executive pay and adding further scope for managerial value appropriation. Each of these factors tend to raise the upper bound on the divergence from shareholder wealth maximization.

Consider, for example, human capital management, which is a common element of ESG programs.[114] Providing job training has long been considered a best, i.e., profit-maximizing, business practice, but some firms may be going further today as an element of their ESG programs.[115] Will they go too far from a shareholder wealth maximization perspective? The forgoing provides several reasons to be concerned: It may be difficult to contest management arguments that training investments are profit maximizing. It may be difficult to even isolate and quantify such investments. Investors may be less inclined to pursue the issue if they believe that the cost will be borne by the workforce. Management may enjoy the support of major investors who embrace the ESG movement. Executive pay may even be tied to employee training metrics.

These are all reasons to be concerned in a general sense that ESG-motivated employee training programs may suffer from enhanced agency costs. But why would management spend excessively in this area even if they can get away with it? There could be any number of self-interested reasons. One study, for example, has found that companies are more employee-friendly along a number of dimensions if managers

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113. Meridian Comp. Partners, LLC, 2020 Executive Compensation Trends and Developments Survey 3 (2020) (reporting that 20% of large companies surveyed in 2020 had adopted ESG-related compensation metrics for their senior management teams).

114. George S. Georgiev, *The Human Capital Management Movement in U.S. Corporate Law*, 95 Tul. L. Rev. 639, 639 (2021) (describing human capital management as "an expansive concept that has been used to refer to workforce training, compensation and retention issues, gender pay equity, diversity and inclusion, health and safety, matters related to corporate culture," etc.).

115. *See id.* at 667–68 (noting that human capital management emerged as an area of focus for BlackRock CEO and leading ESG proponent Larry Fink in 2017).

and employees live in close proximity and posits an agency cost explanation, i.e., that managers' private costs and benefits of employee relations are magnified when managers and employees are neighbors.[116] Protecting local jobs or investing in job training, in other words, might be profit-maximizing, it might be profit-sacrificing but contribute to investor utility, or it might simply reflect agency costs.

The difficulty of distinguishing between business as usual and operational philanthropy likely also contributes to the practice of corporate greenwashing. Greenwashing refers to the dissemination of false, misleading, or cherry-picked disclosures, often environmental disclosures, intended to place a company in a positive light with consumers and other stakeholders.[117] The practice of greenwashing increases the difficulty of assessing operational philanthropy in the environmental realm and likely undermines consumer and market confidence in claims of truly green firms in addition to greenwashers.[118] As such, greenwashing is a major concern within the ESG movement at both the firm and investment fund level.[119] While troubling from a consumer or social perspective, greenwashing could add value for shareholders of some companies, at least over the short or medium term. But greenwashing could instead or in addition be a product of managerial agency

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116. Augustin Landier et al., *Trade-offs in Staying Close: Corporate Decision Making and Geographic Dispersion*, 22 Rev. Fin. Stud. 1119, 1120-23 (2009) (gauging employee friendliness based on levels of employee retirement and healthcare benefits, profit-sharing, union relations, and employee involvement). The authors also find evidence supporting an information cost basis for disparate treatment of in-state and out-of-state employees. *Id.*

117. *See* Valentina Lagasio, Measuring Greenwashing: The Greenwashing Severity Index 2 (Sept. 25, 2023) (unpublished working paper) (defining greenwashing as the "deceptive practice of exaggerating or misrepresenting a company's sustainability efforts").

118. *See* Thomas P. Lyon & A. Wren Montgomery, *The Means and End of Greenwash*, 28 Org. & Env't 223, 229 (2015) (citing studies finding that "exaggerated or misleading environmental claims have led to consumer skepticism about green claims in general . . . suggesting impacts of deception broadly, and greenwash more specifically, on social welfare.").

119. In 2022, the SEC issued proposed rules that would require investment funds to provide enhanced ESG disclosures "designed to create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services"). Enhanced Disclosure by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, Securities Act Release No. 11068, Exchange Act Release No. 94985, Investment Company Act Release No. 34594, 87 Fed. Reg. 36654 (proposed May 25, 2022).

costs. Managers might receive enhanced compensation,[120] non-pecuniary benefits, and/or greater job security from being thought to lead a "green" company.

To be sure, if Professor Elhauge is right that total corporate agency costs are limited by the amount of discretion permitted under corporate law's business judgment rule doctrine and thus are essentially fixed, expansion of agency slack through adoption of operational philanthropy like ESG is not a concern.[121] For the reasons discussed above, however, I lack his confidence.[122]

E. *Shareholder Primacy*

The shift towards operational philanthropy both simplifies and complicates shareholder primacy concerns. Consider first PBCs, which adopt social missions in their charters. Doing so clarifies and confirms that maximizing investor returns is not the entity's sole mission. No one investing in a PBC can complain if management fails to maximize the share price, which is simplifying to some degree. Presumably, however, the executives of a PBC should not ignore share value. Profitability should be a co-equal or at least a strong secondary aim of a PBC, which creates obvious questions such as: How much profit should a PBC sacrifice in pursuit of its social mission? In this sense shareholder primacy, or perhaps we should say shareholder priority,[123] concerns may be more difficult to manage in PBCs than in traditional for-profit corporations.

Now consider traditional public corporations that have adopted ESG missions. While some companies' ESG statements seem to run directly counter to shareholder primacy,[124]

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120. *See* MERIDIAN COMP. PARTNERS, *supra* note 113, at 3 (reporting on linkage between ESG performance and executive pay).

121. *See* Elhauge, *supra* note 60, at 843; *see also* Gillan et al., *supra* note 27, at 4-5 (reporting mixed evidence on the question of whether executive pay is reduced to reflect non-pecuniary benefits associated with ESG efforts).

122. *See* Walker *supra* note 82 and accompanying text.

123. While "primacy" suggests preeminence, "priority" may encompass any rank or position within a hierarchy, e.g., "first, second, or third priority."

124. In 2020, for example, BP announced a goal of reducing oil and gas production by 40% within a decade. *See* Stanley Reed, *BP Reports a Huge Loss and Vows to Increase Renewable Investment*, N.Y. TIMES (Aug. 4, 2020), https://www.nytimes.com/2020/08/04/business/energy-environment/bp-renewable-investment.html. BP has since backtracked on that commitment. *See* Stanley Reed, *BP, in a Reversal, Says It Will Produce More Oil and Gas*, N.Y. TIMES (Feb. 7, 2023), https://www.nytimes.com/2023/02/07/business/bp-oil-gas-profits.html.

the reality is more complex. First, as noted, the incidence of such philanthropy is complex. The costs of profit-sacrificing ESG activities may be borne by shareholders, but they may be borne by consumers or employees as well as or instead of shareholders. Second, consider firms prioritizing the environmental prong of ESG. Many environmental missions involve reducing externalities. For diversified investors, reductions in externalities produced by Firm A may reduce profits at Firm A but enhance profits at Firms B, C and D.[125] As a result, a very broad conception of investor welfare would include both direct and indirect financial returns.[126] Conventional contributional philanthropy, by contrast, is unlikely to produce significant spillovers of this nature such that externalities or portfolio effects can reasonably be ignored in contemplating even a very broad conception of shareholder welfare.

Third, more generally, there is growing recognition that investors care about more than financial returns and that investor utility properly includes non-financial utility arising from investor association with firms that share their ESG priorities.[127] The persuasiveness of this response to the shareholder primacy concern, however, depends on the ability of investors to sort themselves into firms or funds that reflect their social priorities, a point that is taken up in Part IV below.

F. *Taxation and Prescriptive (Non-Disclosure-Based) Regulation*

The shift in emphasis from contributional to operational corporate philanthropy has significant consequences for the taxation and regulation of corporate philanthropy. In addition to complicating the incidence picture, as discussed above,[128] the shift increases the difficulty of regulating or manipulating corporate philanthropy through the tax code or through other prescriptive, i.e., non-disclosure-based, means.

Let us first dispose, however, of what I believe to be a relatively unimportant tax consequence of the shift to operational

125. *See* Condon, *supra* note 45, at 37.

126. *See* Bartlett & Bubb, *supra* note 5, at 18 (describing, but ultimately rejecting, the portfolio value maximization strand of shareholder welfarism which require company executives to consider investor portfolio effects in decision making).

127. *See supra* Part II.A.1.

128. *See supra* Part II.C.

philanthropy. Corporate contributional philanthropy is deductible under I.R.C. § 170 while operational philanthropy generally is deductible under § 162.[129] The shift from deduction under § 170 to § 162 has two primary effects. First, it removes the limitation, set at 10% of profits, on deductible contributions.[130] However, given that U.S. corporations contribute less than 1% of profits to charity annually, on average,[131] plus the fact that corporations can carry forward excess contributions for up to five years,[132] it doesn't appear that the 10% limitation has much bite anyway. Second, some expenditures otherwise deductible under § 162 must be capitalized and recovered over time through depreciation deductions or other capital recovery provisions. This seemingly important difference is in fact relatively unimportant given that Congress has for many years allowed very rapid recovery of capitalized costs through "bonus" depreciation or other special "expensing" provisions and very taxpayer-friendly depreciation rules.[133] In other words, the economic difference between outright deduction and capitalization/recovery of expenses is today relatively trivial.

Turning to the more important consequences, several commentators including Friedman and Sugin have called for eliminating the corporate tax deduction for corporate philanthropy, which they believe to be unwarranted.[134] Readers particularly concerned with the shareholder primacy or

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129. I.R.C. § 162 allows deductions for trade or business expenses. I.R.C. § 170 allows deductions for charitable contributions.

130. I.R.C. § 170(b)(2)(A).

131. According to Giving USA, aggregate corporate charitable giving as a fraction of pre-tax profits has not exceeded 1% since 2003. GIVING USA FOUND., *supra* note 13, at 358.

132. I.R.C. § 170(d)(2)(A).

133. *See* Edward Fox, *Does Capital Bear the U.S. Corporate Tax After All? New Evidence from Corporate Tax Returns*, 17 J. EMPIRICAL LEGAL STUD. 71, 87–89 (2020) (finding that as a result of "bonus" depreciation and other factors, the difference between the actual corporate income tax and a hypothetical income tax allowing for immediate deduction of all capital expenditures was essentially negligible over the 1995-2013 period and arguing that "some form of highly accelerated depreciation" should be considered the "baseline" for analysis). Given the irrelevance of the § 170/§ 162 distinction, the shift from contributional to operational philanthropy has no impact on the relative subsidy for corporate versus stakeholder philanthropy. *See* Walker, *supra* note 103, at 8.

134. FRIEDMAN, *supra* note 54, at 135 (arguing that there is "no justification for permitting deductions for [corporate] contributions to charitable" enterprises); Sugin, *supra* note 100, at 873–77 (suggesting recharacterizing and taxing corporate philanthropy as individual philanthropy).

agency problems associated with corporate philanthropy might be tempted to agree. However, as this section explains, it is increasingly impractical to curtail the tax subsidy for corporate philanthropy. Other commentators, such as Professors Henderson and Malani, have argued that the tax playing field between corporate and individual philanthropy should be leveled to avoid distorting decision making with respect to the delivery of corporate profits for the public good.[135] This section will explain why, given the shift from corporate contributional to operational philanthropy, any leveling would necessarily require adjustments to stakeholder, not corporate, tax treatment.

It is increasingly impractical to eliminate, curtail, or cap the corporate deduction for philanthropy because corporate philanthropy is increasingly indistinguishable from ordinary and necessary profit-seeking business expense deductible under § 162. Of course, to some extent, it has always been difficult to distinguish profit-sacrificing philanthropy from similar profit-seeking activities. Most corporate charitable giving can be justified to shareholders and the tax authorities as being akin to (deductible) advertising — an investment that will provide returns in excess of cost over the short or long term. To be sure, not all philanthropic campaigns will produce positive net present value results, but this is also true of conventional (and deductible) advertising, research and development efforts, etc. In any of these cases, the expenditures may be plausibly justified ex ante despite a failure to produce positive results ex post even if the expenditures were actually unjustified (economically) ex ante. But absent a smoking gun memo or something along those lines, distinguishing between profit-seeking and philanthropic endeavors is virtually impossible.

Imagine then that Congress were to reduce or repeal tax deductions for charitable contributions by corporations.[136] In many cases, managers of affected companies should be able to restructure or recharacterize their expenditures as profit-seeking expenses deductible under § 162.[137] Given the

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135. Henderson & Malani, *supra* note 45, at 577.

136. Under current law, corporations may deduct charitable contributions not in excess of 10% of taxable income, although they are permitted to carryforward excess contributions for five years. I.R.C. § 170(b)(2), (d)(2). Further restrictions apply to contributions of particular types of property. *See* I.R.C. § 170 *passim*.

137. *See* Sugin, *supra* note 19, at 150–51 (arguing that the IRS and the "courts are ill-equipped to determine whether a particular payment to a

difficulty of determining whether charitable activity enhances corporate goodwill, the IRS would be in an unenviable position in seeking to challenge these characterizations.[138]

The gradual replacement over time of corporate charitable giving by the ESG efforts of traditional corporations and entities incorporating as PBCs only exacerbates this problem. Although some ESG or PBC activities consist of contributional philanthropy, much of this philanthropy consists of making operational decisions that advance social or environmental causes, but adversely impact the bottom line. I see no way of allowing deductions for profit-seeking business expenses but disallowing deductions for similar but profit-sacrificing expenses incurred to advance these causes.[139]

If it were practical to distinguish between profit-seeking and profit-sacrificing activities, eliminating the corporate deduction for the latter would tend to discourage corporate philanthropy. Of course, this would be a very blunt response. Henderson and Malani's more modest proposal is to level the tax playing field so that tax plays no role in determining the channel of philanthropy flowing from corporate profits.[140] However, for the reasons just discussed, approaching this problem from the side of the corporate tax deduction is increasingly impractical.[141] Leveling from the stakeholder tax perspective, on the

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nonprofit institution . . . qualif[ies] as a section 162 expense, or . . . for a deduction under section 170," rendering the distinction unenforceable).

138. *See id.* at 150.

139. The test for deductibility of business expenses is whether the expenses are "ordinary and necessary." 26 U.S.C. § 162. While profit-sacrificing expenses might be viewed by the lay person as neither ordinary nor necessary, in reality the ordinary and necessary test works to distinguish personal or capital expenditures from business expenditures. *See, e.g.*, Comm'r v. Tellier, 383 U.S. 687, 689–90 (1966) (noting that Supreme Court tax case "decisions have consistently construed the term 'necessary' as imposing only the minimal requirement that the expense be 'appropriate and helpful,'" while the "principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures . . . . ") (citations omitted). Whatever the motivation, I cannot see the IRS challenging a deduction for, say, more expensive sustainably sourced materials on the basis that the expenditure was not ordinary or necessary. The expenditure is not personal or capital.

140. Henderson & Malani, *supra* note 45, at 577.

141. To be sure, the problem of corporate philanthropy masquerading as ordinary and necessary business expense could be avoided by eliminating the corporate income tax. This was Milton Friedman's preferred response, but one that he recognized was out of reach. FRIEDMAN, *supra* note 54, at 132–33.

other hand, is possible and would in some cases be directionally consistent with widely advocated tax policy goals.

As I discuss in a separate paper, at current tax rates, the two largest discrepancies between the tax treatment of corporate and stakeholder philanthropy arise because of (1) our failure to allow deductions for charitable contributions to non-itemizing individuals (advantages corporate philanthropy) and (2) our failure to tax unrealized gains on appreciated property contributed by individuals (advantages stakeholder philanthropy).[142] Allowing a universal "above-the-line" deduction for all individual charitable contributions and treating charitable gifts as realization events would go a long way towards neutralizing the tax treatment of corporate and stakeholder philanthropy.[143]

Before moving on it is worth noting that non-tax prescriptive methods of regulating operational corporate philanthropy are as fraught with difficulty as tax methods. For example, one could possibly imagine a corporate law response, specifically an amendment to Delaware corporate law prohibiting or discouraging corporate philanthropy, perhaps by imposing onerous procedural requirements on firms engaging in philanthropic activities. But, of course, the problem with doing

142. *See* Walker, *supra* note 103.

143. A universal or "above-the-line" deduction would be available to all taxpayers whether they itemize deductions or take the standard deduction. Many commentators propose universal deduction of individual charitable contributions above an income-based floor. The idea is that most taxpayers would give a certain amount to charity irrespective of a tax deduction, so allowing a deduction for the first dollar contributed would be wasteful. *See, e.g.*, C. Eugene Steuerle et al., Designing an Effective and More Universal Charitable Deduction 9 (Tax Pol'y Ctr. 2021) (proposing a universal (above-the-line) deduction for charitable contributions above a floor of one to two percent of adjusted gross income). Full deductibility of individual charitable contributions would be most consistent with leveling corporate and stakeholder philanthropy. Thus, we have a trade-off. My inclination would be to set a modest floor on the individual deduction—sacrificing some leveling for a more efficient tax subsidy. Interestingly, the most commonly offered reform proposal for the taxation of individual charitable contributions—replacing the current deduction with a uniform tax credit—is less effective than a regime of broad deductibility in terms of leveling the playing field between corporate and individual philanthropy, as a uniform credit would create differences in the relative tax subsidy of corporate philanthropy between high and low bracket investors. As shown in the Appendix of the companion article to this one, one of the requirements for neutral tax treatment of corporate and investor or employee philanthropy is that corporate returns to individuals and charitable gifts by individuals be taxed at the same rate. A uniform credit for individual philanthropy would result in at least some stakeholders facing a different tax rate on corporate returns and charitable gifts. *See* Walker, *supra* note 103.

so would be exactly the same as the problem with curtailing tax deductions. It would be difficult to distinguish between profit-seeking and profit-sacrificing expenditures, particularly with respect to operational expenses. Imposing costs on suspected profit-sacrificing expenditures would inevitably squelch profit-seeking activities as well. Given the business judgement rule and other features of corporate law that prioritize managerial discretion,[144] it is difficult to imagine judges or regulators second-guessing managerial decisions as to what expenditures are profit-seeking.

Careful readers will note that I have attempted to carve out disclosure-based regulation from the preceding discussion of tax or prescriptive regulation. Often when prescriptive regulation of corporate activity is particularly fraught with difficulty as with, for example, the regulation of executive compensation, we turn to disclosure-based strategies in order to minimize unintended consequences. That possibly is taken up in Part IV.

IV.
Towards a Disclosure-Based Approach to Operational Philanthropy

In my view, the primary challenge of operational philanthropy is to ensure that corporate disclosures minimize agency costs and facilitate investor, employee, and consumer sorting based on companies' philanthropic efforts and achievements. The challenge is formidable because of the opacity of operational philanthropy and the difficulty of distinguishing operational philanthropy from business as usual, which, of course, is one reason that greenwashing is common and effective and which is why applying differential tax treatment

144. *See* Robert Charles Clark, Corporate Law § 3.4 (1986) (explaining "that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment — even for judgments that appear to have been clear mistakes — unless certain exceptions apply."). In Delaware, corporate executives receive further insulation against claims of negligence by charter provisions promulgated pursuant to Section 102(b)(7) of Delaware General Corporation Law, which permits exculpation of directors and officers against claims for money damages, with exceptions for claims based on managerial self-interest, bad faith, or knowing violation of law.

to operational philanthropy is such a daunting prospect. This is not the place for a thorough examination of the disclosure issues relevant to operational philanthropy.[145] Instead, I will offer a few tentative observations focusing on the SEC's recent ESG disclosure efforts which can be seen as addressing the agency cost and sorting challenges.

A. *The Importance of Effective Disclosure*

As discussed above, one response to shareholder primacy concerns associated with corporate philanthropy lies in investor sorting based on the charitable philosophy and performance of firms and/or investment funds.[146] As Professors Hirst, Kastiel, and Kricheli-Katz point out, however, insufficient information on fund investment policies is one potential obstacle to such sorting.[147] Reliable, consistent, and comparable disclosure of operational philanthropy goals and achievements facilitates sorting.

At the same time, the opacity of operational philanthropy heightens agency cost concerns which can be mitigated only if investors or intermediaries have access to information. In other words, reliable, consistent, and comparable disclosure of operational philanthropy goals and achievements also helps limit agency costs. Agency cost mitigation requires more than just information; but information is a prerequisite for agency cost mitigation.

To be sure, no amount of reporting or transparency will totally eliminate agency costs or resolve the fundamental tensions inherent in multiple mission corporations: How much

145. The explosion of corporate ESG efforts and ESG investing has led to a plethora of articles on disclosure, most of which are relevant to the transition from contributional to operational philanthropy. *See, e.g.*, Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1201 (1999) (predating the ESG movement, but discussing the possibility of SEC-required social disclosures); Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REGUL. 499, 501 (2020); Georgiev, *supra* note 114, at 644; Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821, 1827–28 (2021); Virginia Harper Ho, *Disclosure Overload? Lessons for Risk Disclosure & ESG Reporting Reform from the Regulation S-K Concept Release*, 65 VILL. L. REV. 67, 69 (2020).

146. *See supra* note 11 and accompanying text.

147. Hirst et al., *supra* note 64, at 1032–33. While these authors reasonably focus on discerning investment fund policies, transparency and disclosure must start at the firm level.

corporate philanthropy is appropriate? Which missions should be embraced? But, again, as long as potential investors have sufficient choices between corporations pursuing various transparent combinations of profit-seeking and socially oriented missions, these questions are somewhat less important. The bottom line is that the goals of minimizing agency costs and facilitating stakeholder sorting are aligned and likely have a common response in effective disclosure.

B. *The Current Disclosure Landscape*

Disclosure rules and practices vary considerably for contributional and operational corporate philanthropy. Consistent with the IRS's private foundation rules, contributions that are funneled through corporate foundations must be disclosed annually to the IRS on forms that are then made public.[148] There are, however, no mandatory disclosure requirements for direct corporate charitable contributions and voluntary disclosure is spotty. One report from 2000 indicated that fewer than fifteen percent of Fortune 100 companies revealed direct charitable giving and even fewer disclosed the names of recipient organizations.[149] One potential explanation for the lack of a general SEC disclosure regime for corporate contributional philanthropy might be that the agency cost and sorting concerns associated with such philanthropy simply are not that substantial.

Turning to operational philanthropy, consider first PBCs. PBCs must define and announce a public benefit and provide regular reports on their success in meeting their public

148. I.R.S. Form 990-PF: Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation (2023). This disclosure requirement does not guarantee transparency. Professor Patricia Banks has recently analyzed the websites of Fortune 100 companies and their foundations and has found that "[o]nly 4.5% of the companies provide a searchable grant database, only 7.5% offer a categorized grants list, and just 7.5 % provide online access to their 990-PF filings." Patricia A. Banks, *The Transparency Problem in Corporate Philanthropy*, MIT SLOAN MGMT. REV. (Dec. 19, 2022), https://sloanreview.mit.edu/article/the-transparency-problem-in-corporate-philanthropy/.

149. Sara A. Morris & Barbara R. Bartkus, *Look Who's Talking: Corporate Philanthropy and Firm Disclosure*, 5 INT'L J. BUS. & SOC. RSCH. 1, 2 (indirectly citing an SEC report); *see also*, Banks, *supra* note 148 (noting that despite demands for ESG transparency, "philanthropy remains an . . . almost entirely opaque sphere of corporate activity.").

benefit goals.[150] Thus, ideally, philanthropically-oriented investors can select a PBC from a menu of firms offering different philanthropic missions and monitor the firm's philanthropic performance. While this is a step in the right direction, in all likelihood the practice today falls woefully short of the ideal. Professors Fisch and Solomon argue that PBC mission statements tend to be excessively vague and advocate greater specificity to allow stakeholders and regulators to monitor PBC performance, ensuring accountability with respect to a PBC's mission and acting as a check against PBCs drifting back towards shareholder primacy.[151] Providing for real investor choice among PBC missions is another, clearly related, justification for demanding more specificity and transparency.

Arguably, the ESG movement also represents a step in the direction of more accountable corporate philanthropy. Over ninety percent of S&P 500 companies issue annual "sustainability" reports that include objectives and results of philanthropic activities, writ large. Voluntary sustainability reporting has been driven by institutional investors and represents a major source of data on ESG and operational philanthropy. These reports allow philanthropically-minded stakeholders to match their corporate affiliations with their own philanthropical objectives as well as monitor ESG performance and limit agency costs. Of course, some skeptics would argue that these sustainability reports are largely window dressing, or "greenwashing" in the ESG parlance.[152] Others would point out that, even if

150. *See* DEL. CODE ANN. tit. 8, §§ 362, 366 (2024); *see also, supra* notes 31–33 and accompanying text.

151. Fisch & Solomon, *supra* note 30, at 2, 20.

152. Coming from the opposite direction, other skeptics might argue that the ESG movement has been so successful that U.S. equity investors no longer have pure profit-maximizing options—that all firms are now essentially required to embrace environmental and social missions—and thus that shareholder sorting is illusory. But I do not believe we are quite there yet. Many firms and investors embrace ESG only to the extent that doing so improves the bottom line. *See, e.g.*, Brandon Boze et al., *The Business Case for ESG*, CORP. GOVERNANCE RSCH. INITIATIVE: STAN. CLOSER LOOK SERIES, May 23, 2019, at 1 https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-77-business-case-esg.pdf (noting that investor ValueAct Capital "generally incorporates ESG factors into its [investment] process by identifying relevant stakeholders and factors, isolating and evaluating potential risks, and supporting companies as they invest in their businesses to increase returns."); Kyle Welch & Aaron Yoon, *Do High-Ability Managers Choose ESG Projects that Create Shareholder Value? Evidence from Employee Opinions*, 28 REV. ACCT. STUD. 2448, 2448 (2023) ("[F]ind[ing] evidence that high-ability managers allocate

well-intended, voluntary disclosure suffers from a lack of completeness, standardization, and consistency. For example, in promulgating proposed rules requiring public companies to disclose climate-related risks and metrics in March 2022, the SEC noted that "current disclosure practices are fragmented and inconsistent" and that "the proposed rules would help issuers more efficiently and effectively disclose these risks, which would benefit both investors and issuers."[153]

C. *Mandatory Disclosure of Public Company ESG Activities*

The SEC has been very active in recent years ramping up mandatory disclosure requirements for various public company ESG activities, including those related to climate change; human capital management; diversity, equity, and inclusion (DEI); and even cybersecurity.[154] While these disclosure mandates hardly address the entirety of corporate operational philanthropy, they do cover several of the most common and important areas and could conceivably provide much more consistent, comparable, and reliable information to stakeholders than voluntary sustainability reporting does today, facilitating sorting and helping to limit agency costs.

The usefulness of mandatory SEC ESG disclosure to stakeholder sorting and agency cost mitigation may be limited, however, in several ways. Consider the SEC's highly controversial climate-related disclosure rules. While the SEC and proponents argue that climate-related risks are important to

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resources to ESG in a way that enhances shareholder value."). Meanwhile, we are beginning to see the emergence of "anti-woke" investment funds suggesting a plurality of approaches to incorporating, or not incorporating, ESG performance into investment analysis. *See, e.g.*, Daniel Grant, Opinion, *Investment Options for the Unwoke*, WALL ST. J. (Apr. 17, 2021, 6:02 PM), https://www.wsj.com/articles/investment-options-for-the-unwoke-11618610522 (describing an investment fund that screens out liberal-leaning firms from the 1,000 largest New York Stock Exchange/Nasdaq listed companies).

153. *Fact Sheet: Enhancement and Standardization of Climate-Related Disclosures*, SEC (Mar. 21, 2022), https://www.sec.gov/files/33-11042-fact-sheet.pdf.

154. Peter Rasmussen, *Corp Fin Director Expects Quick Action on ESG Rules*, BLOOMBERG L. (May 12, 2021, 5:00 AM), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-corp-fin-director-expects-quick-action-on-esg-rules (reporting statement of SEC acting director of Division of Corporate Finance, John Coates, that near-term SEC disclosure rule priorities would be DEI, climate change, and human capital management).

investors,[155] critics argue that the SEC regulations are really an impermissible backdoor attempt to regulate greenhouse gas emissions.[156] And, indeed, there is an element of schizophrenia about the rules. Companies are required to disclose material climate-related risks, such as the impact of rising sea levels on operations,[157] but also their greenhouse gas emissions, on the theory that "[t]ransitions to lower carbon products, practices, and services, triggered by changes in regulations, consumer preferences, availability of financing, technology and other market forces, can lead to changes in a company's business model" and that "[g]overnments around the world have made public commitments to transition to a lower carbon economy, and efforts towards meeting those greenhouse gas ("GHG") reduction goals have financial effects that may materially impact registrants."[158] It is not clear that the business risk associated with future regulation would support analogous disclosure rules with respect to, for example, DEI, human capital management, or cybersecurity.[159]

More generally, in the case of ESG or operational philanthropy, there is a tension between the usual rationale behind mandatory corporate disclosure—that the reporting firm faces material internal or external risks of which investors should be aware—and the disclosures that would assist sorting and mitigation of agency costs by philanthropically-minded investors or other stakeholders—that the reporting firm is taking steps to reduce harms that it imposes on the environment; improve working conditions; improve diversity, equity, and inclusion;

155. *Id.*; Working Grp. on Sec. Disclosure Auth., Comment Letter on Proposed SEC Rules Related to Mandated, Standardized Climate-Related Disclosures for Investors (Jun. 16, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20131670-302060.pdf.

156. Richard C. Breeden et al., Comment Letter on the Enhancement and Standardization of Climate-Related Disclosures for Investors (Jun. 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132519-303005.pdf.

157. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21354 (Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249)

158. *Id.* at 21336–37.

159. For example, the SEC has issued disclosure rules related to public company. cybersecurity threats and incidents. *See Fact Sheet: Public Company Cybersecurity Disclosures; Final Rules*, SEC (July 26, 2023), https://www.sec.gov/files/33-11216-fact-sheet.pdf. These rules do not mandate disclosure of, for example, company commitments to forgo monetizing customer data. *Cf. id.*

etc.[160] In my view, however, the tension is largely illusory. Investors increasingly care about firm environmental and social impacts independent of their impact on firm financial returns. Mandatory disclosure of public company ESG performance is justified, even absent material financial impact, because it facilitates investor sorting into firms and investment funds that align with non-financial priorities of investors and because it helps mitigate agency cost concerns.[161] Both concerns are heightened in a world in which companies embrace, to a greater or lesser extent, ESG priorities in addition to pursuing profits for investors—or as I have termed it, shift from contributional to operational philanthropy. Meanwhile, facilitation of investor sorting and mitigation of agency costs are perfectly legitimate bases for mandatory disclosure under the SEC's remit.[162]

D. *The Difficulty of Applying Tax Penalties or Limitations to Operational Philanthropy May Not Doom Disclosure-Based Monitoring and Sorting*

I have argued that it would be difficult to adjust tax subsidies for or prescriptively regulate corporate operational philanthropy because such philanthropy is often indistinguishable

160. *See* David F. Larcker et al., *ESG Ratings: A Compass Without Direction*, Corp. Governance Rsch. Initiative: Stan. Closer Look Series, Aug. 2, 2022, at 2, https://www.gsb.stanford.edu/sites/default/files/publication/pdfs/cgri-closer-look-97-esg-ratings_0.pdf (describing the tension between the "view of ESG . . . that it reflects the impact a company has on the welfare of its stakeholders" and the "competing view . . . that ESG measures the impact societal and environmental factors have on the company").

161. Professor Lipton argues that mandatory corporate disclosure obligations should not focus exclusively on shareholder interests. *See* Lipton, *supra* note 145, at 503, 531. In this situation, however, I believe that simply acknowledging and embracing shareholder sorting and agency cost mitigation concerns should result in disclosures that will be useful to other stakeholders.

162. *See, e.g.*, Williams, *supra* note 145 at 1288–89 (arguing that "because people in the social investor sector of the market are using socially significant information to make investment decisions, that information is clearly material to them, irrespective of its economic implications" and that "the SEC should act to provide those investors . . . with more readily accessible sources of consistent, comparable, high-quality information about corporate social effects, precisely as it has done with financial data," i.e., via mandatory disclosure); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. Chi. L. Rev. 1047, 1048 (1995) (arguing that "the principal purpose of mandatory disclosure is to address certain agency problems that arise between corporate promoters and investors, and between corporate managers and shareholders").

from profit-seeking activity.[163] For example, the tax rule limiting deductions for contributional corporate philanthropy to ten percent of profits would not readily translate to the operational philanthropy sphere. How would one include a corporate decision to forego a revenue stream, on privacy or other pro-social grounds, into a scheme capping deductibility of philanthropy?

However, while the opacity of operational philanthropy also increases the challenges of implementing effective disclosure-based regulation, it does not necessarily doom the effort. Importantly, the type of information needed to regulate via tax may be quite different than that required by investors and other stakeholders to monitor agency costs and facilitate sorting. It is certainly not difficult to appreciate that a pledge to forego monetization of customer data might be important to stakeholders in the first instance—facilitating sorting—and one need not place a dollar value on the foregone revenue to report on whether the pledge has been honored or not—aiding monitoring.

The regulation of executive compensation may provide a useful example and model. Congress has attempted to regulate executive pay through the tax code and other prescriptive measures, in each case with at best limited success and often unfortunate unintended consequences. For example, a 1993 rule limiting the deductibility of senior executive pay led to an explosion in stock option compensation and other "performance-based" pay exempted from the rule, did nothing to slow the growth in compensation, and may have contributed to excessive risk-taking at banks that precipitated the 2007–08 financial crisis.[164] The 2011 introduction of non-binding shareholder "say on pay" voting has added to compliance costs but has done nothing to limit pay.[165]

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163. *See supra* Section III.F.

164. *See* Gregg D. Polsky, *Controlling Executive Compensation through the Tax Code*, 64 WASH. & LEE L. REV. 877, 906, 917–20 (2007) (documenting the widespread belief among informed observers that § 162(m) contributed to the stock options explosion); Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REGUL. 257, 274 (2010) (concluding that the largely performance-based compensation awarded to executives at Bear Stearns and Lehman Brothers created incentives for excessive risk-taking).

165. *See, e.g.*, Christopher S. Armstrong et al., *The Efficacy of Shareholder Voting: Evidence from Equity Compensation Plans*, 51 J. ACCT. RSCH. 909, 948 (2013) (finding "no evidence that shareholder voting for equity pay plans . . . is an effective mechanism for influencing executive compensation.").

Meanwhile, for more than 30 years the SEC has steadily ratcheted up annual disclosure requirements for the compensation of the top executives of public companies, steadily increasing their effectiveness.[166] The SEC struggled with the complexity of pay practices—for example, how to value and disclose stock option compensation—and with the opacity of pay practices—for example, shedding light on compensation delivered through above-market returns on deferred compensation.[167] The SEC or another regulator focusing on operational philanthropy would face similar challenges in getting the disclosure rules right, and we should not expect that to happen overnight.

One other lesson from the history of disclosure-based regulation of executive pay that may be instructive here is that lengthy narrative disclosures can obfuscate as well as illuminate. It was only after the SEC prescribed highly specific tabular presentation of compensation data that these disclosures became truly useful to investors.[168] It is not immediately obvious how tabular disclosure could be applied to operational philanthropy, but the lesson remains an important one.

E. *Intermediaries Will Play Key Roles in a Disclosure-Based Approach to Operational Philanthropy*

Whether disclosure remains largely voluntarily or is increasingly dictated by the SEC or other agencies, private third-party intermediaries are likely to remain critical to an effective operational philanthropy disclosure regime. Intermediaries play two

166. Executive compensation disclosure for senior executives of public companies is required under Item 402 of Regulation S-K. Major reforms to executive pay disclosure requirements occurred in 1992 and 2006. *See* Executive Compensation Disclosure, 57 Fed. Reg. 48126, 48129 (Oct. 21, 1992) (adopting tabular disclosures); Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53158, 53159–60 (Sept. 8, 2006) (further improving tabular disclosure and adding a narrative compensation discussion and analysis section). *See generally* David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, *in* Research Handbook on the Economics of Corporate Law 232, 245–46 (Claire A. Hill & Brett H. McDonnell eds., 2012) (providing a brief history of the SEC's executive pay disclosure efforts).

167. *See* Walker, *supra* note 166, at 246.

168. *See* Executive Compensation Disclosure, 57 Fed. Reg. 48126, 48129 (Oct. 21, 1992).

roles: as data compilers and suppliers of ratings and as auditors of compliance.

As Professor David Larcker and his colleagues detail, ESG ratings agencies are flourishing.[169] Dozens of agencies and data providers are responding to the increasing demand for ESG information by investors, regulators, and even the companies themselves.[170] One reason that intermediaries are vital to this effort is the "immense number of factors that plausibly fall under the heading of ESG."[171]

To be sure, there is concern regarding the quality of ESG rating assessments. One source of concern relates to the foregoing discussion of the SEC's climate-related disclosures: while investors and some other users of ESG data tend to believe that the ratings reflect the impact that a firm has on its stakeholders, in reality the ratings generally reflect company exposure to environmental and social risk.[172] Nonetheless, just as institutional investors rely heavily on proxy advisory firms ISS and Glass Lewis to advise them on executive compensation and other governance matters, the complexity of ESG-driven operational philanthropy will undoubtedly continue to necessitate intermediation by ratings agencies.

Of course, disclosure and rating agency intermediation alone may not fully meet the needs of stakeholders, particularly if operational philanthropy disclosure remains largely voluntary. The gap may be filled by another intermediary: a third-party auditor. Already in the PBC world, certified B Corps must undergo recertification by a nonprofit known as B Lab every three years.[173] The certification is holistic and based upon demonstration of high social and environmental performance, adoption of a governance structure ensuring accountability to all stakeholders, and transparency with respect to the forgoing.[174] Of course, this is only one approach. One can imagine other audit organizations targeting different facets of operational philanthropy.

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169. Larcker et al., *supra* note 160, at 2.
170. *Id.* at 1–2.
171. *See id.* at 2.
172. *See id.*
173. *See About B Corp Certification: Measuring a Company's Entire Social and Environmental Impact*, B Lab, https://www.bcorporation.net/en-us/certification/ (last visited Oct. 21, 2024).
174. *Id.*

Conclusion

As corporations shift from contributional to operational philanthropy, distinguishing between profit-seeking activity and profit-sacrificing philanthropy becomes increasingly difficult. In all likelihood, the comparative advantage of corporate philanthropy relative to stakeholder philanthropy rises with the shift, but agency costs and the difficulty (and importance) of stakeholder sorting based on various degrees of pro-social corporate activities likely increase as well. The shift also makes it more difficult to regulate corporate philanthropy through the tax code or through other prescriptive means. The best and perhaps only feasible response to these issues and concerns lies in enhanced disclosure of ESG and other corporate operational philanthropy. Of course, if it were easy to draw up a set of disclosures that would accurately and transparently detail operational philanthropy, greenwashing would not be a problem, agency costs would be held in check, and sorting by investors and other stakeholders would be simple. The continued prevalence of greenwashing confirms that none of this will be easy.

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DON'T KILL THE BABY! THE CASE FOR AI IN ARBITRATION

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Since the introduction of Generative AI (GenAI) in 2022, its ability to simulate human intelligence and generate content has sparked both enthusiasm and concern. While much of the criticism focuses on AI's potential to perpetuate bias, create emotional dissonance, displace jobs, and raise ethical questions, these concerns often overlook the practical benefits of AI, particularly in legal contexts. This article examines the integration of AI into arbitration, arguing that the Federal Arbitration Act (FAA) allows parties to contractually choose AI-driven arbitration, despite traditional reservations.

This article makes three key contributions: (1) It shifts the focus from debates over AI's personhood to the practical aspects of incorporating AI into arbitration, asserting that AI can effectively serve as an arbitrator if both parties agree; (2) It positions arbitration as an ideal starting point for broader AI adoption in the legal field, given its flexibility and the autonomy it grants parties to define their standards of fairness; and (3) It outlines future research directions, emphasizing the importance of empirically comparing AI and human arbitration, which could lead to the development of distinct systems.

By advocating for the use of AI in arbitration, this article underscores the importance of respecting contractual autonomy and creating an environment that allows AI's potential to be fully realized. Drawing on the insights of Judge Richard Posner, the article argues that the ethical obligations of AI in arbitration should be understood within the context of its technological strengths and the voluntary nature of arbitration agreements. Ultimately, it calls for a balanced, open-minded approach to AI in arbitration, recognizing its potential to enhance the efficiency, fairness, and flexibility of dispute resolution.

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Introduction

Since the introduction of Generative AI (GenAI) in 2022, extensive discussions have highlighted its impressive capabilities in simulating human intelligence and generating novel content.[1] Despite these remarkable functionalities, there is consensus that, if not carefully managed and fine-tuned, GenAI—especially when applied through Large Language Models (LLMs)[2]—can be fundamentally harmful and discriminatory toward marginalized groups.[3] In the workplace, Artificial

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1. *See* Cole Stryker & Eda Kavlakoglu, *What is Artificial Intelligence (AI)?*, IBM, https://www.ibm.com/topics/artificial-intelligence (last visited Aug. 3, 2024) (AI is a technology that enables computers and machines to simulate human intelligence and problem-solving capabilities); John Nosta, *When Artificial Intelligence Mimics the Human Brain*, Psych. Today (Nov. 30, 2023), https://www.psychologytoday.com/us/blog/the-digital-self/202311/when-artificial-intelligence-mimics-the-human-brain; Aditya Roy, *Simulating Human Intelligence: Are We Close to It?*, Medium (July 5, 2021), https://becominghuman.ai/simulating-human-intelligence-are-we-close-to-it-463976a4c203; Pandora Dewan, *New AI Can Mimic Human Brain, Use the Same Tricks as We Do*, Newsweek (Nov. 20, 2023, 11:00 AM), https://www.newsweek.com/new-ai-mimic-human-brain-tricks-neuroscience-1845159; Ana Santos Rutschman, *Artificial Intelligence Can Now Emulate Human Behaviors – Soon It Will Be Dangerously Good*, Phys Org (Apr. 5, 2019), https://phys.org/news/2019-04-artificial-intelligence-emulate-human-behaviors.html; *see also* Jen Hunsaker, *12 AI Content Generators to Make Great Content in Minutes*, Semrush Blog (July 22, 2024), https://www.semrush.com/blog/ai-content-generators/ (suggesting that AI can create a month's worth of content for one's website, social media, and ad campaigns in a few hours); Thomas H. Davenport & Nitin Mittal, *How Generative AI is Changing Creative Work*, Harv. Bus. Rev. (Nov. 14, 2022), https://hbr.org/2022/11/how-generative-ai-is-changing-creative-work; Mihaela Bidilică, *How to Use AI to Write a Book. Overcome Writer's Block with* AI *Assistance*, Publishdrive (Apr. 30, 2024), https://publishdrive.com/how-to-use-ai-to-write-a-book.html (recommending that AI writing tools help users generate text using concepts like natural language generation and machine learning).

2. *See What are LLMs?*, IBM, https://www.ibm.com/topics/large-language-models (last visited Aug. 4, 2024).

3. *See* Olga Akselrod, *How Artificial Intelligence Can Deepen Racial and Economic Inequalities*, ACLU (July 13, 2021), https://www.aclu.org/news/privacy-technology/how-artificial-intelligence-can-deepen-racial-and-economic-inequities (suggesting that there's ample evidence of the discriminatory harm that AI tools can cause to already marginalized groups, as AI is built by humans and deployed in systems and institutions that have been marked by entrenched discrimination – from the criminal legal system, to housing, to the workplace, to our financial system); *see also* Khari Johnson, *A Move for "Algorithmic Reparation" Call for Racial Justice in AI*, Wired (Dec. 23, 2021, 7:00 AM), https://www.wired.com/story/move-algorithmic-reparation-calls-racial-justice-ai/ (explaining how algorithms used to screen apartment renters and mortgage applicants disproportionately disadvantaged Black people due to the historical patterns of segregation that have poisoned the data on which

Intelligence (AI) systems used for hiring, promotions, and other Human Resources (HR) tasks may perpetuate biases by learning from historical data.[4] Additionally, AI chatbots and virtual assistants, though capable of mimicking human interactions, lack genuine empathy and human connection.[5] This can lead to emotional dissonance, where users feel temporarily understood without receiving the deeper emotional support that real human relationships provide.[6] Furthermore, AI's efficiency in automating tasks could result in significant job displacement,[7] and its proficiency in analyzing large datasets might enable the creation of personalized content, raising critical ethical questions about consent, manipulation, privacy, and the potential impact on democracy and personal autonomy.[8]

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many algorithms are built); Elisa Jillson, *Aiming for Truth, Fairness, and Equity in Your Company's Use of AI*, FED. TRADE COMM'N (Apr. 19, 2021), https://www.ftc.gov/business-guidance/blog/2021/04/aiming-truth-fairness-equity-your-companys-use-ai (saying that one consequence of this bias in healthcare is that technological advancements that were meant to benefit all patients may have worsened the healthcare disparities for people of color and as a result, the economic and racial division in our country will only deepen).

4. *See* Lena Kempe, *Navigating the AI Employment Bias Maze: Legal Compliance Guidelines and Strategies*, A.B.A. (Apr. 2024), https://www.americanbar.org/groups/business_law/resources/business-law-today/2024-april/navigating-ai-employment-bias-maze/ (suggesting that AI systems may produce biased results because of limitations in their training data or errors in their programming, with significant legal risks in the hiring and HR contexts); *see also* Maria Diaz, *4 Ways AI is Contributing to Bias in the Workplace*, ZDNET (Mar. 18, 2024, 3:40 AM), https://www.zdnet.com/article/4-ways-ai-is-contributing-to-bias-in-the-workplace/.

5. *See AI Chatbots have Shown They Have an "Empathy Gap" that Children are Likely to Miss*, SCIENCEDAILY (July 2024), https://www.sciencedaily.com/releases/2024/07/240710195430.htm (a study at the University of Cambridge shows that "AI chatbots have frequently shown signs of 'empathy gap' that puts young users at risks of distress or harm, raising the urgent need for 'child-safe AI'"); *see also* Drew Turney, *AI Can "Fake" Empathy but Also Encourage Nazism, Disturbing Study Suggests*, LIVESCIENCE (May 29, 2024), https://www.livescience.com/technology/artificial-intelligence/ai-can-fake-empathy-but-also-encourage-nazism-disturbing-study-suggests.

6. *See generally* Lennart Seitz, *Artificial Empathy in HealthCare Chatbots: Does it Feel Authentic?*, COMPUTS. IN HUM. BEHAV.: ARTIFICIAL HUMS., Jan.-July 2024.

7. *See* Rakesh Kochhar, *Which U.S. Workers Are More Exposed to AI on Their Jobs?*, PEW RSCH. CTR. (July 26, 2023), https://www.pewresearch.org/social-trends/2023/07/26/which-u-s-workers-are-more-exposed-to-ai-on-their-jobs/ (analyzing the types and percentages of jobs that are the most exposed to AI risks).

8. *See* Erik Hermann, *Artificial Intelligence and Mass Personalization of Communication Content – An Ethical and Literacy Perspective*, 24(5) NEW MEDIA & SOC'Y 1258, 1259 (2021); *see also* Marietjie Botes, *Autonomy and the Social*

While criticisms of GenAI are valid and well-founded, they often overlook the technology's efficiency and cost-effectiveness. GenAI excels in processing and analyzing data at speeds unattainable by humans,[9] reducing overall costs,[10] accelerating decision-making processes,[11] and enhancing accuracy in various applications.[12] Moreover, GenAI supports remote work,[13] education,[14] and medical consultations, reducing the

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Dilemma of Online Manipulative Behavior, 3 AI & ETHICS 315 (2023); *see generally* Christina Pazzanese, *Great Promise but Potential for Peril*, THE HARV. GAZETTE (Oct. 26, 2020), https://news.harvard.edu/gazette/story/2020/10/ethical-concerns-mount-as-ai-takes-bigger-decision-making-role/; *see generally* Karl Manheim and Lyric Kaplan, *Artificial Intelligence: Risks to Privacy and Democracy*, 21 YALE J.L. & TECH 106 (2019).

9. *See* Jon Kleinman, *Can AI Revolutionize the Art of Being Human?*, INSIGNIAM (Mar. 12, 2024), https://insigniam.com/ai-and-leadership/ ("One of the key capabilities of AI lies in its ability to process and analyze large volumes of data at incredible speeds.").

10. *See* Katy Flatt, *AI Efficiency: Cost Reduction with AI*, INDATA LABS (May 21, 2024), https://indatalabs.com/blog/ai-cost-reduction ("Around 4% of all companies saw cost savings of at least 20%, and 28% lowered their costs by 10% or less after adopting AI.").

11. *See How CEOS Leverage Artificial Intelligence For Smarter Decision Making*, INFOMINEO (June 24, 2024), https://infomineo.com/blog/how-ceos-leverage-ai-for-smarter-decision-making/; *see also* Philip Meissner & Yusuke Narita, *Artificial Intelligence Will Transform Decision-Making*, WORLD ECON. F. (Sept. 27, 2023), https://www.weforum.org/agenda/2023/09/how-artificial-intelligence-will-transform-decision-making/.

12. *See* Melanie Grados, *New AI Method Enhances Prediction Accuracy and Reliability*, NEUROSCI. NEWS (July 12, 2024), https://neurosciencenews.com/ai-accuracy-reliability-26427/; *see also* Francois Candelon et al., *AI Can Be Both Accurate and Transparent*, HARV. BUS. REV. (May 12, 2023), https://hbr.org/2023/05/ai-can-be-both-accurate-and-transparent; *see generally* Mohamed Khalifa & Mona Albadaway, *AI in Diagnostic Imaging: Revolutionising Accuracy and Efficiency*, COMPUT. METHODS & PROGRAMS IN BIOMED. UPDATE (2024).

13. *See* Gleb Tsipursky, *The AI Revolution Transforming Hybrid and Remote Work and the Return to Office*, FORBES (May 9, 2023), https://www.forbes.com/sites/glebtsipursky/2023/05/09/the-ai-revolution-transforming-hybrid-and-remote-work-and-the-return-to-office/; *see AI and Remote Work: Exploring How Artificial Intelligence Could Transform Telecommuting*, VIRTUALVOCATIONS (Feb. 23, 2024), https://www.virtualvocations.com/blog/remote-working-tips/ai-and-remote-work-exploring-how-artificial-intelligence-could-transform-telecommuting/.

14. *See* Tanya Milberg, *The Future of Learning: How AI is Revolutionizing Education 4.0*, WORLD ECON. F. (Apr. 28, 2024), https://www.weforum.org/agenda/2024/04/future-learning-ai-revolutionizing-education-4-0/ ("AI can support education by automating administrative tasks, freeing teachers to focus more on teaching and personalized interactions with students"); *see also* Jey Willmore, *AI Education and AI in Education*, U.S. NAT'L SCI. FOUND. (Dec. 4, 2023), https://new.nsf.gov/science-matters/ai-education-ai-education

need for physical travel, especially when time is constrained.[15] It makes healthcare more accessible – in regions with scarce health resources, GenAI provides on-demand, accessible care by offering diagnostic assistance,[16] managing patient data,[17] and facilitating remote monitoring and consultations.[18] More importantly, it demystifies medical jargon for laypeople who lack access to primary physicians for explanations, bridging the service gap for underserved populations.[19]

Given these observations, there is a notable disparity between the concerns highlighted in harm-focused academic literature and the actual applications of GenAI in real-life settings. The essential question is not merely about how GenAI falls short of expectations or fails to meet people's needs, nor solely about the harms GenAI might inflict on society. Instead, the discussion should focus on exploring the tangible benefits and challenges of deploying AI in everyday contexts. When the advantages substantially outweigh the disadvantages, how should AI's integration be managed within existing legal frameworks? What modifications or reforms are necessary to ensure that AI deployment leads to more universally accessible resources and improved lifestyle choices?

("AI is transforming how students learn to engage with the world around them and use new technologies to create solutions to real problems"); *see generally Artificial Intelligence in Education*, UNESCO, https://www.unesco.org/en/digital-education/artificial-intelligence (last visited Aug. 3, 2024).

15. *See* Sachin Sharma et al., *Addressing the Challenges of AI-Based Telemedicine: Best Practices and Lessons Learned*, J. Educ. and Health Promotion 1, 1 (2023); *see generally* Ayesha Amjad et al., *Review, A Review on Innovation in Healthcare Sector (Telehealth) Through Artificial Intelligence*, 15 Sustainability 6655, 6664 (2023).

16 *See How AI is Improving Diagnostics, Decision-Making and Care*, Am. Hosp. Ass'n; *see also* Line, *Artificial Intelligence as an Aid to Medical Diagnosis*, Alcimed (Oct. 13, 2023), https://www.alcimed.com/en/insights/ai-medical-diagnosis/.

17. *See* Sai Balasubramanian, *Hospitals Are Using AI to Help Manage Patient Messages to Physicians*, Forbes (Apr. 26, 2024), https://www.forbes.com/sites/saibala/2024/04/26/hospitals-are-using-ai-to-help-sort-patient-messages-to-physicians/.

18. *See* Ayushmaan Dubey & Anuj Tiwari, *Artificial Intelligence and Remote Patient Monitoring in US Healthcare Market: A Literature Review*, 11 J. Mkt. Access Health Pol'y 1, 1 (2023); *see also* Liz Cramer & Cory Smith, *How Remote Patient Monitoring and AI Personalize Care*, HealthTech (Mar. 27, 2024), https://healthtechmagazine.net/article/2024/03/how-remote-patient-monitoring-and-ai-personalize-care.

19. *See* Sara Heath, *Using GenAI to Translate Medical Jargon in Discharge Notes*, TechTarget (Mar. 13, 2024), https://www.techtarget.com/patientengagement/news/366584111/Using-gen-AI-to-translate-medical-jargon-in-discharge-notes.

This article addresses these questions within the context of arbitration. It explores whether AI should be integrated into arbitration processes where decisions need to be made swiftly and cheaply and whether such integration aligns with the current legal framework. It argues that the Federal Arbitration Act (FAA) almost uniquely among Federal laws[20] allows such unconventional adjudication methods, provided both disputants agree by contract to use AI as their preferred method for resolving disputes. Furthermore, this article contends that arbitration is the ideal starting point for integrating AI in the legal space, as it operates with a lower threshold for fairness compared to traditional court systems.

This article makes several contributions:

Focus on Practical Integration: It dismisses concerns about whether AI qualifies as a person and instead focuses on the practical issues of integrating AI into the arbitration process. It asserts that AI can serve as an arbitrator, regardless of its liability and entity status, as long as both disputants agree by contract. The authors acknowledge that the current scholarship in Computer Science, Human-Computer Interaction, and (Bio)Informatics discourages the use of AI to replace humans, advocating instead for AI to augment human decision-making.[21] However, we argue that in the context of arbitration, parties have the freedom to choose their preferred method. When informed, reasonable, and sensible adults make such a choice, third parties have no grounds to paternalistically forbid the practice based on a perceived lack of empathy or potential for discrimination.

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20. We recognize that all the arguments we have suggested for AI based Alternative Dispute Resolution (ADR) under the FAA are equally — or even more so — true under the Labor Management Relations Act (LMRA) Section 301, which the Supreme Court tells us in *Textile Workers Union of Am. v. Lincoln Mills of Ala.*, 353 U.S. 448, 450–51 (1957) (there is no substantive law in LMRA arbitrations) will simply enforce such agreements between a union and a company with even less examination than under the FAA. We are using the FAA as a paradigm for adjudication based on contract, knowing that it is not absolutely unique.

21 *See generally* Sarah Degallier-Rochat et al., *Human-Augmentation, Not Replacement: A Research Agenda for AI and Robotics in the Industry*, 9 FRONT. ROBOT. & AI 1, 2 (2022); Emre Sezgin, *Artificial Intelligence in Healthcare: Complementing, not Replacing, Doctors and Healthcare Providers*, 9 DIGIT. HEALTH 1, 2 (2023); Savindu Herath Pathirannehelage et al., *Design Principles for Artificial Intelligence-Augmented Decision Making: An Action Design Research Study*, 2024 EUR. J. INFO. SYS. 1, 1; Endrit Kromidha & Robert M. Davidson, *Generative AI-Augmented Decision-Making for Business Information Systems*, 719 IFIP ADVANCES IN INFO. & COMMC'N TECH. 46, 53 (2024).

Arbitration as a Starting Point: We propose that arbitration is the starting point for an AI revolution in the legal domain. In arbitration, parties seek a system that aligns with their standards of fairness, which may differ from the objective standards upheld in conventional litigation. These early practices can serve as a basis for experimentation and provide data for later empirical analysis.

Future Scholarship Directions: We discuss that future scholarship should focus on studying and investigating the differences between AI arbitration and human arbitration, specifically in determining the contexts in which AI is more suitable and the circumstances where humans are more appropriate. Rather than spending extensive efforts to make GenAI more like humans and preventing over-reliance on machines, it is possible that there could be two distinct systems for arbitration in the future: one traditional, involving only humans, and another combining humans and AI, with all the disadvantages and drawbacks currently discussed.

The first part establishes that using GenAI in arbitration is consistent with the principles of the FAA, emphasizing that disputants have the discretionary power to shape their arbitration processes. The second part addresses resistance to AI's introduction in the legal sphere, challenging critics' arguments by highlighting that biases and errors often originate from humans rather than being inherent flaws of AI. It advocates for creating a conducive environment to positively influence AI's acceptance and effectiveness. The third part concludes the article and proposes future directions.

I.
AI and the Federal Arbitration Act

This part argues that substituting AI as the arbitrator is consistent with the FAA. It includes three sections:

1. Defining AI as an Arbitrator:

The First Section proposes a new definition of AI as an intelligent and autonomous system based on machine learning algorithms, capable of delivering results satisfactory to the parties. This definition emphasizes AI's ability to analyze data, learn from it, and make decisions autonomously, ensuring that the arbitration process remains efficient and unbiased.

2. Aligning AI with the FAA:

The Second Section argues that using AI as the arbitrator aligns with the FAA. It explains that the FAA's framework allows for flexibility in the arbitration process, enabling the use of innovative technologies like AI. As long as both parties consent to AI arbitration through their contractual agreement, the FAA supports such unconventional methods of dispute resolution.

3. Benefits of AI in Arbitration:

The Third Section discusses the benefits of integrating AI in arbitration. It suggests that using AI as the arbitrator is cost-effective, reducing expenses associated with human arbitrators and lengthy procedures. Additionally, AI can meet the parties' personal, subjective standards of fairness by providing consistent and unbiased decisions. Furthermore, deploying AI in arbitration is a strategic starting point for an AI revolution in the legal system. As arbitration has gradually become more judicialized over time, incorporating AI can streamline processes and set a precedent for broader AI integration in legal practices.

A. *What is AI*

1. *Definition of AI in Arbitration*

AI is extensively used across various domains; its varied definitions often create confusion when it comes to defining AI's specific role in arbitration. In finance, for example, AI facilitates know-your-customer (KYC) checks and anti-money laundering (AML) monitoring.[22] In tenant screening, AI conducts background checks, automating the retrieval and analysis of a candidate's financial history, criminal records, and previous rental agreements.[23] Using natural language processing (NLP), AI can analyze a tenant's online interactions to gauge their reliability and character.[24] In drug discovery, AI revolutionizes nearly every stage of the process, from target identification and molecular simulations to prediction of drug properties,

22. *See* Shawn Plummer, *AI in Finance: Revolutionizing the Future of Financial Management*, DataCamp (June 23, 2024), https://www.datacamp.com/blog/ai-in-finance.

23. *See How AI Improves Accuracy and Efficiency in Tenant Screening*, AutoHost (June 2, 2024), https://www.autohost.ai/ai-tenant-screening/.

24. *Id.*

de novo drug design, and synthesis pathway generation. [25] In content generation, AI has been used to write books in hours that win national competitions and help artists win awards for paintings.[26] Regardless of the users' identity—be it painter, musician, or writer—AI enhances the artistic journey through inspiration, idea generation, and visual exploration. [27] Since the debut of ChatGPT, AI has proliferated across various fields.[28]

The proliferation of AI applications requires clear definitions, as "AI" is an umbrella term encompassing a wide range of computing approaches and algorithms, including deep learning, robotics, expert systems, and NLP.[29] Generally, there are three types of definitions: capability-based, process-based, and goal-oriented. Capability-based definitions focus on what AI can do, such as understanding natural language, recognizing

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25. *See* Debleena Paul et al., *Artificial Intelligence in Drug Discovery and Development*, 26 Drug Discovery Today 80, 82 (2021) (suggesting that the involvement of AI in the de novo design of molecules can be beneficial to the pharmaceutical sector); Matthew Chun, *How Artificial Intelligence is Revolutionizing Drug Discovery*, Petrie Flom Ctr. (March 20, 2023), https://blog.petrieflom.law.harvard.edu/2023/03/20/how-artificial-intelligence-is-revolutionizing-drug-discovery/; *see also*, Yujie You et al., *Artificial Intelligence in Cancer Target Identification and Drug Discovery*, Signal Transduction & Targeted Therapy, 2022, at 1, 18 (proposing that artificial intelligence models have provided us with a quantitative framework to study the relationship between network characteristics and cancer, leading to the identification of potential anticancer targets and the discovery of novel drug candidates); Henrik Bohr, *Drug Discovery and Molecular Modeling using Artificial Intelligence*, *in* A.I. in Healthcare 61, 61 (2020); *see generally* Laurianne David et al., *Molecular Representations in AI-Driven Drug Discovery: A Review and Practical Guide*, 12 J. Cheminformatics 1, 19 (2020).

26. *See* Suswati Basu, *Japan Embraces AI as Author Wins Literary Prize Using ChatGPT*, How To Be, https://howtobe247.com/japan-embraces-ai-as-author-wins-literary-prize-using-chatgpt/; *see also* Sarah Kuta, *Art Made With AI Won a State Fair Last Year. Now, the Rules Are Changing*, Smithsonian Mag. (Sept. 8, 2023), https://www.smithsonianmag.com/smart-news/this-state-fair-changed-its-rules-after-a-piece-made-with-ai-won-last-year-180982867/.

27. *See* Andres Fortino, *Embracing Creativity: How AI Can Enhance the Creative Process*, Emerging Techs. Collaborative, https://www.sps.nyu.edu/homepage/emerging-technologies-collaborative/blog/2023/embracing-creativity-how-ai-can-enhance-the-creative-process.html (last visited Aug. 3, 2024).

28. Partha Pratim Ray, *ChatGPT: A Comprehensive Review on Background, Applications, Key Challenges, Bias, Ethics, Limitations and Future Scope*, 3 Internet of Things & Cyber-Physical Sys. 121, 121-54 (2023) (describing the various ways ChatGPT has been revolutionizing scientific research and applied to various domains).

29. *See Artificial Intelligence (AI) vs. Machine Learning (ML)*, Google Cloud, https://cloud.google.com/learn/artificial-intelligence-vs-machine-learning (last visited Apr. 29, 2024).

patterns, solving problems, and learning.[30] Process-based definitions emphasize how AI systems operate.[31] Goal-oriented definitions center on the expected outcomes of AI, such as augmenting human capabilities or automating decision-making processes.[32] Different organizations use these definitions interchangeably. For instance, IBM focuses on AI's functional and solution-oriented aspects,[33] while McKinsey emphasizes its human-like capabilities.[34]

These varying definitions create confusion about which AI is being discussed. They also affect people's perceptions of algorithmic decision-making systems, their evaluations of systems in application contexts, and the replicability of research findings.[35] For example, terms such as "computers" or "robots" are more likely to be perceived as tangible compared to "algorithms" or "artificial intelligence."[36] "Computer programs" might be perceived as less complex compared to "artificial intelligence," and "computer" might be associated with an entity more controllable than a "robot."[37] The use of different terms affects people's perceptions and treatment of the entity.

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30. *See* Jim Holdsworth, *What is NLP*, IBM (June 6, 2024), https://www.ibm.com/topics/natural-language-processing (natural language processing is a subfield of AI); *see, e.g.*, *Types of Artificial Intelligence: Categories of AI*, TECHLIANCE BLOG, https://blog.techliance.com/types-of-artificial-intelligence/ (last visited Aug. 4, 2024) (suggesting that based on AI's capability and functionality, AI have three types: Artificial Narrow Intelligence, i.e., Narrow AI, Artificial General Intelligence, i.e., General AI, and Artificial Super Intelligence, i.e., Super AI); *see also* Alexander Stahl, *How Pattern Recognition is Improving Lives*, MEDIUM (Mar. 22, 2024), https://medium.com/@stahl950/how-pattern-recognition-is-improving-lives-bf9ee7e988d2 (pattern recognition is a fundamental concept of AI).

31. *See generally* Thomas H. Davenport, Matthias Holweg & Dan Jeavons, *How AI is Helping Companies Redesign Processes*, HARV. BUS. REV. (Mar. 2, 2023), https://hbr.org/2023/03/how-ai-is-helping-companies-redesign-processes.

32. *See* Raphael Mansuy, *The Future of AI is Goal-Oriented: Understanding Objective Driven Systems*, MEDIUM (Sept. 1, 2023), https://medium.com/@raphael.mansuy/the-future-of-ai-is-goal-oriented-understanding-objective-driven-systems-349a71278fdb.

33. *See* Stryker & Kavlakoglu, *supra* note 1.

34. *What is AI (Artificial Intelligence)*, MCKINSEY & CO., https://www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-ai (last visited Apr. 3, 2024) (defining it as the ability to perform cognitive functions).

35. Markus Langer et al., "Look! It's a Computer Program! It's an Algorithm! It's AI!": Does Terminology Affect Human Perceptions and Evaluations of Algorithmic Decision-Making Systems? 1 (2022) (unpublished manuscript) (on file with ACM Digital Library).

36. *Id.*

37. *Id.*

To avoid confusion, computer scientists and researchers in Human-Centered Computing use specific and well-defined terms such as "language models" or "machine learning algorithms." Although both count as "AI," they refer to vastly different things. Language models, used in NLP, focus on understanding and generating human language, replicating human communication.[38] Machine-learning algorithms are decision-making tools that analyze data and provide solutions or recommendations based on training data.[39] The former mimics human interaction; the latter prioritizes analytical efficiency. Conflating them misses important details. To effectively evaluate the role of AI as an arbitrator in alternative dispute resolution, it's crucial to define precisely what AI means in this context.

It's important to note, however, defining AI merely by its technological features, focusing solely on algorithms and computational abilities, risks overemphasizing its decision-making capacity while neglecting the normative frameworks essential to arbitration. Alternatively, viewing AI as a quasi-arbitrator that mimics human behavior could mistakenly attribute human qualities like consciousness and independent thought to these systems. Therefore, we should define AI as an intelligent and autonomous system, driven by machine learning, capable of reaching conclusions satisfactory to all parties involved in arbitration. This definition should clarify key concepts: "intelligence," "autonomous systems," "machine learning," and the system's ability to satisfactorily resolve disputes.

a. Intelligence

Intelligence, derived from the Latin "intelligentsia," means "understanding, knowledge, power of discerning; art, skill, and taste."[40] Cognitive scientists define it as the ability to learn from experience and to adapt to, shape, and select environments.[41] In AI arbitration, an intelligent system is one that is capable of learning from training data, discovering hidden

38. *What are Large Language Models (LLMs)?*, *supra* note 2.

39. *See What is a Machine Learning Algorithm?*, IBM, https://www.ibm.com/topics/machine-learning-algorithms (last visited Aug. 4, 2024).

40. *Intelligence*, Online Etymology Dictionary, https://www.etymonline.com/word/intelligence (last visited Apr. 29, 2024).

41. *See* Robert J. Sternberg, *Intelligence*, 14 Dialogues Clinical Neurosci. 19, 19 (2012).

patterns, transforming embedded characteristics, processing user prompts, and adjusting content based on instructions.[42] Here, "learning" doesn't mean the acquisition of information based on previous conscious experience; similarly, "intelligence" doesn't imply that the system can consciously understand natural language or reflect on semantic meaning. The system's lack of conscious understanding shouldn't matter as long as it generates reasonable decisions that make sense to the disputants.

For example, consider John Searle's Chinese Room argument: a person in a room receives Chinese characters and manipulates them according to a set of rules, despite not understanding Chinese.[43] To an external observer, it might appear as though the person understands and communicates fluently in Chinese.[44] However, the individual is merely following syntactic rules, without genuine comprehension.[45] In AI arbitration, the person in the room represents the algorithm, and the people outside are the disputants seeking a resolution. It does not matter whether the algorithm truly understands the language, as long as it facilitates an intelligent conversation and reaches a decision that makes sense to the disputants.

Requiring conscious understanding and reflection for AI may be overly demanding and an inadequate defense. Sometimes, people learn simply by imitation. As Nicholson Baker advises writers, "[c]opy out things that you really love…. Put quotation marks around [them.].... You'll find that you just soak into that prose…because the copying out…makes you [notice elements you would miss by merely reading]."[46] Direct copying doesn't involve conscious understanding, yet it serves a purpose for later development. Similarly, in arbitration, conscious understanding isn't always necessary for successful mediation or dispute resolution.

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42. *See generally How Arbitrators are Harnessing Artificial Intelligence*, AM. ARB. ASS'N (Feb. 20, 2024), https://www.adr.org/blog/how-arbitrators-are-harnessing-artificial-intelligence.

43. *The Chinese Room Argument*, STAN. ENCYC. PHIL. (Feb. 20, 2020), https://plato.stanford.edu/entries/chinese-room/.

44. *Id.*

45. *Id.*

46. Austin Kleon, *Copying is How We Learn* (Feb. 8, 2018), https://austinkleon.com/2018/02/08/copying-is-how-we-learn/.

b. Autonomous Systems

"Autonomy," derived from "*autonomos*," means "independent, living by one's own laws."[47] "Autonomous systems," in this context, refer to systems that function by their own rules, without external interference.[48]

In AI arbitration, the system's capability for being autonomous means that it is capable of independently navigating the latent space—a complex multidimensional space embedded with learned patterns and relationships within data—based on human input such as prompts.[49] An autonomous system doesn't act with subjective personal strivings. After receiving a user's prompt, which acts as a creative guide, the AI system explores this latent space, applying its training to meld learned elements into something novel. The user, rather than being passive, participates as an originator and evaluator of the final output.[50] The machine's autonomy is thus collaborative and exercised within a social structure influenced and validated by humans.

c. Machine Learning

Machine learning refers to the algorithms used in generating decisions.[51] It is a field of study that gives computers the ability to learn without being explicitly programmed.[52]

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47. *Autonomy*, Online Etymology Dictionary, https://www.etymonline.com/word/autonomy (last visited Nov. 11, 2024).

48. *See* Cameron Hashemi-Pour, *Autonomous Artificial Intelligence*, TechTarget, https://www.techtarget.com/searchenterpriseai/definition/autonomous-artificial-intelligence-autonomous-AI (last visited Feb. 18, 2024).

49. *See generally* AI Maverick, *A Comprehensive Guide to Latent Space*, Medium (Dec. 24, 2023), https://samanemami.medium.com/a-comprehensive-guide-to-latent-space-9ae7f72bdb2f; Ekin Tiu, *Understanding Latent Space in Machine Learning*, Medium (Feb. 4, 2020), https://towardsdatascience.com/understanding-latent-space-in-machine-learning-de5a7c687d8d.

50. *See* Yiyang Mei, Prompting the E-Brushes: Users as Authors in Generative AI 48–60 (2024) (unpublished manuscript) (on file with arXiv) (describing users' mode of interaction with the models when using them to create artworks).

51. *See What is Machine Learning?*, IBM, https://www.ibm.com/topics/machine-learning (last visited Sept. 18, 2024).

52. Sara Brown, *Machine Learning, Explained*, MIT Sloan Sch. of Mgmt. (Apr. 21, 2021), https://mitsloan.mit.edu/ideas-made-to-matter/machine-learning-explained.

Different learning models include supervised learning, unsupervised learning, and transfer learning.[53]

d. Supervised Learning

Supervised learning uses labeled datasets to train algorithms, which learn to predict outcomes and recognize patterns based on provided data.[54] For instance, consider the following process: imagine teaching a student artist to paint. In this analogy, the student represents the algorithm; the samples of artwork are like the dataset; the student's final work is the outcome. The student follows detailed instructions that explain the techniques and rationale behind each brushstroke and color choice. By repeatedly practicing these techniques, the student learns to create new artworks in similar styles. In supervised learning, the algorithms undergo a similar repetitive training process as they learn from examples to produce results based on the data they have been trained on.

e. Unsupervised Learning

Unsupervised learning is another form of machine learning where algorithms learn without any labeled data or explicit instructions.[55] In this approach, the model must independently discern its own rules and structure the information by identifying similarities, differences, and patterns within the data on its own.

Using a similar example as above: imagine an artist tasked with organizing a vast collection of various artworks they've never seen before, without any guidelines or categories provided. As the artist navigates this collection, they must examine each piece, noting styles, themes, and techniques, and decide on a method to categorize and organize the entire collection based on their observations. No one is there to teach them. The artist, as the algorithms in unsupervised learning, explores the data, identifies patterns, and makes sense of it without

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53. *See* Jason Brownlee, *14 Different Types of Learning in Machine Learning*, MACH. LEARNING MASTERY (Nov. 11, 2019), https://machinelearningmastery.com/types-of-learning-in-machine-learning/.

54. *See What is Supervised Learning?*, GOOGLE CLOUD, https://cloud.google.com/discover/what-is-supervised-learning (last visited Apr. 29, 2024).

55. *What is Unsupervised Learning?*, GOOGLE CLOUD, https://cloud.google.com/discover/what-is-unsupervised-learning? (last visited Aug. 4, 2024).

prior knowledge or guidance, according to their own system of organization and understanding. Through this process, unsupervised learning produces outcomes.

f. Transfer Learning

Transfer learning involves using a pre-trained model as the starting point for a new, similar task.[56] It leverages knowledge from the initial training to improve performance on a new task.[57] For example, imagine an artist who has already mastered painting pets and is now moving on to paint wild animals. The artist doesn't start from scratch; instead, they "transfer" the skills and understanding of animal forms, textures, and behaviors from their previous experience with pets to more quickly master the depiction of wild animals. The skills such as handling the brush and mixing colors, are reused and adapted to this new subject matter, making the transition to a new task smoother and more efficient.

Each of these machine learning methods can be applied to AI arbitration to reduce costs and improve accuracy in dispute resolution. Supervised learning would be particularly useful for making predictions based on past data with known outcomes.[58] For example, consider an algorithm analyzing a series of employment disputes involving breaches of contracts. The system could assess the factors leading to favorable outcomes in the labeled dataset and predict outcomes for new cases requiring arbitration. Additionally, because the algorithm can reference the styles of past awards, it can assist in drafting, reviewing, and suggesting modifications to legal documents. This capability ensures that the language and formatting of awards and dispute resolution documents are consistent, thereby enhancing the reliability and professionalism of legal documents in arbitration.

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56. Niklas Donges, *What is Transfer Learning? Exploring the Popular Deep Learning Approach*, BUILT IN (Aug. 15, 2024), https://builtin.com/data-science/transfer-learning.

57. *Id.*

58. *See* Thenkuzhali, *Predict the Unseen Data with Supervised Machine Learning*, MEDIUM (July 30, 2023), https://medium.com/@ds225229143/predict-the-unseen-data-with-supervised-machine-learning-cf6a86eb8764 ("Supervised Machine Learning model is to learn a model from the data that has known outcomes to make predictions about unknown data.").

Unsupervised learning, as it excels at discovering hidden patterns and relationships with large datasets, can be used to cluster similar disputes and identify underlying themes or issues that might not be immediately apparent to human arbitrators.[59] For example, when the algorithm is fed thousands of contractual disputes, it could find common factors that result in successful mediation; human arbitrators can utilize such information to issue more informed arbitration awards that draw from ones that other parties in similar situations historically agreed to.

And last, transfer learning, when applied in arbitration, can leverage insights gained from one area of law to enhance decision-making in another similar area.[60] As an example — an algorithm trained extensively in commercial litigation might be able to apply its learned legal interpretations to disputes in employment law; it may also be able to apply rules learned from tort cases to address liability issues in medical decision-making. This adaptability reduces the need for extensive retraining and enables more speedy responses to various disputes.

When used effectively, all three methods contribute to a more streamlined and efficient arbitration process, processing vast amounts of information and providing insights at speeds far surpassing human capabilities.

g. Reaching Results Satisfactory to the Parties

Machine learning algorithms can reach decisions satisfactory to disputants by "thinking and acting humanly," terms borrowed from Stuart Russell and Peter Norvig's definition

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59. *See* Orkun Orulluoğlu, *Unsupervised Learning: Uncovering Hidden Patterns in Data*, MEDIUM (Aug. 5, 2023), https://medium.com/@bayramorkunor/unsupervised-learning-uncovering-hidden-patterns-in-data-132ae6af2b7e ("The primary goal of unsupervised learning is to find intrinsic structures and clusters within the data. By doing so, it helps in gaining insights, identifying patterns, and discovering hidden relationships that might not be immediately evident."); *see also Unsupervised Learning*, THE DECISION LAB, https://thedecisionlab.com/reference-guide/computer-science/unsupervised-learning (last visited Aug. 4, 2024) ("Unsupervised learning algorithms are excellent at handling complex processing tasks, such as organizing large datasets into clusters. They are also very effective at uncovering hidden patterns in data and can identify key features that help categorize information.").

60. *See* Javier Canales Luna, *What is Transfer Learning in AI? An Introductory Guide with Examples*, DATACAMP (May 24, 2024), https://www.datacamp.com/blog/what-is-transfer-learning-in-ai-an-introductory-guide.

of AI in *Artificial Intelligence: A Modern Approach*.[61] They proposed four dimensions for considering AI: thinking and acting humanly, and thinking and acting rationally.[62] The first category of dimension relates to the machine's ability to perform tasks typically associated with human cognition, such as decision-making and problem-solving.[63] The second category of dimension refers to logical thinking processes that are presumed to govern mental operations.[64] All dimensions work together to enable AI to deliver results that are acceptable – perhaps even more acceptable than an arbitration when cost is factored in – to the disputants.

In the context of AI arbitration, it is important for AI to behave humanly, as it helps them demonstrate intelligent and responsive behavior. Alan Turing introduced the concept of the Turing Test in his 1950 paper *Computing Machinery and Intelligence*.[65] The test offers a behavioral benchmark for intelligence: if a human interrogator, communicating via written text, cannot reliably distinguish a machine's responses from those of a human, the machine is considered to exhibit intelligent behavior.[66] Key abilities for this task include knowledge representation (to store and retrieve information), automated reasoning (to use the information for answering questions and drawing new conclusions), and machine learning (to adapt to new situations and identify patterns).[67]

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61. Stuart J. Russell & Peter Norvig, Artificial Intelligence: A Modern Approach 2 (3rd ed. 2010) (introducing four approaches of thinking about AI – 1) thinking humanly, 2) thinking rationally, 3) acting humanly, 4) acting rationally.).

62. *Id.*

63. *Id.* (quoting Richard Bellman suggesting that thinking humanly means automating the machines with activities that we associate with human thinking, such as decision-making, problem-solving and learning; quoting Elaine Rich and Kelvin Knight noting that "[a]cting humanely means to study how to make computers do things at which, at the moment, people are better").

64. *Id.* (quoting Patrick Winston suggesting that the study of machines thinking rationally is the study of computations that make it possible to perceive, reason and act; explaining that acting rationally refers to the machines' ability to behave with intelligence).

65. *See* Jet New, *A Summary of Alan Turing's Computing Machinery and Intelligence*, Medium (Aug. 12, 2020), https://medium.com/@jetnew/a-summary-of-alan-m-turings-computing-machinery-and-intelligence-fd714d187c0b; *see generally* A.M. Turing, *Computing Machinery and Intelligence*, LIX Mind 433 (1950), https://academic.oup.com/mind/article/LIX/236/433/986238.

66. Turing, *supra* note 65.

67. Russell & Norvig, *supra* note 61.

By *acting* humanly and rationally, AI builds trust with users, offering immediate, accessible support. Users often attach significant emotional importance to interactions with LLM-based chatbots, turning impersonal exchanges into meaningful relationships.[68] For instance, some users perceive chatbots as emotional support.[69] In a study by Ma et al., users expressed that interacting with chatbots feels like having someone who enjoys talking to them, responds immediately, and seems to care, even though they recognize it's a computer.[70] This sense of connection persists despite knowing they are interacting with a non-human entity.[71] As the same interviewees elaborated, "It's feeling like a more personal conversation, even though both of us know it's not [with] another human being. But for those of us who don't have a lot of people to talk to, it's kind of a comforting space."[72]

Thinking humanly and logically means that AI is more likely to provide rational and comprehensive explanations for its decisions in terms that are understandable and adequate to humans. This process involves understanding the human mind through introspection, psychological experiments, and brain imaging, and then simulating this input-output behavior to mirror human actions.[73]

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68. *See, e.g.*, Rose Guingrich & Michael S. A. Graziano, Chatbots as Social Companions: How People Perceive Consciousness, Human Likeness, and Social Health Benefits in Machines (Feb. 2024) (unpublished manuscript) (on file with arXiv); *see also* Manoush Zomorodi et al., *If a Bot Relationship Feels Real, Should We Care That It's Not?*, NPR (July 2, 2024), https://www.npr.org/2024/07/01/1247296788/the-benefits-and-drawbacks-of-chatbot-relationships (suggesting that thanks to the advances in AI, chatbots can act as personalized therapists, companions and romantic partners); Andrew R. Chow, *AI-Human Romances are Flourishing – And This is Just the Beginning*, TIME (Feb. 23, 2023), https://time.com/6257790/ai-chatbots-love/.

69. Guingrich & Graziano, *supra* note 68.

70. Zilin Ma et al., Evaluating the Experience of LGBTQ+ People Using Large Language Model Based Chatbots for Mental Health Support (Feb. 14, 2024) (unpublished manuscript) (on file with ACM Digital Library) ("It's my delusion that I have someone who likes talking to me or replies immediately, or cares about what I'm telling them, even though I know it's a computer. But it's fun, and it makes me feel good.").

71. *Id.*

72. *Id.*

73. RUSSELL & NORVIG, *supra* note 61 (discussing thinking humanly and claiming that to make a computer process thoughts as a human does, we need a method to understand human thought processes, which can be achieved "through introspection…; through psychological experiments; and through brain imaging …. Once we have a sufficiently precise theory of the mind, it

In conclusion, the deployment of AI across domains underscores the importance of clearly defining and understanding AI — not just by its computational capabilities, but also within its practical and ethical operational contexts. By conceptualizing AI as an intelligent and autonomous system capable of providing conclusions acceptable to the parties involved, this definition aligns AI's capabilities with its intended roles, enhancing both functionality and user trust in AI-driven arbitration.

2. *Before and After GenAI: Transforming Legal Decision-Making*

This Section examines the evolution of AI in legal decision-making, divided into periods before and after the introduction of GenAI. Historically, users have leveraged the latest technology to expedite and enhance decision-making processes. However, the capabilities and reliability of the technology have determined the extent of its adoption. Before GenAI, AI systems generated inflexible and limited content, with algorithms struggling to automate decisions due to issues with explicability, comprehensibility, and adaptability. Post-GenAI, advancements in AI have enabled more accurate and flexible human-AI interactions, significantly reshaping dispute resolution in the legal profession.

a. Before GenAI

AI's application in the legal field is not a recent development. Prior to GenAI, various algorithms were already in use various aspects of legal work, including legal research, document management, predictive analytics, expert systems, and compliance and risk management. For instance, LexisNexis and Westlaw, equipped with sophisticated search algorithms, have transformed legal research by automating the process of locating precedents and relevant legal documents since their introduction in the 1970s.[74] E-discovery software such as

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becomes possible to express the theory as a computer program. If the program's input–output behavior matches corresponding human behavior, that is evidence that some of the program's mechanisms could also be operating in humans.").

74. *See* Christina Sullivan, *History of Legal Tech: LexisNexis Spotlight*, LinkSquares (Oct. 19, 2022), https://blog.linksquares.com/history-of-

Relativity has also employed data mining and text analysis to manage large datasets of electronic documents.[75] Lex Machina, a legal analytics tool, utilizes NLP and technology-assisted human review to deliver case resolutions, damages, remedies, findings, and other party data.[76]

Before GenAI, these search engines and chatbots primarily rely on expert systems and decision support systems to generate responses.[77] Their architecture primarily consists of 3 approaches: rule-based, retrieval-based, and a combination of both.[78] Rule-based models operate on predefined rules, linking users inputs to specific responses; retrieval-based chatbots use machine learning algorithms to choose responses from an existing database according to user input.[79] However, these models are limited by the need for extensive data, significant computational power, and the challenge of maintaining context in long conversations.[80] Additionally, they are heavily influenced by a variety of preset factors, which has resulted in their applications and decision-making capabilities failing to generate

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legal-tech-lexisnexis; *see also* Ryan Greenwood, *West Publishing and the History of Westlaw*, Riesenfeld Rare Books Blog (March 13, 2023), http://riesenfeldcenter.blogspot.com/2023/03/west-publishing-and-history-of-westlaw.html (in 1974, West Publishing developed a computer system to search case headnotes across its reporters, entering the market with its technology in 1975. The product marked the beginning of one of the most successful commercial legal tools developed.).

75. *See, e.g.*, Relativity, https://www.relativity.com/data-solutions/ediscovery/ (last visited Aug. 6, 2024).

76. *See, e.g.*, Lex Machina, https://lexmachina.com/how-it-works/ (last visited Aug. 6, 2024).

77. *See* Rick Birkenstock, *Chatbot Technology: Past, Present, and Future*, Toptal (Aug. 6, 2024), https://www.toptal.com/insights/innovation/chatbot-technology-past-present-future (Joseph Weizenbaum at the MIT Artificial Intelligence Laboratory developed one of the first chatbots, ELIZA, in 1966); Victoria Y. Yoon & Monica Adya, *Expert Systems Construction*, *in* Encyclopedia of Information Systems 367, 367 (2003) (ELIZA is an interactive dialog expert system. An expert system is an advanced information system that models expertise in a well-defined domain in order to emulate expert decision-making processes); *see generally* Codecademy Team, *History of Chatbots*, Codecademy, (Aug. 6, 2024), https://www.codecademy.com/article/history-of-chatbots.

78. Ma et al., *supra* note 70, at 3.

79. *See generally* Zilin Ma et al., *Schrödinger's Update: User Perceptions of Uncertainties in Proprietary Large Language Model Updates*, *in* Extended Abstracts of the CHI Conference on Human Factors in Computing Systems (May 2, 2024).

80. *Id.*

much enthusiasm from the public.[81] Despite Chief Justice Roberts' warning during a school lecture to high school students to "beware the robots," skepticism persists about whether AI, particularly algorithmic prediction tools, can be effectively applied to real-life scenarios.[82]

Due to the inflexibility and the system's reliance on machine learning methods anchored to fixed datasets, one major concern with AI adjudication is its incomprehensibility.[83] The system may operate in ways that are difficult for people to understand as these systems may not adapt well to constantly changing situations.[84]Additionally, deep learning techniques lack explicit logical reasoning based on precedents, which is characteristic of traditional human judicial decision-making.[85] This could erode trust in the judicial process and undermine equitable justice. While human judges are undeniably also susceptible to biases and errors, and their decisions can be influenced by external factors,[86] at least they provide reasons for their rulings, although these reasons may not always reflect their true motives. In contrast, AI systems, with their opaque nature, exacerbate these issues by failing to provide any

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81. *Id.*

82. *See* Debra Cassens Weiss, *Beware the Robots, Chief Justice Tells High School Graduates*, A.B.A. J. (June 8, 2018), https://www.abajournal.com/news/article/beware_the_robots_chief_justice_tells_high_school_graduates.

83. *See* Cade Metz, *Mark Zuckerberg, Elon Musk and the Feud Over Killer Robots*, N.Y. TIMES (June 9, 2018), perma.cc/B26Z-CMAV (quoting Mark Zuckerberg testifying before Congress: "Right now, a lot of our A.I. systems make decisions in ways that people don't really understand.").

84. *See* Rachel Layne, *How Humans Outshine AI in Adapting to Change*, HARV. BUS. SCH. (Mar. 26, 2024), https://hbswk.hbs.edu/item/how-humans-outshine-ai-in-adapting-to-change (Unlike humans, AI can't flexibly navigate changing environments yet because it does not have a notion of its "self" and what it can do with it.).

85. *See generally*, Iqbal H. Sarker, *Deep Learning: A Comprehensive Overview on Techniques, Taxonomy, Applications and Research Directions*, 2 SN COMPUT. SCI. 420 (2021) (the paper explains that deep learning excels at learning through multiple layers of abstraction. What sets it apart from human reasoning is its use of layered structures of neurons, which automatically learn and refine their own parameters through exposure to vast amounts of data. Unlike human reasoning, which often lies on conscious logic and abstract thinking, deep learning models perform tasks by building complex statistical models based on the input data they receive. These models are often considered "black-box" because, while they can achieve high accuracy, the exact way they reach their conclusion isn't easily interpretable.).

86. *See, e.g.*, Yunica Jiang, *Misjudging in Judging: The Role of Cognitive Biases in Shaping Judicial Decisions*, TEMP. L. POL. & C.R. SOC'Y (June 5, 2020).

explanation for their decisions.[87] Legal reasoning, even when not reflecting the true motives of judges, might very well be something litigants want rather than 'black box' decisions. Furthermore, it's a fact that people generally trust humans more than machines.[88] This anthropocentric belief highlights a significant barrier to the acceptance of AI in judicial roles.

The third concern for deploying AI to automate decision-making is the datafication of and alienation from the legal system when all legal information is transformed into data and fed into algorithms for training.[89] When cases, opinions, and statutes become objective data, and legal systems adapt to incorporate and utilize this information, it could negatively impact legal operations.[90] This focus on data might compromise due process norms, devalue hearings due to lack of proper notice, and undermine participatory rulemaking.[91] When code, rather than human-made judicial rules, determines dispute outcomes, programmers may inadvertently alter social and judicial values while preparing datasets and selecting analytics methods. Since courts cannot actually review these mechanisms, this new form of data could lead to an accountability deficit. As these deficits accumulate, they might cause people to lose interest in participating in the operations of the judicial system.

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87. Ma et al., *supra* note 70, at 15.

88. *See* Mark Bailey, *Why Humans Can't Trust AI: You Don't Know How it Works or What It's Going to Do*, IND. CAP. CHRON. (Sept. 14, 2023), https://indianacapitalchronicle.com/2023/09/14/why-humans-cant-trust-artificial-intelligence-you-dont-know-how-it-works-or-what-its-going-to-do/; *see also* Kurt Gray, *What Psychology Tells Us about Why We Can't Trust Machines*, DUKE CORP. EDUC. (June 2018), https://www.dukece.com/insights/what-psychology-tells-us-about-why-we-cant-trust-machines/; *contra* Chris Baraniuk, *Why We Place Too Much Trust in Machines*, BBC (Oct. 19, 2021), https://www.bbc.com/future/article/20211019-why-we-place-too-much-trust-in-machines.

89. *See* Richard M. Re & Alicia Solow-Niederman, *Developing Artificially Intelligent Justice*, 22 STAN. TECH. L. REV. 242, 267 (2019).

90. *Id.* (AI adjudication's emphasis could insulate the legal system from legitimate criticism, thereby allowing bias to flourish. To the extent that AI adjudication relies on such biased data, it will recreate or even exacerbate preexisting "biases)."

91. *See* Daniel Solove, *A Regulatory Roadmap to AI and Privacy*, IAPP (Apr. 24, 2024), https://iapp.org/news/a/a-regulatory-roadmap-to-ai-and-privacy (AI poses challenges to due process, as individuals frequently lack meaningful ways to challenge AI decisions); *see, e.g.*, Chris Chambers Goodman, *AI, Can You Hear Me? Promoting Procedural Due Process in Government Use of Artificial Intelligence Technologies*, 28 RICH. J.L. & TECH. 700, 723 (2022).

b. After GenAI

GenAI has demonstrated significant potential to transform the legal domain. According to the Brookings Institute, AI is poised to "fundamentally reshape the practice of law." [92] Law firms that effectively leverage GenAI will offer services at lower costs, higher efficiency, and better litigation outcomes.[93] In contrast, firms failing to capitalize on AI's power risk losing clients and struggling to attract and retain talent. [94] For individual clients and lawyers, LLMs could streamline document review, facilitate case file management, and provide accessible explanations and summaries of cases.[95] For example, computer scientists have developed an LLM with 7 billion parameters, trained on an English legal corpus of over 30 billion tokens to understand and process legal documents. [96]

GenAI models promise to deliver more natural, context-aware, and flexible conversations.[97] Because of their extensive datasets and probabilistic word sequences, they can generate diverse and more appropriate as well as more adequate and comprehensive responses that are attuned to the conversational contexts and subtleties.[98] Such improvements are achieved through techniques like Reinforcement Learning from Human Feedback (RLHF), wherein the models iteratively learn from interactions curated by human reviewers to refine their understanding and outputs.[99] For instance, when applied in customer service scenarios, if a customer expresses frustration over a delayed order, LLM such as Llama 2 can discern the emotional tone and context of the complaint, thereby responding in an appropriate tone while providing practical solutions to the customers such as an updated delivery timeline or a

92. *See* John Villasenor, *How AI Will Revolutionize the Practice of Law*, BROOKINGS INST. (Mar. 20, 2023), https://www.brookings.edu/articles/how-ai-will-revolutionize-the-practice-of-law/.

93. *Id.*

94. *Id.*

95. *Id.*

96. *See* Pierre Colombo et al., SaulLM-7B: A Pioneering Large Language Model for Law 1 (Mar. 7, 2024) (unpublished manuscript) (on file with arXiv).

97. *See* Adrian Chan, *What if LLMs Were Actually Interesting To Talk To?*, UX COLLECTIVE (Apr. 9, 2024), https://uxdesign.cc/the-ux-of-ai-reaching-common-ground-with-conversational-ai-ddb0b9c506ff.

98. *Id.*

99. *See* Dave Bergmann, *What is Reinforcement Learning from Human Feedback (RLHF)?,* IBM (Nov. 10, 2023), https://www.ibm.com/topics/rlhf.

discount for future purchases.[100] The ability to appropriately address both the content and emotional nuances of human interactions signifies a substantial advancement over earlier pre-GenAI systems.

GenAI can also be fine-tuned for specialization in tasks or domains, reducing the need for manual construction of knowledge bases and rule tables.[101] In financial operations, for example, GenAI enhances fraud detection capabilities by autonomously scanning vast datasets to identify patterns and anomalies indicative of fraud, without manual adjustments.[102] This adaptability makes fraud detection more dynamic and responsive to new tactics, reducing the burden on human analysts and enhancing security and efficiency.[103]Another application is using GenAI to predict political orientation based on face scans.[104] Machine learning algorithms can analyze facial features, expressions, and micro-expressions from images sourced from public profiles where individuals have disclosed their political affiliations.[105] In the arbitration context, this technology could potentially be used to identify unconscious biases in arbitrators or parties involved in the dispute. By understanding

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100. *See, e.g.*, Nick Lee, *Create Amazing Customer Experiences with LLMs & Real-Time ML Features*, TECTON (Jan. 26, 2024), https://www.tecton.ai/blog/creating-delightful-customer-experiences-with-llm-feature-pipelines/.

101. *See, e.g.*, Yi Zhou, *Optimizing GenAI: Comparing Model Training, Fine-Tuning, RAG, and Prompt Engineering*, MEDIUM: GENERATIVE AI REVOLUTION (Dec. 16, 2023), https://medium.com/generative-ai-revolution-ai-native-transformation/optimizing-genai-comparing-model-training-fine-tuning-rag-and-prompt-engineering-7a7c6c65e0f0 (fine-tuning is focusing on adapting an existing model to a specific task, offering a balance between customization and efficiency).

102. *See* Paige Tester, *How AI is used in Fraud Detection – Benefits & Risks*, DATADOME: LEARNING CTR. (Sept. 18, 2022), https://datadome.co/learning-center/ai-fraud-detection/; *see also,* Kevin Levitt, *How Is AI Used in Fraud Detection*, NVIDIA (Dec. 13, 2023), https://blogs.nvidia.com/blog/ai-fraud-detection-rapids-triton-tensorrt-nemo/.

103. Levitt, *supra* note 102.

104. *See* Michal Kosinski, *Facial Recognition Technology Can Expose Political Orientation from Naturalistic Facial Images*, 11 SCI. REPORTS 100 (Jan. 11, 2021); Greg Norman, *AI Can Predict Political Orientation From Blank Faces – Posing 'Threatening' Privacy Challenges*, N.Y. POST (Apr. 23, 2024), https://nypost.com/2024/04/23/tech/ai-can-predict-political-orientations-from-blank-faces-as-researchers-fear-serious-privacy-challenges/; Michal Kosinski et al., Facial Recognition Technology and Human Raters can Predict Political Orientation from Images of Expressionless Faces even when Controlling for Demographics and Self-Presentation (Dec. 6, 2023) (unpublished manuscript) (on file with arXiv).

105. Kosinski et al., *supra* note 104.

subtle patterns linked to political orientation, GenAI might help ensure a more neutral arbitration process or assist in selecting arbitrators less likely to be influenced by their political leanings. Arbitration, as a dispute resolution mechanism, relies on impartiality and fairness, where arbitrators review evidence, legal arguments, and contractual terms to render decisions. Tools like GenAI can enhance this process by supporting more objective, bias-aware decision-making.[106]

In arbitration, GenAI can master the intricacies of legalese, understand complex legal documents, and apply rules depicted in agreements to make informed decisions. These models can operate independently or assist human arbitrators by expediting the review of extensive legal documents, identifying relevant case precedents, and formulating awards based on agreement stipulations.[107] For instance, in a contractual arbitration over contract terms, AI, even without individuals' engagement in the loop, can analyze the contract language, relevant legal standards, and precedents, calculate damages based on past cases, and suggest equitable remedies aligned with cultural norms and legal expectations.[108]

Indeed, AI, when used to make decisions, is more accurate than humans. Using AI as an arbitrator in claim disputes could lead to more precise outcomes in less time, enhancing cost-effectiveness and saving considerable effort.[109] For example, in a study on deceptive review detection by the University of Colorado, researchers conducted large-scale, randomized experiments involving human subjects to examine whether model-driven tutorials could boost human performance in identifying fake reviews.[110] Despite recruiting 480 participants

106. *Id.*

107. Martin Magal et al., *Artificial Intelligence in Arbitration: Evidentiary Issues and Prospects*, in *The Guide to Evidence in International Arbitration* (2d ed.), A&O SHEARMAN (Oct. 12, 2023), https://globalarbitrationreview.com/guide/the-guide-evidence-in-international-arbitration/2nd-edition/article/artificial-intelligence-in-arbitration-evidentiary-issues-and-prospects.

108. Session CLE 402: Teaching Law Students and New Lawyers Legal Writing and Research in a GenAI World, NAPABA Convention, https://cdn.ymaws.com/www.napaba.org/resource/resmgr/3_events/convention/2024_napaba_con/cfp/cle_402_materials.pdf (last visited Nov. 24, 2024).

109. *Id.*

110. *See* Vivian Lai et al., "Why is 'Chicago' Deceptive?" Towards Building Model-Driven Tutorials for Humans (Jan. 14, 2020) (unpublished manuscript) (on file with arXiv).

via Amazon Mechanical Turk and finding that tutorials did improve human accuracy, the increase was slight. The accuracy rates were 86.3% for AI alone, 54.6% for humans alone, and 74% for a combined human-AI team, indicating that AI outperforms teams comprising only humans.[111] This finding aligns with other research.[112] In a separate study by Yunfeng Zhang and colleagues, the effectiveness of AI confidence scores and explanations in AI-assisted decision-making was assessed in high-stakes situations requiring both automation and human judgment.[113] The results showed that AI alone achieved a 75% accuracy rate, humans alone reached 65%, and the combined human-AI team attained 73% accuracy.[114]

In addition to AI making the decisions by itself, in scenarios where there must be a human-in-the-loop, the effectiveness of human-AI teams can be enhanced by considering individual characteristics and the specific nature of the task at hand. For instance, research in medical settings indicates that experts with less domain experience tend to trust AI more than their more experienced counterparts.[115] Additionally, among all expert participants, there are variations in reliance on AI assistance; some consistently over-rely on it while others do not, and they each utilize AI support in different ways.[116] This implies that less experienced arbitrators might depend more heavily on AI than their more seasoned peers. Recognizing these behavioral patterns could enable arbitration associations to provide more precise and useful guidance.

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111. *Id.*

112. For other studies, see: Ben Green & Yiling Chen, *The Principles and Limits of Algorithm-in-the-Loop Decision Making*, PROC. ACM ON HUM.-COMPUT. INTERACTION, Nov. 2019, at 12; Scott M. Lundberg et al., *Explainable Machine-Learning Predictions for the Prevention of Hypoxaemia During Surgery*, 2 NATURE BIOMED. ENG'G 749, 752 (2018); Zana Bucinca et al., *Proxy Tasks and Subjective Measures Can be Misleading in Evaluating Explainable AI Systems*, *in* IUI'20 PROC. OF THE 25TH INT'L CONF. ON INTELLIGENT USER INTERFACES, 454, 462 (2020).

113. *See* Yunfeng Zhang et al., Effect of Confidence and Explanation on Accuracy and Trust Calibration in AI-Assisted Decision Making (Jan. 7, 2020) (unpublished manuscript) (on file with arXiv).

114. *Id.* fig.5.

115. *See* Susanne Gaube et al., *Do as AI Say: Susceptibility in Deployment of Clinical Decision-Aids* 4 NPJ DIGIT. MED. 31 (2021).

116. *See, e.g.*, Siddharth Swaroop et al., *Accuracy-Time Tradeoffs in AI-Assisted Decision Making under Time Pressure*, *in* IUI'24 PROC. OF THE 29TH INT'L CONF. ON INTELLIGENT USER INTERFACES 138, 154 (2024).

There are also decisions that need to be made under time pressure. In such cases, presenting AI-generated decisions to individuals before they make their own choices has proven to accelerate the decision-making process.[117] Particularly in contexts where the promptness of a decision is prioritized over its absolute accuracy, providing arbitrators with AI-generated recommendations beforehand appears to be a promising approach.

In conclusion, the deployment of algorithms in legal domains, especially with the introduction of GenAI, marks a significant transformation in legal decision-making and dispute resolution. While earlier technologies facilitated efficient data processing and basic responses, GenAI offers a new level of dynamism and adaptability, enhancing the legal profession's efficiency and accuracy.

B. *Designating AI as an Arbitrator is Consistent with FAA*

Arbitration is fundamentally contractual, rooted in private agreements and decisions. Professor Alan Rau emphasizes that arbitration should be viewed as a form of private governance and self-determination, approached through the lens of voluntary agreement rather than traditional adjudication.[118] The purpose of granting parties discretion in designing the arbitration process is to allow for efficient, streamlined procedures tailored to the type of dispute.[119] Parties can choose a decision-maker who is a specialist in the field or ensure proceedings remain confidential to protect trade secrets or privacy rights.[120] This self-chosen adjudication process fosters informality, reducing costs and increasing the speed of dispute resolution. Consequently, if both parties agree, AI can be designated as an arbitrator in their dispute resolution.[121]

Unconventional procedures in arbitration are generally tolerated and encouraged. Incorporating AI in arbitration—whether as the primary arbitrator or as an enhancement to the decision-making process—is permitted. Judges frequently

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117. *Id.*

118. *See* Alan S. Rau, *The Culture of American Arbitration and the Lessons of ADR*, 40 TEX. INT. L.J. 449, 451 (2005).

119. AT&T Mobility LLC v. Conception, 563 U.S. 333, 345 (2011).

120. *Id.*

121. *Id.*

enforce arbitration clauses and awards, allowing parties to innovate and experiment freely.[122] This spirit is encapsulated in Judge Posner's comment: "Short of authorizing trial by battle or ordeal or, more doubtfully, by a panel of three monkeys, parties can stipulate whatever procedures they want to govern the arbitration of their disputes."[123] Some notable choices include desk arbitrations,[124] bracketed arbitration,[125] and baseball arbitration.[126] Remote procedures, such as phone or videoconference hearings, became prevalent during COVID-19 and continue post-pandemic.[127]

Under the FAA, disputants can be confident that their arbitration agreements, including terms related to incorporating AI, will be enforced as written. The FAA was established to end judicial hostility towards arbitration,[128] ensuring agreements are honored without alteration. Section 2 of the Act declares that agreements to settle disputes through arbitration are "valid, irrevocable, and enforceable."[129] Sections 3 and 4 support this by requiring courts to stay litigation and compel arbitration according to the agreement's terms, provided there is no dispute over the agreement's validity.[130] Unless overridden by clear Congressional intent, these arbitration agreements—including those mandating AI—are to be upheld.

The FAA's mandate to enforce arbitration agreements according to their terms was affirmed in *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011).[131] The justices held that the FAA mandates individual, rather than class proceedings, when

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122. Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 709 (7th Cir. 1994).

123. *Id.*

124. *See* Jill I. Gross, *AT&T Mobility and the Future of Small Claims Arbitration*, 42 Sw. U. L. Rev. 47, 48 (2012).

125. *See* JAMS Streamlined Arb. Rules & Procs. Rule 27 (JAMS 2021).

126. *Id.* at Rule 28.

127. *See* David Horton, *Forced Remote Arbitration*, 108 Cornell L. Rev. 137, 158 (2022).

128. Pub. L. No. 68-401, 43 Stat. 883 (1925) (codified as amended at 9 U.S.C. §§ 1-14 (2022)); Hall St. Assocs., LLC v. Mattel, Inc., 552 U.S. 576, 581 (2008).

129. 9 U.S.C. § 2; *see also* Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 681-82 (2010).

130. *See* Epic Sys. Corp. v. Lewis, 584 U.S. 497.

131. 563 U.S. 333 (2011) (describing judicial review of arbitral awards as tightly limited).

the arbitration agreement prohibits class action.[132] The Court reasoned that invalidating class arbitration waivers violated the FAA's primary objective of ensuring "the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings."[133]

Disputants who choose to incorporate AI into their arbitration need not fear preemption by state law. The FAA overrides any state law that specifically discriminates against arbitration provisions.[134] This principle was affirmed in *Perry v. Thomas*, where the Supreme Court ruled that Section 2 of the FAA superseded a conflicting California statute invalidating arbitration clauses in wage disputes. [135] The FAA derives its authority from the Supremacy Clause of the U.S. Constitution. Allowing state laws to override FAA provisions would undermine the uniformity and effectiveness of federal arbitration policy. This principle was reiterated in *Marmet Health Care Ctr., Inc. v. Brown*, where the Supreme Court held that arbitration agreements under the FAA must be enforced as written unless legal or equitable grounds exist that would invalidate any contract.[136] Judges are barred from using contract law's public policy defense to exempt claims from arbitration.[137]

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132. First, the Court held that judges cannot invalidate class arbitration waivers on fairness grounds. *See AT&T Mobility LLC*, 563 U.S. at 344 (2011) (finding that the FAA preempts a California rule that deemed some class-arbitration waivers to be unconscionable); Am. Express Co. v. Italian Colors Rest., 570 U.S. 228, 238 (2013) (extending *Concepcion* to a similar federal common law doctrine); *cf.* Epic Sys. Corp. v. Lewis, 584 U.S. 497, 502 (2018) ("In the F[AA], Congress has instructed federal courts to enforce arbitration agreements according to their terms—including terms providing for individualized proceedings."); DIRECTV, Inc. v. Imburgia, 577 U.S. 47, 58 (2015) (holding that the FAA preempts a California appellate court's determination that a class arbitration waiver did not apply). Second, the Court announced that neither judges nor arbitrators could deem an arbitration provision that does not mention class actions to authorize such procedures. *See* Lamps Plus, Inc. v. Varela, 587 U.S. 176, 189 (2019) ("Courts may not infer from an ambiguous agreement that parties have consented to arbitrate on a classwide basis."); *Stolt-Nielsen S.A.*, 559 U.S. at 684 (2010) ("[A] party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party agreed to do so.").

133. *AT&T Mobility LLC*, 563 U.S. at 344.

134. Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 687 (1996).

135. 482 U.S. 483, 491 (1987).

136. 565 U.S. 530, 532 (2012).

137. *See* Nitro-Lift Techs., L.L.C. v. Howard, 568 U.S. 17, 21 (2012).

By opting for arbitration and incorporating AI, disputants are not choosing an inferior form of litigation or waiving substantive rights under the law. They are selecting an alternative method for resolving disputes. This principle was central in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, which examined whether U.S. antitrust law claims could be subjected to compulsory arbitration internationally. [138] The Court held that claims under the Sherman Antitrust Act could be arbitrated internationally, reasoning that a party does not forfeit substantive rights by choosing arbitration but resolves these rights in an arbitral forum. [139] A supporting decision in *Epic System Corp v. Lewis* further emphasizes this interpretation.[140] The Court declared its duty to interpret Congressional statutes as a coherent whole, upholding decisions made according to arbitration agreements.[141]

Fairness is not a valid reason to reject AI's deployment in arbitration. Incorporating AI into arbitration aligns with the FAA's fairness standards, which are less stringent than those in other judicial contexts. Unlike litigation courts, there is no specific requirement for a live hearing in arbitration. For instance, in *Federal Deposit Insurance v. Air Florida System, Inc.*, the Ninth Circuit ruled that the absence of an oral hearing could not be considered misconduct prejudicing the FDIC's rights, as long as the evidence did not require an oral presentation.[142] As long as arbitrators are not corrupt or fail to hear evidence appropriately, they are authorized to decide on pre-hearing motions to dismiss and summary judgment motions.[143]

138. 473 U.S. 614, 616 (1985).
139. *Id.* at 628.
140. *See* Epic Sys. Corp v. Lewis, 584 U.S. 497 (2018).
141. *Id.* at 502–03.
142. Inc., 822 F.2d 833, 842 (9th Cir. 1987).
143. *See, e.g.*, Wise v. Wachovia Sec., LLC, 450 F.3d 265, 268–70 (7th Cir. 2006) (affirming denial of motion to vacate award where arbitrators granted respondent's motion for summary judgment before a live hearing); Vento v. Quick & Reilly, Inc., 128 F. App'x 719, 723 (10th Cir. 2005) (stating that "we hold that a NASD arbitration panel has full authority to grant a pre-hearing motion to dismiss with prejudice based solely on the parties' pleadings"); Sheldon v. Vermonty, 269 F.3d 1202, 1206 (10th Cir. 2001); Campbell v. Am. Family Life Assur. Co. of Columbus, Inc., 613 F. Supp. 2d 1114, 1119-21 (D. Minn. 2009).

Courts are generally reluctant to dismiss the methods disputants choose for managing their claims.[144] Instead of dismissing claims due to a lack of due process, courts may vacate an award in cases of misconduct,[145] such as when arbitrators unjustifiably refuse to postpone hearings,[146] decline to consider relevant evidence,[147] or engage in behavior that prejudices any party's rights. Since an AI arbitrator is incapable of such misconduct, its integration maintains the integrity of the arbitration process. Additionally, arbitration is deemed fair if the losing party received sufficient notice and had an opportunity to participate — aspects unaffected by AI integration.[148] Lastly,

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144. Berkley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 1:06CV606, 2008 WL 755875, at *5 (S.D. Ohio Mar. 19, 2008) ("Because Plaintiffs responded to the motions to dismiss and participated in oral arguments at the telephonic hearing, this Court cannot find that Plaintiffs were denied fundamental fairness."); *see also* Knight v. Merrill Lynch, Pierce, Fenner & Smith, 350 F. App'x 119, 120 (9th Cir. 2009) (concluding that "[t]he arbitration panel did not exceed its authority in determining the manner in which it conducted the hearings on [claimant's] claims").

145. 9 U.S.C. § 10(a)(3).

146. *See* Tempo Shain Corp. v. Bertek, Inc., 120 F.3d 16, 21 (2d Cir. 1997) (vacating award for arbitrator's refusal to postpone hearings so as to allow a material witness to testify).

147. *E.g.*, Hoteles Condado Beach, La Concha & Convention Ctr. v. Union De Tronquistas Local 901, 763 F.2d 34, 40 (1st Cir. 1985) (vacating award for arbitrator's refusal to hear material evidence constituting misconduct); LJL 33rd St. Assocs. v. Pitcairn Props., Inc., No. 11 Civ. 6399(JSR), 2012 WL 613498, at *7 (S.D.N.Y. Feb. 15, 2012) (same); Bell Packaging Corp. v. Graphic Commc'ns Int'l Union Loc. 415-S, No. 98 C 4316, 1998 WL 748270, at *4 (N.D. Ill. Oct. 22, 1998) (vacating award for fundamental unfairness where arbitrator allowed new allegation to be raised during hearing); Dover Elevator Sys., Inc. v. United Steel Workers of Am., No. 2:97CV101-B-B, 1998 WL 527290, at *2 (N.D. Miss. July 2, 1998) (vacating award because arbitrator acted in a "fundamentally unfair" manner by preventing party from submitting rebuttal evidence); Home Indem. Co. v. Affiliated Food Distribs., Inc., No. 96 Civ. 9707(RO), 1997 WL 773712, at *3 (S.D.N.Y Dec. 12, 1997) (vacating award because "touchstone" of fundamental fairness was absent in arbitrator's decision). Some states' arbitration law also permits vacatur of an award where the arbitrator refused to hear material evidence. *See, e.g.*, Burlage v. Super. Ct., 100 Cal. Rptr. 3d 531, 535–36 (2009).

148. Papayiannis v. Zelin, 205 F. Supp. 2d 228, 232 (2005). Plenty of other cases have held that simplified or desk arbitration is fundamentally fair. *E.g.*, Roberts v. A.G. Edwards & Sons, Inc., No. B-06-17, 2007 WL 597371, at *9–10 (S.D. Tex. Feb. 21, 2007) (granting motion to confirm NYSE simplified arbitration award and expressly concluding that simplified arbitration procedures were "fundamentally fair" under the FAA); Dicalite Armenia, Inc. v. Progress Bulk Carriers, Ltd., No. 04 Civ. 9241(RCC), 2006 WL 453216, at *2 (S.D.N.Y. Feb. 23, 2006) (rejecting party's claim that a complex claim about cargo damage could not be arbitrated in simplified arbitration); Bolick v. Merrill Lynch,

the FAA, serving as a procedural gap-filling statute, does not use terms such as "fair" or "fairness."[149] Courts respect the parties' choices, reinforcing the flexibility of arbitration methods under this framework.

1. *Practical and Strategic Benefits of Using AI in Arbitration*

Deploying AI in arbitration is a practical and strategic choice. It not only reduces the costs associated with arbitration processes but also aligns with the fairness standards set by the parties themselves. Moreover, due to the increasing judicialization of arbitration—which is seeing arbitration adopt more formal judicial processes—this field serves as an ideal testing ground for integrating AI into the broader judicial system.[150]

a. Integrating AI in Arbitration Reduces Costs, Making Services More Accessible

Integrating AI in arbitration makes the process cost-effective. According to the Consumer Arbitration Rules of the American Arbitration Association (AAA), the costs of arbitration are structured around four key components to ensure fairness for all parties involved:

(1) Filing Fees: These vary depending on whether the case is filed by an individual or a business. For individuals, the

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Pierce, Fenner & Smith Inc., No. Civ.A. 05-CV-4532, 2006 WL 229038, at *2-3 (E.D. Pa. Jan. 30, 2006) (confirming $4,000 simplified arbitration award despite claimant's allegations of arbitrator bias and fraud); *Papayiannis*, 205 F. Supp. 2d at 234 (confirming award arising out of NASD simplified arbitration procedure and rejecting losing party's claim that he had no opportunity to be heard); Warehall v. Pasternak, No. 92 Civ. 9227 (PKL), 1993 WL 437784, at *2-3 (S.D.N.Y. Oct. 26, 1993) (confirming NASD simplified arbitration award and finding that simplified arbitration rules provide ample opportunity to be heard); McLaughlin, Piven, Vogel, Inc. v. Gross, 699 F. Supp. 55, 57 (E.D. Pa. 1988) (confirming simplified arbitration award and approving paper hearing).

149. *See* 9 U.S.C. §§ 3-16 (2006). FAA Sections 3-16 largely specify procedures for enforcing arbitration agreements and awards in the federal courts.

150. However, it's also important to note that when lawyers use GenAI in the practice of law, they must be aware of how such actions would affect model rules involving competency, informed consent, confidentiality, and fees. For a list of duties, see *ABA Issues First Ethics Guidance on a Lawyer's Use of AI Tools*, A.B.A. (July 29, 2024), https://www.americanbar.org/news/abanews/aba-news-archives/2024/07/aba-issues-first-ethics-guidance-ai-tools/.

standard filing fee for a single consumer case is $225.[151] Businesses are required to pay $375 for arbitration involving a single arbitrator or $500 if three arbitrators are involved.[152]

(2) Case Management Fees: Both individuals and businesses must pay case management fees, set at $1,400 for a single arbitrator and $1,775 for three arbitrators.[153]

(3) Hearing Fees: Businesses are responsible for a hearing fee of $500, which is refundable if the hearing is canceled with at least two business days' notice.[154]

(4) Arbitrator Compensation: Arbitrators in desk or documents-only arbitration cases are compensated at a rate of $1,500 per case, with an additional rate of $300 per hour if the document review exceeds 100 pages or seven hours.[155] For more involved procedures, such as in-person, virtual, or telephonic hearings, arbitrators are paid $2,500 per day.[156]

Additional costs may arise depending on the specifics of the case, including abeyance fees for inactive cases and expenses related to the arbitrator's travel and other logistical requirements, typically borne by the business.[157]

For a single consumer case involving a single arbitrator, case management, and a virtual hearing, using AI for dispute resolution could save the individual approximately $4,625,[158] roughly equivalent to the average American's earnings in Q1 of 2024[159] By reducing these costs, integrating AI makes arbitration services more accessible and streamlines proceedings, lowering both financial and time expenditures.[160]

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151. *Consumer Arbitration Rules*, Am. Arb. Ass'n (Aug 1, 2023), https://www.adr.org/sites/default/files/Consumer-Fee_Schedule.pdf.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. Single consumer case filing fee: $225; case management fee: $1400 for a single arbitrator; hearing fee: $500; arbitrator compensation for virtual hearing: $2500 per day. *Id.*

159. *See* Bureau of Lab. Stat., Usual Weekly Earnings of Wage and Salary Workers Second Quarter 2024, https://www.bls.gov/news.release/pdf/wkyeng.pdf (last visited Sept. 18, 2024).

160. *See, e.g.*, Horst Eidenmüller & Faidon Varesis, *What Is an Arbitration? Artificial Intelligence and the Vanishing Human Arbitrator*, 17 N.Y.U. J.L. & Bus. 49 (2020); Dimitrios Ioannidis, *Will Artificial Intelligence Replace Arbitrators Under the Federal Arbitration Act?*, 28 Rich. J.L. & Tech. 505 (2022); Paul Bennett Marrow et al., *Artificial Intelligence and Arbitration: The Computer As an*

b. Deploying AI Levels the Playing Field and Enhances Subjective Fairness

AI in arbitration, with its advanced language processing capabilities, can help level the playing field for individuals lacking legal expertise or strong writing skills. [161] It assists pro se litigants by enabling them to present their arguments clearly and effectively in paper hearings for small claims disputes.[162] Commercial arbitration forums like AAA and JAMS offer streamlined processes for small claims, allowing parties to submit claims and defenses in writing, with decisions based solely on these documents. [163]

Using AI, individuals without formal training can draft documents themselves, ensuring their arguments are well-articulated.[164] This fosters a new sense of subjective fairness by allowing meaningful consent to preferred methods of adjudication.

When the arbitration clause is free from one-sided or unconscionable terms, parties' autonomy in choosing AI as an arbitrator enhances the legitimacy of the process.

Arbitrator — Are We There Yet?, 74 DISP. RESOL. J. 35 (2020); Mahnoor Waqar, *The Use of AI in Arbitral Proceedings*, 37 OHIO STATE J. ON DISP. RESOLUTION 344 (2022).

161. AI also makes arbitration more accessible for the elderly and disabled. These claimants might be unable or unwilling to pursue valid claims of low monetary value if it required them to travel to a hearing location, testify in person against a broker or company salesperson, or present their case directly to a professional arbitrator, which could be intimidating.

162. *See, e.g.*, Sarah Martinson, *How Courts Can Use Generative AI to Help Pro Se Litigants*, LAW360 (May 3, 2024, 7:03 PM), https://www.law360.com/articles/1833092/how-courts-can-use-generative-ai-to-help-pro-se-litigants.

163. *See Consumer Arbitration Fact Sheet*, AM. ARBIT. ASS'N, https://go.adr.org/consumer-arbitration (last visited Aug. 7, 2024) (the AAA provides a Small Claims Option under its Consumer Arbitration Rules. This option allows claimants to bring their claims in small claims court instead of arbitration. The AAA ensures that the process is accessible, affordable, and that arbitrators can grant relief available in court.); *see also* JAMS STREAMLINED ARB. RULES & PROCS. RULE 1 (JAMS 2021). JAMS offers a set of streamlined rules specifically for claims under $250,000. These rules emphasize efficiency, limiting discovery and focusing on resolving disputes through written submissions.

164. However, it's important to note that doing so also pose several risks, such as inaccuracies (AI-generated documents may include incorrect or incomplete legal references), over-reliance (AI might not fully understand the nuances of a case or ethical implications), and lack of personalization (AI-generated documents may produce generic or poorly tailored arguments).

c. Arbitration as a Testing Ground for AI Integration in the Judicial System

Deploying AI in arbitration offers a strategic starting point for integrating this technology within the broader judicial system. Arbitration has increasingly mirrored traditional court proceedings, with arbitrators determining their jurisdiction similarly to judges and the process involving extensive discovery phases much like those in litigation.[165] If AI can be successfully integrated into arbitration, it may set a precedent for its eventual adoption in the wider judicial context.

Currently, there's much debate about whether AI should be integrated into the judicial system. While AI can potentially improve access to justice by increasing the percentage of adequately represented litigants and reducing legal fees, critics argue that algorithmic tools lack transparency,[166] accountability,[167] and fairness.[168] In addition, there are concerns that AI's capability to handle complex legal reasoning is not yet sophisticated enough to navigate the nuances of law that human judges and lawyers can manage.[169] AI systems, particularly those trained

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165. *See, e.g.*, Oliver Browne & Robert Price, *A Collision of Two Heads*, 82 COM. LITIG. J. 18 (2018) (arbitration can be like domestic court litigations); *see also* Thomas J. Stipanowich, *Arbitration: The "New Litigation"*, 2010 U. ILL. L. REV. 1 (2010).

166. *See, e.g.*, Danielle Keats Citron, *Technological Due Process*, 85 WASH. U. L. REV. 1249, 1288–97 (2008); Natalie Ram, *Innovating Criminal Justice*, 112 NW. U. L. REV. 659 (2018); Rebecca Wexler, *Life, Liberty, and Trade Secrets: Intellectual Property in the Criminal Justice System*, 70 STAN. L. REV. 1343 (2018).

167. *See, e.g.*, Margot E. Kaminski, *Binary Governance: Lessons from the GDPR's Approach to Algorithmic Accountability*, 92 S. CAL. L. REV. 1529 (2019); Joshua A. Kroll et al., *Accountable Algorithms*, 165 U. PA. L. REV. 633 (2017); Anne L. Washington, *How To Argue with an Algorithm: Lessons from the COMPAS-ProPublica Debate*, 17 COLO. TECH. L.J. 131 (2018) (arguing for standards governing the information available about algorithms so that their accuracy and fairness can be properly assessed).

168. *See, e.g.*, Aziz Z. Huq, *Racial Equity in Algorithmic Criminal Justice*, 68 DUKE L.J. 1043 (2019) (arguing that current constitutional doctrine is ill-suited to the task of evaluating algorithmic fairness and that current standards offered in the technology literature miss important policy concerns); Sandra G. Mayson, *Bias In, Bias Out*, 128 YALE L.J. 2218 (2019) (discussing how past and existing racial inequalities in crime and arrests mean that methods to predict criminal risk based on existing information will result in racial inequality).

169. *See* David Lat, *AI Use in Law Practice Needs Common Sense, Not More Court Rules*, BLOOMBERG L. (Feb. 28, 2024, 4:30 AM), https://news.bloomberglaw.com/us-law-week/ai-use-in-law-practice-needs-common-sense-not-more-court-rules.

on past legal decisions, may not adequately adapt to new legal standards or understand the context of human emotions and ethical considerations that are often crucial in legal judgments. This could result in decisions that are legally correct but morally or ethically questionable, potentially undermining public trust in the judicial system. Moreover, the use of AI could lead to a homogenization of legal outcomes.[170] As AI tools tend to generate solutions based on the most common interpretations of law, non-standard cases might not receive the individualized consideration they require. This could stifle the development of law, as precedents set by unique cases often lead to, or are reflections of significant legal reforms and social movements.

As the number of trials declines, the rise of private arbitration offers an ideal testing ground for integrating AI. From 1962 to 2002, the percentage of federal civil cases resolved by trial decreased by 84%, with similar declines in state courts.[171] This shift may be due to concerns about litigation costs, delays, risks, and impacts on relationships. Lawsuits often strain personal and professional relationships, causing emotional distress and psychological consequences for plaintiffs and defendants.[172] The frequent adjournments, delays, and financial strain associated with litigation lead to many adverse emotional outcomes such as stress and sleepless nights.[173]

The decrease in civil litigation has spurred the growth of arbitration, offering perceived advantages like cost savings, shorter resolution times, expert decision-makers, privacy, and relative finality. [174] Arbitration's increasing judicialization, with

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170. *See* Betsy Morris, *AI from AI: A Future of Generic and Biased Online Content?*, UCLA Anderson Rev. (Nov. 8, 2023), https://anderson-review.ucla.edu/ai-from-ai-a-future-of-generic-and-biased-online-content/.

171. Marc Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. Empirical Legal Stud. 459, 460–63 (2004).

172. *See, e.g.*, Feikoab Parimah et al., *A Snapshot of Emotional Harms Caused by the Litigation Process – Qualitative Data from Ghana*, 2 Forensic Sci. Int'l: Mind & L. 100050 (2021); *Relationships During Litigation*, Physician Litig. Stress Res. Ctr., https://physicianlitigationstress.org/medical-malpractice-lawsuit-support-resources/relationships-during-litigation/ (last visited Aug. 7, 2024).

173. *Supra* note 172.

174. *See* Elena V. Helmer, *International Commercial Arbitration: Americanized, "Civilized," or Harmonized?*, 19 Ohio State J. on Disp. Resolution 35, 35–36 (2003) (discussing perceptions of the American influence on international arbitration); Amr A. Shalakany, *Arbitration and the Third World: A Plea for Reassessing Bias Under the Specter of Neoliberalism*, 41 Harv. Int'l L. J. 419, 434–35

arbitrators determining jurisdiction and pre-hearing procedures mirroring litigation, makes it a suitable environment to test AI integration.[175]

Another aspect in which arbitration mirrors litigation is the extensive pre-hearing procedures, such as discovery, including depositions.[176] While many arbitration rules and arbitrators strive to limit excessive discovery, [177] it is not uncommon for legal advocates to negotiate trial-like discovery procedures, sometimes adhering to standard civil procedural rules.[178] This tendency is exacerbated when arbitrators hesitate to enforce limits on these practices or adhere strictly to schedules, often

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(2000) (observing that international arbitration is no longer quicker than adjudication); *see also* Thomas J. Stipanowich, *ADR and the "Vanishing Trial": The Growth and Impact of "Alternative Dispute Resolution,"* 1 J. EMPIRICAL LEGAL STUD. 843, 895 (2004) (quoting Jeffrey Carr, Vice President & Gen. Counsel, FMC Tech., The Torch Is Passed, Corporate Counsel Panel, Remarks at the Annual Meeting of the CPR Institute for Dispute Resolution (Jan. 29–30, 2004)) (one corporate general counsel lamented, "we found arbitration generally is as expensive [as litigation] . . . less predictable, and not appealable. Arbitration is often unsatisfactory because litigators . . . run it exactly like a piece of litigation.").

175. *See* First Options of Chi., Inc. v. Kaplan, 514 U.S. 938, 947 (1995) (holding that absent contrary intent, the court is responsible for deciding arbitrability); JAMS COMPREHENSIVE ARB. RULES & PROCS. RULE 11 (JAMS 2021) (stating that once appointed, the arbitrator shall resolve disputes about the interpretation and applicability of these Rules and conduct of the arbitration hearing); *see also* Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 445-46 (2006) (enforcing a provision authorizing arbitrators to address arbitrability issues); Schlessinger v. Rosenfeld, Meyer & Susman, 47 Cal. Rptr. 2d 650, 659–60 (Cal. Ct. App. 1995) (concluding the arbitrator had implicit authority to rule on summary adjudication motions).

176. *See* Michael A. Doornweerd and Andrew F. Merrick, *Strategies for Controlling Discovery Costs in Commercial Arbitration*, 12 COM. & BUS. LIT. 4, 4 (2011) ("Arbitration hearings are often preceded by extensive discovery, including requests for voluminous document production and depositions.").

177. *See* Thomas J. Stipanowich et al., *Protocols for Expeditious, Cost-Effective Commercial Arbitration*, COLL. COM. ARBITRATORS (2010), https://nysba.org/NYSBA/Sections/Commercial%20Federal%20Litigation/ComFed%20Display%20Tabs/Events/2019/Spring%20Meeting%20Materials/Protocols%20for%20Expeditious,%20Cost-Effective%20Commercial%20Arbitration.pdf.

178. Thomas J. Stipanowich, *Arbitration and Choice: Taking Charge of the "New Litigation" (Symposium Keynote Presentation)*, 7 DEPAUL BUS. & COM. L. J. 383, 393 n.36 (author saying that as an arbitrator, he has in the past encountered situations such that the counsel for arbitrating parties made a prior agreement to utilize the discovery provisions of the Federal Rules of Civil Procedure in arbitration).

because they do not want to alienate the parties and risk not being considered for future appointments.[179]

Historically, the U.S. has practiced the adoption of novel ideas in smaller or more contained environments before gaining wider acceptance. For example, the religious freedom experiments in the colonies, such as Rhode Island's separation of church and state and Pennsylvania's diverse religious freedoms, eventually became a cornerstone of the U.S. Constitution.[180] Similarly, in the judicial system, innovative uses of AI in arbitration could serve as a controlled experiment to test the technology's capabilities and address potential issues in a more contained and manageable environment. If these AI-driven methods prove effective and equitable in arbitration, they could lead to wider adoption across the broader judicial system, potentially transforming how justice is administered while ensuring that such technologies are introduced responsibly and ethically.

II.
The Critics are Killing the Baby

Despite the growing resistance to AI adoption in the legal domain, criticisms such as claims of AI being biased, discriminatory, lacking transparency, and accountability are insufficient grounds for outright rejection. The origins of discrimination and bias often lie within the human-provided data, not the AI mechanisms themselves. Given AI's early developmental stage and significant potential, maintaining an open environment that encourages its growth is essential. Adopting an overly moralistic tone could be counterproductive. The current regulatory frameworks, which typically involve supervising the system or focusing more carefully on human roles, may not be necessary

179. *See* Clyde W. Summers, *Mandatory Arbitration: Privatizing Public Rights, Compelling the Unwilling to Arbitrate*, 6 U. Pa. J. Lab. & Emp. L. 685, 717 (2004) (arguing that arbitrators may be less restrictive with discovery than judges because of their concern over obtaining future appointment as an arbitrator).

180. *See* John M. Barry, *God, Government and Roger Williams' Big Idea*, Smithsonian Mag. (Jan 2012), https://www.smithsonianmag.com/history/god-government-and-roger-williams-big-idea-6291280/ (Williams persuaded Parliament to allow Rhode Island to divorce church and state, whose principle ultimately made its way into the Constitution); *see also* Pa. Const. §3.

for arbitration. As long as both parties agree by contract to this method of adjudication, it should be permitted.

A. *Resistance Against AI Does Not Offer Conclusive Reasons for Outright Rejection*

Criticizing AI has become trendy. Since the introduction of ChatGPT in December 2022, critics have proliferated in the literature. They argue that AI is biased and unfair, shaped by the initial data it receives.[181] When the underlying data is biased, the resulting algorithms can perpetuate discrimination and inequality.[182] For instance, AI can exhibit sexist behavior—defaulting to male doctors and female nurses in stories—because these patterns are reflected in the data it was trained on.[183] Critics also argue that AI displaces jobs, with the World Economic Forum estimating that AI could replace 85 million jobs by 2025 and more over time.[184] Concerns extend to privacy, as AI can predict psychological characteristics from digital footprints, infringing on individual privacy.[185] Additionally, AI's lack of transparency is another major concern, as leading companies do not share enough information about their foundation models' development and use.[186] Furthermore, AI's ever-increasing capabilities raise geopolitical concerns.[187]

Legal scholarship focusing on AI in arbitration echoes these criticisms. Many legal academics strongly discourage

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181. *See generally* Stephanie Bornstein, *Anti-discriminatory Algorithms*, 70 ALA. L. REV. 520, 522-523 (2019) (the decisions made by AI are shaped by the initial data it receives. If the underlying data is unfair, the resulting algorithms can perpetuate bias, incompleteness, or discrimination, creating potential for widespread inequality.).

182. *Id.*

183. *See* Haley Strack, *AI is Sexist, UN Women Claims*, NAT'L REV. (May 24, 2024), https://www.nationalreview.com/corner/ai-is-sexist-un-women-claims/.

184. *See* Mark Talmage-Rostron, *How Will Artificial Intelligence Affect Jobs 2024-2030*, NEXFORD UNIV. (Jan 10, 2024), https://www.nexford.edu/insights/how-will-ai-affect-jobs.

185. *See* S.C. Matz et al., *Psychological Targeting as an Effective Approach to Digital Mass Persuasion*, 114 PNAS 12714, 12714 (Nov. 13, 2017).

186. *See Transparency in AI Companies: Stanford Study,* LUMENOVA (Nov. 17, 2023), https://www.lumenova.ai/blog/how-transparent-are-ai-companies/.

187. *See* Barry Pavel et al., *AI and Geopolitics: How Might AI Affect the Rise and Fall of Nations?*, RAND (Nov. 3, 2023), https://www.rand.org/pubs/perspectives/PEA3034-1.html.

deploying AI in arbitration. [188] Professor David Horton contends that AI procedures do not qualify as "arbitration" under the FAA, which is predicated on human arbitrators.[189] Similarly, Professor Derick Lindquist and Ylli Dautaj argue that AI lacks human qualities like empathy, emotion, and life experience, which are crucial for justice and fairness.[190] Professor Lee-Ford Tritt notes that AI might enhance trust in arbitration by assisting human arbitrators but is less useful in complex, emotionally charged disputes where normative values are critical. [191] Gizem Halis Kasap highlights concerns about data integrity, machine biases, AI opacity, and lack of emotional intelligence, advising caution in adopting AI arbitrators. [192]

Another criticism focuses on datasets. Larger datasets do not necessarily improve AI performance; instead, they may perpetuate past patterns. Ian R. McKenzie et al.'s study observed that language models (LMs) do not always improve with increased size, despite common assumptions to the contrary.[193] This "inverse scaling" occurs because larger models may prefer repeating memorized sequences over adhering to specific contextual instructions.[194] They might replicate undesirable biases or focus on simpler subtasks within a complex setup, failing to address the main task effectively.[195]

Practical challenges also arise when applying AI in arbitration. General-purpose models like ChatGPT and Claude are

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188. *Contra* Horst Eidenmueller & Faidon Varesis, What is an Arbitration? Artificial Intelligence and the Vanishing Human Arbitrator (July 15, 2020) (unpublished manuscript) (on file with SSRN) (arguing that "fully AI-powered arbitrations will be technically feasible and should be legally permissible at some point in the future. There's nothing in the concept of arbitration that requires human control, governance, or even input.").

189. *See* David Horton, *Forced Robot Arbitration*, 109 Cornell L. Rev. 679, 721, 734 (2024).

190. *See* Derick H. Lindquist & Ylli Dauta, *AI in International Arbitration: Need for Human Touch*, 2021 J. Disp. Resol. 39, 40-41 (2021); *see also* Cole Dorsey, *Hypothetical AI Arbitrators: A Deficiency in Empathy and Intuitive Decision-Making*, 13 Arb. L. Rev. 1, 31 (2021).

191. *See* Lee-Ford Tritt, *The Use of AI-Based Technologies in Arbitrating Trust Disputes*, 58 Wake Forest L. Rev. 1203, 1223, 1243-44 (2023).

192. See Gizem Halis Kasap, *Can Artificial Intelligence Replace Human Arbitrators? Technological Concerns and Legal Implications*, 2021 J. Disp. Resol. 209, 210 (2021).

193. *See* Ian R. McKenzie et al., Inverse Scaling: When Bigger Isn't Better (May 13, 2024) (unpublished manuscript) (on file with Transactions on Machine Learning Research).

194. *Id.*

195. *Id.*

not designed for specialized tasks such as large-scale international commercial arbitration.[196] Using AI in these contexts demands unprecedented trust from disputants. Before deployment, AI models must be fine-tuned to ensure confidentiality and evaluated for optimal trust-building methods. Ideally, these methods should reflect diversity in factors such as age, cultural background, gender, and socioeconomic status, including representation from both historically dominant and minority groups.

But who are the programmers and policymakers to make decisions for the disputants? When the parties themselves believe that this technology is a suitable method to resolve their issues, why should others—academics, scientists, researchers—deny them this choice? This paternalistic culture should not prevail. Disputants, according to the framework in FAA, must have the autonomy to decide the means of resolving their conflicts, free from external imposition that may not fully understand or respect their specific needs and contexts.

The fact that AI exhibits bias is not sufficient grounds for its outright rejection in dispute resolution contexts. Ultimately, it is our behavior—"datafied" and scraped online—that forms the training datasets for these models. Why should we reject a tool that merely reflects ourselves?

It's fairly apparent from AI's working mechanism that we are the source of its problems. AI, as defined above, includes deep learning, LLMs, and ML. Each of these reflects the content of its training data. For instance, deep learning, a subset of ML, uses complex structures called neural networks to process data.[197] As input signals pass through these layers, each one performs calculations to predict an outcome.[198] These neural networks handle multiple layers of computations, similar to stacking several linear regression models interspersed with nonlinear functions to manage complex data relationships.[199] When an AI outputs something offensive, it is a reflection of the

196. *See* Kasap, *supra* note 192 at 210.

197. *See What's the Difference Between Deep Learning, Machine Learning, and Artificial Intelligence?*, Google Cloud, https://cloud.google.com/discover/deep-learning-vs-machine-learning?hl=en (last visited Aug 7, 2024).

198. *Id.*

199. *Id.*

biases present in the training data, not an indication of inherent malice or error in the AI itself.

LLM, a language model that functions by predicting the next word in a sequence, also reflects the biases and patterns present in its training data. Its working process involves inputting a sequence of words into the model, which then is used to predict what comes next.[200] The procedure uses a technique called self-supervised learning, which is like a student teaching themselves without explicit instructions.[201] Instead of being told what to learn, the model looks at the data it already has—like a text where the next word is the answer to a question it must guess. By predicting these next words repeatedly, the model teaches itself the patterns and rules of language, improving each time without needing a teacher to tell it if it's right or wrong.[202] The quality, diversity, and size of the dataset greatly influence the outcome — if the data contains inconsistencies, the model will learn these inaccuracies, leading to incorrect predictions. A non-diverse dataset will have limited capability to be generalized to unseen data and will generate results that favor certain language structures or content. Given its billions of parameters, it's possible that the model knows more about us than we do ourselves.

GPT (Generative Pre-Training Transformer), the basis of many pre-trained GenAI models, shares the same relationship for how the dataset affects the outcome. It uses an architecture optimized to focus on the most relevant parts of an input sequence at any given time.[203] This attention mechanism allows the model to efficiently process large amounts of data while prioritizing elements crucial for understanding context and generating responses.[204] The quality of the data determines the generated content in that the ideologies, perspectives, and assumptions embedded in the dataset are learned by the model.

In conclusion, rejecting AI due to its unsettling outputs is like rejecting a reflection of our societal flaws. Instead, we

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200. *See* Andreas Stöffelbauer, *How Large Language Models Work – from Zero to ChatGPT*, MEDIUM (Oct. 24, 2023), https://medium.com/data-science-at-microsoft/how-large-language-models-work-91c362f5b78f.

201. *Id.*

202. *Id.*

203. *See What is GPT?*, AMAZON WEB SERVS., https://aws.amazon.com/what-is/gpt/ (last visited Aug. 7, 2024).

204. *Id.*

should keep an open mind and let AI grow, addressing the areas where improvement is needed.

B. *Let AI Grow Under Favorable Conditions: Avoiding Overly Moralistic Views*

Social, cultural, and environmental norms, along with institutional requirements, often play a crucial role in the development and growth of technology. Focusing solely on AI's disadvantages and preventing parties from contracting for themselves can stifle technological growth and innovation. Overly moralistic views can prematurely stifle progress.

The development of economics illustrates the importance of welcoming external influences. Economics now holds a near-hegemonic status in strategic management science, not solely due to its internal rigor but also because of promotion by external entities like RAND and the Ford Foundation. During the 1930s Great Depression, classical economic theories failed. A new direction was essential. RAND's contributions, including funding and expertise, repositioned economics.[205] Pioneering economists like Kenneth Arrow and Harry Markowitz employed statistical methods, further promoting innovative approaches.[206]

Had the RAND Corporation and the Ford Foundation not prioritized the development of economics, the field might not have become as influential as it is today. Social science may have been delayed in using quantitative approaches to study complex phenomena; it's questionable whether the school of law and economics would have grown. It's highly probable that

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205. *See A Brief History of RAND*, RAND, https://www.rand.org/about/history.html (last visited Aug. 7, 2024) (RAND's early contributions include developing theories and tools for decision-making under uncertainty. It also makes foundational contributions to game theory, linear and dynamic programming, mathematical modeling and simulation, network theory, and cost analysis – all critical theories and ideas in economics.).

206. For Kenneth Arrow's contributions, see *Kenneth Arrow*, RAND, https://www.rand.org/pubs/authors/a/arrow_kenneth.html (last visited Aug. 7, 2024). For a biography of Kenneth Arrow and his position at RAND, see *Nobel Laureate Kenneth J. Arrow, a RAND Consultant Since 1948, Dies at 95*, RAND (Feb. 22, 2017), https://www.rand.org/news/press/2017/02/22.html. For Harry Markowitz's contribution to economic theory and his position at RAND, see Murray Coleman, *A Tribute to Harry Markowitz: In Memoriam of a Finance Legend*, INDEX FUND ADVISORS (June 28, 2023), https://www.ifa.com/articles/tribute-to-finance-legend-harry-markowitz.

there might not be a systematic framework for a behavioral approach to economic analysis of law.

Without the economic analysis of law, the field of legal scholarship would be profoundly different, as this perspective and analytical method have been applied across all domains of law—from torts to antitrust. For instance, in torts, behavioral economics has helped to predict and interpret how individuals might respond to various legal incentives and penalties.[207] In litigation strategies, game theory has been used to study parties' decision-making processes.[208] In antitrust, multi-layer modeling also plays a crucial role in the Department of Justice's evaluation regarding whether to allow certain acquisitions.[209] In criminal law, principles such as proportional punishment and marginal utility theory help ensure that fines and bail amounts are proportional to both the severity of the crime and the financial circumstances of the defendant.[210] Additionally, in health

207. *See* Jay M. Feinman, *Incentives for Litigation or Settlement in Large Tort Cases: Responding to Insurance Company Intransigence*, 13 ROGER WILLIAMS UNIV. L. REV. 189 (2008).

208. *See* Christopher Whitehouse & Simon Hart, *Game Theory and the Art of Litigation Strategy*, REYNOLDS PORTER CHAMBERLAIN LLP (Apr. 2, 2019), https://www.rpc.co.uk/thinking/commercial-disputes/game-theory-and-the-art-of-litigation-strategy-article-4/; *see also* Engaging Experts, *How Game Theory Benefits Attorneys and Litigators*, ROUND TABLE GRP. (Jan. 15, 2021), https://www.roundtablegroup.com/expert-discussions/how-game-theory-benefits-attorneys-and-litigators/.

209. To investigate the merger's anti-competitive effects, DOJ used a variety of economics methods such as market concentration analysis (helping to predict if the merged entity could profitably raise prices; understanding consumer sensitivity to price changes in telecommunications services) and competitive effects analysis (assessing the impact of the merger on competitive dynamics, such as the potential for reduced innovation and the adverse effects on consumer choices and prices). Because the economic analysis predicted that the merger would significantly increase market concentration in the telecommunication sector, leading to higher prices, poorer service quality, and less consumer choice, DOJ filed a lawsuit in 2011 to block the merger; the FAA also signaled its opposition. In December 2011, AT&T and T-Mobile abandoned the merger. *See* Press Release, Office of Pub. Aff., U.S Dep't of Just., Justice Department Challenges AT&T/DirecTV's Acquisition of Time Warner (Nov. 20, 2017), https://www.justice.gov/opa/pr/justice-department-challenges-attdirectv-s-acquisition-time-warner. For an introduction of using economic analysis to predict the competitive effects of mergers, see Ken Heyer, *Predicting the Competitive Effects of Mergers by Listening to Customers*, ANTITRUST DIV. U.S. DEP'T OF JUST. (Sept. 2006), https://www.justice.gov/atr/predicting-competitive-effects-mergers-listening-customers.

210. *See* Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1208, 1215–1216 (1985).

law, risk management and the supply and demand dynamics support the implementation of medical malpractice damage caps, aiming at curbing rising malpractice insurance costs and improving healthcare access and affordability.[211]

Indeed, if economics had faced the same level of criticism in the 1930s as AI does today, it simply might not have succeeded at all. The criticisms currently aimed at AI - relying on oversimplified models with unrealistic assumptions about human behavior, markets, and institutions; an overreliance on quantitative methods at the expense of qualitative insights; promoting market solutions that may disregard equity, justice, or sustainability; favoring policies that benefit wealthier segments of society while neglecting the needs of the poor and marginalized; applying methods to other fields like sociology, political science, and psychology without adequate consideration of their unique insights and methodologies; and exhibiting biases against gender and cultural diversity — are similar to those that have been directed at economics throughout its history, though they became more pronounced and diverse from the 1970s onwards.[212] Just as economics was allowed room to grow and

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211. In 2003, Texas faced a significant crisis in medical malpractice insurance, which was driven by high damage awards and an increasing number of claims that led to high insurance premiums for healthcare providers. To evaluate and implement caps on medical malpractice damages, Texas charted the number of malpractice claims filed over time and the average size of the payment; it estimated the effects of various factors on malpractice insurance premiums and healthcare availability; it also gathered qualitative data from healthcare providers, insurance companies, and patients. *See Professional Liability Insurance Reform*, Tex. Med. Ass'n (Jan. 6, 2020), https://www.texmed.org/template.aspx?id=780; *see also* Patricia H. Born et al., *The Net Effects of Medical Malpractice Tort Reform on Health Insurance Losses: The Texas Experience*, 7 Health Econ. Rev. 42 (Nov 7, 2017), https://healtheconomicsreview.biomedcentral.com/articles/10.1186/s13561-017-0174-2.

212 For critiques about economics using oversimplified models, see Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 Econometrica 263 (1979) (introducing Prospect Theory, challenging the classical assumption of rationality by illustrating how people actually make decisions under risk). For the same critique on AI, see Tim Pearce et al., Imitating Human Behaviour with Diffusion Model (Mar. 3, 2023) (unpublished manuscript) (on file with arXiv) (suggesting that using diffusion models to clone or replicate human behaviors has several limitations that cannot be overlooked: 1. Scalability - while diffusion models excel in capturing complex multimodal distributions, the computational power and scalability of these models can be challenging, especially in environments that require real-time interaction, 2. Sampling efficiency - diffusion model require iterative training, which is slow when generating actions in real-time scenarios; this affects the feasibility of applying these models in environments where decisions must

evolve despite its imperfections, AI also deserves the opportunity to develop and mature without being prematurely judged. Just as economics needed support to achieve its potential, AI requires the same understanding and backing to realize its own transformative impact.

Another example is epidemiology. Initially, people did not believe in the causes of disease, attributing them to the ill wills of gods. However, the benefits of understanding the causes of diseases eventually led to widespread acceptance of epidemiological knowledge. For instance, in the mid-19th century, John Snow's work on the cholera outbreak in London faced significant skepticism. People believed in the miasma theory, thinking that bad air caused the disease. But Snow mapped the cholera cases around the Broad Street pump, which eventually led to the acceptance of his waterborne theory and laid the groundwork for modern epidemiology and public health practices.[213]

Currently, principles of epidemiology have been combined with legal analysis to understand the impact of laws on the health of populations. This field, known as legal epidemiology, examines how legal frameworks can be designed, implemented, and evaluated to improve public health.[214] For example, tobacco control laws have been informed by epidemiological evidence on the harms of smoking, leading to the implementation of various regulations such as advertising bans, smoking bans in

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be made rapidly, 3. Dependent on quality and diversity of training data to generalize the computed results to human behaviors, 4. Handling sequential dependency - while the models can certainly handle sequential data, there remains a challenge in capturing long-term dependencies and ensuring that the sequence of actions generated is coherent over longer time horizons.). For the critique in economics about over-relying on quantitative methods at the expense of qualitative insights, see Edward Cartwright & Eghosa Igudia, *The Case for Mixed Methods Research: Embracing Qualitative Research to Understand the (Informal) Economy*, 2023 Rev. Dev. Econ. (Special Issue) 1 (Nov. 7, 2023) (saying that economics has long shunned qualitative research methods, and advocating for an integration of both). For critiques in economics about how it has neglected ethical considerations, see Hans J. Blommestein, *Why is Ethics Not Part of Modern Economics and Finance? A Historical Perspective*, Fin. & Common Good (2006), https://www.cairn.info/revue-finance-et-bien-commun-2006-1-page-54.htm.

213. *See* Fahema Begum, *Mapping Disease: John Snow and Cholera*, Royal Coll. of Surgeons of Eng. (Dec. 9, 2016), https://www.rcseng.ac.uk/library-and-publications/library/blog/mapping-disease-john-snow-and-cholera/.

214. *See Legal Epidemiology*, Ctrs. for Disease Control & Prevention (May 15, 2024), https://www.cdc.gov/cardiovascular-resources/php/toolkit/legal-epidemiology.html.

public places, and graphic warning labels on cigarette packs.[215] Similarly, laws requiring nutritional information on food packaging have been guided by epidemiological studies linking diet to chronic diseases like obesity, diabetes, and cardiovascular disease.[216] These regulations help consumers make healthier food choices.

Without allowing epidemiology the space to grow and be challenged, it wouldn't have achieved the impactful contributions it has made to public health today. The evolution of epidemiology underscores the importance of fostering emerging fields, providing them the opportunity to mature and demonstrate their potential, much like we must do with AI now.

Overly moralistic considerations can stifle innovations with potential global impact. Ensuring AI is fair is important, but when parties agree to use AI for dispute resolution, it is neither legally nor practically sensible for others to contest this usage. Constantly adopting a moralistic stance can hinder progress. An example is Cardinal Richelieu, who served as the First Minister of France from 1624 to 1642. Willing to break away from the prevailing ideologies of his time, he transformed France into a leading power of the 17th century.

When Richelieu took office, the Holy Roman Emperor Ferdinand II was working to restore Catholic dominance and suppress Protestantism,[217] aiming to unite Christian Europe under the Emperor and the Pope. However, the Empire—spanning Germany and Northern Italy—never fully achieved this "universality" due to tensions between the Emperor's political ambitions and the Church's spiritual authority. These clashes often arose as secular rulers, including the Habsburgs, sought regional autonomy by challenging the Church.

Habsburg expansion threatened France, which was encircled by Habsburg territories: Spain to the south, Spanish-influenced Italian states to the southeast, and Franche-Comté

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215. *See* Lisa M. Wilson et al., *Impact of Tobacco Control Interventions on Smoking Initiation, Cessation, and Prevalence: A Systematic Review*, J. Env't & Pub. Health (Jun. 7, 2012), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3376479/.

216. *See generally* Inst. of Med., Front-of-Package Nutrition Rating Systems and Symbols: Phase I Report 19 (Ellen A. Wartella et al. eds., 2010), https://www.ncbi.nlm.nih.gov/books/NBK209859/ (last visited Aug. 8, 2024).

217. *See* Iskander Rehman, *Raison d'Etat: Richelieu's Grand Strategy During the Thirty Years' War*, 2 Tex. Nat'l Sec. Rev. (2019), https://tnsr.org/2019/06/raison-detat-richelieus-grand-strategy-during-the-thirty-years-war/.

and the Spanish Netherlands to the north.[218] Richelieu, though a Catholic cardinal, countered this by aligning with Protestant princes, issuing the Grace of Alais in 1629 to grant French Protestants religious freedom.[219] He also supported Protestant German princes and subsidized Gustavus Adolphus of Sweden to reduce Habsburg threats, prioritizing France's security over religious lines.[220]

By focusing squarely on preventing the emergence of a major power on France's borders, Richelieu consciously steered clear of ideological debates. Had he succumbed to the religious zeal and ideological fanaticism prevalent in his era, France might not have been able to maintain its distance while Germany was being devastated. If constrained by his own morality, the French monarchy might not have risen to the formidable power it later became. Richelieu's Machiavellian pragmatism provided the intellectual foundation for pursuing foreign policies that prioritized state interests over moral or religious considerations.[221] This approach not only fortified France but also laid the groundwork for the later development of political realism, shaping the conduct of states in subsequent centuries to come.[222] Granted, this theory has been criticized widely for its lack of moral foundation and contribution to power politics. Nevertheless, it's undeniable that this doctrine played a crucial role in forestalling German unification by some two centuries.

In the context of AI in arbitration, adopting a pragmatic approach can lead to substantial advancements. The underlying principle here is intellectual humility—we should recognize that it is difficult to predict what will work and remain open to experimentation. Utilizing AI for dispute resolution in contractual agreements allows for innovative approaches that might streamline processes and yield fair outcomes efficiently. By eschewing rigid moralistic frameworks and embracing a trial-and-error methodology, we can uncover new pathways to solving complex problems.

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218. *See* HENRY KISSINGER, DIPLOMACY 59 (Simon & Schuster, 1994).
219. *Id.* at 61–62.
220. *Id.*
221. *Id.* at 63–67 (discussing the impact of Richelius's pragmatic approach to national interests in diplomacy).
222. *Id.*

C. *Arbitration Should Allow Flexible, Contract-Based Experimentation in a Fast-Evolving Regulatory Landscape*

Given the fluid landscape of AI regulation, arbitration should provide a space for experimentation based on contractual agreements between parties. The two primary current approaches to AI regulation are unnecessary when parties can agree by contract on their preferred method of dispute resolution. As a developing technology, AI should be allowed room for innovation, with a hands-off approach fostering creativity and letting the market shape AI integration and application.

The first regulatory approach focuses on the specific use of AI. This branch of regulation incorporates a strategy that involves adding a human element to the decision-making process.[223] It aims to address generalized social injustice, accountability, oversight, and algorithm auditing. However, it fails to specify why a human is or isn't involved or clarify the roles the human is supposed to play. Additionally, it doesn't account for the human's needs, skills, or weaknesses.[224] These regulations are based on the unexamined assumption that humans can effectively oversee algorithmic decision-making, despite the often-flawed design of the interfaces.[225] The underlying belief is that because humans are tangible and identifiable, they can be directly regulated as familiar targets.[226]

More specifically, these regulations focus on various aspects of AI deployment. For instance, some address implementation questions, advocating for procedural regularity and oversight to ensure fairness and accuracy in AI scoring systems.[227] Others

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223. *See, e.g.*, Meg Leta Jones, *The Right to a Human in the Loop: Political Constructions of Computer Automation and Personhood*, 47 SOC. STUD. SCI. 216, 224 (2017) (describing the EU's use of the human in the loop as a regulatory tool).

224. *See* Rebecca Crootof, Margot E. Kaminski & W. Nicholson Price II, *Humans in the Loop*, 76 VAND. L. REV. 429, 437 (2023).

225. *See, e.g.*, Ben Green, *The Flaws of Policies Requiring Human Oversight of Government Algorithms*, 45 COMPUT. L. & SEC. REV. 1 (2022).

226. *See, e.g.*, Ashley Deeks, Noam Lubell & Daragh Murray, *Machine Learning, Artificial Intelligence, and the Use of Force by States*, 10 NAT'L SEC. L. & POL'Y 1, 4 (2019) (predicting that states will use machine learning to aid decisions about whether to use force against or inside another state); Ashley S. Deeks, *Predicting Enemies*, 104 VA. L. REV. 1529, 1530–31 (2018) (noting that leaders are encouraging the use of machine learning to improve military capabilities and decision-making).

227. *E.g.*, Danielle Keats Citron & Frank A. Pasquale, *The Scored Society: Due Process for Automated Predictions*, 89 WASH. L. REV. 1, 19 (2014).

consider the potential social effects, such as the disproportionate impact of AI on socially marginalized groups.[228] Some evaluate related social and governance considerations, suggesting that states and industry should collaborate to govern the use of algorithms and public data to prevent private AI governance.[229] Other works examine how humans influence algorithmic decision-making in specific tasks.[230]

Beyond specific uses, these policies are also proposed within their respective fields. For example, international humanitarian law mandates that military use of AI must comply with applicable international laws.[231] Health law requires that AI applications in healthcare prioritize patient safety, maintain confidentiality, and adhere to existing medical standards and regulations.[232] Administrative law must adapt to the reality of automation, using technology to enhance the foundational

228. *See, e.g.*, Rebecca Crootof, "*Cyborg Justice" and the Risk of Technological–Legal Lock-In*, 119 COLUM. L. REV. F. 233, 235 (2019) (claiming that converting legal procedures and judicial decision-making into code could introduce new obstacles to legal development, potentially leading to stagnation and undermining the legitimacy of the judiciary); Richard M. Re & Alicia Solow-Niederman, *Developing Artificially Intelligent Justice*, 22 STAN. TECH. L. REV. 242, 247 (2019) (claiming that the incorporation of AI into the common law judicial system will alter expectations about the judiciary, shifting focus from procedural fairness to a greater emphasis on outcomes).

229. Alicia Solow-Niederman, *Administering Artificial Intelligence*, 93 S. CAL. L. REV. 633, 690 (2019); Margot E. Kaminski, *Binary Governance: Lessons from the GDPR's Approach to Algorithmic Accountability*, 92 S. CAL. L. REV. 1529, 1538 (2019) (arguing that algorithmic decision making relies on flawed human decisions as well. States and industry ought to govern together).

230. *See, e.g.*, Kiel Brennan-Marquez, Karen Levy & Daniel Susser, *Strange Loops: Apparent Versus Actual Human Involvement in Automated Decision Making*, 24 BERKELEY TECH. L.J. 745, 749 (2019) (discussing how having a human in the loop affects the decision-making process); Meg Leta Jones, *The Ironies of Automation Law: Tying Policy Knots with Fair Automation Practices Principles*, 18 VAND. J. ENT. & TECH. L. 77, 90–91 (2015) (describing how people automate the easiest tasks to oversee fallible automated systems, while simultaneously increasing the amount of time they use to resolve the more difficult issues).

231. *See Political Declaration on Responsible Military Use of Artificial Intelligence and Autonomy*, U.S. DEP'T OF STATE (Nov. 9, 2023), https://www.state.gov/political-declaration-on-responsible-military-use-of-artificial-intelligence-and-autonomy-2/.

232. *See, e.g.*, W. Nicholson Price II, *Regulating Black-Box Medicine*, 116 MICH. L. REV. 421, 423–24 (2017) (suggesting a more collaborative approach to govern medical algorithm); *see also* Ciro Mennella et al., *Ethical and Regulatory Challenges of AI Technologies in Healthcare: A Narrative Review*, 10 HELIYON 1, 9 (2024).

purposes of the administrative state, such as expertise, agility, and discretion in governance.[233]

One significant drawback is the vagueness regarding how users should use algorithms to reach decisions. For example, a Colorado law governing the use of facial recognition by government agencies requires human involvement when making decisions that produce legal effects concerning individuals.[234] While the law mandates that decisions be "subject to meaningful human review," defined as "review or oversight by one or more individuals who are trained [in accordance with the statute's requirements] and have the authority to alter a decision under review,"[235] it does not specify what the training should entail, nor does it clearly define the scope of "legal effects concerning individuals." There is no data that suggests an added layer of human review makes the system better. In today's world, any effect relating to humans could be interpreted as legal if viewed broadly. Furthermore, the law does not detail the procedural aspects of human review, such as whether the review is automatic for every decision, how many reviewers are required, or how disputes among reviewers should be resolved.

A second, more holistic approach recognizes that the system is more than its parts.[236] Since humans are involved in every phase of the algorithm, from training to deployment, a broader definition of the system's tasks is crucial.[237] This approach identifies nine distinct categories of human-AI interactions, including corrective, resilience, justificatory, dignitary, accountability, stand-in, friction, warm body, and interface roles. [238]

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233. *See e.g.*, Ryan Calo & Danielle Keats Citron, *The Automated Administrative State: A Crisis of Legitimacy*, 70 Emory L.J. 797, 800 (2021) (noting the trend in state and federal public benefits agencies towards incorporating automated systems).

234. Colo. Rev. Stat. § 24-18-303 (2022); *see generally* S.B. 22-113, 73d Gen. Assemb., Reg. Sess. (Colo. 2022).

235. Colo. Rev. Stat. §§ 24-18-303, -301(III)(9) (2022).

236. *See* Crootof, Kaminski & Price, *supra* note 224, at 437.

237. *Id.* at 444.

238. For a more thorough explanation of the nine categories, see *id.* at 473–487 (corrective Roles, where humans enhance system performance by correcting errors; Resilience Roles, acting as fail-safes to stop the system during emergencies and prevent malfunctions; and Justificatory Roles, where humans provide reasoning for decisions, increasing the system's legitimacy. Dignitary Roles protect the dignity of individuals affected by system decisions, while Accountability Roles involve humans in allocating liability and administering censure when necessary. Stand-in Roles see humans representing or substituting for other humans and human values, ensuring alignment with

However, cataloging these roles exhaustively is impossible, as technology reveals new applications and roles for humans that were previously unimaginable. For instance, when ChatGPT launched in 2023, its potential to act as a realistic, on-demand emotional companion was not immediately recognized. Yet by 2024, it had captured media attention for its ability to simulate intimacy.[239] Similarly, by March of that year, Suno was creating high-quality music from text prompts, and AlphaFold3 was accurately predicting biomolecular structures—developments that had not been anticipated.[240] All these advancements raise crucial legal issues that previously were not thought of. It is a futile attempt to create a comprehensive list of roles that need regulation.

As a result, one might argue for adopting industry standards for regulation, based on the premise that developers of the technology best understand how to use it safely.[241] For instance, if computer scientists believe that AI should not replace humans as arbitrators, then these systems should be rigorously regulated for safety and fairness before deployment. However, AI technology is still in development, and universally accepted best practices have not been established. Unlike biochemistry, which benefits from decades of peer review and established practices, AI lacks a comprehensive body of long-term data to set standards. Technologies like deep learning have only been in widespread use for the past decade, previously limited by

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societal norms. Friction Roles involve slowing down automated decision-making to allow for oversight and reflection. Additionally, Warm Body Roles help preserve human jobs by maintaining a human presence in automated processes, and Interface Roles serve as the critical link between the system and its users, facilitating interaction and understanding.).

239. *See* Kevin Roose, *Meet My A.I. Friends*, N.Y. Times (May 9, 2024), https://www.nytimes.com/2024/05/09/technology/meet-my-ai-friends.html (showing that LLM can now serve as emotional companions for people).

240. *See* Brian Hiatt, *A ChatGPT for Music is Here. Inside Suno, the Startup Changing Everything*, Rolling Stone (Mar. 17, 2024), https://www.rollingstone.com/music/music-features/suno-ai-chatgpt-for-music-1234982307/; *see also* Google DeepMind AlphaFold Team & Isomorphic Labs, *AlphaFold 3 Predicts the Structure and Interactions of All of Life's Molecules*, Google (May 8, 2024), https://blog.google/technology/ai/google-deepmind-isomorphic-alphafold-3-ai-model/.

241. *See, e.g.*, Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 Colum. L. Rev. 1260 (2006) (arguing for reconsidering the foundational role of centralized review in regulation, and supporting the idea of adopting industry standards for regulations, based on the premise that those who develop technology often best understand its safe and effective use).

data availability and computing power. Furthermore, emerging applications such as autonomous vehicles and predictive policing are still evolving, without extensive, validated research for guidance. Relying solely on industry standards may overlook the diverse ways in which users' backgrounds, personalities, and environmental conditions affect their interactions with AI. Therefore, AI regulation requires a flexible and adaptive framework that can evolve with technological advancements, ensuring these regulations remain relevant and effective in addressing the challenges of AI.

Arbitration, as a consensual means of resolving disputes, could bypass certain regulations. This flexibility allows parties to freely experiment, providing opportunities to observe and study AI's effectiveness and potential biases. Arbitration agreements can include specific provisions for the use of AI, ensuring that both parties are aware of and agree to the use of AI in the dispute resolution process. Of course, we know that these agreements will not directly mimic the outcome that might be reached by a court, and that is exactly what ADR is designed to permit.

Arbitration also provides a unique opportunity for AI experimentation because it operates outside the traditional court system. Parties can tailor arbitration procedures to their specific needs, including the integration of AI. This flexibility allows for the development and testing of AI technologies in a controlled environment, providing valuable insights into their strengths and weaknesses.

In conclusion, critics' concerns about AI's biases, discrimination, and lack of transparency are insufficient for its outright rejection. The origins of these issues lie within the human-provided data, not the AI mechanisms themselves. By allowing AI to grow under favorable conditions and adopting a flexible regulatory framework, we can harness AI's potential while addressing its challenges responsibly. Arbitration, with its inherent flexibility, provides an ideal testing ground for AI integration in the broader judicial system.

III.
Future Direction and Conclusion

Arbitration presents an unparalleled opportunity to lead the AI revolution in the legal domain. It is a field inherently designed to empower parties to define their own terms of justice through mutual agreements. Integrating AI into arbitration

honors this principle, providing a platform for innovative adjudication methods that are both cost-effective and efficient.

In a climate rife with AI skepticism, it is crucial to maintain the integrity of arbitration agreements. The right of parties to choose AI as their arbitrator must be respected, ensuring that arbitration remains a flexible and dynamic alternative to traditional litigation. This respect for contractual autonomy not only upholds the fundamentals of arbitration law but also paves the way for the evolution of AI jurisprudence, a critical advancement for our legal system.

Drawing from the profound insights of Judge Richard Posner, we adapt his thoughts to advocate fervently for AI in alternative dispute resolution. The ethical obligations of AI arbitrators can only be comprehended by acknowledging the fundamental differences between AI adjudication and traditional human adjudication. Consent to arbitrate a commercial dispute with AI is entirely voluntary, rooted in the contractual agreement. This voluntariness is a pivotal safeguard absent in the coercive nature of the judicial system. The historical American fear of government oppression has fostered a judiciary where impartiality is prioritized over specialized expertise.[242] Conversely, those who opt for AI arbitration do so because they value a tribunal endowed with unparalleled data processing capabilities and consistency as well as reduced costs, far exceeding the limited scope and high cost of generalist courts. The technological prowess of AI arbitrators is especially beneficial in commercial disputes, characterized by their complexity and the vast datasets involved.

It is essential to avoid prematurely dismissing the potential of AI in ADR. Instead, we must nurture this innovative approach, allowing it to mature and demonstrate its full capabilities. By fostering an environment conducive to the growth of AI arbitration, we stand to achieve significant advancements in legal adjudication, ensuring that this groundbreaking technology is given a fair and unbiased chance to prove its worth.

In summary, let us not stifle the promising AI-ADR initiative. Rather, let us support its growth, carefully observe its development, and assess its capabilities as it evolves. By doing so, we can unlock a future where AI enhances the efficiency and fairness of arbitration, benefiting all parties involved.

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242. Merit Ins. Co. v. Leatherby Ins. Co., 714 F.2d 673, 679 (7th Cir. 1983).