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AMERICAN CORPORATE LAW: DIRECTORS' FIDUCIARY DUTIES AND LIABILITY DURING SOLVENCY, INSOLVENCY, AND BANKRUPTCY IN PUBLIC CORPORATIONS

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I. INTRODUCTION

This article examines contemporary differences in the fiduciary duties and liability of corporate directors and officials belonging to non-distressed public corporations, to corporate entities facing insolvency (approaching insolvency), and to those that eventually become insolvent. Delaware General Corporate Law is one of the most advanced and flexible corporation statutes in the United States. The Delaware Court of Chancery has over 200 years of legal precedent as a maker of corporate law.[1] As a result, cases from that state are examined in light of the evolving trend in fiduciary duties of corporate officers and directors.[2]

In the wake of a declining Wall Street market, exorbitant executive salaries, and lofty severance packages, frequently accompanied by dismal company performance, directors' duties and liability are given a closer look than ever before.[3] Other constituents, such as corporate creditors, believe

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1 EPSTEIN, FREER, ROBERTS & SHEPHERD, BUSINESS STRUCTURES 165 (Thompson & West, 2nd ed. 2007).

2 The corporate law of the State of Delaware is said to be understood as a kind of de facto federal law, because most U.S. companies are incorporated in Delaware. *See* Bernard Black et al., *Legal Liability of Directors and Company Officials Part 1: Substantive Grounds for Liability (Report to the Russian Securities Agency)*, 2007 COLUM. BUS. L. REV. 614, 643 (2007).

3 In this vein, some proposed corporate governance reforms have been made with the goal of improving corporate governance, and they include iter alia: i) limiting board discretion

and often assert that directors owe them a fiduciary duty to consider their interest. Hence, with insolvency looming, corporate officers and directors may feel there is little incentive to protect corporate assets for shareholders, because those assets are likely to go to creditors. On the other hand, officers and directors may be tempted to use the creditors' money for their own benefit or to save the company.[4] Yielding to such temptation may expose directors and officers to personal liability.

However, the true question here is whether there should be a shift in the directors' fiduciary duty and liability beyond the shareholders and corporation as the latter becomes financially distressed. Would a shift like that be justified? Another relevant question is whether this duty should be owed to the creditors of the corporation as it approaches insolvency, (i.e., enters the "zone of insolvency") or when it has finally become insolvent. Furthermore, how does recent case law address directors' fiduciary issues under these different corporate contexts? This paper examines the answers to such questions and proposes some guidelines that may help a distressed company's officers and directors limit their exposure to personal liability.

Traditionally, fiduciary duties involve those of care, loyalty and good faith. The duty of care requires directors to act as reasonable, prudent people under all circumstances. This requires a deliberative decision-making process based on full and credible information. The duty of loyalty, in turn, requires a fiduciary to act in good faith for the benefit of the corporation. Therefore, this duty prohibits self-dealing, misappropriation of corporate assets, conflicts of interest, lack of independence, and disloyal conduct. Lastly, the duty of good faith forbids conduct motivated by intent to impede,

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regarding levels and structure of executive compensation (*See* TARP Standard Compensation and Corporate Governance, 74 Fed. Reg. 28394 (June 15, 2009) (31 C.F.R. pt. 30); Excessive Pay Shareholder Approval Act, S. 1006, Cong. 111th (2009); Excessive Pay Capped Deduction Act of 2009, S. 1007, Cong. 111th (2009); Corporate and Financial Institution Compensation Fairness Act of 2009, H. R. 3269, Cong. 111th (2009); ii) increasing shareholder influence in director elections through right of shareholders to access the company's proxy for certain shareholders nominations (SEC Proposing Rel., Facilitating Shareholders Director Nominations, proposed new Rule 14a-11 of the Securities Exchange Act of 1934; iii) providing shareholders with "advisory" vote on aspects of executive compensation (see proposed shareholder Bill of Rights Act, S. 1074, Cong. 111th (2009); Investor Protection Act of 2009, H.R. 3817 Cong. 111th (2009) (draft legislation delivered by the United States Department of the Treasury to the United States Congress on July 10, 2009). *See* The Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities, note 3 (August 2009).

4 Alan D. Lasko & Associates, P.C., *Avoiding Personal Liability when the Corporation is in the "Zone of Insolvency": A Guide for Directors and Officers*, (2004), http://abiworld.net/newsletter/utc/vol2num3/zone.pdf (last visited April 4, 2011).

interfere with, or harm the corporation.[5] This duty invariably impacts the board as well as the interplay between officers and directors.

II. BRIEF OVERVIEW OF THE CORPORATE BOARD OF DIRECTORS & MANAGEMENT

In the traditional model of corporate structure, the board of directors manages the corporation's business. Although boards generally continue to maintain this central legal role, it is widely understood that, under modern corporate practice, it is the corporate executives who hold management functions, not the board members.[6] Because the term *managing model* is now an inaccurate description (especially over the last 25 years), the term *monitoring model* has been adopted to recognize that management functions are no longer exercised by the board, but by senior executives.[7] Hence, in classic governance theory, the role of the board is to oversee and limit the executive officers' exercise of power - a role for which the board is accountable to shareholders. This implies that, being the executive officers responsible to the directors and the directors directly responsible to shareholders, the framework rests on the shareholders' ability to effectively monitor and respond to the board's oversight of the corporation.[8] This intended hierarchy between the boards and management was commonly reversed in the past. The directors' incentive to properly monitor management is undercut by some factors.[9] Today, the monitoring model of

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5 Elizabeth B. Burnette & Elizabeth Gomperz, *The New and Emerging Fiduciary Duties of Corporate Directors*, BANK DIRECTOR MAG., 1st quarter, 2009, http://www.bankdirector.com/issues/articles.pl?article_id=12013. The case of Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003) illustrates how these duties may be evaluated. In this case, a corporation's bankruptcy trustee challenged transactions involving a stock redemption, excessive compensations to a company official, insider loans and the payment of non-business expenses. The court found that in the four year period during which the company was in the zone of insolvency, the directors among other things failed to discuss, investigate and approve the loans made to the corporate official; failed to set up procedures by which loans would be approved or to require the pledge of adequate collateral; and failed to investigate or determine whether the loans were fair to the corporation. For failure in the fiduciary duties of good faith, loyalty to the general creditors and due care to protect the general creditors, the directors and officers were held liable for over $20 million. *See* Alan D. Lasko & Associates, *supra* note 4.

6 *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER ORGANIZATIONS CASES AND MATERIALS 198 (9th ed. 2005).

7 *Id.*

8 *See* Edward Greene & Pierre-Marie Boury, *Post–Sarbanes-Oxley Corporate Governance in Europe and the USA: Americanisation or Convergence?* 1 INT'L J. DISCLOSURE & GOVERNANCE, 26 (2003).

9 These factors include: "the compromised status of officers serving in a dual capacity as directors; domination of the board by executive directors, particularly where a majority of

the board has been almost universally accepted and adopted by publicly held corporations in the United States.[10] It is inadequate to say that the success of the monitoring model rests on its economic advantage in providing an additional system to monitor management efficiency (through the CEO and other executives).[11] However, looking at the board from either managing or monitoring model perspectives, the board of directors is composed of individuals selected by a company's shareholders[12] and is the ultimate

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the board lacked independence; control by management of the supply of information to directors; the lack of sufficiently empowered or vigorous board committees; and subversion of non-executive director's independence through connections with management, such as consulting contracts and other business links." *Id*.

The issue of various constraints on the composition of the board is also an important factor to consider – the typical board generally includes a number of directors who are economically and psychologically tied to the corporation's executives, especially the CEO. Because a number of board seats are usually held by inside directors who are also executives of the corporation, the inside director is somewhat dependent on the CEO for both retention and promotion, and on other executives for day-to-day support. He is therefore unlikely to dissent at a board meeting from a line of action determined by the CEO. *See* EISENBERG, *supra* note 6, at 198. *See also* Florence Shu-Acquaye, *Smith v. Van Gorkom Revisited: Lessons Learned in Light of the Sarbanes-Oxley Act of 2002*, 3 DEPAUL BUS. & COMM. L.J. 19, at 48 (2004). However, with board functioning of monitoring senior executives, for this to be effectively done requires that the board consist of at least a majority of independent directors - independent of the executives. The Sarbanes-Oxley Act of 2002 mandates a certain level of board independence, i.e., have no material relationship to the company and its management, as determined by the board of directors, within certain parameters set forth in the listing rules. Both the Act and NYSE have fostered the notion of more independent board members through a mandatory board composition requirement. *See* Shu-Acquaye, *Id.* at 44. Today, the composition and practices for S & P 500 companies appears to have changed—the percentage of independent directors has grown from 78 % in 1998 to 82 % in 2008; fewer active CEOs and other similarly senior executives now serve on boards, with only 31% of new independent directors also holding position as active CEOs, chairman, president or vice chairman, down from 49% in 1998. *See* Spencer Stuart, *Spencer Stuart Board Index* (2008), http://content.spencerstuart.com /sswebsite/pdf/lib/SSBI_08.pdf.http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf

10 EISENBERG, *supra* note 6.

11 *Id*.

12 The state laws and articles of incorporation or bylaws determine the manner by which the directors are elected to the board. A company may have a unitary board or staggered board of directors. In a unitary board system, all directors stand for election each year, whereas with a staggered board the directors are grouped into classes, (typically three classes, for example, the).Model Business Corporations Act (MBCA) provides in section 8.06 the allowance for classification into two or three groups of as equal size as possible), with one class of directors standing for election each year., *see* MODEL BUS. CORP. ACT § 8.06 (2008). *See* Lucien Arye Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* 4 (HAR L. SCH. JOHN M. OLIN CENTER FOR LAW, ECON. AND BUS., Discussion Paper Series No. 398, 2002) *available at* http://lsr.nellco.org/harvard_olin/398. Theoretically, staggered terms ensure that a corporation will always have experienced directors in office; practically, two annual meetings would be required to replace a majority of the board of decision-making body.[13] The board selects the senior management team, acts as its advisor and counselor, and ultimately monitors its performance.[14] Thus, the board typically delegates significant authority for day-to-day operations to a professional CEO and officers. [15] The CEO and other executive officers therefore derive their authority from the boards, which are responsible for reasonable oversight and supervision of management. [16] This is why the directors and management are said to have a contract with the corporation. In fact, the corporation is often described as an organization consisting of a nexus of contracts:[17] those between the corporation and its

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directors. This invariably means that even a majority shareholder cannot easily change corporate policy by simply electing an entirely new board. *See* CHARLES O'KELLY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 149 (4th ed. 1999). However, boards are becoming more responsive to shareholders concerns. For example, a significant majority of S & P 500 companies (66%) recently adopted some form of a majority voting standard for uncontested director elections, thereby putting teeth to shareholders campaigns. *See The Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities* (August 2009) (hereinafter, the *ABA Section of Business Law CG Task Force*) http://apps.americanbar.org/buslaw/committees/CL260000pub/materials/20090801/delineation-final.pdf.

13 The directors' management power is exercised collectively and individual directors are not given agency powers to deal with outsiders. *See* O'KELLY & THOMPSON, *supra* note 12, at 136.

14 The MBCA, which has been adopted by over thirty states (with some variation in some states), provides in section 8.01 that all corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors. DEL. CODE ANN. tit. 8, § 141(a) (2005) imports the same principle as the MBCA. The language of the MBCA emphasizes the board's responsibility to oversee management of the corporation.

15 However, certain board functions that are central to the focus of board management may not be delegated. This includes but not limited to:
Monitoring corporate performance and assessing whether the corporation is being appropriately managed by senior management team.
Selecting, monitoring, evaluating and compensating, and when necessary replacing the CEO and other key members of senior management.
Developing corporate policy; reviewing and approving financial objectives and major corporate actions.
Overseeing audit, internal controls, risk management and ethics compliance; overseeing financial reporting and related disclosures.
Declaring dividends and approving share repurchase programs. *See* The Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities (August 2009). *Id.*

16 *See id*.

17 Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of The Firm*, 24 J. CORP. L. 819 (1999) (stating that "corporate law is constitutional law; that is, its dominant function is to regulate the manner in which the corporate institution is constituted, to define the relative rights and duties of those employees, suppliers, contractors, shareholders, and directors. The latter is the most important contract, as it relates to the directors' duties and obligations to the corporation. That is why it is not surprising that fiduciary duties are used to describe the shareholder-manager relationship, but not other relationships, such as the creditor-manager relationship. A shareholder's residual return depends on the discretionary performance of another and should require different protection than the creditor's fixed return with a senior claim to the assets of the enterprise.[18]

A director's powers to act on behalf of the corporation are derived from the state of incorporation. Regulation of the corporation by the laws of the state of incorporation is often referred to as the "internal affairs doctrine". This doctrine is also known as a "choice of law rule", since courts look to the laws of the incorporating state to determine the basic rights and duties applicable to a corporation.[19] Consequently, state law, among other things, defines the directors' powers over the corporation;[20] in this vein, corporations are said to be the creatures of state law.[21]

III. FIDUCIARY DUTY OF CORPORATE DIRECTORS: TO WHOM IS THIS DUTY OWED?

The concept of fiduciary duty, a principal aspect of classic corporate law, consists in that management owes certain obligations (of care, loyalty, and good faith) to the corporation and its various stockholders. But as Berle and Means so clearly illustrated, there is a persistent tension between

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participating in the institution and to delimit the powers of the institution vis-à-vis the external world.") *see generally* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 16 (1976). *See also* Jenson & Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

18 *See* Robert Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377 (1990).

19 *See* O'KELLY & THOMPSON, *supra* note 12, at 140.

20 State law, for example, determines the vote required to elect directors, powers of the shareholders to remove directors prior to the end of their term in office, etc.

21. *See* Stephen M. Bainbridge, A Critique of the NYSE Director Independence Listing Standards, 30 SEC. REG. L.J. 370 (2002). *See also* Burks v. Lasker, 441 U.S. 471 (1979). However, the Sarbanes-Oxley Act of 2002 and the SEC rules of implementation are said to have encroached upon state rights by not only regulating the internal affairs of the corporations, but also by being extensive in scope. For example, the Act assigned particular responsibilities and tasks to corporate officers in areas where previously, matters were generally left to their discretion and that of the board; or by mandating specific forms of corporate organization. Greene & Boury, *supra* note 8, at 23. *See also* Shu-Acquaye, *Corporate Governance Issues; United States and the European Union*, 3 HOUS. J. INT'L L., at 593 (2007) for a discussion on the Sarbanes-Oxley Act,.

management's fiduciary obligation and its own self-preservation. [22] Directors and officers, as corporate agents of the shareholders, are traditionally expected to act in the best interest of the corporation, often stated as the responsibility of maximizing wealth for the interest of the principal (the shareholders). However, adhering strictly to such responsibility would tend to exclude other constituents -namely employers, creditors, and the corporate community. Hence, the real issue is whether the fiduciary duty is owed only to the shareholders to the exclusion of other important constituents, such as creditors who usually have contractual rights against the company. It is also important to ask how the financial health of the company plays into this fiduciary duty at the various economic stages of the corporation: from solvency to *zone of insolvency* and finally, to insolvency? That is, the extent to which financial distress may affect the director duties of a troubled enterprise. Given the extent of the economic crisis and its impact on corporate governance, it is only natural to look at directors' fiduciary duties and determine if they should be extended beyond the traditional constituents when determining directors' liability. Therefore, the duties of care and good faith should be examined in light of corporate crisis. It has been argued that when a corporation becomes insolvent, creditors as residual risk-bearers replace shareholders. In such instances, the fiduciary duties are consequently owed to creditors of the corporation. Thus, as long as a corporation is financially sound, its creditors have no additional protection beyond legal enforceability of the terms of their contracts with the corporation. As a corporation approaches insolvency, however, the shareholders' interests decline in value and may eventually become worthless. The creditors, in turn, obtain an equitable interest in the corporation's assets as the ultimate source of the recovery of debt owed to them.[23]

IV. Liability of Officers and Directors of Solvent Corporations

A. The Duty of Care and the Business Judgment Rule

Because a company's affairs are generally managed by, or under the direction of, corporate directors, there is a standard they are expected to

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22 Management has the discretion to exercise its specialized skills, and with discretion comes opportunities for abuse unless the law intervenes. Jenson and Meckling, who do not agree with Berle and Means hypothesis, hold that management has a strong incentive to contract with shareholders (by stock options, bonuses, etc.) to reduce their chances to depart from shareholder interest. *See* ADOLF BERLE, JR. & GARDENER MEANS, *The Modern Corporation and Private Property* (1932); Jenson and Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. & ECON. 305 (1976).

23 Alan D. Lasko & Associates, *supra* note 4.

fulfill as they carry out their responsibilities. These responsibilities consist of two basic functions: a decision-making and oversight.[24] The latter generally involves the formulation of corporate policy and strategic corporate goals, while the former concerns periodic attention to corporate systems and controls, policy issues or any matter necessitating a director's inquiry.[25]

As mentioned above, in carrying out their duties, directors are expected to act in good faith, in the best interest of the corporation, and with the care that a person in a similar position would reasonably deem appropriate.[26] Therefore, in managing the affairs of the company, directors owe a duty of care to the company and its stakeholders. In some states, the fiduciary duty of care is defined by judicial doctrine, whereas in others states, the statutory formulations replace or supplement the common law.[27] For those states that have adopted the Model Business Corporation Act, Section 8.30 delineates the standards of conduct for directors, by concentrating on the manner in which they perform their duties and the level of performance expected of them in managing the business dealings of the corporation.[28]

In addition to their continuing duty to supervise and monitor the affairs of the corporation, directors are also responsible for making important business decisions.[29] Courts invoke the business judgment rule when assessing the conduct of directors and determining whether to impose liability in a particular case.[30] The business judgment rule, as a standard of judicial review, is the common law recognition of the statutory authority that has been vested in the board of directors.[31]

What exactly is the business judgment rule? It is a presumption of regularity that the board decisions are made after an informed and

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24 The general threshold standard is that every director must discharge his duties in good faith and in a manner the director reasonably believes to be in the best interest of the corporation. Florence Shu-Acquaye, *The Taxonomy of the Director's Fiduciary Duty of Care: United States & Cameroon*, 22 N.Y.L. SCH. J. INT. & COMP. L. 585, 592 n. 31 (2003).

25 *See* THE BUSINESS LAWYER, CORPORATE DIRECTOR'S GUIDEBOOK 1578-84 (2001).

26 MODEL BUS. CORP. ACT. § 8.30 (2008).

27 Under Delaware law, Del. Code Ann. tit. 8 § 141 (a) (2011) available at http://delcode.delaware.gov/title8/c001/sc04/index.shtml provides that "the business and affairs of a Delaware corporation are managed by or under its board of directors." *Also*, the MODEL BUS. CORP. ACT. § 8.30(b) states "that members of the board…shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances." This standard is often characterized as a duty of care. *See also* MODEL BUS. CORP. ACT. § 8.30.

28 Directors are expected to perform their duties in "good faith" and in a manner reasonably believed to be in the corporation's best interest. MODEL BUS. CORP. ACT. § 8.30.

29 O'KELLY & THOMPSON, *supra* note 12.

30 *Supra* note 26.

31 MM Companies v. Liquid Audio Inc., 813 A.2d 1118, 1127 (Del. 2003).

reasonable investigation, in good faith, and with the honest belief that the decisions were made in the best interest of the corporation.[32]

Although the business judgment rule is designed to foster the complete exercise of managerial power granted to directors, it is not an unfettered power.[33] Application of the business judgment rule is based on a demonstration that informed directors did in fact make a business judgment regarding the matter being examined.[34] A director's obligation to inform himself, in preparation for his decision, derives from the fiduciary capacity in which he serves the company and its stakeholders.[35] Therefore, to determine whether the directors' business judgment was informed, one needs to examine if turns on whether they took the necessary steps to inform themselves of all material and relevant issues prior to making the business decision.[36] Once this presumption is established, the decision of the board is protected from judicial review of the merits.[37] To overcome this presumption, a challenger must present evidence that directors failed in meeting their fiduciary duties and thus deserve to be stripped of the protection provided by the business judgment rule. Courts are generally reluctant to second-guess the board's decisions, as judges do not necessarily possess the corporate expertise and skills of the board.[38] Hence, a director or officer of a solvent corporation is therefore entitled to the protection of the business judgment rule unless a duty is breached. The shareholders,

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32 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The business judgment rule serves as a shield which protects directors from liability for their decisions. Where it is found that the directors should receive protection of the rule, the courts would not interfere with or second guess the directors' decision. If the directors are found not to be entitled to the protection of the business judgment rule, the courts would then scrutinize the directors' decision to determine whether it was intrinsically fair to the corporation and its shareholders. O'KELLY & THOMPSON, *supra* note 12, at 285.

33 *See generally* Smith v. Van Gorkom, 488 A.2d, 858, 871 (Del. 1985); Hanson Trust PLC v. ML SCM Acquisitions Inc., 781 F.2d 264, 275 (2d Cir. 1986).

34 Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971).

35 Lutz v. Boas, 171 A.2d 381 (Del. 1961).

36 *Aronson*, 473 A.2d, at 812.

37 *See* R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct and Liability*, 56 BUS. LAW 35, 37 (2000).

38 *See* Caremark Int'l Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996) (*arguing against substantive judicial review of the board*). This reluctance was also expressed in Joy v. North, 692 F.2d 880, 866 (Conn. 1982). There are certain circumstances, however, "which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by the directors. Under such circumstances, the court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable, before the protection of the business judgment rule may be conferred." UNOCAL Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). *See* WILLIAM KLEIN, RAMSEYER & STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS 36 (5th ed. Update 2004).

therefore, bear the burden of overcoming the presumption that directors and officers have complied with their fiduciary duties.[39]

Delaware courts have also crafted other standards of review in different contexts that displace the business judgment rule. See *UNOCAL Corp v. Mesa Petroleum Co.*,[40] (enhanced scrutiny for defensive measures); *Mac Andrews & Forbes Holdings, Inc. v. Revlon, Inc.*,[41] (duties attendant to a sale of control).

B. Liability of Officers and Directors during Insolvency or while Entering the "Zone of Insolvency"

While the corporate officer and director's fiduciary obligation is to pursue the best interests of the shareholders in a normal or solvent corporation, case law, primarily from Delaware, establishes different fiduciary duty regimes that may apply when the company is in or approaching insolvency.[42] Delaware defines insolvency as either "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof" or "an inability to meet recurring obligations as they fall due in the usual course of business."[43] So, when a company is financially healthy, the directors owe fiduciary duties to the corporation and its shareholders. Once a corporation becomes insolvent, courts have traditionally refused to extend fiduciary duties for the benefit of creditors, propounding that creditor rights are limited by the terms

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39 *See* Omnicare, Inc. v. NCS Healthcare, 818 A.2d 914, 927 (Del. 2003).
The question then turns on what results when the board is stripped of the protection afforded under the business judgment rule? Once the business judgment rule presumption is pierced, upon a showing that the directors breached their fiduciary duty of care, the burden of proof shifts to the board of directors who must then demonstrate that the decision was intrinsically fair to the company and therefore warranted protection. In other words, the board must meet the two-part "fairness test" delineated in Weinburger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). The first prong of the "fairness test" is a demonstration that the transaction was the result of fair dealings by the board of directors. (Fair dealing encompasses questions of when the transaction was timed; how it was initiated; how the negotiated was structured; the manner in which the transaction was disclosed to the directors; and how the approval of the directors and shareholders was obtained. Fair price deals with the economic and financial considerations of the proposed merger, including such relevant factors as the market value of the assets, future earnings prospectus and any other factor that could affect the intrinsic value of the company's stocks. O'KELLY & THOMPSON, *supra* note 12, at 258. The second element is met, if it is shown that a fair price was obtained.

40 *UNOCAL*, 493 A.2d 946.

41 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

42 Rutheford Campbell, Jr. & Frost Brown, *Managers Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and elsewhere)*, 32 IOWA J. CORP. L. 491, 500 (2007).

43 *Id.*

of their contracts with the corporation.[44] Consequently, directors need not take creditors' interest into account in their decision-making process.[45]

However, when a corporation becomes insolvent, creditors replace shareholders as the residual risk-bearers and the fiduciary duties owed to shareholders consequently shift to the creditors. That is, the creditors can assert a derivative claim on behalf of the corporation against the directors based on fiduciary duties. However, insolvency does not transform derivative claims into direct claims, but it provides creditors with standing to assert those claims belonging to the corporation itself.[46] There is an apparent distinction between being insolvent and approaching insolvency, the latter also known as *entering the zone of insolvency*.[47] In the case of corporations approaching insolvency, some courts hold that fiduciary duties are owed to both shareholders and creditors.[48] The Delaware Supreme Court rejects this

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44 Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485, at 1510 (1993). The American Bar Foundation Commentaries on Indentures 2 (A.B.F., 1971), comments that the rights of a debt securities holder are largely a matter of contract law. There is no governing body of statutory or common law that protects the holder of unsecured debt securities against harmful acts by the debtor except in the most extreme situations. Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrowers which jeopardize its ability to pay the debtor unless he takes a mortgage or collateral or establishes his rights through contractual provisions set forth in the debt agreement or indenture. Id.

45 *Id.*

46 *See* North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, CA (quoting Production Resources Group LLC v. NCT Group, Inc., 863 A2d 772, 776 (Del. Ch. 2004)).

47 This is the period when the corporation is in financial distress, but may or may not be actually insolvent. There is no bright line rule for examining the exact point at which a corporation enters into the zone. Courts have followed several approaches including: being based on the period before insolvency in fact (also called balance sheet insolvency, occurs when a corporation's liabilities exceeds its assets); equitable insolvency, which is an inability to pay debts as they come due. *See* Avoiding Personal Liability when the Corporation is in the "Zone of Insolvency": A Guide for Directors and Officers, a publication from Alan D. Lasko & Associates, *supra* note 4.

48 Bankruptcy, Restructuring and Commercial Law Advisory: Fiduciary Duties and Insolvency: Limiting Personal Liability in Tough Economic Times (2009), http://www.jdsupra.com/post/documentViewer.aspx?fid=40e90886-fd37-4482-9d59-eba3f781012c.

In the earlier Delaware case of Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. 1991), Chancellor Allan stated that when a corporation is operating in the vicinity of insolvency, the board of directors is not merely the agent of the residual risk bearers but owes its duty to the "corporate enterprise." He further stated that the board's obligation in such circumstances is "to the community of interest that sustained the corporation…to maximize the corporation's long term wealth creating capacity." Although the discussion of the court focused on two constituencies, shareholders and creditors, there are other corporate constituencies that might be included notion by holding that officers and directors do not necessarily owe fiduciary duties to creditors of a company in the zone of insolvency. Those creditors cannot bring breach of fiduciary duty actions to recover individually, but may bring derivative claims on behalf of the corporations for such a breach.[49] Likewise, in the 2006 case of *Trenwick American Litigation Trust v. Ernst & Young L.L.P.*[50], the Delaware Court of Chancery explicitly rejected *deepening insolvency* as a cause of action against directors of an insolvent corporation. That is, creditors cannot hold directors liable for prolonging the lifespan of an insolvent corporation and worsening its financial state.[51] Consequently, Trenwick departs from prior federal district and appellate court decisions recognizing the *deepening insolvency* theory.[52] Vice Chancellor Strine, in rejecting this theory, reaffirmed that while directors of an insolvent corporation owe fiduciary duties to creditors, the directors' decision are still protected by the business judgment rule. However, if directors have breached their fiduciary duties in a way that worsens a corporation's insolvency, then that result may lead to additional damages. Nevertheless, the cause of action remains the same (breach of fiduciary duties) and the act of worsening a corporation's insolvency does not constitute a separate cause of action.[53] Hence, so long as directors adhere to their fiduciary obligations, they can continue to operate and pursue business strategies when a company is insolvent without fear of liability to creditors under a standard of review other than the business judgment rule.[54]

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in the "community of interest", including employees and community, and is therefore not very clear. Rutheford Campbell, Jr. & Christopher Frost, *supra* note 42, at 504. Chancellor Strine's dictum in Production Resources exacerbated the ambiguity in Credit Lyonnais, as he views Credit Loyannais as merely creating a "shield" for corporate managers. This is a shield that allows managers operating in the vicinity of insolvency more discretion to make decisions that benefit creditors at the expense of shareholders. That is, the duty of corporate managers in the vicinity of insolvency continues to be an obligation to act in the best interest of shareholders, subject, however, to an expanded right (but not an obligation) to transfer wealth from shareholders to creditors. *Id.*

49 *Id.*

50 Court of Chancery of Delaware, New Castle, 906 A. 2d 168, 99 (2006).

51 The litigation trust attempted to hold the defendant directors liable for "deepening insolvency." The decision also held that, absent insolvency, a parent company's directors do not owe any particular duties to the wholly-owned subsidiaries. The wholly-owned subsidiary's directors' only duty is to serve the parent company unless the parent's directive would cause the subsidiary to violate its legal obligations. *See* 20 Richard Reinthaker, J. Rravis Laster, and Steven Hass, *An End to "Deepening Insolvency" as a Theory of Director Liability, Insights*: THE CORPORATE & SECURITIES LAW ADVISOR, no. 9 (Sept. 2006).

52 *See* Official Comm. of Unsec. Creditors v. R.F. Lafferty, 267 F.3d 340 (3d Cir. 2001) (recognizing deepening insolvency under Pennsylvanian law); OHC Liquidation Trust v. Credit Suisse First Boston, 340 B.R. 510 (Bankr. D. Del. 2006).

53 *Id.*

54 *Id.*

The Delaware Supreme court in a 2007 decision, *North American Catholic Educational Programming Foundation, Inc., v. Gheewalla,*[55] *C.A*., affirming the Court of Chancery's decision on this intriguing issue, ruled that creditors of an insolvent corporation, or of a solvent corporation operating in the "zone of insolvency",[56] may not assert direct claims against the corporation's directors for breach of fiduciary duty. This closed the last narrow window that the Court of Chancery had left open in stating: "we hold that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporate directors.[57] The Delaware Supreme Court therefore saw no basis for enlarging the scope of the duties owed by Clearwire's directors. The court observed that, while the protection of shareholders' interests is entirely dependent on directors acting as fiduciaries, creditors' interests are protected by, among other things, contractual agreements, general commercial law, and bankruptcy law.[58] The court viewed the extension of a director's fiduciary duty to the creditors in the wake of the corporation's financial distress as not only unnecessary, but counter-productive, and reaffirmed the Chancery Court's position that: "an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."[59] In other words, when a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change. Directors must continue to fulfill their fiduciary duties to the corporation and its shareholders by exercising their business

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55 North American Catholic Educational Programming Foundation (NACEPF) was part of an alliance formed to hold FCC-approved spectrum licenses for microwave signal transmissions. The defendants were certain of the directors of Clearwire Holdings, Inc., a Delaware corporation (Clearwire), who were appointed by Goldman Sachs & Co., Clearwire's major investor. Clearwire breached an agreement to acquire the spectrum licenses held by NACEPPF and its alliance members. Following Clearwire's failure, NACEPF sued the defendant directors, alleging that they breached fiduciary duties owed directly to NACEPF as a creditor of a corporation that was either insolvent or operating in the "zone of insolvency". *See* Thompson Hine, Directors of Insolvent Corporation in Delaware Owe No Direct Fiduciary Duties to Creditors, June 21, 2007 *available at* http://www.thompsonhine.com/publications/3publication1130.html.

56 The Delaware Supreme Court did not find it necessary in view of its ultimate disposition of the case to provide a precise definition of what constitutes the "zone of insolvency".

57 Thompson Hine, *supra* note 55.

58 *Id.*

59 *Id.*

judgment in the best interest of the corporation, for the benefit of its shareholders. [60]

C. Duty of Corporate Officers and Directors during Bankruptcy

As a firm's financial situation worsens, individual creditor's natural incentive is to withdraw their capital, which inevitably leads to an inefficient liquidation of the corporate assets if unchecked.[61] Hence, when the corporation files for bankruptcy under Chapter 11 of the United States Bankruptcy Code, there is a change in the fiduciary duties of corporate directors and officers. Chapter 11 substitutes a governance regime with one that includes creditor representation, negotiation and default rules regarding the allocation of value in reorganization plans, and judicial oversight over important decisions.[62] Basically, Chapter 11 stays individual debt collection actions in favor of the continued operation of the business in a manner that allows for collective negotiations over the future of the firm. Creditors may not exercise non-bankruptcy contractual remedies, such as declaring a breach of managerial fiduciary obligations, and then withdraw capital. Rather, the Chapter 11 process substitutes a system of managerial duties to the "estate"[63] - specific voting rights, creditor representation, judicial supervision, and judicial approval of specific managerial decisions.[64] In other words, the directors and officers are still required to fulfill the fiduciary responsibilities of a trustee to act in the interests of both creditors and shareholders, often articulated by bankruptcy courts as the duty to maximize the value of the estate,[65] rather than to benefit a particular group of claimants.[66] In the same vein, the Bankruptcy Code neither require nor permits the bankruptcy judge to consider the effect of managerial decisions

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60 *Id.*

61 Campbell & Frost, *supra* note 42, at 508.

62 *Id.*

63 Under the Bankruptcy Code, the term *estate* refers to all of the pre-bankruptcy corporation's property and interests in property. 11 U.S.C. § 541(a) (1988).

64 Campbell & Frost, *supra* note 42, at 512.

65 Again, this means that the duty to maximize the estate equates to the duty to maximize the value of the corporation's assets for the benefit of the shareholders and creditors without regard to the distributional outcome.

66 *Id.* Managers' duties in Chapter 11 proceedings and how the opposing interests of creditors and shareholders must be delicately balanced is evidenced in Matter of Cent. Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987) where shareholders of the debtor appealed an order of the bankruptcy court approving litigation between the debtor and a third-party. The creditors favored the settlement because it was enough to pay their claims in full. The district court affirmed the order and sanctioned two shareholders for challenging the settlement. In its order approving the settlement, the bankruptcy court made clear that it was guided by the best interests of the creditors.

on other constituents, such as employees or other non-investor constituencies.[67] Therefore, a primary source of funds for the bankruptcy estate consists of recovery from directors and officers, whose breach of fiduciary duties may have contributed to the company's insolvency.[68]

Clearly, the filing of a corporate bankruptcy under Chapter 11 heralds a substantial change in the governance of the corporation. As previously mentioned, there is an inevitable change in the fiduciary duties of directors and officers of the corporation. This shift is compounded by the conflicts of interest between shareholders and creditors from the inception of a loan, heightened as the financial condition of the company deteriorates and its debt equity ratio increases.[69]

V. STATUTORY EXCULPATORY PROVISIONS AND DIRECTOR'S FIDUCIARY DUTY.

It has become commonplace for directors to be held personally liable for actions taken by directors and officers even when such actions involve neither dishonesty nor self-dealing. The question then, is whether it is efficient to expose directors to draconian potential liability for breaching the duty of care? Would the shareholders' interest be served, given that directors may become overly cautious in carrying out their duties or refuse to serve on boards?[70] Consequently, many corporate charters now contain exculpatory provisions, protecting directors from personal liability for breaches of the fiduciary duty of care. Hence, the traditional bulwark against personal exposure has led to the directors' and officers' liability insurance, the so-called "D & O" insurance,[71]which may provide a means for corporations to

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67 *See* Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75 (1995). This may be understood in the context that non-shareholder constituencies are generally expected either to price the risk that management actions may not necessarily be in their best interests or mitigate or eliminate such risks through contract provisions. *Id*.

68 Dennis Klein and Mira Edelman, *Litigating against Directors and Officers of Bankruptcy Dot-Com Entities: A Potential Asset for Debtor's Estate*, 27 DEL. J. CORP. L. 804 (2002). Another possible area of recovering losses is because of director or officer mismanagement. Director & Officer (D & O) Coverage under the Corporate Insurance Policy, *id.,* at 809. See discussion below.

69 *See* MICHAEL JENSEN AND CLIFFORD SMITH, JR., STOCKHOLDERS, *Managers and Creditor Interests: Application of Agency Theory*, in Edward Altman and Marti Subrahmayar., eds., RECENT ADVANCES IN CORPORATE FINANCE, at 112-15 (Irwin 1985).

70 O'KELLY & THOMPSON, *supra* note 12, at 324.

71 Mathew Bender & Company, Inc., Delaware Corporation Law and Practice § 16.01 (2008). There are 3 basic types of coverage found in a typical D & O insurance policy: A direct coverage of officers and directors (also known as "Side A" coverage); coverage of indemnification payments that the corporation is permitted or required to make to directors and officers (also known as "Side B" coverage); and entity coverage, which covers the corporation's own losses arising from a claim. *See* Richard M Cieri and Michael Riela, limit the substantive exposure of directors to liability, as well as strengthening the ability to indemnify directors and officers for litigation expenses.[72] Beginning with Delaware in 1986 (after the Delaware Supreme Court decision in *Smith v. Van Gorkem* [73], finding the directors liable for the breach of their fiduciary duty of care), over 40 states have enacted legislation allowing corporations to limit or eliminate directors' liability for breaches of fiduciary duty. Delaware Corporate Law, Section 102 (b) (7)[74] deals with the substantive limitation on personal corporate liability, while Section 145, as amended, deals with indemnification of director and officer liability.[75]

An exculpatory provision such as Section 102 (b) (7) is in the nature of an affirmative defense, and therefore, the burden of the defendants (directors) is to demonstrate that they are entitled to the protections of the relevant charter provisions. On the other hand, Section 2.02 (b) (4) of the Model Business Corporation Act provides similar protection by eliminating or limiting the liability of a director to the corporation for money damages for any action or omission, except in cases of "liability for: a) the amount of

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Protecting Directors and Officers of Corporation that are Insolvent or in the Zone of Insolvency, 2 DEPAUL BUS. & COMM. L.J. 295 (2004) (*citing* Nan Roberts Eitel, *Now You Have It, Now You Don't: Director's and Officers' Insurance after a Corporate Bankruptcy*, 46 LOY L. REV. 585, 585-86 (2000)).

72 *Id.* It is being said that a properly structured and implemented D & O insurance and corporate indemnification program serves the same purpose as the business judgment rule, although more broadly, given that these directors and officers are insulated not only from duty of care and in some cases, loyalty litigation, but also from securities fraud litigation, as well as, Securities and Exchange Commission (SEC) and Department of Justice (DOJ) investigations. *See* Timothy W. Burns, *Complete Guide to D & O Insurance*, (2007), *available at* https:\\www. Directorship.com\complete-guide-to-d-and-o. In fact, the following four activities are considered those that pose the greatest threat of liability to officers and directors: 1) Securities Fraud class-action law suits, 2) derivative actions for breaches of director's or officer's duty of care or loyalty to the corporation, 3) SEC investigations and 4) DOJ investigations and indictments. *Id.*

73 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

74 Again, this provision authorizes Delaware corporations, by a provision in the certificate of incorporation to exculpate their directors from monetary damage liability for breach of duty of care. The statute carves out several exceptions including "acts or omissions not in good faith…." JEFFREY BAUMAN, CORPORATIONS & OTHER BUSINESS ASSOCIATION STATISTICS, RULES AND FROMS 415 – 442 (2009).

75 *Id.* Section 145 summarily put, permits a corporation to indemnify (inter alia) any person who is or was a director, officer, employee or agent of the corporation against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement of specified actions, suits or proceedings, where among other things: (i) that person is, was or is threatened to be made a party to that action, suit or proceeding and (ii) that person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interest of the corporation…." ROBERT HAMILTON, JONATHAN MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 776 (Thompson West Ed. 2007).

financial benefit received by a director to which he is not entitled; b) an intentional infliction of harm on the corporation or the shareholders; c) a violation of section 8.33 or d) an intentional violation of criminal law."[76]

The real question is whether such exculpatory provisions should be extended to directors for a breach of fiduciary duty to creditors? That is, even if such a breach has been found, could it breach be covered by officer and director's insurance? Generally, a breach of duty to creditors may or may not be covered by *O & D* insurance depending on the policy language. However, while directors may be personally liable to creditors for a failure to meet their duty of care, that duty, as discussed above, is not enforceable by creditors. The obligations to creditors are deemed contractual and the responsibility of corporate directors is thereby measured by the terms of the contract, trust indenture, or charter provision. A claim for breach of this duty is considered a breach to the entire class of creditors and therefore should be prosecuted by either a Chapter 7 Trustee, a Debtor-in-Possession (DIP) under Chapter 11, or Creditors' Committee.[77] Accordingly, many courts have recognized this fiduciary duty under a trust-fund doctrine, in which the directors are considered trustees of the corporate assets held for the benefit of the insolvent corporation's creditors.[78]

VI. Advice and Recommendations on How to Minimize Directors' Personal Liability

How directors or candidate directors/officers may minimize potential personal liability on the boards they serve or manage is a real challenge for contemporary corporations. Excerpts of some recommendations/checklists obtained from various articles are summarized below.

From *Howard Rice, Nemerovski Canady, Falk & Rabkin*,[79] directors can minimize personal liability by acting diligently and on an informed basis, including:

- Following proper board processes and ensuring that adequate systems exists for receiving corporate information;
- Remedying all regulatory and accounting deficiencies quickly and thoroughly;

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76 MODEL BUS. CORP. ACT ANN.

77 Alan D. Lasko & Associates, P.C., *supra* note 4.

78 *See* Dennis Klein & Mira Edelman, *Litigating against Directors and Officers of Bankrupt Dot-Com Entities: A Potential Asset for the Debtors' Estate*, 27 DEL. J. CORP. L. 803, 804 (2002). *See* Upton v. Tribilcock, 91 U.S. 45, 47-48 (1875); Automatic Canteen Co. of AM. v. Wharton, 358 F.2d 587, 590 (2d Cir. 1966).

79 Howard Rice Alert, *Director Liability in the Wake of the Worldcom and Enron Settlements*, Feb. 25, 2005, http://www.iln.com/articles/pub_169.pdf.

- Practicing good corporate governance, including vigilance over compliance with the Sarbanes-Oxley Act (SOX) of 2002 as well as NYSE or NASDAQ corporate governance rules, paying special attention to executive compensation issues and related party transactions;
- Directors should ensure they have adequate indemnification agreements with the corporations, including sufficient D & O insurance coverage;[80]
- Potential directors should engage in enhanced diligence prior to accepting a board seat and should only associate with corporations and management teams that maintain the highest ethical standards.

A check-list for avoiding personal liability to creditors for their actions when the corporation is or may be in the zone of insolvency, includes:[81]

- If the corporation is encountering significant fluctuations in asset values, be apprised of its net worth based upon realistic market values, rather than inflated cost or outdated goodwill;
- If decisions would pose a substantial risk to corporate assets, it may be prudent to consult with and/or obtain the consent of major creditors before implementing decisions;
- Seek expert legal and financial advice about the likely effects for major stockholders and creditors when considering a financially significant transaction;
- Consider alternative courses of action before approving any transactions, such as a financial restructuring, that may have the effect of placing the corporation in the zone of insolvency;
- Consider retaining financial advisors to evaluate whether contemplated transactions are fair to the creditors of the corporation;
- Maintain neutrality with respect to preserving corporate value for the community of the corporation's interests

[80] Directors and officers should not rely on indemnification claims against the corporation after it enters bankruptcy proceedings, because such claims may be disallowed by the bankruptcy court—this means the directors and officers would receive nothing on account of their claims.

[81] Excerpted from Alan D. Lasko & Associates, P.C., *supra* note 4. *See also* Richard M. Cieri & Michael Reila, *Protecting Directors and Officers of Corporation that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J., at 295 (2004).

when it is in the zone of insolvency; avoid preferring one constituency (stockholders, creditors, officers) over another; likewise, avoid any action that prefers one creditor over another;

- Assure that decisions are defensible on the basis of good faith judgment—generally, it is prudent to avoid dividends or stock redemption while in the zone of insolvency;
- Be prepared to demonstrate, based on reports and outside advisors, reflected in the records of the board's deliberations, that any awards of executive compensations were reasonable and necessary;
- Be very cautious when engaging in insider transactions; and
- Beware of Fraudulent Transfer and Preference Liability Statutes.

VII. CONCLUSION

This paper has shown that directors and officers generally enjoy the broad protection of the business judgment rule presumption that they have fulfilled their fiduciary duties in the absence of self-dealing, fraud, or bad faith. We have also seen that even where the directors are found liable for a breach of their fiduciary duties, many state laws allow for corporations to include exculpation provisions in the certificate of incorporation. These provisions indicate that, in the absence of self-dealing and bad faith, the directors should not be held monetarily liable for their actions. With some exceptions, a corporation may indemnify its directors and officers against most liabilities. The fiduciary duties of directors and officers shift when the corporation is solvent, to when it is in the zone of insolvency, to when it becomes insolvent. In fact, the most likely type of claims against former directors and officers of an insolvent corporation is often a claim by the bankruptcy trustee for breach of fiduciary duties leading to the corporation's insolvency. Some courts have held that directors and officers of an insolvent company have a fiduciary duty to the creditors to protect the assets of the company. For example, in *Geyer v. Ingersoll Publications Company*,[82] the Delaware Court of Chancery expressly affixed the label "fiduciary obligation" to the duty owed by directors to a creditor of a putatively insolvent corporation, thus presaging the potential expansion of creditors' remedies against corporate directors.[83] The plaintiff in this case resold his shares to

82 Belcher v. T. Rowe Price Foundation, 621 A. 2d 873 (Del. Ch. 1992).

83 David A. Drexler et al., *Delaware Corporation Law and Practice – The Proper Exercise of Directors' Responsibilities* MB Lexis Nexis, (2008).

the defendant corporation for a promissory note upon which the corporation defaulted. The creditor sued the board chairman/controlling stockholder, alleging that he had engaged in a series of transactions which resulted in a shift of corporate assets to the stockholder, rendering the corporation unable to pay its debt to the plaintiff. The court held that, because the corporate defendant was allegedly insolvent, the complainant validly alleged a breach of fiduciary duty owed by the director directly to the plaintiff creditor. [84] Consequently, directors and officers of a corporation must be conversant with the shifting fiduciary duties and their continuing obligations to comply with the law in the new paradigm. Although this shifting duty may vary from one jurisdiction to another, the fundamental issue is the same: Was the fiduciary duty of the directors and officers breached, and if so, who was hurt by the breach? Was it the shareholders, the corporation, or other constituents including creditors? Who can bring action for breach of such duty and who recovers damages for that breach, if found? Depending on the jurisdiction or interpretation of how and when there is a shift in the fiduciary duty, the answer to these questions may vary. However, understanding these duties in a shifting paradigm becomes undoubtedly essential for the directors and officers, who can minimize personal liability by acting diligently and on a fully informed basis.

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84 *Id.*

HOLDUPS AND HISTORY: THE GENERAL MOTORS-FISHER BODY MERGER REVISITED

F.E. GUERRA-PUJOL*

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> *The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is: how should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature.*[1]
>
> *The past is, by definition, a datum which nothing in the future will change. But the knowledge of the past is something progressive which is constantly transforming and perfecting itself.*[2]
>
> *Chosen examples are never serious evidence for any worthwhile generalization.*[3]

I. FISHER BODY AND GENERAL MOTORS: CONFLICT OR COOPERATION?

In a recent paper,[4] Ronald Coase revisits the storied events leading up to General Motors' acquisition of Fisher Body in 1926, the so-called classic example of opportunistic behavior by contracting parties due to the presence

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1 Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2 (1960) [hereinafter *Coase (1960)*].

2 MARC BLOCH, THE HISTORIAN'S CRAFT 58 (Peter Putnam trans., Vintage Books 1953).

3 RICHARD DAWKINS, THE SELFISH GENE 6 (2d ed.1989).

4 Ronald H. Coase, *The Conduct of Economics: The Example of Fisher Body and General Motors*, 15 J. ECON. MAN. 255 (2006) [hereinafter *Coase (2006)*].

of firm-specific investments.[5] Coase traces the origins of this classic example to a paper by Benjamin Klein, Robert Crawford, and Armen Alchian[6]—a paper published in the *Journal of Law and Economics* of which Coase himself was the editor at the time of its publication – and to several subsequent papers by Klein writing alone.[7] But Coase smells a rat: "The problem with this widely used example is that the events never happened."[8] According to Coase and several other scholars, it now turns out that the relations of Fisher Body and General Motors were, in fact, cooperative and not opportunistic after all.[9] The revised view of the *Fisher Body-GM* affair thus appears to be gaining the upper hand, and I shall refer to this account as the *Coasean view*.

Coase, moreover, does not dispute the standard account of the *Fisher Body-GM* merger for its own sake. Instead, he concludes his paper by making a larger point about the conduct of economics in general. According to Coase, the standard account of the *Fisher Body-GM* affair is symptomatic of what is wrong with economics overall. He asserts that economics has become a theory-driven subject and that professional economists should do more careful empirical work. "What is needed is a change in the way economics is conducted. If our discussions are to have any value, our theories must have an empirical basis."[10] Coase thus addresses two separate and important questions in his 2006 paper. One question is historical: what was the nature of the relationship between Fisher Body and General Motors? The other question is methodological: has economics become a theory-driven subject as Coase alleges?

I shall explain why Coase's approach to both questions appears to be wide off the mark. While the weight of the historical evidence seems to support the Coasean view and not the standard account of the GM-Fisher Body affair, both narratives neglect two crucial considerations: the reciprocal

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5 *See, e.g.,* Joel P. Trachtman, *The Theory of the Firm and the Theory of International Economic Organization*, 17 NW. J. INT'L. & BUS. 470, 521 (1997).

6 Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

7 *See* Benjamin Klein, *Contract Costs and Administered Prices: An Economic Theory of Rigid Wages*, 74 AM. ECON. ASSOC. PAPERS & PROC. 332 (1984); Benjamin Klein, *Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 213-226 (Oliver Williamson and S. Winter eds., 1991); Benjamin Klein, *Hold-up problem, in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241-244, (Peter K. Newman ed., 1998).

8 *Coase (2006) supra* note 4 at 255.

9 *See, e.g.*, Robert F. Freeland, *Creating Holdup Through Vertical Integration: Fisher Body Revisited*, 43 J.L. & ECON. 33 (2000); *See also* Ramon Casadesus-Masanell & Daniel F. Spulber, *The Fable of Fisher Body*, 43 J.L. & ECON. 67 (2000); Yoshiro Miwa & J. Mark Ramseyer, *Rethinking Relationship Specific Investments: Subcontracting in the Japanese Automobile Industry*, 98 MICH. L. REV. 2636 (2000).

10 *Coase (2006)*, *supra* note 4, at 277.

nature of contractual relations and the process of exchange, and the problem of historical observation. Coase's general critique of theory-driven work in economics is itself, ironically, largely non-empirical and theory-driven.

II. The Reciprocal Nature of Contractual Relations and Contractual Disputes

What was the precise nature of the relationship between Fisher Body and General Motors? Where Klein sees conflict and opportunism at every turn, Coase sees cooperation and harmony. Their respective narratives of the Fisher Body affair differ. Nevertheless, both narratives do share one thing in common. They seem to take an extreme *either-or* approach to contractual relations—either such relations are cooperative or they are opportunistic in nature. While this approach is perhaps understandable, in reality contractual relations are essentially reciprocal in nature.[11]

The parties to an exchange are by definition mutually dependent on each other. Any given contractual relationship is reciprocal in nature because *ex ante* each party needs the other in order to bring about the desired exchange. This reciprocal relationship—or mutual dependence—is especially acute in the case of long-term performance contracts, such as the one between Fisher Body and General Motors.[12] Each party is a hostage of the other during the performance period, and it is this mutual dependence or reciprocal relation that normally acts as a check against opportunistic behavior by either party.

From a purely theoretical perspective, the problem of post-contractual opportunism should be considered a reciprocal one. Each party has the potential of acting opportunistically towards the other, at least during the pre-performance stage. I shall call this the problem of *reciprocal opportunism*. In general, reciprocal opportunism will be checked and not spiral out of control if both parties follow what is called in game theory a *tit-for-tat* strategy.[13] That is, either party will act opportunistically if, and only if, the other has engaged in opportunistic behavior first. In this sense, Coase is

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11 Professor Coase uses the phase 'reciprocal in nature' to describe the problem of harmful effects – i.e., negative externalities, such as pollution, straying cattle, noise, etc. *See e.g.,* Ronald H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON.1, 26 (1959) [hereinafter *Coase (1959)*]; *Coase (1960)*, *supra* note 1, at 2. In essence, Coase was the first economist to realize that the problem of harmful effects is a reciprocal one, an insight that can be extended to contractual relations, opportunism, and other problems as well. *See, e.g.*, F.E. Guerra-Pujol, *Ronald Coase: Philosopher* (unpublished manuscript, on file with the author).

12 For readers not familiar with the Fisher Body literature, Fisher Body and GM had negotiated a 10-year supply contract in 1919 in which Fisher Body agreed to produce car bodies for GM's assembly plants.

13 *See, e.g.*, ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984).

correct to emphasize the exceptional nature of post-contractual opportunistic behavior in the real world.[14]

Nevertheless, the fact that post-contractual opportunistic behavior is rare does not indicate the absence of conflict. Conflict is inherent in the process of exchange precisely because of its reciprocal nature. The process of exchange is not a simple *either-or* proposition. Instead, exchange is better seen as a tangled mixture of cooperation and conflict. By cooperating, both parties to an exchange can obtain gains from trade, since they are better off cooperating than going their separate ways. A voluntary exchange will not take place unless both parties expect to be made better off from the exchange.[15] But how will the parties divide the surplus between them? Each will want the largest share possible. It is this conflict of interest over the surplus that produces a certain amount of tension and conflict between the parties, for when it comes to dividing the surplus, one party's loss is the other's gain: "Each cooperative endeavour generates new resources and thus new areas of potential conflict."[16] Though the idea of the reciprocal and inherently conflictive nature of cooperative exchange relations is perhaps novel in the context of industrial organization and contractual relations, this idea is amply supported by the literature on evolutionary biology and game theory.[17]

Likewise, disputes and conflicts of interest over unforeseen contingencies are also reciprocal in nature. Consider, for example, the 1925 dispute between Fisher Body and General Motors over the location of a proposed new body plant. Fisher Body was an independent supplier of car bodies. General Motors—which was in the business of assembling automobiles—could either produce its own car bodies or purchase them from an independent supplier, such as Fisher Body. Initially, GM chose the latter option. In 1919, GM and Fisher Body negotiated to a long-term, 10-year supply contract in which Fisher Body agreed to produce car bodies for GM's

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14 *See, e.g., Coase (2006)*, *supra* note 4, at 260.

15 *See, e.g.,* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 15 (6th ed., 2003).

16 *See* Helena Cronin, *The Battle of the Sexes Revisited*, *in* RICHARD DAWKINS: HOW A SCIENTIST CHANGED THE WAY WE THINK 16 (Alan Grafen & Mark Ridley editors, 2006); *cf.* JOHN MAYNARD-SMITH & EÖRS SZATHMÁRY, THE ORIGINS OF LIFE 146 (1999).

17 *See generally,* Dawkins, *supra* note 3; *see also* Robert L. Trivers, *Parent-Offspring Conflict*, 14 Am. Zool. 249 (1974). Put another way, if there is conflict even within the firm (*see, e.g.*, *Coase (2006)*, *supra* note 4, at 268, noting that holdups can also occur within the administrative structure of a firm), how much more severe must be the potential conflict between firms, who do not share the same administrative hierarchy. My apologies to Richard Dawkins: "If there is conflict of interest between parents and children [parent-offspring conflict], who share fifty per cent of each other's genes, how much more severe must be the conflict between mates, who are not related to each other" (Dawkins, *supra* note 3, at 140).

assembly plants.[18] Then, in 1925, several years into the business relationship, GM wanted Fisher Body to build a new body plant in Flint, Michigan, while Fisher Body in contrast wanted to meet GM's excess demand by expanding its production of car bodies in Fisher Body's existing plant in Detroit.

Coase concedes that this was a *serious dispute*[19] but claims that the clash over the body plant was a normal dispute that was settled amicably in a matter of months.[20] For his part, Klein sees Fisher Body's opposition to GM's proposal as opportunistic (holding-up) behavior.[21] What Coase and Klein both fail to consider; however, is the reciprocal nature of the 1925 dispute. If the factory were built in Flint as GM wanted, this would have increased Fisher Body's production costs. On the other hand, if Fisher Body were to expand its existing factory in Detroit in place of building a new plant in Flint, this would have increased GM's costs. In either case, one side's loss would be the other's gain. Thus, without more information about the relative costs of each option, it is not at all clear which party is holding-up the other.

Coase, however, energetically objects at the possibility of Fisher Body holding up GM over the location of the body plant. At one point, he asks, "[a]re the coach passengers who resist the highwayman holding up the highwayman?"[22] Perhaps this is meant as a rhetorical question, but in a purely intellectual sense the answer is affirmative, because the dispute between the coach passengers and the highwayman is reciprocal in nature, at least from an *ex ante* perspective.[23] Of course, one could argue that Coase's analogy is inappropriate, since the highwayman is attempting to realize an involuntary exchange (armed robbery).[24] But to a certain extent, the same can be said of both GM and Fisher Body with respect to the location of the body plant. Each party wants the other to bear the costs resulting from either

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18 GM also purchased 60% of Fisher Body's stock at this time (1919). GM eventually purchased the remaining 40% of Fisher Body's shares in 1926, a year after the dispute between GM and the Fisher brothers over the location of the new body plant.

19 *See Coase (2006)*, *supra* note 4, at 267, 270 (emphasis added).

20 *Id.* at 271.

21 *See* Benjamin Klein, *Fisher-General Motors and the Nature of the Firm*, 43 J.L. & ECON. 105 (2000).

22 Coase (2006), *supra* note 4, at 270.

23 This is not the place for me to get into the intricacies of the *ex ante* perspective of philosophy. My philosophical point is simply that we have no way of choosing between the highwayman or the passengers before legal entitlements are assigned to them, such as the entitlement to enjoy one's property or the entitlement to take another's property. *See, e.g.,* Guido Calabresi & A. Douglas Melamud, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1973).

24 Though, for what it is worth, Coase himself once described the problem of blackmail (which can be viewed as either a voluntary or involuntary exchange) as reciprocal in nature. *See* Ronald H. Coase, *Blackmail*, 74 VIRG. L. REV. 655, 657 (1988).

course of action. On either view of the 1925 dispute—the Coasean view or Klein's standard account—the problem remains reciprocal in nature.

In sum, even a mutually beneficial long-term relationship between a buyer and a seller will display elements of tension, discord, and manipulation, especially at the margin over the spoils of the joint venture. This is especially true when unforeseen contingencies occur. Whether this inherent tension between contracting parties will result in open opportunism or whether it will be checked by the parties' mutual dependence will depend on a host of variables.[25] This latter question is beyond the scope of this paper. The main point here is that the process of exchange is reciprocal in nature. Ironically, it is worth noting that it was Ronald Coase himself who initially developed the idea of reciprocal relationships in the context of nuisance law.[26] In his now-classic paper, *The Problem of Social Cost*, Coase uses the prosaic example of factory smoke to illustrate the reciprocal relationship between the owner of a factory (who wishes to emit smoke) and the neighbors of the factory (who want clean air). Coase states that the traditional approach in nuisance law to the problem of the factory smoke (i.e., imposing legal liability on the party said to be causing the harm) is wrong. Coase's analysis is so perceptive and original that it is worth quoting in full:

> The traditional approach [to the problem of factory smoke] has tended to obscure the nature of the choice that has to be made [between A, the owner of the factory, and B, the neighbors]. The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is, How should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. The real question that has to be decided is, Should A be allowed to harm B or should B be allowed to harm A? The [correct solution] is to avoid the more serious harm.[27]

Coase is not just repeating the old saw that there are two sides to every story. His basic point is far more original and insightful than that. He is saying that one side to the dispute over the factory smoke will suffer 'harmful

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25 *See, e.g.,* Maynard-Smith & Szathmary, *supra* note 16; Axelrod, *supra* note 13.

26 *Coase (1959), supra* note 11, at 26; *Coase (1960)*, *supra* note 1, at 2. It is also worth noting that Guido Calabresi, while studying law at Yale, had independently reached the same conclusion as Ronald Coase did regarding the reciprocal nature of the externality problem (*reciprocity of causation*) , but Calabresi made the *unfortunate* mistake of removing this point from his 1961 paper on risk distribution, his first published paper. *See* Guido Calabresi, *Neologisms Revisited*, 64 MD. L. REV. 736, 738 (2005).

27 *Coase (1960)*, *supra* note 1, at 2.

effects' no matter what the result is. For example, if the courts permit the owner of the factory to continue emitting smoke, the neighbors will be harmed. However, if the courts rule in favor of the neighbors, then the owner of the factory will be harmed.[28] One of the parties will suffer harmful effects however the dispute between them is resolved. Thus, in place of the traditional approach, the courts should balance (a) the cost to the neighbors caused by the emission of smoke versus (b) the cost to the factory owner and to consumers that will be caused by preventing the emission of smoke.[29]

I have extended Coase's basic idea about reciprocal harms to the process of exchange. In summary, I have argued that contractual relations are reciprocal in nature since the parties are mutually dependent on each other and since the gains resulting from cooperation contain the seeds of conflict. Though this is something of a paradox, it helps to explain the radical divergence between Coase and Klein over how to interpret the relations between Fisher Body and General Motors. But putting aside for the moment the reciprocal nature of the *Fisher Body-GM* case, one must also contend with the thorny problem of historical observation.

III. The Problem of Historical Observation (or, What Is a Fact?)

In his devastating and persuasive critique of the standard account of the *Fisher Body-GM* case, Coase goes on to make a larger and more interesting point about the nature of historical facts: "Facts are not like clay on the potter's wheel that can be molded to produce the desired result. They constitute the immutable material that we have to accept."[30] The analogy is a memorable one, but is it really that helpful? How does one distinguish fact from opinion (or fact from inference)? Put another way, how does one go about deciding who is telling the truth about a historical event, especially when the facts in question are composed of intangible and non-falsifiable

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28 In fact, it is not just the owner of the factory who will be harmed but rather all consumers who wish to purchase the products produced by the factory. Of course, the extent of the consumers' injury will depend in large part on the price elasticity of demand for the factory's products.

29 In addition, Coase appears to be making a deeper philosophical point, implying that neither party to the factory-smoke dispute has an *ex ante* moral right to be free from harmful effects. For example, to say that the owner of the factory has a moral right to use the factors of production free from legal intervention is no answer because one could argue that the neighbors have a moral right to clean air or to good health. However we frame the problem—as one involving property rights in the factors of production or moral rights to good health—the essence of the problem remains reciprocal. *Cf.* F.E. Guerra-Pujol, *In Defense of Intellectual Agnosticism*, 65 REV. COL. ABOG. P.R. 55 (2004) [hereinafter *Guerra- Pujol (2004)*].

30 *Coase (2006)*, *supra* note 4, at 270.

historical events that occurred in the distant past? One is reminded of Pontius Pilate's immortal but inscrutable words during the trial and execution of Jesus: "What is truth?"[31]

I am not arguing that Coase got his facts wrong. I am, however, arguing that Coase's implicit theory of historical facts may be a bit too simplistic.[32] Indeed, both the Coasean view and the standard account of the Fisher Body affair suffer from a kind of *historical dogmatism*. There are facts and then there are facts. A good many facts are no doubt fixed and immutable, as Coase puts it. One can, for instance, come to agreement on a host of basic facts regarding Fisher Body and General Motors: the fact that GM and Fisher Body negotiated a 10-year supply contract in 1919; the fact that the parties had a serious dispute in 1925; and the fact that GM acquired Fisher Body in 1926. These are hard facts. No one can deny them. Fair enough. But often, the significance of these hard facts will be open to debate and dialogue. That is, even if all the historical facts are clear and well-established, such facts can still be open to conflicting interpretations.[33] This problem appears to be inherent in all historical observation, and the main source of the problem is that one's knowledge of the past is necessarily *indirect* and thus non-falsifiable in the scientific sense:

> [T]he historian is, by definition, absolutely incapable of observing the facts which he examines. No Egyptologist has ever seen Ramses. No expert on the Napoleonic Wars has ever heard the sound of the canon at Austerlitz. We can speak of earlier ages only through the accounts of eye-witnesses.[34]

As a result, the reason why even hard historical facts can be open to interpretation is the fragmentary and incomplete nature of the historical record. As Bloch puts it: "we are in the predicament of a police magistrate who strives to reconstruct a crime he has not seen."[35] The events leading up to the acquisition of Fisher Body by General Motors are not immune to the problem of historical observation. This episode occurred almost a century

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31 John 18:38.

32 *Cf.* Elodie Bertrand, *The Coasean Analysis of Lighthouse Financing: Myths and Realities*, 30 CAMB. J. ECON. 389 (2006).

33 *Cf.* JONATHAN WEINER, THE BEAK OF THE FINCH 47 (1994): "Hard facts" are those rare details in this confusing world that have been recorded so clearly and unambiguously that everyone can agree on them. The shape of a finch's beak is a hard fact." Even so, the significance of this hard fact is open to differing interpretations, depending on whether you are a scientist or a preacher: either the shape of the beaks are various because of evolution by natural selection or because the Creator made them that way.

34 Bloch , *supra* note 2, at 48.

35 *Id.*

ago, and the principal actors in the events leading up to the merger – Alfred Sloan, the Fisher brothers, and their sundry lieutenants – have long since left this world. Our knowledge of the relations between Fisher Body and General Motors is necessarily indirect, circumstantial, and fragmentary, and thus a certain amount of interpretative wiggle room is unavoidable and inescapable.

Another related difficulty with historical facts is the problem of eyewitness testimony. In essence, the observer of historical events must ultimately rely on eye-witnesses for his information. In the words of Bloch, "[a] good half of all we see is seen through the eyes of others."[36] And even when the eyewitness testimony consists of primary sources, such testimony may be incomplete or unreliable for a wide variety of reasons. Even first-hand accounts of an event are partial and limited. Again, the competing narratives of the *Fisher Body-GM* case are a fitting illustration of this problem. The relative paucity of eyewitness reports and documents of the relations between Fisher Body and General Motors is striking. Coase, for instance, refers in passing to only four primary sources: 1) the 1919 contract between Fisher Body and General Motors; 2) a memorandum recording a discussion with GM executives in 1922; 3) the 1926 Notice to Stockholders of the Fisher Body Corporation; and 4) a letter from Pierre du Pont to Fred Fisher.[37] No doubt one could easily draw a number of different inferences from such a limited number of sources.[38]

Ironically, if anyone alive is intimately familiar with the facts of the *Fisher Body-GM* affair, a strong case can be made that it is Ronald Coase himself. For of all the economists who have written about the Fisher Body example, Coase is probably the only person alive to have personally interviewed executives of General Motors soon after GM had acquired Fisher Body.[39] But even Coase's direct and first-hand knowledge of the Fisher Body affair is partial and imperfect. It appears that he never spoke with executives of Fisher Body. His visit to the United States occurred several years after the events in question. That is probably why even Coase has to rely mostly on secondary hearsay sources to reach his conclusions regarding the *Fisher Body-GM* case. By this, I do not wish to imply that Coase got his facts wrong. I

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36 *Id*. at 49

37 *See generally Coase (2006), supra* note 4, at 256-272.

38 The duPont letter, for example, documents a moment of severe tension in the relations between GM and the Fisher brothers, though as Coase notes, this strain occurred several years after the merger between and GM and Fisher Body.

39 As Coase has noted on various occasions, *see,* e.g., Ronald H. Coase, *The Nature of the Firm: Origins*, 4 J. ECON. MAN. 7 (1988); RONALD H. COASE, *The Instutional Structure of Production*, *in* ESSAYS ON ECONOMICS AND ECONOMISTS 7 (1994), he spent the academic year 1931-1932 in the United States on a Cassel Travel Scholarship, visiting automobile factories and personally interviewing business executives in the automobile industry.

merely wish to emphasize that even hard historical facts can be open to interpretation.

The 1925 dispute between Fisher Body and General Motors also serves as a good illustration of the problem of historical observation. How should one interpret this dispute and GM's subsequent decision to buy out the Fisher brothers? Certainly, the 1925 dispute was no minor matter. Even Coase recognizes that this quarrel rose to the level of a serious dispute.[40] The question is: was GM's proposal an attempt to hold-up Fisher Body—either you (Fisher) agree to build the new plant in Flint or we (GM) will not renew the 1919 contract—or was Fisher Body's opposition to GM's proposal an attempt to holdup GM? Or is Coase right? Was this just a normal (non-opportunistic) dispute between friends? All these interpretations are plausible, so we shall never know with a high degree of certainty which interpretation of the 1925 dispute is the correct one. All we can do is draw reasonable inferences. Historical events are by their very nature non-falsifiable and thus open to interpretation.

Both Coase and Klein "are in the predicament of a police magistrate who strives to reconstruct a crime he has not seen."[41] This is so because the same set of hard historical facts can often be open to radically differing interpretations. One should thus distinguish between the past, which is fixed, and one's interpretation of the past, which can change over time.[42] Of course, one person's interpretation may be more plausible than another's, but it is still an interpretation, not a fact *per se*. Coase himself seems to recognize this point when he states that "the important difference between Klein and me [is] due to a difference in our *perception* of the facts"[43] – all the more reason why historical dogmatism should be discarded out of hand.

Up to this point, my comments should perhaps be taken as the minor quibbles of a friendly academic.[44] At the end, however one looks at contractual relations or historical facts, Coase is correct: there appears to be little holding-up behavior in the relations of Fisher Body and General Motor. But Coase makes a major blunder towards the end of his paper. The most serious flaw of Coase's analysis has nothing to do with Fisher Body, but rather with his wholesale critique of the economics profession. Though Coase may be right in believing that economics has become theory-driven and non-

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40 *Coase (2006)*, *supra* note 4, at 267-70.

41 Bloch , *supra* note 2, at 48.

42 *See id.*

43 *Coase (2006)*, *supra* note 4, at 262 (emphasis added).

44 I say friendly because I admire the work of Ronald Coase very much, especially his 1974 paper on *The Market for Goods and the Market for Ideas*, *in* ESSAYS ON ECONOMICS AND ECONOMISTS 7 (1994); in addition, I consider myself a *Coasean* because of Coase's insight that most relationships are reciprocal in nature. *See Guerra-Pujol (2004)*, *supra* note 29, at 59-63.

empirical, Coase's critique of the conduct of economics is itself largely theory-driven and non-empirical.

IV. Coase's Theory-driven Critique of Theory-driven Economics

I shall now devote my full attention to the last few all-important pages of Coase's 2006 paper, where he draws a number of sweeping generalizations from the *Fisher Body-GM* affair. Coase claims that economics has become a theory-driven subject and that this state of affairs has led to a very casual attitude toward checking the facts and a lack of interest in what actually happens.[45] But how empirical is Coase himself? The great irony in Coase's own critique of economics is that the Coasean critique itself appears to be largely theory-driven and casual towards the facts. In essence, Coase's theory is that economics is too theoretical. His hypothesis at least has the virtue of being testable. The problem, however, is that Coase makes no retense to test his theory. He simply assumes that it is true and thus commits the same fallacy he accuses other economists of.[46]

Coase is not a naïve empiricist, in the mold of Francis Bacon. He is fully aware of the complex interplay between fact and theory. The problem is not that Coase is against theory *per se*. The problem is just the opposite. Coase is too theoretical and not empirical enough. He uses the Fisher Body episode to condemn the entire economics profession *carte blanche*, implying that theory-driven work in economics is typical of the economics profession. But on what grounds can one draw this inference? Instead of conducting a rigorous empirical review of the journal literature to test his hypothesis, Coase is content with a small handful of isolated examples—the usual suspects, to be sure—Samuelson, Meade, and of course, Pigou.[47] Frankly, Coase's anecdotal evidence is pretty feeble. In all, he is able to muster but three specific examples of theory-driven work in economics: lighthouses; the fable of the bees; and, of course, the Fisher Body affair. Yet, however egregious these errors may be, it is not at all clear whether these particular examples of error and sloppiness are representative of the majority of research in economics—or whether, in the alternative, these cases are mere aberrations or atypical instances. Coase himself has provided absolutely no

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[45] *Coase (2006)*, *supra* note 4, at 274-77.

[46] In fairness to Coase, I believe that the problem of theory-driven work is common to all mature sciences. *See, e.g.*, Thomas S. Kuhn, THE ESSENTIAL TENSION 193 (1977). Consider, for example, Charles Darwin's influential theory of evolution by natural selection or Richard Dawkins's intriguing theory that 'memes' are the unit of cultural transmission or any other theoretical construct (such as game theory) that helps us to explain diverse natural phenomena. Thus, Coase is in pretty good company.

[47] *Coase (2006)*, *supra* note 4, at 275-76.

reliable empirical evidence on this larger question. I am afraid that anecdotal evidence will not suffice.

Instead, Coase seems to assume the posture of a stern British schoolmaster, stating that "the investigations by the economics profession of the relations between Fisher Body and GM stand as a glaring example of how economic research should *not* be concluded."[48] But even this bold claim is open to question. Even if Klein interpreted the facts wrong, one could still persuasively argue that this entire episode is actually a rather fitting tribute to the conduct of economics. After all, a number of scholars, working independently during the latter-half of the 1990s, were able to question the standard account, uncover new evidence, and present a more accurate account of the events leading to the GM-Fisher Body merger. As I see it, the very fact that these scholars were able set the record straight seems to vindicate the conduct of economics. Though Klein's sloppiness created a false narrative of the holdup problem, Klein was not able to pull the wool over their eyes. The same can be said with respect to Coase's other two glaring example of error: lighthouses and beekeeping.[49] Steven Cheung corrected Meade's incorrect account of the relations between beekeepers and apple farmers,[50] while Coase did the same for lighthouses.[51] Indeed, the very fact that these errors were eventually discovered and rectified by Coase, Cheung, and others suggests that these glaring examples (involving lighthouses and beekeeping) are isolated errors.

Furthermore, one could argue that there is an optimal rate of purely theory-driven work in any given scientific discipline. Most such theory-driven work is likely to be widely off the mark and ultimately discarded, while only a few theories are able to survive the test of time and lead to fruitful research.[52] But so what? After all, why should the market for academic theories be any different from any other ordinary product market?[53] Likewise, perhaps there is even an optimal rate of error and sloppiness in any academic discipline as well. Perhaps one must be willing to

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48 *Id.* at 277. (emphasis added).

49 *See, e.g.*, Ronald H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357 (1974) [hereinafter *Coase (1974)*]; Steven S. Cheung, *The Fable of the Bees*, 16 J.L. & ECON. 11 (1973).

50 Cheung , *supra* note 49.

51 *Coase (1974), supra* note 49.

52 Dawkins, *supra* note 3, at 325: "Some bad scientific ideas can spread widely, at least for a while. And some good ideas lie dormant for years before finally catching on …" Though Dawkins had in mind W.D. Hamilton's idea of kin selection as an example of a good idea taking time to catch on, Coase's own idea that markets are not costless is an even more dramatic example of this phenomenon. *See generally* William Hamilton, *The Genetical Evolution of Social Behavior*, 7 J. THEOR. BIO., (1964) and Ronald H. Coase, *The Nature of the Firm, 4* ECON. (1937).

53 *See* George Stigler, MEMOIRS OF AN UNREGULATED ECONOMIST 170-74 (1988).

tolerate a large amount of error in order to discover and clutch those few kernels of truth that are so rare in this complex and confusing world. Whatever the case may be, and whatever the optimal rate of error—who would doubt the ruthless effectiveness of the marketplace of ideas in weeding-out error and false ideas? As I mentioned, the papers on the Fisher Body affair seem to bear this out. So my question to Coase is: why worry about a few bad apples?

Having said this, however, let me make it abundantly clear that I have neither quarreled with Coase's theory *per se*, nor with his professed desire to improve the conduct of economics. Coase's central message about the value of empirical work is well taken.[54] Instead of plucking examples out of thin air to illustrate one's theories, scholars should take the trouble to check their facts and get them right. For students of Coase, this theme will no doubt sound familiar. In his paper on the British lighthouse system, for instance, Coase the economist dons a historian's cap and meticulously reconstructs the historical record regarding the financing and operation of lighthouses in England and Wales.[55] Although Coase's historical analysis has recently been put to question, his larger point is an important one: economists should base their theories on empirical evidence rather than assume willy-nilly the facts into evidence, as a lawyer might say. What a pity that Coase should not do the same.

V. CONCLUSION

If one thing is clear about the Fisher Body affair, it is that Coase is quite put off by Klein's various accounts of the events leading up to GM's acquisition of Fisher Body. Whereas Klein depicts Fisher Body as the archetypical opportunistic supplier, Coase, in contrast, asserts that the opportunistic actions supposedly carried out by Fisher Body never happened. The dispute between Klein and Coase over the proper interpretation of the acquisition of Fisher Body by General Motors illustrates two important but neglected issues in economic research and social-science research generally: the reciprocal (conflictive and cooperative) nature of the

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54 Although I am an academic lawyer and not a formal economist, I must confess that Coase's message has had a profound impact on my way of looking at the world. Consider the problem of 'racial profiling', for example. Many of my colleagues believe that racial profiling is morally or legally wrong because it constitutes a form of racial discrimination. But the question of discrimination is beside the point, since the victims of crime are likewise mostly black and poor. The real question, as I see it, is whether racial profiling works. Does it reduce crime at the margin? Alas, a cursory glance at the legal literature shows that law professors do not seem to be interested in this more practical empirical question.

55 *Coase (1974)*, *supra* note 49.

process of exchange and the problem of historical observation. While Coase is right to point out the cooperative elements of the relations between Fisher Body and GM, one must not ignore or play down the conflictive elements as well, such as the 1925 dispute over the location of the body plant. One must also recognize the limitations of the historical record. Finally, whether Coase's larger critique of economics as a theory-driven subject is a correct one is a subject that requires further empirical investigation.

QUIS CUSTODIAT CUSTODIUM? CORPORATE OVERSIGHT THROUGH DERIVATIVE ACTION

RAFAEL PAGÁN-COLÓN*

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I. INTRODUCTION

Corporations are legal entities subject to the pertinent statutes that govern them.[1] In *Trustees of Dartmouth College v. Woodward*, the U.S. Supreme Court defined a corporation as ". . . an artificial being, invisible, intangible and existing only in contemplation of law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence"[2]; and also as:

> . . . a collection of individuals, united into one collective body under a special name and possessing certain immunities, privileges and capacities in its collective character which do not belong to the natural persons composing it. Among other things, it possesses the capacity of perpetual succession and of acting by the collected vote or will of its component members, and of suing and being sued in all things touching its corporate rights and duties. It is, in short, an artificial person, existing in contemplation of law and endowed with certain powers and franchises which, though they must be exercised through the medium of its natural members, are yet considered as subsisting in the corporation itself as distinctly as if it were a real personage. Hence, such a corporation may sue and be sued by its own members, and may contract with them in the same manner as with any strangers.[3]

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1 DAVID G. EPSTEIN, RICHARD D. FREER, MICHAEL J. ROBERTS & GEORGE B. SHEPARD, BUSINESS STRUCTURES 148 (2nd ed., Thomson/West 2007).

2 Trustees of Darmouth College v. Woodward, 17 U.S. 518, 636 (1819).

3 *Id.* at 667-668.

Epstein[4] lists the principal sources of laws that define and govern a corporation (i.e., corporate law) as (1) state statutes, (2) the corporations' articles of incorporation, (3) case law, and (4) federal statutes. The authors explain that, regardless of the jurisdiction, state corporation statutes provide that (1) a corporation is a legal entity separate from its owners and, (2) as a general rule, these owners (called shareholders) are not personally liable for the debts of the corporation. At most, the owners' potential loss or liability is limited by the amount of their investment in the corporation; a concept known as *limited liability.*[5]

The order in which Epstein et al.[4] list the previous sources is not by coincidence. Federal courts grant great latitude to state courts except in situations where an exclusive federal statute applies. In *Burks v. Lasker,*[6] the U. S. Supreme Court stated that "federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [Investment Company Act of 1940] and [Investment Advisers Act of 1940]."[7]

Estes[8] infers from *Burks* that in the absence of a strong congressional expression of intent to the contrary, the Supreme Court still considers state law as controlling in corporate governance matters. He adds that "most state laws have provisions requiring that directors shall manage - or direct the management of - the business of the corporation. Individual versions of this mandate have not resulted in the development of significantly different lines of cases from state to state, as a general proposition."[9]

Davis[10] believes that in comparison to the corporate laws of other countries, the United States' corporate law is flexible and loose. He is of the opinion that those who control and manage a corporation are given ample leeway. Davis identifies two underlying institutions whose strength makes this possible. One is a disclosure system that ensures a full picture to investors of the operational and fiscal state of the corporation. The other is the fiduciary concept, which replaces standardized prohibitions with the opportunity to evaluate managerial conduct on a more holistic basis. The fiduciary concept filters self-opportunistic behavior by those in control of a corporation without deterring good faith efforts to further shareholder welfare in ways that might run afoul of a more technical set of restrictions.

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4 EPSTEIN ET AL., *supra* note 1, at 151.

5 EPSTEIN ET AL., *supra* note 1, at 148.

6 Burks v. Lasker, 441 U.S. 471 (1979).

7 *Id*. at 486.

8 Robert M. Estes, *Corporate Governance in the Courts*, 58(4) HARV. BUS. REV. 50, 51-52 (1980).

9 *Id*. at 64.

10 Kenneth B. Davis Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 388 (2008).

The critical issue is who performs the fiduciary evaluation. Over the last three decades, this task has been assumed by independent members of corporations' boards of directors.

The members of the board of directors of a corporation are the elected representatives of the shareholders. In Delaware, Section 141(a) of the General Corporation Law states that directors, rather than shareholders, manage the business and affairs of the corporation.[11] In Puerto Rico, Article 4.01(A) of the 2009 General Law of Corporations[12] establishes that the board of directors is responsible for leading the corporation.[13] Smith and Wilson point out that shareholders entrust their interests to these directors,[14] who in turn (ideally) watch out for these interests. Nevertheless, there are times when the interests of the directors diverge from those of the shareholders; at such times, agency conflicts arise. It may be that such differences of opinion are *bona fide* perceptions of what is best for the corporation. However, conflicts of interest may exist between directors' personal interests, shareholders' personal interests, and the going concern of the corporation. On such occasions, Reisberg[15] explains that shareholders have several mechanisms at their disposal to protect their interests in a corporation when agency conflicts arise. In theory, they control directors with the threat or action of substituting them during the annual shareholder meetings. He also cites the professional standards required of managers, oversight by outside directors, the disciplinary power of the market, and shareholder voting as other mechanisms available to shareholders. However, these courses of action are not always feasible in cases where minority shareholders with little effective power are involved. A shareholder can choose to sell his or her interest in the corporation. A shareholder could also dilute his or her risk by having diverse interests in different corporations (a concept also known as diversification).

Regardless of the mechanisms that a market or a corporation provides to reduce a shareholder's risk and protect his or her interest, some form of

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11 DEL. CODE ANN., tit. 8, § 141(a) (West 2011).

12 P.R. LAWS ANN. tit. 14, § 2721 (2011).

13 P.R. LAWS ANN. tit. 14, § 2721 (A) (2011) ("Los negocios y asuntos de toda corporación organizada con arreglo a las disposiciones de esta Ley serán dirigidos por la junta de directores, salvo cuando otra cosa se disponga en esta Ley o en el certificado de incorporación. Cuando el certificado de incorporación contenga tal disposición, las facultades y obligaciones que esta Ley confiere o impone a la junta de directores serán ejercidas o desempeñadas por la persona o personas designadas en el certificado de incorporación.").

14 ROY C. SMITH & INGO WALTER, GOVERNING THE MODERN CORPORATION: CAPITAL MARKETS, CORPORATE CONTROLS, AND ECONOMIC PERFROMANCE,74 (Oxford University Press 2006).

15 Arad Reisberg, *Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions*, 6 EUR. BUS. ORG. L. REV. 227, 229-230 (2005).

statutory or judicial control should be available to them in order to protect their interests.[16] One such judicial control is the possibility of a shareholder suing one or more directors of the board in court. A shareholder suit may take one of two forms, depending on whether the purpose is to protect a personal right or to protect the corporation which he or she owns in part. The former case is considered a direct action; which, for the purpose of the topic discussed herein, falls outside the scope of this paper; and will therefore not be discussed. The latter is a derivative action.

II. DERIVATIVE ACTIONS: CONCEPT DEFINITION

Aronson, Tomkins, Hassi, and Sorah-Reyes[17] identify several cases that provide definitions of what constitutes a derivative action. In *Aronson v. Lewis*,[18] the Delaware Supreme Court observed that a derivative action is actually two causes of action. On the one hand, it is the equivalent of a suit by shareholders to force the corporation to sue. On the other hand, it is a suit by the corporation, asserted by the shareholders on the corporation's behalf, against those parties liable to it.[19] The Illinois Supreme Court in *Brown v. Tenney*[20] stated that a derivative action entails one action against the directors for failing to sue, and another based upon the right that belongs to the corporation. In *Ross v. Bernhard,*[21] the U. S. Supreme Court stated that a derivative action seeks to redress two distinct wrongs: (1) the act whereby the corporation was caused to suffer damage, and (2) the refusal of the corporation itself to redress said act.

A derivative action is not a *qui tam pro corporatus quam pro se ipso*.[22] The shareholder is not demanding a right in his or her name as well as the corporation's; but rather a right solely in the corporation's name. In *Meyer v.*

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16 William M. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporation Rights: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 107 (2008).

17 Seth Aronson, Sharon L. Tomkins, Ted Hassi & Tristan Sorah-Reyes, *Shareholder Derivative Actions: From Cradle to Grave*, 1620 P.L.I./CORP 259, 263 (2007).

18 Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

19 Reisberg, *supra* note 15, at 811.

20 Brown v. Tenney, 532 N.E.2d 230, 232 (Ill. 1988).

21 Ross v. Bernhard, 396 U.S. 531, 534 (1970).

22 Black's Law Dictionary 1282 (8th ed. 2004). The full Latin nomenclature for a *qui tam* statement is *qui tam pro domino rege quam pro se ipso in hac parte sequitur*; translates to "who as well for the king as for himself sues in this matter". An action brought under a statute that allows a private person to sue for a penalty, part of which the government or some specified public institution will receive.

Within the context used herein, a play of words is used, substituting government for the corporation, to highlight that a derivative action is not executed to benefit both the shareholder and the corporation.

Fleming,[23] the U.S. Supreme Court explained that the derivative action allows shareholders a mechanism for protecting the interests of the corporation from negligence and abuse by "faithless directors and managers."[24] As explained in *Willhelm v. Murchison*[25], a shareholder is allowed to enforce a right on behalf of the corporation which the corporation refuses to assert despite being properly able to do so.

In *Alleghany Corp. v. Kirby*,[26] the 2nd Circuit Court of Appeals explained that "[the] theory behind allowing a stockholder to bring a derivative stockholders' action rests upon the belief that wrongdoing directors will not voluntarily sue themselves or willingly admit their wrongful acts; hence, the right to bring an action on behalf of the corporation is given to a stockholder."[27]

Clifford & Maher[28] report that a company law reform package enacted in New Zealand in July of 1994 provided improved judicial remedies for the individual shareholder. Citing the case of *Vrij v. Boyle*[29], the authors explain that the New Zealand High Court allows the shareholder to originate a derivative action, depending on the likelihood of the proceedings succeeding and the costs of the proceedings compared with any likely relief and the interests of the company in having the claim pursued. In relation to the first criterion, the Court held that it was not required to conduct an interim trial on the merits. Instead, the appropriate test was deemed to be whether a prudent business person would bring a claim considering the amount at stake, apparent strength of the claim, likely costs and the prospect of executing any judgment.

A recent article in the Economist[30] describes Hong Kong courts' low tolerance for the cavalier attitude of dominant shareholders towards their minority counterparts and towards corporate governance in general. The article explains that the court, in the recent case of Hong Kong's dominant telecommunications operator, P.C.C.W., cracked down particularly harshly on the operator's Board of Directors due to the extended slump in share prices and because other tycoons who ran similarly convoluted empires did not generate such big returns.

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23 Meyer v. Fleming, 327 U. S. 161 (1946).

24 *Id*. at 167.

25 Wilhelm v. Murchison, 206 F. Supp. 733 (S.D.N.Y. 1962).

26 Alleghany Corp. v, Kirby, 333 F.2d 327 (2d Cir. 1964).

27 *Id.* at 332.

28 Denis Clifford & Chris Maher, *Shareholder Derivative Action*, 14(12) I.F.L. REV. 56 (December 1995).

29 Vrij v Boyle, (1995) 7 NZCLC 260 (HC) 844.

30 *Split Decision,* THE ECONOMIST (April 23, 2009), *available at* http://www.economist.com/node/13527945 (last visited Mar. 13, 2011).

Furthermore, an article in the Business Torts Reporter[31] informs that, just last year, in the case of *Tzolis v. Wolff*[32], a New York Appellate court determined that even a limited liability corporation (LLC) may have a derivative suit brought on its behalf by a member. This determination is more a matter of jurisprudence than statute, given that when New York's Limited Liability Company Law was enacted in 1994, no reference was made to derivative suits. The court interpreted that said omission did not imply that such suits are prohibited; explaining that derivative suits have been recognized in New York corporate law at least since 1832 when a court held it essential to allow shareholders to have some sort of recourse when those who ran the corporation betrayed their duties to the company.[33]

As to the case of limited liability partnerships (LLP), a derivative action brought by a partner on behalf of the partnership is also permitted, as stated by the courts in *Klebanow v. New York Produce Exch.*[34]and *Riviera Congress Assoc. v. Yassky*.[35] In *Quiñones-Reyes v.* Registrar,[36] the Puerto Rico Supreme Court held that although the limited liability partnership has a separate judicial personality, distinct and independent from its partners, this fact should not serve as hindrance to partners who seek to represent the limited liability partnership in actions conducive to the protection and vindication of the partnership's rights before the courts.

The Business Torts Reporter[37] article points out that in both the case of the limited liability corporation as well as the limited liability partnership, the same principle applies as with conventional corporations. Fiduciaries who betray the trust invested in them must be held accountable.

A. Requirements to undertake a derivative action

Federal Rule of Civil Procedure 23.1[38]states that a derivative action may be brought in favor of a corporation solely by a shareholder. Although the rule refers to the state of the shareholder at the time the action is

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31 20, Bus. Torts Rep. 165 (April, 2008).

32 Tzolis v. Wolff, 10 N.Y.3d 100 (2008).

33 Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832).

34 Klebanow v. New York Produce Exchange, 344 F.2d 294 (2d Cir. 1965).

35 Riviera Congress Association v. Yassky, 18 N.Y.2d 540, 223 N.E.2d 876 (1966).

36 Quiñones-Reyes v. Registrar, No. RG-2007-02, 2009 PRSC 63, at 17 (P.R. April 28, 2009). The actual text in Spanish states "*Si bien es cierto que la sociedad especial ostenta una personalidad jurídica independiente a la de sus socios, ello no es óbice para que los socios puedan comparecer en tal carácter y en representación de la sociedad especial en aras de realizar ciertas y determinadas acciones encaminadas a salvaguardar y vindicar los derechos de tal ente jurídico*".

37 Business Torts Reporter, *supra* note 31, at 166.

38 FED. R. CIV. P. 23.1.

brought, a second requirement - called the "contemporaneous ownership" requirement has been established by the federal courts in cases such *as Brambles USA, Inc. v. Blocker*[39] and *In re Penn Central Transportation Co.*[40]in order to ban potential plaintiffs from "buying into" a lawsuit. Except for an extreme reason such as fraud, this requirement is founded on the principle that should a shareholder cease to have shares in the corporation (whether by way of a merger or any other reason), then he or she ceases to have an interest in the corporation and thus loses standing to present a derivative action.

Before a court accepts a derivative suit against one or more corporate directors, state and Federal forums require that the plaintiff shareholder(s) submit a written complaint to the board of directors notifying them of specific facts regarding an alleged offending situation, how the situation adversely impacts the corporation, and the expected remedial actions. In lieu of this action, plaintiff shareholders are hard-pressed by the courts to prove the futility of said notice and procure that this condition be waived.[41]

In addition to presenting a demand to the board, states such as Michigan also require that some proof of fraud or abuse of trust be presented against the board of directors of the corporation in failing or refusing to enforce a corporate right or claim. If a demand to the board was not presented, the shareholder should furnish proof that such a demand would have been useless. Such was the case in *Futernick v. Statler Builders, Inc.*[42]

In *Aronson v. Lewis*,[43] the Delaware Supreme Court addressed the matter of when was a stockholder's demand upon a board of directors to redress an alleged wrong to the corporation excused as futile prior to the filing of a derivative suit. The case overruled a Delaware Chancellory decision that stated that the plaintiff's allegations raised a "reasonable inference" that the directors' action was unprotected by the business judgment rule. Thus, the board could not have impartially considered and acted upon the demand. The Delaware Supreme Court ruled that a demand [against the board of directors] "can only be excused when facts are alleged with such particularity so as to create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule."[44] In other words, the futility of placing a demand to the board of directors cannot be inferred, but rather must be proven "with particularity" by the plaintiff shareholders. The argument of domination or overbearing influence by a particular director

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39 Brambles U.S.A., Inc. v. Blocker, 731 F. Supp. 643 (D. Del. 1990).

40 In re Penn Central Transportation, 341 F. Supp. 845 (E.D. Pa. 1972).

41 Davis, *supra* note 10, at 396.

42 Futernick v. Statler Builders, Inc., 112 N.W.2d 458 (Mich. 1961).

43 Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

44 *Id.* at 807.

over the board is insufficient to justify a waiver of the demand requirement. The Aronson case adds that:

> [T]o properly allege domination of the Board, particularly domination based on ownership of less than a majority of the corporation's stock, in order to excuse a pre-suit demand, must allege ownership plus other facts evidencing control to demonstrate that the Board could not have exercised its independent business judgment.[45]

The court points out that although the General Corporation Law of the State of Delaware invests the board of directors with the authority to administer the corporation, "existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders"[46]; and recognizes that "a stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management."[47]

The Aronson case recognizes that, by nature, the derivative action infringes on the managerial freedom of directors. Therefore, it exists at the threshold of the board of directors' authority, primarily to insure that a stockholder exhausts the available intracorporate remedies, and secondarily to provide a safeguard against strike suits. By promoting this form of alternate dispute resolution rather than an immediate recourse to litigation, the demand requirement recognizes the fundamental precept that directors manage the business and affairs of corporations.[48]

In *Hawes v. Oakland*,[49] the U.S. Supreme Court declared that in addition to establishing the existence of grievances, which call for the kind of relief obtainable through a stockholder's derivative action:

> . . . it is equally important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to

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45 *Id.* at 810.

46 *Id.* at 811.

47 *Id.* at 811.

48 *Id.* at 811-812.

49 Hawes v. Oakland, 104 U. S. 450 (1881).

> induce remedial action on their part, and this must be made apparent to the court. If time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains. And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

The efforts to induce such action as complainant desires on the part of the directors, and of the shareholders when that is necessary, and the cause of failure in these efforts should be stated with particularity, and an allegation that complainant was a shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law, and that the suit is not a collusive one to confer on a court of the United States jurisdiction in a case of which it could otherwise have no cognizance, should be in the bill, which should be verified by affidavit.[50]

Kemper[51] explains the three purposes of the "demand requirement", in respect to both the demand on the directors and the demand on the other stockholders prior to the commencement of a stockholder's derivative suit. Its purposes are the following: (a) to relieve the courts of the need for interfering in the management of routine, internal, corporate business affairs; (b) to afford a measure of protection to corporate directors against harassment by dissident minority shareholders who may disagree with such directors on matters involving business judgment; and (c), to discourage "strike" suits in which stockholders make charges, without regard to the truth, for the purpose of coercing corporate management into settling worthless claims in order to get rid of them.

The Supreme Court of Delaware's solution in *Aronson v. Lewis*[52] was to link the demand requirement to the availability of the business judgment rule. Specifically, to establish demand futility, the complaint must allege "particularized facts" that create a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."

Furthermore, plaintiff shareholders that seek to bring a derivative action on behalf of the corporation must seek their own legal counsel. Under no circumstance should the corporate counsel be used. In *Liquilux Gas v. Berríos*[53], the Puerto Rico Supreme Court stated that a corporation's legal counsel has a lawyer-client relationship with the entity rather than the

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50 *Id.* at 460-461.

51 J.R. Kemper, Annotation, *Circumstances Excusing Demand Upon Other Shareholders Which is Otherwise Prerequisite to Bringing of Stockholder's Derivative Suit on Behalf of Corporation*, 48 A.L.R. 3d 595 (1973).

52 *Aronson,* 473 A.2d at 814.

53 Liquilux Gas v. Berríos, 138 P.R. Dec. 850 (1995).

entity's members. Rule 21 of the Puerto Rico Bar's Ethical Canons[54] states that a corporate lawyer owes the corporation complete loyalty to it as a juridical entity and not to its associates, directors, employees or shareholders; and can only represent the interests of these persons when these interests are not in conflict with those of the corporation. Citing Fletcher's Cyclopedia of the Law of Private Corporations[55], the court recommends that in order to insure the corporation the freedom of alignment that will serve its best interest, it seems that independent counsel should be retained - either by the corporation or the shareholder - whenever there is a potential for abuse and suggestion of conflict.

Nevertheless, in *Elfenbein v. Gulf & Western Industries, Inc.*,[56] the court established that the demand requirement is not absolute. It explains that the purpose of the "demand" rule is to give the corporation the opportunity to take over a suit, which was brought on its behalf, and allow the directors the chance to occupy their normal status as drivers of the corporation's affairs. However, the demand need not be made on the directors or shareholders when such a demand would be futile, useless, or unavailing. Where said directors and controlling shareholders are antagonistic, adversely interested, or involved in the transaction attacked, a demand on them is presumptively futile and need not be made.

When looking to determine whether the demand requirement is futile, courts apply what has come to be known as the Aronson Test.[57] For demand to be excused, the plaintiff shareholder must allege facts that if taken as true raise a reasonable doubt that (1) a majority of the directors are disinterested and independent or (2) that the challenged transaction was otherwise the product of a valid business judgment. Both conditions must be met in order for the demand requirement to be excused.

Pogostin v. Rice[58] explains the concept of interest by a director. The case states that interest exists wherever the potential for conflict exists between a director's loyalty to the corporation and his or her personal interests. This condition arises where a director has received, may receive, or is entitled to receive, a personal benefit through the transaction being challenged; and no such benefit is extended to the stockholders.

B. Directors v. Shareholders: the Business Judgement Rule as Defense

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54 P.R. LAWS ANN. tit. 4, app. IX (1970).

55 13 WILLIAM MEADE FLETCHER, FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6025, at 442-443 (1991).

56 Elfenbein v. Gulf & Western Industries, Inc., 590 F. 2d 445 (1978).

57 *Aronson,* 473 A.2d at 814.

58 Pogostin v. Rice, 480 A.2d 619, 624-625 (Del. 1984).

The primary defense against a derivative suit available to directors and officers is the business judgment rule. In summary, this rule holds that a director cannot be held accountable for a decision made in the performance of his or her duties as an officer of the corporation as long as two conditions are met. The first condition is one of diligence. It requires that the decision be based upon reasonable information provided by trustworthy sources: information which would make a prudent, proficient director arrive at a similar decision. The second condition is one of loyalty towards the corporation: no conflict of interest should exist between the interests of the corporation and those of the deciding director. The protection against liability provided by the business judgment rule is predicated upon compliance of both conditions. Delaware acknowledges the business judgment rule as one of the managerial prerogatives of directors under Section 141(a) of the state's Corporation Law.[59] In Puerto Rico, Article 4.01(I) of the 2009 General Law of Corporations defines the business judgment rule. Translated from Spanish, it reads in the following manner:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall be, upon conducting his functions, completely protected and exempt from liability when trusting in the good faith of the corporate records and in the information, opinions, reports and communications presented to the corporation by any corporate officer or employee, or board of directors committee, or by any other person regarding matters that the member reasonably believes to be within the scope of professional competency or expertise of said person that was selected with reasonable care by or for the corporation.[60]

That a plaintiff shareholder complies with the demand requirement to the board does not necessarily entail that the board of directors is forced to proceed with the litigation. Aronson[61] identifies several cases that explain the possible actions open to a board of directors that has received a demand

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59 DEL. CODE ANN., tit. 8, § 141(a) (West 2011).

60 P.R. LAWS ANN. tit. 14, § 2721(I) (2011). (Original text reads: "*Un miembro de la junta de directores, o un miembro de cualquier comité designado por la junta de directores, estará, en el desempeño de sus funciones, completamente protegido* y exento de responsabilidad*al confiar de buena fe en los récords de la corporación y en la información, opiniones, informes o ponencias presentados a la corporación por cualquiera de los oficiales o empleados de la corporación, o comités de la junta de directores, o por cualquiera otra persona sobre asuntos que el miembro razonablemente cree están dentro del ámbito de la competencia profesional o experta de dicha persona que fue seleccionada con cuidado razonable por o para la corporación.*").

61 Aronson et al., *supra* note 17, at 303.

from a shareholder. Estes[62] presents the following example: A shareholder, in the name of the corporation, sues management individuals in a lawsuit alleging that the corporation has been disadvantaged by inappropriate management performance and that the board of directors has refused or would refuse to represent the corporation in seeking redress. Then, the board - or a committee of the board - determines, after investigation, that it would not be in the best interests of the corporation to have the charges litigated. The board petitions the court to dismiss the shareholder lawsuit on the theory that under state law such decisions are in the exclusive province of the board.

Estes explains that the business judgment rule applies to the facts of the case; and adds that the rule is a judicial invention of the turn of the century that, in matters involving corporate governance, reflects both a preference for the resolution within the corporate structure of disputes concerning the management of the corporation and a reliance on state statutes that exalt the power of management at the expense of the traditional power of stockholders.

In *Corbus v. Alaska Treadwell Gold Mining Co.,*[63] the U.S. Supreme Court took the following position:

> The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs.[64]

Based upon the previous decision of the courts, Reisberg[65] states that a traditional view of the decision to proceed (or not) with a litigation is that

62 Estes, *supra* note 8, at 50.

63 *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455 (1903).

64 *Id.* at 463.

65 Reisberg, *supra* note 15, at 231.

said decision is a commercial one which involves balancing risks and expenses against possible advantages and is usually one for the board of directors to analyze and take.

Furthermore, the deference of the courts towards the business judgment rule increases if the board of directors is able to demonstrate ample due diligence in assessing the shareholder claims, particularly in actions such as the use of external counsel and the establishment of a special litigation committee that is truly independent from the rest of the board.[66]

However, despite the U.S. Supreme Court decision in *Corbus*, the Michigan Supreme Court ruled to the contrary more than a decade later. In the extreme the landmark case of *Dodge v. Ford Motor Co.*[67] the Michigan Court stated that:

> [A] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes. . . . it 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.[68]

Estes[69] observes that the earlier cases had established a presumption that independent directors would act honestly in the exercise of their best judgment, that they would be free of personal conflicts of interest, and that they would otherwise act in good faith. This presumption placed a burden of proof on shareholder plaintiffs that has in practice been virtually impossible to meet successfully. By late 1979, there was a clear trend in corporate law that the good faith exercise of business judgment by a special litigation committee of disinterested directors is immune to attack by shareholders or the courts.

In *Burks v. Lasker*,[70] the U.S. Supreme Court highlighted state law as controlling in corporate governance matters in the absence of a strong

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66 *See, e.g.,* Evans v. Paulson, 2007 WL 1549242 (D. Minn. May 24, 2007). (The Minnesota court establishes the primary factor to determine the independence of the special litigating committee as whether the Board delegated its power to control the litigation to a disinterested party.)

67 Dodge v. Ford Motor Co., 204 Mich. 459, 507 (1919); 170 N.W. 668, 684 (Mich. 1919).

68 *Id.* at 507; 684.

69 Estes, *supra* note 8, at 51.

70 Burks v. Lasker, 441 U.S. 471 (1979).

congressional expression of intent to the contrary; and reaffirmed the presumption of objectivity and good faith. Thus the burden continues to be on the plaintiff to disprove the exercise of independent good faith judgment. In *Burks*, the U.S. Supreme Court stated that:

> [T]he structure and purpose of the [Investment Company Act of 1940] indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders. There may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue . . . for example, where the costs of litigation to the corporation outweigh any potential recovery. . . .[71]

Estes[72] points out that the derivative lawsuits currently reaching the courts demonstrate that directors involved in the cases have been paying meticulous attention to the criteria being developed by the courts for the proper handling of these responsibilities. Directors tend to be individuals of independent stature who are experienced in the handling of complex controversial issues and thus avoid getting involved in inappropriate conduct. They take great pains in selecting counsel who themselves procure to be diligent in developing and evaluating independent sources of information. Among the determinations made by directors is judging the merits of a plaintiff's cause of action. Where merit is found, the rationale for nevertheless seeking dismissal of the action has been painstakingly developed and recorded.

The Aronson[73] case explains that requirements for the protection of the business rule are twofold. Firstly, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction; nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders. Secondly, to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. The Delaware court further explains that the business judgment rule operates only in the context of

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71 *Id.* at 484-485.

72 Estes, *supra* note 8, at 52.

73 Aronson v. Lewis, 473 A.2d 805, 812-813 (Del. 1984).

director action. It has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. However, the court recognizes that "a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule."[74]

An article from the International Financial Law Review[75] states that in recent years, Japanese corporate governance has undergone major reform to limit director liability and the power of derivative actions. Changes to Japan's Commercial Code that took effect in 2002 allow directors' liability to be limited with respect to violations of the law or a corporation's articles of incorporation when directors do not knowingly misperform their duties and when such misperformance is not grossly negligent. So long as a company's articles of incorporation allow such a limitation, and subject to certain conditions being satisfied, a company may set a limit on the amount of damages that its directors will be required to pay. One such condition is that the board of directors issues a resolution to that effect; or in the alternative, a majority of shareholder may also issue a special resolution. If a shareholder sues with a derivative action, once the action has begun, public notice or a notice to all shareholders must be provided in order to ensure that each shareholder has an opportunity to participate in the proceeding.

C. The Derivative Action And Corporate Oversight

In *Aronson v. Lewis*,[76] the Delaware Supreme Court observed that the machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid and unfaithful management. In *Rank v. Lease Associates, Inc.*,[77] the Wisconsin Supreme Court stated that derivative actions are an effective remedy for corporate abuses and that the constant potential threat of derivative action has done much to keep corporate directors responsive to the interests of the shareholders.

Based upon analysis of statistical data, Vafeas[78] understands that shareholder litigation is a more useful alternative when a firm's ownership is dispersed and neither insiders nor major unaffiliated blockholders (entities such as fund managers which control the votes of a significant quantity of directors or shareholders) are likely to guard shareholder interests. Vafeas observes that, based upon research of conflicting interests between

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74 *Id.* at 813.

75 *Japan: Corporate Governance Amendments Introduced*, 21(5) I.F.L. REV. 70 (May 2002).

76 *Aronson,* 473 A.2d at 811. .

77 Rank v. Lease Associates, Inc., 45 Wis. 2d 689 (1967).

78 Nikos Vafeas, *Shareholder Lawsuits and Ownership Structures*, 16(1) J. APPL. BUS. RES..35 (2000).

management and shareholders over a score of years, a theme that has emerged from academic research is that agency conflicts may be reduced through: a) the disciplining effects of corporate control, product and other factor markets, or b) through intra-firm mechanisms such as the board of directors, executive compensation policy, and corporate ownership structure.[79] Put simply, external blockholders help monitor management and, in their presence, shareholder lawsuits become less likely.

This is not to say that there is general agreement on the benefits of derivative actions. Authors such as Kalchev[80] have presented evidence that the quality of corporate governance has a predictive power upon shareholder litigation. Kalchev states that different measures of corporate governance appear to be significant, whether in present or lagged values. He expresses preference for having better corporate governance in order to decrease the probability of litigation and risks for managers, and ultimately protect shareholder wealth. Nevertheless, there is common agreement that – at the very least – derivative actions are a necessary mechanism to rein in directors who, to quote Uebler,[81] view law violations as a rational means of maximizing shareholder wealth (even to the detriment of said shareholders).

Reisberg[82] endeavors to go beyond the traditional view of compensation for the derivative action. He states that merely seeing the action as a form of recovering damages will keep the derivative action as subordinate to the business judgment rule when a simple cost-benefit analysis may rule out a corporation deciding on pursuing litigation. The author compares the principles behind the derivative action against those that underlie most penal codes. In effect, Reisberg proposes to establish a justification for pursuing derivative action as a deterrence mechanism against unwanted behavior; even if there is no financial compensation to the corporation or the shareholders. He makes the assumption that what shareholders lose by pursuing a costly litigation on behalf of a corporation, they'll recover through other corporations whose shares they own and whose management will refrain from illicit actions that would have otherwise forced their own derivative actions.

Although Reisberg[72] makes a fair case for extending the role of derivative actions towards enforcement of directors' duties and filling gaps in what he calls "incomplete contracts between shareholders and managers", he recognizes that selling this approach is an uphill battle. The advantage of

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79 *Id.*, at 37.

80 Georgi Kalchev, *Corporate Governance and Shareholder Litigation*, 8(2) THE ICFAI UNIVERSITY JOURNAL OF CORPORATE GOVERNANCE 41 (2009).

81 Thomas A. Uebler, *Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. CORP. L..199, 221-222 (2008).

82 Reisberg, *supra* note 15, at 241.

taking a traditional view on derivative actions, as a compensation mechanism is that there exists over a century of jurisprudence throughout the world establishing a direct correlation between shareholder litigation and a monetary value. On the other hand, deterrence is much harder to value. As with ethical and licit behavior, there is general agreement that they constitute accepted behavior, which should be encouraged; but at times, suffers when it comes to placing a corporation's money where its mouth is. Reisberg[83] concludes that any possible advantages to a deterrent approach towards derivative actions are outweighed by the action's costs.

III. Conclusion

Regardless of the preference or rejection that most authors may feel towards or against the derivative action, all agree that this type of litigation limits the protection that directors enjoy under the business judgment rule. The shareholder who owns a corporation and the director who leads it are the two most important stakeholders to the going concern of the corporation. Oftentimes, both have conflicting views regarding what decisions are best for the corporation. More often than not, conflicts arise because of a divergence between the corporation's interests and those of the person making a decision that has an impact on the corporation. As a matter of fact, conflict may arise merely because of fear and mistrust.

Under these circumstances, the derivative action is more than a mere channel through which a shareholder can protect his or her interest. Neither is it the inconvenience perceived by some corporate directors; who see the derivative action as a hindrance on their right to steer a corporation. Ultimately, it is a valid trigger that allows the court, as an unbiased third party, to bring both sides (shareholder and director alike) under its jurisdiction. By using applicable statutes – and sometimes common sense - the courts can mediate to protect the corporation even from itself.

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83 Reisberg, *supra* note 15, at 267.

EL PLEITO DE CLASE CONTRA LA CORPORACIÓN PÚBLICA PUERTORRIQUEÑA: ALGUNAS CONSIDERACIONES DE POLÍTICA PÚBLICA

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I. INTRODUCCIÓN

Las últimas décadas han visto un vertiginoso aumento en la radicación de pleitos de clase contra todo tipo de empresa.[1] No es raro toparse con noticias de pleitos de clase contra corporaciones que se acogen a la quiebra, o de consumidores de un producto electrónico que han sufrido algún daño, por pequeño que sea, que buscan constituirse en una clase para recobrar alguna compensación. Además, las ondas de televisión y radio en los Estados Unidos están llenas de comerciales de firmas de abogados especializadas en pleitos de clase orientando a pacientes de medicamentos y aditamentos médicos sobre pleitos activos contra las manufactureras del producto. Por lo general, cuando un pleito de clase es exitoso, la sentencia es por una suma considerable.

Algunos argumentan que existe una crisis de pleitos de clase abusivos, impulsado por abogados especializados que buscan cobrar una lucrativa porción de la sentencia final, mientras que los individuos de la clase que representan sólo disfrutan de la pequeña porción en que consiste su reclamación. Otros dicen que el pleito de clase es una herramienta útil para el

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1 HERNÁNDEZ COLÓN, PRÁCTICA JURÍDICA DE PUERTO RICO § 1005 (4ta ed. 2007). Dice el tratadista que "el uso del pleito de clase para estos fines estaba limitado en el foro federal hasta las enmiendas que se hicieron en 1996 . . . [que] se dio la explosión de la litigación en pleitos de clase en el foro federal que ha llegado hasta nuestros días".

ciudadano y el consumidor en general, que sirve de freno contra las prácticas abusivas de algunas empresas, a la misma vez que pueden tener un efecto publicitario devastador contra una compañía. Por otro lado, muchas de las más famosas e importantes conquistas en el campo de los derechos civiles fueron a través del mecanismo de pleito de clase.[2]

Lo cierto es que, crisis o no, la figura del pleito de clase tiene sus ventajas. En primer lugar, la certificación como clase de varias reclamaciones judiciales similares conserva los limitados recursos de la rama judicial, evitando que existan miles de pleitos con los mismos derechos y obligaciones en nuestras salas de justicia. Además, reduce el riesgo que los tribunales decidan de manera distinta ante hechos similares. Por último, permite que una persona con una acción de daños de poca cuantía monetaria pueda acceder a la justicia a través de una clase, que al aunar esfuerzos puede llevar un pleito judicial de manera apropiada. Sin embargo, un pleito de clase mal administrado, o llevado viciosamente, puede convertirse en un dolor de cabeza para cualquier tribunal que vea su expediente inundado de numerosos y complejos recursos de múltiples partes.

Más allá de analizar la figura del pleito de clase, este artículo busca analizar algunos escenarios donde una corporación pública puertorriqueña sea objeto de un pleito de clase. Exceptuando la telefonía, todos los servicios básicos del pueblo puertorriqueño son proveídos por el Gobierno a través de corporaciones públicas.[3] Éstas, facultadas por ley a funcionar como empresas privadas, tienen la responsabilidad de asegurar que la infraestructura del país funcione apropiadamente. Existen casos contra compañía proveedoras de servicios básicos en los Estados Unidos, y es previsible que en algún momento ocurra lo mismo en Puerto Rico.

Nos proponemos a analizar el escenario donde una corporación pública sea demandada en un pleito de clase, y se vea expuesta a pagar millones de dólares en un veredicto adverso. Estudiaremos las repercusiones de tal acción, y veremos si es necesario que los jueces en casos similares tengan en mente el interés público, según ha sido reconocido por el Tribunal Supremo de Puerto Rico, a la hora de otorgar un fallo contra una corporación pública, o si debería atenerse a la doctrina del pleito de clase y otorgar daños como si se tratara de una corporación particular.

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2 Brown v. Board of Education, 347 U.S. 483 (1954). *Brown* fue el responsable de lanzar el movimiento de los derechos civiles en Estados Unidos. En una histórica decisión unánime, el Tribunal Supremo de los Estados Unidos terminó con la política de segregación de razas que había existido en las escuelas públicas de los Estados Unidos desde la abolición de la esclavitud. *Brown* comenzó como un pleito de clase que la N.A.A.C.P. radicó a nombre de estudiantes afro-americanos contra el distrito escolar de Topeka, Kansas.

3 Estos son agua potable y alcantarillado, energía eléctrica, el cuidado de salud terciario, entre otros.

En la primera parte del artículo discutimos el trasfondo histórico de la figura del pleito de clase, y sus reglas tanto en Puerto Rico como en los Estados Unidos. En la segunda parte, presentaremos algunos ejemplos de sentencias otorgadas contra compañías proveedoras de servicios básicos. En la tercera parte, analizaremos la figura de la corporación pública puertorriqueña, su relación con el gobierno del Estado Libre Asociado y su tesoro, y el posible efecto de una sentencia adversa a esta en el país, tomando en cuenta la definición del interés la jurisprudencia aplicable. También, analizaremos la reciente decisión del Tribunal de Primera Instancia, que decidió no certificar como clase un grupo de consumidores que alegaban una sobrefacturación por parte de la Autoridad de Energía Eléctrica. Finalmente, haremos nuestras recomendaciones y conclusiones.

II. Un breve trasfondo histórico

El Pleito de clase es de origen anglosajón. El Profesor Yeazell, de la Universidad de Boston, propone que el origen de la litigación de grupos, y el concepto de representación que permea toda la doctrina del pleito de clases, nació con la organización de grupos de interés que buscaban acceso a los tribunales y a la justicia.[4] En el siglo XVI fueron los gremios medievales, en el siglo XVII los siervos y trabajadores del campo, en el siglo XVIII los inversionistas, en el XIX los predicadores y en el siglo XX los grupos pro derechos civiles.

El feudalismo de la edad media en Inglaterra, y la visión del colectivo hacían que el gobierno inglés funcionara como sí "el grupo, y no el individuo, fueran tratados como la unidad básica de pensamiento". Por esta razón, los grupos sociales eran partes rutinarias en una diversidad de pleitos legales. Al igual que en los pleitos de clase, los miembros de un grupo lo eran, sin poder decidir si salían o no, y habían unos representantes que acudían a corte en su nombre.

Ya para el principio del siglo XVIII, con la modernización de Inglaterra, la litigación grupal se había convertido en la excepción y no la norma. El Profesor Yeazell cree que la concentración de un poder central estatal, el enfoque en las libertades personales, el desarrollo de los grandes centros urbanos, y la creación de la corporación, entre otros, fueron los responsables de este cambio e hicieron necesaria la creación de una razón que justificara los pleitos grupales que se veían en los tribunales.

Fue la propia corporación la que proveyó la justificación para el resurgimiento de los pleitos grupales pues, durante esa época, la corporación no era otra cosa sino que un grupo de inversionistas, gerentes y empleados

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[4] Stephen C. Yeazell, From Medieval Group Litigation to the Modern Class Action (1988). Todas las citas en cuanto al desarrollo histórico de la figura son de esta obra. Por razones de espacio, no damos el detalle de las págs. en cada una de éstas.

asociados laxamente con el único fin de generar ingresos. Aunque estos grupos eran menos unidos y homogéneos que los grupos medievales, sus necesidades y objetivos eran lo suficientemente similares para justificar su ingreso a corte de manera grupal. Nuevamente, los tribunales se vieron obligados a permitir que representantes de ciertos grupos, aquellos que "ocupaban temporeramente intereses sociales y judiciales" pudieran argumentar a nombre del resto del grupo. Este acceso especial a las cortes le otorgó a estos grupos una posición privilegiada sobre el resto de la sociedad, pues podían incurrir en pleitos complejos y beneficiosos para todos, sin tener que incurrir en gastos como asegurar la presencia, participación y consentimiento, de todas las partes en un pleito.

Curiosamente, este aumento en el poder político de las corporaciones logró que a mitad del siglo XIX se detuviera casi en su totalidad el litigio grupal en Inglaterra. Fue para esta época que el Parlamento inglés le otorgó personalidad jurídica a las corporaciones, haciendo innecesario todo el andamiaje que se había levantado para justificar los pleitos grupales. A pesar de esto, para el 1830 se había publicado un tratado en Inglaterra que recogía la jurisprudencia y prácticas de los tribunales en cuanto a la litigación de pleitos grupales, y las doctrinas de representación que fundamentaban su existencia. Este tratado, de Frederic Calver, fue recogido por el norteamericano Joseph Story, que según el Profesor Yeazell, no entendió bien las doctrinas allí esbozadas y procedió a crear un sistema que duraría en la jurisdicción norteamericana por el próximo siglo.

El tratado de Story, creó la teoría de representación de intereses.[5] Esta teoría fue acogida por James Moore, en un intento por formular una regla general para los pleitos de clase en la Regla 23 de Procedimiento Federal de 1938. Poco después, la Regla fue acogida por el Tribunal Supremo en Hansberry v. Lee.[6] En ese caso, el Tribunal se enfrentó a la pregunta de sí la Corte Suprema de Illinois podía ejecutar una sentencia anterior contra unos demandados que no habían sido parte del pleito original, sin violar el debido proceso de la XIV enmienda de la Constitución federal.[7] La controversia versaba sobre un contrato que prohibía la venta de unos terrenos a afro-americanos, que había sido invalidado en un pleito anterior.[8] El presente pleito fue traído por cuatro afro-americanos que exigían se les vendiera los terrenos. Para los demandados el contrato seguía siendo válido, pues no

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5 Hansberry v. Lee, 311 U.S. 32, 44 (1940). El Tribunal Supremo de los Estados Unidos la definió como: "some members of a class may represent other members in a litigation where the sole and common interest of the class in the litigation, is either to assert a common right or to challenge an asserted obligation."

6 *Id*.

7 *Id* en la pág. 37.

8 Burke v. Kleiman, 277 Ill. App. 519 (1934).

había sido emplazados ni habían formado parte en ningún procedimiento anterior.

La Corte Suprema de Illinois concluyó "in the present case that Burke v. Kleiman was a 'class' or 'representative' suit and that in such a suit 'where the remedy is pursued by a plaintiff who has the right to represent the class to which he belongs, other members of the class are bound by the results in the case unless it is reversed or set aside on direct proceedings".[9] Al haber sido representados como clase, los resultados del mismo eran ejecutables contra el demandado, que también formaba parte de una clase en el pleito original. El Tribunal Supremo entiende que no se puede concluir que la representación del demandando en el caso anterior, donde no fue ni siquiera notificado, pueda tener efectos sobre éste en el pleito de marras. Por lo tanto, entiende que el veredicto del máximo foro de Illinois violó la XIV enmienda. La importancia de este caso es que constitucionaliza la teoría de representación de intereses,[10] pero a la misma crea dudas sobre la posibilidad de que en algún supuesto exista el interés grupal suficiente para justificar un pleito de clase.[11]

Además, durante este periodo, y según el tratado de Story, los pleitos de clase se clasificaban en tres tipos: verdaderos, híbridos y espurios. Los pleitos verdaderos e híbridos, una vez culminados, tenían efecto de cosa juzgada sobre cualquier otra acción que alguien quisiera presentar en el futuro, no así los espurios. Sin embargo, las categorías no estaban muy claras, y los tribunales enfrentaban problemas a la hora de categorizar cada pleito, además que no había un procedimiento estándar par la notificación de la clase. Este problema fue finalmente resuelto con la aprobación de la Regla 23 de Procedimiento Civil Federal en 1966.[12]

Ahora, veamos como la figura llegó a Puerto Rico. El caso normativo sobre pleitos de clase en nuestra jurisdicción es Cuadrado Carrión v. Romero Barceló.[13] Aquí, el Tribunal establece que la figura del pleito de clase llegó a Puerto Rico con el Art. 66 del Código de Enjuiciamiento Civil, que en su historial dice:

> Es menester recordar que debido al desenfrenado crecimiento poblacional, los miembros de la sociedad no alcanzan a conocer personalmente a sus demás congéneres, distinto a como sucedía en antaño cuando se habitaba en poblaciones íntimas y reducidas. Por eso es que la Regla 17 (acumulación de partes) no cumple a

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9 *Hansberry*, 311 U.S. en la pág. 39.

10 *Id.* en la pág. 43.

11 *Id.* en las págs. 44-45.

12 HERNÁNDEZ COLÓN, *supra* nota 1, § 1006.

13 Cuadrado Carrión v. Romero Barceló, 120 D.P.R. 434 (1988).

> cabalidad las distintas aspiraciones de reforma social que hallamos en diversos sectores de nuestro país y, que después de todo, son responsables de la necesidad de que haya un procedimiento eficaz disponible para adjudicar los derechos de un crecido número de personas. Con las nuevas reglas pretendemos afrontar las limitaciones que nos pone el actual sistema procesal, pues éste ya no responde adecuadamente a la urgencia del nuevo ritmo de marcha acelerada de la administración de la justicia. [14]

De este Artículo 66 pasó a ser la Regla 20 de Procedimiento Civil.[15] Entre los riesgos que el Tribunal le reconoce a la figura, se encuentran el peligro que una parte, al ser representado por otra, pierda el derecho a ser oído en un tribunal donde se adjudicarán sus derechos, y el riesgo que un caso sin una debida programación y control redunde en costos administrativos y una pobre administración de la justicia.[16] Hernández Colón nos dice que el pleito de clase es de uso muy "escaso" en Puerto Rico.[17] Añade el tratadista, que el "el pleito de clase es el medio por excelencia para hacer del derecho un instrumento de cambio social, por cuanto a través de este mecanismo se puede hacer comparecer. . . a millones de personas en procura de remedios que instrumenten la política pública que ampara sus derechos".[18]

III. REQUISITOS Y FUNCIONAMIENTO

Nos dice la hoy jueza asociada del Tribunal Supremo de Puerto Rico, Hon. Liana Fiol Matta, en su artículo *La acción de clase del consumidor*,[19] que la acción de clase "permite que una persona o un grupo de personas demande o sea demandado a nombre propio y en representación de aquellas personas en situación similar a la suya que no se encuentren ante el Tribunal". Los requisitos básicos de la acción de clase son la numerosidad de los miembros de la clase, el interés común en la litigación y la adecuada representación de la clase por los miembros que comparecen ante el Tribunal.[20] Podemos resumir los requisitos en numerosidad, comunidad, tipicidad y adecuada representación.[21]

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14 *Id.* en la pág. 445, nota al calce 4, *citando a* 32 L.P.R.A. § 316 (1983).

15 *Id.*

16 *Id*. en la 446.

17 HERNÁNDEZ COLÓN, *supra* nota 1, § 1005.

18 *Id.*

19 Liana Fiol Matta, *La acción de clase del consumidor*, 36 REV. COLEGIO ABOGADOS P.R. 683 (1975).

20 *Id.*

21 HERNÁNDEZ COLÓN, *supra* nota 1, § 1005.

Fiol Matta escribe que la acción de clase es muy particular, pues el representante de la clase se "nombra a sí mismo" la mayoría de las veces, sin el consentimiento expreso del resto de la clase.[22] A primera instancia, esto parecería una posible violación del debido proceso de ley. Sin embargo, intereses como la economía procesal, y la obtención de justicia en casos que por lo general no serían atendidos por un tribunal, han permitido la aceptación judicial y legislativa de la acción de clase.

Por ejemplo, una reclamación cuya cuantía a nivel individual no sea cuantiosa no motivaría al perjudicado a reclamar sus derechos judicialmente. Lo mismo ocurriría con su representación legal, que al hacer un análisis económico del asunto, probablemente recomendaría al individuo no llevar la acción, pues el esfuerzo y el costo de la misma superarían por mucho el posible remedio.[23] Un caso representativo es el recientemente litigio contra el servicio de renta de películas por correo, Netflix.[24] El modelo de negocios de Netflix consiste en que el consumidor paga una mensualidad, y puede alquilar un número ilimitado de películas, sin temor a pagar recargos. Las películas son enviadas por correo en un sobre predirigido. El cliente las puede retener el tiempo que quiera, y cuando las devuelva, Netflix automáticamente le envía la próxima película en su lista. Un consumidor de California descubrió que Netflix penalizaba a los clientes más activos, atrasando artificialmente el envío de películas a su casa e incumpliendo su promesa de un servicio ilimitado.

Este entabló una demanda de clase contra la compañía. La clase fue certificada, y las partes finalmente llegaron a un acuerdo donde los clientes de Netflix recibirían un mes gratis como compensación. El valor real mensual de la suscripción de Netflix puede ser tan bajo como seis dólares o tan caro como cuarenta y ocho dólares, una cantidad muy pequeña como para que alguien entable un pleito individualmente. Sin embargo, una clase puede organizarse, y hacer que la compañía compense el daño por sus prácticas ilícitas contra los consumidores.

Además, el pleito de clase permite que grupos marginados racial, económica, o socialmente aúnen sus esfuerzos en pleitos colectivos que no estarían al alcance de un individuo.[25] Sin embargo, las últimas décadas han traído una proliferación de pleitos de consumidores contra corporaciones y gobiernos, que no tan sólo buscan resarcir al consumidor de alguna daño de

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[22] *Fiol Matta*, *supra* nota 19, en la pág. 684.

[23] *Id.* citando a James L. Starr, *The Consumer Class Action – Part II: Considerations of Procedure*, 49 B.U. L. REV. 407, 417 (1969).

[24] Frank Chavez v. Netflix, Inc., Case No. CGC-04-434884 (California, 2006). Netflix creó un sitio de internet para que los miembros de la clase se registraran. Además, el sitio contiene los detalles del acuerdo. Disponible en línea en http://www.netflix.com/Settlement (última visita 23 de mayo de 2008).

[25] *Fiol Matta*, *supra* nota 19, en la pág. 684.

poca cuantía, sino que al incluir en la reclamación el daño a una clase completa, sirven como *disuasivo por su impacto económico y publicitario* a las corporaciones y empresas a la hora de atentar contra los derechos de sus consumidores.[26]

A. Pleitos de Clase en los Estados Unidos

Los pleitos de clase en los Estados Unidos están regulados por la Regla 23 de Procedimiento Civil Federal.[27] La Regla establece cuatro prerrequisitos para certificar un pleito como clase. Estos son: que la clase sea tan numerosa que unirlos a todos es poco práctico; que hayan cuestiones de hecho y derecho comunes a la clase en general; que las alegaciones de los demandantes y las defensas de los demandaos sean típicas de la clase; y que haya una adecuada representación de parte de los que ejercen su derecho en el Tribunal hacía los miembros de la clase que no comparecen personalmente. Es decir, los requisitos de numerosidad, comunidad, tipicidad y adecuada representación que nos describió la juez Fiol Matta.

Las reglas además incluyen tres parámetros para que los tribunales se basen al momento de determinar si se certifica la clase. La presencia de uno de éstos es suficiente para la certificación como clase. En primer lugar, el juez debe preguntarse si permitir múltiples acciones de parte de la clase crearía un riesgo de sentencias inconsistentes y contradictorias que no permitirían a los demandados comportarse de cierta manera en todos los casos, o si atender los casos individualmente crearía un problema o atentaría contra los intereses de las personas no representadas en el pleito. En segundo lugar, el juez debe ponderar si la parte que se opone a la certificación de la clase se ha comportado de manera tal que afecta a la clase en general, y existen fundamentos para emitir un interdicto o sentencia declaratoria que actúe como remedio apropiado a la clase en general. Por último, el juez puede sopesar si las cuestiones de hecho y derecho típicas a toda la clase predominan sobre cualquier otra cuestión de hecho o derecho disponible a uno de los individuos de la clase en su carácter personal, y si el pleito de clase es un vehículo judicial superior a cualquier otro método alterno disponible.

La Regla utiliza cuatro factores para determinar si se debería certificar la clase en cuanto a este último estándar. Primero, hay que medir el interés de los miembros de la clase en controlar el flujo del caso en acciones separadas. Dos, la naturaleza y extensión del litigio, y si la clase es la demandante o la demandada. Otro factor que debe considerar el tribunal es la deseabilidad de concentrar el litigo en un solo foro. Por último, se deben

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[26] *Id.* en la pág. 686.

[27] Regla 23 de Procedimiento Civil Federal, 28 U.S.C.A. § 1332(d).

medir las dificultades técnicas y logísticas que un tribunal enfrenta al manejar un pleito de clase.

La § 1332(d) de la Regla, otorga jurisdicción por diversidad de ciudadanía a los tribunales federales para atender pleitos de clase cuando la suma de la reclamación de la clase sobrepasa los 5,000,000 de dólares, sin considerar costas ni intereses.[28] Para que un tribunal federal tenga jurisdicción por diversidad de ciudadanía, solamente uno de los miembros de la clase debe ser ciudadano de un estado o nación extranjera distinta al de cualquiera de los demandados. Generalmente, existe una percepción de que las cortes federales son menos amigables a los pleitos de clase que las cortes

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28 28 U.S.C.A. § 1332 (d)(2). Esta Regla nace del Class Action Fairnes Act of 2005 (C.A.F.A.), una ley federal aprobada con la intención de hacer más fácil la jurisdicción federal para los pleitos de clase multi-estatales, y facilitar la opción del "removal" a los demandados. Esto responde a la percepción generalizada que los tribunales federales son más reacios a la hora de certificar pleitos de clase. La anterior norma solo otorgaba jurisdicción federal por cuantía cuando la reclamación individual de cada miembro de la clase sobrepasaba los $75,000. Ahora, se permite acumular la reclamación de la clase en general. Además, se eliminó el requisito de unanimidad de todos los demandados para solicitar el "removal", y se quitó el término de un año, a partir de la radicación de la acción en la corte estatal, para solicitar el mismo.

Además, la ley otorga al juez federal discreción de ejercer o no la jurisdicción por diversidad, cuando más de un tercio, pero menos de dos tercios, de los miembros de una clase son ciudadanos del mismo estado donde la acción se radicó. Entre las consideraciones que el tribunal debe tomar al descartar o aceptar la acción de remover se destacan: (A) si la acción involucra asuntos de alto interés público, nacional o interestatal; (B) si la acción nace de leyes del estado donde se radicó la acción, o de otros estados; (C) si la acción fue alegada de manera tal que buscara evadir la jurisdicción federal; entre otras.

La ley también niega jurisdicción en pleitos donde más de dos terceras partes de los demandados son ciudadanos del mismo estado donde se radica la acción, cuando por lo menos uno de los miembros de la clase es del mismo estado que un número significativo de los demandados o cuando la causa de acción ocurre en el mismo estado donde se radica la acción, entre otras. La ley hace excepción de estos requisitos cuando la parte demandante incluye oficiales de gobierno. Específicamente, "Paragraphs (2) through (4) shall not apply to any class action in which—(A) the primary defendants are States".

El Federal Justice Center se ha dedicado a estudiar el impacto de C.A.F.A. en la radicación, litigación y resolución de pleitos de clase. En su más reciente informe, de abril del 2008, se ha encontrado que C.A.F.A. ha tenido un impacto significativo en el comportamiento de los abogados a la hora de radicar acciones de clase. En primer lugar, ha habido un aumento dramático de casos radicados por diversidad de ciudadanía en todos los distritos federales, de un promedio de 11.9 mensuales antes de C.A.F.A., a 34.5 luego de la nueva regla. Además, los "removals" de la jurisdicción estatal a la federal, que aumentaron con la aprobación de C.A.F.A., se han reducido a niveles similares a los que existían antes de la ley.

Estas estadísticas sugieren que la ley ha tenido el impacto esperado, y que los abogados han alterado su comportamiento, pues ya no intentan evitar la jurisdicción federal, y acuden directo al tribunal federal. Emery G. Lee III, Thomas E. Willging, *The Impact of the Class Action Fairness Act of 2005 on the Federal Courts: Fourth Interim Report to the Judicial Conference Advisory Committee on Civil Rules*, FEDERAL JUDICIAL CENTER, April 2008.

estatales, por lo que es común que un demandando busque remover el caso a la jurisdicción federal.[29]

B. Pleitos de clase en Puerto Rico

La Regla 20 de Procedimiento Civil rige los pleitos de clase en Puerto Rico. Esta es prácticamente una traducción de la regla federal, con los mismos cuatro requisitos iniciales para la certificación de una clase: 1) un grupo tan numeroso que incluirlos a todos en una demanda sería impracticable; 2) que existan cuestiones de hecho y de derecho comunes a toda la clase; 3) las reclamaciones o defensas del grupo representativo sean típicas de las reclamaciones o defensas de la clase; y 4) que los representantes tengan la capacidad de proteger los intereses de la clase de una manera justa.[30]

Además, y al igual que las reglas federales, para certificar el pleito como uno de clase en Puerto Rico, se debe cumplir por lo menos uno de los siguientes requisitos: 1) que si se tramitaran pleitos individuales, se correría el riesgo de decisiones judiciales inconsistentes o podrían afectarse sustancialmente derechos de personas individuales; 2) que la parte que se opone haya asumido una posición aplicable a la clase en general, de suerte que un injunction o sentencia declaratoria resolvería el caso para todos; 3) que el juez debe concluir que las cuestiones de hecho y derecho comunes son más importantes en el pleito que cualquier reclamación individual que haya.

El caso normativo sobre los pleitos de clase en Puerto Rico es *Daisy Cuadrado v. Romero Barceló*.[31] Allí el Tribunal Supremo denegó certificar como clase a un grupo de maestros que alegaron ser discriminados por razones políticas al no ser ascendidos a plazas permanentes. Luego de discutir los requisitos y el trasfondo histórico de la figura, nuestro más alto foro resuelve que el pleito no cumplía con los requisitos de comunidad, pues "no se puede concluir que existan cuestiones comunes o que sus reclamaciones sean extensivas al grupo" pues el acceso a los puestos de maestros no se logra al descartar el elemento de discrimen político del panorama. Hay requisitos de preparación académica, méritos, excelencia en el servicio público, entre otros, que hacen necesario que cada caso se discuta y analice en sus méritos.

IV. Ejemplos de pleitos de clase contra compañías de servicios públicos en los Estados Unidos

[29] Amanda Griscom Little, *Eric Brokovich, Drop Dead*, SALON (12 de febrero de 2005), disponible en http://dir.salon.com/story/opinion/feature/2005/02/12/class_action/index.html (última visita 4 de enero de 2011).

[30] Regla 20.1 de Procedimiento Civil. 32 L.P.R.A. Ap. III, Regla 20.1.

[31] Cuadrado Carrión v. Romero Barceló, 120 D.P.R. 434 (1988).

En nuestra investigación encontramos una serie de pleitos de clase contra corporaciones privadas que ofrecen servicios análogos a las corporaciones públicas puertorriqueñas. Por lo general, son pleitos contra compañías de cable televisión,[32] telefónicas y de celulares, por cargos excesivos y violación del contrato de servicio. El primer caso es *Dotson v. Bell Atlantic*, una servicio telefónico en el estado de Maryland.[33] En este caso, la clase incluía a todas las personas que fueron clientes de la compañía desde el 1995, o cualquier persona que haya sido cliente durante ese periodo y haya pagado una penalidad por atraso de pago. El pleito fue traído bajo la Ley de protección del consumidor del Estado y la Constitución de Maryland que impone un tope de 6% del cobro de cualquier tipo de intereses ("usury cap"). Luego de la certificación como clase, las partes llegaron a un acuerdo.

El acuerdo original, solo otorgaba a la clase un veredicto a su favor de $135,000 (lo que se traducía a solo seis dólares para cada miembro de la clase), mientras asignaba una partida de $13 millones en honorarios para los abogados de la clase. Este acuerdo fue impugnado con éxito ante el Tribunal de Apelaciones de Maryland por la "Trial Lawyers for Public Justice". La opinión citada asigna un síndico especial del Tribunal para que determine una nueva cuantía de daños para la clase, y una partida ajustada a la realidad del caso en honorarios de abogados.

El segundo caso es *Ting v. AT&T*.[34] En este, se certificó una clase de consumidores de servicios de larga distancia, alegando que una enmienda unilateral por parte de AT&T al contrato de servicio de telefonía era inoficiosa. La enmienda obligaba a todo cliente de la compañía a acogerse a un proceso mandatario de arbitraje antes de llevar una reclamación judicial, además de imponer un término de dos años para llevar una acción contra la proveedora. La corte federal del distrito norte de California encontró esta cláusula como "unconscionable", en su modalidad de sorpresa. Una cláusula de un contrato es "unconscionable" por sorpresa cuando la parte que controla el poder económico y el ritmo de la negociación redacta el contrato unilateralmente y de manera tal que sus obligaciones estén escondidas. En apelación, la Corte para el 9no Circuito confirmó el dictamen en cuanto a la

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32 Aunque no podemos decir que el servicio de televisión por cable es uno de naturaleza esencial, utilizamos ejemplos de pleitos de clase contra compañías de esta naturaleza, pues ofrecen su servicio de la misma manera que las compañías de utilidades públicas. Entiéndase, poseen un monopolio natural, los clientes no tienen opción entre competidoras y facturan una tarifa más o menos uniforme, entre otras.

33 Dotson v. Bell Atlantic of Maryland, CAL 99-21004 (Maryland, 2003).

34 Ting v. AT&T, 182 F. Supp. 2d 902 (2002). Existe un caso similar ante la consideración del Tribunal Supremo del estado de Washington, McKee v. AT&T, 164 Wash. 2d 372 (2008), donde una clase que aún no ha sido certificada, impugna varias cláusulas similares a la ya descualificada por el Tribunal Federal en *Ting*.

invalidez de la cláusula.[35] De la faz de las opiniones surge que el único remedio otorgado fue un interdicto permanente impidiendo la entrada en vigor del nuevo contrato.

Otro pleito de clase incoado contra una compañía telefónica es *Campbell v. Air Touch Cellular d.b.a. Verizon Wireless*.[36] En este caso, también radicado en un tribunal del estado de California, se impugnaban ciertas prácticas impropias de cobro, mercadeo y ventas. La clase fue certificada, y Verizon tuvo que enviar sobre 27 millones de notificaciones a clientes alrededor de todos los Estados Unidos informándoles sobre el pleito. Además, se consolidaron en la corte pleitos estatales similares de otras jurisdicciones. Las partes llegaron a una estipulación. En la misma, Verizon se comprometió a cambiar sus prácticas corporativas, enmendar sus reglamentos y políticas, y publicar los términos de sus contratos en español. Además, Verizon le ofreció a todos sus clientes dos cupones como compensación.[37]

En los casos analizados vemos como se manifiestan varias características de los pelitos de clase. En el primer caso, Dotson, observamos como abogados especializados en pleitos de clase pueden abusar del sistema que tan bien conocen, aprobando acuerdos con los demandados que los benefician primordialmente a ellos y perjudican a la clase. Afortunadamente, en ese caso los tribunales fueron diligentes y detuvieron el abuso. En el segundo caso, *Ting*, podemos ver como a través de un pleito de consumidores, promovido por una organización y no por particulares, se puede lograr acceso a los tribunales y terminar con una práctica abusiva por parte de una empresa poderosa. Esto es un ejemplo de la figura del pleito de clase funcionando apropiadamente. Por último, en Campbell vemos como el pleito de clase es una herramienta útil para que una clase numerosa pueda obtener remedios apropiados, que individualmente representan una cuantía ínfima, pero que en la contabilidad de la empresa que viola los derechos de los consumidores representa una partida importante de recursos. Ahora, analicemos la figura de la corporación pública en el ordenamiento jurídico y social puertorriqueño, y veamos las repercusiones que un pleito de clase, como los aquí descritos, pudiera tener sobre ésta.

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35 Ting v. AT&T, 319 F.3d 1126 (9th Cir. 2003).

36 Campbell v. Cellular, 2006 Cal. App. Unpub. LEXIS 2459.

37 El primer cupón le daba la opción al cliente de escoger entre un descuento de $15 dólares en su contrato anual, seis meses de mensajes de texto gratis, un 25% de descuento en accesorios hasta un máximo de $15 dólares, una tarjeta de llamadas de larga distancia con un valor de $120, o un crédito de hasta tres dólares mensuales por ocho meses. El segundo cupón otorgaba al cliente un dispositivo "hands free" para su móvil, o un cupón de $15 para la compra de otro dispositivo de mejor calidad. La sentencia no especifica sobre el monto otorgado en pago de honorarios de abogados.

V. LA CORPORACIÓN PÚBLICA PUERTORRIQUEÑA

Como dijimos anteriormente, la mayoría de los servicios básico en Puerto Rico son provistos por el Gobierno a través de corporaciones públicas. El Art. 27 del Código Civil de Puerto Rico le otorga personalidad jurídica a las corporaciones públicas, cuando su ley orgánica así lo diga.[38] Establece que la misma comenzará desde "el instante mismo, en que con arreglo a derecho, hubiesen quedando válidamente constituidas". El Art. 30, establece las facultades de esa personalidad jurídica, que incluyen el adquirir y vender bienes de toda clase, contraer obligaciones y ejercitar acciones civiles o criminales, conforme a las reglas y leyes de su constitución.[39] He aquí la principal característica de una persona jurídica, el poder demandar y ser demandada.

Nuestro Tribunal Supremo ha definido la corporación pública como "una institución que ofrece un servicio económico o social en nombre del gobierno, pero como una entidad jurídica independiente; conduce sus operaciones con gran autonomía, aun cuando es responsable ante el público, a través del gobierno y del parlamento, y sujet[a] a alguna directriz de parte del gobierno; equipada, por otro lado, con sus propios fondos independientes y separados, y con los atributos jurídicos y comerciales de una empresa comercial. Estos atributos colocarían a la corporación pública en algún lugar intermedio entre una autoridad pública pura y una compañía comercial de derecho privado".[40]

En *Pagán v. E.L.A.*,[41] se enumeran los seis principios principales para determinar si una agencia gubernamental es una corporación pública: a) poseer ingresos propios, b) tener autonomía fiscal para realizar préstamos, emisión de bonos y cuentas bancarias, c) poseer propiedades, d) contar con una Junta de Directores, e) poder aceptar donaciones, y f) tener capacidad para concertar acuerdos o contratos.[42]

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[38] Art. 27, CÓDIGO CIVIL DE PUERTO RICO, 31 L.P.R.A. § 101.

[39] Art. 30, CÓDIGO CIVIL DE PUERTO RICO, 31 L.P.R.A. § 104.

[40] Commoloco of Caguas v. Benítez, 126 D.P.R. 478, 490 (1990), *citando a* W. FRIEDMAN, THE PUBLIC CORPORATION: A COMPARATIVE SYMPOSIUM 541 (traducción en el original).

[41] Pagán v. ELA, 131 D.P.R. 795, 805 (1992). Este caso ofrece un buen trasfondo sobre la corporación pública, tal como su creación y proliferación en Puerto Rico.

[42] *Id.* Otros factores que se pueden considerar incluyen: si los empleados de la agencia concernida están cubiertos por la Ley de Personal del Estado Libre Asociado; si los servicios prestados por la agencia, por su naturaleza intrínseca, nunca han sido prestados por la empresa privada; si la agencia está capacitada para funcionar como una empresa o negocio privado; si la agencia de hecho funciona como una empresa o negocio privado; el grado de autonomía fiscal de que disfrute la agencia; el grado de autonomía administrativa de que goce; si se cobra o no un precio o tarifas por el servicio rendido (precio que debe ser básicamente equivalente al valor del servicio); si los poderes y facultades concedidos en la ley orgánica de la agencia la asemejan fundamentalmente a una empresa privada; y si la

Esta distinción es importante a tenor con la doctrina de inmunidad soberana del Estado. A grandes rasgos, la doctrina impide que se inste un procedimiento judicial contra el Estado en sus propias cortes, a menos que éste consienta a ello.[43] El Estado renunció parcialmente a esta inmunidad en la Ley de pleitos contra el Estado.[44] Decimos parcialmente, pues aunque se puede demandar al estado en pleitos de daños y perjuicios, donde se halle responsabilidad al gobierno el máximo de la sentencia no puede sobrepasar los $75,000 por cada causa de acción, hasta un máximo de $150,000. Sin embargo, esta ley no aplica a las corporaciones públicas, pues al funcionar como negocios privados, tienen la misma responsabilidad que pudiera tener una corporación privada que preste servicios similares.[45] Por lo tanto, una reclamación contra una corporación pública puede ser por una cantidad mayor a la establecida por la Ley de Pleitos contra el Estado. Esto, en lo que a un pleito de clase se refiere, podría representar una sentencia multimillonaria contra la corporación pública.

A pesar de esto, nuestro Tribunal Supremo ha reiterado en múltiples ocasiones el aspecto público de estas corporaciones, sobretodo en cuanto a sus fondos operacionales. En *Commoloco*, el tribunal nos dice que a pesar de su autonomía en operaciones y presupuesto, las corporaciones públicas nunca "pierden su cualidad de instrumentalidad gubernamental, creada para responder a propósitos de utilidad pública" y los fondos de éstas "se consideran como públicos, independientemente de que éstos no pasen a formar parte del presupuesto del Estado".[46] La dicotomía entre negocio privado y público, es lo que convierte en un tema de análisis interesante el choque entre el pleito de clase y la corporación pública. A continuación, discutimos más a fondo esa dicotomía.

VI. LA FUNCIÓN GUBERNAMENTAL ESENCIAL DE LA CORPORACIÓN PÚBLICA

En *Librotex v. Autoridad de Acueductos y Alcantarillados*,[47] nuestro Tribunal Supremo se enfrentó al problema de si se podía embargar los activos de una corporación pública como método de asegurar una sentencia judicial. La decisión es importante para este escrito, pues otorga una protección adicional sobre los fondos de las corporaciones públicas. Librotex era una corporación dedicada a la impresión de libros y panfletos, acreedora de la Autoridad por $2,514,650.80. Luego de recibir un dictamen judicial en

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agencia tiene o no la capacidad para dedicarse en el futuro a negocios lucrativos o a actividades que tengan por objeto un beneficio pecuniario. *Id*.

43 Defendini v. E.L.A., 134 D.P.R. 18, 40 (1993).

44 LEY DE PLEITOS CONTRA EL ESTADO, 32 L.P.R.A. §§ 3077-84.

45 Opinión del Secretario de Justicia, Op. Sec. Just. Núm. 14 (1986).

46 Commoloco of Caguas v. Benítez, 126 D.P.R. 478, 491 (1990).

47 Librotex v. Autoridad de Acueductos y Alcantarillados, 138 D.P.R. 938 (1995).

cobro de dinero a su favor, Librotex procedió a radicar un embargo de los fondos de las cuentas bancarias de la Autoridad. La Autoridad acudió al Tribunal de Instancia en auxilio de su jurisdicción, alegando que al tratarse de un organismo estatal, sus fondos y bienes eran inembargables. El Tribunal falló a favor de la Autoridad, y Librotex recurrió al Tribunal Supremo.

En una opinión mayoritaria del juez Negrón García, el Tribunal analiza sucintamente la figura de la corporación pública y los servicios que éstas brindan a la ciudadanía. En primer lugar, cita la ley habilitadora de la Autoridad, que claramente dice, "El ejercicio por la Autoridad de los poderes conferidos por las secs. 141 a 161 de este título se estimará y juzgará como una función gubernamental esencial".[48] Luego, y sin apoyarse en doctrina o fuente judicial, establece que: "[l]a suma que ha de ser embargada es considerablemente alta. Si bien reconocemos que las peticionarias son acreedores por sentencia de la Autoridad, las consecuencias extraordinarias que el embargo tendría sobre dicha entidad requieren que reconozcamos esta protección [la protección solicitada por la Autoridad]. No incidió, pues, el tribunal de origen al dejar sin efecto el embargo".[49]

Entre los factores que considera nuestro más alto foro es la crisis financiera por la que atravesaba la Autoridad en esa época, y la sequía que afectaba al país. Entiende la opinión mayoritaria que una sentencia permitiendo el embargo agravaría aún más la crisis.[50] Como remedio, el Tribunal ordena a la demandada a incluir en su próximo presupuesto operacional una partida para pagar la deuda de Librotex, pues "este remedio haría justicia cumplida a las peticionarias, a la vez que mantendría a la Autoridad libre de gravosas y monumentales cargas inmediatas que podrían desestabilizar su importante gestión pública, principalmente hoy que vivimos un momento de crisis en la suficiencia de los abastos de agua".[51] En general, la opinión mayoritaria de *Librotex* parece imponer una prohibición total al embargo en contra de las corporaciones públicas, pues realizan una función gubernamental esencial.

El juez Rebollo López escribe una opinión concurrente, en la que se une la juez Naveira de Rodón, pues está de acuerdo con el resultado, pero entiende que no procede una la regla general de prohibición de embargos contra los bienes de una corporación pública esbozada por la opinión mayoritaria, ". . . [pues] es extensiva, no sólo a todos los acreedores por

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48 LEY DE ACUEDUCTOS Y ALCANTARILLADOS DE PUERTO RICO, 22 L.P.R.A. § 142.

49 *Librotex*, 138 D.P.R. en la pág. 942.

50 *Id.* en la pág. 943. *citando a* D.A. Díaz Suárez, *Los jueces ante la crisis de la justicia*, 523 REV. GENERAL DE DERECHO 1669, 1673 (1988). "Las aportaciones de la labor judicial al conglomerado social se reconocen fácilmente en tiempos de crisis y cambio social en los que, al cuestionarse la vigencia de ciertas normas generales, se impone una mayor dosis de creatividad y remodelación de la materia jurídica".

51 *Id.*

sentencia de la AAA, sino que a todos los acreedores por sentencia de las restantes corporaciones públicas que operan en nuestro País, no importa la cuantía de los créditos judiciales de los referidos acreedores."[52] La concurrente entiende que aunque la corporación pública no pierde su cualidad de instrumentalidad gubernamental, a pesar de la autonomía e independencia que la caracteriza,[53] éstas están sujetas "a procedimientos judiciales como en circunstancias análogas lo estaría cualquier empresa privada, siempre que tal procedimiento no *interfiera con la ejecución de sus funciones ejecutivas*".[54] Este estándar de interferir con la ejecución de sus funciones ejecutivas es importante, pues con toda probabilidad una sentencia en un pleito de clase sería por una cantidad mayor a la de *Librotex*.

Para la concurrente, una sentencia con una suma de dinero extraordinariamente alta tendría el efecto de interferir con la ejecución de sus funciones ejecutivas. El juez Rebollo entiende que ésta sería la situación en *Librotex*. Además, propone un análisis de cuatro puntos para que los jueces apliquen en situaciones similares y determinen si la cuantía a ser embargada por el tribunal interfiere con la ejecución de las funciones ejecutivas de una corporación pública: a) la cuantía envuelta b) la condición fiscal al momento del embargo solicitado de la corporación pública, c) las consecuencias extraordinarias que el embargo de los fondos pueda ocasionar, y d) si el mismo interfiere con la ejecución de las funciones ejecutivas.[55] Sin duda, ésta opinión es importante a la hora de analizar un posible pleito de clase contra una corporación pública, pues establece claramente la dicotomía entre la corporación pública y privada, y la peculiaridad de sus fondos públicos. Nos parece que el estándar de interferir con la función ejecutiva de la corporación es uno que podría aplicarse a la hora de pagar una hipotética sentencia en un pleito de clase contra una corporación pública.

VII. EL COBRO EXCESIVO DE LA AUTORIDAD DE ENERGÍA ELÉCTRICA

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52 *Id.* en la pág. 945.

53 *Id.* en la pág. 947, *citando a* Commoloco v. Benítez, 126 D.P.R. 478 (1990).

54 *Id.*, *citando a* Arraiza v. Reyes, 70 D.P.R. 614, 618 (1949) (énfasis suplido). En ese caso un ciudadano privado, Arraiza, buscó embargar un crédito de la AAA que Reyes tenía a su favor por construir unas obras en Cabo Rojo para la corporación pública. Reyes se defendió de la acción diciendo que ese crédito era inembargable pues se trataban de fondos estatales. El Tribunal negó tal protección. Dijo que los fondos de una corporación pública eran embargables siempre y cuando no se afectará el ejercicio de sus funciones ejecutivas.

55 *Id.* en la pág. 953. El juez Hernández Dentón escribe una opinión disidente y concurrente, pues recomendaría que se adoptara como regla el estándar expuesto por la concurrente, pero ordenaría que fuera el Tribunal de Primera Instancia quien se ocupara de aplicarlo de acuerdo a la evidencia del caso.

Recientemente, un grupo de consumidores entablaron varios pleitos contra la Autoridad de Energía Eléctrica (AEE) por supuesta sobrefacturación, basadas en la fórmula de ajuste por petróleo y compra de energía que la AEE incluye en todas sus facturas mensuales.[56] El Tribunal consolidó todos los casos presentados en *Pérez Kolp v. Autoridad de Energía Eléctrica*,[57] y lo catalogó como uno complejo. Luego establecido el comité timón de abogados que dirigirían el litigio, radicaron una demanda enmendada solicitando que se les certificara como clase. En general alegaron que desde el 1990 la AEE ha estado cobrando 11% en exceso a sus abonados, transfiriendo a éstos los subsidios y la compra de energía a las co-generadoras de electricidad que venden su producción a la Autoridad. En síntesis, la AEE tiene unas obligaciones en ley de subsidiar ciertas operaciones municipales y de comprar la energía generada por las co-generadoras privadas, y en vez de cumplirlas directamente, estaba transfiriendo el monto de estos gastos a los consumidores.[58]

Los demandantes definieron la clase como: "todos los abonados de la Autoridad de Energía Eléctrica de Puerto Rico, consumidores de dicha electricidad, que desde 1990 hasta el presente en sus facturas mensuales se les incluye cargos excesivos y/o ilegales según se detallan en las diferentes causas de acción enumeradas en esta demanda". La AEE se opuso a la certificación.

Entre las determinaciones de hecho emitidas por el Tribunal se destacan: que la clase está definida de una manera muy extensa;[59] que "debido a que los abonados en la clase varían sistemáticamente en cuanto a la forma en que se les factura por la AEE, la clase propuesta consiste de por lo menos 149 grupos de abonados cuyas facturas se computan de la misma manera, y que dentro de esos 149 grupos no hay un abonado que esté en una situación similar a la de los otros abonados de ese mismo grupo;[60] además, ninguno de los 149 grupos puede representar a los otros grupos, ya que las diferencias son notables;[61] y que de resultar victoriosos en este litigio, se eliminaría el 11% para todos los abonados, lo que beneficiaría a algunos pero perjudicaría a otros, pues ese por ciento no es uniforme, sino que representa una proporción distinta para cada consumidor, dependiendo el monto total

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56 El pleito fue radicado a base de un informe del Contralor de Puerto Rico, el CP-04-27, que concluyó que la AEE había sobrefacturado a sus clientes $49.8 millones en exceso desde 1998 hasta el 2003. Informe del Contralor, CP-04-27, en la pág. 11.

57 Pérez Kolp v. Autoridad de Energía Eléctrica, Civil Núm. KDP2005-1591.

58 *Id.* en las págs. 2–5.

59 *Id*. en la pág. 21.

60 *Id.* en la pág. 21.

61 *Id*. en la pág. 21.

de su factura.[62] En conclusión, el Tribunal entendió que de prevalecer los demandantes "serían los consumidores de la AEE quienes afrontarían los resultados de este litigio, a través de aumentos en sus facturas de energía eléctrica".[63]

Quizás la determinación de hecho más importante, en cuanto a este escrito se refiere, es la última, que reproducimos en su totalidad: "Además, si se incorporan a la facturación de la AEE las reducciones propuestas por la parte demandante se le restarían $370,000,000 a la economía de Puerto Rico, lo cual significaría un impacto total sobre la economía de Puerto Rico entre 600 millones y 1.2 billones de dólares. Y, ese efecto, se sentiría por toda la economía, pero se concentraría en determinados sectores de la comunidad. En los lugares donde se concentraría esa pérdida de hasta 1.2 billones de dólares, es difícil pensar que una rebaja de 12% de su factura de energía eléctrica equivaldría a una compensación justa".[64] Es claro que el Tribunal está incluyendo consideraciones en cuanto al bien común a la hora de certificar o no el pleito como uno de clase. Al igual que hizo el Tribunal Supremo en *Librotex*, aunque no lo cita, el juez de instancia incluye en sus determinaciones de derecho consideraciones sobre el fin público de las corporaciones públicas, y su efecto sobre el bienestar del país en general.

En sus conclusiones de derecho, el juez entiende que la clase no cumple con los requisitos para ser certificados como tal. En primer lugar, nos dice el tribunal que no se cumple con el requisito de comunidad entre los demandantes, pues no todos están afectados negativamente por la alegada sobrefacturación.[65] Descansó en la prueba pericial para afirmar que "entre los 1.4 millones de clientes de la AEE existían diferencias sustanciales que dominan, por mucho, las características que tienen en común".[66] El Tribunal también dice que no se cumple el requisito de tipicidad, pues existe un claro conflicto de interés entre las partes, el cual, de prevalecer, se perjudicarían muchos miembros de la propia clase con un alza en sus facturas.[67]

El tribunal despacha el requisito de adecuada representación, diciendo que la presencia de conflicto de interés entre las partes hace imposible cumplir con el requisito de representación.[68] Además, el Tribunal concluye que la participación de los litigantes en el pleito ha sido insuficiente, y que han delegado casi en su totalidad en los abogados demandantes, lo que los descalifica como representantes de los 1.4 millones de abonados de la

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62 *Id.* en la pág. 28.
63 *Id.* en la pág. 28.
64 *Id.* en la pág. 28.
65 *Id*. en la pág. 30.
66 *Id*. en la pág. 31.
67 *Id*. en la pág. 33.
68 *Id.* en la pág. 34.

AEE.[69] Los demandantes apelaron ante el Tribunal de Apelaciones, que en una sucinta opinión reafirmó la decisión del Tribunal de Primera Instancia.[70]

VIII. Un hipotético pleito de clase contra una corporación pública

Analizada la figura del pleito de clase, de la corporación pública puertorriqueña y discutidos varios ejemplos de pleitos contra corporaciones que ofrecen servicios análogos a los de una corporación pública, analicemos ahora un escenario donde se certifique una clase y se resuelva en contra de una corporación pública. Presumamos, para este ejercicio, que el tribunal de primera instancia decidió certificar como clase a todos los consumidores de la Autoridad de Energía Eléctrica. Presumamos, además, que luego de desfilada la prueba y celebrado el juicio, el tribunal entiende que en efecto la Autoridad lleva más de una década sobrefacturando ilegalmente a sus clientes. ¿Qué remedios podría otorgar el tribunal?

En primer lugar, podría sentenciar a la Autoridad a pagar los $370 millones que los demandantes alegan la corporación sobrefacturó al momento de la sentencia. Procesalmente esta es la solución más simple, pues solamente requiere que se divida la cantidad en una forma equitativa entre todos los miembros de la clase. Esto se podría hacer mediante el pago, a cada miembro de la clase, de la cantidad cobrada ilegalmente u otorgando un crédito a cada cliente por la cantidad adeudada. Sin embargo, la sencillez de esta solución afectaría grandemente a la Autoridad de Energía Eléctrica. El presupuesto de la Autoridad para el año 2008 es de $3,368,140,000 billones de dólares,[71] lo que implicaría que una sentencia de $370,000,000 millones de dólares erogaría el 9% del presupuesto total de la agencia para el 2009.[72] Como corporación pública no puede acogerse al procedimiento de quiebra, ni puede comenzar a vender activos o propiedades de alto valor, pues es la única autorizada a prestar el servicio de electricidad en la Isla, y no sería posible encontrar un comprador para una planta generadora de electricidad si este no la va poder utilizar.

Una erogación de casi el 10% del presupuesto de la corporación seguramente implicaría un aumento inmediato en las tarifas de energía

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69 *Id.* en la pág. 35.

70 Pérez Kolp v. Autoridad de Energía Eléctrica, 2007 PR App. LEXIS 3168. No discutimos la sentencia en detalle, pues se trata de un mero resumen de la figura del pleito de clase y su jurisprudencia. Al tratarse de una sentencia interlocutoria, la opinión del Tribunal Apelativo se circunscribió a analizar si el TPI abusó de su discreción al no certificar la clase.

71 *Presupuesto recomendado para el año fiscal 2009*, Oficina de Gerencia y Presupuesto, *disponible en* http://www.presupuesto.gobierno.pr/Tomo_II/energiaElectrica.htm (última visita el 4 de enero de 2011).

72 Decimos 2009, pues a tenor con lo resuelto en *Librotex*, la AEE se vería obligada a presupuestar la partida de la sentencia en su próximo presupuesto operacional.

eléctrica, pues no podrían cumplir las obligaciones con sus bonistas, ni con los convenios colectivos de sus empleados. Lo que a su vez afectaría la economía y el bienestar general del país, y posiblemente los bonos generales del ELA. Por otro lado, un aumento de 9% en la factura de la luz, eliminaría casi en su totalidad la compensación de 11% a la que la clase tendría derecho según los hechos del caso. Nos parece entonces, que aún sin entrar en lo que dijo el Tribunal en *Librotex*, esta primera opción no es viable.

Otro curso que podría seguir el Tribunal es el de otorgar un crédito a pagarse a prorrata por la Autoridad. El juez podría ordenar a la Autoridad a dar un descuento a sus clientes por un periodo de tiempo definido, hasta que se cubra la totalidad de la deuda. Este mecanismo es más flexible, pues podría distribuirse por un periodo de tiempo prolongado y reducir así el impacto a las finanzas de la AEE. Por ejemplo, un crédito por treinta años significaría unos $12.3 millones al año o un 0.004% del presupuesto total de la agencia. Sin embargo, aunque esta cantidad sea manejable para la corporación, no resuelve del todo el problema pues habría que pagar los honorarios de los abogados de la clase.

Digamos que los abogados quieren cobrar, y el tribunal así lo concede, el 33% del monto total de los daños, o sea $122,100,000. De ser así, estaríamos ante un escenario similar al anterior. Obviamente, no es probable que un tribunal apruebe una cantidad tan exorbitante de honorarios, pero podría aprobar una cantidad menor, por ejemplo un 5% del veredicto, lo que serían $18.5 millones de dólares. Esta cantidad, que representa el 0.5% del presupuesto anual de la corporación, a primera instancia no parecería entorpecer las operaciones presupuestarias de la agencia. Pero un análisis más profundo nos dice otra cosa. Por ejemplo, la partida recomendada para aumentos de sueldo y compromisos de convenios colectivos de los empleados de la Autoridad para el año 2009 es de $26,738,000.[73] Pagarle a los abogados tan solo el 5% del veredicto, podría afectar esas partidas, lo que obligaría a la agencia a subir las tarifas, o de lo contrario enfrentarse a un déficit presupuestario o a problemas laborales. Por otro lado, prorratear esa cantidad a 30 años, si es que eso fuera posible a tenor con los Cánones de ética que rigen la profesión, tan solo significaría $616,666 anuales, partida que seguramente no cubriría, al menos durante los primeros años, el trabajo realizado por el equipo de abogados de la clase, ni los gastos que incurrieron en peritos, expertos, documentos, testimonios, entre otros. Un arreglo como éste podría afectar la disponibilidad de que una clase pueda conseguir representación legal en el futuro, además que no eliminaría la paradoja del consumidor que más adelante explicamos.

Al parecer, cualquier manera en que se diseñe un remedio monetario tendría consecuencias serías sobre el presupuesto de la corporación, y a su

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[73] *Presupuesto recomendado*, *supra* en la nota 71.

vez, sobre el presupuesto del ELA. El pleito de clase contra la corporación pública pone al consumidor ante una paradoja, pues si logra conseguir un veredicto a su favor, siempre se verá afectado al final pues acabaría pagando el aumento en las tarifas que la corporación tendría que realizar para pagarle. Quien único se beneficiaría en un escenario como el antes descrito serían los abogados de la clase, quienes asegurarían una partida para sí mucho mayor a la que tendrían que pagar como consecuencia del aumento en la tarifa.

Sin embargo, como consumidores, este arreglo no nos parece satisfactorio. Rendirse ante este panorama implicaría otorgarle una patente de corso a las corporaciones públicas para que abusen de sus consumidores, pues saben que al final del trayecto no existe modelo judicial capaz de hacerle justicia al consumidor sin, a la misma vez, afectarlo. Además, sería derrotar la política pública del pleito de clase de abrir los tribunales a reclamaciones pequeñas que no tendrían cabida en nuestras salas de justicia si no pudieran agruparse, y sólo serían aquellos con capacidad económica, o los que consumen una mayor porción del servicio ofrecido por la corporación, los que tendrían un incentivo para acudir al tribunal, pues no importa si al final la Autoridad se ve obligada a subir las tarifas, el ahorro de ellos será mayor proporcionalmente al aumento de los demás.

Entonces, ¿existe realmente una solución? La primera que se nos ocurre es la solución política. El pueblo, si así lo desease, podría escoger a líderes políticos comprometidos con terminar con la figura de la corporación pública como mecanismo exclusivo para prestar servicios esenciales. Una vez privatizadas, las corporaciones perderían la protección judicial y su carácter estatal, y estarían sujetas a todo tipo de reclamación de clase. En caso de verse afectados por un pleito de clase, podrían acogerse al procedimiento de quiebra, o vender sus activos y pagar la sentencia.

Por otro lado, el tribunal podría aplicar el procedimiento expuesto por el juez Rebollo en su opinión concurrente en *Librotex*, es decir: a) la cuantía envuelta b) la condición fiscal al momento del embargo solicitado de la corporación pública, c) las consecuencias extraordinarias que el embargo de los fondos pueda ocasionar, y d) si el mismo interfiere con la ejecución de las funciones ejecutivas. Aunque la aplicación de este estándar significaría que la corporación sólo tenga que pagar hasta el nivel donde no interfiera con sus funciones ejecutivas, por lo menos algo tendría que desembolsar a favor de los consumidores. Esta solución también tiene la ventaja del costo político. Una sentencia que declare que una corporación pública ha estado abusando del consumidor puertorriqueño tendría efectos directos, y contundentes, sobre la alta gerencia de la Agencia y el gobierno de turno.

Otra posible solución sería que la legislatura extienda la doctrina de inmunidad del Estado a las corporaciones públicas y establezca un límite sobre el monto que se puede recobrar de las mismas en un pleito de clase.

Aquí también se podría aplicar el estándar del juez Rebollo a la hora de confeccionar la legislación y poner como límite un por ciento del total del presupuesto de la corporación como el máximo que se puede otorgar a una clase en caso de una sentencia adversa a la corporación. Esta legislación podría incluir salvaguardas para evitar que los costos de la sentencia se transfieran al consumidor, obligando a la corporación a pagar la misma de fondos discrecionales, como aquellos destinados a aumentos y beneficios marginales de sus ejecutivos, a gastos de publicidad y otros que no afecten los compromisos laborales, programáticos ni financieros de la corporación pública. Estas salvaguardas servirían de incentivo para que los altos directivos de las corporaciones se aseguren de nunca abusar del consumidor puertorriqueño.

Por último, la legislatura podría desautorizar completamente la radicación de pleitos de clase de consumidores contra las corporaciones públicas. El costo político de una medida como esta sería considerable, más no implica que no sea viable o ilegal. Claro, los efectos de una medida como esta serían nefastos pues eliminaría cualquier obligación de la agencia a dar cuenta sobre sus prácticas de facturación o sus relaciones contractuales con sus clientes. Además, incentivaría a la corporación a llegar a acuerdos extrajudiciales con cualquier cliente quejoso, de manera que no se enteré el público en general de sus prácticas en perjuicio de la ciudadanía.

IX. Conclusión

Sin duda, la efectividad del pleito de clase se enfrenta a varios obstáculos ante la corporación pública puertorriqueña. La paradoja del consumidor a la hora de llevar un pleito es patente, y no hemos encontrado una solución simple que satisfaga a la misma vez los principios y objetivos de la acción de clase de los consumidores y los principios y objetivos de ofrecer los servicios básicos de un pueblo a través de corporaciones públicas. Sin embargo, ante esta incertidumbre la opción no puede ser ignorar el problema. Aunque la sentencia en *Pérez Kolp* parece indicar que existen pocas posibilidades de que se certifique una clase que contenga a todos los consumidores de servicios públicos del país, esto no quiere decir que no vaya a pasar. Además, nada impide que la creciente tendencia en los Estados Unidos de otorgar grandes sumas de dinero como compensación en pleitos de clase tarde o temprano llegue a nuestras costas.

Lo que sí sería inaceptable es que se elimine la disponibilidad del pleito de clase contra las corporaciones públicas. Más allá de derrotar la justificación de los pleitos, y significar un retroceso en el movimiento en favor de los derechos de los consumidores, una acción así crearía incentivos adicionales para que el gobierno, a través de las corporaciones públicas, no sea transparente en sus procedimientos y en la facturación a los ciudadanos.

Podrían inflar las tarifas de las corporaciones, inmunes a un pleito judicial, y convertir las mismas en fuentes de poder político para los allegados al gobierno en el poder. Muchos ya perciben que esto es así, y eliminar el pleito de clase consolidaría esa percepción en la ciudadanía.

Es menester principal de la legislatura atender este problema con seriedad. Debería añadir este elemento como un esfuerzo de replantearse la figura de la corporación pública en general ante las realidades del siglo XXI, la globalización y la competitividad de la isla. De ésta no actuar le corresponde a los tribunales. Nos parece que el esquema del juez Rebollo en *Librotex* es el más apropiado en caso de que un tribunal tenga que atender este problema. El estándar ofrece un balance apropiado entre los derechos del consumidor y la protección de la política pública de que sea el gobierno quien provea ciertos servicios a la ciudadanía.

A fin de cuentas, este debate termina siendo uno de política pública y de la visión del país que queremos. Si como sociedad, entendemos que la prestación de servicios públicos debe ser llevada a cabo por el gobierno, entonces tenemos que renunciar a ciertos privilegios e instrumentos legales, como sería el pleito de clase que otorga sentencias multimillonarias como castigo. Pero este interés tiene que limitarse a que el pueblo sea dueño de sus servicios básicos, y para esto no es necesario que el gobierno tenga mano libre para abusar de sus constituyentes con la excusa de proteger el patrimonio nacional.

Terminamos este artículo resaltando un pleito de clase contra una corporación pública puertorriqueña cuyo resultado final cumplió con los objetivos que dieron vida a la figura, haciendo justicia a una comunidad cuyos residentes de manera individual nunca hubiesen podido mover el aparato gubernamental. Esto sucedió en el pleito de Agua Pa'l Campo contra la Autoridad de Acueductos y Alcantarillados el cual cumplió su objetivo y la comunidad de Cubuy en Canóvanas hoy disfruta de un servicio de agua eficiente como el que se merecen.[74] El representante de la clase, Carlos Navarro, se expresó así sobre la sentencia final:

> Éstas son las cosas que hay que contar a sus hijos . . . se comienza desde abajo y estos son los resultados cuando la gente se une. Esta comunidad siempre ha estado dispuesta y donde estuvo la palabra, estuvo la acción. Este País no camina si la gente no lo hace caminar.[75]

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74 Limarys Suárez Torres, *Culmina el pleito judicial Agua Pa'l Campo*, EL NUEVO DÍA (16 de mayo de 2008).

75 *Id.*

En esas palabras, el señor Navarro resume elocuentemente el por qué no se puede eliminar completamente el pleito de clase del arsenal del consumidor a la hora de enfrentarse a las corporaciones públicas.

FALLING SHORT: HAS THE SEC'S QUEST TO CONTROL MARKET MANIPULATION AND ABUSIVE SHORT-SELLING COME TO AN END, OR HAS IT REALLY JUST BEGUN?

RICHARD E. RAMIREZ*

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I. BACKGROUND

A. Brief Introduction

Despite continued attempts by regulators to curtail abusive short-sales and increase transparency, the pattern and practice of fraudulent manipulation continues to proliferate and threaten the capitalization of a wide variety of issuers within the securities market. Identifying a meaningful resolution requires analyzing capital market objectives and addressing the inequities of our current regulatory scheme.

B. Capital Market Objectives

The key attribute of a sophisticated capital market system is overall market efficiency.[1] In an efficient market, the price of a security generally

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reflects all current public and private information that is available to investors.[2] Since all market participants are privy to the same information, no investor has the ability to significantly outperform another.[3] Market efficiency requires a delicate balance of two critical elements. The first element, informational efficiency, is defined as the speed and accuracy with which prices in the market reflect new information.[4] The second element, price continuity, is a characteristic of a liquid market whereby the price movements between transactions are relatively small as a result of the large number of buyers and sellers of a security.[5]

An efficient market functions optimally when both of these ends operate in unison. The market value of securities would reflect the present value of expected future cash flows and revaluation would occur as new information is produced and disseminated.[6] The U.S. Supreme Court effectively affirmed this concept in 1988 when it held:

> With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.[7]

The relationship between informational efficiency and price continuity allows valuation to reach new highs or lows in a methodical manner while maintaining confidence and liquidity within the market.[8] The sustained liquidity would result in low transaction costs, reduced risk and a nominal market rate of return for investors.[9] Issuers of securities within the

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1 *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

2 *See Id.* at 383.

3 *See* Jay Shanken & Clifford W. Smith, *Implications of Capital Markets Research for Corporate Finance*, 25 FIN. MGMT., 98, 98 (1996).

4 *See* Douglas M. Branson, *Nibbling at the Edges—Regulation of Short Selling: Policing Fails to Deliver and Restoration of an Uptick Rule*, 65 BUS. LAW. 67, 75 (2009).

5 *See Id.*

6 *See* Shanken & Smith, *supra* note 3, at 99.

7 *See* Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988).

8 *See* Douglas M. Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy and the Individual Investor*, 75 NW. U. L. REV. 857, 896-97 (1980).

9 *See* Yakov Amihud & Haim Mendelson, *Liquidity, Asset Prices and Financial Policy*, 47 FIN. ANALYSTS J., 56, 56-57 (1991).

market would experience stable asset pricing, which is of particular importance in the capital budgeting process as the issuers strive to meet their operating capital obligations and maintain solvency.[10] Moreover, the liquidity would offer issuers quick access to capital and preferential financing opportunities to grow or downsize their businesses as they deem appropriate.

Imbalances in the relationship between informational efficiency and price continuity may have detrimental effects on the market. An overabundance or dearth of information would cause prices to move quickly and erratically, often revaluing securities some distance away from a previous equilibrium.[11] The resulting volatility would increase risk and transaction costs, and reduce liquidity as more investors exit the market in search of more stable investment opportunities.[12] Issuers would be faced with a higher cost of capital, as risk-averse investors require higher expected returns to match the increased risk.[13] These factors may interfere with the issuers' ability to raise capital to meet their operating obligations and remain solvent, as well as their capacity to obtain favorable financing opportunities.[14] Accordingly, while informational efficiency and price continuity often work at cross-purposes, a degree of both is necessary for overall market efficiency.[15]

C. Short-Selling

The securities market is made up of buyers and sellers – all of whom utilize various strategies to effectuate transactions and maximize their return. Among these strategies is the short-sale, which is generally defined by the SEC as the sale of a security that the seller does not own but has borrowed for delivery to the buyer.[16] In a short-sale, the investor speculates that the price of a particular security will decline and subsequently proceeds to borrow the stock from a broker or institutional investor for sale in the market at its present value.[17] If the price falls as predicted, the seller can purchase an equivalent security at the lower price from the market, return it

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10 *See* Shanken & Smith, *supra* note 3, at 101.

11 *See* Branson, *supra* note 4, at 74-76.

12 *See Id.*

13 *See* Amihud & Mendelson, *supra* note 9, at 56.

14 *See* Zachary T. Knepper, *Future Priced Convertible Securities and the Outlook for "Death Spiral" Securities Fraud Litigation*, 26 WHITTIER L. REV. 359 (2004).

15 *See* Branson, *supra* note 4, at 74-76.

16 *See* SEC Rule 200(a) of Regulation SHO, 17 C.F.R. § 242.200(a) (2011).

17 *See* Alexis Brown Stokes, *In Pursuit of the Naked Short*, 5 N.Y.U. J. L. & BUS. 1, 3 (2009).

to the lender, and keep the difference as profit.[18] Although short-selling poses obvious risks to the seller, it is a legitimate trading strategy regulated by the SEC and a practice generally endorsed for its positive effects on securities markets.[19]

Short-selling facilitates market efficiency by increasing liquidity and the number of sellers in the market at any given time.[20] The increase in liquidity occurs when market makers and other market specialists use short-sales to offset temporary imbalances in the supply and demand of a security.[21] The added selling interest makes more shares available to purchasers and lowers the risk that the price paid for the shares will be artificially high due to a temporary shortage in the available supply of shares.[22] The increase in liquidity also occurs when investors purchase securities to cover the shares borrowed from lenders in a short-sale transaction.[23]

In addition to increasing market liquidity, short-selling also improves informational efficiency by informing the market of the trader's selling interest and reflecting the short-seller's prediction of the security's lower future value within its current market price.[24] The subsequent variation in buying and selling interests is precisely the type of information that affects the present value of the security.[25] Short-selling provides investors with an incentive to seek out inefficient or corrupt companies and bet against them, contributing to the exposure of firms like Enron and WorldCom.[26] In 2007, the Second Circuit Court of Appeals held that short-selling can help move the market price of an overvalued stock toward its true value, thus creating a more efficient marketplace in which stock prices reflect all available information about the stock's economic value.[27] Accordingly, short-selling can be a beneficial market correction device that identifies weak and fraudulent companies as well as those that are overvalued so as to prevent wasteful allocation of resources and provide for a liquid and efficient market.

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18 *See* Branson, *supra* note 4, at 74-76.

19 *See* James W. Christian, Robert Shapiro & John-Paul Whalen, *Naked Short Selling: How Exposed are Investors?*, 43 HOUS. L. REV. 1033, 1042 (2006).

20 *See* Knepper, *supra* note 14, at 369.

21 *See Id.*

22 *See Id.*

23 *See* Exchange Act Release No. 48,709 (Oct. 28, 2003), 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003) ("Short Selling").

24 *See* Christian et al., *supra* note 19, at 1043.

25 *See* Exchange Act Release No. 48,709, *supra* note 23.

26 *See* Matt Taibbi, *Wall Street's Naked Swindle*, ROLLING STONE, Oct. 2009, *available at* http://www.rollingstone.com/politics/news/wall-streets-naked-swindle-20100405.

27 *See* ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 101 (2d Cir. 2007).

D. Manipulation and Deception

The benefits of short-selling come at a high price as the practice may be abused to manipulate the market. Abusive short-sellers often create and exploit inefficiencies in the market to exceed the nominal market rate of return on their investments.[28] The U.S. Supreme Court has long recognized market manipulation and defined the process as intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.[29] The manipulation often manifests itself in cases where short-sellers spread false market rumors about the issuer to perpetuate the decline in value of a particular security in order to maximize their profits.[30] This practice can be especially dangerous in large-scale scenarios called "bear raids," where groups of traders take a short position in the stock of a particular corporation pursuant to an express or implied agreement with the intention of reducing the market price enough to trigger stop-loss orders placed by investors and institutions with long positions in the stock.[31] As the overwhelming number of sell orders cascade into the market, the stock price continues to spiral downward while the short-sellers realize tremendous profits.[32] Although bear raids are difficult to detect, there is now evidence that they have occurred in several large companies, affecting not only investors in those companies, but also obstructing market confidence over a relatively broad horizon.[33]

E. Naked Short-Selling

The naked short-sale is a perverse variation of the short-sale that has been increasingly scrutinized by regulators for its ability to dilute and depress markets – particularly when used in conjunction with manipulative trading tactics.[34] It is identical to the traditional short-sale at the outset of the transaction because both are motivated by the speculated decline in price of

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28 *See* David Weidner, *Hedge Funds Back Under Fire*, MARKETWATCH (Mar. 10, 2011), http://www.marketwatch.com/story/pequot-probe-may-serve-as-warning-to-hedge-fund-industry.

29 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

30 *See* George H. White, *Short Sale Restrictions: SEC Releases Short Sale Rule Proposals and Seeks Comments on Price Test and Circuit Breaker Proposals*, 1783 PLI/Corp 155, *158 (2010).

31 *See* Branson, *supra* note 4, at 75.

32 *See Id.*

33 *See Id.*

34 *See* Gary Matsumoto, *Naked Short Sales Hit Fraud in Bringing Down Lehman*, BLOOMBERG (Mar. 10, 2011), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aB1jlqmFOTCA.

a particular security.[35] However, the transactions are distinguished by the fact that the naked short-seller does not borrow or arrange to borrow the securities from a lender in time to make delivery to the buyer within the standard three-day settlement period required by the SEC.[36]

The SEC generally requires the short-seller to deliver securities to the buyer within three days from the date of sale to settle or "cover" the transaction.[37] This is known as the close-out requirement.[38] Settlement is regulated because brokers and investors are exposed to more market risk as the length of time between trade execution and trade settlement increases.[39] Settlement is of particular importance to the parties because it allows the short-seller to be paid and the buyer to receive legal and equitable title to the securities and all rights therein – including voting rights and the right to receive dividend payments.[40] The SEC defers to the Depository Trust and Clearing Corporation (DTCC) for settlement oversight.[41] The DTCC maintains custody of the physical securities and effectuates settlement between the parties through a change in electronic records.[42] When the short-sale is not covered within the three-day settlement period it is effectively "naked" and classified by the DTCC as a failure-to-deliver (FTD) until the short-seller delivers the shares.[43] In the interim, the DTCC proceeds to credit the buyer with equitable title through a security entitlement to the undelivered shares,[44] commonly referred to as FTDs, which the buyer may hold or trade in place of the actual securities.[45]

The basis of the naked short-selling dilemma is the independent value and alienability of the FTDs. The market makes no distinction between the undelivered securities and the FTDs.[46] The most logical explanation for this indifference is that the naked short position divides the ownership interest of the securities between the buyer and the lender from whom the short-seller

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35 *See* Stokes, *supra* note 17, at 3.

36 *See* Exchange Act Release No. 57511 (Mar. 17, 2008), 73 Fed. Reg. 15,376 (Mar. 21, 2008) ("Anti-Fraud Rule").

37 *See* Rule 204 of Regulation SHO, 17 C.F.R. § 242.204 (2011).

38 *See Id*.

39 *See* 15 U.S.C. § 78q-1(a)(1)(A)-(D) (2011).

40 *See* James J. Angel & Douglas M. McCabe, *The Business Ethics of Short Selling and Naked Short Selling*, 85 J. BUS. ETHICS, 239, 241 (2009).

41 *See* SEC Rule 17(a) of Exchange Act, 17 C.F.R. § 242.17(a).

42 *See* Christian et al., *supra* note 19, at 1050 (2006).

43 *See* Stokes, *supra* note 17, at 6.

44 *See* Angel & McCabe, *supra* note 40, at 242.

45 *See Id.* at 6-7.

46 *See Id.* at 7.

would obtain shares.[47] The buyer holds equitable title by virtue of the FTDs while the lender retains legal title through possession of the securities.[48] Accordingly, the two ownership interests may be freely traded and circulated within the market until the naked short-seller covers, after which legal title would transfer to the buyer. The significance is that the undelivered securities and FTDs may be in circulation for an indefinite period of time, and there is no limit to naked short-interest or the extent of FTDs in circulation.[49] In extreme cases of naked short-selling, the amount of shares sold could exceed the amount of the issuer's public float.[50] This would dilute the market with FTDs and create an artificial oversupply of the security akin to the overprinting of currency. There would be an increase in the security's? circulation but no increase in the underlying assets upon which its value is based. Accordingly, the dilution by prolonged FTDs would significantly reduce share value and create numerous challenges for the issuer as it struggles to obtain capital and meet its operating obligations until the naked short position is covered.[51]

The extent to which naked short-selling occurs continues to be the subject of significant debate. Current short-sale volume overshadows that which existed prior to the adoption of recent regulation and repeal of longstanding rules.[52] The DTCC does not typically release information on FTDs, but in 2005 it reported FTDs in 1/10 of 1 percent of all transactions settled and processed by the DTCC – accounting for approximately $6 billion daily.[53] Many market participants believe that short-selling is a contributor to the volatility that exists in the markets today.[54]

It is important to note that not all FTDs are the result of manipulative naked short-selling.[55] The Federal Reserve Bank of New York has stated that FTDs occur for a variety of reasons, including misunderstandings between traders over transaction details, technical problems and "daisy chain" reactions in which one FTD prevents a subsequent delivery.[56] These

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47 *See* Knepper, *supra* note 14, at 373.

48 *See Id.*

49 *See* Stokes, *supra* note 17, at 7.

50 *See* Peter Koh & Helen Avery, *Naked Shorting: The Curious Incident of the Shares that Didn't Exist*, EUROMONEY (Mar. 10, 2011), http://www.euromoney.com/Article/1001047/Naked-shorting-The-curious-incident-of-the-shares-that-didnt-.html.

51 *See* Stokes, *supra* note 17, at 7.

52 *See* Branson, *supra* note 4, at 69-70.

53 *See* Angel & McCabe, *supra* note 40, at 241.

54 *See* Branson, *supra* note 4, at 70.

55 *See* Angel & McCabe, *supra* note 40, at 242.

56 *See* Michael J. Fleming & Kenneth D. Garbade, *Explaining Settlement Fails*, 11 CURRENT ISSUES IN ECON. & FIN., no. 9, Sept. 2005, at 2-3, *available at* http://www.newyorkfed.org/research/current_issues/ci11-9.pdf.

erroneous FTDs do not violate SEC regulations. They have a minimal effect on the market because they are quickly settled upon discovery.[57]

In contrast, the prolonged FTDs caused by manipulative naked short-selling are unethical and illegal.[58] They challenge the efficient operation of capital markets and create significant obstacles for the distressed and/or undercapitalized companies therein.

F. Effects of Market Manipulation and Naked Short-Selling

The economic effects of market manipulation and naked short-selling pose a viable threat to the securities market. Small companies with limited capital are especially vulnerable to manipulation and abusive short-selling. The ability of a naked short-seller to diminish the value of stock is amplified in smaller markets that operate with reduced liquidity and higher transaction costs.[59] The subsequent decline in value can impair the company's ability to attract investors, raise capital, and negotiate financing.[60] In these situations and in the absence of other options, the company will reluctantly obtain future-priced convertible financing, commonly known as "toxic" or "death spiral convertible" financing, under which capital is accepted on unfavorable terms.[61] The lender acquires the contractual right to convert the debt into a fixed value of the issuer's stock at some future date for a variable, discounted market price.[62] For example, if the future-priced security is convertible into $10 million of common stock at some future date, the lender would receive one million shares if the borrower's common stock is valued at $10 per share or ten million shares if the borrower's common stock is valued at $1 per share.[63] The lender will receive more shares and gain a greater share of control of the borrower's company upon conversion if the stock price is lower. Accordingly, the lender is motivated to encourage or participate in manipulation and naked shorting of the company's stock – which could push the company into insolvency and eliminate investors.

The collateral damage from death spiral convertibles and manipulative naked short-selling can be devastating. According to former Under Secretary of Commerce, Robert Shapiro, naked short-selling has caused one thousand companies to collapse and cost investors nearly $100

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57 *See* Christian et al., *supra* note 19, at 1045.

58 *See* SEC Rule 10(b) of Exchange Act, 15 U.S.C. § 78j; SEC Rule 10b-5 of Exchange Act, 17 C.F.R. § 240.10b-5; and SEC Rule 17(a) of Securities Act, 15 U.S.C. § 78c.

59 *See* Christian et al., *supra* note 19, at 1059.

60 *See* Stokes, *supra* note 17, at 7.

61 *See* Knepper, *supra* note 14, at 362.

62 *See Id.*

63 *See Id.*

billion since 1997.[64] It destroyed companies that could have made valuable contributions to the economy through technology and employment and eliminated investors' savings and retirement accounts.[65] In 2003, the SEC settled a civil action against the Rhino Advisors investment firm and its President, Thomas Badian, in connection with allegations of manipulative short-selling of Sedona common stock to enhance their client's economic interest in a future-priced convertible instrument.[66] The complaint, filed by the SEC in a related proceeding against agents of the lender, alleged that defendants were ordered to short-sell massive amounts of Sedona stock with "unbridled levels of aggression" until it collapsed.[67] The complaint further alleged that short-selling accounted for 40 percent of all trading activity in the stock.[68] Small companies are often affected by a great deal of manipulation and naked short-selling within the small-cap market. This is a significant policy issue because these practices limit the growth of our economy and prevent legitimate companies from developing.

The plight of these smaller companies has drawn little concern from mainstream market commentators because many small and micro-cap companies are often revealed to be overvalued and/or fraudulent.[69] Some commentators argue that the overvalued micro-cap stocks during the dot-com bubble would have climbed even higher but for the practice of naked short-selling.[70]

The practice has been under increased scrutiny since manipulative short-sellers broadened their horizons to prey on larger companies. Overstock.com, an internet retailer, has become an icon for its campaign against naked short-selling.[71] The company alleges that naked short-sellers reduced its share price by 77 percent in less than two years.[72] Moreover, the company's trading volume has reached four to five times its float on distinct occasions.[73] CEO Patrick Byrne has stated that naked short-selling warps the

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64 *See* Christian et al., *supra* note 19, at 1040.

65 *See Id.*

66 *See Rhino Advisors and Thomas Badian Settle Claims and Agree to Pay Jointly a $1 Million Penalty*, SEC Litigation Release No. 18003, 2003 SEC LEXIS 461 (Feb. 27, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18003.htm.

67 *See* Complaint, SEC v. Andreas Badian et al., No. 06 Civ. 2621 (S.D.N.Y. Apr. 4, 2006), *available at* http://www.sec.gov/litigation/complaints/2006/comp19639.pdf.

68 *See Id.*

69 *See* Stokes, *supra* note 17, at 10.

70 *See Id.*

71 *See Id.* at 11.

72 *See Id.* at 12.

73 *See Id.*

price of small-cap companies and destroys American entrepreneurship.[74] Byrne has been a very active supporter of naked short-sale restrictions. In 2006, the state of Utah passed a law that allowed local companies like Overstock.com to collect fees from brokerage firms that failed to disclose when they could not deliver securities to the buyer.[75] However, immediately after its passage the Securities Industry and Financial Markets Association (SIFMA) filed a claim alleging violation of federal law on the basis of preemption.[76] The Utah legislature eventually repealed the law and settled the claim in 2007.[77]

The events surrounding the financial crisis of 2008 demonstrated that large corporations are not immune to the hazardous economic effects of market manipulation and naked short-selling. On March 11, 2008, approximately $1.7 million was invested on a series of options betting that shares of Bear Stearns & Co., a well-respected American investment bank, would lose more than half their value within nine days.[78] In less than one week, the number of FTDs in Bear Stearns increased nearly seventy-fold while negative rumors in the media concerning the bank's creditworthiness spawned panic.[79] By March 17, 2008, Bear Stearns stock had fallen from $62.97 to $2 per share as regulators facilitated the sale of the formerly glorified investment bank to JPMorgan Chase & Co.[80] Senator Edward E. Kaufman publicly admitted having no doubt that naked short-selling helped destroy Bear Stearns,[81] and former SEC Counsel Brent Baker argues that the large number of FTDs over the course of the week amounted to one of the most obvious cases of stock manipulation in Wall Street history.[82]

Following the crash of Bear Stearns stock in March 2008 and concerns about deteriorating stock prices at other major financial institutions later in the summer, regulators sought to introduce new restrictions on short-selling and increase their commitment to investigating naked short-sales.[83] Unfortunately, their efforts were too late to stabilize the system. Within six

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74 *See* Bob Drummond, *Games Short Sellers Play*, BLOOMBERG MARKETS, Sept. 2006, at 120, 122, *available at* http://www.buyins.net/articles/gamesshortsellersplay.pdf.

75 *See* Christopher M. Salter & Christopher F. Chase, *Short Selling and Naked Shorts in the Regulation SHO Environment*, 1617 PLI/Corp 289, *303-305 (2007).

76 *See Id.* at 304.

77 *See Id.*

78 *See* Taibbi, *supra* note 26.

79 *See Id.*

80 *See Id.*

81 *See* Press Release, Sen. Edward F. Kaufman, Kaufman Turns Up Heat on SEC to Curb Abusive Short Sales, (June 25, 2009) (on file with author).

82 *See* Taibbi, *supra* note 26.

83 *See* Andrew J. Ceresney, Gordon Eng & Sean R. Nuttall, *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225, 253 (2009).

months of the demise of Bear Stearns, abusive short-sellers targeted Lehman Brothers Holdings, another prestigious American investment bank, with the same pattern and practice of market manipulation and naked short-selling. As Lehman struggled to survive, as many as 32.8 million shares in the company were sold and not delivered to buyers – resulting in a 57-fold increase over the prior year's peak of 567,518 failed trades.[84] Former SEC Chairman Harvey Pitt attributed the massive increase in FTDs to fraud because hundreds of thousands of failed trades coincided with false speculation that Lehman was being acquired by Barclays Bank at a significant discount.[85] Subsequent speculation that the company was losing two trading partners also proved untrue.[86] Some commentators felt the collapses of Bear Stearns and Lehman Brothers were nothing more than financial assassinations committed by malicious short-sellers who infected the marketplace with disinformation to reap a murderous profit.[87] While greed may have been the motivating factor behind their behavior, the collapses highlighted several flaws in the regulatory scheme, prompting a whirlwind of reform and raising the question of whether the benefits of short-selling outweigh its risks.

G. Justification for Speculation

There is a significant policy argument against allowing short-sales in the market and it is ultimately premised on the potential for abuse by market manipulators. As discussed in the preceding sections, short-sales may be abused to exploit inefficiencies in the market and severely reduce stock prices through dilution and excessive selling pressure. Moreover, short-sale profits encourage disingenuous investors to manipulate the market through fraudulent statements and misrepresentations of fact to initiate bear raids on targeted companies.

In spite of these issues, there is at least one fundamental justification for allowing short-sales in the market. The unadulterated practice of short-selling is critical to the core operation of a fair and efficient market. Eliminating the short-sale will reduce overall market efficiency through higher prices and diminished liquidity. It is essential to an efficient market because it contributes information necessary for the proper valuation of securities and encourages investors to seek out inefficient or fraudulent companies. It also increases liquidity by allowing market makers to offset

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84 *See* Matsumoto, *supra* note 34.

85 *See Id*.

86 *See Id.*

87 *See* Robert L.D. Colby, David L. Portilla & Christian L. Land, *The Bear "Naked" Truth: Short Sales and Rumors,* PRACTICAL COMPLIANCE & RISK MANAGEMENT FOR THE SECURITIES INDUSTRY, Sep-Oct. 2009, at 45, 45.

temporary contractions in the supply of securities and reduces the risk that investors acquire overpriced stock.

The market is based on the speculation of buyers and sellers and it would be both fundamentally unfair and operationally inefficient to create an imbalance in the ability of either market participant to contribute information. Speculation is defined as the buying or selling of something with the expectation of profiting from price fluctuations.[88] There is no distinction between the act of buying or selling. The short-seller who speculates that the future value of a security will be lower is no different from the long-buyer who speculates that the future value of a security will be higher. In fact, when a short-sale is stripped of all manipulative and fraudulent externalities, it is nothing more than the inverse of a long-buy, where the investor acquires a position pursuant to speculation of an increased future value. The potential for short-sale abuse will only exist in the absence of the appropriate laws and strict enforcement. Accordingly, the goal of a free and fair efficient market can be achieved through effective regulation and enforcement to reduce market exposure to abusive practices.

II. Regulatory Landscape

A. Historical Background

The potential for abuse has led to the regulation of short-sales throughout the history of organized markets. In fact, concern over abusive short-selling and its role as a possible catalyst behind the market crash of 1929 played an important part in the formation of the original U.S. securities regulations.[89] Following the market crash of 1929, several periodicals and prominent individuals cited bear raids as reasons for both the crash and for the long recovery period.[90] Congress considered short-selling during the enactment of the Exchange Act of 1934 but was unable to determine how it would be regulated.[91] In fact, the Senate Banking and Currency Committee observed that few subjects relating to exchange practices have been characterized by greater difference in opinion than that of short-selling.[92] Congress subsequently granted authority to the SEC under Section 10(a) of the Exchange Act to regulate short-selling and purge the market of abuses connected to short-selling.[93] The regulatory structure governing short-sales

88 *See* Black's Law Dictionary (3rd ed. 2006).

89 *See* Christian et al., *supra* note 19, at 1043.

90 *See Id.*

91 *See* White, *supra* note 30, at *158.

92 *See* S. Rep. No. 73-1455, at 55 (1934). *See also* H.R. Rep. No. 73-1383, at 11 (1934).

93 *See Id.*

that emerged from the stock market crash of 1929 remained mostly unchanged for over sixty years, but additional reform became necessary as trading technology and strategies progressed.[94]

The first major reform took place in 1973 when the DTCC was created to organize and control the increasingly high volume of paperwork and diminishing level of security associated with the settlement of transactions.[95] The DTCC was designed to provide a safe and efficient mechanism for market participants to buy and sell stock. The DTCC would retain custody of the physical securities and the transfer of shares would be effectuated by a simple change in records.[96] Prior to its formation, brokers employed a complicated network of couriers to physically deliver stock certificates to buyers for settlement of previously executed transactions.[97] This haphazard system grew increasingly difficult, inefficient, and expensive during the late 1960s after the U.S. securities market experienced an unprecedented surge in trading volume.

The advent of the new paperless system may have resolved all of the inequities of the system it replaced, but, in doing so, it created a series of legal loopholes under which financial innovators could cheat the market. Under the old system, short-sellers had to physically borrow paper shares prior to execution of a short-sale.[98] The new system, however, merely required short-sellers to make a good faith effort to locate the shares they wanted to borrow.[99] There was no requirement in place to prevent a disingenuous broker, who promises to loan one short-seller a particular allocation of its shares, from making the same promise to numerous others. Brokers were essentially able to lend shares they did not possess while short-sellers could sell shares they never borrowed.

The most significant loophole in the new system was the absence of a requirement for the short-seller to deliver actual shares to the buyer.[100] If the short-seller defaulted on delivery, either because the located shares were now unavailable or because he simply had no intention of borrowing them, the DTCC would credit the buyer with phantom FTD shares in place of the originals.[101] These FTDs had economic value and could be traded as if they were original shares of the stock purchased by the buyer.[102] In the short-

94 *See* Christian et al., *supra* note 19, at 1043.
95 *See Id.* at 1050.
96 *See Id.*
97 *See* Taibbi, *supra* note 26.
98 *See Id.*
99 *See* SEC Rule 10a-2 of Exchange Act, 40 Fed. Reg. 25,445 (June 16, 1975).
100 *See Id.*
101 *See* Koh & Avery, *supra* note 50.
102 *See* Matsumoto, *supra* note 34.

term, only the DTCC, which maintains records of delivery obligations, would recognize the absence of the real assets in the buyer's account.[103] Furthermore, there was no requirement for the actual shares to be delivered by the defaulting short-seller, allowing the market to grow saturated with phantom FTD shares.[104] Accordingly, the new system provided financial innovators with a legal loophole for the counterfeiting of stock and the foundation for naked short-selling.

The problems stemming from the DTCC loopholes were largely unnoticed until 1993, when Susanne Trimbath, an economist working for the DTCC, was approached by a group of transfer agents who found a discrepancy between the number shares outstanding and the number of votes cast in corporate elections.[105] In a traditional short-sale, the lending party gives up his right to vote when he lends the shares to the short-seller for delivery. The buyer will then become the shareholder of record and the only person who can vote with those shares. Trimbath concluded that naked short-sales did not account for share ownership and because of that, multiple owners were assigned to one share.[106] This effect of this problem, which has yet to be resolved, could be widespread in the context of corporate governance if naked short-selling is used to control the outcome of the shareholder vote.

The DTCC has often been criticized for its neglect and indifference to short-selling. In the early 1990s, Trimbath approached the DTCC and expressed concern over the effects of naked short-selling.[107] The DTCC virtually ignored the problem and held that naked short-sales only accounted for a small percentage of the $1.8 quadrillion in assets handled by the DTCC in any given year.[108] This paradoxical explanation neglected to consider the fact that virtually any percentage of such a significant value would be material. Moreover, the opportunity costs of that percentage and the financial leverage they could provide to the shorted companies are worth noting. In 2004, the SEC finally sought to address the naked short-sale issue, pursuant to numerous complaints from investors, with the adoption of Regulation SHO.

B. Evolution of Regulation

1. Regulation SHO (2004)

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103 *See Id.*

104 *See* Taibbi, *supra* note 26.

105 *See Id.*

106 *See Id.*

107 *See Id*.

108 *See Id.*

Regulation SHO represented the first significant change to the regulation of short-selling since 1938, when the SEC began to regulate the practice in a declining market.[109] It also represented a significant change of direction for the SEC in combating naked-short selling after many years of silence on the issue. Promulgated in 2004, Regulation SHO was comprised of SEC Rules 200, 202T and 203 – the latter of which adopted a three-part approach for dealing with manipulative short-selling.[110]

The first component established uniform locate requirements which restricted broker-dealers from accepting short-sales unless, pursuant to Rule 203(b)(1), the short-seller borrowed the security or entered into a bona fide arrangement to borrow the security, or pursuant to Rule 203(b)(2), the short-seller had reasonable grounds to believe that the security could be borrowed by the delivery due date. The second component, pursuant to Rule 203(b)(3), required exchanges to publish a daily list of threshold securities, which represents individual companies with at least 10,000 shares or more than 0.5% of the company's total outstanding shares sold short and not delivered to a buyer for five consecutive trading days. The third component, pursuant to Rule 203(b)(3), required broker-dealers to cover their FTD positions in the threshold securities within thirteen days and restricted them from engaging in any further short-selling of the threshold securities until their positions were settled.

Ambiguity within the language of Regulation SHO undermined its efficacy in reducing persistent and prolonged FTDs. In particular, the construction of Rule 203(b)(2), which allowed broker-dealers to execute a short-sale if the short-seller had "reasonable" grounds to believe that the security could be borrowed, included a potential loophole for market participants that surreptitiously intended on using naked short-sales to manipulate the market.[111] The loophole revolved around what might constitute a reasonable belief when the broker-dealer did not rely on an easy-to-borrow list,[112] and the extent to which the lack of firm guidelines would motivate manipulative broker-dealers to substitute their own subjective interpretation of a "reasonable belief" to meet the standard.[113]

Regulation SHO contained two questionable exemptions to the uniform locate requirement. The first exemption applied when a broker-

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109 *See* Exchange Act Release No. 34-1548 (Jan. 24, 1938), 3 Fed. Reg. 213 (Jan. 26, 1938).

110 *See* Stokes, *supra* note 17, at 45-46.

111 *See* Christian et al., *supra* note 19, at 1071-1072.

112 List that is published daily and contains securities with a high degree of liquidity or shares outstanding to help ascertain delivery for short-sellers who plan to borrow the securities and sell them immediately. *See* Release No. 34-50103 (July 28, 2004), 48 Fed. Reg. 48,008 (Aug. 6, 2004) ("Short Sales").

113 *See Id.*

dealer accepted a short-sale from another broker-dealer.[114] This exemption was problematic because the thirteen-day clock for mandatory settlement would reset with each trade, allowing broker-dealers to refrain from settling their positions for an indefinite amount of time.[115] The second exemption applied when a naked short-seller was engaging in bona fide market making.[116] This was arguably the most problematic of the three exemptions because almost anyone could apply to become a market maker and take advantage of the exemption to engage in legalized naked short-selling.[117] Identifying abuse under this exception was very difficult because a bona fide market making transaction could evolve into an aggressive naked short-selling scheme over an extended period of time if the shares are never covered and the transaction results in prolonged FTDs.[118] In addition to the two exemptions, the SEC also reserved discretionary power to exempt people, transactions, and practices from the rules without public disclosure.[119] Accordingly, public confidence in the ability of Regulation SHO to effectively control abusive short-selling was undermined by its provision of numerous avenues for short-sellers to continue with the manipulation that Regulation SHO was intended to eliminate.

Regulation SHO failed to address or provide a solution to companies that remained on the threshold list for extended periods of time.[120] In theory, a market participant responsible for an extended FTD would purchase the equivalent securities on the market and deliver them to reduce the number of FTDs, increase market price, and cause the threshold stock to be removed from the list. In practice, these threshold stocks remained on the list for months, or even years, at a time with no upward movement in stock price and no significant change in FTDs.[121] The likely explanation for this phenomenon lies within the first exemption to the locate requirement, which resets the clock for mandatory settlement and subsequently allows broker-dealers to refrain from covering for an indefinite period of time if they continue to trade amongst themselves.[122] Several companies, including Delta Airlines, Overstock.com, Krispy Kreme, and Martha Stewart Omnimedia, have

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114 *See* Stokes, *supra* note 17, at 47.

115 *See Id.*

116 *See Id.*

117 *See Id.* at 48.

118 *See* Christian et al., *supra* note 19, at 1073.

119 *See* Stokes, *supra* note 17, at 47-48.

120 *See* Karl Thiel, *The Naked Truth on Illegal Shorting*, THE MOTLEY FOOL. (Mar. 10, 2011), http://www.fool.com/investing/dividends-income/2008/09/22/the-truth-about-naked-shorts.aspx.

121 *See Id.*

122 *See Id.*

appeared on the list for extended periods of time.[123] The threshold list succeeded in alerting investors, regulators, and the issuers that something was wrong – but Regulation SHO failed in its inability to fix and correct the underlying problem.[124]

2. Elimination of the Uptick Rule (2007)

While the SEC promulgated Regulation SHO in 2004, it contemporaneously undertook a pilot study through the SEC Office of the Inspector General (OIG) to determine the continued efficacy of SEC Rule 10a-1(a), also known as the Uptick Rule. [125] The rule generally prohibited the short-selling of stock except upon an uptick in its price.[126] It was adopted in 1938 in response to an increasingly negative sentiment towards short-sellers and designed to prevent short-selling from being used to drive down share prices, particularly during bear raids.[127] The SEC abolished the Uptick Rule pursuant to the results of the pilot study, which cited empirical evidence in concluding there was no association between manipulative short-selling activities and price test restrictions on short-selling.[128] The SEC argued that market changes, such as increased transparency and regulatory surveillance, rendered the rule less effective and less essential in modern markets.[129] Moreover, the SEC also cited the need for regulatory simplicity and uniformity in further justifying its decision.[130] Ironically, the trading pattern that emerged from 2008 SEC data just one year later clearly indicates that naked short-selling contributed to the fall of both Bear Stearns and Lehman Brothers.[131]

At the peak of the financial crisis in 2008, critics denounced the SEC's decision to eliminate the Uptick Rule[132] and cited various limitations to the OIG pilot study – including its narrow scope and implementation during a

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123 *See* Stokes, *supra* note 17, at 50.

124 *See Id*.

125 *See* Release No. 34-50103, *supra* note 112, at 36.

126 *See* SEC Rule 10a-1(a), 17 Fed. Reg. 242.10a-1(a) (Jan. 24, 1938).

127 *See* Dan Slater, *The Latest Wachtell Memo on Short Selling: Did it Move the SEC?,* THE WALL STREET JOURNAL LAW BLOG, (July 16, 2008), http://blogs.wsj.com/law/2008/07/16/the-latest-wachtell-memo-on-short-selling-did-it-move-the-sec/.

128 *See* Regulation SHO and Rule 10a-1, Release No. 34-55970 (June 28, 2004), 72 Fed. Reg. 36,348 (July 3, 2004), at 16.

129 *See Id*.

130 *See Id.*

131 *See* Taibbi, *supra* note 26.

132 *See* Memorandum from Edward D. Herlihy & Theodore A. Levine, *It's Time for the SEC to Constrain Abusive Short Selling* (June 17, 2009) (on file with author).

period of rising market and unusually low volatility.[133] The SEC was criticized for its blind dependence on mere surveillance and enforcement efforts to address abusive activities after the damage was done.[134] Shortly after the collapse of Lehman Brothers in late 2008, the SEC announced emergency actions to stabilize the market – including the institution of a ban on the short-selling of financial stocks for 14 trading days.[135] However, the SEC did not extend the ban to bona fide market makers because of their role in providing liquidity to the market.[136] Former SEC Chairman, Christopher Cox, stated that the emergency order was not a response to unbridled naked short-selling, but instead, a preventative measure to restore market confidence. I suspect the emergency order was a combination of both because diminishing market confidence would have a direct effect on speculation and the expectation that prices would continue to decrease – motivating more legal and illegal short-selling thereafter. In retrospect, thousands of critics have blamed repeal of Rule 10a-1(a) for the significantly increased market volatility that led to severe price declines associated with the 2008 financial crisis.[137]

3. Naked Short-Sale Antifraud Rule (2008)

In 2008, the SEC adopted Rule 10b-21 as part of new SEC efforts to combat naked short-selling and highlight the liability of short-sellers who misrepresent their ability to obtain shares for trade settlement.[138] In particular, the rule prohibits short-sellers from deceiving their brokers about their ability to locate shares.[139] These deceptive practices include selling short without a bona fide good faith effort to locate the shares, misrepresenting the quantity of owned or deliverable shares, and making a bona fide good faith effort to locate but never actually attempting to borrow the shares.[140] The SEC has acknowledged that Section 10(b) of the Securities Exchange Act of 1934 already provides plaintiffs with a cause of action for manipulative and fraudulent activity – including the type that 10b-21 seeks

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133 *See Id.*

134 *See Id.*

135 *See* Emergency Order Taking Temporary Action to Respond to Market Developments, Release No. 34-58592 (Sep. 18, 2008), 73 Fed. Reg. 55,169 (Sep. 24, 2008).

136 *See Id.*

137 *See* Letter from Jim Cramer, William Furber, Eric Oberg & Scott Rothbort to Mary Schapiro, Chairman, Securities and Exchange Commission (July 8, 2009) (on file with the SEC).

138 *See* Release No. 34-58774 (Oct. 14, 2008), 73 Fed. Reg. 61,666 (Oct. 17, 2008) ("Anti-Fraud Rule Adopting Release").

139 *See Id.* at 2.

140 *See Id.* at 41.

to address.[141] The SEC further stated that the rule imposes no additional liability or requirements beyond existing Exchange Act rules[142] and was simply intended to supplement the existing federal antifraud rules.[143]

The adoption of Rule 10b-21 adds nothing to the regulatory landscape because deceptive naked short-selling has always been illegal under Section 10(b) and Rule 10b-5 therein. The SEC appears to acknowledge this fact and proceeds to state that deceptive activities are detrimental to markets and the rule should restore some measure of predictability for market participants.[144] I suspect the SEC recognized manipulative naked short-selling to be more of a problem than it was originally willing to admit. The adoption of this rule appeared to be nothing more than a reaction to political scrutiny for the 2008 financial crash as well as an attempt to stimulate and increase investor confidence in the market.

4. Firm Delivery and Settlement Rule (2009)

In addition to the antifraud provisions of Rule 10b-21, the SEC adopted temporary Rule 204T, which imposed strict penalties for delivery failures.[145] Specifically, if a short-seller fails to deliver within three days of the sale, its broker-dealer will be prohibited from facilitating any further short-sales of that security for any of its customers unless it previously arranged to borrow the shares.[146] The penalty was designed to encourage broker-dealers to prevent naked short-selling by their own customers.

Contemporaneous with temporary Rule 204T, the SEC adopted amendments to Rule 203(b)(3) to reduce FTDs in threshold securities by eliminating the options market maker exception to the firm close-out requirements of Regulation SHO.[147] The SEC conducted a balancing test and concluded that the benefits of protecting and enhancing the operation, integrity and stability of the markets as well as reducing potential short-selling abuses outweighed the costs and burdens on market makers required to cover their short positions.[148]

In 2009, the SEC concluded that it had seen a significant reduction in the number of FTDs in all equity securities since the adoption of temporary

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141 *See Id.* at 23.

142 *See Id.* at 24.

143 *See Id.* at 23.

144 *See Id.* at 27.

145 *See* Release No. 34-58773 (Oct. 14, 2008), 73 Fed. Reg. 61706 (Oct. 17, 2008) ("Amendments to Regulation SHO").

146 *See Id.* at 43.

147 *See* Release No. 34-56213 (Aug. 7, 2007), 17 Fed. Reg. 242 (Aug 14, 2007) ("Amendments to Regulation SHO").

148 *See Id.* at 16.

Rule 204T and the elimination of the options market maker exception in Rule 203(b)(3).[149] Consequently, the SEC adopted final Rule 204 and made permanent, with some differences, the firm delivery and close-out requirements for the sale of securities contained in temporary Rule 204T.[150] The differences included increased flexibility to broker-dealers by allowing them to settle FTDs by either borrowing or repurchasing securities in certain cases where a strict repurchase was required by Rule 204T and expanding the class of securities eligible for a 35-day close-out period to include certain securities the seller is deemed to own.[151]

The SEC also indicated that it would not renew temporary Rule 10a-3T, which required institutional investment managers to report their short positions, because of the significant compliance burden it placed on them.[152] In allowing the rule to expire, the SEC announced a joint effort with SROs aimed at increasing public availability of short-sale date by providing short-sale volume and transaction data on SRO websites.[153] No details have been announced, but it seems as though the agency has no intention of publicly identifying individual short-sellers or position holders.[154]

Although the disclosure requirement was dropped, the SEC issued new rules to govern short-selling and promised to provide investors with more information concerning the volume and speed of short-sales in the market.[155] The new rules are a middle-ground that highlight the SEC's struggle to identify the best way to regulate short-selling without obstructing market activity.[156]

5. The Alternative Uptick Rule (2010)

The SEC continued to experience intense political scrutiny because, despite recent rulemaking efforts, it failed to eliminate the manipulative practice of naked short-selling within the securities market.[157] The SEC subsequently held a roundtable discussion with market participants for

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149 *See* Release No. 34-60388 (July 27, 2009), 74 Fed. Reg. 38,265 (July 31, 2009) ("Amendments to Regulation SHO").

150 *See Id.* at 1.

151 *See Id.* at 43.

152 *See* Release No. 34-58785 (Oct. 15, 2008), 73 Fed. Reg. 61,678 (Oct. 17, 2008) ("Disclosure of Short Sales and Short Positions by Institutional Investment Managers").

153 *See* Kara Scannell, *U.S. Issues New Rules on Short-Selling*, WALL ST. J., July 29, 2009, at M3.

154 *See Id.*

155 *See Id.*

156 *See Id.*

157 *See* Letter from Senator Edward Kaufman to Mary Schapiro, Chairman, Securities and Exchange Commission, (Mar. 3, 2009) (on file with the SEC).

comments on reinstatement of the Uptick Rule or a variation thereof.[158] In February 2010, the SEC adopted an Alternative Uptick Rule under Rule 201 of Regulation SHO.[159] It was designed to restrict short-selling from further reducing the price of a stock that has dropped more than 10 percent in one day and enable long-sellers to sell their shares before the short-sellers once the circuit breaker is triggered.[160] The rule applies to all equity securities – regardless of whether traded on an exchange or in over-the-counter markets.[161]

The Alternative Uptick Rule is more narrowly tailored than the original. The original rule provided that, subject to certain exceptions, a listed security could be sold short only at a price above that at which the preceding sale was effected, or at the last sale price if it was higher than the last different price.[162] In simpler terms, the original rule broadly required every short-sale to be entered at a price higher than the price of the previous trade. In contrast, the Alternative Uptick Rule generally requires short-sellers to reduce the price of a security by at least 10 percent in one day before the rule takes effect, after which the security may only sold short at a price above the national best bid.[163]

I suspect the broad application of the older rule would provide prolonged protection against bear raids and naked short-selling as compared to the limited scope of the new rule. The narrow application of the Alternative Uptick Rule requires a whole 10 percent decrease in price, which can account for a significant amount of capital for a large issuer to lose within one day before the new rule offers its protection. In spite of its narrow application, the subsequent restriction on short-selling might be more effective than that of the original rule because it will only accept a short-sale at a price higher than anyone else is willing to pay – as opposed to the price of the previous trade. However, the restriction under the Alternative Uptick Rule only lasts for one day – as opposed to an indefinite period of time. This allows uncontrolled naked short-selling to promptly resume and decrease share price by another 10 percent until the cycle repeats itself again. Accordingly, the Alternative Uptick Rule represents a step in the right direction but fails to provide adequate safeguards against clever market manipulators as compared to its predecessor.

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158 *See* Release No. 34-59855 (May 1, 2009), 74 Fed. Reg. 21,423 (May 7, 2009) ("Roundtable on Short Selling Price Test Restrictions and Short Sale Circuit Breakers").

159 *See* Release No. 34-61595 (Feb. 26, 2010), 17 Fed. Reg. 242 (Mar. 10, 2010) ("Amendments to Regulation SHO").

160 *See Id.* at 121.

161 *See Id.* at 92.

162 *See* SEC Rule 10a-1(a), 17 C.F.R. § 240.10a-1(a).

163 *See* Release No. 34-61595 (Feb. 26, 2010), 17 Fed. Reg. 242 (Mar. 10, 2010) at 125 ("Amendments to Regulation SHO").

C. Enforcement and Challenges

The Securities Exchange Act of 1934 ('34 Act) was promulgated to regulate securities trading in secondary markets and designed to protect investors against manipulation of stock prices.[164] The legislative philosophy underlying the adoption of the '34 Act's extensive disclosure requirements emphasized that there could not be honest markets without honest publicity – and manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy.[165] In furtherance of its goal, Congress formed the SEC under Section 4 of the '34 Act with broad authority over all aspects of the securities industry – including the power to register, regulate and oversee brokerage firms, transfer agents, clearing agencies, and self-regulatory organizations.[166] In addressing the manipulation and dishonest practices, Congress granted the SEC authority under Section 10(a) of the Exchange Act to regulate short-selling and purge the market of abuses connected to short-selling.[167] Accordingly, the core functions of the SEC, as intended by Congress, are to enforce the rules, purge the market of short-selling abuse, and further the goal of an honest market.

The SEC has demonstrated its intention to combat manipulative short-selling in recent years through the adoption of new rules and regulations; however, enforcement actions involving naked short-selling have been extremely rare.[168] In fact, over 5,000 tips on naked short-selling abuses were emailed to the SEC between January 2007 and June 2008 – but only 123 were forwarded for further investigation and none led to enforcement actions.[169] In March 2009, SEC Inspector General David Kotz stated that the enforcement division was reluctant to expend additional resources to investigate complaints because they did not include sufficient information.[170] Kotz subsequently recommended that the division increase analysis of tips and designate a person or office to provide oversight of complaints.[171] In September 2009, the SEC announced a sweeping investigation into possible market manipulation in the securities of certain financial institutions, but findings have yet to be publicly released.[172]

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164 *See* S. REP. NO. 73-792, at 1-5 (1934).

165 *See* H.R. REP. NO. 73-1383, at 11 (1934).

166 *See* Securities Exchange Act of 1934, 17 C.F.R. § 240 (1934).

167 *See* S. REP. NO. 73-1455, at 55 (1934). *See also* H.R. REP. NO. 73-1383, at 11 (1934).

168 *See* Ceresney et al., *supra* note 83, at 256.

169 *See* Matsumoto, *supra* note 34.

170 *See* SEC SEMIANNUAL REP. (Oct. 1, 2008 – Mar. 31, 2009), at 28.

171 *See Id*.

172 *See* Press Release, Securities and Exchange Commission, SEC Expands Sweeping Investigation of Market Manipulation, (Sep. 19, 2009) (on file with the SEC).

Subsequently, SEC Chairman Mary Schapiro vowed to revitalize enforcement efforts after drawing scrutiny from lawmakers and investors for failing to follow up on tips that Bernard Madoff's money management business was a Ponzi scheme.[173]

Enforcement faces a significant challenge in proving that the market participants had the requisite intent to manipulate.[174] The dissemination of false or inaccurate information about a company is not illegal unless it is motivated by manipulative intent – even if the information has a material impact on the issuer's stock price.[175] The U.S. Supreme Court has applied a presumption of reliance on market integrity and the credibility of information circulated therein.[176] In its application, the court held:

The presumption is also supported by common sense and probability. An investor who trades stock at the price set by an impersonal market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations may be presumed for purposes of a Rule 10b-5 action.[177]Accordingly, short-sellers who contribute to the excessive selling pressure or circulate negative rumors about an issuer at a time of market distress may escape liability if they lacked manipulative intent.

Many market participants circulate rumors without manipulative intent because the dissemination of information is critical to their role as buyers and sellers as well as the overall goal of market efficiency.[178] One commenter stated that rumors, gossip, and idle speculation are the lifeblood of investors.[179] Market speculation often involves ideas and opinions that are difficult to label objectively false, unless it can be shown that the speaker had no reasonable basis for the statement or that she deliberately misrepresented her actual opinion.[180] Accordingly, the fraudulent intent of the person originating the rumor is easier to demonstrate than the intent of those who simply contribute to its dissemination.

D. Ethical and Practical Crossroads

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173 *See Hearing Before the Subcomm. on Fin. Serv. and Gen. Gov't of the S. Comm. on Appropriations*, 111th Cong. 1-2 (2009) (statement of Mary Schapiro, SEC Chairman).

174 *See* Ceresney et al., *supra* note 83, at 256.

175 *See Id*.

176 *See* Basic Inc. v. Levinson, 485 U.S. 224, 225 (1988).

177 *See Id*.

178 *See Id*.

179 *See* Jonathan D. Glater, *Whispering with Intent*, N.Y. TIMES, July 20, 2008, at WK4.

180 *See In re* Salomon Analyst AT&T Litig., 350 F. Supp. 2d 455, 465-466 (S.D.N.Y. 2004) (citing Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1095-1096 (1991)).

With the advent of recent proposed and newly adopted rules, the SEC has been able to overcome certain challenges in the regulatory environment, but other concerns remain. The SEC is faced with numerous policy issues as it tries to offset the balance of stringent and relaxed market regulation. Many corporate CEOs want the SEC to regulate short-selling extensively because of the impact it has on their businesses.[181] In contrast, many free market investors have argued for more relaxed restrictions on the practice because of its contribution to informational efficiency.[182]

The SEC must weigh ethical considerations as it strives to balance the competing interests of relaxed and stringent regulation. Traditional business ethics literature has devoted little attention to the ethical issues involved in the context of short-selling.[183] However, the facts have clearly demonstrated that short-selling creates an incentive for unethical activity – such as the rumor-mongering associated with bear raids and the conflicts of interest associated with death spiral financing. I suspect that proponents of relaxed regulation would argue that short-sellers owe no social or ethical duty to the market – and they may in fact be correct. This is why our ethical concerns should not focus on the short-sellers, but instead, the SEC. The SEC is a public government agency developed by Congress pursuant to the '34 Act – which was designed to protect investors against manipulation of stock prices.[184] Accordingly, the SEC has both a legal and ethical duty to ensure that short-selling abuses do not occur within the markets. Short-selling should co-exist with other forms of trading on a level playing field with clear boundaries established and enforced by the SEC.[185]

III. ADJUDICATION

A. Preemption and Pleading Challenges

In passing the federal securities laws after the stock market crash of 1929, Congress preserved the oversight role of the states with respect to the various blue sky laws.[186] These laws generally provided for the registration of securities and sellers of securities, required a permit from the state before the sale of securities, and gave state regulators the power to investigate

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181 *See* Stokes, *supra* note 17, at 12.

182 *See* Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and a Modest Proposal for Letting More Shorts Go Naked*, 8 J. BUS. & SEC. L. 135, 156 (2008).

183 *See* Angel & McCabe, *supra* note 40, at 243.

184 *See* S. REP. NO. 73-792, at 1-5 (1934).

185 *See* Branson, *supra* note 4, at 72.

186 *See* Ceresney et al., *supra* note 83, at 260.

firms.[187] As years passed, much of the states' authority was preempted under federal law in response to criticism that the various state approaches led a "balkanized" or inconsistent patchwork of regulations.[188]

The first challenge to adjudication arose after Congress adopted the Private Securities Litigation Reform Act of 1995 (PSLRA), which was created to reduce the outbreak of frivolous Rule 10b-5 securities litigation.[189] The PSLRA achieved this goal by increasing the pleading standards in three ways. The first component requires the plaintiff to plead each false or misleading statement with particularity.[190] If the plaintiff is unable to identify the fraudulent or misleading statements made by the defendant, the complaint will be dismissed. It should be noted that a plaintiff might be able to overcome this challenge by alleging fraud-on-the-market, where the market price of a security reflects the alleged misrepresentation and the plaintiff relies therein.[191] The second component requires the plaintiff to demonstrate a strong inference of scienter, or intent to deceive or defraud.[192] In 2007, the U.S. Supreme Court raised the standard by holding that an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.[193] This is a difficult standard to meet because the plaintiff does not have the benefit of discovery or access to circumstantial evidence that might help prove the requisite intent. The third component requires the plaintiff to prove causation, or the nexus between the plaintiff's loss and the defendant's act or omission.[194] This requires the plaintiff to be an actual purchaser or seller of the securities.[195] Moreover, the plaintiff must incur the loss after the relevant truth is revealed in order to meet the requirement.[196]

The PSLRA was flawed because it only applied to securities class action claims brought in federal courts.[197] This allowed plaintiffs to avoid the heightened pleading requirements by filing securities class action claims in state court. This forum shopping strategy resulted in a significant increase in state securities litigation for several years after the PSLRA was enacted.

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187 *See Id*.

188 *See Id*.

189 *See* Steve A. Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, 308-309 (2003).

190 *See* Private Securities Litigation Reform Act of 1995, § 101(a), 15 U.S.C. § 78u-4(b)(1).

191 *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988).

192 *See* 15 U.S.C. § 78u-4(b)(2), *supra* note 190.

193 *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

194 *See* 15 U.S.C. § 78u-4(b)(4), *supra* note 190.

195 *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

196 *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).

197 *See* Radom, *supra* note 189, at 309-310 (2003).

Congress sought to close this loophole by adopting the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The SLUSA amended portions of the Securities Act of 1933 and Securities Exchange Act of 1934 to preempt certain class action lawsuits alleged under state law in connection with the purchase or sale of securities.[198] The effect of both laws is state preemption and higher pleading standards for class action securities claims.

B. Litigation

In both federal and state courts, no plaintiff has ever won a final judgment based on naked short-selling claims and most suits do not progress beyond the initial pleadings.[199] The DTCC has often been the target of state action by plaintiffs unable to obtain relief from broker-dealers.[200] These plaintiffs typically assert common law negligence claims, by arguing that the DTCC should force settlement of FTDs to curb naked-short selling.[201] They also assert state law fraud claims, by arguing that the DTCC stock borrow program, which credits a buyers account with FTD shares, fraudulently counterfeits shares of stock.[202] The DTCC usually defends itself against the fraud claim by maintaining the position that it always holds someone accountable for an FTD, and accordingly, does not enable short-selling or fraudulent market manipulation.[203] The DTCC contends that its functions are regulated and overseen by the SEC – so any naked short-selling claims based in common law negligence would be preempted by federal law.[204] Unless Congress broadens the scope of the preemption doctrine, which already allows a state law cause of action for antifraud claims, plaintiffs' only recourse is to rely on the SEC to fulfill its responsibilities as a federal regulator.

IV. CONCLUSION

The threat of market manipulation and naked short-selling continues to proliferate and threaten the capitalization of a wide variety of issuers within the securities market. These fraudulent and manipulative practices disrupt overall market efficiency by increasing informational efficiency and reducing price continuity – causing investors to retreat from otherwise liquid

198 *See Id.* at 310.

199 *See* Stokes, *supra* note 17, at 1.

200 *See Id.* at 34.

201 *See Id*.

202 *See Id*.

203 *See Id.* at 35.

204 *See Id*.

markets and issuers to struggle with their capital obligations. The effects of these abusive practices have manifest themselves in both the failure of small companies and the collapse of highly respected investment banks.

The practice of short-selling is a very important market device that provides increased liquidity and information to the market. It helps investors identify overvalued, inefficient or even fraudulent companies – and it should not be fully restricted. The potential for short-sale abuse will only exist in the absence of the appropriate laws and strict enforcement. History has taught us the importance of adequate market regulation through the market crash of 1929 and the recent financial collapse of 2008. In both cases, market manipulation and uncontrolled short-selling contributed to the collapse of the securities market – and ultimately the U.S. economy.

The SEC has recognized market manipulation and naked short-selling to be valid problem within the securities market, but it has failed to address the problem despite active rulemaking on the subject since 2004. The SEC faces several enforcement challenges in proving intent to manipulate, because the nature of the market requires the constant dissemination of speculative information. It is also faced with balancing over-regulation and under-regulation of the market with its duty to eliminate fraud and manipulation therein. Plaintiffs are procedurally and substantively limited in their ability to actively pursue claims against alleged manipulators. Accordingly, the burden falls on the SEC to actively regulate the market and strictly enforce the federal securities laws.

The SEC should reinstate the original Uptick Rule because of its stated advantages over the recently adopted Alternative Uptick Rule at preventing potentially harmful bear raids in the market. Moreover, the SEC should establish a mandatory pre-borrow requirement similar to the system that was in effect prior to the formation of the DTCC because the uniform locate requirements of Regulation SHO clearly do not work. Manipulation and fraud have no place in a sophisticated market. If the SEC is not up to the challenge of carrying out the spirit of the federal securities laws, then we need to determine who is because the efficiency of our markets clearly depends on it.

La novación unilateral en el contrato de empleo individual a tiempo indeterminado

William Marrero Quiñones*

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> *They concern first of all the question of work, which must be regarded not merely as a commodity, but as a specifically human activity. In the majority of cases a man's work is his sole means of livelihood. Its remuneration, therefore, cannot be made to depend on the state of the market. It must be determined by the laws of justice and equity. Any other procedure would be a clear violation of justice, even supposing the contract of work to have been freely entered into by both parties.*[1]

I. Introducción

Posiblemente, en una sociedad moderna-capitalista, el contrato más importante en la vida del hombre y la mujer es el contrato de empleo. De éste dependen infinidad de otros contratos que, ahora ponen a correr la imaginación del lector, en busca de algún otro que entienda es más trascendental, con el propósito de contradecir este planteamiento.

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[1] Juan XXIII. *Mater et magistra*. Carta encíclica sobre el reciente desarrollo de la cuestión socia la luz de la doctrina cristiana. 15 de mayo de 1961. *Disponible en* http://www.vatican.va/holy_father/john_xxiii/encyclicals/documents/hf_j-xxiii_enc_15051961_mater_en.html.

Este artículo, sin embargo, no pretende discutir el abarcador tema del contrato de empleo, que de por sí ha abarrotado bibliotecas enteras alrededor del mundo. Su propósito es llevar al lector a entender el concepto de la novación dentro del contexto del contrato de empleo. Para ello, comienza por elucidar la figura del contrato en general, en la Sección II; luego aborda la figura del contrato individual de empleo, en la Sección III; lo que posibilita discutir la figura de la novación civil, en la Sección IV; y finalmente poder abordar la figura de la novación en el contrato de empleo individual, en la Sección V. La razón de tal recorrido analítico es que, aún cuando la figura de la novación en el empleo ha sido mencionada por el Tribunal Supremo de Puerto Rico en distintas opiniones, éste lo ha hecho de pasada, por lo que no le ha provisto de contenido ni la ha aplicado formalmente dentro del contexto del contrato de empleo.

II. El contrato

El contrato de empleo, como los demás contratos en Puerto Rico, está regido por nuestro Derecho civil. De tal modo, le aplican sus preceptos contractuales; específicamente, los Artículos 1206 hasta el 1266 del Código Civil de Puerto Rico.[2] Aunque vale aclarar que éstos le aplican sólo de manera supletoria, frente al Derecho laboral.

Esencialmente, el Código Civil establece que el contrato es una de las formas en que nacen las obligaciones.[3] Dispone además, que éste tiene fuerza de ley entre las partes y que debe cumplirse a tenor del mismo.[4] El contrato puede ser unilateral o bilateral y se perfecciona con el mero consentimiento.[5]

Además del consentimiento, se requiere que los contratos posean objeto cierto y causa.[6] Los mismos son obligatorios, sin importar la forma en que se hubiesen celebrado, si concurren las condiciones esenciales para su validez[7] y si no son contrarios a la ley, moral u orden público.[8] Salvo por estos requisitos necesarios para su perfeccionamiento, el Código Civil no establece otras formalidades. Excepcionalmente, en ciertas ocasiones, le establecen requisitos de forma, tales como que deberán constar en escritura pública o por escrito, según se ve en el contexto de los derechos reales.[9]

El contrato es la realización paradigmática de la *autonomía de la voluntad*. Según el tratadista español, Puig Brutau, "[e]sta autonomía significa que, en principio, todo particular puede contratar cuando quiera, como

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[2] Arts. 1206-1266 CÓD. CIV. PR, 31 LPRA §§ 3371-3525.
[3] 31 LPRA § 2992.
[4] 31 LPRA § 2994.
[5] 31 LPRA § 3375.
[6] 31 LPRA § 3391.
[7] 31 LPRA § 3451.
[8] 31 LPRA § 3372.
[9] 31 LPRA § 3453.

quiera y con quien quiera".[10] Claro, según preceptúa nuestro Código Civil, esta autonomía de la voluntad no es absoluta. Ésta está delimitada, en principio por el Código Civil. Además, según explica el mencionado tratadista, su fuerza obligacional proviene de la combinación que se da entre las voluntades de los contratantes y el efecto que la expresión de dichas voluntades produce en terceros.[11]

En conclusión, este somero recuento del Derecho civil apunta a que sus disposiciones normativas inciden sobre las relaciones contractuales que se dan en el ámbito del empleo. La razón es que éste impone una serie de deberes jurídicos que llevan a que empleador y empleado adapten sus conductas libres a un particular mandato contractual, en aras de fomentar el tráfico mercantil y la formación de capital.

III. Contrato de empleo individual

Al igual que los demás contratos, el contrato de empleo va dirigido a fomentar el tráfico jurídico. Para lograrlo, éste busca ofrecer certeza y estabilidad a esas relaciones jurídicas destinadas a crear riquezas. Pero, en comparación a otros contratos, el contrato de empleo ha tenido un desarrollo jurídico distinto. Aunque el contrato de empleo incluye la palabra *contrato*, el ordenamiento ha distinguido esta figura, asignándole un valor especial y brindándole una característica protección jurídica, no sólo a las riquezas que produce, sino a quienes trabajan para producirlas también. Algunas de las razones esbozadas para esta particular valoración jurídica son de carácter humanista o social, mientras otras son económicas, mercantiles o políticas. Irrespectivo de cuál sea la motivación hilvanada, como mínimo, ellas apuntan a que, junto al surgimiento de la relación contractual en el empleo, se confeccionaron una pluralidad de prácticas que terminaron redefiniendo, en múltiples niveles, la convivencia humana en la modernidad.

A la luz de estas consideraciones, se comienza por definir lo que es el contrato de empleo. Éste es un instrumento jurídico mediante el cual se establece una relación de trabajo entre dos contratantes.[12] Esta definición nos permite entonces distinguir al contrato de empleo del contrato de prestación de servicios, denominado por el Código Civil como arrendamiento de servicios.[13] Dicha figura, sólo considera el servicio que se habrá de ofrecer, sin pensar en la persona del trabajador. Tampoco toma en cuenta las

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[10] II-1 José Puig Brutau, Fundamentos de Derecho Civil 5 (3ra ed. 1985).
[11] *Id.*, en la pág. 16.
[12] Aunque el Tribunal Supremo ha cualificado que el contrato de empleo es uno típico de adhesión, en este artículo se optó por una definición más amplia, en aras de abarcar la multiplicidad de relaciones contractuales que pudiesen surgir en el contexto laboral. Orsini García v. Srio. De Hacienda, 2009 TSPR ___ (2009); Santiago v. Kodak Caribbean, Ltd., 129 DPR 763 (1992).
[13] 31 LPRA §§ 4111-4115.

características de colaboración y continuidad que son típicas del contrato laboral. Como bien explica Puig Brutau, el contrato de prestación de servicios del Derecho civil posibilita la prestación de un servicio a cambio de cierta remuneración dentro de una relación de dependencia, aunque no de permanencia.[14] En cambio, el contrato de empleo pretende regular una relación de permanencia. Por ello, es regido en carácter de especialidad por el Derecho laboral y sólo de forma supletoria por el Derecho civil.

El contrato de trabajo, como se le denominó en un principio y se le sigue conociendo, es un término que economistas esgrimieron por primera vez a finales del Siglo XIX. De forma jurídico-oficial, sin embargo, fue utilizado por vez primera en una ley que se redactó en Bélgica en el 1900, según nos relata el Dr. Alfredo J. Ruprecht.[15]

A modo de recuento histórico, Ruprecht menciona que, en un principio, el hombre trabajó para sí mismo, procurándose sus alimentos, abrigo y techo. Luego, con las guerras recurrentes, surgió la práctica de convertir a los vencidos en esclavos. Por ejemplo, en Roma se consideraba que el servicio militar y la agricultura eran las únicas tareas dignas para los ciudadanos, por lo que las demás faenas eran delegadas a los esclavos. Esta incipiente práctica de dividir el trabajo fue el germen para que, siglos más tarde, surgiera la mano de obra *libre* para la realización de particulares tareas que se concebían como capaz de ser delegadas en otros.

Retomando el ejemplo de Roma, se encuentra que las relaciones de trabajo de entonces se daban como un simple arrendamiento o como un arrendamiento de obras. No obstante, ya para el Medioevo, ésta había evolucionado. Ahora, los hombres se sometían a un patrono con la expectativa de recibir su protección y benevolencia; a cambio, éstos ofrecían su trabajo, fidelidad y obediencia. De esta forma, desapareció la esclavitud y surgió un nuevo modelo: la servidumbre. Éste, sin embargo, no trajo consigo un dramático cambio paradigmático, pues al igual que el modelo de la esclavitud, el trabajador era tratado como mercancía canjeable y transferible.

No es hasta la Revolución Francesa que se le dio un contenido puramente contractual a la relación de trabajo. Tanto en el *Code civil des Français* como en el *Bürgerliches Gesetzbuch*, se reconoció la dignidad del trabajador. Además, se independizó el Derecho laboral, como área especial del Derecho, y se desarrolló el contrato de trabajo. En su escrito, Ruprecht detalla más de veinte definiciones del contrato de trabajo de diferentes estudiosos del Derecho. Vale señalar que, generalmente, todas ellas giraban en torno a un vínculo jurídico o una convención bipartita en la cual una de las

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[14] II-2 JOSÉ PUIG BRUTAU, FUNDAMENTOS DE DERECHO CIVIL 384 (3ra ed. 1956).
[15] ALFREDO J. RUPRECHT, CONTRATO DE TRABAJO 3 (1960).

partes se obligaba a prestar ciertos servicios y la otra se comprometía a remunerarlos.[16]

A diferencia de la Roma de antaño y de los tiempos de la Revolución Francesa, actualmente se concibe y define de forma distinta al contrato de empleo. El ordenamiento provee a dicha figura con un tratamiento especial con el fin de brindarle unas salvaguardas mínimas al empleado y al empleador. La razón es que reconoce que dicho contrato se confecciona dentro de una relación desigual de poder, donde el empleado ostenta una posición de subordinación frente al patrono. Cuenta entonces con un conjunto de medidas que restringen la libertad de contratación de ambos con el fin de evitar que la parte contratante en desventaja económica (el empleado), se vea presionada a aceptar cláusulas u ofrecer prestaciones que le perjudiquen o sean contrarias a su voluntad. En otras palabras, las leyes sobre el empleo establecen unas condiciones mínimas e inviolables que aspiran a establecer cierto equilibrio entre las partes y a forjar un cierto grado de equivalencia entre las prestaciones. A cambio, éstas le proveen un esquema mínimo de uniformidad y seguridad a quienes dependen de la labranza del empleado (los patronos). El precio a pagar por estos beneficios es que las facultades de contratación de ambas partes son en gran medida restringidas.

De forma análoga, en Puerto Rico el contrato de empleo goza de un trato especial por el ordenamiento jurídico. Tanto así que, en ocasiones, es caracterizado como un contrato *sui generis*, en aras de distinguirlo de los tradicionales contratos al amparo del Derecho civil.[17]

Otra característica del contrato de trabajo es que existen múltiples regulaciones que gobiernan el empleo –normas limitando la duración de la jornada laboral, el salario mínimo, las licencias, vacaciones, y condiciones de trabajo, la seguridad, entre otras. Esto ha llevado a que algunos teóricos preconicen que este tipo de contrato está próximo a desaparecer, pues las regulaciones le dejan a las partes poco por *negociar*. Otros, no obstante, entienden que el contrato de trabajo es la piedra angular del crecimiento y desarrollo, de manera que la relación entre patrono y empleado sólo puede forjarse y ser comprendida a través de las voluntades que en él quedan plasmadas.

Una tercera característica es que las normas que regulan a este tipo de contrato responden a unas políticas públicas cuyo eje central es el orden público. Su premisa inarticulada es que la vida social moderna no puede ser funcional si el contexto del empleo es disfuncional. Por tanto, el ordenamiento se vale del poder de razón del estado para restringir las condiciones contractuales y laborales y considera un abuso de poder que el

[16] *Id.*, en las págs. 6-7.
[17] *Id.*, en las págs. 11-12, 23.

empleador o empleado, según sea el caso, abuse de las facultades que les confiere u omita observar sus disposiciones.

Todas estas características del contrato de empleo, sin embargo, surgieron por unas particulares necesidades de la vida moderna en una sociedad industrializada. La industrialización hizo del trabajo la única vía para el sustento y para el logro de un nivel de vida adecuado. En sus orígenes, el contrato laboral era básicamente un contrato de adhesión.[18] Esto propiciaba que muchas veces los empleados se vieran obligados a someterse a patronos inescrupulosos. Esta práctica resultó ser demasiado onerosa para los empleados y la sociedad en general. Dicho de otro modo y en las palabras del Tribunal Supremo de Puerto Rico, bajo las leyes aplicables podían "pagarse con impunidad salarios de hambre".[19] Entonces, el Estado se interpuso entre el empleado y empleador en aras de brindarle cierto poder de negociación frente al poderoso patrono.

Es por ello que la legislatura de PR, al igual que las legislaturas de otros países, comenzó a enfocar sus esfuerzos en desarrollar proyectos que potenciaran un mejor estándar de vida, tanto para los obreros como para sus familias. Algunos ejemplos de las protecciones que lograron son: (1) el pago de salarios en moneda legal de los Estados Unidos de América;[20] (2) el pago en indemnización por despido injustificado;[21] (3) el pago de compensación extraordinaria por una jornada de trabajo mayor de ocho (8) horas en un día;[22] (4) delimitación de la jornada legal diaria y semanal de trabajo;[23] (5) protección contra riesgos para la salud e integridad personal en el trabajo o empleo;[24] y (6) establecimiento de un salario mínimo,[25] igualándolo al establecido por ley federal;[26] entre otros.

Este último punto merece ser comentado. Para ello, aludimos a las palabras del Juez Fuster, cuando destacó que "nuestro propio derecho laboral, que tiene al derecho federal como modelo y que en gran medida es solo supletorio de éste, se nutre continuamente de normas federales que se

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18 Se define como un contrato en el cual la intervención de una de las partes consiste en su mera conformidad, involuntaria y muchas veces sin conocimiento real de los términos de un documento redactado unilateralmente por una empresa poderosa que le fuerza a aceptarlo. RUTH ORTEGA VÉLEZ, DICCIONARIO JURÍDICO: DERECHO PUERTORRIQUEÑO 137-138 (2005).

19 Cardona v. Corte de Distrito de Humacao, 62 DPR 61, 69 (1943).

20 Para Reglamentar el Contrato de Trabajo, Garantizar el Salario del Obrero, Imponer Ciertas Penalidades por la Violación de la Misma y Otros Fines, Ley Núm. 17 de 17 de abril de 1931, 29 LPRA § 175 (2009).

21 Ley de Despido Injustificado, Ley Núm. 80 de 30 de mayo de 1976, 29 LPRA §§ 185 a-m (2009).

22 CONST. P.R. art. II, § 16.

23 29 LPRA § 271.

24 29 LPRA § 361.

25 29 LPRA § 250.

26 Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (2006).

incorporan a nuestro Derecho por la pertinencia y vinculación que este Tribunal les reconoce".[27] Dicho esto, se elaborará a continuación, y con mayor profundidad, el asunto del contrato de trabajo.

Dentro de la teoría del Derecho civil, se concibe al contrato laboral como uno bilateral. En éste, una parte (empleado) se obliga a rendir unos servicios a la otra parte (patrono) a cambio de una remuneración que se presupone ser justa y autónoma. Esta relación de empleado se considera personalísima e intransferible, pues es contratado por sus atributos y condiciones particulares. Lo mismo no ocurre con el patrono, quien podrá ser unilateralmente sustituido.

Por otro lado, usualmente dicho contrato trata de una obligación permanente, pues una vez comenzado no tiene fecha determinada o determinable de terminación. El patrono sucesor deberá cumplir con lo pactado por su predecesor. Sin embargo, esto no significa que los contratantes quedarían obligados por el resto de sus vidas el uno para con el otro. Lo primero que hay que tomar en consideración es que, nuestra Constitución reconoce el derecho de todo empleado a "escoger libremente su ocupación y a renunciar a ella".[28] De igual forma, nuestra legislación le provee al patrono la opción de despedir a un empleado contratado sin tiempo determinado, por justa causa. Incluso, tiene la opción de despedir al empleado sin justa causa, si cumple con el pago de la indemnización que estipula la Ley Núm. 80.

La regla general es que este tipo de contrato se perfecciona como otros, con el mero consentimiento de las partes. No obstante, a diferencia de los contratos regulados por el Derecho civil, a algunos tipos de contratos y cláusulas, en el ámbito laboral, se les exigen ciertos requisitos de forma. Algunos ejemplos de éstos son el contrato de período probatorio,[29] de empleo temporero[30] y las cláusulas de no competencia.[31]

En España ocurre algo similar. Así, requieren reducir a escrito los siguientes contratos:

> [l]os de prácticas y para la formación, los contratos a tiempo parcial, fijo-discontinuo y de relevo, los contratos de trabajo a domicilio, los contratos para la realización de una obra o servicio determinado, los contratos de inserción así como los de los trabajadores contratados en España al servicio de empresas españolas en el extranjero.

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[27] Universidad de Puerto Rico v. Asociación de Profesores Universitarios, 136 DPR 335, 368 (1994).
[28] CONST. P.R. Art. II, § 16.
[29] 29 LPRA § 185 h.
[30] 29 LPRA § 185 k.
[31] Arthur Young & Co. v. Vega III, 136 DPR 157, 176 (1994).

> Igualmente constarán por escrito los contratos por tiempo determinado cuya duración sea superior a cuatro semanas.[32]

Además, el ordenamiento laboral español permite que cualquiera de las partes solicite la formalización escrita del contrato, aún cuando la relación laboral ya se hubiese iniciado.

Esta somera mirada al Derecho español sirve para ilustrar como en España, al igual que en Puerto Rico, existe un interés público de patente intensidad para con las relaciones de empleo. Ello, por tanto, justifica la intervención del Estado en aras de limitar la autonomía de la voluntad de las partes envueltas y realizarles exigencias mínimas, tales como los requisitos de forma y contenido expuestos aquí.

IV. La novación

El anterior recuento sobre las diversas disposiciones legales que aplican al contrato de empleo permite que ahora se pueda abordar la figura de la novación, objeto del presente artículo. Al igual que en los dos acápites anteriores, primero se expondrá brevemente el tratamiento que hace el Derecho civil de la figura de la novación para luego analizarla dentro del contexto del empleo.

La novación es una figura con una larga trayectoria histórica y, desde sus inicios, ha variado considerablemente. En primera instancia, bajo el Derecho romano, las obligaciones tenían "un carácter totalmente invariable, no pudiéndose introducir en ella[s] modificación alguna sin destruir el vínculo".[33] Éste solo permitía que operase la figura del *novatio* por estipulación o contrato *litteris*, si surgía un elemento nuevo y si el objeto de la obligación seguía siendo el mismo.[34] De concurrir todos estos elementos, podía operar la *novatio* y transformar la obligación original en otra, revestirla "con una forma nueva".[35] Explica Puig Brutau que el "formalismo de la contratación exigía que la más leve variación en los términos de una relación obligatoria se tradujera en la extinción de la obligación primitiva y en la creación en su lugar de otra relación nueva".[36] La rigidez de dicha figura —en cuanto a su poder extintivo y requisitos formales— dio paso a la *stipulatio*.[37] Ésta permitía los pactos verbales mediante "el pronunciamiento de unas

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32 Estatuto de los Trabajadores, Título I, Artículo 8 (2) (R.D.L. 1995, 997),(España).
33 *Id.* en la pág. 15.
34 Guaroa Velázquez, Las obligaciones según el derecho puertorriqueño 196 (1964).
35 *Id.*
36 I-2 José Puig Brutau, Fundamentos de Derecho Civil 389 (4ta ed. 1988).
37 Rivera García 404 (2000). Contrato verbal en Derecho romano, el cual constituía el más solemne y formal de todos los contratos.

palabras solemnes" que, si bien no cumplían con los rígidos requisitos romanos de la *novatio*, eran legalmente válidos.[38]

Según García De Marina, es de la figura romana del *stipulatio* que se deriva la norma española de la prevalencia de la voluntad en las obligaciones y contratos. Dicha figura, con el transcurso del tiempo, se fue tornando menos rígida hasta que se comenzó a requerir el *animus novandi* para que pudiese surgir la figura de la novación extintiva. Eventualmente, ello llevó a que se aceptare la figura de la novación modificativa, que surtiría efectos cuando no ocurriesen *cambios sustanciales*.[39]

En la actualidad, la novación recoge el derecho de los individuos a obligarse, liberarse o alterar sus relaciones jurídicas[40] o, como destaca el profesor Michel Godreau, la autonomía de la voluntad. Esta novación puede clasificarse en varias categorías. La primera es la novación extintiva, que opera ante la sustitución de una obligación anterior por otra nueva. Ello se puede hacer de forma expresa —cuando los contratantes exteriorizan terminantemente su voluntad de dejar sin efecto la obligación anterior— o tácita —cuando la nueva obligación es incompatible en todo punto con la anterior.[41] A continuación se exponen varias definiciones de conocidos tratadistas sobre este tema:

> La novación, o sea la transfusión del primer débito en otra obligación, de suerte que desaparezca el primero, según indica el Digesto, es aquella especie de contrato en virtud del cual se modifica una obligación preexistente o se destruye sustituyéndola por otra nueva.
>
> \- Mucius Scaevola

> Novación es el cambio, sustitución, renovamiento de una obligación, o relación obligatoria, por otra con ánimo de extinguir o modificar esencialmente la primera.
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> \- Sánchez Román

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38 I LUIS DÍEZ-PICASO, FUNDAMENTOS DEL DERECHO CIVIL PATRIMONIAL INTRODUCCIÓN TEORÍA DEL CONTRATO 139 (5ta ed. 1996). Las palabras solemnes que se debían pronunciar eran *"Spondes? Spondeo" y "Promittis? Promitto"*. BLACK'S LAW DICTIONARY 1268-1269 (5ta ed. 1979).

39 Se define como "lo esencial y más importante de una cosa". REAL ACADEMIA ESPAÑOLA, DICCIONARIO DE LA LENGUA ESPAÑOLA 2115 (22da ed. 2001).

40 MANUEL GARCÍA DE MARINA, LA NOVACIÓN 20 (1993).

41 29 LPRA § 3242.

> Novación es la extinción de una obligación por la creación de otra nueva destinada a remplazarla.
>
> \- Valverde
>
> La novación consiste en la sustitución de una relación obligatoria por otra destinada a extinguir aquella.
>
> \- Puig Peña[42]

En segundo término, existe la novación modificativa, que aplica en aquellas instancias en que los cambios en la obligación no sean *sustanciales*. Este tipo de modificación puede ser objetiva —un cambio en el objeto del contrato o de las prestaciones— o subjetiva —una sustitución de la persona de los contratantes. Se puede advertir la modificación del contrato o la obligación, sin que la obligación principal se vea afectada en casos, tales como los aumentos o disminuciones en las usuras[43] y la creación o supresión de fianzas.[44]

Al analizar la novación, en su vertiente extintiva y modificativa, se encuentra que la extinción o pervivencia de la obligación o relación jurídica anterior dependerá, necesariamente, de la determinación de sustancialidad que se haga.

Sobre ello, Puig Brutau, citando a Diez Picazo, explica que existe incompatibilidad (sustancialidad) "cuando las obligaciones pertenecen a tipos distintos".[45] Ofrece, como ejemplo, el arrendatario de un apartamento que conviene con su arrendador que, en lo sucesivo, habría de ocupar dicho inmueble en otro concepto, compra con precio aplazado o como un derecho de habitación, por mencionar solo algunos.[46]

Puig Brutau explica los requisitos generales de la novación en España, aludiendo a una sentencia del Tribunal Supremo de España del 1º de diciembre de 1951. Establece que requiere de: (1) una obligación preexistente; (2) la creación de una nueva obligación; (3) la disparidad entre ambas y (4) la voluntad de llevar a cabo la sustitución.[47] Sobre ello, García De Marina aclara algo que parece un tanto obvio, pero que merece ser

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[42] GARCÍA DE MARINA, *supra* nota 40, en las págs. 20-21.
[43] REAL ACADEMIA ESPAÑOLA, *supra* nota 39, en la pág. 2259. Interés que se lleva por el dinero o el género en el contrato de mutuo o préstamo.
[44] GARCÍA DE MARINA, *supra* nota 40, en la pág. 20.
[45] PUIG BRUTAU, *supra* nota 10, en la pág. 390.
[46] *Id.*, en la pág. 390.
[47] *Id.*, en la pág. 391.

mencionado: que entre el tercer y cuarto requisito se exige la capacidad de las partes para realizar el acto.[48]

Por otro lado, al igual que nuestro Código Civil no define claramente la novación, el Código Civil de Louisiana peca de igual falla.[49] Así, encontramos que éste la define de la siguiente manera:

> Art. 1881. Objective novation. Novation takes place when, by agreement of the parties, a new performance is substituted for that previously owed, or a new cause is substituted for that of the original obligation. If any substantial part of the original performance is still owed, there is no novation.
>
> Novation takes place also when the parties expressly declare their intention to novate an obligation.
>
> Mere modification of an obligation, made without intention to extinguish it, does not effect a novation. The execution of a new writing, the issuance or renewal of a negotiable instrument, or the giving of new securities for the performance of an existing obligation are examples of such a modification.[50]

Salta a la vista que éste habla de la voluntad de las partes, como versando de cambios en las prestaciones o en la causa. También, menciona la sustancialidad como criterio para determinar si hubo o no novación. Además, aclara que la emisión de un nuevo instrumento negociable o de nuevas garantías, como meras modificaciones sin intención de extinguir la obligación anterior, no producen una novación.

De forma similar, el Código Civil puertorriqueño menciona que la novación es capaz de extinguir una obligación cuando opera con cualquiera de los deudores solidarios.[51] También, opera como forma de extinguir[52] o modificar[53] las obligaciones. Establece, además, que la novación en un contrato no se presume por lo que tiene que acreditarse sin duda alguna y, que sólo si fue la voluntad e intención de las partes, habrá de surtir efecto.[54] Preceptúa además, que "[c]uando la obligación principal se extinga por efecto

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[48] GARCÍA DE MARINA, *supra* nota 40, en la pág. 29.

[49] La razón por la que se alude al Código Civil de Louisiana es que la Comisión Codificadora, creada por la primera legislatura de Puerto Rico mediante la Ley de 31 de enero de 1901 en respuesta a la Ley Foraker, integró al Código Civil de Puerto Rico partes del Código Civil de Louisiana de 1825. *Véase* Angela Figueroa v. Municipio de San Juan, 98 DPR 534 (1970); Índice y Apéndice Complementario, 97 DPR 685 (1999); Departamento de Justicia, Consulta Núm. 07-130-B, 11 de diciembre de 2007.

[50] LA. CIV. CODE ANN. ART. 1881 (1984).

[51] 31 LPRA § 3107.

[52] 31 LPRA § 3151.

[53] 31 LPRA § 3241.

[54] Op. Sec. Just. Núm. 22 de 1995.

de la novación, sólo podrán subsistir las obligaciones accesorias en cuanto aprovechen a terceros que no hubiesen prestado su consentimiento"[55] y que será "nula si lo fuere también la obligación primitiva, salvo que la causa de nulidad sólo pueda ser invocada por el deudor, o que la ratificación convalide los actos nulos en su origen".[56]

En el caso de la novación del deudor, el deudor nuevo la puede efectuar sin el consentimiento del deudor primitivo, pero nunca sin el consentimiento del acreedor.[57] Por último, las escrituras de reconocimiento de un acto o contrato nada prueban contra éstos, a menos que conste en éstas expresamente la novación.[58]

El Tribunal Supremo de Puerto Rico ha señalado que los cambios en la duración del término de un contrato implican su novación.[59] También, ha destacado que se da la novación extintiva cuando la obligación anterior y la posterior son mutuamente excluyentes o cuando hay un cambio tan radical en la naturaleza de la nueva obligación que no puede coexistir con la anterior.[60] De igual forma, esta figura se da cuando hay alteraciones esenciales en la obligación; es decir, cuando varían las condiciones principales, como el objeto o precio de un contrato.[61]

V. La novación en el contrato de empleo

Durante los inicios de la modernidad, se impulsó, bajo la consigna de *laissez-faire*, la concepción de que el Estado no tenía razón para intervenir con las relaciones contractuales. Tanto así, que se llegó a generalizar la idea de que las limitaciones a la libertad de contratar no eran más que "atentados a la libertad de la persona".[62] Sin embargo, el pasar del tiempo permitió que surgieran nuevos paradigmas, de índole socio-económicos e ideológicos, que han servido para justificar que el Estado imponga límites al poder irrestricto que antes se promovía. Ahora, bajo los contratos normados o reglamentados de la economía intervenida, el Estado "puede alcanzar a las prestaciones contractuales" e incluso, el "resto del contenido normativo del contrato".[63]

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[55] 31 LPRA § 3245.
[56] 31 LPRA § 3246.
[57] 31 LPRA § 3243.
[58] 31 LPRA § 3279.
[59] Atocha Thom McAn, Inc. v. Registrador, 123 DPR 571, 582 (1989) (explicando el tratamiento a darle a un contrato de arrendamiento al que se le había extendido el término).
[60] 31 LPRA § 3242.
[61] Miranda Soto v. Mena Eró, 109 DPR 473 (1980) (estableciendo y enfatizando que al determinar si la novación fue extintiva o modificativa, lo más importante será la voluntad e intención de las partes. Si expresan que sería extintiva, aunque el cambio fuese insignificante, así se atenderá, pues se le da una mayor primacía a la voluntad de las partes, y su intención que a lo expresamente positivado).
[62] Díez-Picaso, *supra* nota 38, en la pág. 121.
[63] *Id.*

Ambas concepciones, y su consecuente pugna, encontraron expresión en el ordenamiento puertorriqueño cuando, en 1917 el Congreso de EE. UU. decidió aprobar la Ley Orgánica Jones, su correspondiente Carta de Derechos y reconocer, entre otras cosas, como un derecho fundamental en Puerto Rico que "no law impairing the obligation of contracts shall be enacted".[64] No obstante, varios párrafos posteriores dispuso que "[n]othing contained in this Act shall be construed to limit the power of the legislature to enact laws for the protection of the lives, health, or safety of employees".[65] Con este primer paso, reconoció que la Legislatura puertorriqueña tenía autoridad para, entre otras cosas, crear leyes que limitasen la autonomía de la voluntad de los contratantes en el ámbito laboral. Sin embargo, dicho poder fue nuevamente modificado cuando, en 1950, el Congreso aprobó la nueva Ley de Relaciones Federales con Puerto Rico.[66] Ésta autorizó a Puerto Rico a redactar un proyecto de Constitución, cuya validez dependería de que fuese aprobada por el Presidente y Congreso de EE.UU. Al aprobar ambos la nueva Constitución, quedó derogada la carta de derechos de la Ley Jones, "puesto que la § 2 de Ley 600, 64 Stat. 319, requería que la Constitución puertorriqueña contuviera una carta de derechos".[67] No obstante, ésta recogió una cláusula análoga a la de la Constitución federal y a la de la Carta de Derechos de la Ley Jones.[68] Con tales actuaciones, fueron re-articuladas las relaciones de poder entre EE. UU. y Puerto Rico y la autoridad de la Legislatura puertorriqueña para reglamentar áreas como el derecho de empleo y laboral. Todo lo cual tuvo como resultado que el Gobierno de Puerto Rico pudiese subordinar el contrato de empleo "al poder de razón de estado cuando [alegase que] existan razones superiores de orden público".[69]Esta autoridad del Estado es de singular importancia, pues le pone trabas a la concepción generalizada de que el patrono, por "el poder jerárquico que le es reconocido en virtud del contrato de trabajo", tiene la facultad de administrar su empresa como mejor entienda.[70] Tal entendido ha posibilitado el nacimiento de la figura de la novación dentro del contexto del empleo en diversas jurisdicciones.

De la investigación realizada, no se encontraron tratadistas de Puerto Rico discutiesen la novación dentro del contexto del empleo. Por tanto, se expone a continuación un análisis de Derecho comparado.

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64 Acta Jones, Carta Orgánica de 1917 de Puerto Rico, del 2 de marzo de 1917, Cap. 145, 39 Stat. 951, 1 LPRA Documentos Históricos; *derogada en parte por* An Act to Provide for the Organization of a Constitutional Government by the People of Puerto Rico, L. Púb. Núm. 6oo, 64 Stat. 319 (3 de julio de 1950) *codificada* en 48 U.S.C. §731(b) (1994).

65 *Id.*

66 48 U.S.CA. § 731.

67 JOSÉ JULIÁN ÁLVAREZ, DERECHO CONSTITUCIONAL DE PUERTO RICO Y RELACIONES CONSTITUCIONALES CON LOS ESTADOS UNIDOS 442-43 (2009).

68 CONST. P.R. art. II, § 7.

69 Marina Ind., Inc. v. Brown Boveri Corp., 114 DPR 64, 79 (1983).

70 JUAN CARLOS GOYENA, RUPTURA ABUSIVA DEL CONTRATO DE TRABAJO 31 (1966).

Para propósitos ilustrativos, brevemente se comenzará por incursionar en la jurisdicción española. La misma reconoce como un deber del trabajador, "[c]umplir las órdenes e instrucciones del empresario en el ejercicio regular de sus facultades directivas".[71] Éste es un poder discrecional, pero no arbitrario, por lo que se reconoce que puede alterar unilateralmente aquellas condiciones no esenciales de su contrato de trabajo. Es, precisamente, la *esencialidad* o *sustancialidad* de estas condiciones las que se explorarán a continuación.

La doctrina española denomina como *ius variandi* o *jus variandi* la facultad que posee el patrono para modificar unilateral y admisiblemente aquellas condiciones, explícitas o implícitas, no sustanciales del contrato individual de trabajo.

El *ius variandi* proviene del derecho del patrono a dirigir los destinos de su empresa y las labores de sus brigadas como una "derivación compensatoria del riesgo a que está expuesto el principal en su carácter de inversor del capital".[72] Este supuesto justifica que se diferencien las potestades de los contratantes, dentro del mismo contrato de empleo y en relación al régimen establecido para los contratos en general.

Los límites a la aplicación de esta doctrina son: (1) la razonabilidad del cambio, de modo que no sea arbitraria; (2) la funcionalidad, es decir que obedezca a un motivo *bona fide* del negocio; y (3) la indemnidad del obrero, que no se menoscabe su patrimonio o deteriore su moral.[73] El primer y segundo límite, exigen que las condiciones a variar sean las que se dirijan a satisfacer las necesidades operacionales o económicas de la empresa. El tercer límite entraña la protección del Estado al bienestar pecuniario y personal del trabajador. En síntesis, aclara el tratadista argentino Goyena, se trata de permitir todos aquellos cambios que hagan viable la empresa, con la única limitación del uso abusivo de dichas atribuciones.[74]

Se reconoce dentro de las autoridades del patrono: (1) el cambio en el lugar de trabajo; (2) la alteración de la jornada laboral; (3) el cambio en las labores o funciones del empleado; y (4) la alteración de salarios. También, habrá que analizar la voluntad de los contratantes y las razones que les motivaron a entrar en una relación contractual. Por ejemplo, el cambio en la jornada de trabajo o en el lugar de empleo, podría o no ser esencial a la hora de pactar un contrato laboral. De tal modo, el análisis parte de estos cuatro criterios objetivos, para ser conjugado con consideraciones subjetivas sobre las voluntades y motivaciones de las partes.

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[71] Estatuto de los Trabajadores, Título 1 Art. 5(c) (R.D.L. 1995, 997),(España).

[72] GOYENA, *supra* nota 70, en la pág. 32.

[73] Ley Núm. 20,744, 13 de mayo de 1976(Arg.) (17 de abril de 2011, 11:40 AM), http://infoleg.mecon.gov.ar/infolegInternet/anexos/25000-29999/25552/texact.htm.

[74] GOYENA, *supra* nota 70, en las págs. 34-35.

Lo anterior se ve ejemplificado en Brasil, cuyo ordenamiento claramente positivó en su Código de las leyes del trabajo que "en los contratos individuales del trabajo es lícita la alteración de sus condiciones por mutuo acuerdo, siempre que éstas no resulten en perjuicio, directo o indirecto, del empleado, so pena de nulidad de la cláusula que infrinja esta garantía".[75] Es decir, en Brasil, cualquier alteración que ocasione perjuicio al empleado, será prohibida, salvo cuando estuviesen expresamente autorizadas por ley.

El Código del Trabajo de Chile también se expresa en relación a las variaciones de este tipo y, entre otras cosas, establece que el patrono puede cambiar la naturaleza o el lugar en que se ofrecen los servicios siempre "que se trate de labores similares, que el nuevo sitio o recinto quede dentro del mismo lugar o ciudad, sin que ello importe menoscabo para el trabajador".[76] Éste también dispone que:

> Por circunstancias que afecten a todo el proceso de la empresa o establecimiento o a alguna de sus unidades o conjuntos operativos, podrá el empleador alterar la distribución de la jornada de trabajo convenida hasta en sesenta minutos, sea anticipando o postergando la hora de ingreso al trabajo, debiendo dar el aviso correspondiente al trabajador con treinta días de anticipación a lo menos.[77]

A diferencia de dichas jurisdicciones, Puerto Rico no cuenta con una ley específica que expresamente autorice las alteraciones del contrato de empleo. Sin embargo, ello no ha sido óbice para reconocer dicha facultad. Así, por ejemplo, el Artículo 5 de la Ley Núm. 80 establece, utilizando un lenguaje restrictivo a tales efectos, que se considerará despido "la renuncia del empleo motivada por actuaciones del patrono dirigidas a inducirlo o forzarlo a renunciar tales como imponerle o intentar imponerle condiciones de trabajo más onerosas, reducirle el salario, rebajarlo en categoría . . .".[78] Ello indica que, en Puerto Rico, está prohibida toda variación en las condiciones de empleo que resultare más onerosa al obrero, sin importar si es razonable o si se hizo en pro de los mejores intereses de la empresa.

En el aspecto subjetivo del *ius variandi*, se discutió anteriormente que la sustitución del patrono sin consentimiento del obrero es permisible,

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[75] Decreto Núm. 5.452, 1 de mayo de 1943, art. 468, Diário Oficial da União [D.O.U] de 09.08.1943 (Bras.)em (17 de abril de 2011, 11:40 AM), http://www.jusbrasil.com.br/legislacao/anotada/2387363/art-468-consolidacao-das-leis-do-trabalho-decreto-lei-5452-43.

[76] Ley Núm. XXXX, XX de XX de 19XX, Código del Trabajo [Cód. Trab.] (Chile), (17 de abril de 2011, 11:40 AM), http://www.leychile.cl/Navegar?idNorma=207436.

[77] *Id.*

[78] 29 LPRA § 185e.

siempre que el nuevo empleador asuma las obligaciones pactadas por el anterior.[79] Comenta también Goyena que las facultades concedidas por esta figura jurídica pueden verse reducidas tanto por leyes especiales como por convenios colectivos, si no contrarían la ley, la moral o el orden público.[80] El autor también explica que existen varias teorías para explicar esta facultad del empleador. La primera de ellas es análoga a la concepción propietaria absolutista de la figura del *señorío propietario*, pues concibe al patrono con un poder absoluto sobre su empresa y sus empleados.[81] Es decir, el patrono podría afectar unilateralmente el contrato de trabajo en todas aquellas disposiciones que creyere pertinente para la consecución de sus objetivos empresariales. La segunda teoría va dirigida a prohibir cualquier cambio unilateral en el contrato. Toda modificación deberá realizarse expresamente y en común acuerdo, entre el patrono y empleado. Esta teoría está fundamentada en la autonomía de la voluntad e inviolabilidad de los contratos.

El intento de establecer un balance entre ambas teorías es denominado como Derecho laboral. Éste insiste en proteger tanto a la empresa y riquezas económicas que crean los empleos, como al obrero desventajado, pues concibe que es una pieza clave para el desarrollo económico. Es decir, el Derecho laboral reconoce la necesidad del inversionista de dirigir su empresa con el fin de proteger y aumentar su capital, pero también contempla la importancia del sostenimiento de la fuerza obrera en aras de promover la explotación de su trabajo y la creación de nuevas riquezas.

En Puerto Rico, la novación se ha tratado en casos laborales tanto en el sector público[82] como en el privado y se ha relacionado exclusivamente al período prescriptivo de las reclamaciones de salarios, bajo el Artículo 1867 del Código Civil. Éste específicamente dispone que:

> Por el transcurso de tres (3) años prescriben las acciones para el cumplimiento de las obligaciones siguientes:
> (1) La de pagar a los jueces, abogados, registradores, notarios, peritos, agentes y curiales, sus honorarios y derechos . . . .
> (2) La de satisfacer a los farmacéuticos las medicinas que suministraron; a los profesores y maestros sus honorarios y estipendios . . . .
> (3) La de pagar a los menestrales, criados y jornaleros el importe de sus servicios . . .

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[79] GOYENA, *supra* nota 70, en la pág. 42.
[80] *Id.*, en las págs. 42-43.
[81] *Id.*, en la pág. 36.
[82] Villanueva v. U.P.R., 166 DPR 96, 98 (2005) (Rebollo, J., disintiendo) (citando a Aponte v. Srio. de Hacienda, E.L.A, 125 DPR 610 (1990)).

> (4) La de abonar a los posaderos la comida y habitación . . . .
> El tiempo para la prescripción de las acciones a que se refieren los tres párrafos anteriores se contará desde que dejaron de prestarse los respectivos servicios.[83]

Este artículo proviene, a su vez, del Artículo 1967 del Código Civil español, que procede de la Ley 10, Título 11, Libro 10, de la Novísima Recopilación, según ha explicado el Tribunal Supremo de Puerto Rico.[84]

En la elucidación de *Muñoz Colón v. Corte de Distrito de Ponce*, el Tribunal Supremo explicó que la intención del legislador al legislar sobre los trabajadores era protegerle frente al poderoso patrono. Por ello, no pretendía obligar al empleado a enfrentar a su jefe en una disputa por salarios, hasta tanto terminase definitivamente su relación obrero-patronal. Plantearon que los autores del Código Civil decimonónico se dieron cuenta que, al cambiar las funciones del empleado, operaba una novación del contrato de empleo que iniciaba el conteo del periodo prescriptivo.[85] Para evitar que ello ocurriese, se añadió al Artículo 1867 del Código Civil el último párrafo.

Fuera de lo anteriormente expuesto, el Tribunal permaneció silente respecto a cuáles son las variaciones que ocasionan la novación del contrato laboral y cuáles son sus efectos. Lo único que explica es que de no haber incluido el legislador este párrafo final, hubiese aplicado el Artículo 1869 del Código Civil que dice que el tiempo para la prescripción de toda clase de acciones se contará desde el día que pudieron ejercitarse, "cuando no haya disposición especial que otra cosa determine".[86]

A su vez, el Tribunal Supremo ha dicho que para que se produzca la novación que inicie el conteo del periodo prescriptivo antes mencionado, "por lo menos debe haber un cambio efectivo en la clase de trabajo realizado por el empleado".[87] Ello lo expresó en *Avellanet v. Porto Rican Express Co.*, caso en que la empleada realizaba tareas de oficina sobre el despacho y recibo de carga en una compañía de porteo local. Alegaba la parte demandada que el periodo prescriptivo había comenzado a contar desde que la demandante cambió la naturaleza de sus servicios.

Según el Tribunal, la realidad era que la demandante continuaba realizando las mismas funciones, pero en lugar de continuar atendiendo el

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83 31 LPRA § 5297.

84 Muñoz Colón v. Corte de Distrito de Ponce, 63 DPR 236, 247 (1944) (expresándose por primera vez el Tribunal Supremo en torno a la figura de novación dentro del contexto del contrato de empleo. Mediante opinión suscrita por el juez asociado De Jesús, nuestro más alto foro explicó la interpretación del artículo español en que se basó y su importancia para con la controversia).

85 *Id.*, en las págs. 247-248.

86 31 LPRA § 5299.

87 Avellanet v. Porto Rican Express Co., 64 DPR 693, 699 (1945).

recibo y despacho de carga local, trabajaba con carga que se movía en el comercio interestatal. Por ello, el Tribunal no encontró: (1) diferencia alguna en las tareas realizadas antes y después, (2) ni que las partes por sí mismas llegaron a un nuevo convenio, que produjera la novación.

Tres años más tarde el Tribunal Supremo decidió *Chabrán v. Bull Insular Line*.[88] Aunque, no se discutirá si éste ya no es doctrina vigente en nuestro ordenamiento, en ocasión a la ley federal de Derechos Civiles de 1964,[89] sirve para ilustrar la visión del Tribunal sobre la figura de la novación en el empleo. En dicho caso, varios empleados, entre ellos el demandante, se fueron a huelga y no regresaron hasta seis semanas después, luego de haber firmado un nuevo contrato. El demandante alegó que el periodo prescriptivo para su reclamación sobre los servicios prestados antes de la huelga no comenzó en el momento en que entró en la nueva relación contractual, pues ésta sólo reflejaba un aumento de sueldo de 25%.

El Tribunal Supremo resolvió que Chabrán abandonó voluntariamente su empleo, por no estar de acuerdo con sus condiciones de trabajo. Determinó, además, que el nuevo contrato realizó varios cambios sustanciales en las condiciones de trabajo de los empleados y sobre el funcionamiento de la industria. Como parte de la decisión, presentó ejemplos de lo que serían explicaciones suficientes –tales como, la enfermedad del obrero, la rotura de la maquinaria, o la escasez temporal de trabajo– para evitar el comienzo de la prescripción del Artículo 1867.[90] Resalta, además, que dicha prescripción comenzará solo en casos en que hubiese acción voluntaria del empleado. Dice además que:

> La combinación de la interrupción de servicios durante mes y medio y del nuevo contrato nos convencen de que en este caso específico el término prescriptivo, en virtud del lenguaje que acabamos de citar de los casos de *Muñoz* y de *Jiménez*[91], empezó a correr desde el 1ro. de enero de 1938, fecha del nuevo contrato.[92]

Ya en el caso de *Jiménez*, éste había decidido que ausentarse por seis o tres meses sin explicación alguna suponía dejar de prestar servicios para efectos del Artículo 1867. No así ausentarse poco más de un mes por estar enfermo.[93] En concreto, el tribunal dijo que:

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[88] Chabrán v. Bull Insular Line, 69 DPR 269 (1948).
[89] Civil Rights Act, 42 U.S.C. § 2000(e)-3 (2006).
[90] 31 LPRA § 5297.
[91] Jiménez v. Corte de Distrito de Bayamón , 65 DPR 37 (1945).
[92] *Chabrán*, 69 DPR en la pág. 282.
[93] *Jiménez*, 65 DPR en las págs. 43-44.

> [C]uando un querellante abandona el trabajo por meses o años en una industria que funciona todo el año, y no se ofrece una explicación para ello, el obrero cesa en dicho momento de rendirle servicio al patrono dentro del significado del artículo 1867.[94]

Menciona también dicha decisión que el contrato tuvo cambios sustanciales en la industria y en las condiciones de otros empleados. Sin embargo, ello lo hizo someramente, sin orientar sobre la importancia de estos señalamientos. Alude a que la decisión no menoscaba el derecho a la huelga y señala que, si los empleados hacen huelga y la ganan, se conforma un nuevo contrato de servicios, por lo que no procede la contención de que los servicios anteriores no fueron terminados. Lo que sí explicó claramente es que fue la combinación del nuevo contrato y la huelga la que definió el comienzo del periodo prescriptivo. Parecería ser que, más que el nuevo contrato pactado, fue el tiempo y la voluntariedad del abandono del empleo para efectuar una huelga, lo que mereció más peso para que nuestros jueces decidieran que hubo suficientes cambios sustanciales como para que operase la figura de la novación.[95]

En 1959, se produjo *Sierra Berdecía v. Mario Mercado e Hijos*,[96] que trataba sobre un listero que pasó a ser superintendente de la finca donde trabajaba. Pero ello, no ocasionó cambios sustanciales en las funciones de forma tal que pudiese operar la novación y resultase prescrita la reclamación de jornales. El Tribunal señala que ha:

> [R]esuelto repetidamente que el término de tres años provisto en el inciso 3 del Art. 1867 del Código Civil, debe contarse desde la fecha en que por motivo de cambios sustanciales en la naturaleza de los servicios, se opera una novación que extingue el contrato anterior para dar paso a un nuevo contrato, sin tener en cuenta el hecho de que el obrero continúe al servicio del mismo patrono. A ese fin es imprescindible considerar todos los términos y condiciones del

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[94] *Chabrán*, 69 DPR en la pág. 281.

[95] En cambio, vale destacar que en España se habla de modificaciones sustanciales, las cuales son motivo de extinción del contrato de empleo, "por la voluntad del trabajador fundamentada en un incumplimiento contractual del empresario". *Véase* Estatuto de los Trabajadores, Título I, Artículo 50.1(a) (R.D.L. 1995, 997), (España). Éste dispone que opera la extinción cuando el empresario haya procedido a aplicar al trabajador modificaciones sustanciales en las condiciones de trabajo que redunden en perjuicio de su formación profesional o en menoscabo de su dignidad. *Véase además* el Estatuto de los Trabajadores, Título I, Artículo 49.1(j) (R.D.L. 1995, 997), (España).

[96] Sierra Berdecía v. Mario Mercado e Hijos, 81 DPR 314 (1959).

> empleo: la tarea realizada, los deberes, las obligaciones, la compensación devengada, etcétera.[97]

Entonces, devolvió el caso al Tribunal de Instancia y descartó su conclusión de derecho al haber excluido a Sierra Berdecía de las leyes,[98] decretos y reglamentos que regulaban las horas y los salarios en Puerto Rico, por ser un ejecutivo a la luz de *Correa v. Mercado*.[99] Sin embargo, luego no se encontró demostrado el estatus de ejecutivo para producir la novación del contrato de empleo y dar pie a la prescripción de su reclamación. Por tanto, el Tribunal de Instancia debía entonces aquilatar nuevamente la prueba, para determinar si en efecto hubo cambios sustanciales en la naturaleza de los servicios.

En *Agostini v. Tribunal*, el Tribunal explica que el obrero deja de prestar los respectivos servicios cuando, entre otras cosas, trabajando para el patrono, se opera una novación del contrato por motivos de cambios sustanciales en la naturaleza de los servicios que el obrero venía prestándole.[100] En dicho caso, los querellantes habían alegado que no les aplicaba el Artículo 1867 del Código Civil y sí la nueva Ley de Salario Mínimo de 1956. Ésta dispuso sobre el término de prescripción que ocurre:

> (a) Por el transcurso de tres años prescribirá la acción. . .
>
> (b) Cuando el empleado estuviere trabajando con el patrono, la reclamación solamente incluirá los salarios a que tuviere derecho el empleado, por cualquier concepto, durante los últimos diez años anteriores a la fecha en que estableciere la acción judicial.
>
> (c) En el caso de que el empleado …
>
> (d) En relación con el término prescriptivo provisto en esta sección, un cambio en la naturaleza de las labores del empleado no constituirá una novación del contrato de empleo.
>
> (e) Lo dispuesto en esta sección en nada afectará los casos ya radicados en los tribunales o que se radicaren dentro de un (1) año después de entrar en vigor las secs. 245 a 246m de este título.[101]

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[97] *Id.*, en las págs. 324-325.
[98] Nótese que, para ese entonces, ya había entrado en vigencia la Ley de Salario Mínimo de 1956.
[99] Correa Torres v. Sociedad Mario Mercado e Hijos, 72 DPR 80 (1951).
[100] Agostini v. Tribunal, 82 DPR 219, 228 (1961).
[101] Ley de Salario Mínimo, Vacaciones y Licencia por Enfermedad, Ley Núm. 180 del 27 de julio de 1998, 29 LPRA §§ 250 a-j.

Así, el Tribunal dispuso, mediante opinión suscrita por el juez asociado Pérez Pimentel, que, por orden de la Asamblea Legislativa, la Ley de Salario Mínimo regía la reclamación y no el Código Civil.[102] Expuso además que quedaban inválidas las doctrinas esbozadas en los casos de *Avellanet*, *Vincenty v. Corona Brewing Corp.*[103] y *Chabrán*. Es decir, mientras rigiese esta ley, ningún cambio en la naturaleza de las labores supondría una novación que diese inicio al conteo del periodo prescriptivo de tres años para las reclamaciones de salarios. La razón es que dicha ley se había redactado con el propósito de proteger al empleado, al impedir que prescribiese su reclamación, hasta tanto hubiese definitivamente dejado de trabajar para ese patrono. Señala el Tribunal que en definitiva "de conformidad con las disposiciones de la nueva Ley de Salario Mínimo de 1956, ni la interrupción de los servicios prestados por el obrero causada por una huelga, ni la firma de un nuevo contrato, ni la combinación de ambos hechos, dan comienzo al término prescriptivo."[104]

Es necesario añadir que, en este caso, el gobierno, a través de la Administración de Emergencia de Muelles, se había hecho cargo de la empresa durante la huelga, por razones de orden público. Se consideró, por tanto, una intervención que no produjo la cesantía de los trabajadores. Además, al nuevo convenio se le dio efecto retroactivo, para cubrir el periodo de emergencia decretado por la Legislatura.

Sin embargo, en 1988, el Tribunal Supremo trató la promoción de un empleado como una novación del contrato de empleo, aunque no discutió las razones para ello. *Narváez v. Chase Manhattan Bank* trató de una novación expresa y por consenso. Esto permitió que el patrono evaluase al empleado, en relación a sus nuevas funciones, y le despidiese en base a esta evaluación.[105] Los hechos específicos del caso fueron que el empleado aceptó una plaza que le ofrecieron y, al no cumplir con las expectativas del banco, fue despedido. El Tribunal entendió que no había la necesidad ni la obligación de devolverlo a su anterior puesto y que constituyó un despido con justa causa, bajo la Ley Núm. 80.

Luego, en *Vega Torres v Lacot*, el Tribunal volvió a mencionar la "alteración sustancial en la naturaleza de las funciones", pero reiteró que "[u]n aumento módico en sueldo no constituye el cambio sustancial exigido por nuestra jurisprudencia".[106] Esta vez se trató de maestros del sistema

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102 *Agostini*, 82 DPR en la pág. 230.

103 Vicenty v. Corona Brewing Corp., 73 DPR 135 (1952) (devolviendo el el caso al Tribunal de Primera Instancia para que determinase si los cambios en las funciones del empleado eran sustanciales, a pesar que no había cambiado el título de su posición. La razón es que el foro inferior no le había permitido al demandado presentar prueba al respecto).

104 *Agostini*, 82 DPR en la pág. 233.

105 Narvaez v. Chase Manhattan Bank, 120 DPR 731 (1988).

106 Vega Torres v. Socorro Lacot, 125 DPR 689, 695 (1990).

público que instaron una causa de acción contra el Departamento de Instrucción Pública, bajo el Artículo 1867 del Código Civil. El Tribunal destacó que ya había determinado, en *Aponte v. Secretario de Hacienda*, que las prescripciones en el sector público se regían por el Código Civil, pues había sido excluido de la Ley de Salario Mínimo.[107]

Con este caso, concluye el recuento jurisprudencial sobre la figura de la novación en el contrato de empleo en nuestra jurisdicción. De éste, se desprende que no ha habido un solo caso en Puerto Rico en el que se haya encontrado un cambio sustancial tal, que produzca la novación del contrato de empleo.

En aras de entender dicha figura a cabalidad, se estudia, a continuación, el tratamiento que otras jurisdicciones no civilistas le han brindado. En Pensilvania, por ejemplo, se resolvió un caso similar. En *M.S. Jacobs & Associates v. Duffley*, un empleado renunció para aceptar un empleo en otra empresa, pero su patrono le ofreció un aumento de sueldo y éste aceptó quedarse. El Tribunal Supremo de Pensilvania entendió que no se había producido la novación a pesar de la renuncia, pues ésta nunca fue aceptada por lo que el empleado nunca dejó de percibir salarios.[108]

Por otro lado, cabe señalar que la Ley de Salario Mínimo de 1956 fue derogada en 1988 por la Ley de Salario Mínimo, Vacaciones y Licencia Por Enfermedad.[109] Ahora, el periodo de prescripción de reclamaciones de salarios se rige por la § 250j la cual dispone que:

> (a) Por el transcurso de tres (3) años prescribirá la acción en reclamación de salarios que pueda tener un empleado contra su patrono al amparo de este capítulo o cualquier decreto mandatorio, ya aprobado o que se apruebe, de acuerdo con las disposiciones de este capítulo o al amparo de cualquier contrato o ley. Para la prescripción de esta acción, el tiempo se contará desde que el empleado cesó su empleo con el patrono . . . .
>
> (b) Cuando el empleado estuviere trabajando con el patrono, la reclamación solamente incluirá los salarios a que tuviese derecho el empleado, por cualquier concepto, durante los últimos tres (3) años anteriores a la fecha en que se estableciese la acción judicial.
>
> (c) En el caso de que el empleado hubiese cesado en su empleo con el patrono, la reclamación solamente incluirá los últimos tres (3) años anteriores a la fecha de su cesantía.

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107 Aponte Martinez v. Collazo, 125 DPR 610 (1990).
108 M.S. Jacobs & Associates v. Duffley, 303 A.2d 921, 923 (1973).
109 29 LPRA § 250-250j.

> (d) En relación con el término prescriptivo provisto en esta sección, un cambio en la naturaleza de las labores del empleado no constituirá una novación del contrato de empleo.[110]

Esta sección, al igual que la § 246d de la Ley de Salario Mínimo de 1956, impide que opere la novación por cambios en la naturaleza del trabajo. Es decir, la prescripción de las reclamaciones no comienzan a contar hasta terminada la relación con el patrono. No obstante, ésta no deja al patrono en la eterna incertidumbre que la figura de la novación busca evitar, pues el legislador restringió dicha reclamación a los tres años anteriores a la fecha de la acción interpuesta bajo la nueva ley.

Esta ley resuelve el asunto de la novación en el sector privado, que es donde más problemas ha causado, y nos deja con el caso del sector público. En este sector, se produce una novación por el cambio sustancial en las condiciones de empleo. Aunque no está claro qué constituye un cambio sustancial que dé paso a que opere la novación en el sector público, según *Vega Torres v. Lacot*, un aumento módico en la remuneración no constituye tal requisito. Sin embargo, los casos de cambios sustanciales en la naturaleza de empleo, difícilmente se pueden producir en el sector público, debido a su propia estructura burocrática y rígida.

Por último, cabe destacar que el Tribunal Supremo ha encontrado la ocurrencia de un *cambio sustancial*, en el contexto de un contratista independiente. En *Hernández v. TOLIC*, se decidió que la intervención de un nuevo Director de Agencias en los asuntos internos administrativos de una contratista independiente produjo “un cambio sustancial en las relaciones entre las partes”.[111] Este cambio se trató de que usurpó la toma de decisiones de la contratista, sobre aspectos relacionados al reclutamiento y adiestramiento de empleados, técnicas de mercadeo y la presidencia de las reuniones mensuales con sus agentes. Aunque el Tribunal al resolver no menciona expresamente la novación, destaca que las acciones del nuevo Director produjeron un cambio sobre la relación del contratista independiente, convirtiéndola en una de patrono-empleado. Con ello, produjo una sentencia favorable a la demandante, quien obtuvo una sentencia favorable por despido injustificado por discrimen por razón de edad, bajo la Ley Núm. 100. [112]

VI. Conclusión

Parece ser que la novación no es una figura que encaje bien en el contexto del contrato de empleo y que, el pasar del tiempo y los cambios en las leyes del empleo, han hecho que el Tribunal Supremo se ponga aún mas

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[110] 29 LPRA § 250j.

[111] Hernández v. TOLIC, 151 DPR 754, 772 (2000).

[112] Ley contra el discrimen en el empleo, Ley Núm. 100 de 30 de junio de 1959, 29 LPRA § § 146-XX.

reacio a aplicarla en dicho contexto. El supuesto de que un empresario puede alterar las funciones del obrero, si ello beneficia a la empresa y permite su continuidad, competitividad y desarrollo frente a los constantes cambios del comercio mundial y local parece aplicar en ciertas jurisdicciones, pero no en Puerto Rico.

Ese poder patronal se debería permitir, aunque no de forma irrestricta o absoluta. Jurídicamente, ya existe un freno para sus excesos: las protecciones que se le brinda al empleado, ante su desigual relación con el patrono.

Lo anterior cobra aun mas sentido y relevancia al considerar la actual realidad. En una esfera mercantil globalizada como la que vivimos, es vital que los patronos cuenten con cierto grado de flexibilidad, para relocalizar sus recursos, incluyendo el recurso humano. Necesitamos lograr que el riesgo de capital sea rentable, para sobrevivir en una economía sumamente dinámica y vertiginosa. A la vez, nuestro ordenamiento debe velar por la protección de esos mismos recursos humanos que le dedican muchas horas de su vida a trabajar para sustentarse a si mismos y a sus familias. En otras palabras, el método de análisis y adjudicación en el contexto de empleo debe ser un concienzudo balance de intereses.

No le haríamos un buen servicio a nuestros conciudadanos, si pretendiéramos salvaguardar al patrono sin tomar en cuenta al obrero, pero tampoco aportaríamos al desarrollo de capital si se sacrifican a los patronos para proteger a ciegas a los trabajadores. Debemos encontrar ese equilibrio que permita a los comercios desarrollarse, sin quebrantar la salud física o mental de aquellos trabajadores y trabajadoras que lo hacen posible con su esfuerzo.

La novación unilateral del contrato de empleo individual por parte del empleado resulta impensable. Por otro lado, la novación unilateral por parte del patrono, podría resultar una herramienta peligrosa contra del obrero, tal como pretendió utilizarse en el pasado. Afortunadamente, ni el Tribunal Supremo de Puerto Rico le dio el visto bueno a esta defensa patronal de prescripción, ni la Asamblea Legislativa tuvo el descuido de permitir la continuación de la discusión jurídica de dicha figura en el ámbito laboral, a través de su legislación oportuna aplicable a la empresa privada.

A JUSTIFIED "ASSAULT UPON THE CITADEL OF PRIVITY" AND THE FIRST AMENDMENT: A THEORY OF LIABILITY FOR INVESTORS SEEKING RECOVERY FROM CREDIT RATING AGENCIES†

JOSEPH G. BUNN*

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I. INTRODUCTION

The active involvement of credit rating agencies (hereinafter "CRAs") in the recent financial crises involving structured finance market an adequate basis for negligent misrepresentation claims by investors against CRAs. Traditionally, CRAs have qualified for protection from suit by investors under the privity doctrine and under the First Amendment. CRAs qualified for protection under the privity doctrine because they are not typically in a contractual relationship with investors who utilize their ratings. Moreover, CRAs qualified for protection under the First Amendment because courts viewed their ratings as *speech* regarding public matters. However, this dual protection should not apply in the aforementioned circumstances.

Third party beneficiaries of a contract may have a cause of action against a service-providing party when there is a relationship *approaching that of privity*. Such a relationship exists when a contract party provides services for a particular purpose in furtherance of which a known party or parties are intended to rely, and the service-providing party provides those services in a manner that constructively links the service provider to the reliant party. The ratings of structured financial products (hereinafter

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† 1 Ultramares Corp v. Touche, 255 N.Y. 170, 174 N.E. 441, 445 (1931) (Cardozo, J.)

* Special thanks to C. Haley Cook, Esq. for love and inspiration, and Prof. Andre Douglas Pond Cummings, West Virginia University College of Law for endless hours of editing and comments

"SFPs") serve a particular purpose because those ratings provide issuers the ability to offer SFPs to qualified institutional investors under Rule 144A of the Securities Act of 1933. Qualified institutional investors are known, reliant parties of such ratings because many of them are required by law to only purchase securities equal to or exceeding investment-grade. Finally, CRAs provide these ratings in a manner that constructively links them to investors because the process of providing SFP ratings is plagued by conflicts of interest, improper management, and poor use of information. Thus, CRAs and should be liable for losses incurred by investors who relied on their inflated structured financial product ratings.

Furthermore, the First Amendment should not protect CRAs from this liability because a structured financial product rating is *speech* that is not *of public concern*. First Amendment protection is extended only to matters of public concern. A credit rating's "content, form, and context . . . as revealed by the whole record" indicates whether such rating is of public concern or not. There are a variety of factors that indicate SFP ratings are not a matter of public concern. First, SFP ratings are solely in the interests of CRAs and their specific audience because they are the only parties who will financially benefit from an SFP rating's issuance. Second, SFP ratings are not typically disseminated in a broad fashion. Third, the large profit margin that CRAs derive from each SFP rating will encourage CRAs to continue providing SFP ratings, despite additional regulation. Fourth, SFP ratings are more objectively verifiable than other protected forms of speech. Because the content, form, and context of a typical SFP rating indicates that such rating is not a matter of public concern, the First Amendment should not protect SFP ratings.

To fully explain the issues discussed above, the following analysis is composed of three parts: (I) Credit rating agencies' involvement in the financial crisis, (II) An "approaching privity" relationship among credit rating agencies and structured financial product investors, and (III) The First Amendment's lack of protection for structured financial product ratings.

II. Credit Rating Agencies' Involvement in the Recent Financial Crisis.

Prior to exploring CRAs' potential liability to investors for inflated credit ratings, an examination of many facts is necessary. First, it is necessary to understand the CRAs' origins because they give insight into the limits of CRAs' First Amendment protection. Additionally, examining the CRAs' influence and function in the structured finance market sheds light on the special relationship that exists between CRAs and structured financial product investors. Finally, the policing of imposing liability exposure upon CRAs is strengthened by understanding the losses suffered by investors in excess of the risk of loss represented to them by CRAs before the recent financial crisis.

Thus, this section is separated into the following subsections: (A) The traditional credit rating business model, (B) Credit rating agencies' regulatory entanglement, (C) The emergence of structured financial products, (D) The structured financial product rating process, (E) Inherent flaws in the structured financial product rating process, and (F) Damage caused by inaccurate structured financial product ratings.

A. The traditional credit rating business model.

Near the beginning of the 20th century, John Moody began rating the creditworthiness of railroad, utility, and industrial corporation bonds.[1] Soon thereafter, Standard Statistics (predecessor to Standard & Poor's) and the Fitch Publishing Co. introduced a similar service.[2] Ratings were delivered in the form of a letter grade, which indicated the likelihood of a debt instrument's default, or failure to pay.[3] The ratings typically ranged in descending order from Aaa to C. Obligations rated Aaa were represented as the highest quality with minimal credit risk, and obligations rated C were represented as the lowest-rated class of bonds that were typically in default with little prospect for recovery of principal or interest.[4] Various objective and subjective characteristics[5] of obligors were used to distinguish between the low-risk obligors and the high-risk obligors. Customers of CRAs valued this service because the rating provided a simplistic, independent opinion as to the creditworthiness of their investments from a qualified, reputable source. In exchange for this value-added service, customers paid CRAs subscription fees similar to newspaper or magazine subscribers.

B. Credit rating agencies' regulatory entanglement.

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1 *See* RICHARD SYLLA, *A Historical Primer on the Business of Credit Ratings, in* RAITINGS, RAITING AGENCIES, AND THE GLOBAL FINANCIAL SYSTEM (Richard M. Levich, Giovanni Majnoni & Carmen Reinhart eds., 2002); WILLIAM E. FRUHAN, JR., NOTE: CREDIT RATING AGENCIES 1 (Harvard Business Publishing 2009).

2 *See* FRUHAN, *supra* note 2, at 1.

3 *See* Moody's Investors Service Homepage, *Rating Definitions* (August 2, 2008), *available at* http://www.moodys.com (indicating that Moody's ratings actually reflect *both* the likelihood of default and any financial loss suffered in the event of default).

4 *See id.*

5 Some of the various objective characteristics used by the CRAs include a firm's annual earnings coverage of fixed charges, debt to capitalization ratio, annual cash flow to long-term debt outstanding. *See* FRUHAN, *supra* note 2, at 5. (One of the subjective factors used for arriving at a final credit rating is the perceived quality of a firm's senior management team).

Because CRAs provided an independent evaluation of very complex financial products and delivered their findings in a simple form, the U.S. government endorsed their service by adopting their letter grade system as a standard of creditworthiness in many statutes, regulations, and rules. In 1936, the Federal Reserve endorsed the CRAs by requiring all commercial banks to purchase only bonds rated above *investment grade*, or BBB in CRA lingo.[6] Many other government institutions soon followed the Fed's lead by substantively incorporating the CRAs' letter system into their regulations.[7] With these government endorsements, the credit rating agencies effectively controlled what investments the U.S. government and regulated industries could purchase with their spare capital. Surprisingly, CRAs were not regulated during this time period.

Partial regulation came in 1973 with the issuance of 17 C.F.R. § 240.15c3-1, which created the Nationally-Recognized Statistical Rating Organization (hereinafter "NRSRO") designation. While the impetus for the SEC's issuance of Rule 15c3-1 is unclear, the replacement of Bretton Woods System by a floating-exchange rate regime created an opening for freer international capital flows and financial globalization, which led to the need for a global investment standard.[8] The NRSRO designation substantially restricted the number of CRAs because the designation required new entrants to be *nationally-recognized*.[9] New players found it hard to qualify as *nationally-recognized* because they did not have the experience of issuing ratings for a large number of bond issues over a considerable period of time. Thus, competition was nearly eliminated, and existing CRAs were granted something close to an oligopoly on the market[10] of selling regulatory

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6 *See* TIMOTHY J. SINCLAIR, THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS 43-44 tbl.3 (Cornell University Press 2005).

7 For example, the Securities & Exchange Commission created the uniform net capital rule by incorporating credit ratings into Rule 15c3-1, the Financial Institutions Recovery and Reform Act of 1989 prohibited Savings & Loans from investing in below-investment grade bonds, and the Transport Infrastructure Finance and Innovation Act of 1998 prohibited the Department of Transportation from extending credit assistance to projects with below-investment-grade ratings. *See, e.g.*, *id.* (discussing these particular examples and indicating numerous other examples).

8 *See* SYLLA, *supra* note 2, at 23.

9 The SEC on a case-by-case basis granted the CRA designation to credit rating agencies through the issuance of a no action letter. While many objective criteria were examined in this process, the key issue was whether the agency was nationally recognized by issuers who used the ratings. *See* U.S. SEC. & EXCH. COMM'N, SEC REPORT ON CREDIT RATING AGENCIES 9-10 (January 2003).

10 *See The Role of Credit Rating Agencies in the Structured Finance. Market: Hearing Before the Subcomm. on Capital Markets, Ins., and Gov't Sponsored Entities, H. Comm. on Fin. Servs.*, 110th Cong. 137 (2007) (statements of Julia Whitehead and Sean Mathis) (testifying that the credit rating market share of Moody's, Standard & Poors, and Fitch were 39%, 40%, and 16%, respectively, and 95% collectively).

compliance licenses to entities bound by regulations that substantively incorporated their ratings.[11] Armed with legally guaranteed business and very few competitors, CRAs became extremely influential entities.[12]

C. The emergence of structured financial products.

CRAs found the opportunity they had been waiting for when the U.S. Federal Reserve Bank (hereinafter "the FED") began dropping interest rates to unprecedented levels from 2000 to 2007. Because interest rates were so low, many new homebuyers entered the market and the outstanding amount of mortgages in United States rose 214.54% from $6.785 trillion to $14.557 trillion.[13] This massive growth caught the eye of many financial players.

While this business opportunity was new, the process that banks utilized to exploit it – securitization - was not. During the 1960s and 1970s, banks began selling off mortgage loans to outside investors in an effort to diversify their portfolios.[14] Because investors wanted to scrutinize the details of the mortgages to guard against the risk of default, these sales became too cumbersome for the banks.[15] Accordingly, the banks began to bundle up large quantities of loans in packages to spread the risk of any problematic loans across a large portfolio, which obviated the need for strict scrutiny of mortgage terms.[16]

Over time, banks began aggregating the future income streams of their own mortgages into a trust and then issuing securities to investors, which granted rights to those income streams.[17] Banks made money from the mortgage payments because their cost of capital was lower than the rate paid by mortgagors. Additionally, banks made money from the sale of securities through underwriting fees, retained equity positions in the newly created SFP, and other investment banking methods. These securities- currently known as SFPs- became a booming business for the banks because

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[11] *See generally* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U. L.Q. 619 (1999).

12 As Thomas Friedman stated in a 1996 television interview:
There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful. *See id.*, no. 3 at 620.

13 *See* FRUHAN, *supra* note 2, at 5.

14 *See* GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 52 (Free Press 2009).

15 *See id.*

16 *See id.*

17 *See* FRUHAN, *supra* note 2, at 6.

they allowed the banks to make money from both the mortgage payments and the sale of the securities. [18]

When the Fed began to drop interest rates dramatically, banks tweaked the securitization process further to entice a broader investor audience: development of different tranches of creditworthiness within these trusts. Sometimes the trust underwriter developed tranches based merely on a difference in the expected yield to investors. Other times, underwriters would subordinate the rights of high-risk, high-yield securities to its low-risk, low-yield securities. Occasionally, the high-risk nature of the assets contained in the trust required the underwriter to over-collaterize the pool, or contribute more assets to the pool per security than the sales price of such security. Frequently, underwriters used bond insurance to improve the creditworthiness of these artificial securities. These specific techniques along with many others, alone and in combination, created a plethora of SFPs.

An SFP composed of individual mortgages, or pools of mortgages, was particularly interesting to investors. Those SFPs offered reliable cash flows because mortgagors typically paid their mortgage payments on time. Aggregating mortgages of varying borrower risk profiles throughout different geographic regions also offered diversification. The tranche structures also allowed investors to theoretically choose the level of risk they desired.

Even though there was adequate supply and demand, a delivery method was needed. The method needed to be quick (to offset the interest rate exposure of underwriters) and reach a well-capitalized audience (to handle the acquisition cost inherent of the gluttony of new mortgages when the underwriter unloaded them). The method was found in Rule 144A of the Securities Act of 1933.[19] A Rule 144A offering is quick because it does not impose the cumbersome, time-consuming disclosure requirements of public offerings.[20] Rule 144A also reaches a well-capitalized audience because one of the essential qualifications for Rule 144A investors is substantial net worth.[21] However, many qualified institutional investors eligible for Rule 144A offerings are prohibited by other regulations from purchasing securities that are not investment grade. Because CRAs establish whether a

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18 *See* TETT, *supra* note 15, at 52.

19 17 C.F.R. § 230.144A (2010).

20 *See id.*, Preliminary Note 4 (2008) (indicating that nothing in 17 C.F.R. § 230.144A obviates the need for any issuer or any other person to comply with the securities registration requirements of the Securities Exchange Act of 1934 whenever such requirements are applicable).

21 *See* 17 C.F.R. § 230.144A(a)(1)(i)(2010) (indicating that any qualified institutional investor buyer must "in the aggregate own or invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity").

security is investment-grade, CRAs held a pivotal role in completing the SFP supply chain. Recognizing their influence, CRAs demanded higher prices for their ratings of SFPs.[22]

D. The structured financial product rating process.

The CRAs' traditional rating process was not helpful when rating SFPs because SFPs did not have a history of financial performance like traditional financial instruments.[23] Underwriters began the process by sending a CRA a range of data on the income-producing assets contained in the trust, the proposed capital structure of the trust, and the proposed levels of credit enhancement applied to each tranche of securities in the trust.[24] After the lead analyst of the agency received this information, the analyst developed predictions as to how many assets in the trust would default under varying levels of economic stress.[25]

The default predictions of each tranche were compared to the agencies' particular rating requirements. If the analyst concluded that the capital structure of the SFP did not support the underwriter's desired rating, that preliminary conclusion was communicated to the underwriter. The underwriter was free to move forward with the transaction based on the preliminary rating, to modify the capital structure and receive a lower or higher credit rating based on the effect of such modification,[26] or to pursue the services of another CRA.[27]

Once this back-and-forth negotiation was complete, the analyst conducted a cash flow analysis on the trust's expected interest and principal payments to determine whether those cash flows were sufficient to pay the interest and principal due to each tranche. Following these initial steps, the analyst developed a rating recommendation for each tranche and presented those ratings to a rating committee composed of analysts and senior level analytic personnel. The rating committee voted on the analyst's

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22 Since the mid-1970s, CRAs have charged issuers fees, typically two to three basis points of a bond's face amount. *See* PARTNOY, *supra* note 12, at 652. Today, ninety-five percent of the agencies' annual revenue is from those issuer fees. *Id.* The fee-shifting has been a windfall for the CRAs: between 2005-2007 Moody's and Standard & Poor's had operating profit margins equal to 53.6% and 44%, respectively. *See* FRUHAN, *supra* note 2, at 6.

23 *See* SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 7-10 (July 2008).

24 *Id.* at 7.

25 *Id.* at 7-8.

26 *Id.* at 8.

27 However, such an instance rarely happened. In an internal email in April 2007 between two agency analysts, one analyst expressed concern that the model did not capture "half" of the deal's risk, but that "it could be structured by cows and we would rate it." *Id.* at 12.

recommendations and communicated its decision to the analyst. If the committee approved the recommendation, then the ratings were published and subsequently monitored through surveillance processes.[28]

E. Inherent flaws in the structured financial rating process.

There were many flaws inherent in the SFP-rating process prior to the recent market meltdown. CRAs did not staff their organizations well enough to accommodate the huge volume of the SFP market.[29] Furthermore, CRAs did not document essential steps in the rating process or substantial participants in the rating process.[30] This apathetic routine of documentation also carried over into CRAs' surveillance processes for existing rated securities.[31] Furthermore, conflicts of interest involving the *Issuer Pays* pricing model,[32] securities transactions by CRA employees,[33] and internal audit procedures[34] plagued the rating process. Finally, CRAs' overreliance on dissimilar historical data negatively impacted the accuracy of their ratings.[35]

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28 In a typical surveillance scenario, issuers of structured products provide CRAs with information indicating the underlying performance of the assets contained in the SFP and CRA analysts relook at an existing deal by inputting those new assumptions into the existing model. *Id.* at 21. If the result differed from the SFP's current rating, the CRA would issue a downgrade or an upgrade, depending on the circumstances. *Id.*

29 *Id.* at 10.

30 *Id.* at 13-20.

31 *Id.* at 21-23.

32 Most CRAs have adopted the "issuer pays" pricing model in the SFP rating businesses. Under the "issuer pays" model, the underwriter of the SFP pays the CRA who rates the SFP. *Id.* at 23-27, 31-32.

33 Two of the three largest CRAs do not prohibit SFP analysts from owning shares of investment banks that may participate in SFP transactions. Furthermore, only one of the CRAs employs a third-party service to identify undisclosed brokerage accounts to ensure that employees are submitting complete information about their brokerage accounts. *Id.* at 28.

34 One CRA only required a one-page checklist limited in scope to evaluate the completeness of deal files and the CRA only provided four examples where the reviewer forwarded findings to management and no examples of management's response thereto. Another CRA's internal audit revealed that its SFP rating group had failed to comply with document retention policies and had failed to adhere to rating committee guidelines. Furthermore, the same CRA's management had failed to formally review and validate derivatives models prior to posting for general use. *Id.* at 30.

35 SFP analysts relied upon historical data in order to predict future behavior. However, the data that the analysts relied upon was very short and the information available occurred under very benign economic conditions. Even after realizing their flawed analysis, analysts infrequently re-estimated their models by applying new data. *Id.* at 35.

External factors also contributed to flawed ratings. The concentrated underwriting market for SFPs[36] encouraged CRAs to concede on negotiation points during the rating process to prevent the loss of a valuable customer. The CRAs standard-setting status also provided liability insurance to investment banks that chose to underwrite riskier investments, which encouraged more risk taking.[37] These internal and external factors were essential ingredients in the financial crisis that followed this egregious conduct.

F. Damage Caused By Inaccurate Structured Financial Product Ratings

The *root cause* of the recent financial crisis was the housing correction, which resulted in illiquid mortgage-related assets that choked off the vital flow of credit in our economy.[38] While the *root cause* of the recent financial crisis might have been the housing correction, the subsequent *choking off* of credit would not have occurred had CRAs assessed risk in the SFP market in a disinterested fashion.

By comparing the 2007 seven-year cumulative default rates of asset-backed securities to other securities with the same credit rating, the CRAs' failure and refusal to properly assess risk becomes obvious. The cumulative default rate of triple-A rated, asset-backed securities was 7.17%, whereas the default rate in the same time period for triple-A rated municipal debt, sovereign debt, and corporate debt was 0.00%, 0.00%, and 0.25%, respectively.[39] The cumulative default rate of Baa-rated asset-backed securities was 34.04%, whereas the default rate in the same time period for Baa-rated municipal debt, sovereign debt, and corporate debt was 0.11%, 3.90%, and 2.96%, respectively. In April of 2008, the International Monetary Fund reported that the recent financial crisis had caused prospective losses equal to $1 trillion. [40] Surprisingly, CRAs received excessive compensation

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36 *Id.* at 31 (explaining that 12 arrangers accounted for 80% of subprime mortgage-backed securities deals, in both number and dollar volume; and 11 arrangers accounted for 92% of the deals and 80% of the dollar volume of collateralized debt obligations composed of mortgage-backed securities).

37 *See* Marc Flandreau, *Rating Agencies v. Investment Banks: Who's Minding The Shop?*, ECONOMICS BLOG FROM THE FINANCIAL TIMES, (Aug. 25, 2009, 5:11PM), http://blogs.ft.com/economistsforum/2009/08/rating-agencies-vs-investment-banks-who's-minding-the-shop/

38 *See Turmoil in U.S. Credit Mkts. Recent Actions Regarding Gov't Sponsored Entities, Investment Banks and Other Financ. Insts.: Hearing Before the Senate Banking Comm.*, 111th Cong. (2008) (statement of Treasury Secretary Henry M. Paulson, Jr.).

39 *See* FRUHAN, *supra* note 2, at 23-24.

40 *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: CONTAINING SYSTEMIC RISKS AND RESTORING FINANCIAL SOUNDNESS, (2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm; *See also* RGE Monitor, during this same timeframe, but did nothing to improve the quality of their ratings.

III. An *Approaching Privity* Relationship Exists Between Credit Rating Agencies and Structured Financial Product Investors.

An *approaching privity* relationship exists between CRAs and investors because CRAs provided SFP ratings to enable the SFP transactions, the CRAs knew that investors would rely on those ratings, and CRAs participated enough in the creation of these securities to link them to investors. Generally speaking, an individual who provides contract services to another in the course of his employment, profession, or business is not liable for negligent misrepresentations to third party beneficiaries of such contract.[41] However, third party beneficiaries of accounting services may sue professionals if a privity relationship or a relationship *approaching that of privity* exists.[42] A relationship approaching that of privity exists when a contract party provides services for a particular purpose in furtherance of which a known party or parties are intended to rely, and the service-providing party provides those services in a manner that constructively links it to the reliant party.[43] As time has progressed, an "assault of the citadel of

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Roubini Pegs Credit Related Losses at $2 trillion!, RGEMONITOR, (Aug. 5, 2008), *available at* http://www.rgemonitor.com (claiming losses exceed $2 trillion).

41 *See* Winterbottom v. Wright, 10 M & W 109, 152 Eng. Rep. 402 (1842).

42 *Compare* Merit Ins. Co. v. Colao, 603 F.2d 654, 659 (7th Cir. 1979) (recognizing a relaxed privity requirement in the case of negligent conduct by an accountant involving known parties who reasonably rely upon the accountant's negligent representations), *cert. denied* 445 U.S. 929 (1980) (citations omitted); *with* Koch Indus. v. Vosko, 494 F.2d 713, 724-25 (10th Cir. 1974) (granting recovery to third parties only in instances of intentional misrepresentation or fraud); (citations omitted); *cf.* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214, n. 33 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748 (1975).

43 *See* Credit Alliance Corp*.* v. Arthur Andersen & Co.*,* 493 N.Y.S. 2d 435, 483 N.E.2d 110, 118 (1985) (defining "relationship approaching privity" test in its application to accountants); Coleco Indus., Inc. v. Berman, 423 F.Supp. 275, 309 (E.D. Pa. 1976) (holding an accounting firm liable to a nonprivy party because the nonprivy party had chosen the accounting firm, had explained the role it would play in the ongoing transactions, and had direct dealings with throughout the transactions); Seedkem, Inc.v. Safranek, 466 F. Supp. 340, 343-44 (D. Neb. 1979)(applying the "approaching privity" test because the accountant's notes to the audited financial statements specifically identified the nonprivy party); *see also* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90 (D.R.I. 1968) (holding an accountant liable to a third party because the accountant had prepared balance sheets for his client with the "end and aim" of influencing the third party to extend credit to the accountant's client); *see also* LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*,* 951 F.Supp. 1071, 1092-93 (S.D.N.Y. 1996) (applying *Credit Alliance* accountant standard to credit rating agencies intimately involved in structuring financial products); Guildhall v. Silberman, 688 F. Supp. 910, 914 (S.D.N.Y. 1988) (applying *Credit Alliance* standard to appraisers of real property).

privity"[44] has continued, and courts have extended the approaching privity doctrine to instances involving other professional services.[45]

The court in *LaSalle National Bank v. Duff & Phelps Credit Rating Co.* held that CRAs are in a relationship *approaching that of privity* with third party investors. In *LaSalle National Bank*, Duff & Phelps had been hired by Towers Financial Corp. to rate $200 million of bond issues, the proceeds of which would be used to acquire qualified healthcare receivables.[46] Duff & Phelps' involvement was necessary to sell the bonds because it was a condition of the initial issuance of each series of bonds that Duff & Phelps rate them AA.[47] Prior to the issuance of each series of bonds, Duff & Phelps assigned a rating of AA and consented to the use of its name and the assigned rating in connection with the disclosure documents, advertisements, and description of the issue.[48] Duff & Phelps directly communicated with six of the twenty-six purchasers prior to and following their purchase regarding the rating process, and assured them of the merits of the bond issues.[49] In addition to rendering initial ratings of the bond issues, Duff & Phelps committed to perform due diligence on the underlying assets of the bonds every quarter 'in order to enable it to reaffirm, upgrade, or downgrade the outstanding ratings.'[50]

After purchasing the bond issues, the qualified institutional investors discovered that Towers Financial had engaged in a massive fraud by acquiring non-conforming healthcare receivables, selling those receivables to third party investors, and diverting millions of dollars its insiders' own purposes.[51] In response to Towers' fraud, the investors brought suit against Duff & Phelps asserting negligent misrepresentation. Duff & Phelps responded by making a motion to dismiss for lack of privity.[52]

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44 *See* Ultramares Corp v. Touche, 174 N.E. at 445.

45 *See* LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. at 1092 (extending the "relationship approaching privity" test to credit rating agencies that are intimately involved in the structuring of financial products); Guildhall Ins. Co. v. Silberman, 688 F. Supp. 910, 913 n.2 (applying approaching privity test to "appraisers" of artifacts); Chemical Nat'l Bank v. Nat'l Union Fire Ins. Co., 74 A.D.2d 786 (N.Y. App. Div. 1980) (extending relaxed privity requirement to appraisers of real property); Gordon v. Holt, 65 A.D.2d 344 (N.Y. App. Div. 1979) (recognizing the application of a relaxed privity requirement to architects for negligently preparing reports, but not holding architect liable under such standard).

46 *See* LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. at 1074-75.

47 *Id.* at 1076.

48 *Id.*

49 *Id.* at 1078-79.

50 *Id.* at 1078.

51 *Id.* at 1076.

52 *Id.* at 1073.

The court reasoned that Duff & Phelps was aware of a particular purpose for the rating because Duff & Phelps consented to including their name and rating in the offering memoranda.[53] The court also found that Duff & Phelps knew that the investors would rely on the inaccurate ratings because Duff & Phelps consented to the use of its name in the offering memoranda and directly communicated to some investors regarding the merits of the investments.[54] Finally, the court found that Duff & Phelps' conduct linked it to the investors because Duff & Phelps had advised Towers how to apply credit enhancement features[55] to its securities, so that such securities could attain an AA rating, which was requirement of the offering.[56] The court also noted that Duff & Phelps's direct communications with some of the investors, and the subsequent purchases made by initial purchasers strengthened the evidence that Duff & Phelps "was particularly aware of the 'select group of qualified investors' to whom its ratings would be given to induce Bond purchases."[57] Therefore, the court held that Duff & Phelps had a relationship "approaching privity" with the qualified investors and denied its motion to dismiss for lack of privity.[58]

While *LaSalle National Bank* appeared to state a narrow holding, there is no reason why it should not apply more broadly because the essential facts are present in every typical SFP offering. First, most SFP ratings serve a particular purpose because SFP offerings could not occur without a rating. Without an investment-grade rating, many qualified institutional investors could not participate in the offering because regulations or privately-tailored restrictions would prevent them from purchasing the products. Because CRAs have this gate keeping power, the ratings they issue serve a particular purpose.

Second, due to the large number of assets contained in an SFP and the complexity of the SFP's trust agreement, investors have no option but to rely on the rating. SFPs typically contain thousands of individual loans with different borrowers in different geographic regions bound by different terms and conditions. The complexity of an SFP is amplified by its trust agreement because most SFP trust agreements are littered with complex provisions that subordinate rights to future income streams between tranche owners and

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53 *Id.* at 1093.

54 *Id.* at 1093-94.

55 While the court did not specifically disclose what type of credit enhancement features Duff & Phelps had advised Towers to utilize, the typical credit enhancement features are creation of tranches within a pool with superior priority over other tranches, creation of tranches with superior yield over other tranches, over-collateralization, and utilization of bond insurance as discussed in part I(C), *supra*.

56 *Id.* at 1094.

57 *Id.*

58 *Id.* at 1095.

create indemnity relationships between the trust and insurers.[59] CRAs' ability to perform due diligence services on already existing ratings in exchange for a fee is further evidence of the complexity of SFPs and the reliance it creates between investors and CRAs. Because an SFP is so immensely complex, investors must rely on the credit rating to make an investment decision.

Finally, the process by which an SFP rating is created establishes conduct that links reliant investors to credit rating agencies. After the underwriter has forwarded information regarding the offering to credit rating agencies, the credit rating agencies disclose preliminary ratings of the different tranches to the underwriter. If the preliminary ratings do not conform with the underwriters' representations to potential investors, then the underwriter and the credit rating agency negotiate about modifying particular features of the trust's structure to ensure conformity with investors' expectations. While this preliminary negotiation might pass muster if the bargaining power of the parties was equal and no conflicts of interest were present, a typical SFP offering does not satisfy either of these requirements.

The fee of SFP rating equals as much as three times the amount of a typical bond-rating fee.[60] Furthermore, most SFP offerings are conducted by a small number of large investment banks, which are repeatedly returning to CRAs to rate new SFP offerings. If the CRAs want to ensure repeat, high-profit margin business; then the rating agencies must concede on particular points of the negotiation or suffer a major loss of business to a competitor who will probably concede on those points. Because the rating process is plagued by these conflicts of interest, CRAs are not acting in a disinterested fashion- a conduct that links the CRAs to reliant third party investors. Therefore, a relationship "approaching privity" should be present between CRAs and SFP investors because the ratings serve a particular purpose, affect a known reliant party, and involve conflicted conduct by CRAs.

IV. The First Amendment's Lack of Protection for Structured Financial Product Ratings.

When rendering SFP ratings, CRAs should not qualify for First Amendment protection because SFP ratings are not matters "of public concern." Generally speaking, speech in the form of a credit rating is fully protected by the First Amendment because the intent of the speaker is to use

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59 *See* Part I(C), *supra*.

60 *See* The GSE Report (June 18, 2007), *available at* www.gsereport.com.

the material to disseminate information to the public.[61] However, First Amendment protection is not granted to speech involving "no issue of public concern"[62] or to commercial speech.[63]

A credit rating's content, form, and context . . . as revealed by the whole record indicate whether such rating is of public concern or not.[64] Some factors that indicate a credit rating is not a matter of public concern are the rating is rendered "solely in the individual interests of the speaker and its specific audience," the rating is "wholly false and clearly damaging," the rating is not broadly disseminated, the rating is "hardy and unlikely to be deterred by incidental state regulation,"[65] and the rating is "more objectively verifiable than speech deserving of greater protection".[66] Appling these factors, some courts have recently held that credit ratings are not matters "of public concern" and, accordingly, have denied CRAs of First Amendment protection.

LaSalle National Bank v. Duff & Phelps Credit Rating Co. sheds light on the lack of First Amendment protection entitled to CRAs in the SFP context. In *LaSalle National Bank*, LaSalle and other qualified institutional investors brought suit against Duff & Phelps for negligent misrepresentation, and Duff & Phelps moved to dismiss the action by asserting First Amendment immunity. However, the court rejected this argument because the rating was privately contracted for between the underwriter and Duff & Phelps.[67] Duff & Phelps also argued that it was entitled to publisher immunity because its rating had been broadly disseminated like other financial information

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61 *See, e.g.*, Compuware Corp. v. Moody's Investors Servs., Inc., 499 F.3d 520, 529 (6th Cir. 2007); Jefferson County School Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999).

62 *See* Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 757 (1985) (plurality).

63 The commercial speech exception is well recognized in Supreme Court jurisprudence. *See* Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 554 (2001); U.S. v. United Foods, Inc., 533 U.S. 405, 409 (2001); Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 504 (1996); Rubin v. Coors Brewing Co., 514 U.S. 476, 482 (1995); City of Cincinnati v. Discovery Network, Inc., 507 U.S. 410, 421 (1993); Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 761 (1976). However, applying the commercial speech exception to CRAs' SFP credit ratings could impose dire consequences on commercial entities seeking to protect their interests. For example, a misleading Consumer Reports opinion regarding the quality of a consumer product would fall within the commercial speech exception if Consumer Reports also received advertisement revenue from the manufacturer of that product. Such a result is inconsistent with the broad principles of the First Amendment. Thus, the commercial speech doctrine is inappropriate in this context.

64 *See Dun & Bradstreet, Inc.*, 472 U.S. at 761.

65 The court clarified that "hardy" speech is speech that is solely motivated by the desire for profit, which is a force that is less likely deterred than others. *See id.*

66 *Id.*

67 *See LaSalle Nat'l Bank*, 951 F. Supp. at 1096.

entitled to First Amendment protection. The court also rejected this defense because Duff & Phelps's rating was only published through a very limited means, i.e., the offering memoranda.[68] Because Duff & Phelps's rating was rendered in accordance with a specific, private contract and was disseminated only to a limited number of people, the court determined that the rating was not a matter of pubic concern and rejected Duff & Phelps's plea for First Amendment protection.

Another particularly instructive case regarding SFP rating's protection under the First Amendment is *In re Fitch, Inc.,* where the Second Circuit only found that Fitch participated unlike a journalist in an SFP transaction, but nevertheless denied First Amendment protection. After bank regulators concluded that a bank's CDOs were not investment grade and compelled the bank to sell them, the bank demanded that its broker accept return of the CDOs. The broker refused to accept the CDOs. Accordingly, the Bank sued the broker and subpoenaed Fitch after learning that Fitch and the broker "had extensive communications about the structure of the transactions."[69] Fitch refused to comply with the subpoena asserting a defense under New York's shield law and the First Amendment. However, the district court rejected Fitch's defense because Fitch only covered its own clients, unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy. Unhappy with the district court's holding, Fitch appealed the district court's decision to the Second Circuit.

The Second Circuit noted that Fitch was not entitled to First Amendment protection because a Fitch employee took "a fairly active role . . . in commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings," which demonstrated "a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports."[70] Because Fitch was not behaving like a typical journalist, the court held that its CDO rating was not an issue "of public concern" and denied Fitch protection under the First Amendment.

Because most typical SFP ratings are rendered under factual circumstances similar to *LaSalle National Bank* and *Fitch*, a typical SFP rating should not possess First Amendment protection. First, SFP ratings are disseminated to a relatively small audience because most SFPs are offered to investors under Rule 144A. Rule 144A requires potential investors to be qualified institutional investors. Because qualified institutional investors must have assets in excess of $100 million, the audience of an SFP

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68 *Id.*

69 *See* In re Fitch, 330 F.3d 104, 107 (2d Cir. 2003).

70 *Id.* at 110.

transaction is relatively small when compared to the audience of a newsworthy article.

Second, the ratings are solely in the individual interests of CRAs and their audience because only CRAs, underwriters, broker-dealers, and qualified institutional investors stand to financially benefit from information contained in the rating. Unlike a newsworthy article where the subject matter involves an issue that pertains to a broad class of individuals and entities, the outcome of a particular SFP rating only affects the interests of a select group of stakeholders. CRAs get upfront fees from the rating. Underwriters capture any gain between their basis in the assets contained in the SFP and the price that those assets are sold to investors in the form of an SFP. Broker-dealers usually get a piece of the underwriter's profit and investors hope to experience an increase in the value of their investment. Any other party involved, i.e., the mortgagors of the mortgages contained in the SFP, do not stand to benefit from the rating because their rights are already contractually fixed before the rating is rendered. Because the subject matter of an SFP rating does not directly bear upon an issue that affects a broad class of individuals and entities, an SFP rating is solely in the interests of CRAs and other SFP market participants.

Third, while many SFP ratings were not verifiably false prior to the financial meltdown, the subsequent downgrades and resulting losses are evidence that they were misleading and clearly damaging. As indicated in Part I (F), *supra*, the default rates of asset-backed securities varied significantly from other asset classes with the same credit rating between 2000 and 2007.

Fourth, the ratings are hardy, and unlikely deterred, because they provide CRAs with huge profits. Moody's and Standard & Poor's had operating profit margins equal to 53.6% and 44%, respectively, during the 2005-2007 timeframe. Furthermore, CRAs have continued doing business with severe conflicts of interest -- back-and-forth negotiation, issuer-pays model, etc. -- despite regulations prohibiting analogous conduct. Because CRAs have reaped major profits from these ratings and have rendered these ratings through seriously conflicted processes, despite regulation, SFP ratings are hardy speech that is unlikely deterred by further regulation.

Finally, SFP ratings are more objectively verifiable than political opinion, or other strictly protected speech, because of their numerical nature. As indicated in Part I (D), most of the SFP rating process involves applying assumptions to the underlying performance of an SFP's assets to determine the SFP's performance in varying market conditions. Therefore, a typical SFP rating is probably not a matter of public concern, which deserves First Amendment protection, because a typical SFP's content, form, and context indicates that it is not a matter of public concern.

V. CONCLUSION

The egregious errors committed by CRAs during the boom days of SFPs are factually similar to the egregious errors committed by accounting firms during the Enron, WorldCom, and Adelphia scandals. Yet, Congress has refused to address the conflicts of interest and poor management practices inherent in a typical SFP rating. Thus, courts should slacken the privity requirement in suits by third party beneficiaries of SPF ratings to respond to a problem that Congress is unwilling to address. For similar reasons, courts should not shield CRAs from liability by applying the First Amendment. Both approaches clearly fall within established legal exceptions and will protect the coffers of Wall Street and Main Street.

LENDER LIABILITY IN CONSTRUCTION AND REAL ESTATE FINANCING

JOSÉ A. DÍAZ BRUGUERAS

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It has been said that the love of money is the root of all evil. The want of money is so quite as truly."[1]

I. INTRODUCTION

Economic prosperity and industry booms do little to portray the extent to which individuals and corporations reach in order to protect their financial interests. It is during economic hardships and recessions, periods such as the one we are currently going through, when the true colors of contracting parties in financing agreements are revealed.

As Puerto Rico's economy continues to deteriorate, and the real estate industry along with it, we may expect continuous foreclosures and frequent litigations in the near future regarding defaulted construction loans. Along with these foreclosures will come numerous defensive arguments, on behalf of borrowers, who will do anything to avoid the onerous results of foreclosures and the subsequent execution of personal guarantees that comes with them. One of these arguments, Lender Liability, will be discussed and developed in this article through the examination of treatises, jurisprudence, and actual situations which I myself have had the opportunity to witness. Predominantly, I wish to examine cases under which courts

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1 SAMUEL BUTLER, EREWHON, 179 (1872).

sustain the lender liability argument and *what* are the remedies granted to the prevailing party, with particular focus on construction loan agreements.

Unsurprisingly, lender liability gained prominence and acceptance as a substantive body of law during the early 1980's,[2] at which time the United States was also experiencing a deep recession. Lender liability law basically consists of the principle that lenders must treat their borrowers fairly and, in those instances in which they do not, they can be subject to borrower litigation under a variety of legal claims.[3] Indications of potential lender liability include inordinate lender control, atypical lending practices, lack of professionalism, abuse of a special relationship, and conflicts of interest. Lender liability theories often permit a plaintiff to go beyond the *four corners* of loan documents. According to Edward F. Mannino:

> Awards in recent lender liability suits have been obtained on a wide range of theories – tort, contract, and statutory, some new and some old. Breach of contract, fraud, misrepresentation, duress, control, and intentional infliction of emotional distress are each settled common law doctrines, which are now being applied to lender liability cases, while bad faith, breach of fiduciary duty, and joint venture are new or evolving common law doctrines of lender liability. Statutory requirement, including those set forth in RICO, CERCLA, federal tax, and federal securities laws, also supply additional theories of lender liability.[4]

Throughout this article, the different theories under which lender liability awards have been obtained and which may apply to construction financing agreements will be discussed in further detail.

As it pertains to Puerto Rico and its jurisprudence, although the doctrine of lender liability, as such, has not been the direct target of scrutiny, the local Supreme Court has had more than enough opportunities to examine most of the theories under which lender liability claims have been upheld. Namely, Puerto Rico's Supreme Court has thoroughly examined the theories of breach of contract, fraud, misrepresentations, estoppel, good faith requirements, and excessive control by lenders. We should expect some new local jurisprudence in the next few years with regards to these topics and how they pertain to real estate financing, as there are currently dozens of large foreclosure suits and borrower counterclaims either in the District Court or in the Court of Appeals. Nevertheless, given the lack of substantive

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2 Cappello & Noël, LLP, *What is Lender Liability?* (1999), *available at* http://www.cappellonoel.com/news_articles/what_is_lender_liability.html.

3 *Id.*

4 Edward F. Mannino, *New Developments in Lender Liability: Theories of Lender Liability Litigation,* 1993 A.B.A. SEC. BUS. L. 3.

jurisprudence concerning the specific issue of lender liability from the local courts, with some exceptions, most of the jurisprudence referenced to within these pages originate in the U.S.' federal and state courts.

II. LENDER LIABILITY ARGUMENTS – CONTRACT THEORIES

Most lender liability causes of action arise from either contract or tort theories. Hence, the focus of this piece will begin by examining the lender liability arguments arising from contract theories and will later turn to those arguments based on tort theories.

In Puerto Rico, contractual obligations are, for the most part, governed by the Civil Code, which, among other things, states in Art. 1230 that "Contracts shall be binding, whatever may be the form in which they may have been executed, provided the essential conditions required for their validity exist."[5] Furthermore, Art. 1213 of the Civil Code utters the essential conditions for a contract to be valid, which are: consent, object and cause.[6] But for the type of contract that will be discussed throughout this section, the construction or real estate financing agreement, it is important to highlight the fact that Art. 1232 of the Civil Code states that contracts must be in written form, in order to be enforceable, if the object or service originating the agreement is worth more than $300.[7] Thus, it would be difficult for either a borrower or lender, in our jurisdiction, to enforce an oral agreement for a construction or real estate loan.

"Lender contractual liability is usually based on one of the following concepts: anticipatory repudiation, promissory estoppel, condition precedent, acceleration, duty to inspect, and breach of good faith."[8] It is very important to note that courts will generally enforce contracts as written, thus:

> Bank[s] have the right to insist that a borrower comply with the provisions of the contract, which is embodied in the various loan documents executed in connection with any loan or financing transaction. Such insistence cannot constitute, or give rise to, a claim by the borrower of breach of contract by the lender.[9]

A. Anticipatory Repudiation

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5 P.R. LAWS ANN. tit. 31, § 3451 (2007).

6 P.R. LAWS ANN. tit. 31, § 3391 (2007).

7 P.R. LAWS ANN. tit. 31, § 3452 (2007).

8 Roy Ryden Anderson and Diane K. Lettelleir, *Contracts Theories, in* 1 Lender Liability Law and Litigation § 3-36 (2009).

9 *Id.*

Anticipatory repudiation occurs when a promisor (lender) without justification and before any breach has been committed by the promisor unequivocally indicates by statement to the promisee (borrower) or by the promisor's conduct that the promisor is no longer willing or able to substantially perform its contractual obligations. The repudiating statement or conduct must be positive and unequivocal; a mere implication of repudiation is not sufficient:[10]

> For a borrower to recover on a theory of anticipatory repudiation, the following elements must be established: 1) that the lender made a loan commitment to the borrower; 2) that the lender withdrew the commitment before the expiration of the time allotted to the borrower to comply with the required conditions, or the lender insisted that the borrower perform conditions not contained in the original commitment agreement; 3) that the borrower was damaged as a result of the withdrawal of the commitment.[11]

The question under the anticipatory repudiation principle would then be: may a lender, who has objective reason to believe that the borrower will not be able to repay the debt incurred under a construction financing commitment, withdraw its commitment to fund the project without exposing itself to lender liability? For instance, if the borrower has experienced long delays in beginning the project and, as a result, will also suffer significant cost overruns, may the lender withdraw its commitment to fund, knowing that the project will be out of budget? Or, if an in depth market analysis performed by a third party shows that a construction project, as originally proposed, is no longer feasible, may the lender refuse to continue funding the project without exposing itself to a lender liability claim? The answer to these questions seems to be "*yes*".

Courts have repeatedly allowed banks to withdraw their commitments under circumstances such as the ones described above. However, they usually place the burden of proof on the bank to show that the borrower would have been unable to meet the required conditions of the financing agreement. For instance, a bank would have to show that conditions of a construction loan agreement, such as an *in balance* provision, would not be able to be fulfilled because the construction project has had numerous setbacks, change orders or delays, or simply establish, with a preponderance of the evidence, that the budget of the project has been significantly altered.

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10 *Id.* at 3-38 (citations omitted).

11 *Id.*

In *Glatt v. Bank of Kirkwood Plaza,*[12] the Bank committed $1.7 million to finance the plaintiff's project which involved the purchase of condominiums and the construction of a restaurant, bar and racquetball club. Prior to the commitment's expiration, the bank withdrew its commitment and took definite action to repudiate the agreement, arguing that "racquetballs and the recreation facilities in the areas are not successful", and that "the loan was not a workable loan."[13] The court ruled in favor of the developers on the issue of anticipatory repudiation and placed the burden of proof on the bank saying, "but in terms of trying to establish whether or not they [the developers] could have met those conditions, it would not be a matter then of them proving they could have, but a matter of you [the Bank] proving that they could not."[14] Despite this ruling and the assertions made by the court in this case, a bank should be successful in its defense of the anticipatory repudiation claim provided it can, as a matter of fact, establish the inability of the borrower to meet the conditions set forth in the loan agreement, including repaying the loan.

In practice, many borrowers use the anticipatory repudiation argument when establishing a counterclaim against the lenders. Their main argument is that, by repudiating the contract prematurely, the lender did not give the borrower, or the project, a chance to succeed. In other words, they argue that by repudiating the contract the lender set up the borrower, or the project, to fail. It remains to be seen if local courts will give way to those arguments and what, if any, will be the remedy awarded to the grieving party. Nonetheless, even if the courts do not accept this argument, these counterclaims will at least buy the borrower some time, avoid summary judgments in favor of the lender and postpone the foreclosure and execution of the personal guarantees.

According to authors Roy Ryden and Diane Lettelleir, damages for anticipatory repudiation can be extremely large.[15] As an example, the authors cite *Federal Deposit Insurance Corp. v. Scharenberg*, which arises from a construction loan default. In said case:

> Although the borrower had complied with all loan conditions, the lender declared the loan to be in default and turned the loan over to the FDIC. [The lender alleged] that the borrower would have been unable to meet certain conditions. The FDIC sued the borrower for this alleged default and recovered a $55 million judgment. A week

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12 Glatt v. Bank of Kirkwood Plaza, 383 N.W. 2d 473 (N.D. 1986) (citation omitted).

13 *Id.* at 475.

14 *Id.*

15 Anderson & Lettelleir, *supra* note 8, at 3-40.

> later, the borrower won a $105 million jury verdict against the lender for breaching the loan contract.[16]

Legal counsel for financial institutions should pay plenty of attention to the language included in commitment letters and financing agreements with regards to the obligation of lenders. The language of said documents should contain as many exceptions or *ways out* of the contract for the lender as possible. For commitment letters a good practice is to set a very short-term expiration date. Thus, if the borrower takes his time in reviewing the terms of the commitment letter and does not accept it before the expiration date, the lender may revisit his decision or may simply change some of the terms originally included in the letter, without the risk of anticipatory repudiation liability. For financing agreements a good practice is to include *in balance* provisions. These provisions usually state that the project's budget must be *in balance* at all times. If there is a cost overrun or a change order, the covenant states that the borrower must make a capital contribution in order to reestablish the balance in the budget. Failure to do this gives the lender the right to declare the default and repudiate the contract. Moreover, another good practice for construction loan contracts is to establish deadlines for construction termination. Therefore, if the borrower suffers delays in the beginning of construction and it can be proven, as a matter of fact, that he will not be able to comply with the construction termination date, the lender may once again declare the default and repudiate the contract.

B. Promissory Estoppel and Negligent Misrepresentation

> Even though the lender has not made a binding loan commitment, liability may attach for promises made by the lender during the loan negotiation process. If the proposed borrower (the promisee) has reasonably acted to its detriment in reliance upon such promises, it may have a successful action against the lender (the promisor) under the doctrine of promissory estoppel.[17]

The Court explained this doctrine in *Consolidated Services, Inc. v. Keybank National Association* stating that it is, "[a] doctrine of contract law, its purpose is to enforce promises that while not supported by consideration, and so not enforceable under traditional principles of Anglo-American

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[16] *Id.* at 3-41.

[17] *Id.* at 3-42.

contract law, were likely to induce and did induce reliance by the promisee."[18] As explained by the author, "promissory estoppel does not create a contract that otherwise did not exist, but only prevents a party from insisting upon his strict legal rights when it would be unjust to allow him to enforce them."[19]

In MSA Tubular Products, Inc. v. First Bank and Trust Co., the court expresses the following in relation to lender liability cases involving promissory estoppel and negligent misrepresentation:

> In order to recover, a plaintiff . . . must allege and prove by a preponderance of the evidence: (a) A misrepresentation or omission of a fact; (b) That the representation or omission is material or significant; (c) That in responding to the credit inquiry the bank officer failed to exercise that degree of diligence and expertise the public is entitled to expect of reasonably competent bank officers; (d) That it reasonably relied upon the bank's misrepresentation or omission; and (e) That it suffered damages as a direct and proximate result of such reasonable reliance.[20]

Even though in Puerto Rico contracts that involve a sum that exceeds $300 must be in writing, the Supreme Court in cases such as *Int. General Electric v. Concrete Builders*[21] has admitted the promissory estoppel argument, or what it calls *self acts doctrine*, to enforce obligations between non-contracting parties. Thus, the question which arises from the theory of promissory estoppel is: does a borrower have a cause of action, under the promissory estoppel theory, when he acts relying on a credit officer's oral statements that a construction loan has been approved or that the loan will be forthcoming subject to the performance of certain conditions? Can a prospective borrower enforce an oral promise to lend?

In cases based on theories of negligent misrepresentation or promissory estoppel, courts in a number of jurisdictions have answered affirmatively to these questions in several recent decisions, some resulting in multimillion-dollar awards. Other courts have disagreed with the approach taken in these decisions.[22] Thus, it seems that the potential results in our jurisdiction, for situations based on these theories, will have to be evaluated on a case-by-case basis. The Supreme Court's ruling will probably be

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18 Consolidated Services, Inc. v. Keybank National Association, 185 F.3d 817, 822 (Ind. 1999).

19 Anderson & Lettelleir, *supra* note 8, at 3-43 (citations omitted).

20 MSA Tubular Products, Inc. v. First Bank and Trust Co., 869 F.2d 1422, 1424 (Okl. 1989).

21 Int. General Electric v. Concrete Builders, 104 D.P.R. 871 (1976).

22 Mannino, *supra* note 4.

determined by the particular facts of the case, the precedent that the court wishes to establish, and the protection that the court wants to grant either to borrowers or to lenders.

As a matter of example, in *Rhode Island Hospital Trust National Bank v. Varadian*, the court reversed a verdict in excess of $4,000,000 in favor of borrowers, based on promissory estoppel theory, where bank personnel orally promised to provide borrowers a construction loan of $43,500,000. The court found such promise was not a commitment because "the bank made an oral *promise* which the bank did not intend, and the defendants did not understand, to be a commitment because both parties contemplated a written agreement that would govern the intricacies of the $43,500,000 construction loan."[23] The court concluded that "because the evidence in this case did not warrant a finding that a *promise* in the contractual sense had been made, any reliance by the defendants (borrowers), who were experienced businessmen, would be unreasonable as a matter of law."[24]

On the other hand, in *Federal Land Bank Association v. Sloane,*[25] a loan officer informed the borrower that the bank's board had approved the loan, and that the borrower could go ahead with site preparation work. The contractor hired by the borrower to build the new chicken houses contacted the bank's loan officer to see if he should begin construction, notwithstanding the pending nature of the loan. The loan officer said that there was "no problem, and that there was not any reason for them not to continue at that point." The borrower had one of their old chicken houses demolished, and paid approximately $9,000 for further site preparation. Later, the borrower received a letter from the bank denying their loan application, giving as reasons for the denial the fact that they failed to include two outstanding debts on their application and that they incurred in additional liability for a car purchase while the loan was being processed. The borrower then sued the bank alleging that the loan officer had negligently misrepresented that their loan application would be approved. The court ruled in favor of the borrower based on the facts that: (1) the representation was made by the lender in the course of his business, or in a transaction in which he has a pecuniary interest; (2) the lender supplied "false information" for the guidance of others in their business; (3) the lender did not exercise reasonable care or competence in obtaining or communicating the information; and (4) the plaintiff suffered pecuniary loss by justifiably relying on the representation.

These two examples show how courts are still fairly inconsistent in their rulings of cases based on promissory estoppel and negligent

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23 R.I. Hosp. Trust Nat'l Bank v. Varadian, 419 Mass. 841, 850 (1995).

24 *Id.*

25 Federal Land Bank Association v. Sloane, 825 S.W. 2d 439 (Tex. 1991).

misrepresentation. One thing is certain, however, and it is that courts usually deny recovery for lost expectation damages and limit recovery solely to reliance damages. For instance, in *Wheeler v. White,*[26]

> the court made clear that damages based upon expected profits should not be allowed even though such a loss could be proved with certainty. The court stated that any recovery must be limited to damages based upon the detriment sustained by Wheeler [the borrower] in reliance upon White's [the lender's] promise that the loan would be forthcoming.[27]

In Puerto Rico, lenders are litigating cases with a factual background similar to *Federal Land Bank Association v. Sloane* arduously. The cases, which focus in negligent misrepresentation and estoppel, are being litigated in local courts and focus on contractors and third party suppliers, rather than on the borrower. These third parties constantly argue that they relied on the loan officers' and lender's representations when they begin to work on the borrower's project. Often the result of this action is that, if the project is unsuccessful, the third parties could end up not getting paid for the work already done. Also, another scenario is that the developer ends of owing the reitanage to these third parties. At this stage the third parties usually look to the lender in order to satisfy their claim.

The problem that these third parties face, when making their claims to the lenders is that, in the majority of the cases, they have no solid evidence to prove that the lenders are liable to them. Given the absence of any contractual relationship between the bank and the third party contractor, their argument lacks merit. Nonetheless, it was a usual practice for the lenders a few years ago to issue a simple letter to the contractors stating that a given amount of dollars had been approved, for use by the borrower, to pay for work performed by that contractor. When the borrower, for whatever reason, fail to make payment to that contractor, those third parties always include the bank in their collection lawsuits. It remains to be seen what the local courts will decide in those particular cases. Nevertheless, those letters issued by the bank certainly qualify for a solid estoppel or negligent misrepresentation argument.

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26 Wheeler v. White, 398 S.W. 2d 93 (Tex. 1965).

27 Anderson & Lettelleir, *supra* note 8, at 3-45.

C. Conditions Precedent – Lender Satisfaction

> As a condition precedent, lenders occasionally require that the borrower perform certain tasks to the individual satisfaction of the lender. The general rule is that such conditions require only good faith satisfaction of the lender. Some courts have stated that without this good faith requirement, an agreement conditional upon one party's satisfaction would be illusory and would cause the entire contract to fail under the basic contract doctrine of mutuality of obligation.[28]

One question quickly jumps to mind under this topic of lender satisfaction: may a lender refuse to honor a commitment to lend because the bank's lending policy has not been performed by the borrower to the individual lender satisfaction? Authors Roy Ryden and Diane Lettelleir provide the example of *First Texas Savings Association of Dallas v. Dicker Center, Inc*.,[29] in which a "loan commitment for $2 million was conditioned upon receipt by the lender of a satisfactory appraisal of the property after improvement."[30] In said case,

> the bank['s] policy was to advance not more than 75 percent of the appraised value of the property. Even though the borrower submitted two appraisals, it was unable to meet this 75 percent requirement. Accordingly, the lender refused to make the loan, contending that the appraisal condition had not been satisfactorily met.
>
> The court found that the only issue raised was whether the lender's refusal had been made in good faith. The record showed that the 75 percent ratio of loan to land value was standard for the industry in the lender's area. . . [T]he court concluded that the lender's decision not to fund the loan was made in good faith.[31]

What if the conditions for approval of the loan commitment are established in such a way that the bank knows that the borrower will not be able to perform them to the individual satisfaction of the lender? For instance, it is not uncommon to see a lender establishing as a condition for granting a loan commitment that the borrower must make a capital

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28 *Id*. at 3-51, 3-52 (citations omitted).

29 First Texas Savings Association of Dallas v. Dicker Center, Inc., 631 S.W. 2d 179 (1982).

30 Anderson & Lettelleir, *supra* note 8, at 3-52.

31 *Id*.

contribution of 25 percent of the total costs of a construction project, knowing that the borrower does not possess such capital. The practice among developers is to offer the bank with what they call *deferred equity contributions*, which consist mainly of the contractor's retainage, the sales and marketing costs, and municipal taxes and patents. May a bank refuse this sort of equity contribution and demand *cash equity* based upon an individual lender satisfaction clause? Would this constitute bad faith? Courts do not seem to believe so, as long as the lender can prove that said capital requirement is part of the bank's lending policy. Nevertheless, lenders must be extremely careful when establishing and, later on, accepting or rejecting the performance of these types of conditions.

D. Acceleration

> Lenders frequently include in the loan agreement an acceleration clause[,] which will allow the lender, upon default by the borrower, to declare all future obligations immediately due and payable and, upon nonpayment, to foreclose on the loan collateral. The note or loan agreement generally will contain a list of various acts, or the occurrence of various events, that constitute an event of default, any one of which gives the lender the right to accelerate.[32]

However, problems may arise if there is ambiguity in the documents regarding precisely what constitutes a default. In *First National Bank of Gainesville v. Appalachian Industries, Inc,*[33] the court determined that any ambiguity in the meaning of a term in the loan document should be construed most strongly against the lender who was the author of the agreement. This doctrine prevails in our jurisdiction and is frequently raised, by borrowers, as a defense for not complying with, what they argue are, ambiguous provisions in the loan agreements. Thus, events of default should be clearly defined in these agreements in order to avoid confusion and ambiguity.

There is uncertainty as to whether a lender may exercise a right to accelerate a loan and demand payment of any outstanding balances without first allowing the borrower to cure the instances which gave rise to the default. Once again, the courts seem to be in disagreement as to how to answer this question. For instance, some cases state that a lender must first give notice of intent to accelerate and allow the borrower a reasonable time to correct the default upon which the acceleration is based. Once the final

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32 *Id.* at 3-56 (citations omitted).

33 First National Bank of Gainesville v. Appalachian Industries, Inc. 247 S.E.2d 422 (1978).

decision to accelerate has been made, further notice of the acceleration must be given to borrower to effectively cut off any remaining rights the borrower may have to cure the default.[34] On the contrary, other courts have enforced the express terms of a note, which stated that the bank, without notice or demand, could accelerate a loan upon a change in the financial condition of the borrower, which increased the bank's risks. The courts have also held that the fact that this acceleration provision could be exercised without notice did not constitute a violation of the implied obligation of good faith and fair dealing. What's more, other courts have held that all that is required is that the lender undertake some act, which signifies an intention to accelerate. This act may be an affirmative act, other than a demand or notice, or it can be a simple demand.[35]

Local courts do not seem to have a problem with acceleration provisions. However, the local lender's practice is first to notify the default, allow for a curing period and then, if the default continues, accelerate the loan and demand payment. This is probably the safest practice for a lender when accelerating a loan, as it will demonstrate good faith and fair dealing to the court.

E. Bad Faith or Breach of Implied Covenant of Good Faith and Fair Dealing

> An emerging theory of lender liability is breach of a covenant of good faith and fair dealing arising by implication from the loan commitment agreement. . . . To sustain a claim for breach of the good faith obligation, the party must first establish a breach of an express provision of a contract.[36]

Most of the cases which have indicated that a lender may be liable for breaching the good faith requirement have involved an abrupt termination of credit, with insufficient or no advance notice, where there has not been a payment default. These have arisen in various contexts, including: "1) refusal to provide additional advances; 2) failure to renew a line of credit; 3) acceleration of loans; 4) foreclosure and repossession of collateral; 5) setoff and freezing of accounts; 6) refusal to accept late payments; and 7) refusal to continue honoring overdrafts."[37]

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34 Anderson & Lettelleir, *supra* note 8, at 3-57 (citations omitted).

35 *Id.* at 3-58 (citations omitted).

36 *Id.* at 3-66 (citations omitted).

37 Mannino, *supra* note 4 at 25 (citations omitted).

In Puerto Rico, the Supreme Court has stated time after time that the good faith principle permeates over contractual agreements.[38] In this respect, Art. 1210 of the Civil Code states that: "Contracts are perfected by mere consent, and from that time they are binding, not only with regard to the fulfillment of what has been expressly stipulated, but also with regard to all the consequences which, according to their character, are in accordance with good faith, use, and law."[39] Thus, it is evident that in our jurisdiction contracting parties are obligated to act in a good faith manner when enforcing obligations established in a loan agreement. Failure to do so would result in a possible award of damages to the affected party.

In jurisdictions similar to ours, where courts have recognized that a covenant of good faith and fair dealing exists in every contract, it has been determined, among other things, that "the purpose of this covenant is to preclude parties from engaging in conduct that will destroy or impede the right of the other party to receive the benefits of the contract."[40] These courts have held that "[t]he obligation to act in good faith cannot act to vary the rights and liabilities of the parties by a claim that in exercising a contractual right the party did not do so in good faith."[41] "The good faith duty does not require that a bank refrain from enforcing the terms of the contract but only that a bank, in the exercise of its rights in enforcing contractual terms and obligations of the borrower, exercise good faith in its performance."[42]

There is truly no standard factual instance in which the breach of good faith and fair dealing argument may be claimed by a borrower. Instead, it seems that borrowers will claim that lenders acted in bad faith under almost every circumstance in which they are alleging lender liability. Consequently, we may see arguments of breach of the good faith and fair dealing covenant in a variety of instances, although the court may not always sustain these arguments. Nevertheless, it is possible to think of several instances in construction financing in which a borrower may successfully contend that a lender acted in bad faith. For instance, when the lender refuses to disburse funds to cover certain line items in a construction certification without any reasonable justification. Or, furthermore, when a lender takes unreasonable time to handle a renewal of the line of credit or an increase in the amount of the loan, damaging the borrower's financial expectations in the process. What is reasonable or unreasonable is certainly a matter for the courts to decide, and will surely depend on the particular circumstances of each case.

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38 Velilla v. Pueblo Supermarkets, 111 D.P.R. 585 (1981).

39 P.R. LAWS ANN. tit. 31, § 3375 (2007).

40 Anderson & Lettelleir, *supra* note 8, at 3-68 (citations omitted).

41 *Id.*

42 *Id*. at 3-73 (citations omitted).

III. Lender Liability Arguments – Non-contract and Tort Theories

Focus will now be turned to lender liability arguments arising from issues not contained in a loan contract agreement. These theories include, among others, the instrumentality theory or exercise of inordinate control, equitable subordination, fraud, duress, atypical lending practices, wrongful setoff, breach of fiduciary duty, and conflicts of interest. Of these doctrines, the instrumentality theory, or exercise of inordinate control, will be the most developed in this piece, since it is currently the most relevant to the construction industry, given the precarious financial position of many borrowers and the active involvement of lenders in trying to prevent further losses.

A. Instrumentality

> Lenders, in a typical relationship, will exercise some control over a borrower, usually by including restrictive covenants in the loan agreement. As a means of controlling credit risk, it is also common for a lender to exact numerous conditions to their obligation to advance funds, and otherwise take various actions to periodically monitor the business of the borrower. In monitoring the business, the lender may take on somewhat of an advisory role and provide suggestions to the borrower as to the running of the business. Liability is dependent upon the degree of control that is exercised.[43]

> Under [the instrumentality doctrine], a lender becomes responsible for the debts of a corporation it controls where that control is so pervasive that the borrower becomes a "mere instrumentality" of the lender. Typically, three factors are required for lender liability: 1) the lender actually controls the borrower's affairs; 2) the lender uses its control to commit fraud or to bring about an unjust result; 3) the lender proximately causes harm to the borrower through misuse of its control.[44]

According to Edward F. Mannino, "while a lender may monitor a borrower's business or participate in its affairs to protect its loan, it may not assume management control of the borrower and dominate its normal daily business affairs."[45] "[C]ourts will permit a lender to monitor the affairs of its

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43 *Id.* at 3-77.

44 Mannino, *supra* note 3 at 4 (citations omitted).

45 *Id.*

borrower closely and give advice or suggestions to improve the business, so long as the debtor is not *required* to follow them."[46]

As economic conditions deteriorate, lenders will be forced to request borrowers in construction loans to, among other things, lower the prices of the units, slow down the pace of construction, as well as cut down on overhead, administrative and non-essential costs. The question under the instrumentality theory thus becomes, when do the lender's actions exceed the standard practice, making him liable to the borrower under the instrumentality theory? More importantly, when does the lender become so intertwined with the borrower that he would be liable to third parties for actions brought about against the borrower?

The Supreme Court of Puerto Rico in *The Chase Manhattan Bank v. Emmanuelli Bauza,*[47] evaluated the question of when a lender becomes, so to say, the developer (borrower) in the face of third party claims. However, nothing is said about when a lender becomes liable to the borrower under the instrumentality doctrine. In the Chase Manhattan case the plaintiffs alleged that the Chase Manhattan Bank was jointly and severally liable, along with Chase's borrowers, for the repair of a number of construction flaws found in houses of a development financed by Chase. The plaintiffs argued that since Chase disbursed funds for the repairs via one of the other defendants (Trust Mortgage), and prohibited Trust Mortgage from declaring dividends, issuing stock, selling their assets or dissolving the company, that they should be liable under the notion that Chase became the developer of the project as soon as they began exercising control over both the developer and Trust Mortgage. The Supreme Court rejected all of the plaintiffs arguments stating that under the material facts of the case, it could not be determined that Chase Manhattan Bank controlled any of the defendants or infringed the standard operating procedures of a financial institution. Thus, Chase could not be found liable for the construction flaws of the project.

Moreover, the court in the Chase Manhattan case reinforced the view, previously established in *United Federal Savings v. DACO*, of what constitutes a *developer* for purposes of third party claims, stating that:

> Developer or Builder means any person engaged in the construction business as a trader, or primarily responsible, for the promotion, design, sales, construction of housing developments, or construction of housing on a large scale, either individual or multilevel. It includes the real estate broker, individual or business entity, who engages in the promotion or sale of individual or multilevel

46 *Id*. at 7.

47 The Chase Manhattan Bank v. Emmanuelli Bauza, 111 D.P.R. 708 (1981).

> residential units; provided that the realtor is not responsible for the faulty construction of houses built and covered by this Chapter.[48]

Based on this definition, the court concluded that the fact that Chase Manhattan had a pecuniary interest in the sale of the homes was not sufficient evidence to prove that they became a developer or exercised inordinate control over the actual homebuilder.

Both the *Chase Manhattan* and the *United Federal Savings* cases have become an integral part of the lenders' defenses against third party claims. In the past few years, claims have become extremely frequent, not only from third party contractors and suppliers, but also from individual purchasers and residents of construction projects, which are in the process of foreclosure. Many times, projects are left unattended while the project is being foreclosed, given that the borrower is no longer engaged in the development enterprise and the lender is not yet the title holder of the property. Thus, the projects are sometimes abandoned by both the developer and the bank, resulting in a lack of security, maintenance and care. This leads to a depreciation of property prices, being the bearers of the depreciation the individuals who decided to invest in the residential units developed.

These individuals will usually look to the Department of Consumer Affairs (DACO) to vindicate their rights against both the developers [borrowers] and the lenders. Even though many of these residents have no claim against the lender, given the lack of a contractual relationship, the experience is that DACO will pay little attention to arguments about lack of jurisdiction, and will hold a lender responsible for the deficiency in maintenance and security of a residential complex, as well as for construction defects in the individual units or in the project as a whole. Thus, lenders are forced to cite the *Chase Manhattan* and *United Federal Savings* cases in their attempts to avoid being liable for said claims. Most of the times, the lender is forced to appeal the DACO decision in the Court of Appeals in order to avoid liability. In the end, the decision for the lender becomes one of either paying to protect their collateral or paying lawyers to protect their pecuniary interests, whichever costs less.

A similar decision as in the *Chase* case is cited by Roy Ryden and Diane Lettelleir in a South Carolina appellate case which stated that the general rule is that "a construction lender is not responsible for torts committed by the borrower unless the lender exercises such control over the construction that would exceed the actions that are normally expected to be taken by a

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[48] United Federal Savings v. DACO, 111 D.P.R. 424, 425 (1981), (translation provided by editor)

lender."[49] Other examples provided by Edward F. Mannino as to when lenders have been found liable under the instrumentality theory are:

> 1) when the lender requires the borrower to turn over the proceeds from sales to the lender, with the lender paying bills from third parties; 2) when the lender precludes the borrower from encumbering assets, paying dividends, purchasing stock, or making capital improvements or repairs without the lender's prior consent; 3) requiring the borrower consistently to sell its product to the lender at a loss and below market price; 4) requiring the borrower to implement strict and oppressive credit, sales and inventory policies for all of its products, and taking key personnel off salary.[50]

All of these are circumstances, which may arise while dealing with troubled construction borrowers. Thus, lenders must make sure that their involvement in the borrower's operations, decision-making, and day-to-day activities does not go beyond the customary practices for the industry. Furthermore, lenders must also be wary of their liability once they have foreclosed on a project and have become the title holders of the property. As a result of the lenders' abundance [or perceived abundance] of financial resources, contractors and suppliers will demand payment for past services rendered and residents will definitely demand repairs and improvements to the foreclosed project, resulting in further losses, liability and costs for the lender. What we are beginning to see from lenders is an increase in the incorporation of Special Purpose Vehicles (SPV's), which deal exclusively with the ownership and administration of foreclosed projects. This way, they intend to limit the liability of the financial institution to the assets available to that particular subsidiary or SPV.

B. Equitable Subordination

The equitable subordination doctrine is very closely related to the Instrumentality doctrine discussed above.

> Under the doctrine of equitable subordination, bankruptcy courts sitting as courts of equity will subordinate the claim of a creditor which has engaged in inequitable conduct to the claims of other creditors. . . . Equitable subordination is a more flexible and stringent theory of liability than the instrumentality doctrine, and poses a far greater threat to lenders. It generally requires proof of three

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[49] Anderson & Lettelleir, *supra* note 8, at 3-79 (citations omitted).

[50] Mannino, *supra* note 3, at 5 (citations omitted).

> elements: 1) inequitable conduct, 2) injury to other creditors, or an unfair advantage to the wrongdoer, and 3) imposition of liability must not be inconsistent with the Bankruptcy Act.[51] Most equitable subordination cases continue to turn on whether a creditor has engaged in inequitable conduct. Three broad categories of such conduct have been identified, consisting of (1) fraud, illegality, or breach of fiduciary duty, (2) substitution of debt for capital where the debtor is undercapitalized, or (3) use of the debtor as the creditor's alter-ego or instrumentality.[52]

Most of the cases subordinating a lender's claim to those of other creditors have involved the exercise of extensive bank controls over every aspect of a debtor's day-to-day business. Mannino cites the case of *In re American Lumber Co.*,[53] in which a bank devised a liquidation plan, which barred other creditors from reaching the debtor's assets. As a result the bank opened all debtor's mail, collected all accounts receivable, terminated most of debtor's employees, hired security guards, drastically cut the salaries of the debtor's officers, determined which creditors to pay, and forced the debtor to execute security agreements in favor of the bank on its only free assets.[52]

An example of one specific case of the doctrine of equitable subordination is whether a lender concerned with a borrower's substantial leverage and precarious financial condition may require the borrower to transfer the assets related to a particular construction project financed by the lender to a new entity- borrower which would only have the indebtedness linked to said project and payable only to that lender. Following an analysis of the doctrine discussed in this section, as well as of theories related to fraud, it would be safe to believe that bankruptcy courts would be very skeptical about this sort of transaction.

C. Fraud and Related Theories

> Fraud is an ancient tort whose contours have been well settled over years of precedent and is now being applied in the lender liability context. . . . The elements of actionable fraud are: 1) making false representation concerning a material fact, or failing to disclose a material fact where there is a duty to do so; 2) making such statement or omission knowingly; 3) an intent by the maker of the representation to induce action or inaction by the recipient; 4)

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51 *Id*. at 6 (citations omitted).

52 *Id*. at 7 (citations omitted).

53 In re American Lumber Co., 5 Bankr. 470 (D. Minn. 1980).

52 Mannino, *supra* note 4, at 7.

> justifiable reliance by the recipient; 5) Damages proximately resulting to the recipient from the misrepresentation or omission.
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> Fraud has been found against lenders where they have made false threats to declare a default or call a loan, or false promises to provide or consider future financing or not call outstanding loans if additional security is given or management changes are made. Fraud has also been found where borrowers, in reliance upon false or incomplete representations by their lenders, have been induced to start a business prematurely, to invest in financially troubled enterprises controlled by or owing substantial sums to the lenders, or to accept the services of unwanted turn-around consultants.[53]

Courts have also found that statements, which are literally true or ambiguous, may nevertheless be found to constitute fraudulent misrepresentations if they are misleading.

According to Mannino, several recent cases have also applied fraud, estoppel, breach of contract, unjust enrichment, equitable lien, and fiduciary duty theories to protect contractors or suppliers of a borrower from being deceived into continuing work or supplying the borrower, thereby adding value to the lender's collateral. For example, Mannino cites the case of *R.A. Peck, Inc. v. Liberty Federal Savings Bank*,[56] in which:

> [A] lender was found to owe a duty to disclose to a contractor for the borrower that a construction loan account was depleted, where the lender had benefitted through the enhancement of the value of its mortgage collateral by the contractor's work, and had encouraged the contractor to submit its pay requests directly to the lender.[54]

In this case the court stated:

> The Bank's involvement in disbursing funds, transferring funds and making assurances regarding available funding in the future well exceeded a "normal lender's" role. Having chosen to thrust itself into the transaction, and placing itself in a position to reap financial benefits by its nondisclosure, it cannot now forego responsibility by cloaking itself under the duty of nondisclosure owed its customers.[55]

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53 *Id.* at 15 (citations omitted).

56 R.A. Peck, Inc. v. Liberty Federal Savings Bank, 766 P. 2d 928 (Ct. App. 1988)

54 Mannino, *supra* note 3, at 17 (citations omitted).

55 R.A. Peck, Inc. v. Liberty Federal Savings Bank, 766 P. 2d 928, 936.

Thus, it is evident from this decision, that banks may be held liable in cases in which they refrain from disclosing material information regarding their borrower's financial condition to third parties, if, under the circumstances of the case, they are benefitting from the third party's ignorance.

So far, we have seen how lender liability claims may arise from tort theories related to the lender's inordinate control of a borrower's operations or the lender's inequitable conduct as it pertains to the borrower's other creditors. Borrowers may have a claim under other tort theories such as duress, atypical lending practices, wrongful setoff, breach of fiduciary duty and conflicts of interest. These theories, although important, will not be discussed here due to the limited scope of this article and their minor relevance to construction financing. Focus will now be turned to the remedies available to borrowers who are successful in establishing their lender liability arguments.

IV. Remedies

"In general, damages in cases of breach of contract to loan money are the extra costs of obtaining funding elsewhere."[56]

> The traditional rule is that general damages for a breach of contract to lend money are to be calculated by the difference between the interest rate on the breached contract and the interest rate paid for a substitute loan. . . . [I]n most cases, then, the lender's liability will be limited to the relatively small additional amount that it would ordinarily cost to get a similar loan.[57]

"In addition to general damages based on the interest differential (reduced to present value), the courts have also allowed the borrower to recover incidental damages for expenses incurred in procuring the substitute loan."[58] "If the borrower is unable to obtain substitute financing, the measure of damages is said to be the difference between the interest under the breached contract and the interest rate generally available to similar borrowers on the open market on the date of the breach."[59]

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56 Anderson & Lettelleir, *supra* note 8, at 3-85.

57 *Id*. (citations omitted).

58 *Id*. at 3-86 (citations omitted).

59 *Id*. at 3-87 (citations omitted).

> [T]he developing modern rule is that the borrower may also recover consequential damages . . . also called *special* damages, subject to the general damage rules of foreseeability, avoidability, and certainty of proof. In the context of breach of loan commitments, consequential damages will usually take the form of the economic loss that the borrower has suffered on the underlying project which the loan funds were to be used to finance.[60]

Examples of consequential damages, recognized by courts, include out-of-pocket expenses such as appraisal fees, commitment fees and broker's fees. Borrowers have also been allowed to recover expenses incurred in attempts to preserve the financed property, such as rent, taxes and interest. The most controversial form of consequential damages is lost profits on the underlying venture or property. However, new businesses, like a new construction development, present serious difficulties in proving anticipated profits with a reasonable degree of certainty. Thus, many courts have found the profits of such businesses to be too remote and speculative for recovery to be allowed.[61]

> [A] potential borrower may also have a cause of action based upon promissory estoppel for damages incurred in reliance on promises made by the proposed lender during negotiations even though an enforceable commitment to lend is not consummated. In such cases, damages are usually measured to compensate for the reliance expenditures incurred; and loss of potential profits or other lost expectation damages are not allowed.[62]

Finally, in cases in which the plaintiff pleads and proves that the contract breach also constituted a tort, punitive damages are recoverable. Under Puerto Rico's judicial system, punitive damages are not awarded to prevailing parties in tort cases. However, if the party is able to prove that the defendant's tortuous conduct resulted in specific monetary damages, then courts will usually allow a plaintiff to recover the amount related to his or her losses. According to Ryden and Lettellier, in order for a court to award punitive damages:

> a) there must be actual damages, meaning compensatory (as opposed to nominal) damages; and b) the lender must show actual malice, meaning 'conduct manifesting personal ill will or oppression,

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60 *Id.* at 3-89 (citations omitted).

61 *Id.* at 3-90, 3-91 (citations omitted).

62 *Id.* at 3-98 (citations omitted).

> or showing a reckless or wanton disregard of one's rights'. Further, where the claim is against a corporation for actions of its employees, the acts must be those of the governing officers, or one lawfully exercising their authority, or the governing officers directed the act, participated in it, or ratified it.[63]

V. CONCLUSION

As it has become evident throughout this article, lender liability is a complex body of law, which incorporates many contract and tort theories to protect borrowers from unjust treatment by their counterparties. Today, lenders face the same potential for liability that sellers of goods and services in the marketplace have faced for well over a century. As the economy in Puerto Rico and in the U.S. mainland continues its decline, many developers who see themselves defaulting on their construction loans will consider bringing about a lender liability claim against their lenders to escape the harsh effects of foreclosures and bankruptcy. Thus, we should expect many new developments in upcoming years regarding this body of law. We are already seeing some of these developments such as the Special Purpose Vehicles, the DACO cases, the third party claims against the lenders, and the more careful and creative drafting of loan documents taking place in the local jurisdiction. Hopefully, with what appears to be an imminent array of construction loan defaults and foreclosures, we will also see the jurisprudential vacuum existing in Puerto Rico, with regards to the lender liability doctrine, being filled.

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63 *Id*. at 3-95 (citations omitted).