COMMENT

PUERTO RICAN DEBT LEGISLATION: IS THE TERRITORY BETTER OFF RESTRUCTURING MUNICIPAL DEBT UNDER PROMESA?

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I. INTRODUCTION

In 1984, and without explanation, Congress stripped Puerto Rico of its access to Chapter 9 of the Bankruptcy Code,[1] titled Adjustment of Debts of a Municipality. Thirty-two years later and seventy-two billion dollars in debt,[2] the territory of Puerto Rico needs relief.

In February of 2015, a simple, one-page bill was introduced in Congress to reinstate Puerto Rico's access to Chapter 9.[3] This bill would have affected two-thirds of Puerto Rico's debt by affording its municipalities the same opportunity to utilize bankruptcy as all the other U.S. States' municipalities have; however, the bill was not passed.[4] Instead, sixteen months later, Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), paving the way for a robust bill that goes beyond Chapter 9.[5]

This comment begins by discussing the Supreme Court decision of June of 2016 that eliminated Puerto Rico's ability to create its own legislation to address its debt problem. It also describes the many underlying factors that contributed to Puerto Rico's enormous debt. This assessment is followed by a discussion of three key differences between PROMESA and Chapter 9. After weighing the advantages and disadvantages of the key differences, the comment concludes that Puerto Rico fairs better by restructuring municipal debt under PROMESA than it would have been under Chapter 9.

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[1] Puerto Rico v. Franklin California Tax-Free Trust, 579 U.S. __, 136 S.Ct. 1938, 1940 (2016).
[2] D. ANDREW AUSTIN, CONG. RESEARCH SERV., R44095, PUERTO RICO'S CURRENT FISCAL CHALLENGES 12 (Apr. 11, 2016).
[3] *All Bill Information (Except Text) for H.R.870–Puerto Rico Chapter 9 Uniformity Act of 2015*, CONGRESS.GOV, https://www.congress.gov/bill/114th-congress/house-bill/870/all-info (last visited Aug. 6, 2017).
[4] *Id.* (claiming the latest action on H.R. 870 was referral to a subcommittee on Mar. 16, 2015).
[5] *S.2328–PROMESA*, CONGRESS.GOV, https://www.congress.gov/bill/114th-congress/senate-bill/2328 (last visited Aug. 6, 2017) (noting the bill became public law on Jun. 30, 2016).

II. BACKGROUND

A. Puerto Rico v. Franklin California Tax-Free Trust Ensured Puerto Rico Had No Where to Turn but Congress

In 2014, the territory of Puerto Rico enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act").[6] This was the island's response to its position between a rock and a hard place: the territory's corporations were under a mountain of debt but could not utilize Chapter 9 of the Federal Bankruptcy Code (the "Code"). Nevertheless, this was not always the case. Up until 1984, Puerto Rico could utilize Chapter 9,[7] but in that year the definition of "State" was revised to include Puerto Rico for all purposes "except for the purpose of defining who may be a debtor under Chapter 9."[8] Why the definition was updated to include this language is unknown:

> The only comment on excluding Puerto Rico from Chapter 9 came from Professor Frank Kennedy, former Executive Director of the Commission on Bankruptcy Laws, who said: "I do not understand why the municipal corporations of Puerto Rico are denied by the proposed definition of 'State' of the right to seek relief under Chapter 9."[9]

With this seemingly minor adjustment, Puerto Rico was disallowed the ability to use Chapter 9. It's important to note, however, that having access to Chapter 9 is not synonymous with the ability to declare bankruptcy. A state's access to Chapter 9 does not mean the state can declare bankruptcy. What Chapter 9 involves is that the state can permit any of its municipalities or corporations to declare bankruptcy: "An entity may be a debtor under Chapter 9 of [the Bankruptcy Code] if and only if such entity . . . is a municipality . . . [and] is specifically authorized . . . to be a debtor . . . by State law . . . ."[10] Bankruptcy is a very useful tool that can be beneficial for all parties involved because it brings order to an otherwise disorderly situation. When a municipality stops paying its debt, each creditor that was not paid can sue individually. In fact, there is a so-called race to the courthouse because each creditor wants his or her judgment first. In this way, an individual creditor can make the insolvent municipality pay its debt before other creditors. Bankruptcy can bring order to this process by staying all litigation against the municipality, getting all the creditors involved in the same proceeding, and having a federal bankruptcy judge oversee a restructuring process.[11] The judge determines how much the debtor can pay back, who should be paid back first, and how much each creditor should be paid back.[12] As Professor Pottow summarized before Congress:

> [A]llow me to sing the praises of Chapter 9 . . . . Chapter 9 —like chapter 11— allows collective resolution of a municipal debtor's financial distress. In the absence of a collective forum, value-destroying fights with individual creditors will consume what

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[6] *Franklin California Tax-Free Trust*, 136 S.Ct. at 1942–43 (2016).
[7] *Id.* at 1951–1952 n.1.
[8] *Id.* at 1940 (quoting 11 U.S.C. § 101(52) (2015)).
[9] *Id.* at 1954 n.2 (quoting *Bankruptcy Improvements Act, Hearing on S. 333 et al. Before the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. 326 (1983)).
[10] 11 U.S.C. § 109(c) (2015).
[11] *Chapter 9–Bankruptcy Basics*, USCOURTS.GOV, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics (last visited Aug. 6, 2017).
[12] *Id.*

> little assets there are for repayment. The orderly resolution of debt in the U.S. chapter 11 bankruptcy system is world-renown and increasingly emulated.[13]

After it became clear that Puerto Rico's corporations could not pay their debt or utilize Chapter 9, the territorial government decided to enact the Recovery Act.[14] The Recovery Act was Puerto Rico's own version of Chapter 9 bankruptcy.[15] It provided the territory's public corporations (e.g., the power, sewer, and transportation authorities) with an avenue to restructure their crushing debt. Soon after its enactment, the Recovery Act was challenged by bondholders who would have been affected by it.

The bondholders alleged, and the Supreme Court agreed, that Puerto Rico's Recovery Act was pre-empted by section 903(1) of the Federal Bankruptcy Code,[16] which states: "[A] law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition . . . ."[17] That is, *states* may not enact their own bankruptcy laws because that right was reserved to Congress in the Constitution[18] and Congress forbids states from doing so in section 903(1) of the Code.[19] This remains true despite the fact that Puerto Rico is a territory —not a state— because the Code includes within its definition of state "the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under Chapter 9 of this title."[20] However, even though Puerto Rico *is* considered a state for the purposes of prohibiting it to enact its own bankruptcy laws, Puerto Rico *is not* a state "for the purpose of defining who may be a debtor under Chapter 9 of this title."[21] And, as previously mentioned, a municipality must be granted access to Chapter 9 by the laws of the state in which it resides. In sum, to preclude Puerto Rico from enacting its own bankruptcy laws, it *is* a state; to preclude Puerto Rico from utilizing Chapter 9, it *is not* a state. This was the Supreme Court's holding in *Franklin California Tax-Free Trust*[22] and is why Puerto Rico, under a mountain of debt, could only turn to Congress for relief.

Puerto Rico's legal situation vis-à-vis municipal bankruptcy seems unjust, especially considering that Puerto Ricans are American citizens and that the 1984 amendment disallowing them access to Chapter 9 was made without comment or explanation. However, this unjustness is tolerated due to Congress's plenary power over territories.

Article IV of the Constitution states: "The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to

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[13] *Puerto Rico Chapter 9 Uniformity Act of 2015: H.R. 870 Before the H. Comm. on the Judiciary*, 114th Cong. 21 (2015) (Prepared statement of John A. E. Pottow, Esq., Professor of Law, University of Michigan Law School).

[14] *Franklin California Tax-Free Trust*, 136 S.Ct. at 1942-43 ("Puerto Rico responded to the fiscal crisis by enacting the [Recovery Act] in 2014").

[15] *See id.* at 1943 ("Chapter 3 of the Recovery Act, on the other hand, mirrors Chapters 9 and 11 of the Federal Bankruptcy Code by creating a court-supervised restructuring process intended to offer the best solution for the broadest group of creditors.").

[16] *Id.* at 1943.

[17] 11 U.S.C. § 903(1) (2015).

[18] *Franklin California Tax-Free Trust*, 136 S.Ct. at 1944 (Through U.S. CONST. art. I, § 8, cl. 4, "[t]he Constitution empowers Congress to establish 'uniform Laws on the subject of Bankruptcies throughout the United States.'").

[19] *Id.* at 1945 ("Congress enacted a provision expressly pre-empting state municipal bankruptcy laws." *Id.*).

[20] 11 U.S.C. § 101(52) (2015).

[21] *Id.*

[22] *Franklin California Tax-Free Trust*, 136 S.Ct. at 1942 ("[T]he Code prevents Puerto Rico from authorizing its municipalities to seek Chapter 9 relief. Without that authorization, Puerto Rico's municipalities cannot qualify as Chapter 9 debtors. § 109(c)(2). But Puerto Rico remains a 'State' for other purposes related to Chapter 9, including that chapter's pre-emption provision. That provision bars Puerto Rico from enacting its own municipal bankruptcy scheme to restructure the debt of its insolvent public utilities companies." *Id.*).

the United States . . . ."[23] The Supreme Court, in the first quarter of the twentieth century, held that Congress's power over territories was plenary; this ultimate power was only limited by the most fundamental constitutional protections for the people of Puerto Rico.[24] Thus, regardless of the inequity in (1) stripping Puerto Rico of its access to Chapter 9 without explanation or debate, and (2) prohibiting Puerto Rico from enacting its own bankruptcy laws, Congress is acting within its plenary powers. However, the islanders have a different name for Congress's incredible authority: colonialism.

B. How Puerto Rico Became Buried in a Mountain of Debt

Puerto Rico's importance was heightened during the late 1950's due to the Cold War and Fidel Castro's overthrow of its neighbor, Cuba.[25] At that time the world was being divided among communist and democratic lines. The U.S.'s decision to:

> [E]nable Puerto Ricans to develop a local Constitution was intended to provide credibility to the United States in its struggle with the Communist Bloc, and to win the hearts of third world countries in the United Nations . . . .
>
> . . . . U.S. lawmakers envisioned using Puerto Rico as a financial bridge that could facilitate the United States' economic interests in Latin America.[26]

Suffice to say, during the Cold War, Puerto Rico was of particular importance to the U.S.

Puerto Rico prospered as a manufacturing hub until the mid-1970's because it served as a cheap labor base within the U.S.[27] Since Puerto Rico was within the U.S., its products were not subject to tariffs as they were brought to the mainland.[28] However, when the free trade policies of the 1970's began reducing tariffs, Puerto Rico was no longer the cheapest labor market.[29] Since companies could import products more cheaply, they began moving to third world countries with labor rates more attractive than Puerto Rico's.[30] Also in the 1970's, the federal government applied its minimum wage to Puerto Rico,[31] which increased labor costs and made the territory an even less appealing place for manufacturers.[32]

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[23] U.S. CONST. art. IV, § 3, cl. 2 ("The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; and nothing in this Constitution shall be so construed as to Prejudice any Claims of the United States, or of any particular State." *Id.*).

[24] Juan R. Torruella, *Outstanding Constitutional and International Law Issues Raised by the United States-Puerto Rico Relationship*, 100 MINN. L. REV. HEADNOTES 79 (2016) ("Pursuant to this theory, the inhabitants of Puerto Rico, as denizens of an 'unincorporated territory,' were to be denied all but the most fundamental constitutional protections and Congress was granted almost unlimited plenary powers." *Id.*).

[25] *See* Larry Rohter, *Puerto Rico Fighting to Keep Its Tax Breaks for Businesses*, N.Y. TIMES (May 10, 1993), http://www.nytimes.com/1993/05/10/business/puerto-rico-fighting-to-keep-its-tax-breaks-for-businesses.html?pagewanted=all ("During the cold war, a tax-incentive program was the principal instrument used by Washington to build Puerto Rico as a free-market, democratic alternative to Cuba." *Id.*) (last visited Aug. 6, 2017).

[26] Charles R. Venator-Santiago, *Cold War Civil Rights: The Puerto Rican Dimension*, 42 CAL. W. INT'L. L. J. 423, 432-33 (2011).

[27] Barry P. Bosworth, *Speech at an Inter-American Dialogue Event: Debt and Politics in Puerto Rico*, C-SPAN (Jun. 1, 2016), https://www.c-span.org/video/?410433-1/interamerican-dialogue-hosts-discussion-puerto-ricos-debt (discussing the sentence's proposition at 8m 08s).

[28] *Id.* (discussing the sentence's proposition at 8m 20s).

[29] *Id.* (discussing the sentence's proposition at 8m 29s).

[30] *Id.* (discussing the sentence's proposition at 8m 46s).

[31] Jack Salmon, *How the Minimum Wage Helped Wreck Puerto Rico's Economy*, FOUNDATION FOR ECONOMIC EDUCATION (April 16, 2016), https://fee.org/articles/how-the-minimum-wage-helped-wreck-puerto-ricos-economy/.

[32] Bosworth, *supra* note 27 (discussing the sentence's proposition at 9m 27s) (last visited Aug. 6, 2017).

In 1976, Congress added section 936 to the Internal Revenue Code, which was intended to establish Puerto Rico as "a free-market, democratic alternative to Cuba."[33] Section 936 gave manufacturers a federal income tax credit for (1) producing products within Puerto Rico and selling them abroad, and (2) for investing their profits in Puerto Rico.[34] This led Puerto Rico to accumulate large amounts of U.S. investment capital, which "provided key support to bank liquidity from the late 1970s to the late 1990s . . . ."[35]

By the early 1990's, the cold war era was over and the Clinton administration wanted to reduce the deficit.[36] In 1996, Congress passed legislation that eliminated Section 936 over a period of ten years, completely phasing it out by 2006.[37]

> Before the credit was repealed, U.S. corporations' possessions claiming tax credits comprised most of Puerto Rico's manufacturing sector and employed many Puerto Ricans. With the repeal of § 936, the largest employers left the island, taking jobs and corporate tax dollars with them . . . . Manufacturing has declined by two thirds since the repeal.[38]

In addition to the economic damage done by corporations and manufacturers leaving the island, the Puerto Ricans themselves have been leaving.[39] Puerto Ricans are U.S. citizens at birth and can migrate to the mainland if they so choose. Between 2000 and 2015, the island's population decreased by 334,000, or nine-percent.[40] Forty-percent of Puerto Ricans who to the mainland do so because the economic opportunities are greater than on the island.[41] This decrease in population is a decrease in the Commonwealth's tax base and is another contributor to Puerto Rico's economic decline over the past decade.

Over the same period of time that the corporations and people were leaving, Puerto Rico began amassing an incredible public debt. Between 1960 and 2000, the Commonwealth's debt grew from three billion to thirty billion dollars (adjusted for inflation).[42] That is, it took forty years to increase its debt by twenty-seven billion. However, from 2000 to 2015 —while the Section 936 tax credit was expiring, citizens were moving to the mainland and the Great Recession was setting in— Puerto Rico increased its debt from thirty billion to seventy billion dollars.[43]

This blatant debt growth begs the question: Why did investors continue lending money to Puerto Rico? Presumably for two reasons: Puerto Rico's bonds have significant tax breaks and Puerto Rico's financial data was unclear. Puerto Rican municipal bonds are a particularly attractive investment because of their triple tax-exempt status.[44] As Timiraos explains, "unlike

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[33] Rohter, *supra* note 25.
[34] Diane Lourdes Dick, *U.S. Tax Imperialism in Puerto Rico*, 65 AM. U. L. REV. 1 (2015).
[35] *Id.* at 74 (quoting Fed. Res. Bank of N.Y., *Report on the Competitiveness of Puerto Rico's Economy* 15 (2012)).
[36] Rohter, *supra* note 25.
[37] Dick, *supra* note 34, at 76.
[38] Hannah Geller, *Reforming Municipal Bankruptcy: Lessons from Puerto Rico*, 7 U.P.R. BUS. L.J. 152, 166–167 (2015).
[39] Jens Manuel Krogstad, *Historic population losses continue across Puerto Rico*, PEWRESEARCH.ORG (March 24, 2016), http://www.pewresearch.org/fact-tank/2016/3/24/historic-population-losses-continue-across-puerto-rico/ (last visited Aug. 6, 2017).
[40] *Id.*
[41] *Id.*
[42] AUSTIN, *supra* note 2, at 12–14.
[43] *Id.*
[44] Nick Timiraos, *Puerto Rico's Debt Crisis in Seven Questions*, WALL ST. J. (Apr. 13, 2016), http://blogs.wsj.com/economics/2016/04/13/puerto-ricos-debt-crisis-in-seven-questions/ (last visited Aug. 6, 2017).

other municipal bonds, Puerto Rican debt is exempt from local, state, and federal taxes, which made them an attractive investment during an era of low yields."[45] For example, a California investor's interest earned on out-of-state municipal bonds is subject to California personal income tax.[46] Only in-state, Californian municipal bonds would enjoy triple tax exemption[47] and, of course, Puerto Rican municipal bonds. Thus, generally speaking, anyone who would like to earn tax free investment income in the municipal bond market may either invest in his or her home state or invest in Puerto Rico.

Another likely reason lenders continued to lend, was their misunderstanding of the true picture of Puerto Rico's finances. Anne Krueger, a Senior Research Professor of International Economics at Johns Hopkins, performed a study for the Government Development Bank of Puerto Rico. In it, she wrote:

> [Puerto Rico's] published quarterly figures are too narrow in scope to provide an accurate picture, while the [Consolidated Annual Fiscal Report's] consolidated accounts appear with a long lag and are difficult to interpret. Analysts should not have to engage in jujitsu with the data in order to figure out the fiscal deficit . . . . Better statistics are not a luxury. Without them the Commonwealth is flying blind and market uncertainty about underlying developments is reflected in the risk premium on government debt.[48]

This lack of timely, clear, and reliable data made it difficult for investors to foresee how serious the debt crisis had become. Additionally, the Great Recession hit in 2007 and 2008, making the economic picture even blurrier. With these two occurrences skewing the true picture of Puerto Rico's finances, it's no wonder investors didn't see Puerto Rico's debt crisis coming.

Another reason that investors continued pouring money into Puerto Rico was because, as of 1984, the territory was incapable of declaring bankruptcy. Following Congress' law denying Chapter 9 access to the territory of Puerto Rico, "millions of individuals nationwide invested billions of dollars in reliance on that law."[49] Though this reasoning was used to argue against reinstating Puerto Rico's access to Chapter 9, its foundation can be attacked:

> Some might worry that [reinstating Puerto Rico's access to Chapter 9 and allowing it to apply retroactively] to pre-existing debts is somehow unfair or even unconstitutional to the holders of that debt. This concern is mistaken . . . . [The Nation's previous bankruptcy law] generally applied to pre-existing debts when enacted, and the Supreme Court confirmed the permissibility of Congress exercising its power under the Bankruptcy Clause in this manner . . . . This of course makes sense because Congress has authority under the Constitution's Bankruptcy Clause to adjust debts . . . putting all on notice that their contractual rights are always subject to adjustment by the Congress . . . .[50]

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[45] *Id.*

[46] Franchise Tax Board, *Taxing municipal bond interest in California*, FTB.CA.GOV, https://www.ftb.ca.gov/Archive/Professionals/Taxnews/1106/1106_9.shtml (last visited Nov. 11, 2016).

[47] Morgan Stanley, *California Tax Report*, MORGANSTANLEYFA.COM (Rev. Jan., 2013), http://www.morganstanleyfa.com/public/projectfiles/b5ca6d9c-fdc8-4956-8154-9035fd8cbbce.pdf.

[48] ANNE O. KRUEGER ET AL., PUERTO RICO – A WAY FORWARD 22-23 (2015), http://www.bgfpr.com/documents/PuertoRicoAWayForward.pdf.

[49] *Puerto Rico Chapter 9 Uniformity Act of 2015: H.R. 870 Before the H. Comm. on the Judiciary*, 114th Cong. 88 (2015) (written testimony of Thomas Moers Mayer, Esq., Partner and Co-Chair, Corporate Restructuring and Bankruptcy Group, Kramer Levin Naftalis and Frankel, LLP) [hereinafter, *Chapter 9 Hearing*].

[50] *Id.* at 20 (Prepared statement of John A. E. Pottow, Esq., Professor of Law, University of Michigan Law School).

However, the original argument that people relied on Puerto Rico's inability to file bankruptcy has pragmatic strength. It seems that an average investor is likelier to know simply that Puerto Rico's municipalities can't declare bankruptcy, not that Congress has the constitutional powers to change this ability at any time.

Lastly, investors continued to pour money into Puerto Rico because its government started selling secured bonds. In 2007, Puerto Rico reached its debt ceiling and could borrow no more.[51] To get around this, the government began selling bonds secured by sales tax by pledging sales tax revenues to payback these new bonds.[52] One can imagine how displeased the old lenders would be since a great source of revenue —sales tax— was being pledged to new lenders. Ten years later, this has created a tremendous issue for the courts. Puerto Rico's constitution claims that those who lend directly to the island's government —those who buy general obligation bonds— will be paid back first.[53] However, those lenders who have securitized debt —those whose loans are backed by sales-tax revenue— have a property interest that likely cannot be disrupted by the courts without triggering the Takings Clause of the Constitution.[54] In July of 2016, fund managers holding general obligation bonds "sued Governor Alejandro García Padilla in [the] U.S. District Court in San Juan to stop the administration from transferring funds away from bondholders."[55] This litigation still looms and, on October 24, 2016, the sales-tax bondholders requested that it be temporarily halted as Puerto Rico works to restructure its debt.[56]

The underlying reasons for Puerto Rico's incredible debt are numerous and spread throughout the public and private sectors. The federal government, territorial government, and creditors all share blame for allowing Puerto Rico's debt to achieve such a level. Had this situation arisen within a state, rather than a territory, the solution would be clear: have the state's municipalities file for Chapter 9 bankruptcy. Nevertheless, this was not an option for Puerto Rico. Instead, Congress passed an entirely new law —the Puerto Rico Oversight, Management, and Economic Stability Act— to remedy this debilitating situation. We now consider the main differences between Chapter 9 and PROMESA to ultimately determine whether Puerto Rico has benefited from the new legislation.

III. KEY DIFFERENCES BETWEEN CHAPTER 9 AND PROMESA

The simplest way Congress could have granted Puerto Rico relief would have been to reinstate its access to Chapter 9. In fact, a modest one-page bill was introduced in Congress which would have achieved this goal.[57] Had it passed, Puerto Rico would have been on the same

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[51] Michelle Kaske, *Hedge Funds Face Off Over Puerto*, BLOOMBERG LAW (Nov. 3, 2016), https://www.bloomberglaw.com/s/news/66d09c6f196026f22f8f165e3f835717/document/OG1SLQ6VDKHT?headlineOnly=false&highlight=Puerto+and+Rico+and+debt. (last visited Aug. 6, 2017).

[52] *Id.*

[53] Michelle Kaske, *Hedge Funds Holding Puerto Rico GOs Sue Over Sales-Tax Bonds*, BLOOMBERG.COM (Oct. 7, 2016), http://www.bloomberg.com/news/articles/2016-10-07/hedge-funds-holding-puerto-rico-gos-sue-over-sales-tax-bonds ("Puerto Rico's constitution states its general obligations must be repaid before other expenses. A portion of the island's sales-tax revenue is dedicated to repaying bonds, called Cofinas by their Spanish acronym." *Id.*). (last visited Aug. 6, 2017).

[54] *Chapter 9 Hearing*, *supra* note 49, at 20 (Prepared statement of John A. E. Pottow, Esq., Professor of Law, University of Michigan Law School) ("Secured creditors hold liens on collateral, and so one could argue that the Bankruptcy Code's invalidation of those property rights might implicate the Taking Clause. I say 'might' because the issue has never been definitively resolved by the Supreme Court . . . .").

[55] Kaske, *supra* note 53.

[56] Kaske, *supra* note 51.

[57] CONGRESS, *supra* note 3.

playing field as all other states in terms of municipal bankruptcy. However, the bill did not pass; instead, Congress choose to enact an entirely new law known as PROMESA. The remainder of this comment explores the key differences between Chapter 9 and PROMESA to determine which is better for Puerto Rico.

A. The Oversight Board

Undoubtedly, the most controversial component of PROMESA is its implementation of an oversight board with broad powers to control the spending of Puerto Rico. A federal oversight board is well beyond the bounds of Chapter 9 because of constitutional concerns over state sovereignty.[58] A federal bankruptcy judge controlling a municipality's spending is akin to the federal government directing a state government's municipality on how to spend its tax dollars.[59] This goes too far and would not be allowed under current judicial precedent,[60] but these concerns don't apply when dealing with a territory like Puerto Rico.

The PROMESA oversight board is comprised of seven members, all appointed by the President, and has the authority to reject budgets approved by the Puerto Rican legislature.[61] Why is this oversight board so controversial? The true controversy lies not in the mere existence of a board, but Puerto Rico's inability to influence it.

Oversight boards are not novel; consider Detroit's recent bankruptcy. In July of 2013, "Detroit filed for Chapter 9 protection . . . with an estimated $18–$20 billion in debt."[62] The following year, the state legislature passed the Michigan Financial Review Commission Act of 2014 in which a commission was created to "[r]eview, modify, and approve proposed and amended operational budgets of [Detroit]."[63] In fact, "[a] proposed budget or budget amendment amendment does not take effect unless approved by the commission."[64] However, there was little, if any, controversy surrounding the implementation of this oversight board.[65]

The Michigan commission was made up of nine members: the state treasurer; the director of the department of technology, management, and budget; three experts appointed by the governor; one expert recommended by the senate majority leader; one expert recommended by the speaker of the house of representatives; Detroit's mayor; and Detroit's City Council President.[66] Thus, only two of the nine members had to be from Detroit's local government: the mayor and the City Council President. Five of the nine members had to be experts, but did not

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[58] Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150, 1166 n.54 (2016) (quoting *In re N.Y.C. Off-Track Betting Corp.*, 434 B.R. 131, 140 (Bankr. S.D.N.Y. 2010) ("[Section 904 of the Bankruptcy Code] codifies the Tenth Amendment's general prohibition on a bankruptcy court's power to interfere with a state entity." *Id.*).

[59] USCOURTS, *supra* note 11.

[60] Gillette & Skeel, *supra* note 58, and accompanying text.

[61] D. ANDREW AUSTIN, CONG. RESEARCH SERV., R44532, THE PUERTO RICO OVERSIGHT, MANAGEMENT, AND ECONOMIC STABILITY ACT 1 (Jul. 1, 2016) ("PROMESA would establish an Oversight Board with broad powers of budgetary and financial control over Puerto Rico." *Id.*).

[62] Peter Saunders, *Detroit After Bankruptcy*, FORBES (Apr. 24, 2016), https://www.forbes.com/sites/petesaunders1/2016/04/24/detroit-after-bankruptcy/#6ecc1fec63d7 (last visited Aug. 6, 2017).

[63] Mich. Comp. Laws Ann. § 141.1637(c) (2014).

[64] *Id.*

[65] Only one quasi-critical news report was discovered regarding the Michigan Financial Review Commission. *See, e.g.*, Chastity Pratt Dawsey, *Is Detroit's financial oversight board too big to succeed?*, MLIVE.COM (Jul. 10, 2014), http://www.mlive.com/politics/index.ssf/2014/07/is_detroits_financial_oversigh.html (last visited Aug. 6, 2017).

[66] Mich. Comp. Laws Ann. § 141.1635 (2014).

have to be tied to Detroit in any way. However, there were few, if any, protests, even though Detroit's autonomy was being eroded by unelected appointees from Lansing, ninety miles away.

Even Puerto Rico attempted to implement its own control board under the now defunct Puerto Rico Public Corporation Debt Enforcement and Recovery Act.[67] This act would have created a three-person oversight board for each public debtor, each of whom would be appointed by the Governor. [68] However, no more than one of the three members could have been a resident of Puerto Rico, meaning that the remaining two must be experts from outside the territory.[69] Therefore, even Puerto Rico's self-enacted oversight board would have included a majority of members from beyond its borders.

Therefore, why is the federal oversight board under PROMESA so controversial? Since oversight boards are common in municipal bankruptcy cases, the controversy cannot be simply from the mere presence of a board. Instead, the controversy must stem from Puerto Rico's inability to influence the board. In Michigan, thirty-nine percent of the state's voters are in the Detroit Tri-County area.[70] Even though the state instituted a financial commission to oversee Detroit during its bankruptcy, the people of Detroit maintained significant influence over the state government via their ability to vote in state elections. This was an implicit check on the financial commission's broad powers. Under the Recovery Act in Puerto Rico, the three-person oversight committee could only make recommendations to the territorial government on how to deal with a municipality refusing to follow its restructuring plan.[71] Therefore, the citizens of Detroit gave up some autonomy, but could still influence the board by voting in state elections, and the citizens of Puerto Rico did not give up any autonomy.

Under PROMESA, "[t]he Oversight Board shall consist of seven members appointed by the President . . . ."[72] Though the President appoints the seven members, he may only appoint one at his sole discretion; his remaining appointees must be from recommendations received by several congressional leaders.[73] "The Governor [of Puerto Rico] . . . shall be an ex officio member of the Oversight Board *without voting rights*."[74] Thus, unlike the Michigan commission that included Detroit's mayor and City Council President, PROMESA does not require that any voting members of the oversight board have any current ties to Puerto Rico. Though this ensures the board's objectivity, it also significantly reduces the ability of Puerto Ricans to exert political pressure on the board.

On August 31, 2016, President Obama named the seven members of the board: a conservative think-tanker, an insurance broker, two bankers, a former federal bankruptcy judge, a former director of the California Department of Finance, and an Ivy League corporate law

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[67] *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938, 1946 (Jun. 13, 2016) (holding Puerto Rico's Recovery Act preempted by the Bankruptcy Code).
[68] 2014 P.R. Laws Act No. 71 § 203 [hereinafter, Recovery Act].
[69] Recovery Act § 101(42) ("'[O]versight commission' means a body composed of three (3) independent experts appointed by the Governor under chapter 2 of this Act, not more than one (1) of whom may be a resident of the Commonwealth at the time of appointment." *Id.*).
[70] Mich. Dept. of Tech., Mgmt., and Budget, *Population Density in Michigan: 2010*, MICHIGAN.GOV (Mar. 22, 2011), https://www.michigan.gov/documents/cgi/cgi_census_map_popdens_tract_10_347989_7.pdf; U.S. Bureau of the Census, *Mich. Population by Cnty.*, SENATE.MICHIGAN.GOV (May 18, 2017), http://www.senate.michigan.gov/sfa/economics/MichiganPopulationByCounty.PDF.
[71] Recovery Act § 203 ("If the oversight commission… finds that an eligible obligor has failed to meet an interim performance target… the oversight commission shall issue a noncompliance finding… explaining the reasons for such noncompliance and making recommendations for curing such noncompliance." *Id.*).
[72] 48 U.S.C. § 2121 (2016).
[73] *Id.*
[74] *Id.* (emphasis added).

professor.[75] Four of these seven members are native Puerto Ricans,[76] one of which maintains an office in Puerto Rico.[77] Undoubtedly, this majority of Puerto Rican natives were meant to "soothe anxiety on the island."[78] Nevertheless, their presence is no guarantee that the three and one-half million American citizens living within Puerto Rico will have any influence over the board or its decisions. Their only direct line to the board will be through a governor who holds a non-voting position.

If Puerto Rico had been given access to Chapter 9, it's likely that they would have instituted its own control boards with *non-Puerto Ricans* to oversee municipalities.[79] Under PROMESA, the federal government instituted a control board that includes *a majority of Puerto Ricans* to oversee all of the territory. In this light, PROMESA's oversight board does not seem to be a far cry from what Puerto Rico would have experienced had it been given access to Chapter 9. The key difference between the two is that Puerto Rican politicians cannot veto what the PROMESA oversight board does,[80] but this is not necessarily a bad thing. Mismanagement of Puerto Rico finances —for example, circumventing the debt ceiling and failing to publish accurate data— is a main contributor to its current economic crisis. If Puerto Rico maintains control over its finances, it is liable to be locked out of capital markets, which, in turn, would be a devastating proposition for the Puerto Rican people.[81] By handing over fiscal responsibility to unelected officials, Puerto Rico's reputation should increase, thereby restoring creditors' confidence, and reducing the rates that such creditors are willing to lend to Puerto Rico.[82]

So, regarding the oversight board, is Puerto Rico better off under PROMESA than it would have been under Chapter 9? The is answer is yes: if you want an omelet, then you must crack a few eggs. In this case, the eggs being cracked are Puerto Ricans' ability to elect officials to control the territory's spending; and the omelet will be long-term fiscal health and access to capital markets.

B. Creditor Collective Action

Another controversial portion of PROMESA that differs from Chapter 9 is its Title VI, Creditor Collective Action. This title retroactively inserts collective action clauses (CAC) into all the contracts between Puerto Rico and its creditors. CACs allow a majority of holders of a particular bond to agree to restructure the issuer's debt —even if a minority of those

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[75] Office of the Press Secretary, The White House, *President Obama Announces the Appointment of Seven Individuals to the Financial Oversight and Management Board for Puerto Rico* (Aug. 31, 2016), https://www.whitehouse.gov/the-press-office/2016/08/31/president-obama-announces-appointment-seven-individuals-financial (last visited Aug. 6, 2017).

[76] *Id.*

[77] Hub International CLC, *Firm Overview*, CLC INSURANCE PR, http://www.clcinsurancepr.com/firm_overview.html (last visited Aug. 6, 2017).

[78] Steven Mufson, *White House names seven to Puerto Rico oversight board*, WASH. POST (Aug. 31, 2016), https://www.washingtonpost.com/business/economy/white-house-names-seven-to-puerto-rico-oversight-board/2016/08/31/9cee9376-6f8b-11e6-9705-23e51a2f424d_story.html (last visited Aug. 6, 2017).

[79] This assessment is supported by the control boards presented in the Recovery Act. *See* Recovery Act § 203.

[80] Recovery Act § 203 (providing the oversight commission power to simply write noncompliance notices and curative recommendations).

[81] *See* Bill Cooper, *Keeping the Promise of PROMESA: Next Steps for Puerto Rico*, YOUTUBE (Sep. 27, 2016), https://youtu.be/qZ2JKpeI8po?list=PLEMqhsjmFr7yJ_B2xjEPrO1YYkK8uw083 (claiming the purpose of PROMESA is to impose fiscal responsibility to allow Puerto Rico to get back into the capital markets, at 6m 35s) (last visited Aug. 6, 2017).

[82] *See id* and accompanying text.

bondholders do not consent.[83] Thus, CACs are meant to eliminate hold-outs, which has become a troublesome issue over the past several decades.[84] CACs began appearing as part of sovereign debt agreements in England in the 1870's, but were not adopted in the U.S. until the early 2000's.[85] They are important for sovereign bonds because "unlike corporate debtors, sovereigns do not have the option of filing for bankruptcy."[86] Therefore, sovereigns must create this collective action process as part of their bond contracts if they hope to have any chance at future restructuring of their debts.

Under PROMESA, the oversight board will divide the bondholders into pools according to their "relative priority or security arrangements."[87] Then the bond issuer or bondholder may propose a modification of the bond,[88] which becomes qualified so long as (1) the issuer consults with all of the bondholders in the pool, (2) the modification treats all the bondholders the same, and (3) the modification is approved by the oversight board.[89] Once it is qualified, the modification will be voted on by the bondholders, which is the first step in making the modification binding.[90] If (a) at least half of the bondholders vote, and (b) the bondholders holding two-thirds of the principle amount vote affirmatively,[91] the modification passes its first hurdle to becoming binding. Next, the oversight board must approve the modification;[92] and lastly, the district court must enter an order that the requirements of Title VI have been satisfied.[93] At this point, the modification becomes binding on all of the bondholders —even those who voted against it.[94]

This is peculiar because "Title VI of [PROMESA] contains a mechanism for retroactively changing contract rights of bondholders . . . ."[95] Chapter 9 of the Bankruptcy Code and Title III of PROMESA provide similar mechanisms, but these processes are overseen by a federal judge. The Creditor Collective Action under PROMESA takes place almost entirely outside of the courtroom. The only judicial involvement is the final order from the district judge. In said final order, the judge, instead of certifying that the modification is reasonable —in the best interest of the creditors— and feasible,[96] it merely states that Title VI has been followed.[97] In other words,

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[83] Antonio J. Pietrantoni, *Collective Action Clauses for Puerto Rican Bonds: Borrowing Costs, Practical Considerations and Lessons from Sovereign Debt*, 84 REV. JUR. U. P.R. 1195, 1199–1200 (2015).
[84] Intl. Monetary Fund, *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* 15 (Sept. 2, 2014) ("In light of the evolution of the sovereign debt market over the past 30 years, there has been a growing awareness that 'collective action' problems may undermine the sovereign debt restructuring process." *Id.*).
[85] Pietrantoni, *supra* note 83, at 1205 ("It was not until after Mexico included a C.A.C. in a bond issued in the spring of 2003 that sovereign bonds under New York Law began to embrace them." *Id.*).
[86] David A. Skeel, Jr., *Can Majority Voting Provisions Do It All?*, 52 EMORY L.J. 417, 418 (2003).
[87] 48 U.S.C. § 2231(d)(3)(A) (2016).
[88] *Id.* at § 2231(i).
[89] *Id.* at § 2231(g)(1).
[90] *Id.* at § 2231(m)(1)(A).
[91] *Id.* at § 2231(j).
[92] *Id.* at § 2231(m)(1)(B).
[93] 48 U.S.C. § 2231(m)(1)(D) (2016).
[94] *Id.* at § 2231(m)(2).
[95] *Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA): Discussion Draft Before the H. Comm. on Natural Resources*, 114th Cong. 44 (2016) (statement of Susheel Kirpalani, Partner, Quinn Emanuel Urquahart & Sullivan).
[96] 11 U.S.C. § 943(b) (2015).
[97] 48 U.S.C. § 2231(n)(3) ("The district court shall nullify a Modification and any effects on the rights of the holders of Bonds resulting from such Modification if and only if the district court determines that such Modification is manifestly inconsistent with this section.").

Congress has enabled private parties (i.e., bondholders) to bind together and vote to retroactively affect the contractual rights of other private parties.

Contract rights are normally considered property under the Takings Clause of the constitution.[98] When Congress' interference with those rights is its legislation's intended purpose (rather than an ancillary byproduct), the *Penn Central* test is used to determine if the legislation constitutes a taking.[99] This test comes from a 1978 Supreme Court case, *Penn Central Transp. Co. v. New York City*,[100] which established several factors for the court to consider: "(1) the economic impact of the government action on the property owner; (2) the degree of interference with the property owner's investment-backed expectations; and (3) the 'character' of the government action."[101] Considering the economic impact of the government action means the court must measure the change in "fair market value caused by the regulatory imposition."[102] Considering the owner's investment-backed expectations means the creditor must "demonstrate that they bought their property in reliance on a state of affairs that did not include the challenged regulatory regime . . . ."[103] Finally, considering the character of the government action means "a court must balance the liberty interest of the private property owner against the government's need to protect the public interest through the imposition of the restraint."[104]

If a dissenting bondholder whose contractual rights were modified as a result of a creditor collective action alleges a government taking, he or she will first have to show that Title VI constitutes a direct interference with a property right rather than an ancillary one. After this, the bondholding plaintiff will have to show a detrimental change in the fair market value of the bond as a result of the collective action. The fact that the fair market value must be considered, rather than the face value is paramount because Puerto Rican municipal bonds are being traded at approximately sixty to seventy cents on the dollar.[105] Thus, a suing bondholder will have to show that his contract has been impaired more than thirty-percent to forty-percent of the face value of the bond.

Another hurdle for a dissenting and litigating bondholder will be to show that he or she purchased the bond in reliance that it would not be adjusted by legislation. Bondholders have several significant arguments to make regarding this factor. First, Puerto Rico was specifically exempted from Chapter 9 protection in 1984. Second, Puerto Rico's constitution guarantees that general obligations bonds will be paid back before all other bonds.[106] Consequently, a potential bond purchaser likely concluded that Puerto Rico will have no recourse but to pay back the bond. Furthermore, specifically for general obligation bonds, a holder likely thought that if all else fails, his or her bonds will be paid back. However, this argument would only apply to a

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[98] ROBERT MELTZ, CONG. RESEARCH SERV., R42635, WHEN CONGRESSIONAL LEGISLATION INTERFERES WITH EXISTING CONTRACTS: LEGAL ISSUES 13-14 (Aug. 20, 2012).
[99] *Id.* at 15.
[100] *Id.* at 15, n.102 ("The test was announced by the Supreme Court in Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978)." *Id.*).
[101] *Id.* at 15.
[102] 26 AM. JUR. 2D *Eminent Domain* § 14 (2016).
[103] *Id.*
[104] *Id.*
[105] Michelle Kaske, *Most Dreaded Provision of Puerto Rico Law Seen Spurring Pact*, BLOOMBERG (Oct. 28, 2016), http://www.bloomberg.com/news/articles/2016-10-28/most-dreaded-provision-of-puerto-rico-law-seen-spurring-pact ("Not everyone is as optimistic. Prepa debt is trading below the potential 85-cents on the dollar recovery rate. Bonds maturing in 2040 with a 5.25 percent coupon changed hands Thursday at an average price of 67.9 cents, according to data compiled by Bloomberg." *Id.*) (last visited Aug. 6, 2017).
[106] Kaske, *supra* note 51 ("Puerto Rico's constitution states that general obligations must be repaid before other expenses...".).

bondholder that purchased the bond before having a reason to suspect Puerto Rico would be able to pay back its debt without legislative intervention. Such a bond holder would probably have to be holding a bond that predated Puerto Rico's investment rating slide, which began at the end of 2011 when Moody's downgraded Puerto Rican bonds.[107] After that, it would be hard for a purchaser to claim innocent ignorance.

Lastly, the bondholder who dissents from credit creditor collective action under Title VI and sues under the Takings Clause will have to show that his or her liberty interest is more important than the common good. This will be a difficult burden for a dissenting bondholder to overcome. Following the *Penn Central* test, "a 'taking' may more readily be found when the interference with property can be characterized as a physical invasion by the government . . . than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good."[108] Thus, a bondholder will have several significant hurdles to overcome before getting a court to rule that either the Title VI is unconstitutional or that the Government should compensate the bondholder for the decrease in the value of his contract due fellow bondholders exercising Title VI.

Under Supreme Court precedent, it seems that only those bonds with securitized interests would likely overcome all of these hurdles. In *Louisville Joint Stock Land Bank v. Radford*,[109] the Supreme Court determined that a congressional act, which modified a mortgagee's (i.e., creditor) contractual rights against the mortgagor (i.e., borrower), violated the Takings Clause.[110] The challenged legislation allowed bankrupt farmers to retain possession of their farms for five years (for a reasonable rent fixed by the court) and allowed the farmers to purchase their property at any time for an appraised amount.[111] The act, therefore, stripped the mortgagee's "right to retain the lien until the indebtedness thereby secured is paid . . . [and] to assure having the mortgaged property devoted primarily to the satisfaction of the debt . . . ."[112] Thus, the Supreme Court long ago established that the bankruptcy proceedings are subject to, and limited by, the Takings Clause of the Fifth Amendment.[113] This is especially true when discussing securitized debt.

Puerto Rico's sales tax financing corporation (COFINA) has issued approximately fifteen billion dollars in secured debt.[114] As noted by Marxuach, "[b]onds issued by COFINA are secured by Act 91–2006, as amended [ ], which allocates a portion of the Commonwealth sales and use tax to pay debt service on the bonds issued by COFINA."[115] Under Title VI of PROMESA, the oversight board could group COFINA bondholders together into a *secured* pool and allow them to vote on restructuring their debt. However, if a minority of COFINA bondholders dissent, their secured interest can be impaired by a two-thirds majority of

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[107] Gov't Dev. Bank of P.R., *Commonwealth of P.R. Moody's Historical Rating*, http://www.gdbpr.com/investors_resources/commonwealth.html (last visited Aug. 6, 2016).
[108] Cienega Gardens v. United States, 331 F.3d 1319, 1338 (Fed. Cir. 2003) (quoting Penn Cent. Transp. Co. v. City of N.Y., 438 U.S. 104, 124 (1978)).
[109] Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).
[110] Ann K. Wooster, Annotation, *What Constitutes Taking of Property Requiring Compensation Under Takings Clause of Fifth Amendment to United States Constitution—Supreme Court Cases* 10 A.L.R. FED. 2d 231, § 30 (2006).
[111] *Id.*
[112] *Id.*
[113] Julia Patterson Forrester, *Bankruptcy Takings*, 51 FLA. L. REV. 851, 868 (1999).
[114] Sergio M. Marxuach, Center for a New Economy, *The Endgame: An Analysis of Puerto Rico's Debt Structure and Arguments in Favor of Enacting a Comprehensive Debt Restructuring Mechanism for Puerto Rico* 3 (Apr. 28, 2016).
[115] *Id.* at 6.

bondholders without their consent. This process would seemingly violate the Supreme Court precedent established in *Radford*.[116]

Presumably to avoid such constitutional issues, Congress included in Title VI a provision that allows bondholders of a secured pool who dissent from a creditor collective action to either (1) retain the lien securing their bond or (2) receive a deferred cash payment or substitute collateral in the amount of their bond.[117] This provision will have the effect of making creditor collective actions non-existent for secured bondholders. The entire point of allowing a two-thirds majority vote to bind the entire pool is to eliminate holdouts. This provision, though necessary to avoid violating the Takings Clause, effectively gives holdouts a reward: those who dissent from a collective action retain the ability to be paid in full. As noted by Kirpalani during his statement before the House Committee on Natural Resources, "the ability to bind holdouts if they engage in brinkmanship is the only way to get everyone to the table and have any hope of a voluntary agreement."[118] Thus, Title VI effectively applies to unsecured debt, but not secured debt because a secured creditor can simply retain his or her lien and wait for payment in full.

Regarding the creditor collective action, is Puerto Rico better off under PROMESA than it would have been under Chapter 9? No. Chapter 9 provides for bondholders to bind holdouts with a two-thirds vote, but it must be done as part of a federal court proceeding.[119] This means that the federal bankruptcy judge, with a fifteen-year appointment, can reject the plan if it is too hard on the municipality's people. As criticized by Professor David Skeel, a member of the PROMESA oversight board, the federal bankruptcy judge handling Detroit's adjustment plan allowed general obligation bondholders to take a sixty-percent cut, but pensioners to only take a forty-percent cut —even though they were of the same priority.[120] Professor Skeel suggests that to pass Chapter 9's fairness test, the plan simply had to satisfy the judge's consciousness. However, under Title VI of PROMESA, the federal judge does not get to decide if the qualified modification is fair.[121] This decision is made by the oversight board[122] —political appointees with a limited guarantee of continued employment.

It comes down to from where the bondholder-creditors will get a better deal from at the expense of the debtors: the oversight board or a federal bankruptcy judge. A federal bankruptcy judge is not beholden to anyone and may be sympathetic to the Puerto Rican people, thereby permitting bigger cuts for hedge funds than pension funds. The oversight board, on the other hand, is a group of appointees with three year terms who may be removed for cause.[123] Billion-dollar bond fund managers would likely have an easier time persuading the oversight board than they would persuading a federal judge. Conversely, the Puerto Rican people would likely have an easier time persuading a federal judge than they would the oversight board —after all, Puerto Ricans only have a non-voting member in Congress and aren't counted in federal elections. Thus, the Creditor Collective Action clause is probably not positive for the Puerto Rican people. It

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[116] Wooster, *supra* note 110, at § 30.
[117] 48 U.S.C. § 2231(m)(1)(C) (2016).
[118] *Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA): Discussion Draft Before the H. Comm. on Natural Resources*, 114th Cong. 41 (2016) (statement of Susheel Kirpalani, Partner, Quinn Emanuel Urquahart & Sullivan).
[119] 11 U.S.C. § 1126(c) (2015).
[120] David A. Skeel, Jr., *Fixing Puerto Rico's Debt Mess*, WSJ.COM (Jan. 5, 2016), http://www.wsj.com/articles/fixing-puerto-ricos-debt-mess-1452040144 (last visited Aug. 6, 2017).
[121] 48 U.S.C. § 2231(g)(1)(C) (2016).
[122] *Id.* at § 2231(g)(1)(C).
[123] *Id.* at § 2121(e)(5).

gives bondholders a way to modify their debt without facing a potentially sympathetic federal judge.

C. Capturing all of Puerto Rico's Debt

Chapter 9 applies only to municipal debt. Professor Skeel explains that only "distressed municipalities can file for bankruptcy if their state permits this, as roughly half do. The states themselves do not have a bankruptcy option, however, no matter how bleak their circumstances may be."[124] Why? In a 2013 article, Professor Skeel provided five reasons why states are not extended the right to file for bankruptcy: (1) people's unwillingness to change the status quo; (2) protection of public employee compensation and pension; (3) bankruptcy will not fix the underlying political issues causing the debt; (4) bankruptcy would be ineffective since bond obligations make up less than ten percent of annual budget in even the most indebted states; and (5) allowing a state to file bankruptcy would reduce the federal government's ability to impose tough fiscal reforms in return for a bailout.[125] Thus, it is not that a state bankruptcy would be unconstitutional, it is simply that the federal government hasn't put the framework in place.

Had Resident Commissioner Pierluisi's Puerto Rico Chapter 9 Uniformity Act (H.R. 870) been passed, it would have granted Puerto Rico the ability to allow its municipalities to file for Chapter 9 bankruptcy. Under the Bankruptcy Code, "[t]he term 'municipality' means political subdivision or public agency or instrumentality of a State."[126] Political subdivisions include "counties, cities, towns, townships, villages . . . ."[127] Public agencies and state instrumentalities include "public corporations, school, fire, water/irrigation or improvement districts, and boards and authorities that own or run utilities, hospitals, housing developments, transportation systems, and other public services."[128]

As of September 30, 2015, Puerto Rico's debt was approximately seventy-billion-dollars.[129] A little over forty-seven billion, or two-thirds of that debt, was issued by Puerto Rican municipalities.[130] On the other hand, close to twenty-three billion, or one-third, of Puerto Rico's debt were issued by Puerto Rico itself.[131] Therefore, simply giving Puerto Rico access to Chapter 9 would have only affected two-thirds of its total debt. This issue was flagged by one bondholder representative during the Puerto Rico Chapter 9 Uniformity Act's hearing: "This bill would affect $48 billion of bonds. Notice I said $48 billion. The other $25 billion . . . is held by all the funds who support this bill. They want it to apply to everybody other than them."[132] The point is well taken. Had Puerto Rico been given access to Chapter 9, all the municipal debt would have been on the chopping block, affecting a subset of the creditors. Creditors of the Commonwealth —e.g., creditors of general obligation bonds— would have been protected. In fact, creditors of the Commonwealth would probably have benefited from the Puerto Rico

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[124] David A. Skeel, Jr., *Is Bankruptcy the Answer For Troubled Cities And States?*, 50 HOUS. L. REV. 1063, 1064 (2013).
[125] *Id.* at 1067-77.
[126] 11 U.S.C. § 101(40) (2015).
[127] 5 WILLIAM L. NORTON JR. & WILLIAM L. NORTON III, NORTON BANKR. L. & PRAC. § 90:5 (3d ed. 2016).
[128] *Id.*
[129] Marxuach, *supra* note 114, at 3.
[130] *See id.* (claiming the "Other Public Sector Debt" amounted to $47,145 million).
[131] *See id.* (claiming the "Debt Payable from General Fund" amounted to $22,764 million).
[132] *Puerto Rico Chapter 9 Uniformity Act of 2015: H.R. 870 Before the H. Comm. on the Judiciary*, 114th Cong. 1st Sess. 81 (2015) (Oral testimony of Thomas Moers Mayer, Esq., Partner and Co-Chair, Corporate Restructuring and Bankruptcy Group, Kramer Levin Naftalis and Frankel, LLP).

Chapter 9 Uniformity Act because, the more debt Puerto Rico could restructure elsewhere, the abler Puerto Rico would be to repay the debts it didn't structure.[133] Thus, simply giving Puerto Rico access to Chapter 9 would have hit municipal creditors hard and given Commonwealth creditors a windfall.

However, unlike Chapter 9, PROMESA applies to all debt held by the Commonwealth of Puerto Rico. Section 2162 establishes that a debtor may be "a territory that . . . has had an Oversight Board established for it by the United States Congress . . . or a covered territorial instrumentality . . . ."[134] Under Chapter 9, only a state can authorize a municipality to be a debtor and utilize bankruptcy.[135] Here, this power is not extended to Puerto Rico. Title I of PROMESA reserves this power to the oversight board: "[The] Oversight Board, in its sole discretion . . . may designate any territorial instrumentality as a covered territorial instrumentality that is subject to the requirements of this chapter."[136]

This difference between PROMESA and Chapter 9 is incredibly important for holders of municipal or instrumentality debt, and in turn, important for the Puerto Rican people. Had Resident Commissioner Pierluisi's simple one-page bill been passed, Puerto Rico's municipalities would have shouldered the entire debt restructuring burden. This would have sent borrowing rates for just the municipalities —such as the electric power authority and gas authority— skyrocketing, while the borrowing rates for Puerto Rico remained low. Such a situation would have caused utility rates to increase and this cost would be passed on to the Puerto Rican people. At the same time and due to Puerto Rico's continued low borrowing rate, the territorial government would have been able to continue racking up debt. Under this topic, it seems that PROMESA is better for Puerto Rico and its people than simply extending Chapter 9.

IV. CONCLUSION

Though the people of Puerto Rico continue to protest PROMESA, they are likely better off than they would have been had Puerto Rico simply been given access to Chapter 9. The oversight board provides the Puerto Rican government credibility, which enables it to regain access to capital markets and to borrow at reasonable rates. Even though the people of Puerto Rico have no direct influence on the oversight board, the majority of its members are native Puerto Ricans. This provides at least an avenue of influence by way of compassion for the territory's people and situation. PROMESA, unlike Chapter 9, also corrals all of Puerto Rico's debts, providing all lenders certainty. Unfortunately, Title VI would allow bondholders to wheel and deal largely unchecked by an impartial federal judge. However, Title VI actions are overseen by the oversight board, which again, is populated by a majority of Puerto Rican natives. Furthermore, collective action clauses are relatively new in the United States and, consequently, Title VI's utility remains to be demonstrated. Puerto Rico's road ahead is austere, but it will be better navigated with PROMESA than with Chapter 9.

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[133] University of Pennsylvania Law School, *A way forward for Puerto Rico's debt crisis*, YOUTUBE (Jun. 6, 2016), https://www.youtube.com/watch?v=SC2B3X-z0S0&index=1&list=PLEMqhsjmFr7yJ_B2xjEPrO1YYkK8uw083 (David A. Skeel, Jr. discussing the sentence's proposition at 13m15s) (last visited Aug. 6, 2017).

[134] 48 U.S.C. § 2162 (2016).

[135] 11 U.S.C. § 109(c)(2) (2016) ("An entity may be a debtor under Chapter 9 of this title if and only if such entity... is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law . . . ." *Id.*)

[136] 48 U.S.C. § 2121(d)(1)(A) (2016).

THE DOCTRINE OF UNCONSCIONABILITY: A JUDICIAL BUSINESS ETHIC

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I. INTRODUCTION

The historical public policy favoring freedom of contract is promoted through expansive allocations of power to contractual parties who seek to engage in the presumptive transactional and economic benefits of contractual relations. These policies instill confidence in the enforcement of contractual provisions so long as the provisions are mutually and voluntarily agreed. The presupposition that human beings are mature, responsible, and sufficiently morally upstanding so as to engage in fair exchanges has recurrently proven itself a rule with vicissitudes of exceptions. Perhaps it is the nature of humanity or perhaps it is due to unfortunate circumstances of nurturing that some human beings become so self-interested that they attempt to attain advantage by unscrupulous means at the expense of other, more vulnerable human beings. When such advantage is gained through contract and the degree of that advantage becomes sufficiently immoral, unjust, or inequitable, the doctrine of unconscionability becomes a prophylactic of the vulnerable. Although outside of contractual settings, often advantageous behavior of humans, sometimes arising from an abundance of self-love or a failure of empathy, rarely has a viable legal remedy. When such behavior is documented in an otherwise legally binding contract, there is recourse for victims of such injustice. What constitutes an unconscionable contract remains an amorphous standard that encourages minimal adherence to ethical behavior in both the process of contracting and in the terms of the contract itself, thereby promoting a necessary, albeit imprecise baseline of ethics in business. This article proposes a new approach to examining purportedly unconscionable contracts –an approach based in ethical pluralism– and by doing so, contends that business ethics theory may play an integral role in defining the boundaries of unconscionability.

Part II traces the major historical developments of the doctrine of unconscionability. Part III contends that the pragmatic implementation of the doctrine of unconscionability is creating a judicially construed business ethic. Part IV suggests that business ethics theory may inform future applications of the doctrine of unconscionability. Part V introduces a pluralistic approach to unconscionability. Part VI concludes.

II. THE RISE OF THE DOCTRINE OF UNCONSCIONABILITY

The notion that a contract with unfair terms can be rescinded is not unique to common law countries, but is also present in many civil law countries. In civil law countries, this notion is rooted in the doctrine of *laesio enormis* which is preserved in, among other places, the Roman Code of Justinian (529-565 C.E.).[2] The doctrine, as defined in the Code of Justinian, allows a seller to rescind a contract if the sales price is less than half of the actual price.[3] Today, the doctrine of

[2] *Code of Justinian*, THE ENCYCLOPEDIA BRITANNICA, (Nov. 12 2014), http://www.britannica.com/topic/Code-of-Justinian (last visited Aug. 5, 2017). In addition to the doctrine of *laesio enormis*, doctrines similar to unconscionability are found in a variety of places in many civil law countries. A group of scholars compiled many of the legal instruments in several European countries that relate to the common law doctrine of unconscionability. *See* MEL KENNY, JAMES DEVENNEY, & LORNA FOX O'MAHONY, UNCONSCIONABILITY IN EUROPEAN PRIVATE FINANCIAL TRANSACTIONS: PROTECTING THE VULNERABLE (Eds. 2010). *See also* ELENA D'AGOSTINO, CONTRACTS OF ADHESION BETWEEN LAW AND ECONOMICS: RETHINKING THE UNCONSCIONABILITY DOCTRINE (2015) (for criticisms of the main criteria of the doctrine of unconscionability in the context of contracts of adhesion).

[3] RAYMOND WESTBROOK, EX ORIENTE LEX: NEAR EASTERN INFLUENCES ON ANCIENT GREEK AND ROMAN LAW (edited by Deborah Lyons and Kurt A. Raaflaub) (2015).

laesio enormis continues to protect buyers and sellers in many civil law countries.[4] Although spurring from similar principles, the doctrine of unconscionability emerged much later in history.

The doctrine of unconscionability arose in English courts of equity. As early as 1686, Lord Chancellor Jefferies enunciated a loan agreement an "unconscionable bargain" in the case of *Berney v. Pitt*.[5] In *Berney*, the debtor borrowed two-thousand English pounds from the lender, promising (among other things) that if the debtor's father died, the debtor would pay the lender five-thousand pounds in return for the two-thousand pound loan.[6] However, if the debtor died before his father, the lender was to forgive the loan.[7] After the debtor's father died, the lender attempted to collect the five-thousand pounds, but instead of paying the lender in full, the debtor filed a bill of complaint.[8] The case was first heard by Lord Nottingham who enforced the loan agreement, and ordered the borrower to repay the five-thousand pounds plus interest.[9] Upon rehearing, Lord Chancellor Jefferies found the loan-arrangement to be an "unconscionable bargain," and decreed the lender pay back all monies collected from the debtor except the original two-thousand pounds with interest.[10] Lord Jefferies did not elaborate as to the meaning of "unconscionable," but it is apparent he perceived this loan agreement to be distasteful and unfair.

In 1750, a similar outcome was reached in *Earl of Chesterfield et al. v. Janssen*.[11] In *Chesterfield*, Lord Chancellor Hardwicke eloquently considered the principles and powers of English courts of equity when he inquired into whether a contract was "contrary to conscience" and concluded that preventing uncontentious contracts was the "duty of a court."[12] In his analysis, Lord Chancellor Hardwicke discussed *Berney*,[13] and categorized several types of fraud including what he termed as "unequitable or unconscientious bargains" which are those that "no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other."[14] The doctrine of unconscionability began to develop from early English equity cases like *Berney* and *Chesterfield*. Whereas the doctrine of *laesio enormis* often provides a bright-line, half-the-price rule, the doctrine of unconscionability provides a much more flexible standard, based in equity, which is better suited to meet the changing needs of individual factual circumstances.

The doctrine of unconscionability was carried across the pond to early American colonial and state courts. In 1730, the General Court of Virginia declared in *Graves v. Boyd* that courts will not enforce "unconscionable Bargains" and that "Now if it be a Sin and a Man in Conscience ought not to Insist on an unreasonable Bargain; no Court of Conscience will Decree such a Bargain to be Executed."[15] In 1787, the Connecticut Superior Court held in *Lankton v. Scott* that when a note was unconscionably and unduly attained, a decree declaring the note void and null is appropriate,[16] and in 1795 this same court deemed the sale of a property worth an estimated 60 pounds for 300 pounds to be unconscionable.[17] In *Whipple v. McClure* the Connecticut Superior

[4] Van den Bergh H., *The long life of laesio enormis*, SERIE: IURISPRUDENTIA 4 (Studia Universitatis Babes-Bolyai, 2012).
[5] Berney v. Pitt, 2 Vern 14, 15 (1686).
[6] *Id.* at 14–15.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Earl of Chesterfield et al. v. Janssen, 2 Ves. Sen. 125 (1750).
[12] *Id.* at 156.
[13] *Id.* at 129.
[14] *Id.* at 156.
[15] Graves v. Boyd, 1 Va. Colonial Dec. R45 (1730).
[16] Lankton v. Scott, 1 Kirby 356, 358-359 (Superior Court of Connecticut 1787).
[17] Whipple v. McClure, 2 Root 216, 217 (Superior Court of Connecticut 1795).

Court took into account, not only the disparity between contract and true price, but also the "debility of intellects" spurring from the victim's limited capacities[18] when declaring the sale unconscionable. In the 1801 case, *Beall v. Prather*, the Court of Appeals of Maryland, enforced a contract which it deemed fair at the time it was created, and that no "subsequent change of circumstance will alter the case,"[19] reserving, however, that a "court of equity is not bound to decree a specific execution of articles which appear. . .*unjust* or *unconscionable*. . ."[20] In 1815, the Supreme Judicial Court of Massachusetts held in *Baxter v. Wales* that an agreement to hire cows for six dollars a year per cow was "unconscionable".[21] The *Baxter* court explicitly acknowledged that courts should render reasonable damages and are not bound by the damages terms of the contract (when courts deem contracts unconscionable).[22] The doctrine of unconscionability was recognized early in American jurisprudence across the colonies and then the states.

By the late 1800s, the Supreme Court of the United States expressly recognized the doctrine of unconscionability. In its 1870 decision, the Supreme Court held that "[i]f a contract be unreasonable and unconscionable, but not void for fraud, a court of law will give to the party who sues for its breach damages, not according to its letter, but only such as he is equitably entitled to."[23] Moreover, in 1889, the Supreme Court not only acknowledged but discussed the doctrine of unconscionability in *Hume v. United States*.[24] *Hume* involved a contract for shucks; the evidence showed that a mistake was made in the contract drafting, setting the price for shucks much too high.[25] The appeal to the Supreme Court came from the Court of Claims which determined that "an agreement to pay $1,200 a ton for shucks, actually worth not more than $35 a ton, is a grossly unconscionable bargain."[26] In considering the appeal from the Court of Claims, Chief Justice Fuller intricately analyzed the types of fraud set forth by Lord Chancellor Hardwicke in *Chesterfield*, and acknowledged the use and necessity of the doctrine of unconscionability.[27] Chief Justice Fuller affirmed the decision of the Court of Claims holding the contract unconscionable, and that the seller was only due the market rate for the shucks.[28] After the Supreme Court's recognition and application of the doctrine of unconscionability, it was continued to be utilized by lower courts across the United States.[29]

The codification of the doctrine of unconscionable contracts is rooted in the 1940s with the drafting of the Uniform Commercial Code (hereinafter, UCC). The drafting of the UCC is often attributed to the tenacious efforts of Karl Llewellyn, but other people, such as Hiram Thomas, also assisted in the process.[30] In the early stages of drafting the UCC, Thomas suggested the "unconscionability" standard be included in the code.[31] Thomas's suggestion was ultimately

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[18] *Id.* at 219.
[19] Beall v. Prather, 1 H. & J. 210, 223 (Court of Appeals of Maryland 1801).
[20] *Id.* at 221 (emphasis in original).
[21] Baxter v. Wales, 12 Mass. 365, 367 (1815).
[22] *Id.*
[23] Scott v. United States, 79 U.S. 443, 445, (1870).
[24] Hume v. United States, 132 U.S. 406 (1889).
[25] *Id.*
[26] *Id.* at 406; *see* also Hume v. United States, 21 Ct.Cl. 328 (1886).
[27] *Id.* at 411.
[28] *Id.*
[29] In 1853, the U.S. Supreme Court also acknowledged that "[a] disposition of property so revolting to common sense and natural affection ought to be looked upon with suspicion." Eyre v. Potter, 56 U.S. 42, 46, (1853).
[30] Allen R Kamp, *Downtown Code: A History of the Uniform Commercial Code 1949-1954*, 49 BUFF. LAW REV. 359, 380-381 (2001).
[31] *Id.*

accepted when the doctrine of unconscionability was incorporated into UCC §2-302.[32] UCC Article 2, which includes §2-302, has been adopted (often without modifications) into the statutory law of 49 states.[33] As a consequence of the UCC, the doctrine of unconscionability is preserved in the sales law of most states, yet the term "unconscionable" is not fully defined by the UCC.[34] Although not defined, the official comments do lay out the test of unconscionability: "The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract."[35] The official comments also note the underlying "principle is one of the prevention of oppression and unfair surprise…and not of disturbance of allocation of risks because of superior bargaining power."[36] Despite these clarifying comments, as a result of the insufficient definition in the UCC, critics claim that there is the potential for judicial abuse of the amorphous unconscionability doctrine and, further, that the UCC proffers insufficient practical guidance to businesspeople who seek to identify proper business conduct when drafting and entering contracts.[37] Critics claim that the doctrine of unconscionability has become an "all-purpose weapon" for resolving problems of contract.[38] As a result, many judges look to the common law to define unconscionability even in the context of statutory sales law.

In the 1960s, courts began citing the adopting state statutes of UCC §2-302 in their opinions. In 1964, *American Home Improvement Co. v. MacIver* cited §2-302, holding a contract invalid because of its unconscionable features.[39] In this case, the New Hampshire Supreme Court held that "Inasmuch as the defendants have received little or nothing of value and under the transaction they entered into they were paying $1,609 for goods and services valued at far less, the contract should not be enforced because of its unconscionable features. This is not a new thought or a new rule in this jurisdiction…It has long been the law in this state that contracts may be declared void because unconscionable and oppressive…"[40] Surrounding the citation to §2-302, the court expressly confirmed that the common law doctrine of unconscionability had long been accepted in New Hampshire.[41] Subsequently, in 1965, the District of Columbia Circuit Court explicitly confirmed the applicability of the doctrine of unconscionability in *Williams v. Walker-*

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[32] UCC §2-302 provides:

> (1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result. (2) When it is claimed, or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

[33] Louisiana has not adopted UCC Article 2. California has not adopted §2-302 of Article 2, but has adopted most of Article 2 provisions.

[34] Martin B. Shulkin, *Unconscionability—The Code, the Court and the Consumer*, 9 B.C.L. REV. 367, 367-368 (1968), available at: http://lawdigitalcommons.bc.edu/bclr/vol9/iss2/3 (last visited Aug. 5, 2017).

[35] UCC §2-302, Official Comment 1.

[36] *Id.*

[37] Shulkin, *supra* at 369 (also commenting that some criticize §2-302 because the official comment 2 allows for judicial reformation of unconscionable clauses, and thus altering the agreement of the parties).

[38] John A. Spanogle, Jr., *Analyzing Unconscionability Problems*, 117 UNIV. OF PENN. LAW REV. 931, 931 (1969).

[39] American Home Improvement Co. v. MacIverv, 105 N.H. 435 (1964). *See also* Martin B. Shulkin, *Unconscionability—The Code, the Court and the Consumer*, 9 B.C.L. REV. 367, 369 (1968).

[40] *Id.* at 439.

[41] *Id.*

Thompson Furniture Co.[42] The contracts in *Williams*, however, arose before the legislature adopted §2-302 but the court nevertheless pronounced several guidelines for unconscionability determinations.[43] These include considering (1) whether there was a meaningful choice or if meaningful choice was absent due to unequal bargaining power; (2) the manner by which the parties entered the contract, including whether the parties had a reasonable opportunity to understand it; and (3) if the terms of the contract were so grossly unfair so as to require enforcement be withheld.[44] In 1966, the principles enunciated in *Williams* were applied by a New York Supreme Court in *Application of State of New York v. ITM, Inc.*[45] Then in 1969, a New York Supreme Court applied §2-302 to invalidate a contract in *Jones v. Star Credit Corp.*[46] In *Jones*, the plaintiffs, husband and wife, were welfare recipients who contracted to purchase a freezer from a salesman, inclusive of all fees, insurances, and taxes, for the amount of $1234.80.[47] The evidence showed the freezer was worth only approximately $300.[48] In deeming this contract unconscionable, the court stated that "[t]here was a time when the shield of *caveat emptor* would protect the most unscrupulous in the marketplace –a time when the law, in granting parties unbridled latitude to make their own contracts, allowed exploitive and callous practices which shocked the conscience of both legislative bodies and the courts," but that time has now passed, and the doctrine of unconscionability protects victims of such abuses.[49] Decisions citing §2-302 continued as the doctrine of unconscionability evolved through judicial decisions over the subsequent decades.

Since 1964, courts have rendered many controversial decisions involving the doctrine of unconscionability. The doctrine has been used (or attempted to be used) in a variety of contexts including real estate transactions,[50] exculpatory clauses,[51] entertainment contracts,[52] arbitration clauses and agreements,[53] waivers of class action lawsuits,[54] matrimonial agreements (such as

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[42] Williams v. Walker-Thompson Furniture Co., 350 F.2d 445 (1965).
[43] *Id.* at 448-449.
[44] *Id.* at 449-450.
[45] Application of State of New York v. ITM, Inc., 2 Misc. 2d 39, 275 N.Y.S.2d 303 (Sup. Ct. 1966).
[46] Jones v. Star Credit Corp., 59 Misc. 2d 189; 298 N.Y.S.2d 264 (1969).
[47] *Id.* at 265.
[48] *Id.*
[49] *Id.*
[50] Sitogum Holdings, Inc. v. Ropes, 352 N.J. Super. 555 (2002) (using unconscionability in a real estate transaction).
[51] *See, e.g.*, Trudy Nobles Sargent, *Unconscionability Redefined: California Imposes New Duties on Commercial Parties Using Form Contracts*, 35 HASTINGS L.J. 161 (1983); James F. Hogg, *Consumer Beware: The Varied Application of Unconscionability Doctrine to Exculpation and Indemnification Clauses in Michigan, Minnesota, and Washington*, 2006 MICH. ST. L. REV. 1011 (2006).
[52] *See generally* Catherine Riley, *Signing in Glitter or Blood?: Unconscionability and Reality Television Contracts*, 3 NYU J. INTELL. PROP. & ENT. L. 106, 121-122 (2013).
[53] *See, e.g.*, DIRECTV, Inc. v. Imburgia, 136 S. Ct. 463 (2015); *Franchisee's Unconscionability Claims in Court's Hands*, 62 DISP. RESOL. J. 5 (February-April 2007); Sarah Rudolph Cole, *On Babies and Bathwater: The Arbitration Fairness Act and the Supreme Court's Recent Arbitration Jurisprudence*, 48 HOUS. L. REV. 457, 463 (2011); Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757 (2004); Gerald M. Levine, *Challenging Arbitration Agreements for Unconscionability: An Uphill Battle for Employees and Others*, 65 DISP. RESOL. J. 24 (November 2010-January 2011); William Allen Nelson II, *Take It or Leave It: Unconscionability of Mandatory Pre-Dispute Arbitration Agreements in the Securities Industry*, 17 U. PA. J. BUS. L. 573 (2015).
[54] *See, e.g.*, Megan Barnett, *There is Still Hope for the Little Guy: Unconscionability is Still a Defense Against Arbitration Clauses Despite AT&T Mobility v. Concepcion*, 33 WHITTIER L. REV. 651 (Spring 2012); *See also* AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1743 (2011); Steven G. Pearl, *The Conscience of Arbitration*, 37 L.A. LAW. 34 (April 2014); Jerett Yan, *A Lunatic's Guide to Suing for $30: Class Action Arbitration, The Federal Arbitration Act and Unconscionability after AT&T v. Concepcion*, 32 BERKELEY J. EMP. & LAB. L. 551 (2011).

prenuptial agreements),[55] sports liability waivers,[56] internet and software agreements,[57] lease contracts,[58] warranty disclaimers,[59] contracts containing excessive prices,[60] mandatory mediation clauses,[61] and music and recording contracts.[62] It has even been argued that corporate executive compensation should be checked by an unconscionability standard,[63] and that hospital-patient agreements are sometimes unconscionable.[64] The breadth of the application of the doctrine of unconscionability corresponds to the scope of situations wherein individuals are victimized by inequitable contracting processes or contract terms.

State and federal courts adopt a variety of definitions of unconscionability and approaches to applying the doctrine of unconscionability.[65] Some courts define an unconscionable contract

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[55] *See, e.g.*, Paul Bennett Marrow & Kimberly S. Thomsen, *Drafting Matrimonial Agreements Requires Consideration of Possible Unconscionability Issues*, 76 N.Y. ST. B.J. 26 (March/April 2004); Lou McPhail, *Divorce—Alimony, Allowance, and Disposition of Property – Abuse of Discretion – The Unconscionable Stipulated Divorce Agreement and Rule 60(B)(VI): What about the Children? Crawford v. Crawford, 529 N.W.2d 833 (N.D. 1994*), 72 N.D. L. REV. 1099 (1996);

[56] *See, e.g.*, Douglas Leslie, *Sports Liability Waivers and Transactional Unconscionability*, 14 SETON HALL J. SPORTS & ENT. L. 341 (2004).

[57] *See, e.g.*, Paul J. Morrow, *Cyberlaw: The Unconscionability / Unenforceability of Contracts (Shrink-Wrap, Clickwrap, and Browse-Wrap) On the Internet: A Multijurisdictional Analysis Showing the Need for Oversight*, 11 U. PITT. J. TECH. L. & POL'Y 7 (Spring 2011); Cory S. Winter, *The Rap on ClickWrap: How Procedural Unconscionability is Threatening the E-Commerce Marketplace*, 18 WIDENER L.J. 249 (2008); Lucille M. Ponte, *Getting a Bad Rap? Unconscionability in ClickWrap Dispute Resolution Clauses and a Proposal for Improving the Quality of these Online Consumer Products*, 26 OHIO ST. J. ON DISP. RESOL. 119 (2011).

[58] *See generally* Charles A. Heckman, *Unconscionability and Personal Property Leasing Law in Connecticut*, 18 QLR 203 (1998); Michael J. Herbert, *Unconscionability Under Article 2A*, 21 U. TOL. L. REV. 715 (1990).

[59] *See generally* John A. Menchaca II, *Unconscionability and As Is Disclaimers in Sales Contracts*, 16 OKLA. CITY U. L. REV. 345 (1991).

[60] *See, e.g.*, Frank P. Darr, *Unconscionability and Price Fairness*, 30 HOUS.L.REV. 1819 (1994); Kugler v. Romain, 58 N.J. 522, 279 A.2d 640 (1971); Toker v. Westerman, 113 N.J. Super. 452, 274 A.2d 78 (Dist. Ct. 1970); Toker v. Perl, 103 N.J. Super. 500, 247 A.2d 701 (Super. Ct. Law Div. 1968), *aff'd in part*, 108 N.J. Super. 129, 260 A.2d 244 (Super. Ct. App. Div. 1970); Jones v. Star Credit Corp., 59 Misc. 2d 189, 298 N.Y.S.2d 264 (Sup. Ct. 1969); Lefkowitz v. ITM, Inc., 52 Misc. 2d 39, 275 N.Y.S.2d 303 (Sup. Ct. 1966); Frostifresh Corp. v. Reynoso, 52 Misc. 2d 39, 274 N.Y.S.2d 757 (Dist. Ct. 1966), *rev'd as to damages*, 54 Misc. 2d 119, 281 N.Y.S.2d 964 (App. Term 1967); Patterson v. Walker-Thomas Furniture Co., 277 A.2d 111 (D.C. 1971); Morris v. Capital Furniture & Appliance Co., 280 A.2d 775 (D.C. 1971); see also Craig Horowitz, *Reviving the Law of Substantive Unconscionability: Applying the Implied Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts*, 33 UCLA L. REV. 940 (1986).

[61] *See, e.g.*, Jennifer M. Ralph, *Unconscionable Mediation Clauses: Garrett v. Hooters-Toledo*, 10 HARV. NEGOT. L. REV. 383 (2005); Paul Bennett Marrow, *Coming to New York? An Unconscionable Mediation Agreement*, 78 N.Y. ST. B.J. 40 (2006).

[62] *See, e.g.*, Omar Anorga, *Music Contracts Have Musicians Playing in the Key of Unconscionability*, 24 WHITTIER L. REV. 739 (2003); Ian Brereton, *The Beginning of the New Age?: The Unconscionability of the "360-Degree" Deal*, 27 CARDOZO ARTS & ENT. L.J. 167 (2009); Emily Burrows, *Termination of Sound Recording Copyrights & the Potential Unconscionability of Work for Hire Clauses*, 30 REV. LITIG. 101 (2010); Phillip W. Hall Jr., *Smells Like Slavery: Unconscionability in Recording Industry Contracts*, 25 HASTINGS COMM. & ENT L.J. 189 (2002).

[63] *See, e.g.*, Lawrence A. Cunningham, *A New Legal Theory To Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177 (2011); and Kent Greenfield, *Unconscionability and Consent in Corporate Law (A Comment on Cunningham)*, 96 IOWA L. REV. BULL. 92 (2011).

[64] *See generally* George A. Nation III, *Obscene Contracts: The Doctrine of Unconscionability and Hospital Billing of the Uninsured*, 94 KY. L.J. 101 (2005-2006).

[65] *See, e.g.*, THE RESTATEMENT (SECOND) OF CONTRACTS, § 208 (1981) ("If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result.")

as "one abhorrent to good morals and conscience..."[66] Other courts define an unconscionable contract as requiring "an absence of meaningful choice on the part of one of the parties to a contract, combined with contract terms that are unreasonably favorable to the other party."[67] Generally, courts divide the concept of "unconscionability" into substantive and procedural unconscionability; thus including both aspects of the previous definition within a dichotomous definition of unconscionability.[68] Substantive unconscionability generally relates to the fairness of the contract terms. A contract is substantively unconscionable when a clause or term in the contract is "alleged to be one-sided or overly harsh" such as contracts that contain terms that are "shocking to the conscience, monstrously harsh, and exceedingly callous."[69] Procedural unconscionability relates to the fairness of the process of contract formation.[70] Contracts are procedurally unconscionable when, "impropriety during the process of forming a contract" results in a party not having a "meaningful choice" when entering into the contract.[71] In deciphering whether a contract is substantively and procedurally unconscionable, some courts adopt the "sliding scale" approach (a sliding scale is used so that the more substantively oppressive a contract term, the less of a need there is for procedural unconscionability, and *vice versa).*[72] The evolving and various applications of the doctrine of unconscionability aside, this essay next discusses how the pragmatic implementation of the doctrine of unconscionability is creating a judicially construed business ethic, albeit one not consistent across the nation.[73] The essay then explains how business ethics theory may be utilized to inform the doctrine of unconscionability.

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[66] Driggers v. Campbell 247 Ga.App. 300, 303 (2000); F.N. Roberts Pexst Control Co. v. McDonald, 132 Ga.App. 257, 260(3) (1974). *See* also Ahern v. Knecht, 202 Ill.App.3d 709, 150 Ill.Dec. 660, 563 N.E.2d 787, 792 (1990) ("[g]ross excessiveness of price alone can make an agreement unconscionable"); Frostifresh Corp. v. Reynoso, 52 Misc.2d 26, 274 N.Y.S.2d 757 (Dist.Ct.1966), *rev'd as to damages only*, 54 Misc.2d 119, 281 N.Y.S.2d 964 (App.Div.1967); Toker v. Perl, supra, 103 N.J.Super. 500, 247 A.2d 701; Toker v. Westerman, 113 N.J.Super. 452, 274 A.2d 78 (Dist.Ct.1970).; Hall v. Wingate, 159 Ga. 630, 667 (126 SE 796) (1924) (internal quotations and citations omitted); Thomas v. T & T Straw, Inc., 254 Ga. App. 194, 561 S.E.2d 495, 497 (Ga. App. 2002).

[67] Collins v. Click Camera & Video, Inc. 86 Ohio App.3d 826, 834 (1993); Wilmer v. Exxon Corp., 495 Pa. 540, 551 (1981).

[68] *See, e.g.*, *Nelson*, 73 Wash. App. at 768; Patterson v. Walker–Thomas Furniture, 277 A.2d 111 (D.C.1971); Mobile Am. Corp. v. Howard, 307 So.2d 507, 508 (Fla.Dist.Ct.App.1975); K.D. v. Education Testing Service, 87 Misc.2d 657, 386 N.Y.S.2d 747 (Sup.Ct.1976); Truta v. Avis Rent A Car System, Inc., 193 Cal.App.3d 802, 238 Cal.Rptr. 806 (1987); Adams v. American Cyanamid Co., 1 Neb.App. 337, 498 N.W.2d 577 (1992).

[69] *Nelson*, 127 Wash.2d at 131 (internal citations and quotations omitted).

[70] Sitogum Holdings, Inc. v. Ropes, 352 N.J.Super. 555, n. 13 (2002) ("There do not appear to be any decisions where procedural unconscionability was present but not substantive unconscionability. This should not come as any surprise. No matter how the contract came about, it would be unlikely that a party would complain—or a court would listen—if the contract was otherwise fair or reasonable. It would be much like arguing about negligent conduct which failed to result in any damage").

[71] *Nelson*, 127 Wash.2d at 131 (internal citations and quotations omitted).

[72] *Sitogum Holdings, Inc.*, 352 N.J.Super. 555 (2002); *see* also Funding Systems Leas. Corp. v. King Louie Intern., 597 S.W.2d 624, 634 (Mo.Ct.App.1979) ("if there exists gross procedural unconscionability then not much be needed by way of substantive unconscionability, and that the same 'sliding scale' be applied if there be great substantive unconscionability but little procedural unconscionability"); Tacoma Boatbuilding, Inc. v. Delta Fishing Co., 28 UCC Rep.Serv. 26, 1980 WL 98403 n. 20 (W.D.Wash.1980) ("The substantive/procedural analysis is more of a sliding scale than a true dichotomy"); and Hahn v. Massage Envy Franchising, LLC, No. 12CV153 DMS BGS, 2014 WL 5099373, at *7 (S.D. Cal. Apr. 15, 2014) ("A sliding scale is applied, so that the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to find it unenforceable, and *vice versa.")*

[73] Kugler v. Romain, 58 N.J. 522, 543, 279 A.2d 640, 651 (1971) ("The intent of the [unconscionability] clause is not to erase the doctrine of freedom of contract, but to make realistic the assumption of the law that the agreement has resulted from real bargaining between parties who had freedom of choice and understanding and ability to negotiate in a meaningful fashion. Viewed in that sense, freedom to contract survives, but marketers of consumer goods are

III. UNCONSCIONABILITY: A JUDICIALLY CONSTRUED BUSINESS ETHIC

The doctrine of unconscionability is an inherently moral doctrine.[74] It allows judges to invalidate morally repugnant contracts. The doctrine of unconscionability is necessary to ensure a minimal standard of decency within the unique factual circumstances of contractual and business relationships. It is utilized by judges to invalidate otherwise valid contracts that violate the ethical norms of society. The doctrine of unconscionability is regularly used to enforce the norm that the vulnerable should not be exploited. In unconscionability's early enunciation in English courts of equity, the doctrine was used to protect the youth from being taken advantage of by usurious agreements. Since that time, it has regularly been used to protect the youth along with the ignorant, the poor, the elderly, the grieving, and others exploited by cunning businesspeople attempting to maximize profits. The doctrine of unconscionability is also frequently used to promote the ethical norm of equality. It is regularly utilized to invalidate otherwise valid contracts that were created pursuant to an inequality of bargaining power. The rest of this section discusses judicial applications of unconscionability involving the enforcement of these ethical norms.

A. Protecting the Vulnerable and Unconscionability

The doctrine of unconscionability is regularly used as a vehicle for protecting vulnerable contractual parties from exploitation. It has long and recurrently been held that a core purpose of unconscionability is to protect the vulnerable. The vulnerability of the victims is occasionally cited as not merely the purpose, but in some cases, as a prerequisite or element of unconscionability. Although classes of particularly vulnerable individuals may be identified, each case brings with it unique facts that describe why the victims of unconscionable contracting are deemed vulnerable. Classes of the vulnerable people include, among others, those of lessened or weakened education, age, intelligence, wealth, business experience, and those subject to a position of trust or influence.[75]

The client in an attorney-client relationship is a class of individuals that is particularly vulnerable because clients are subject to a position of trust and influence.[76] *In the Matter of Cassel*[77] the New York Supreme Court considered the vulnerability of an elderly woman who was a client of an attorney.[78] *Cassel* involved an attorney who was charged with a number of violations of the New York rules of professional conduct.[79] Some of these violations involved a conflict-of-interest spurring from representing his elderly client, Eliane Veve, in a dubious transaction.[80] Although Cassel represented Eliane in many transactions going back to 1978 including assisting with settling her husband's estate and a wrongful death action, in May of 1983, when Eliane was

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brought to an awareness that the restraint of unconscionability is always hovering over their operations and that courts will employ it to balance the interests of the consumer public and those of the sellers").

[74] Turner v. Ferguson, 149 F.3d 821, 825 (1998) (referring to the "moral issue of unconscionability"); F.N. Roberts Pest Control Co. v. McDonald, 208 S.E.2d 13 (Ga. App. 1974) ("An unconscionable contract is one abhorrent to good morals and conscience. It is one where one of the parties takes a fraudulent advantage of another") (quotations omitted).

[75] Johnson v. Mobil Oil Corp., 415 F. Supp. 264, 268 (E.D. Mich. 1976). See also Larry DiMatteo & Bruce Louis Rich, *A Consent Theory of Unconscionability: An Empirical Study of Law in Action*, 33 FL. ST. UNIV. L. REV. 1067, 1075-1080 (2006) (discussing the factors of procedural and substantive unconscionability).

[76] Keith William Diener, *A Battle for Reason: The Unconscionable Attorney-Client Fee Agreement*, 2016 THE J. OF THE PROF. LAW. 129 (2016).

[77] Matter of Cassel, 154 A.D.2d 876, 547 N.Y.S.2d 427 (1989).

[78] *Id.*

[79] *Id.*

[80] *Id.*

84 years old, approximately two weeks before she died, Cassel did prepare a deed to transfer Eliane's residence to Cassel and his wife.[81] Eliane signed the deed and transferred her residence for no consideration, and without independent counsel.[82] When questioned about this dubious transaction, Cassel said that Eliane owed his wife approximately $40,000 for running errands for her and taking her to doctor's appointments for a five-year period.[83] Mrs. Cassel claimed she and Eliane agreed to a wage of $8 per hour and that after five years, Eliane owed her $40,000, and thus signed the house over to her.[84] The court determined that "such an arrangement, if in fact it existed, would be unconscionable given [Eliane] Veve's vulnerable condition and meager assets."[85] The vulnerability of Eliane, and the circumstances surrounding the transfer of the property only two weeks before her death did play a significant role in the court's deeming this contract unconscionable. Cassel was ultimately suspended from the practice of law for a period exceeding five years.[86] In *Cassel*, the client was deemed particularly vulnerable not only because of the intimate relationships with her attorney but also because of her (elderly) age and the unique circumstances surrounding her unconscionable contract. From its very inception, the doctrine of unconscionable contracts has protected the young,[87] and it has recurrently been used to protect the elderly (particularly when ill or grieving).[88]

Courts have recurrently used the doctrine of unconscionability to protect the elderly residents of nursing homes.[89] The New Mexico Court of Appeals identified the vulnerability of nursing home residents and their families as a key reason why contracts with nursing homes should be considered special, and treated different than other commercial contracts.[90] The court

[81] *Id.* at 877.
[82] *Id.*
[83] *Id.* at 879.
[84] *Id.*
[85] *Id.* at 879 (the court also mentioned that Cassel sold the property for $65,000 only months after acquiring it).
[86] *Id.* (suspending Cassel initially for five years); *see* also Matter of Cassel, 220 A.D.2d 925, 925-26, 632 N.Y.S.2d 984, 985 (1995) ("We conclude that petitioner has not shown by clear and convincing evidence that he possesses the character and general fitness to resume the practice of law. . . .We especially note the circumstances of his involvement with his former client Elaine Veve which, in part, resulted in his suspension from practice") (internal citations omitted).
[87] Berney v. Pitt, 2 Vern 14 (1686) (holding a contract unconscionable, in part, because of the young age of one party). *See* also State v. Vernor, 191 P. 729 (1920) (holding an attorney-client fee agreement unconscionable, in part, because of the vulnerability of a young girl).
[88] Sitogum Holdings, Inc. v. Ropes, 352 N.J. Super. 555 (2002) (the New Jersey Superior Court held an option agreement entered into by a grieving, eighty-one year old widow as unconscionable).
[89] Clark v. Renaissance W., LLC, 232 Ariz. 510, 514, 307 P.3d 77, 81 (Ct. App. 2013) ("a vulnerable patient who was retired with a fixed income, and little savings, who entered into an agreement with an arbitration provision with a nursing facility, successfully had arbitration provision deemed unconscionable because he would not be able to afford to arbitrate"); Estate of Ruszala ex rel. Mizerak v. Brookdale Living Communities, Inc., 415 N.J. Super. 272, 299, 1 A.3d 806, 822 (App. Div. 2010) ("When considered together, the restrictions on discovery, limits on compensatory damages, and outright prohibition of punitive damages form an unconscionable wall of protection for nursing home operators seeking to escape the full measure of accountability for tortious conduct that imperils a discrete group of vulnerable consumers. . . .We thus hold that these provisions in the arbitration clause of the residency agreement are void and unenforceable under the doctrine of substantive unconscionability"); Strausberg v. Laurel Healthcare Providers, LLC, 2012-NMCA-006, 269 P.3d 914, 920 (N.M. Ct. App. 2011*), rev'd, and remanded*, 2013-NMSC-032, 304 P.3d 409 (N.M. 2014), *on remand*, 2013 N.M. App. Unpub. LEXIS 292 (N.M. Ct. App. Sept. 11, 2013); Brown ex rel. Brown v. Genesis Healthcare Corp., 228 W. Va. 646, 724 S.E.2d 250 (2011) *cert. granted, judgment vacated sub nom.* Marmet Health Care Ctr., Inc. v. Brown, 132 S. Ct. 1201, 182 L. Ed. 2d 42 (2012) ("The Supreme Court held that West Virginia's prohibition against predispute agreements to arbitrate personal-injury or wrongful-death claims against nursing homes was categorical rule which prohibited arbitration of particular type of claim, which was preempted by the Federal Arbitration Act (FAA)").
[90] *Strausberg*, 269 P.3d at 920.

noted that when individuals are being admitted to a nursing home, the issues of health are often critical, and so severe that "such individuals are often at their most vulnerable, emotionally or physically, or both."[91] Moreover, due to "illness, incapacitation, or physical or mental impairment, people being admitted to a nursing home are usually quite vulnerable...."[92] This rationale rooted in protecting the vulnerable nursing home residents, and even their families, was used to challenge arbitration agreements with nursing homes.

Although protecting the vulnerable from being taken advantage of by grossly unfair contract terms is at the heart of unconscionability, and many courts consider the vulnerability of the victims in their unconscionability analyses, in some cases, a lack of vulnerability has prevented findings of unconscionability.[93] The Seventh Circuit is particularly elucidating with its distinction between unsophisticated parties ("vulnerable consumers or helpless workers") and sophisticated parties ("business people") as determinative in finding a contract unconscionable.[94] According to the Seventh Circuit, the doctrine is meant to apply to those vulnerable and helpless classes.[95] Other classes of individuals that are normally considered "the poorest and most vulnerable members of society" include "single parents, pensioners, persons on social assistance, the working poor, [and] the chronically underemployed."[96] Some courts consider the vulnerability of parties as indicative of a lack of choice. These courts examine, *inter alia*, the "age, education, intelligence, business acumen and experience" of the parties when analyzing whether there was a choice and a meeting of the minds.[97] The moral imperative of protecting the vulnerable is promoted through *ad hoc* applications of the doctrine of unconscionability in state and federal courts.[98] Promoting the equality of parties is also an often cited moral imperative underpinning the doctrine of unconscionability.

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[91] *Id.* at 920.

[92] *Id.*

[93] Best Vendors Co. v. Air Express, Inc., No. CIV. 00-2224 JRTFLN, 2002 WL 31163039, at *7 (D. Minn. Sept. 23, 2002); Siemer v. Quizno's Franchise Co. LLC, No. 07 C 2170, 2008 WL 904874, at *7, n. 2 (N.D. Ill. Mar. 31, 2008); We Care Hair Dev., Inc. v. Engen, 180 F.3d 838, 843 (7th Cir.1999); Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir.1992); Vaeda Indus., Inc. v. Jason, Inc., No. 3:07-CV-348, 2008 WL 687304, at *5 (N.D. Ind. Mar. 7, 2008); Reno v. SunTrust, Inc., No. E2006-01641-COA-R3CV, 2007 WL 907256, at *6 (Tenn. Ct. App. Mar. 26, 2007) (denied finding arbitration agreement unconscionable, in part, because the plaintiffs were not in a vulnerable position relative to defendants). Cf. Howell v. NHC Healthcare-Fort Sanders, Inc., 109 S.W.3d 731 (Tenn.Ct.App.2003); Raiteri v. NHC Healthcare/Knoxville, Inc., No. E2003-00068-COA-R9-CV, 2003 WL 23094413 (Tenn.Ct.App.E.S., Dec. 30, 2003).

[94] Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir.1992).

[95] *Id.*

[96] Baillie v. Processing Sols., LLC, No. A125167, 2010 WL 2127000, at *7 (Cal. Ct. App. May 27, 2010) (quoting the complaint in this action).

[97] Nahra v. Honeywell, Inc., 892 F. Supp. 962, 970 (N.D. Ohio 1995) (quoting Johnson v. Mobil Oil Corp., 415 F.Supp. 264, 268 (E.D.Mich.1976)).

[98] Bennett v. Bailey, 597 S.W.2d 532, 535 (Tex.Civ.App. 1980) ("holding a dance studio liable for an unconscionable act in its inducement of a vulnerable widow to pay $30,000 for dance lessons"); Abbott Labs., Inc. (Ross Labs. Div.) v. Segura, 907 S.W.2d 503, 509-10 (Tex. 1995); Nahra v. Honeywell, Inc., 892 F. Supp. 962, 970 (N.D. Ohio 1995) ("The doctrine of unconscionability, like the public policy exception to limitation clauses, protects vulnerable parties from undue coercion."); In re Elkins–Dell Manufacturing Co., 253 F.Supp. 864, 871 (E.D.Pa.1966) (citing 3 CORBIN, CONTRACTS § 559, at pp. 270–71 (1960)) (one species of unconscionability requires "a finding that the position of one was so vulnerable as to make him the victim of a grossly unequal bargain"); Peoples Mortgage Co. v. Fed. Nat. Mortgage Ass'n, 856 F. Supp. 910, 927 (E.D. Pa. 1994); Bank of Commerce v. Goolsby, 129 Ark. 416, 196 S.W. 803, 811 (1917) (the "arrangement...to exploit the necessities of the poor by unconscionable contracts...therefore were usurious and void"); Voicestream Wireless Corp. v. U.S. Communications, Inc., 912 So.2d 34 (Fla. 4th DCA 2005) (arbitration agreement not procedurally unconscionable where part of commercial transaction between experienced business persons and no evidence party was "vulnerable"); Reuter v. Davis, No. 502001CA001164XXXXMB, 2006 WL 3743016,

B. Equality and Unconscionability

The notion of equality is itself an amorphous and contextual conception, the definition of which is tailored to the specific needs of a given time. The ironic phallogocentrism evident in the Declaration's assertion that "all men are created equal" is reminiscent of a time when the second sex remained subordinated to the whims of the masculine.[99] Beyond the Declaration, equality has played an essential role in the development of the jurisprudence of the U.S. since as early as 1868 when the Fourteenth Amendment to the Constitution came into effect, espousing that a state shall not "deny to any person within its jurisdiction the equal protection of the laws."[100] This notion of "equality," for over a half century, meant that "separate but equal" facilities for minorities were Constitutional.[101] Yet, the meaning of equality changed over time towards a more absolutist, yet less convenient meaning for the generations imbued with bigotry.[102] Within the context of unconscionability, far from an absolute equality is required, but rather, when the inequality reaches beyond normal transactional differences, the moral norm of equality is utilized to undermine improperly advantageous business arrangements. It is exactly because gross inequalities continue to exist within contemporary business and societal organizations that the doctrine of unconscionability necessitates the avoidance of certain contractual provisions.

Although the inequality in bargaining power does not *ipso facto* equate to unconscionability, it is one principle of morality that regularly influences such determinations. It is the forced adherence to an inequitable contractual diktat that makes inequality of the oppressive kind repugnant. As the official comment to UCC §2-302 provides, unconscionability is based in a principle "of the prevention of oppression and unfair surprise...and not of disturbance of allocation of risks because of superior bargaining power."[103] Contracting becomes an instrument of oppression when inequality crosses beyond the differentiating characteristics of

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at *3 (Fla. Cir. Ct. Dec. 12, 2006); Higgins v. Superior Court, 140 Cal.App.4th 1238, 1252-1253, 45 Cal.Rptr.3d 293 (2006) ("finding procedural unconscionability where the arbitration clause was buried in a document of 24 single-spaced pages plus attachments; there was nothing to draw attention to the clause; and plaintiffs were young, unsophisticated, and emotionally vulnerable"); Phelps v. U.S. Metals Grp., No. 1:09-CV-1039, 2010 WL 816609, at *16 (N.D. Ohio Mar. 4, 2010); McGuire v. CoolBrands Smoothies Franchise, LLC, No. H030202, 2007 WL 2381545, at *14 (Cal. Ct. App. Aug. 22, 2007) ("We conclude that in the context of adhesive contract involving franchisees, a vulnerable group widely recognized as needing protection an inherently one-sided provision barring class or consolidated proceedings, whether in arbitration or in the courts, is unconscionable under California law in the absence of evidence establishing otherwise. This state-law principle is not predicated on the fact that a contract to arbitrate is at issue."); Gatton v. T-Mobile USA, Inc., 152 Cal. App. 4th 571, 585, 61 Cal. Rptr. 3d 344, 355-56 (2007); Sosa v. Paulos, 924 P.2d 357, 360 (Utah 1996) (finding Sosa in a nervous, anxious, and vulnerable position, and thus finding unconscionability); Feacher v. Hanley, 2014 U.S. Dist. LEXIS 4526, 15 (2014) (mentioning vulnerability as evidence of substantive unconscionability); Assocs. Home Equity Servs. v. Troup, 343 N.J. Super. 254, 278, 778 A.2d 529 (App. Div. 2001) (quoting Kugler, 58 N.J. at 544) ("[T]he need for application of that standard 'is most acute when the professional seller is seeking the trade of those most subject to exploitation—the uneducated, the inexperienced and the people of low incomes'"); Waugh v. Nevada State Bd. of Cosmetology, 36 F. Supp. 3d 991, 1019 (D. Nev. 2014) (considering the vulnerability of students); Joule, Inc. v. Simmons, No. SUCV200904929A, 2011 WL 7090714, at *5 (Mass. Super. Dec. 5, 2011) (citing Waters v. Min., 412 Mass. at 68–69, 587 N.E.2d 231 ("trial court's finding of unconscionability upheld where naive and vulnerable plaintiff was inveigled by agent of defendant to enter contract to sell her rights under annuity for one-fourth of its present value"));
Garrett v. Fite, 2009 Ark. App. 869, 3 (2009) (finding of unconscionability because of inadequate consideration coupled with vulnerability spurring from depression, sickness, and family conflict).

[99] DECLARATION OF INDEPENDENCE, ¶.2 (U.S. 1776).

[100] U.S. CONST. amend. XIV, §2.

[101] Plessy v. Ferguson, 163 U.S. 537 (1896).

[102] *See, e.g.*, Brown v. Board of Education of Topeka, 347 U.S. 483 (1954); and Loving v. Virginia, 388 U.S. 1 (1967).

[103] UCC §2-302, official comment 1.

individuals and companies transacting in the marketplace and into the subjugating and repressive arena of contractual abuse. Indeed, unconscionability "rarely exists in a commercial setting involving parties of equal bargaining power,"[104] because utilizing the freedoms of contract granted for pernicious purposes is antithetical to the norms of the marketplace. When fairly positioned savvy businesspeople are engaging in commercial transactions, rarely will courts use unconscionability to avoid otherwise valid contracts even if the contract is arguably unfair.[105] That is, because businesspeople have a greater understanding of the risks they assume when engaging in such contracts, thus placing them on a more equal footing when negotiating and executing contractual provisions.

Many courts consider the principle of equality in contract analyses. The language comes in a variety of guises, including consideration of "the parties' relative bargaining position,"[106] the parties' inequality of bargaining power,[107] and the "imbalance of power"[108] relevant to the circumstances. Some courts describe unconscionability as "the absence of meaningful choice on the part of one party due to one-sided contract provisions, together with terms that are so oppressive that no reasonable person would make them and no fair and honest person would accept them."[109] Despite the various linguistic formulations, the principle of equality remains the underpinning commonality in each standard. Across jurisdictions, ethics and particularly the principles of equality and protecting the vulnerable are frequently considered in unconscionability analyses.[110] Both of these principles are commonly accepted principles of justice and morality.[111] The next section explains how business ethics theory may further inform a more rigid understanding of unconscionability.

IV. USING BUSINESS ETHICS THEORY TO INFORM THE DOCTRINE OF UNCONSCIONABILITY

The field of business ethics has exploded since the 1970s with several camps of commentators supporting varied views of ethics in business. The major factions include those

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[104] Dry Dock, L.L.C. v. Godfrey Conveyor Co., 717 F. Supp. 2d 825, 834 (W.D. Wis. 2010).
[105] *Id.*
[106] Rudbart v. North Jersey District Water Supply Comm'n, 127 N.J. 344, 356, 605 A.2d 681, *cert. denied*, 506 U.S. 871, 113 S. Ct. 203, 121 L. Ed. 2d 145 (1992).
[107] Valhal Corp. v. Sullivan Assoc., Inc., 44 F.3d 195, 204 (3rd Cir.1995); Marbro, Inc. v. Borough of Tinton Falls, 297 N.J. Super. 411, 416-18, 688 A.2d 159 (Law Div.1996).
[108] Hahn v. Massage Envy Franchising, LLC, No. 12CV153 DMS BGS, 2014 WL 5100220, at *7 (S.D. Cal. Sept. 25, 2014)
[109] Simpson v. MSA of Myrtle Beach, Inc., 644 S.E.2d 663, 668 (S.C. 2007); *see* also Gainesville Health Care Ctr,, Inc. v. Weston, 857 So. 2d 278, 284 (Fla. Dist. Ct. App. 2003) ("Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party") (quotations omitted); Wisconsin Auto Title Loans, Inc. v. Jones, 714 N.W.2d 155, 165 (Wis. 2006) ("Unconscionability has often been described as the absence of meaningful choice on the part of one of the parties, together with contract terms that are unreasonably favorable to the other party"); and F.N. Roberts Pest Control Co. v. McDonald, 208 S.E.2d 13 (Ga. App. 1974) ("An unconscionable contract is one abhorrent to good morals and conscience. It is one where one of the parties takes a fraudulent advantage of another") (quotations omitted).
[110] *See* also Romero v. Allstate Insurance Co., 2016 U.S. Dist. LEXIS 9968, 24-26 (2016); Novak v. Tucows, Inc., No. 06CV1909(JFB)(ARL), 2007 WL 922306, at *12 (E.D.N.Y. Mar. 26, 2007) *aff'd*, 330 F. App'x 204 (2d Cir. 2009); Meshinsky v. Nichols Yacht Sales, Inc., 110 N.J. 464, 541 A.2d 1063 (1988); S.M. Wilson & Co. v. Smith Int'l, Inc., 587 F.2d 1363 (9th Cir. 1978); Royal Indemnity Co. v. Westinghouse Elec. Corp., 385 F.Supp. 520 (S.D.N.Y.1974) (applying New Jersey law); Wille v. Southwestern Bell Tel. Co., 219 Kan. 755, 549 P.2d 903 (Sup.Ct.1976); Abel Holding Co., Inc. v. American Dist. Tel. Co., 138 N.J. Super. 137 (Law Div.1975), aff'd, 147 N.J. Super. 263 (App.Div.1977); Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 403-404 (1960); and Allen v. Prudential Property and Casualty Insurance Co., 839 P.2d 798, 815 (1992).
[111] Keith William Diener & Shazia Rehman Kahn, *Thwarting the Structural and Individualized Issues of Mediation: The Formalized Reflective Approach*, 26 THE S. LAW J. 137, 139-142 (2016); TIM FORT, THE VISION OF THE FIRM: ITS GOVERNANCE, OBLIGATIONS, AND ASPIRATIONS 128-30 (2015); DAVID SCHMIDTZ, THE ELEMENTS OF JUSTICE (2005).

that support stockholder theory, stakeholder theory, the social contract, and virtue ethics.[112] Although these theorists do not always marry themselves to a single theory, some commentators do view these approaches as mutually exclusive.[113] Other commentators contend that some renditions of each theory may be compatible with others.[114] Each theory of business ethics has something of value to add to the discussion of what constitutes an unconscionable contract. In this way, the field of business ethics may aid the judiciary and practitioners by more rigidly refining the boundaries of the amorphous doctrine of unconscionability. The rest of this section discusses each theory in turn and explains how each may influence determinations of unconscionability. The next section utilizes these theories to develop a pluralistic approach to unconscionability.

C. Stockholder Theory

The stockholder theory, sometimes referred to as shareholder theory, provides a framework by which ethical restraints upon contracting may be perceived. The stockholder theory itself is limited to corporations that separate ownership from control of the company, typically through delegations of the power to make the day-to-day decisions of the firm to managers and executives.[115] For this reason, stockholder theory is most often utilized within publicly traded corporations (which contain stockholders who presumptively own the corporation and managers who perform the corporation's daily operations).[116] Stockholder theory is one of the most misunderstood and misinterpreted theories in contemporary business because the restrictions inherent in its central mandates are often overlooked by practitioners.[117] Among those central mandates is the notion of giving primacy, or first consideration, to the interests of stockholders.[118] In most situations, it is presumed that stockholder interests involve increasing the amount of wealth of the stockholders by increasing company profits.[119] Among the often overlooked inherent restrictions to stockholder primacy are the requirements that profits be maximized only when doing so accords with legal and ethical requirements.[120] Although originally intended to apply to corporate structures, theories of profit motivations have followed in the progeny of classical stockholder theory, which contend that businesses should seek profits

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[112] Each of these theories is a "normative" theory of business ethics in the philosophical sense, wherein each asserts a "should" or an "ought." Although, at times, stockholder and stakeholder theory may be considered theories of corporate governance insofar as they are often infused with prescriptions regarding how managers should govern their organizations, they are regularly also considered normative theories of business ethics. *See generally* John Hasnas, *The Normative Theories of Business Ethics: A Guide for the Perplexed*, 8 BUS. ETHICS Q. 19 (1998); and TIM FORT, THE VISION OF THE FIRM: ITS GOVERNANCE, OBLIGATIONS, AND ASPIRATIONS (2015).

[113] See e.g., John Hasnas, *The Normative Theories of Business Ethics: A Guide for the Perplexed*, 8 BUS. ETHICS Q. 19, 22 (1998).

[114] *See, e.g.*, THOMAS DONALDSON & THOMAS DUNFEE, THE TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS 235–62 (1999).

[115] *See, e.g.*, Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970.

[116] Keith William Diener, *Shareholder Primacy*, in THE ENCYCLOPEDIA OF BUSINESS ETHICS AND SOCIETY (2d ed., Robert Kolb ed., forthcoming 2018).

[117] *See, e.g.*, Keith William Diener, *The Restricted Nature of the Profit Motive: Perspectives from Law, Business, and Economics*, 30 NOTRE DAME J. OF LAW, ETHICS, & PUB. POL'Y 225 (2016).

[118] *Id.*

[119] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970.

[120] *See, e.g.*, Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970; and Friedrich A. Hayek, *The Corporation in a Democratic Society: In Whose Interest Ought It to and Will It Be Run?*, *in* STUDIES IN PHILOSOPHY, POLITICS AND ECONOMICS 300, 301 (Friedrich A. Hayek ed., 1967).

(but typically the profit motive is asserted only within the bounds of legal and ethical restrictions).[121]

Stockholder theory offers insight into the underpinning justifications for the doctrine of unconscionability. The far-reaching public policy of freedom of contract permits significant leeway for those seeking to profit via contracting. Nevertheless, there are limits to permissible contracting, just as there are limits to permissible profit-seeking. One uncontroversial limit to both permissible contracting and profit-seeking is the limitation of legality. In order for a contract to be valid, it must not violate the law. This limit prevents, among other things, purported contracts that violate usury laws, licensing laws, or gambling laws from meeting the requirements of a valid and enforceable contract.[122] In a similar vein, the theoretical limitations to profit seeking, as described in stockholder theory and its progeny, incorporate prohibitions against violating laws in the pursuit of profits. Albeit the remedy for such prohibitions is quite different than the remedy for illegal purported contracts, which are generally deemed void *ab initio* in a court of law, and restitution offered the parties, when appropriate. In the case of profit-seeking that violates the law, the sanctions may indeed be extreme, particularly when harm is caused to consumers pursuant to the illegal transaction.

Insofar as the ethical restrictions upon profit seeking are concerned, stockholder theory remains ominously vague as to what constitutes ethical violations aside from the baseline of prohibiting fraudulent transactions.[123] Like the ethical restrictions upon profit-seeking, unconscionability is contract law's means of placing ethical restrictions upon freedom of contract by limiting the situations by which profits may be pursued pursuant to contractual agreements. The public policy in favor of freedom of contract is immense, but so is the need to protect vulnerable and weak parties from being taken advantage of by means of contracts. In this way, the doctrine of unconscionability provides the process by which stockholder theory's mandate of restricting profit-seeking by ethical precepts is implemented by the judiciary.

The extent of the comparison between the doctrine of unconscionability and stockholder theory is limited, however, due to the limited applicability of stockholder theory to mandate the dictates of the stockholder-manager relationship. Theories of profit motivations that were inspired by stockholder theory (and are applicable beyond the stockholder-manager relationship), do allow the comparison to extend further.[124] Stockholder theory and its progeny do provide a framework that limits the permissible scope of profit-seeking, including profit-seeking via contracting. Next, this essay suggests that stakeholder theory may fill the explanatory gap of stockholder theory.

D. Stakeholder Theory

The central mandate of stakeholder theory is that obligations are owed to all stakeholders, including stockholders. For each decision, the decision maker should attempt to identify stakeholders and determine which stakeholder should be given primacy in a given circumstance. According to stakeholder theory, the stockholders should not in all circumstances be given

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[121] *See, e.g.*, Keith William Diener, *The Restricted Nature of the Profit Motive: Perspectives from Law, Business, and Economics*, 30 NOTRE DAME J. OF LAW, ETHICS, & PUB. POL'Y 225 (2016).

[122] *See, e.g.*, TIM FORT & STEPHEN B. PRESSER, BUSINESS LAW 342 (2015); and Jimerson v. Tetlin Native Corp., 144 P.3d 470 (Alaska 2006).

[123] *See, e.g.*, Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970; and Friedrich A. Hayek, *The Corporation in a Democratic Society: In Whose Interest Ought It to and Will It Be Run?*, *in* STUDIES IN PHILOSOPHY, POLITICS AND ECONOMICS 300, 301 (Friedrich A. Hayek ed., 1967).

[124] *See, e.g.*, Keith William Diener, *The Restricted Nature of the Profit Motive: Perspectives from Law, Business, and Economics*, 30 NOTRE DAME J. OF LAW, ETHICS, & PUB. POL'Y 225 (2016).

primacy, but rather, which stakeholder should be given primacy varies and should be determined on an *ad hoc* basis.[125] There is no universally accepted definition of a stakeholder, but one commonly cited definition is that a stakeholder is anyone who is affected by or can affect the business decision at issue, including its consequences.[126] Any viable definition of a stakeholder includes those people and companies one does business with, including those with whom one contracts. Consequently, stakeholder theory informs the doctrine of unconscionability insofar as its primary precept entails that moral obligations are owed to those with whom one contracts.

Although stakeholder theory unquestionably imposes moral obligations on contracting parties, the scope and extent of those obligations are controversial. Some leading stakeholder theorists contend that being in business places enhanced moral obligations upon those doing business, over and above the baseline ethical obligations owed generally to all persons.[127] In other words, one owes one's stakeholders increased moral obligations that are more stringent than the obligations owed to non-stakeholders. In essence, there are two types of obligation owed within this version of stakeholder theory: first, the general moral obligation owed to all mankind, and, second, the specific moral obligation owed within a business relationship.[128] The general moral obligations include abiding by principles, such as those embodied by moral rights and duties, justice, and utilitarianism.[129] The general moral obligations also include those obligations embodied by hypernorms.[130] These general moral obligations remain constant across time and locations, but the specific moral obligations owed uniquely within business relationships are circumstantially variable.

The doctrine of unconscionable contracts may be informed by the two types of obligation suggested by stakeholder theorists. A contract may purportedly be deemed unconscionable when it violates either type of moral obligation: those general obligations applicable to all of humanity, or those specific obligations applicable to people in business relationships. The contours of these obligations has not reached consensus among stakeholder theorists, but there is no need to identify all obligations by type in order for this dichotomy to pose instrumental value to applications of the doctrine of unconscionability. The dichotomy, if accepted, allows one to hold business practitioners morally culpable for certain actions, even is a person outside of business would not be held to the same standard. Assuming there is some business component to all contracting, and there likely is, even in the case of marital contracts, all contracting parties may similarly be held morally culpable for their actions in contracting even if similarly-situated people would not be held morally culpable for similar actions outside of contractual settings. The implications of accepting this dichotomy are vast and open the potential for judicial findings of unconscionability in unique business situations which give rise to breaches of moral obligation that may not manifest also as general obligations in non-business settings.

A close analogy to the enhanced "stakeholder obligations" is the notion of "fiduciary obligations," which similarly place enhanced, although different obligations upon fiduciaries. Nonetheless, there are at least two caveats to this comparison. First, the stakeholder obligation is not identical to the fiduciary obligation, but the two obligations merely function in a similar manner. Second, the stakeholder obligation is a moral obligation whereas the fiduciary obligation

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[125] R. Edward Freeman, *A Stakeholder Theory of the Modern Corporation*, in ETHICAL THEORY AND BUSINESS, 7TH ED. (Tom L. Beuchamp & Norman E. Bowie eds., 2004).
[126] *Id.* at 58.
[127] ROBERT PHILLIPS, STAKEHOLDER THEORY AND ORGANIZATIONAL ETHICS 162-163 (2003).
[128] *Id.*
[129] WILLIAM FREDERICK, VALUES, NATURE, AND CULTURE IN THE AMERICAN CORPORATION 251 (1995) (analyzing rights, justice, and utilitarianism as the basis for ethical business behavior).
[130] *See* infra, Part IV(C) Social Contracts Theory.

is first and foremost a legal obligation. A fiduciary has enhanced legal obligations to her principal beyond those legal obligations generally owed by persons (who are not in fiduciary relationships). These legal obligations include, *inter alia*, avoiding conflicts of interest, not usurping principal opportunities, not accepting undisclosed gifts, not self-dealing, not attaining secret profits, and not disclosing confidential information.[131] Although these are certainly good practices in many non-fiduciary settings, and various other laws may at times make these same practices illegal under other circumstances, generally, a person is free to accept undisclosed gifts, self-deal, attain secret profits, disclose confidential information, or usurp the business opportunities of others. Such actions are often necessary to excel within a capitalistic environment. Simultaneously, both fiduciaries and persons generally must follow all generally applicable laws, such as avoiding fraud, abiding by regulations, and so on. The fiduciary has enhanced obligations over and above the baseline obligations that are generally applicable to all people. Relevant stakeholder theorists similarly claim that businesspeople have enhanced moral obligations to stakeholders over and above the baseline moral obligations owed to people generally.[132] Although any analogy can only be taken so far, there are heuristically motivated parallels between the fiduciary and stakeholder obligations. These additional obligations of stakeholder theory may be better identified by use of social contracts theory and virtue ethics.

E. Social Contracts Theory

The political social contract is forever sealed in the historical works of such authors as Jean-Jacques Rousseau, John Locke, and Thomas Hobbes.[133] The business social contract, on the other hand, is a relatively new phenomenon which aims to provide guidance to individuals seeking to behave ethically in business. The traditional political social contract analyzes the principles and norms upon which society and its political construct should be formed. The business social contract is concerned with the principles and norms upon which businesses and business communities should be formed, as well as business's relationship to society. The business social contract attempts to define intra-business obligations, inter-business obligations, and obligations between business and other community members (such as non-business entities and individuals). The business social contract is a source of guidance for those seeking to behave ethically in business.

The preeminent vision of the business social contract is magnificently articulated by theorists, Thomas Donaldson and Thomas Dunfee, in what they term as "Integrative Social Contracts Theory" (hereinafter, ISCT).[134] ISCT is the leading attempt to provide a means of classifying, identifying, and prioritizing ethical norms within the business social contract. Although a full explication of ISCT is beyond the scope of this essay, some useful classifications from this theory arise in ISCT's distinction between hypernorms and microsocial norms. Hypernorms are generally applicable obligations of all human beings.[135] Some theorists suggest that the obligations of stakeholder theory that apply to all humans are embodied in something akin to hypernorms.[136] According to Donaldson and Dunfee, hypernorms include core human

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[131] *See, e.g.*, TIM FORT & STEPHEN B. PRESSER, BUSINESS LAW 604 (2015); Tarnowski v. Resop, 236 Minn. 33, 51 N.W.2d 901 (1952).

[132] ROBERT PHILLIPS, STAKEHOLDER THEORY AND ORGANIZATIONAL ETHICS 162-163 (2003).

[133] *See, e.g.*, JEAN-JACQUES ROUSSEAU, THE SOCIAL CONTRACT (1762); JOHN LOCKE, THE SECOND TREATISE ON GOVERNMENT (1689); THOMAS HOBBES, LEVIATHAN (1651).

[134] THOMAS DONALDSON & THOMAS DUNFEE, THE TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS (1999).

[135] *Id.* at 49-138.

[136] ROBERT PHILLIPS, STAKEHOLDER THEORY AND ORGANIZATIONAL ETHICS 124-125 (2003).

rights, human dignity, and necessary social efficiency.[137] Hypernorms play a unique function within ISCT by acting both as a baseline for moral obligations owed by everyone and to everyone, but also as a means of validating microsocial contracts.[138] Microsocial contracts give rise to microsocial norms, and so long as they accord with hypernorms, these microsocial norms are considered legitimate norms.[139] Microsocial contracts are extant, actual agreements within a community that reflect the shared understandings about the microsocial moral norms in a community.[140] These microsocial norms are abided by, via actions and attitudes, by a substantial majority of the relevant community.[141] It is this concept of microsocial norms and particularly legitimate microsocial norms that has significant potential for aiding the application of the doctrine of unconscionable contracts.

Many vocations and particularly the professions have conventional practices that are understood and abided by within each particular vocation. Microsocial norms reflect those moral practices that are understood and abided by within a particular vocation or community. ISCT explicitly allows for differing moral practices to exist within different communities (and communities is defined quite broadly by ISCT, by including different businesses, vocations, industries, or even societies). The microsocial norm is that moral practice that a substantial majority of a community adopts and adheres to. Microsocial norms are somewhat similar to the "usage of trade" descriptor of the Uniform Commercial Code,[142] but the concept of the "microsocial norm" includes only the moral customs of a trade that are adopted by a clear majority of a community, and not non-moral customs or moral customs not adopted by a clear majority of a community. Further, the concept of a "microsocial norm" is applicable beyond a mere trade, but also within any industry, business, department of a business, vocation, profession, or any other community.

Looking to norms within a given trade is not foreign to unconscionability analyses. In fact, the official comment to U.C.C. §2-302 instructs courts to look to the "general commercial background" of "the particular trade" when determining if a given contract or provision thereof is unconscionable.[143] What ISCT adds to this analysis is the explicit identification of not only moral norms that are generally applicable to all mankind (hypernorms) but also moral norms that are particular to the trade, or other relevant community (microsocial norms). Hence, the moral norms that are particular to a trade, business, or industry may inform determinations of unconscionability. If microsocial moral norms are violated when contracting, a violation may, although not dispositive in and of itself, provide evidence in favor of a finding of unconscionability. Microsocial norms may be found in a variety of places. For a trade or industry, they may be found in professional codes of conduct, or professional or industry standards.[144] For a business or company, they may be found in corporate creeds, mission statements, or even ethics or compliance

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[137] THOMAS DONALDSON & THOMAS DUNFEE, THE TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS 49-138 (1999).
[138] *Id.*
[139] *Id.* at 83-116.
[140] *Id.*
[141] *Id.*
[142] UCC §1-303(c) ("A 'usage of trade' is any practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question. The existence and scope of such a usage must be proved as facts. If it is established that such a usage is embodied in a trade code or similar record, the interpretation of the record is a question of law.")
[143] UCC §2-302 (cmt. 1).
[144] THOMAS DONALDSON & THOMAS DUNFEE, THE TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS 105 (1999).

programs.[145] Any of these proxies are places where microsocial norms could arise from, but microsocial norms need not be found in one of these places in order to be practiced in a business, trade, industry, or other community.

Different industries reflect different norms which develop over time to meet certain needs of that industry. In the industry of publishing academic articles, for example, within some professional fields the norm is that authors submit for publication consideration to only one journal at a time. In other fields, it is acceptable to submit to multiple journals simultaneously for publication consideration. Depending on the field, the norm may be to send only one journal an article to consider it for publication, or to send an article to many journals. Within those fields wherein it is acceptable to submit to multiple journals, there is a generally accepted moral norm that once an author accepts an offer of publication with a journal, that the author not then rescind the acceptance subsequently even if a higher quality journal makes the author an offer. There are the occasional violators of this norm, but the substantial majority of the academic publishing community abides by it. In certain industries and locations, a simple hand-shake signifies the commitment of the parties to an agreement, yet in other industries and locations, a hand-shake means little without a binding contract accompanying it. When deciphering whether a contract is unconscionable, the judiciary should consider industry and community specific moral norms (microsocial norms), which may influence whether a contract should be deemed unconscionable or not. Hypernorms and microsocial norms often work in conjunction with relevant virtues – altogether, they may be used to determine whether a contract is violative of morality.

F. Virtue Ethics

Ethicists have used virtue ethics theory to address certain financial problems since the time of its original enunciation in ancient Greece, despite that Aristotle himself proclaimed disdain for exploitative trade practices.[146] Virtue ethics theory has since played an influential role in the development of Catholic Theology, and is utilized still today to address questions of ethics in business.[147] In Aristotle's original declaration of virtues, he identified liberality as a virtue pertaining to spending; a virtue that exists at the mean between the two vices of niggardliness and prodigality.[148] In contemporary business ethics literature, many ethicists apply virtue ethics to attempt to provide ethical guidance to businesspersons. The core mandate of virtue ethics is that persons should seek to act virtuously, which often requires balancing the unique circumstances at hand to decipher what the proper moral action is in each circumstance. To act virtuously is to aim to act in accordance with the virtues which include not only liberality, but also courage, honor, integrity, trustworthiness, humility, responsibility, community, and mercy.[149] As one leading virtue ethicists declares, "the integrity of the corporation and of the individual within the corporation is the essential ingredient in the overall viability and vitality of the

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[145] *Id.*

[146] Antony Flew, *The Profit Motive*, 86 ETHICS 312, 312-322 (1976).

[147] F. A. HAYEK, THE FATAL CONCEIT: THE ERRORS OF SOCIALISM 47 (1988), available at: http://cnqzu.com/library/Philosophy/neoreaction/Friedrich%20August%20Hayek/Friedrich_Hayek%20-%20The_fatal_conceit.pdf

[148] ARISTOTLE, NICOMACHEAN ETHICS, BOOK IV, available at: http://classics.mit.edu/Aristotle/nicomachaen.4.iv.html (last visited Aug. 5, 2017).

[149] This is a non-exclusive list of virtues composed from the author's education and experience. Virtues, more broadly construed, include: integrity, trust, honesty, proper pride, humility, courage, tenacity, frugality, community, mercy, responsibility, and respectability.

business world."[150] One should embrace integrity and the other virtues by attempting to act in accordance with them in every action and reaction, in life and business.

Virtue ethics theory provides businesspeople with the flexible guidance of the virtues, making virtue ethics an often pragmatic approach to the ever-changing and often plastic environment of business. The virtues may be particularly illuminating when analyzing procedural unconscionability because the actions that give rise to an unfair process of contracting do frequently involve a failure to act with integrity, trust, honor, or in accordance with any number of other virtues. The oppressive tactics that some parties embrace when inducing others to enter into contractual relations are often lacking in virtuous behavior, but instead violate the very virtues which, if embraced, would promote a more functional and feasible business environment.

In summary, the four leading theories of business ethics have potential to add to the richness and refine the boundaries of the amorphous doctrine of unconscionable contracts. Business ethics theory may help legal practitioners attempting to educate their clientele about the boundaries of unconscionability. Business ethics theory may also assist the judiciary in properly applying the doctrine, and particularly in deciphering circumstances involving ethical violations in the process of contracting. As an inherently moral doctrine, unconscionability should take into account the general ethical obligations of humankind, those specific obligations within the business community at issue, and virtue, by analyzing unconscionability, when appropriate, through appeals to stockholder theory, stakeholder theory, social contracts theory, and virtue ethics theory. These theories provide a framework for examining obligations, and more fully realizing the observation of the New Jersey Supreme Court that the doctrine of unconscionable contracts is aimed at establishing "a broad business ethic."[151] This essay next utilizes these theories of business ethics to develop a pluralistic framework for examining purportedly unconscionable contracts.

V. A PLURALISTIC APPROACH TO UNCONSCIONABILITY

The preceding theories of business ethics provide the basis for a pluralistic framework for examining purportedly unconscionable contracts. In this section is an elaborate sketch of this pluralistic framework which may be used to determine if a contract or provision should be deemed unconscionable. The framework consists of three levels, each of which incorporates three stages, and a final legitimizing test that follows the three level/stage analysis. These levels, stages, and the test are summarized in diagram 5.1. For the purposes of developing this framework, it is assumed that pluralism is a viable philosophical position that, at a minimum, provides a pragmatic or instrumental approach to analyzing questions of morality. The three levels of moral obligation are: the individual level, the local level, and the global level. This is not to say that there are not additional levels of moral obligation (there very well may be), but these three levels are utilized in this model because they are the levels most examined in the writings of contemporary business ethics theorists. The three stages are: the process of contracting, the terms of the contract, and the morality of the enforcer. These three stages, respectively, incorporate procedural unconscionability, substantive unconscionability, and the ethics of enforcement. The final test considers the legitimacy of deeming a purported immoral contract as unconscionable. This model is detailed in the following paragraphs.[152]

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[150] ROBERT C. SOLOMON, ETHICS AND EXCELLENCE 21 (1993).

[151] Kugler v. Romain, 58 N.J. 522, 543, 279 A.2d 640, 651 (1971).

[152] Although purportedly the levels and stages could be analyzed in any order, for ease of flow, this model presents the levels in a smaller to larger spectrum, and the stages in a chronological spectrum.

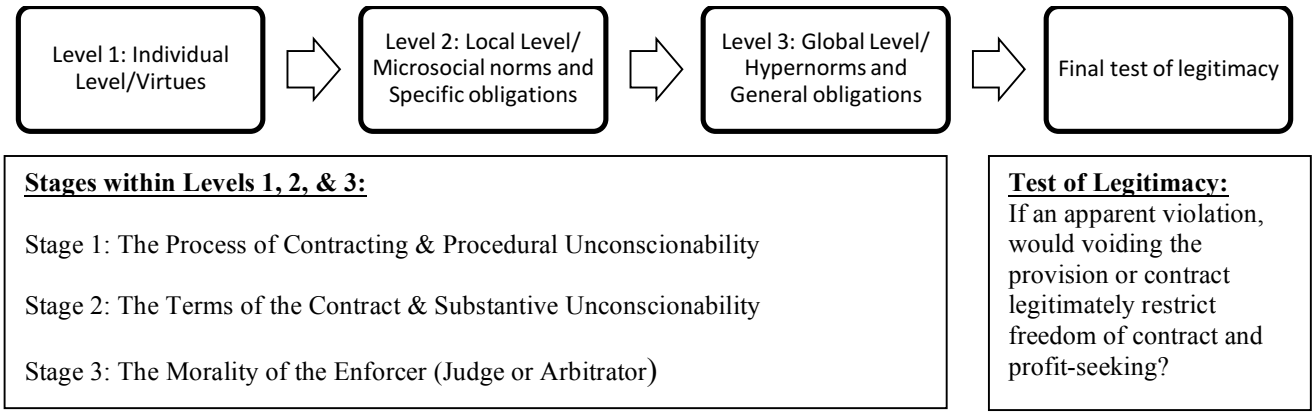

Diagram 5.1: A Pluralistic Model of Unconscionability

A. Three Stages of the Pluralistic Analysis

The stages of pluralistic analysis are aimed at working through the relevant evidence associated with an unconscionable contract, both the procedural and substantive aspects of unconscionability, and providing an analysis of the morality of the individual or individuals tasked with deciphering unconscionability ("the enforcer"). In most cases, the enforcer is a judge or arbitrator. Each stage is briefly explained in the following paragraphs; the application of the stages within each level is further explicated in the next section.

1. Stage 1: The Process of Contracting & Procedural Unconscionability

The first stage of the analysis is devoted to identifying potential moral breaches within the process of contracting, thus deciphering if a contract may be deemed procedurally unconscionable. In stage one, the process of contracting is examined to decipher if any moral obligations are breached in the process of contract formation. The process of contract formation is analyzed within each of the three levels of morality. All relevant facts concerning how the contract came into being, including facts relating to the equality of bargaining power, unfair surprise, or other aspects of the contracting process should be examined for moral breaches.[153]

2. Stage 2: The Terms of the Contract & Substantive Unconscionability

The second stage of the analysis involves examining potential moral breaches that are reflected within the terms of the contract itself, thus deciphering if a contract may be deemed substantively unconscionable. In stage two, the terms of the contract are examined to decipher if any breaches of moral obligation are reflected in the contract itself (or its specific provisions). The terms of the contract are analyzed within each of the three levels of morality. All terms of the

[153] *See* Willie v. Southwest Bell Company 549 P.2d 903, 907 (Kan. 1976) (providing a list of factors to consider in the context of procedural unconscionability, which also relate to the relevant facts one should consider in stage 1. These include: if the contract is standard form, if the relevant clause is boilerplate, if the clause is not conspicuous, if the language is comprehensible to a lay person, if there was inequality of bargaining power, or if there were exploitation of a vulnerable party). *See also* Johnson v. Mobil Oil Corp. 415 F.Supp. 264, 268 (E.D. Mich. 1976) (for a list of factors of procedural unconscionability including: meeting of the minds, vulnerability of the parties, bargaining power, who drafted the contract, if the terms were discussed or explained to the weaker party, if alterations were possible, or alternatives for supply).

contract, but particularly overly harsh, grossly unfair, or other unusual or inequitable contract terms should be examined for moral breaches.[154]

3. Stage 3: The Morality of the Enforcer (Judge or Arbitrator)

The third stage of the analysis involves an examination by the enforcers, of the enforcers and enforcement of the contract, to decipher if there are any moral obligations that may influence the decision of enforceability or a finding of unconscionability. The enforcers examine themselves from all three levels of morality. The enforcers' moral preconceptions, the context of the enforcement, and the totality of all facts relevant to enforcement should be examined for moral breaches.[155] As explained in the following section, each stage is analyzed within all three levels of moral obligation.

B. Three Levels of Moral Obligation

The three levels of moral obligation correspond to the different types of obligations examined by the leading theories of business ethics. The first level, the individual level, analyzes the virtues. The second level, the local level, analyzes microsocial contracts and specific stakeholder obligations. The third level, the global level, analyzes hypernorms and general stakeholder obligations. Each level is detailed in the following paragraphs.

1. Level 1: The Individual Level

Within the individual level, the enforcer should examine virtues in the process of contracting, virtues in the contract terms, and virtues associated with the enforcement of the contract. All three of these stages should be examined for violations and fulfillment of relevant virtues, if any are reflected in the individual circumstances of the case-at-hand. The enforcer may wish to examine integrity, trust, honesty, proper pride, humility, courage, tenacity, frugality, community, mercy, responsibility, and respectability, to the extent that they are relevant to the case.[156] Although virtues may not be apparent in every circumstance, when they are, the circumstances should be analyzed for potential violations of virtues. The fulfillment of virtues could, in some cases, also be relevant.

2. Level 2: The Local Level

Within the local level, the enforcer should examine microsocial norms and specific stakeholder obligations, within the process of contracting, contract terms, and enforcement of the contract. All three stages should be examined for violations of microsocial norms and specific stakeholder obligations, if any are reflected in the individual circumstances of the case-at-hand. The enforcer should examine the particular moral norms of business generally, the industry, company, locality, trade, vocation, profession, region, or other locality-specific norms that are

[154] *See* Willie v. Southwest Bell Company 549 P.2d 903, 907 (Kan. 1976) (providing some substantive factors, that may be relevant to examination of this stage, including: the disparity between cost and price, a clause that undermines basic remedies and rights, penalty clauses, or overall bargaining imbalances).

[155] This stage is significant because it involves a reflective process by the enforcer, of the current circumstances of the enforcer and enforcement. Relevant considerations may include the enforcer's religious preconceptions, the current economic climate at the time the case is heard, and other factors unique to the circumstances of enforcement of the contract at the time that avoidance via unconscionability is sought.

[156] *See* ARISTOTLE, supra note 4. *See* also ROBERT C. SOLOMON, ETHICS AND EXCELLENCE: COOPERATION AND INTEGRITY IN BUSINESS (1992) (for the application of virtue ethics to business).

relevant to the case, to decipher if they were followed or violated.[157] Attorneys' rules of professional conduct, judges' professional rules, professional codes, ethics codes, and other local level norms should be analyzed for potential violations. The fulfillment of microsocial norms and specific stakeholder obligations may also be relevant in some cases.

3. Level 3: The Global Level

Within the global level, the enforcer should examine hypernorms and general stakeholder obligations, within the process of contracting, contract terms, and enforcement of the contract. All three stages should be examined for violations of hypernorms and general stakeholder obligations, if any are reflected in the individual circumstances of the case-at-hand. The enforcer should examine generally applicable ethical norms such as rights, justice (including protecting the vulnerable and equality), utilitarian principles, necessary social efficiency, and human dignity, to the extent they are relevant, to decipher if these norms were adhered to or not.[158]

C. The Final Test of Legitimacy

The final step of the analysis is a stockholder theory-inspired screening test aimed at deciphering if an apparent moral breach should result in a finding of unconscionability and thus the avoidance of a contract or provision. This final test is to inquire into whether the moral breach is sufficiently severe so as to legitimately form a basis for restricting the far-reaching public policies of freedom of contract and reasonable profit-seeking. There is reasonable discretion built into this final test of legitimacy, which acts as a sliding scale, to decipher the degree and severity of the moral breach, and if it merits avoidance of the contract or provision at issue. The necessary implication of this legitimacy test is that not all moral breaches are sufficient to constitute avoidance of a contract on the basis of unconscionability. In applying this final test, the enforcer should examine judicial precedent, all of the stages and levels, the severity of the identified moral breaches, and the underpinning facts in combination, weighing them as necessary, to determine if the contract should be avoided.[159]

D. Application of the Pluralistic Framework

To illustrate how the pluralistic framework functions, this section provides two example cases, and applies the framework to these cases. The framework is a fact-specific framework, and not all virtues, norms, or principles will be relevant to each case. To the contrary, in most cases, only a few moral virtues, norms, or principles will be relevant. Through examining all stages and levels, the enforcer can ensure a detailed examination of unconscionability, and articulate, in the language of ethics, whether or not there are moral breaches.

EXAMPLE CASE 1: Phyllis and her husband owned a waterfront property in Brielle, New Jersey which they utilized as their principal residence. Her husband suddenly died on January 3, 2000. Immediately after his death, Phyllis (then, 81 years old), while stricken with grief, took several steps in a very short time period to attempt to sell the Brielle property. Among them, in a

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[157] *See, e.g.*, THOMAS DONALDSON & THOMAS DUNFEE, THE TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS (1999) (for a discussion of microsocial norms and their application).

[158] *See* WILLIAM C. FREDERICK, VALUES, NATURE, AND CULTURE IN THE AMERICAN CORPORATION 251-276 (1995) (for an explanation of justice, rights, and utilitarianism in the context of natural and sociocultural processes). *See* also THOMAS DONALDSON & THOMAS DUNFEE, THE TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS (1999) (for an explanation of hypernorms).

[159] *See* Keith William Diener, *The Restricted Nature of the Profit Motive: Perspectives from Law, Business, and Economics*, 30 NOTRE DAME J. OF LAW, ETHICS, & PUB. POL'Y 225 (2016) (for an analysis of the theoretical restrictions upon permissible profit-seeking).

three-week period, she executed three powers-of-attorney. One attorney-in-fact entered into an option agreement on behalf of Phyllis with Sitogum (an entity which would not be incorporated for another six days). The January 2000 option agreement gave Sitogum the right to purchase, within eight months, the Brielle property, for the amount of $800,000, so long as Sitogum paid $1000 per month to keep the option open. In February 2000, an appraisal of the property valued it at between $1.5 million and $1.75 million. Sitogum, on February 28, prepaid six months of options ($6000) to attempt to reserve its right to buy for the next six months. Nevertheless, on April 13, 2000, Phyllis contracted to sell the property to another party for $1.5 million. Upon learning of this sale, Sitogum attempted to exercise its option to buy on April 28, 2000. Phyllis informed Sitogum she would not sell to them. Consequently, Sitogum brought a lawsuit seeking to compel specific performance from Phyllis, and Phyllis claimed the option agreement was unconscionable.[160]

1. Application of the Pluralistic Framework to Example Case 1

The Individual Level/Level 1: Within level 1, all three stages should be considered, but all stages will not always be relevant. In this case, stage 1 is particularly relevant to the analysis of virtue. Within the process of contracting, three virtues may have been violated. First, are the virtues of responsibility and trust which may have been violated by the attorney-in-fact who entered into the option agreement for Phyllis. From the facts, it is apparent that this attorney-in-fact entered into an agreement to sell a property (which had not been appraised) for substantially less than its fair market value. The failure by this attorney-in-fact to fulfill her responsibilities as a diligent agent also reflects a breach of trust between the attorney-in-fact and Phyllis. Second, is a breach of the virtue of mercy by Sitogum, an entity which should have had mercy upon the grieving widow, and understood the difficult time she was going through when the option agreement was executed. The lack of mercy led to a lawsuit to enforce the option agreement despite the grieving circumstances of the widow.

The Local Level/Level 2: On the local level, moral norms of the real estate industry in the locality should be considered, as well as any other moral norms of other relevant communities within any of the 3 stages (to the extent any are identifiable). For example, if Sitogum maintained a code of ethics, which was breached in this case, such a breach would be relevant to the local level. Within the facts-at-hand, there is potential that a moral norm based in fairness, of permitting a seller to attain an appraisal prior to buying a property, may be present and violated. The presence of such a moral norm depends on the real estate industry of the locality at issue. While such a norm exists in most areas, evidence would be needed to support this moral norm in the locality of Brielle, New Jersey.

The Global Level/Level 3: The global level presents many questions in the context of Phyllis's case, as to stages 1 and 2. In the process of contracting, the moral principle of justice, and particularly the need to protect the vulnerable (here an 81 year-old grieving widow), has been violated. Moreover, the stage 2 contract terms, which reflect a gross disparity between contract price and market price, reflect violations of respect for human dignity, justice, and moral rights to fair exchanges in the marketplace.

Test of Legitimacy: The final test of legitimacy requires that the enforcer consider if avoiding this contract is a legitimate restriction upon freedom of contract. In this case, there are many ethical violations both in the process of contracting and in the terms of the contract itself, and many are quite severe violations, so avoiding this contract appears a legitimate restriction

[160] The facts from "Example Case 1" are adapted from Sitogum Holdings, Inc. v. Ropes, 352 N.J.Super. 555 (2002).

upon profit-seeking and freedom of contract. If the violations were fewer and minor, the result would be different.

EXAMPLE CASE 2: In 1917, a young, black, and relatively uneducated girl who had inherited property, entered into a contract with two attorneys. Stella, a resident of the District of Columbia, on her eighteenth birthday, inherited valuable land in Oklahoma which contained deposits of oil and gas. This land was held with a guardian, also in Oklahoma, until her eighteenth birthday, when she was due to take possession and control over her inheritance. In a devious and intricate plot to separate Stella from her wealth, Stella was induced to go to the offices of two attorneys to sign a contract for their representation shortly after midnight on her eighteenth birthday. They convinced her that she needed their services to protect her newly acquired wealth, which they said was threatened despite that no litigations or legal issues were pending regarding the property or wealth. The contract was for employment of the two attorneys for a period of five years, with payment for all years required in advance, and the $25,000 prepayment to come from the oil producing lands that Stella inherited moments before signing this contract, thus putting cloud upon the title of her land.[161]

2. Application of the Pluralistic Framework to Example Case 2

The Individual Level/Level 1: The violations of virtues are particularly apparent in stage 1, but there are also virtue violations in stage 2. Within stage 1, the process of contracting, the attorneys deceived Stella and took advantage of her by convincing her she required their legal representation, thus violating the virtues of honesty, trust, and integrity. Within stage 2, the contract reflects a $25,000 prepayment for services for the next five years, which reflects a violation of the virtue of liberality in the pricing of the attorneys' contract. For illustrative purposes, a stage 3 consideration would include whether the enforcer of the agreement maintains any racial prejudices (common in the 1920s), and whether such prejudice might impugn the integrity of the enforcer's decision.

The Local Level/Level 2: The norms of level 2, the local level may involve stage 1 and 2 norms pertaining to local ethics rules and the local practices for attorney fee agreements. The stage 1 violation is reflected in the violation of the attorney ethics rules, which at the time of this case, required attorneys to act always in the utmost good faith and not attain their own advantage at the expense of their client.[162] This may also involve stage 2 violations, depending on the terms of the contract. For example, in contemporary times, rarely would an attorney require a five-year prepayment for services, and this was also likely the case in the early 1900s in Oklahoma. This may go to the attorneys' advantageous behavior. For illustrative purposes, an example of a stage 3 local consideration would be if the attorneys had engaged in this type of conduct on other occasions.

The Global Level/Level 3: The global level violations are reflected in both stages 1 and 2. The advantageous behavior of the attorneys, in their attempts to deceive the young and uneducated Stella out of her wealth, violates the requirement of justice, that the vulnerable be protected. The substantive terms of the contract, including the cloud of title which would be caused to form over Stella's property, also violates this requirement. Moreover, this behavior violates human dignity, insofar as it requires abidance to the second formulation of the Kantian categorical imperative, *viz.*, that we treat others always as an end in themselves and not solely as a means. For illustrative purposes, a stage 3 consideration, for example, would be if there were a

[161] These facts from "Example Case 2" are adapted from State v. Vernor, 191 P. 729 (Okl. 1920).

[162] *Vernor*, 191 P. at 736-737 (the attorneys in this case were suspended from the practice of law for six months).

national or global economic crisis at the time of enforcement, that might impact the policies underpinning the enforcer's decision.

Test of Legitimacy: In this case as well, there are multiple severe ethics violations in both stages 1 and 2 which result in a determination, upon weighing the evidence, that the contract can legitimately be avoided on the grounds of unconscionability without undermining the far reaching public policies of freedom of contract and reasonable profit-seeking.

Example cases 1 and 2 are illustrations of how the pluralistic framework functions. As with any illustrations, they are limited in their usefulness, as the factual circumstances of each case will inevitably vary. The variation in facts correlates to the identification of different moral virtues, norms, and principles, for each individual case. Nevertheless, with conscientious application, the pluralistic framework provides a detailed methodology for identifying moral breaches in contractual settings which extends beyond the bounds of contemporary substantive/procedural unconscionability analyses.

VI. CONCLUSION

The doctrine of unconscionability developed in equity to provide a judicial procedure for avoiding grossly immoral contractual bargains. Over time, the necessity of the doctrine has become ever more apparent as courts continue to strike down contractual terms that seek to improperly advantage one party over a more vulnerable party. The imprecision of the doctrine of unconscionability spurs from the lack of a common understanding regarding the morals of the marketplace, coinciding with the distinct factual circumstances of each case. Business ethics theory provides a means of better defining the amorphous doctrine of unconscionability, a lens by which the doctrine of unconscionability may be viewed, and a pluralistic approach to identifying immoral actions in the process of contracting and immoral contractual terms. The pluralistic framework suggested in this article may be utilized to ensure that moral breaches are identified and weighed against public policy interests. This framework advances the historic doctrine of unconscionable contracts by infusing it with theories of business ethics and thereby ensuring a minimal baseline of ethics in contracting.

CRYPTOCURRENCIES AND THE UNIFORM COMMERCIAL CODE: THE CURIOUS CASE OF BITCOIN

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I. INTRODUCTION

Virtual currencies have been gaining traction in the media and markets, with Bitcoin as its most well-known cryptocurrency. They are defined as "digital representations of value, issued by private developers and denominated in their own unit of account."[1] Advocates praise their decentralized nature, transparency, convenience, and anonymity. Virtual currencies "can be obtained, stored, accessed, and transacted electronically, and can be used for a variety of purposes, as long as the transacting parties agree to use them."[2]

Bitcoin was originally introduced as a white paper by an anonymous author or authors under the pseudonym Satoshi Nakamoto in 2008, primarily as a way to negotiate in the Internet's black market.[3] Throughout the years, it has grown in popularity to encompass several sectors and a diversity of uses. Transactions involving bitcoins are like cash payments and are practically anonymous, for the customer is not required to hand over substantial personal information through the use of the blockchain. However, recent federal regulations and court

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[1] DONG HE, *ET AL.*, VIRTUAL CURRENCIES AND BEYOND: INITIAL CONSIDERATIONS, IMF SDN/16/03, 7 (2016) https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf.

[2] *Id.*

[3] James P. Gerkis & Serafima Krikunova, *Bitcoin and Other Virtual Currencies: Approaching U.S. Regulatory Acceptance*, 39 ADMIN. & REG. L. NEWS 4 (2014).

decisions are contradictory as to the true nature of bitcoins: is it property, a currency, a commodity, a security, or something entirely different requiring new legislation to promote its growth?

This article examines the current regulatory framework for Bitcoin and the implications of this virtual currency under the Uniform Commercial Code (hereinafter, U.C.C.), specifically under Article 9. In order to provide a background of how this particular virtual currency works Part II will explain the nature and inner workings of Bitcoin. Part III discusses the conflicting current regulatory framework that has been used to categorize Bitcoin by different federal agencies and court rulings. Part IV of this article proposes how Bitcoin can be categorized under Article 9 of the U.C.C. and, particularly, the implications of its categorization as a general intangible. Lastly, Part V provides arguments for a new regulatory framework away from the limiting definitions of the U.C.C. and the particular interests of parties in a case or of specific agencies, one that incorporates all the categories under which Bitcoin can fall and the advantages it has as a medium of exchange.

II. THE MECHANICS AND INNER WORKINGS OF BITCOIN

As previously discussed, virtual currencies are digital representations of value that are issued by private developers and that are not denominated in fiat currency, but rather have their own unit of account.[4] Cryptocurrencies are decentralized, meaning there is no central party that administers or issues them, instead, there is "a framework of internal protocols that govern the operation of the system and allow the verification of transactions to be performed by the system participants themselves."[5] By operating as decentralized systems, users can make secured transactions, denominated in virtual coins that rely on encryption for security, which are carried out over virtual networks on the Internet.[6]

Additionally, most cryptocurrencies are pseudo-anonymous because users are solely known by addresses that cannot be easily traced back to their real-world identity, but that are publicly recorded in the blockchain.[7] Lastly, cryptocurrencies derive their value from the expectation that others also value and use them. The main concern with respect to cryptocurrencies is that because of their rigid supply rules due to a fixed number of possible outstanding units, these virtual currencies can pose the risk of structural deflation.[8] Money demand grows with the growth of the economy, but when the supply is fixed, a growing demand often leads to structural deflation because the supply cannot satisfy the demand.

Bitcoin is an open source, peer-to-peer, decentralized protocol that can be used as a payment system without the use of intermediaries; however, it can also be used as a digital currency.[9] Bitcoin was created in 2008 by someone anonymously called Satoshi Nakamoto and it is a virtual currency that relies on the principles of cryptography by using a distributed database across nodes of peer-to-peer networks.[10] Bitcoin was built upon the basis of cryptography and blockchain technology, which "are the foundational technologies accomplishing the tracking of

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[4] DONG HE, *ET AL.*, *supra* note 1.
[5] *Id.* at 9.
[6] Sam Hampton, *Undermining Bitcoin*, 11 WASH. J. L. TECH. & ARTS 331, 335 (2016).
[7] DONG HE, *supra* note 1, at 9.
[8] *Id.* at 34.
[9] Jeanne L. Schroeder, *Bitcoin and the Uniform Commercial Code*, 24 U. MIAMI BUS. L. REV. 1, 10 (2016).
[10] Octav Neguriță, *Bitcoin – Between Legal and Financial Performance*, 6 CONTEMP. READINGS L. & SOC. JUST. 242 (2014).

transactions without requiring third party verification."[11] No legal entity controls or administers Bitcoin, while no sovereign or commodity backs the currency; consequently, "the value of a [B]itcoin is determined solely by public perception, trust, and adoption, causing great volatility."[12] The blockchain means that, although at its conception Bitcoin prided itself in being anonymous, it is in fact pseudonymous.[13] As a result, there is a public record and chain of custody of each Bitcoin, although publicly the identity of the owner may remain unknown.[14]

Bitcoins are generated by a process called mining, in which computer programmers known as miners solve complex math problems based on cryptography and, consequently, are rewarded with bitcoins that are stored in a digital wallet, from which miners can electronically distribute them.[15] Additionally, "the Bitcoin algorithm is programmed to release bitcoins in decreasing quantities up to a total of twenty-one million bitcoins. No additional bitcoins will be created once this number is reached."[16] Besides mining, "users may also obtain bitcoins by purchasing them on various online exchanges, through peer-to-peer transfers, or by receiving them as payment for a product or service."[17] Transactions are completed "between Bitcoin addresses, which are somewhat like email addresses, though it is important to note that any individual user could control many addresses."[18] Each transaction has a private key, with exchanges and all transactions are being recorded on a public ledger, which is known as the blockchain.[19] The blockchain is searchable in terms of addresses and transactions,[20] which are carried out in the following manner:

> To transfer [B]itcoin out of one's digital wallet, the owner must enter in an account number, known as a public key, and a password or private key. Obviously, one could hide one's actual identity behind these numbers, but sophisticated computer analyses have enabled large transactions to be tracked. Moreover, although owners theoretically do not need intermediaries to transfer bitcoins, in fact, a variety of intermediaries and exchanges have developed.[21]

Bitcoin has been growing in popularity as more and more businesses use it as a digital form of cash to purchase goods and services.[22] Moreover, businesses are using bitcoins in novel ways to perform transactions that at Bitcoin's conception where not even contemplated. For example:

> Overstock, Inc. announced that it was issuing the first "cryptosecurity" —a Regulation D offering of bonds that will be recorded on a blockchain rather than a more traditional security transfer ledger. Overstock's founder and Chief Executive Officer, Richard Byrne, known as a strong libertarian, has suggested that this may help free finance from the

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[11] Gregory M. Karch, *Bitcoin, the Law and Emerging Public Policy: Towards a 21st Century Regulatory Scheme*, 10 FLA. A & M U. L. REV. 193, 194 (2014).
[12] Matthew Kien-Meng Ly, *Coining Bitcoin's "Legal Bits": Examining the Regulatory Framework for Bitcoin and Virtual Currencies*, 27 HARV. J. L. & TECH. 587, 590 (2014).
[13] Schroeder, *supra* note 9, at 13.
[14] Gerkis & Krikunova, *supra* note 3.
[15] *Id.*
[16] Kien-Meng Ly, *supra* note 13.
[17] *Id.*
[18] Hampton, *supra* note 7, at 336.
[19] *Id.*
[20] *Id.* at 337.
[21] Schroeder, *supra* note 9, at 13.
[22] Kien-Meng Ly, *supra* note 13, at 591.

> tyranny of the [S.E.C.] and the brokerage industry or, at least, prevent naked short-selling that he believes is used maliciously to drive down the price of issuer's stock.[23]

Bitcoin's growth in popularity is primarily attributed to its benefits and advantages such as privacy, convenience, decentralized nature, and the ease of transfer. It also provides a quick, cheap, and private way to transfer currency across the globe to anyone with a digital wallet and an Internet connection without the need for a bank account.[24] Since Bitcoin transactions do not require an intermediary or central agency, it "provides users with high levels of privacy. Transferors and recipients of bitcoins remain nearly anonymous . . . [and] personal information [is not] available by cross-referencing account numbers."[25] Additionally, there are minimal or no associated transaction fees.[26]

However, Bitcoin's pseudonymous ownership can pose certain risks, such as:

> While there is a public ledger (the "blockchain") of all Bitcoin transactions, the parties' actual identities are not included because [b]itcoins are held at anonymous digital addresses through encrypted software programs . . . While the actual parties to a Bitcoin transaction might be identified through subpoenas, the necessary information might be outside the U.S.A. (and, therefore, beyond [a] Court's jurisdiction) or too expensive and/or time consuming to obtain.[27]

Bitcoin's advantage as a decentralized virtual currency that is not subject to any specific regulation can also be a disadvantage. This poses a threat because "anyone can illegally enter in the system and generate a lot of [b]itcoins."[28] In turn, this causes Bitcoin's value to be volatile. Additionally, government regulations and intervention can hinder the cryptocurrency's performance, such as, when Bitcoin "experienced a dramatic price drop after regulators in China prohibited banks and payment companies from dealing with Bitcoin by classifying it as a commodity rather than a currency."[29]

III. CURRENT REGULATORY FRAMEWORK

A. Bitcoin as a Currency

The U.C.C. defines money as "a medium of exchange currently authorized or adopted by a domestic or foreign government . . . includ[ing] a monetary unit of account established by an intergovernmental organization or by agreement between two or more countries."[30] On the other hand, the Department of Treasury and the Financial Crimes Enforcement Network (hereinafter, FinCEN) defines currency, also referred to as real currency, as "[t]he coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance."[31] However, contrary to real currencies, "'virtual' currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real

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[23] Schroeder, *supra* note 9, at 7.
[24] Gerkis & Krikunova, *supra* note 3.
[25] Kien-Meng Ly, *supra* note 12, at 593.
[26] *Id.* at 594.
[27] Michael R. Gordon, *et al.*, *Bitcoin to Blockchain: How Laws and Regulations Are Conforming to and Impacting the Use of Virtual Currency*, 20160428P NYCBAR 1, 28 (2016).
[28] Neguriţă, *supra* note 10, at 247.
[29] Gerkis & Krikunova, *supra* note 3.
[30] U.C.C. § 1-201(24) (2015).
[31] 31 C.F.R. § 1010.100(m) (2016).

currency."[32] The FinCEN Guidance also adds that virtual currency does not have any legal tender status in any jurisdiction.[33] FinCEN concludes that convertible virtual currency, much like Bitcoin, "either has an equivalent value in real currency, or acts as a substitute for real currency."[34] Consequently, it appears that this equivalent value or role as a substitute is how "FinCEN then concludes Bitcoin exchanges may be treated as money transmitters, by virtue of acting as a substitute for real currency."[35]

Moreover, FinCEN has ruled that "a user who obtains convertible virtual currency and uses it to purchase real or virtual goods or services is not [a money services business] under [the agency's] regulations,"[36] but "an administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN's regulations, unless a limitation to or exemption from the definition applies to the person."[37] The Guidance further adds that the definition of a money transmitter is not different for real currencies and convertible virtual currencies, but that a person is a money transmitter under the regulations implementing the Bank Secrecy Act when they accept and transmit anything of value that is substituted for currency.[38] Lastly, the Guidance concludes on decentralized convertible virtual currency by stating that:

> A person that creates units of this convertible virtual currency and uses it to purchase real or virtual goods and services is a user of the convertible virtual currency and not subject to regulation as a money transmitter. By contrast, a person that creates units of convertible virtual currency and sells those units to another person for real currency or its equivalent is engaged in transmission to another location and is a money transmitter. In addition, a person is an exchanger and a money transmitter if the person accepts such [decentralized] convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency.[39]

It is important to note, that the FinCEN ruling conflicts with the Internal Revenue Service (hereinafter, I.R.S.) decision classifying Bitcoin as property because "FinCEN applies money-laundering regulations against Bitcoin exchanges as if they are money transmitters, meaning FinCEN maintains that [B]itcoin is money or digital currency."[40]

Notwithstanding, some academics have argued that due to its inherent instability, Bitcoin cannot be a currency. This is "because [of] the built-in limits on the number of bitcoins that can exist, the value of bitcoins will continue to fluctuate radically and trend towards deflation,"[41] making it difficult for Bitcoin to become customarily used and widely accepted by any country. Additionally, a literal application under the U.C.C. definition of money would likely lead to Bitcoin not being defined as a currency or money because it lacks the recognition

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[32] U.S. Dep't of Treas., *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FIN-2013-G001, 1 (March 18, 2013), https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf [hereinafter FinCEN].
[33] *Id.*
[34] *Id.*
[35] Karch, *supra* note 11, at 230.
[36] FinCEN, *supra* note 32, at 2.
[37] *Id.* at 3.
[38] *Id.* at 1.
[39] *Id.* at 5.
[40] Karch, *supra* note 11, at 232.
[41] Mitchell Prentis, Note, *Digital Metal: Regulating Bitcoin as a Commodity*, 66 CASE W. RES. L. R. 609, 622 (2015).

by any state.[42] However, the innovative nature of virtual currencies could result in the revision of the U.C.C. definition of money by limiting it to "a medium of exchange, regardless of its form and regardless of state backing or legal status by a government."[43]

B. Bitcoin as Property

The I.R.S. has defined virtual currency as a "digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value."[44] When defining Bitcoin, the I.R.S. characterized it as a convertible virtual currency because it "can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies."[45] Moreover, the agency determined that for tax purposes Bitcoin and other virtual currencies would be classified and treated as property.[46] With this determination, the I.R.S. "has decided to disregard the characteristics of Bitcoin as a currency and a payment system."[47]

Nevertheless, this classification by the I.R.S. has been controversial. Taxpayers must now calculate for each virtual currency transaction the capital gains or losses when exchanging virtual currency for other property; consequently, all payments made with virtual currencies are subject to reporting.[48] What this means is that all taxpayers must calculate the fair market value whenever a Bitcoin is purchased or used in the purchase of goods and services. In the end, "by classifying [B]itcoin as property, the I.R.S. threatens the widespread consumer adoption of bitcoin[s]."[49] Additionally, the property definition might be off-putting because property does not tend to have the characteristic of anonymity like Bitcoin does; on the contrary, the American legal system has extensive case law, statutes, and regulations regarding the public status of ownership and property rights.[50]

C. Bitcoin as a Security

Some have suggested that Bitcoin is a security, particularly under the dispositions of Article 8 of the U.C.C. For example, an owner of bitcoins could treat it as a financial asset by choosing "to hold it indirectly through a financial intermediary,"[51] but this comes with the price of "eliminating one of the primary attractions of cryptocurrency, namely the ability to engage in financial transactions directly without a third-party intermediary."[52] To mitigate this effect, Bitcoin could be classified under uncertificated securities, although these dispositions were created in a time when cryptocurrencies were beyond the wildest imagination of the U.C.C.'s drafters.[53]

Nonetheless, it is likely that the suggestion of classifying Bitcoin as a security has become popular because many buy bitcoins as an investment part of their portfolio. Moreover,

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[42] Karch, *supra* note 12, at 231.
[43] *Id.*
[44] I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, https://www.irs.gov/pub/irs-drop/n-14-21.pdf [hereinafter I.R.S.].
[45] *Id.*
[46] *Id.* at 2.
[47] Karch, *supra* note 11, at 228.
[48] Seth Litwack, *Bitcoin: Currency or Fool's Gold?: A Comparative Analysis of the Legal Classification of Bitcoin*, 29 TEMP. INT'L & COMP. L. J. 309, 332 (2015).
[49] *Id.* at 333.
[50] Karch, *supra* note 11, at 239.
[51] Schroeder, *supra* note 9, at 9.
[52] *Id.*
[53] *Id.*

treating Bitcoin as a security could be attractive because of the ample securities regulations that the United States has in place. However, since bitcoins have a decentralized operating framework and are not a backed form of exchange, it is unclear whether Bitcoin meets one of the defining characteristics of a security, which is a claim against an issuer or entity.[54] If Bitcoin has any possibility of being considered a security, it will be because it meets the requirements of the catchall classification of the investment contract.[55]

The United States Supreme Court, in *S.E.C. v. W.J. Howey Co.*,[56] first laid out the standard for what is a security, particularly an investment contract. In this particular case the Court had to determine if the sale of a portion of an orange grove, including the service contract for its maintenance, was an investment contract security. The Court concluded that the transactions in the case constituted investment contracts.[57] However, since the term investment contract was undefined by the Securities Act or by relevant legislative reports, the Court used this case to define what was an investment contract and concluded:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[58]

Using the *Howey* Test, Bitcoin most likely would not be classified as a security and, ultimately, as an investment contract. Although "Bitcoin likely satisfies the first prong of the *Howey* investment test and meets the requirement for an investment of money because bitcoins have value,"[59] it would likely not satisfy the remaining two elements. It is difficult to find commonality within Bitcoin because it is hard to determine what the common enterprise entails.[60]

Courts analyze and define commonality within horizontal and vertical commonality.[61] Under a horizontal commonality lens, "by buying a [B]itcoin, a person is taking a stake in how the Bitcoin system fares."[62] Nonetheless, people don't solely buy bitcoins for this reason, but rather different people buy the cryptocurrency for different reasons ranging from an investment perspective to an electronic payment use. For this reason, "Bitcoin investors are likely far more concerned with the value of Bitcoin as a whole over the long term, while people only looking to use bitcoins to buy things are arguably more concerned with short term pricing, and whether the retailers they want to transact with will accept bitcoins."[63] Due to the different motivations behind the purchase of bitcoins, the risks can be different; however, "[b]uyers' risks differing with their motivations is not an issue for traditional securities, because an expectation of profit

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[54] Prentis, *supra* note 41, at 622.
[55] *Id.* at 622–23.
[56] S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946).
[57] *Id.* at 299.
[58] *Id.* at 298–99.
[59] Prentis, *supra* note 41, at 623.
[60] *Id.* at 624.
[61] "Horizontal commonality examines the relationship between all investors in an enterprise and whether all the investors' pooled funds are exposed to the same risks. In contrast, vertical commonality examines the relationship between investors and the promoter, and how closely the investors' profit are tied to the promoter's efforts." *Id.*
[62] *Id.*
[63] *Id.*

is a prerequisite for an investment to be a security, under the *Howey* Test."[64] Similarly, when viewed from a vertical commonality perspective, Bitcoin developers work independently from each other, seeking to make a profit for themselves and not for a general base of users. Consequently, due to the competing dynamic between developers, "it would be difficult to substantiate that they are all working together toward a common end."[65] For these reasons, it cannot be concluded that bitcoins meet the commonality standard of the *Howey* Test.

Lastly, the third component of the *Howey* Test requires that investors expect profits from the efforts put forth by others. However, Bitcoin would most likely not satisfy this requirement due to the variety of reasons why people purchase or hold bitcoins. Most people hold "them with the expectation, or at least hope, that they will appreciate, because the limited number of merchants that accept bitcoins make them difficult to spend."[66] Consequently, "[t]hose holding bitcoins solely for transacting business, however, would not likely satisfy this prong, for the same reason that it is generally accepted that a person who holds dollars does not expect to make a profit from holding them."[67] Additionally, those who hold bitcoins expecting to make a profit don't necessarily depend on the efforts of an intermediary but rather on the inherent qualities of Bitcoin itself, such as its usefulness, practicality, and scarcity.

D. Bitcoin as a Commodity

In 2015, the Commodity Futures Trading Commission concluded that Bitcoin and other virtual currencies were included in the definition of commodities.[68] A commodity is defined to include, among other things, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[69] Additionally, "[s]ome countries, such as China, Japan, and Finland, have officially classified bitcoins as commodities."[70] Moreover, Bitcoin could be a commodity because it acts as money within its community of users and, "from a pricing standpoint, it is valued like other commodities. The price of traditional commodities, like gold, silver, and agricultural products, vary in accordance with their demand and scarcity. When more people want a commodity that has a fixed supply, the price rises."[71] Bitcoins are naturally scarce because its algorithm has a set limit that can be created; therefore, they are considered rare, which leads users to pay increasing prices. As a result, the "value of a [B]itcoin is ultimately driven by supply and demand —a coin is worth whatever someone is willing to pay for it."[72] Additionally, Bitcoin possesses the characteristics necessary to be traded on a futures exchange:[73]

> Bitcoins are homogenous, imperishable, and susceptible to standardized grading, as all bitcoins are the same, and their quality does not vary. Further, a large supply of bitcoins exists, and demand for them fluctuates in an uncertain manner. And the Bitcoin market is

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[64] *Id.*
[65] Prentis, *supra* note 41, at 625.
[66] *Id.*
[67] *Id.*
[68] In re Coinflip, Inc., C.F.T.C. Docket No. 15-29, 3 (Sept. 17, 2015), http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.
[69] 7 U.S.C. § 1a(9) (2016).
[70] Chelsea Deppert, *Bitcoin and Bankruptcy: Putting the Bits Together*, 32 EMORY BANKR. DEV. J. 123, 138 (2015).
[71] Prentis, *supra* note 41, at 628.
[72] *Id.* at 629.
[73] "In order to be traded on a futures exchange, a commodity must: 1) be homogenous; 2) be susceptible to standardized grading; 3) have large supply and demand; 4) have an unrestricted market; 5) have uncertain supply and demand; and 6) not be perishable." *Id.* at 630–31.

> unrestricted, as no single entity controls the supply or demand of bitcoins. There is nothing that conceptually prevents bitcoins from being traded on a futures contract. Two parties could easily contract for the sale of some amount of bitcoins at a present price, with the actual exchange of the bitcoins happening in the future. Furthermore, the risks of Bitcoin are such that futures trading would be beneficial to Bitcoin users; futures contracts would be of great use for companies being paid in bitcoins to protect against [B]itcoin price drops.[74]

However, classifying bitcoins as a commodity could clash with other classifications given by different agencies or court rulings.

E. Bitcoin Classification in Court Rulings

To date, the most well-known case relating to the characterization of Bitcoin is *Sec. & Exch. Comm'n v. Shavers*,[75] in which "the U.S. District Court in Sherman, Texas held that bitcoin is a currency, but also meets the definition of an investment contract and/or note."[76] The District Court found that "Shavers created and operated a Ponzi scheme called Bitcoin Savings and Trust (BTCST), defrauding investors of more than 700,000 bitcoin[s] worth $4.5 million U.S. dollars at the time. He was able to solicit investments from users in various online forums and chats."[77] The Securities and Exchange Commission (S.E.C.) argued that these investments were both investment contracts and notes; hence, they were securities. The court concluded that bitcoins could be used as money, even if only accepted by a limited amount of businesses or entities. Moreover, it also found that bitcoins can be used in the purchase of goods or services and that it can be exchanged for conventional currencies; therefore, Bitcoin is a currency or form of money constituting an investment of money in scenarios such as the one at controversy in the case.[78] Furthermore, the court held that "those who invested in BTCST 'provided an investment of money' via [B]itcoin, similar to using U.S. dollars to purchase stock in a corporation; therefore, according to the court, [B]itcoin is a currency."[79]

On the other hand, the first case in a bankruptcy court to address cryptocurrencies was *Hashfast Technologies LLC v. Lowe (In re Hashfast Technologies, LLC)*[80] in the state of California, which reached a conflicting ruling with the *S.E.C. v. Shavers* decision. The controversy was over a clawback motion involving a blogger that was paid to promote Hashfast Technologies LLC.[81] The Court determined that, despite defendant's arguments stating that the bitcoins were currency, Bitcoin is not United States dollars by stating:

> The court does not need to decide whether [B]itcoin are currency or commodities for purposes of the fraudulent transfer provisions of the bankruptcy code. Rather, it is sufficient to determine that, despite defendant's arguments to the contrary, [B]itcoin are not United States dollars.[82]

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[74] *Id.* at 631.
[75] Sec. & Exch. Comm'n v. Shavers, 2013 WL 4028182 (E.D. Tex. 2013).
[76] Litwack, *supra* note 48, at 333.
[77] *Id.* at 333–34.
[78] Gerkis & Krikunova, *supra* note 3, at 6.
[79] Litwack, *supra* note 48, at 334.
[80] Hashfast Technologies, LLC v. Lowe *(In re* Hashfast Technologies, LLC), No. 14-30725 (Bankr. N.D. Cal. 2016) (order on motion for partial summary judgment), https://www.bloomberglaw.com/public/desktop/document/Kasolas_v_Lowe_Docket_No_315ap03011_Bankr_ND_Cal_Feb_17_2015_Cour/5?1480287105.
[81] Joyce E. Cutler, *Bitcoins Are Not Dollars in Bankruptcy Court*, 28 BNA BANKR. L. REP. 265 (2016).
[82] *Hashfast Technologies*, No. 14-30725 at 1.

IV. BITCOIN UNDER THE UNIFORM COMMERCIAL CODE

Although it is not binding law, the Uniform Commercial Code has been adopted in one form or another by a majority of states and Puerto Rico. The U.C.C. includes a framework to govern sales and other commercial contracts. At a quick glance, it might appear that the U.C.C. can be used to validate Bitcoin transactions rather than limit them, regardless of how Bitcoin is classified. However, Article 9 poses a particular challenge to Bitcoin's advantages and can hinder its marketability, for depending on how Bitcoin is classified, attaching and perfecting a security interest may vary. This part will analyze how Bitcoin can be categorized under Article 9 of the U.C.C., particularly the implications of its categorization as a general intangible.

Article 9 governs security interests in personal property —including inventory, goods, and general intangibles, among others— called blanket liens. Generally speaking, when a portion of a debtor's general intangibles includes bitcoins, they "become subject to the blanket lien in which the creditor has a secured interest, assuming the lien has been perfected. However, if the debtor uses the bitcoins to purchase inventory . . . the creditor maintains a security interest in those bitcoins, which persists for subsequent transfers."[83] Nevertheless, "Bitcoin's feasibility as a medium of exchange may nonetheless be challenged once the digital currency's increasing popularity pushes it to confront existing commercial law under the Uniform Commercial Code."[84]

As previously discussed, the U.C.C. defines money as:

> [A] medium of exchange currently authorized or adopted by a domestic or foreign government. The term includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more countries.[85]

At first glance, it seems that Bitcoin cannot be treated as money because no government has adopted it as its currency. It appears that the U.C.C. has limited the definition of money to hand-to-hand currency because it does not include in its definition the most common form of money held in the United States —deposit accounts.[86] Moreover, Bitcoin's use as collateral if it were money would be difficult because it would be impossible to create a perfected security interest:

> [P]ursuant to Sec. 9-312(b)(3) a non-proceeds "security interest in money may be perfected only by the secured party's taking possession." This means that characterizing [B]itcoin as money under the U.C.C. would actually make it less able to function as a currency.[87]

As a result, it is forceful to conclude that Bitcoin is not money and cannot be money nor a deposit account under the U.C.C.'s current definition.

If held directly by the owner, Bitcoin falls under the catchall category of general intangibles, which is defined as the personal property that does not fall within any other category.[88] If Bitcoin is a general intangible, then to perfect a security interest, "it should be

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[83] Deppert, supra note 70, at 137.
[84] Nicolas Wenker, *Online Currencies, Real-World Chaos: The Struggle to Regulate the Rise of Bitcoin*, 19 TEX. R. L. & POL. 145, 190 (2014).
[85] U.C.C. §1-201(24) (2015).
[86] Schroeder, *supra* note 9, at 20.
[87] *Id.* at 23.
[88] *See* U.C.C. § 9-102(a)(43) (2015). "General intangible" means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction.

enough for the creditor to obtain a Security Agreement sufficiently identifying the Collateral and make an Article 9/UCC-1 Filing."[89] However, this characterization can negatively affect the marketability and the advantages of Bitcoin because general intangibles are not negotiable. This is due to the fact that "Article 9 has no negotiation rule for the buyers of general intangibles that are subject to a perfected security interest. That is, once a security interest in a general intangible is perfected, it survives even after multiple transfers to third parties."[90]

As pointed out by Professors Bob Lawless of the University of Illinois College of Law and Lynn LoPucki of the UCLA School of Law, the potential issue that arises under Article 9 is the attachment and perfection of a security interest to Bitcoin depending on how it is classified.[91] This part will be largely based off their analysis. For purpose of this analysis, let's suppose a small family-run business sells clothes and other fashion items both to a local clientele and faithful online customers.[92] Most of their business is conducted in cash, but seeing the growing popularity of Bitcoin as an online payment method, the owners decide to start allowing payments in this cryptocurrency, in order to expand their online presence and because they read that many Bitcoin holders have made large profits on their holdings. It is important to note, that the store has a line of credit with a bank that allows them to borrow at a predetermined rate, which they mainly use to pay suppliers. The terms of the store's line of credit and loans that the bank provides are that the bank has a security interest in the store's inventory, goods, accounts, equipment, and intangibles; hence, the bank has a blanket lien.

The problem that the owners could face with respect to Article 9 of the U.C.C. involves the attachment and perfection of a security interest over the bitcoins that the owners might receive as payment from their customers and wish to use in purchasing inventory or paying suppliers. When customers pay for a purchase using bitcoins, the store receives them in their digital wallet and gains possession over them. Consequently, if these bitcoins are viewed as property, much like the I.R.S. has ruled, then the bank's blanket lien covers these bitcoins because they are the part of the store's intangible property. For some, this might not be an issue because the argument could be that the owners are in the same position as if they received cash or money for their sales and used it to purchase inventory which is still covered by the bank's blanket lien. However, if the storeowners want to pay suppliers with these bitcoins the scenario is different:

> It is true that transferees of money take free and clear of a pre-existing security interest under [U.C.C.] § 9-332. However, whether or not a Bitcoin is "money" for other purposes, a Bitcoin does not appear to be "money" under the [U.C.C.] and, therefore, [U.C.C.] § 9-332 would not apply. In effect, under [U.C.C.] § 1-201(b)(24), "money" is a "medium of exchange currently authorized or adopted by a domestic or foreign government" and Bitcoins are not authorized or adopted by governments. Perhaps a secured creditor could authorize Bitcoin dispositions for ordinary course operations, but it is unclear how a transferee would confirm that all liens that previously attached to the relevant Bitcoins

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The term includes payment intangibles and software. *Id.*

[89] Gordon *et al.*, *supra* note 27, at 35.

[90] Schroeder, *supra* note 9, at 30.

[91] Bob Lawless, *Is UCC Article 9 the Achilles Heel of Bitcoin?*, CREDIT SLIPS (Mar. 10, 2014, 8:17 PM), http://www.creditslips.org/creditslips/2014/03/is-ucc-article-9-the-achilles-heel-of-bitcoin.html.

[92] This scenario is based on a real-life example of a bakery accepting payments in Bitcoin, which is described and discussed by Lawless in his article. *Id.*

have been released.[93]

Specifically, returning to our family-run store example, let us assume that one of the store's suppliers accepts payments in Bitcoin and the owners want to start paying for their purchases with their holdings. Under the U.C.C., the security interest that the bank acquired in the store's property "continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest."[94] Consequently, unless the bank authorizes the disposition of the asset free and clear of any and all security interests, the bank retains their blanket lien on the store's bitcoins, even if the cryptocurrencies are now under the possession of the suppliers.[95] The bank's security interest will continue through all subsequent transfers.[96] Additionally, "a security interest created by a debtor is subordinate to a security interest in the same collateral created by another person if: (1) the debtor acquired the collateral subject to the security interest created by the other person."[97] This means that, even when the new owner attaches a security interest to the collateral, the bitcoins in this example, this security interest is subordinate to the previous liens on the property, even those made by previous owners; hence, in this example, the bank has priority over all other creditors with a security interest in the bitcoins.

One could argue that the U.C.C. has specific dispositions to protect buyers in the ordinary course. However, these provisions apply to the goods defined within the U.C.C., which exclude general intangibles.[98] This protection is designed to eliminate security interests in goods when purchased in commercial transactions; therefore, "a buyer in ordinary course of business . . . takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence."[99] Nonetheless, when defining goods, the U.C.C. definition excludes accounts, general intangibles and investment property, among others,[100] which are essentially all the categories under which Bitcoin might fall. Consequently, the bank would retain its security interest over the store's bitcoins.

As Professors Lawless and LoPucki discuss, the problem of the security interest over Bitcoin comes not only when attaching or perfecting said interest, but also when the bank wants to call in its interest in the Bitcoin collateral if and when the debtors default on their loan.[101] Returning to my example, assume that the storeowners are three months behind on their loan payments, which the bank considers a default. Now, the bank has the option to retrieve the collateral included in the blanket lien to satisfy the debt, this includes the bitcoins, regardless of who has possession of them. The problem that this action poses is that it hampers the advantages and marketability of Bitcoin as a commercial asset or form of payment, which might lead to fewer businesses and individuals accepting the cryptocurrency as a form of payment because of the possibility of there being an attached and perfected lien over the property.[102] However, this would not be a problem if bitcoins were viewed as currency or money.[103] Pursuant

[93] Gordon et al., *supra* note 27, at 36.
[94] U.C.C. § 9-315(a)(1) (2015).
[95] Lawless, *supra* note 91.
[96] *Id.*
[97] U.C.C. § 9-325(a)(1) (2015).
[98] Lawless, *supra* note 91.
[99] U.C.C. § 9-320(a) (2015).
[100] U.C.C. § 9-102(44) (2015).
[101] Lawless, *supra* note 91.
[102] *Id.*
[103] *Id.*

to the U.C.C., "[a] transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party."[104] Consequently, if bitcoins were considered money, the cryptocurrency could serve as collateral to a loan, but if transferred, the security interest would not follow it; hence, the current owners of the bitcoins are not at risk of having their holdings taken because of the default of some other debtor.[105] Nevertheless, as previously discussed, Bitcoin does not meet the current definition of money under the U.C.C.; therefore, for it to be classified as money, it would have to be recognized as such by the government or a foreign state or the U.C.C. definition would need to be changed.

Bitcoin has the potential to be used as collateral under the limits of Article 9 of the U.C.C.; however, "creditors are likely more concerned with restricting Bitcoin acquisition or use by borrowers due to the uncertain regulatory landscape, irreversible nature of payments, extreme volatility of value, and anonymity of the system."[106] Moreover, perfecting a security interest in Bitcoin can be challenging due to the following:

> Identifying the appropriate wallet may be difficult or impossible due to the system's anonymity. Bitcoin is not tangible and therefore it does not appear possible to perfect by possession, nor is a Bitcoin wallet a bank deposit account, meaning it does not appear possible to perfect by control either. Instead, if a wallet is identified, the collateral description in the security agreement should be broadened to cover it, and the security interest perfected by filing a [U.C.C.] financing statement. Should a borrower transfer collateral funds out of a Bitcoin wallet, it is likely impossible for a creditor to recover since transactions cannot be reversed. Once again, without a control agreement, the option of sweeping the Bitcoin wallet is not available.[107]

All in all, "[r]emoving funds from a payment platform account such as a Bitcoin exchange through a UCC-1 is therefore a lengthier, more expensive, and more uncertain process than exercising control agreements over the actual bank deposit accounts of debtors."[108] This, "combined with the general anonymity and volatility of the digital currency, [might be] good reasons why creditors may prefer to have nothing to do with borrowers' Bitcoins."[109]

Even if a secured creditor has a valid, perfected security interest in bitcoins, the concern arises of whether the secured creditor would have an effective remedy over the collateral in case of default. This is due to the fact that Bitcoin transactions are recorded on the blockchain, are pseudonymous, and are irreversible; hence, upon default, "a secured creditor would have difficulty learning that Bitcoin collateral had been transferred or identifying the transferee . . . [and] would have no rapid mechanism to prevent the debtor from transferring Bitcoins (unlike when a secured creditor has a control agreement with a bank and can sweep an account)."[110] Lastly, "there is a question as to whether Bitcoins can be described with sufficient specificity to create and perfect a security interest [because,] although each Bitcoin is unique, Bitcoin

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[104] U.C.C. § 9-332(a) (2015).
[105] Lawless, *supra* note 91.
[106] Pamela J. Martinson & Christopher P. Masterson, *The Hazards of Lending to Bitcoin Users*, AMERICAN BANKER (Jan. 2, 2014), http://www.americanbanker.com/bankthink/the-hazards-of-lending-to-bitcoin-users-1064622-1.html (last visited Aug. 6, 2017).
[107] *Id.*
[108] Wenker, *supra* note 84, at 193.
[109] *Id.*
[110] Gordon et al., *supra* note 27, at 36.

exchanges might place all [b]itcoins into a single pot and Bitcoin wallets present an anonymity issue."[111]

V. TOWARDS A NEW REGULATORY FRAMEWORK

Due to Bitcoin's innovative and transformative nature and framework, it merits that the regulation and policy regarding this cryptocurrency and others be as unique as the actual digital currency. Some have suggested that this regulation should not come from court rulings or from individual agencies, but rather from Congress by taking into account what the Bitcoin community values and concludes that would work because, ultimately, Congress cannot legislate something that it doesn't know or fully comprehend.[112] There is no constitutional impediment for Bitcoin to be regulated as an alternative currency, as long as it "does not aim to deceive or mimic United States currency."[113] Yet, the main concern is the inconsistent classification that has been given to Bitcoin throughout a variety of federal agencies and different court rulings; this, in turn, "suggests the need for legislative action to provide a definitive and conclusive classification or classifications for Bitcoin and digital currencies."[114]

Some have argued that the best approach would be to amend the U.C.C., particularly, that "for [B]itcoin really to take off as a payment system, let alone a currency, it may be necessary to amend the U.C.C. to add a super-negotiability rule for cryptocurrency."[115] On the other hand, Bitcoin's classification under the U.C.C. might require the following hypothetical solutions:

> [R]evising the UCC definition of money, convincing the U.S. or a foreign jurisdiction to officially authorize or adopt Bitcoin as a recognized medium of exchange, or hoping that courts generally become willing to apply [U.C.C.] legal "outs" for Bitcoin collateral (such as the "equitable principles" directive for resolving debtors' comingled accounts).[116]

Nonetheless, amending the U.C.C. would be a difficult task that would not necessarily lead to a uniform classification of Bitcoin because it would not be binding for all 50 states and territories, unless, the local state governments opt to adopt the amendment.

On the other hand, others have discussed the possibility of classifying Bitcoin as both a currency and an investment/asset as a balance between the advantages and the novelties that the cryptocurrency has introduced in the current market landscape, so as not to stifle its growth and further innovation.[117] The main goals pursued with this approach, due to Bitcoin's decentralized structure, are that this classification allows government to effectively "tax huge sources of revenue, protect individuals using [B]itcoin, and prevent crime through the usage of [B]itcoin."[118] Additionally, "governments of other nations [have] recognize[d] this complex nature, and many have determined that the best [way is] to regulate and tax [B]itcoin as both a currency and investment/asset."[119] Ultimately, "the role of the government in regulating [B]itcoin

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[111] *Id.*
[112] Karch, *supra* note 11, at 242–43.
[113] *Id.* at 225.
[114] *Id.*
[115] Shroeder, *supra* note 9, at 18.
[116] Wenker, *supra* note 84, at 192.
[117] *See* Litwack, *supra* note 48, at 346.
[118] *Id.* at 346-7.
[119] *Id.* at 347.

should be to maximize the overall advantages and minimize the risk."[120]

Arguably, the best approach is for Congress to give Bitcoin legitimacy through a unique classification and treatment as a "dynamic new technology, broadly classified to encompass all of its qualities and develop a legal and regulatory framework that recognizes its unique characteristics."[121] The current problem is that a sole classification that takes into account only one characteristic will be flawed because regulators will take the approach most beneficial to their interests, in sum:

> The [I.R.S.] views Bitcoin as property because that is the best definition for generating maximum tax revenue. FinCEN has defined Bitcoin as currency to ensure Bitcoin falls under the money laundering statutes and enable FinCEN to pursue those engaging in money laundering through Bitcoin. The [S.E.C.] persuaded a district court to define Bitcoin as currency in order to establish the purchase of investments and its jurisdiction of the sale of securities in a Ponzi scheme funded by Bitcoin.[122]

Consequently, government officials, mainly Congress, should assess and evaluate Bitcoin from a larger perspective because "Bitcoin more and more seems to be its own category, encompassing the characteristics of a commodity, a currency, an investment or security, a payment system, and, probably least of all, an asset or property."[123] As a result, the classification must encompass all of these characteristics because "[a] classification embracing its full capacity as a currency, a commodity, a payments system, and future uses would provide an optimal foundation to advance Bitcoin by establishing credibility and certainty, leading to substantial transformative technologies."[124]

The International Monetary Fund has proposed some regulatory principles for nations to follow in preparing their virtual currency and cryptocurrency regulations.[125] Regulator flexibility to the innovative nature of Bitcoin and similar digital currencies is the main factor as "[r]egulatory responses should be commensurate to the risks without stifling innovation . . . [and] should adapt to the changes in the [virtual currency] landscape."[126] Future regulations and public policy must "take into account the novel business models inherent in [virtual currency] schemes."[127] Moreover, regulations will need to address intermediary participation in the sale and purchase of virtual currencies because "[t]he failure of an intermediary may have implications for the protection of consumers and the stability of the payments system . . . [and] regulators may need to consider imposing prudential regulatory requirements on [virtual currency] intermediaries."[128] Finally, "[r]egulators should consider the potential implications of financial institutions (i) having [virtual currency] intermediaries as clients; (ii) holding [virtual currencies] as an investment; and (iii) performing the functions of [virtual currency] intermediaries."[129] Consequently, the factors to consider are whether to "[p]rohibit any interaction between the financial institutions and the [virtual currency] market; [a]llow a

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[120] *Id.*
[121] Karch, *supra* note 11, at 225–26.
[122] *Id.* at 240.
[123] *Id.* at 239
[124] *Id.* at 226.
[125] DONG HE, *ET AL.*, *supra* note 1, at 35–36.
[126] *Id.* at 35.
[127] *Id.* at 36.
[128] *Id.*
[129] *Id.*

certain degree of integration; or [a]llow full integration."[130]

VI. CONCLUSION

It is undeniable that the popularity of virtual currencies and cryptocurrencies, such as Bitcoin, has been growing. Many praise their flexibility, pseudonymity, decentralization and convenience. Throughout its development, Bitcoin has taken various forms and uses. This has led to recent federal regulations and court decisions that are contradictory as to the true nature of Bitcoin: is it property, a currency, a commodity, a security, or something entirely different requiring new legislation to promote its growth? The conclusion seems to be that Bitcoin is all of the aforementioned, ultimately, being a specific and particular classification all by itself.

Regarding U.C.C. Article 9, the potential issue with Bitcoin's classification concerns the attachment of a security interest to the cryptocurrency when it is considered property or a general intangible. If a business or individual holds bitcoins at the time that a bank or financial lender gains a blanket lien over the borrower's personal property, then the bitcoins would be part of the loan collateral. Pursuant to U.C.C. regulations, this security interest would encumber the bitcoins through further transfers. This significantly hinders the feasibility and marketability of Bitcoin because not many merchants and individuals would be willing to accept a payment that could be taken from them in case of default by the original debtor. Notwithstanding, if Bitcoin were classified as a currency, these issues would not arise. However, Bitcoin does not fall within the U.C.C.'s definition of money and has not been recognized by any state government as money or currency.

Due to the aforementioned problems, the solution is a new regulatory framework away from the limiting definitions of the U.C.C. and the particular interests of parties in a case or of specific agencies, one that incorporates all the categories under which Bitcoin can fall and the advantages it has as a medium of exchange. Any final regulation should incorporate all of these qualities to ensure Bitcoin's credibility and legitimacy as a medium of exchange of value. Additionally, Congress should take action to provide uniformity in the classification of virtual currencies and cryptocurrencies, while also taking into account what the Bitcoin community values and concludes that would work, for Congress cannot legislate something that it doesn't know or fully comprehend.

[130] *Id.*

EUROPEAN UNION'S PROPOSAL FOR A DIRECTIVE ON SINGLE-MEMBER PRIVATE LLCS AND SHARE CAPITAL: ONE OBSTACLE DOWN OR CREDITOR FRAUD WAITING TO HAPPEN?

FRANCISCO J. CARDONA REYES*

I. INTRODUCTION

On September 4, 2014, the European Commission proposed the *Directive of the European Parliament and of the Council on single-member private limited liability companies* (hereinafter, the "2014 Directive").[1] The purpose of the 2014 Directive is to facilitate investments across Member States. To achieve this purpose, Member States shall adopt a uniform legal entity known as, *Societas Unius Personae* (hereinafter, "SUP"), which is basically a single-member liability company (hereinafter, "single-member LLC"). However, the nature and extent of regulations in the European Union regarding single-member LLCs have caused controversy among Member States. Consequently, scholars, interest groups, and professionals have seriously criticized and

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[1] *See Commission Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, COM (2014) 212 final (Apr. 9, 2014), *available at* http://eur-lex.europa.eu/resource.html?uri=cellar:100dbdec-c08b-11e3-86f9-01aa75ed71a1.0002.01/DOC_1&format=PDF.

analyzed the 2014 Directive. Although many agree with numerous parts of the 2014 Directive, others have expressed grave concerns. Accordingly, this article, examines certain thoroughly studied issues of the 2014 Directive. Specifically, we will focus on the minimum share capital requirements provided by the 2014 Directive. Therefore, we will review the comments made regarding this requirement and discussing the positive and negative aspects discussed by a diverse array of professionals. In addition, we will examine the minimum capital requirements in other jurisdictions such as the United States, China, and Japan to establish how minimal capital requirements pose negligible risks to creditors. Finally, we will demonstrate how the purpose of minimum capital requirements is outdated.

II. CONTEXT AND BACKGROUND

Single-member limited liability companies (hereinafter, "single-member LLCs") are not new to the European Union. In fact, single-member LLCs have been subject to intense debate for over twenty years. Since 1989, the European Union has had a directive (hereinafter, the "1989 Directive") regarding single-member LLCs that provided for limited regulation.[3] In this sense, the 1989 Directive only aimed at harmonizing national law, by requiring Member States to allow limited liability companies to have a sole member.[4] The 1989 Directive did not regulate technical or controversial issues regarding single-member LLCs. As a result, there was diverse regulations regarding single-member LLCs throughout the European Union.

Regulation of single-member LLCs was still a topic of deep interest for the European Union, and further regulation of these entities was not out of their scope. Consequently, in 2008 the European Commission proposed a regulation regarding the establishment of a statute for a European private company, or as the proposal called it, *Societas Privata Europaea* (hereinafter, "SPE").[5] "). The SPE proposal was designed to help small and medium-sized enterprises (hereinafter, "SMEs") establish throughout the European Union.[6] Nonetheless, the SPE proposal failed at being adopted.[7] According to Pierre-Henri Conac, a Professor of Commercial and Corporate Law at the University of Luxembourg, this proposal failed due to opposition of many important Member States, such as the United Kingdom.[8] In short, the author suggests that the failure of the SPE was mainly caused as a result of the rejection by Member States of a corporate entity form created by the European Corporate Act.[9] It is to say, a corporate form at a European Union level. However, this intent of establishing a corporate regulation or directive at a European Union level responds to the doctrine of *freedom of establishment*.

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[3] Twelfth Council Company Law Directive of 21 December 1989 on single-member private limited-liability companies 89/667/EEC, 1989 O.J. (L 395) 40.

[4] *Proposal for a Directive on Single-Member Private Limited Liability Companies*, PRICEWATERHOUSECOOPERS LEGAL (June 2014), A Legal Update from PwC's Legal Services, *available at* https://www.pwclegal.co.uk/pdf/directive-on-single-member-plc.pdf.

[5] *See Commission Proposal for a Council Regulation on the Statute for a European private company*, COM (2008) 396 final (Jun. 25, 2008), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008PC0396&qid=1491328105299&from=EN (last visited Apr. 4, 2017).

[6] *Id.*

[7] *See Proposal for a Directive on Single-member Private Limited Liability Companies* , PRICEWATERHOUSECOOPERS LEGAL (June 2014), A Legal Update from PwC's Legal Services, *available at* http://www.pwclegal.co.uk/pdf/directive-on-single-member-plc.pdf.

[8] Pierre-Henri Conac, *The Societas Unius Personae (SUP): A "Passport" for Job Creation and Growth*, 12 EUR. COMPANY & FIN L. REV. 139, 141 (2015).

[9] *Id.* at 141–42.

A. Freedom of Establishment

Pursuant to Article forty-nine of the Treaty on the Functioning of the European Union:

> [R]estrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.[10]

As we can appreciate, the Article mainly aims at prohibiting discrimination by Member States of citizens from another Member State. In other words, it is primarily focused on facilitating transfer of citizens between Member States. In this manner, if a citizen from Member State A wishes to invest and establish a subsidiary in Member State B, no restrictions or obstacle can be place by Member State B that hinders this investment. Accordingly, the European Court of Justice has faced a considerable amount of cases alleging discrimination by Member States on basis of nationality. Said Court, in the case of *Reinhard Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, formulated a four tier test for the review of alleged discriminatory measures adopted by Member States.[11] This test consisted of evaluating if the measure: (1) was applied in a non-discriminatory way, (2) was justified by imperative requirements in the general interest, (3) had a rational relation with the end sought, and (4) does not go beyond what is necessary in order to achieve the goal pursued by the Member State.[12] It is apparent that the European Court of Justice established an intermediate scrutiny for evaluating alleged discrimination by Member States. It is important to note that this anti-discrimination rule was established before the adoption and ratification of the Treaty on the Functioning of the European Union. In this sense, Christoph Allmendinger explains that the antidiscrimination rule set out by the Treaty on the Functioning of the European Union, was already established in article fifty-two of the Treaty of Rome almost fifty years earlier.[13]

When facing cases regarding article fifty-two of the Treaty of Rome, the European Court of Justice has consistently given a broad meaning to the term "freedom of establishment".[14] For example, in *Ordre des Avocats au Barreau de Paris v. Onno Klopp,* Advocate General Sir Gordon Slynn stated that prohibiting an attorney from establishing himself in more than one place violated the freedom of establishment, which the Court determined was a fundamental right.[15] Moreover, in *Dieter Kraus v. Land Baden-Württemberg*, the European Court of Justice reiterated that the freedom of establishment was a fundamental right and no national measure could impair this right.[16] In this context, it is imperative to analyze the case *Centros Ltd. v. Erhversus-og Selskabsstyrelsen.*[17] The shareholders of Centros, a Danish couple, listed their main office address in United Kingdom. However, when they tried to establish a branch in Denmark, the Trade and Companies Board of Denmark (hereinafter, "Board") refused. The Board alleged that the

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[10] Consolidated Version of the Treaty on the Functioning of the European Union art. 49, May 9, 2008, 2008 O.J. (C 115) 47 (emphasis added).
[11] Case C-55/94, Reinhard Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, 1995 E.C.R. I-4165.
[12] *Id.* at ¶ 37 (Judgment of the Court).
[13] Christoph Allmendinger, *Company Law in the European Union and the United States: A Comparative Analysis of the Impact of the EU Freedoms of Establishment and Capital and the U.S. Interstate Commerce Clause*, 4 WM. & MARY. BUS. L. REV. 67, 75–76 (2013).
[14] *Id.*
[15] Case C-107/83, Opinion of AG Slynn in Ordre des Avocats au Barreau de Paris v. Onno Klopp 1984 E.C.R. 2971, 2992.
[16] Case C-19/92, Dieter Kraus v. Land Baden-Württemberg, 1993 E.C.R. I-1663, ¶ 32.
[17] Case C-212/97, Centros Ltd. v. Erhversus-og Selkabssyrelsen, 1999 E.C.R. I-1459.

shareholders were trying to evade meeting minimum capital requirements pursuant to the Law of Denmark.[18] Considering this, the United Kingdom, where Centros was listed, did not have a minimum capital requirement, contrary to Denmark where there was a minimum capital requirement of no less than 200,000 DKK. For sustaining this, the Board argued that Centros had never engaged in a business in the United Kingdom.[19] On the other hand, Centros challenged the determination of the Board. After various appeals and procedural issues, the case arrived before the European Court of Justice. In this proceedings, Centros sustained that it met the requirements "imposed by the [Law of Denmark] on private limited liability companies relating to the registration of a branch of a foreign company."[20] Also, it sustained that it had the right to establish pursuant to Article fifty-two, fifty-eight of the Treaty of Rome.[21] When solving this suit, the European Court of Justice stipulated that the right of free establishment, as stipulated in the Treaty of Rome, "includes the right for [persons] to take up and pursue activities as self-employed persons and to set up and manage undertakings under the same conditions as are laid down by the law of the Member State of establishment for its own nationals."[22] More importantly, the Court established that the Treaty of Rome requires Member States to treat persons of other Member States "in the same way as natural persons who are nationals of Member States."[23] Furthermore, when solving this case, the European Court of Justice determined that the requirement made by Denmark was "an obstacle to the exercise of the freedoms guaranteed by those provisions."[24] When evaluating the claims by Denmark, the Court determined that, although fraudulent conduct may be incurred by persons who do not meet minimum capital requirements, this should be determined by courts on a case by case basis.[25] It is important to take note the opinion submitted by the Advocate General, Antonio Mario La Pergola.[26] In said opinion, La Pergola argues that the right of establishment contains "the right to set up and manage undertakings under the conditions laid down for its own nationals by the law of the host country and the setting up of agencies, branches or subsidiaries by Community nationals having their principal establishment in the territory of another Member State."[27] In other words, it is clear that the European Court of Justice concurred with the opinion of the Advocate General. By following the opinion of La Pergola, the Court determined that the right of establishment entails a right to invest across borders, without foreign national laws serving as obstacles for this investment.

In short, we can see how the relevant case law and the Treaty on the Functioning of the European Union are reluctant to accept any discrimination among Member States. Thus, the freedom of establishment set out on said treaty serves as one of the issues addressed by the 2014 Directive.

B. The *2014 Directive*: A Fresh Start

The 2014 Directive is the European Commission's third and latest attempt at regulating single-member LLCs throughout all Member States. Unlike the fate of the SPE proposal, Jesper Lau Hansen suggests that the 2014 Directive has greater possibilities of being adopted, as it only

[18] *Id.* at ¶ 12.
[19] *Id.* at ¶ 7.
[20] *Id.* at ¶ 10.
[21] *Id.*
[22] Case C-212/97, Centros Ltd. v. Erhversus-og Selkabssyrelsen, 1999 E.C.R. I-1459, ¶ 19.
[23] *Id.*
[24] *Id.* at ¶ 22.
[25] *Id.* at ¶ 25.
[26] *Id.* at I-1461 (Opinion of AG La Pergola).
[27] *Id.* ¶ 12 (Opinion of AG La Pergola).

requires Member States to adjust national law accordingly.[29] In contrast, some suggest the SPE proposal failed, in part, since it aimed at establishing a new company form under Europe's Company Law, which required a unanimous vote from Member States; a figure many Member States were not comfortable with.[30] In other words, the 2014 Directive does not impose a new company figure onto the Member States. It is to say, it does not create a European Union level regulation. Instead, it opts at harmonizing national laws in order to have identical legal requirements.[31] This effort could have been done in coordination between Member States, but the European Commission clarified that this would be highly unlikely. Therefore, intervention at a European Union level was needed.[32] In this sense, it has been noted that the European Commission does not want the 2014 Directive to have the same fate as that of 2008 Directive.[33]

C. SME, Economic Development, and the SUP

The 2014 Directive arose in a specific context and preoccupation of the European Union. In 2008, over ninety-nine percent of the companies established in the European Union consisted of SMEs.[34] Of these, only eight percent established business in other Member States, and five percent had subsidiaries abroad.[35] Six years later, these estimates do not seem to have changed much. The 2014 Directive states that because of the costs and difficulties that represent doing business across borders, only a small number of SMEs undertake this type of investment.[36] When doing business across borders, SMEs face a variety of obstacles and challenges. Specifically, customers and business partners do not trust foreign SMEs, and there is diversity of national legislations.[37] Furthermore, SMEs "have an essential role to play in strengthening the EU economy."[38] In this sense, SME's generate fifty-eight percent of the European Union's gross domestic product and sixty-seven percent of the private sector.[39] It is for the aforesaid reason that the 2014 Directive proposes to:

> [F]acilitate cross-border activities of companies, by asking Member States to provide in their legal systems for a national company law form that would follow the same rules in all Member States and would have an EU-wide . . . . It would be formed and operate in compliance with the [harmonized] rules in all Member States which should diminish set-up and operational costs. In particular, the costs could be reduced by the [harmonized] registration procedure, a possibility of on-line registration with a uniform template of articles of association and a low [share] capital required for the set-up. The creditors would be protected by the obligation imposed on the SUP enable require that an SUP's

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[29] Jesper Lau Hansen, *The SUP Proposal: Registration and Capital (Articles 13–17)*, 12 EUR. COMPANY & FIN L. REV. 177, 177 (2015).
[30] *Id.*
[31] *See Commission Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, COM (2014) 212 final (Apr. 9, 2014) at 5–6.
[32] *Id.*
[33] Audrey Kravets, *Discussion Report: The Proposal for a Directive on the Single-Member Private Limited Liability Company*, 12 EUR. COMPANY & FIN L. REV. 125, 125 (2015).
[34] *See Commission Proposal for a Council Regulation on the Statute for a European private company,* COM (2008) 396 final (Jun. 25, 2008) at 2.
[35] *Id.*
[36] *See Commission Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, COM (2014) 212 final (Apr. 9, 2014) at 2.
[37] *Id.*
[38] *Id.*
[39] *Directive on single-member private limited liability companies*, MODEL EUROPEAN UNION ZAGREB, http://meuz.eu/single-member-company-directive/ (last visited Aug. 5, 2017).

> registered office and its central administration be necessarily located in the same Member State.[40]

Correspondingly, the 2014 Directive creates what it denominates as the SUP. The SUP serves as an integral part of the 2014 Directive. In fact, the SUP has been stated to be "*an opportunity for change and modernization*."[41] In this sense, the SUP has been praised due to its objective of facilitating business,[42] which influences employment and investments abroad.[43]

The aforementioned context provides a historical recount on to how and why the 2014 Directive is being proposed. Accordingly, we established how the European Union has, throughout the last thirty years, tried to create the ideal vehicle for investment abroad. Likewise, by taking into consideration that SME's are the economic motor that mainly drive the European Union's economy, the European Commission has taken a different approach in order to get the proposal adopted by the Member States. Hence, we understand the European Commission has determined that SUP serves as the ideal vehicle for SMEs to invest transnationally. Lastly, it is clear that this directive serves as a means for enforcing the right of *freedom of establishment* codified in the Treaty on the Functioning of the European Union. For this reason, some have seen how the SUP represents a *passport* for easy and fast establishment across all Member States.[44] Regarding this idea, Pierre-Henri Conac in his article, *The Societas Unius Personae (SUP): A "Passport" for Job Creation and Growth*, mantains that this directive proposal "is designed to facilitate the establishment of single-member companies under the form of an SUP (1) and also the functioning of those companies (2)."[45] In other words, the author suggests SUPs are intended to serve as a key vehicle for facilitating SME to invest across Member States.[46]

Despite the apparent sound and efficient mission, this proposal has been subject to extended criticism on key points. For example, some have criticized the form of registration, given that it is on-line.[47] This concern arises from the apprehension for the authenticity and safety of the process.[48] More importantly, others have expressed worries about the low capital requirement. This will be examined in the next section.

III. Capital Requirements, Creditors, and the 2014 DIRECTIVE

Throughout this part, we will focus on the comparison between the minimum capital requirements made by other Member States with those proposed in the 2014 Directive. Initially, we will examine how low capital requirements serve as a key element for the success of SUPs, without increasing the risk to creditors. Finally, we will establish what other tools can be used to safeguard creditor's interests. Given that other, more efficient tools can be employed, there is consensus that the concept of share capital is obsolete.

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[40] *Commission Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, COM (2014) 212 final (Apr. 9, 2014) at 3.
[41] Kravets, *supra* note 32, at 125 (emphasis added).
[42] *Id.* at 126.
[43] *Id.*
[44] Conac, *supra* note 7.
[45] *Id.* at 144.
[46] *Id.* at 144–45.
[47] Lau Hansen, *supra* note 28, at 179.
[48] *Id.*

A. Preliminary Comments

The 2014 Directive states that the minimum capital requirement shall be at least one euro, or one unit of national currency in a Member State that does not use the euro.[49] This is not the first time that the European Union has examined a low capital requirement. In fact, the 2008 SPE proposal also set minimum capital requirement of one euro.[50]

Now, how has the European community reacted to this requirement? First, the European Trade Union Confederation (hereinafter, "ETUC") reacted skeptically to the 2014 Directive overall.[51] Specifically, they condoned the way the European Commission established the minimum capital requirement: unilaterally, thus, undemocratic. The ETUC took another approach as to why low capital requirements are evil. Companies need this capital requirement, not only to protect creditors, but also clients and the workforce. In this sense, the ETUC maintained that the SUP would serve as a *letterbox company*, therefore, affecting workers' rights.[52] Although the ETUC positions may be correct to some extent, it did not analyze other means by which creditors are protected. The approach it decided to take is different to that which has been subject to debate. Others argue that "companies with low share capital will not command the respect of the business community."[53]

One could wonder why the European Commission would insists in establishing such a low minimum capital requirement, if said proposals were just six years apart from each other and provided the same justification for such requirement. Regarding this, the European Commission explains that low capital requirements serve as a savings for entrepreneurs.[54] The reason for this is that SMEs typically do not need any capital to start a business. In other words, low capital requirements facilitate business across borders and provide cost savings to entrepreneurs. These savings are crucial since high capital requirement would most likely discourage investment across borders.[55] Additionally, low capital requirements may provide the flexibility companies need to "determine the amount of the [company's] capital by reference to their business model and the requirements of third parties such as those providing financing to the company without requiring the single member to commit more share capital than is needed at an early stage."[56]

Before we continue, a key question must be answered: What is share capital? On one hand, according to Palmiter and Partoney, share capital represents "a cushion of capital [required by state corporation law] designed to protect debt holders."[57] They also state the way to calculate it. Meanwhile, Manning and Hanks maintain that the concept of share capital is driven to calm the conflict of interest between shareholders and creditors, since shareholders are

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[49] *Commission Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, COM (2014) 212 final (Apr. 9, 2014) at 7.
[50] *See Commission Proposal for a Council Regulation on the Statute for a European private company,* COM (2008) 396 final (June 25, 2008) at 7.
[51] *ETUC position on Single-Member Private Limited Liability Companies*, EUROPEAN TRADE UNION CONFEDERATION (June 12, 2014), *available at* https://www.etuc.org/print/11878#.Vx760se7dhB (last visited Apr. 5, 2017).
[52] *Id.*
[53] Lau Hansen, *supra* note 28, at 184.
[54] *See Commission Staff Working Document, Impact Assessment, accompanying the document Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, SWD (2014) 124 final (Apr. 9, 2014) at 14, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014SC0124&qid=1491498121511&from=EN (last visited Apr. 5, 2017).
[55] *Id.*
[56] Vanessa Knapp, *Directive on Single-Member Private Limited Liability Companies: Distributions*, 12 EUR. COMPANY & FIN L. REV. 191, 200 (2015).
[57] ALAN PALMITER & FRANK PARTNOY, CORPORATIONS: A CONTEMPORARY APPROACH 278 (1st ed. 2010).

interested in the distribution of the assets of the company, while the creditor is interested that the assets maintain committed to the corporation's treasury.[58] Moreover, share capital is a legal requirement for companies to have a reserve of money, mainly for creditor protection. On another part, share capital is required by law in order to pacify the adverse interest present between shareholders and creditors. Now, it is important to ask ourselves if this scenario is present in SUP. It should be noted that some authors have argued that share capital should be a uniform requirement among the Member States. In this sense, Jesper Lau Hansen argues that "[e]ither something is so dangerous that it requires an immediate safeguard or it is not. The same goes for share capital in a limited liability company, *either it is necessary when the company commence its business or it is not necessary at all.*"[59]

B. Share Capital Requirements as a means for Creditor Protection

When facing low share capital requirement, Member States have expressed their concern regarding the protection of creditors. In fact, rules relating to share capital have been the focus of recent European Company Law debates.[60] For example, when the SPE proposal was proposed some Member States expressed their concerns given that the low share capital requirement would substantially reduce creditor protection.[61] Likewise, others argue that by requiring high share capital requirements current and future creditors would have certainty regarding the quantity of corporate resources and may not distribute freely to shareholders.[62] When explaining the benefits of share capital requirements, Shuangge Wen explains that this requirements has two aspects: "[t]hey were to create genuine rather than 'empty-shell' investment vehicles by preventing frivolous incorporation and they were to furnish a sufficient material basis—the so-called 'equity cushion'—for a company's operation so that the risk of insolvency, if not eliminated, could at least be reduced for the benefit of creditors."[63] Those in favor of share capital requirements sustain that this demand brings creditors a fair valuation of the company, therefore bringing lenders a key variable to measure risk.[64] Furthermore, Kraakman exposes that this type of requirement *compensates* creditors for having to give asking individuals for personal liability.[65] The issue regarding creditor protection is especially important given that "lending-and-borrowing procedure is an age-honored tradition in all societies and almost in all creeds, *as an indispensable aspect of commercial activities.*"[66] It is in this commercial activity that creditors incur in the risk of losing their invested monies.[67] Therefore, it is important for creditors to have the tools available to measure the risk they would incur when lending to a certain company. Likewise, they would also be prone to incur in lending

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[58] BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 5 (3d ed. 1990).
[59] *See* Lau Hansen, *supra* note 28, at 189 n.28 (emphasis added).
[60] *See* John Armour, *Legal Capital: An Outdate Concept*, 7 EUR. BUS. ORG. L. REV. 5, 6 (2006).
[61] *See* Conac, *supra* note 7. *See also* Corrado Malberti, *The Relationship Between the Societas Unius Personae Proposal and the Acquis: Creeping Toward an Abrogation of EU Company Law?*, 12 EUR. COMPANY & FIN L. REV. 238, 260 (2015).
[62] Luca Enriques & Jonathan R. Macey, *Creditors versus Capital Formation: The Case against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165, 1186 (2001).
[63] Shuangge Wen, *The Ideal and Reality of a Legal Transplant — The Veil Piercing Doctrine in China*, 50 STAN J. INT'L L. 319, 329 (2014).
[64] *See* Enriques & Macey, *supra* note 61, at 1186–88.
[65] *See* Reinier Kraakman, *Concluding Remarks on Creditor Protection*, 7 EUR. BUS. ORG. L. REV. 465, 466 (2006).
[66] Sinan Caya, *Creditor-Psychology, with Special Emphasis on the Eurozone Crisis*, 185 SOCIAL AND BEHAVIORAL SCIENCES 84, 84 (2015) (emphasis added).
[67] *Id.* (citation omitted).

if they would have legal tools that control corporate decision making regarding spending and distributions to shareholders.

C. Recent Comments on Share Capital: An Outdated Concept?

The concept of share capital has been subject to large debate and criticism for decades. For example, Palmiter and Partnoy sustained that since the 1970s "few people believed the notion that [share] capital actually protected anyone."[68] They go further and establish that "[c]reditors *[don't] actually rely on par value for protection*, and *par value [doesn't] reflect economic value*."[69] Others, such as Jesper Lau Hansen, argue that low share capital requirements are a fallacy, since creditors will often demand personal guarantees; eliminating limited liability.[70] Consequently, Lau Hansen sustains that it is rare to establish a SUP with only one euro, since *creditors*, and not banks, will *require higher capitalization*.[71] Hansen clarifies that "to stipulate that the share capital of a company can be one EUR is not to say that it should be that sum; *it is to say that the size of the share capital should be determined ad hoc by the parties themselves and not by legislators*."[72] The author suggests that low share capital requirements are more of a legislative aspiration, than a practical reality. Therefore, if creditors demand certain share capital requirements from borrowers, it can be concluded that these seem to view share capital as a means for their protection. In fact, Enriques and Macey state that in the real world, creditors do not care about share capital requirements.[73] They argue that:

> The primary reason that creditors do not give significant weight to [share] capital is that as soon as a firm starts to operate, it can use its capital to purchase assets that decline in value. Because a firm may immediately begin to incur losses, either merely in the normal course of business or by entering into one of the many kinds of unfair transactions that Article 11 of the Second Directive does not cover, the initial paid-in capital is a meaningless amount. In other words, creditors willing to inform themselves about a firm's existing equity cushion must examine its entire balance sheet. Moreover, creditors must consider the current value of the firm's assets, not the value of such assets at the time of purchase.[74]

Conclusively, Palmiter and Partnoy explain that the concept of share capital has lost its meaning since 1970, and "[o]ver time, the teeth of these statutes have been removed, and states permitted corporations to issue low-par or no-par stock."[75] Furthermore, they elaborate that legislation in the United States regarding share capital requirements has basically disappeared.[76] This may respond to a change in the financial field. In this sense, these *traditional* rules of capital requirement were implanted in a moment mere financing "was primarily based on debt rather than equity financing."[77] The concept of share capital responded to a historical reality that is no

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[68] PALMITER & PARTNOY, *supra* note 56, at 279.
[69] *Id.* (emphasis added).
[70] Lau Hansen, *supra* note 28, at 185.
[71] *Id.*
[72] *Id.* (emphasis added).
[73] *See* Enriques & Macey, *supra* note 61, at 1186.
[74] *Id.* at 1186-87.
[75] PALMITER & PARTNOY, *supra* note 56, at 279–80.
[76] *Id.* at 280.
[77] *See* Wolfgang Schön, *The Future of Legal Capital,* 5 EUR. BUS. ORG. L. REV. 429, 432 (2004).

more. This, since capital markets have become key and leaders of financing operations and ventures of companies.[78]

Additionally, other authors suggest that the concept of share capital is just plain and *outdated*.[79] John Armour, in his article *Legal Capital: An Outdated Concept?*, rebuttals various arguments which favor share capital requirements, in order to establish that this concept has no present value or effect.[80] First, he states that the benefits obtained by creditors through share capital requirements have been substituted by loan covenants.[81] Sophisticated lenders do not simply rely on present legislation. They take affirmative steps to reduce their risk exposure by including in said loan covenants limitations to the actions and decisions by the borrower's company. In other words, commercial parties already incur in these costs themselves by stipulating in the agreement with the borrower. Additionally, Armour states that the minimum capital requirements impose an undue burden to small companies, which are typically owner managed.[82] This affects both the entrepreneurial spirit of individuals and the economic growth in Member States.[83] Moreover, Armour suggests that share capital requirements do not reflect the quality of an entrepreneur's project.[84] Thus, share capital requirements do not give *certainty* to creditors on the possibility of default, hence, its uselessness. Accordingly, "it makes no sense for a highly-leveraged company that transports radioactive waste to have the same minimum capital requirements as a company with little leverage that designs software."[85] In other words, requiring the same share capital to different types of companies does not result in equal creditor protection. This arises due to companies having different financial structures depending on what industry it develops its business.

Similarly, legal scholars often scrutinize the costs capital requirements impose in parties. Armour suggest that mandatory rules based on share capital are outweighed by the benefits creditors can obtain from them.[86] Regarding this issue, the author maintained that minimum share capital requirements constitute a substitution to the possible negotiations and terms the contracting parties may stipulate. Accordingly, these types of requirements reduce the need for creditors to negotiate a more efficient alternative; *default terms*.[87] On this issue, Armour suggest that the possibility to negotiate default terms with borrowers equals a more efficient alternative than capital requirements.[88] Also, Wolfgang Schön exposes that Member States, such as the United Kingdom, have considered eliminating minimum capital requirements and replacing it with fiduciary duties towards directors of corporations.[89] That is to say, it substituted the supposed creditor protection provided by minimum capital requirements for a fiduciary duties towards them. This proposal is troubling to us, given that in most instances creditors are protected by the agreements they reach with the lenders. Consequently, they do not need this *extra protection*. To this effect, Armour establishes that "[j]ust as it is undesirable to offer

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[78] Dorothea Schäfer *et al.*, *The Determination of Debt and (Private) Equity Financing: The Case of Young, Innovative SMEs from Germany*, 11 INDUSTRY AND INNOVATION 225 (2004).
[79] Armour, *supra* note 59.
[80] *Id.*
[81] *Id.* at 16.
[82] *Id.* at 17.
[83] *Id.* at 17–18.
[84] *Id.*
[85] Enriques & Macey, *supra* note 61, at 1186.
[86] Armour, *supra* note 59 at 21.
[87] *Id.*
[88] *Id.* at 21–22.
[89] *See* Schön, *supra* note 76, at 431.

creditors *too little* protection, it may be equally undesirable to mandate *too much protection* that is to emphasi[z]e creditors' interests at the expense of other constituencies."[90]

In contrast, Enriques and Macey stipulate the adverse effect and inefficiency of the share capital doctrine.[91] These authors analysed that different aspects of the share capital doctrine impose substantial costs. First, they maintain that the share capital doctrine "burdens companies. . . by making their financial structures inflexible, burdening them with cumbersome procedures, and forcing them to pay for useless expert reports and legal advice."[92] Equally, this problem eliminates certain opportunity costs from the company, since it compromises a determined amount of assets to be *frozen*.[93]

Finally, it has been suggested that minimum capital requirements alone "[do] not necessarily ensure that the company will have enough money available to meet debts and other liabilities as they fall due . . . and so may not provide protection to creditors."[94] In view of this possibility, the Impact Assessment for the 2014 Directive clarifies that "some creditors, such as banks, often *insist on other means of additional protection be it a personal guarantee, a mortgage or any other form of security*."[95] Consequently, although in reality creditors are very well protected by their own requirements, other *legislative* means should be required regarding corporate decisions in order to ensure creditor protection. The 2014 Directive does not fall short in providing these alternative safeguards that ensure the SUP will be able to pay its debts over the next year after a distribution has been made.[96] These alternative safeguards will be examined in the following section.

D. Alternative Safeguards for Creditors

The 2014 Directive explains that various stakeholders were concerned with the proposed low share capital requirement.[97] Nonetheless, they maintained that if this requirement was accepted as proposed, it should be complemented with other protective measures, such as *solvency tests*.[98] In other words, stakeholders are, to some degree, concerned with the low share capital requirements, and agree that there are other means that may provide them the certainty and protection needed. To this effect, Vanessa Knap examines the alternative safeguards provided by the 2014 Directive.[99] In her article, she explains how the 2014 Directive tries to balance the *moral hazard* that can arise between the single member of the SUP, distributions,[100] and creditor protection.[101] In this sense, the author explains that the 2014 Directive proposes to create two tests in order to deal with the protection of creditors *vis-à-vis* the moral hazard faced by single

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[90] Armour, *supra* note 59, at 11 (emphasis added).
[91] Enriques & Macey, *supra* note 61.
[92] *Id.* at 1184–85.
[93] *Id.*
[94] *See* Knapp, *supra* note 56, at 200
[95] *See Commission Staff Working Document, Impact Assessment, accompanying the document Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, SWD (2014) 124 final (Apr. 9, 2014) at 37 (emphasis added).
[96] *Id* at 36.
[97] *See Commission Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, COM (2014) 212 final (Apr. 9, 2014) at 4.
[98] *Id.*
[99] Knapp, *supra* note 56.
[100] *Id.* at 191. (The author explains that when referring to distributions, she means distributions made to stockholders. It is to say, dividends or *any financial benefit* derived from to SUP to the single-member).
[101] Knapp, *supra* note 56, at 191.

members when determining the making of distributions.[102] These tests serve as the *alternative* for high share capital requirements. It is to say, the European Commission seems to have found that in order for this proposal to receive better *acceptance*, the net asset and solvency tests would serve as a compromise between share capital requirements and creditor protection. As explained by Knapp, the *net asset test* establishes that the "SUP cannot make a distribution if [its] net assets on the closing date of the last financial year are, or following the distribution would become lower than the amount of the share capital plus those reserves which may not be distributed under the SUP's articles of association."[103] On another hand, the *solvency test* states that the "SUP shall not make a distribution to the single member if it results in the SUP being *unable to pay its debts as they become due and payable after distribution*."[104] Moreover, this test requires the SUP to make a full inquiry into the businesses that may affect its solvency, and prevents the SUP from making distributions that would make it unable to meet its financial obligations.[105] Finally, it is important to clarify that in order to make distributions, the SUP must meet *both* tests. Thus, these tests are clear examples of how there are efficient alternatives for dealing with creditor protection; share capital requirements are not the only route available.

This was not the first instance these tests were devised. Authors such as Manning and Hanks, in their book *Legal Capital*, have proposed similar tests as an alternative to share capital requirements. Regarding the *solvency test*, these elucidate that it aims at barring shareholders from distributing the company's assets, leaving it with insufficient funds to pay its creditors.[106] Similar to the solvency test in the 2014 Directive, the solvency test proposed by Manning and Hanks aims at determining if the company is able to pay its creditors even after a distribution is made.[107]

Another test suggested by Manning and Hanks is the *bankruptcy test*, also known as the balance sheet test.[108] As the name suggests, under the balance sheet test, the balance sheet of the company is analyzed to compare the assets of the company in relation to its liabilities.[109] By doing this comparison, the shareholder, or a person contesting a distribution, should determine that if the company performs a certain business activity, it would not constitute an impairment of its financial obligations.[110] Nonetheless, this test has different variations, such as stated capital/surplus, stated capital, earned surplus, net worth, and adjusted net worth that serve as different types of tests to determine a company's solvency.[111]

Although many tests exist to provide creditors with a greater degree of protection, the 2014 Directive only aims at adopting two tests: the solvency test and the net asset test. As a result, the Impact Assessment expressed that it is their opinion that —in order to provide better protection to creditors— other tests should be demanded from single-members before making a

[102] *Id.* at 193.
[103] *Id.* at 193–94.
[104] *Id.* at 194 (emphasis added).
[105] *Id.* at 194.
[106] MANNING & HANKS, *supra* note 57, at 63.
[107] *Id.* at 63.
[108] *Id.* at 65.
[109] *Id.* at 65.
[110] *Id.*
[111] MANNING & HANKS, *supra* note 57, at 67–78.

distribution; they suggested the balance sheet and solvency test.[112] Nonetheless, they agree with maintaining a minimum capital requirement of just one euro.[113]

Another alternative not involving tests relates to the terms that can be negotiated between the parties. In this sense, if a creditor feels it is negotiating a transaction with a substantial risk, he or she may charge higher interests, request a collateral of some kind, or impose limitations and restrictions on shareholder distributions.[114]

IV. Share Capital Requirements: A Comparative Analysis

A. United States of America

According to Catá Backer, the United States has taken two approaches to share capital requirements.[115] The first one consist of the traditional approach, which is related to the Law of Delaware. Under this approach, companies must retain a minimum on their capital account, based on the statutory minimum price.[116] It is to say, the product of par value (statutory price) and outstanding shares is equal to share capital. Conversely, Catá Backer explains the approach taken by the Revised Model Business Corporations Act (hereinafter, "RMBCA"). The approach taken by the RMBCA "is based on assessment of corporate solvency at the time of distributions to shareholders."[117] Nonetheless, both approaches do not demand from companies a minimum amount to be saved to guarantee their solvency.[118] In other words, these approaches are identical to that of the 2014 Directive, in the sense that neither of these three require companies to have save a determined minimum amount of money.

Of the two approaches aforementioned, the one that has gained major popularity in the United States is that of Delaware. Delaware has been considered the jurisdiction that has most influenced the development of American Corporate Law.[119] Therefore, it is important to examine the relevant case law of Delaware and its implications on share capital requirements. Nonetheless, it is important to take into consideration the fact that minimum capital requirements have been abolished in the United States.[120] In *Klang v. Smith's Food & Drug Centers, Inc.*, the Supreme Court of Delaware examined an action of the board of directors which was contested on the grounds that it did not meet the requirements of the *Delaware General Corporate Law*.[121] To this effects, the Supreme Court of Delaware clarified that the board of directors is not subject to one method of valuation in order to determine if it meets the requirements made by law.[122] When examining the validity of a revaluation of the company's assets, the Court determined that, "[r]egardless of what a balance sheet that has not been updated may show, an actual, though unrealized, appreciation reflects real economic value that the corporation may borrow against or

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[112] *See Commission Staff Working Document, Impact Assessment, accompanying the document Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, SWD (2014) 124 final (Apr. 9, 2014) at 40–41.
[113] *Id.*
[114] *See* Enriques & Macey, *supra* note 61, at 1188.
[115] LARRY CATÁ BACKER, COMPARATIVE CORPORATE LAW: UNITED STATES, EUROPEAN UNION, CHINA AND JAPAN 793 (2002).
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] *See* Harwell Wells, *The Modernization of Corporation Law: 1920-1940*, 11. U. PA. J. BUS. L. 573 (2009).
[120] Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 739–42 (2001).
[121] Klang v. Smith's Food & Drug Centers, Inc., 702 A.2d 150 (Del. 1997).
[122] *Id.* at 152–56.

that creditors may claim or levy upon."[123] Furthermore, the Court determined that "[a]llowing corporations to revalue assets and liabilities to reflect current realities complies with the statute and serves well the policies behind this statute."[124] As we can see, the Supreme Court of Delaware chose a different path to determine the financial soundness of the company. We think that if the same Court, seventy years ago, would have examined these same facts, it would have relied heavily on the concept of share capital requirements to determine the legality of the board's actions. On the contrary, the Court in *Klang* relied heavily in the impairment of capital doctrine.[125] Said court emphasized in other means for creditor protection, such as the surplus and insolvency tests.[126] These being alternative tools to using the primitive concept of share capital. Finally, the concept of share capital in the United States has been said to have no future, and that it can be *categorized as obsolete*.[127]

B. Japan

According to Catá Backer, share capital requirements in Japan are "[closer] in spirit to those of Germany and France than they are to those of the United States."[128] However, the author was referring to the Germany and France of 2002, when both States had strong minimum capital requirements. Nonetheless, this comparison is still valid, since these States currently do not have minimum capital requirements. Accordingly, by 2016 the scene has changed dramatically. Tomotaka Fujita gives us an insight regarding this issue in Japan.[129] Fujita illustrates that Japan has no share capital requirement, and that it is possible to "incorporate a company with a capital of *one yen*."[130] Moreover, the author establishes that prior to 2005, the Commercial Code *had share capital* requirements, but an amendment in 2005 eliminated that requirement.[131] Fujita goes further to suggest that the elimination of share capital requirement, by the amendment of 2005, removed a "burden for the incorporation of small firms while the requirement had not provided significant protection for their creditors."[132] Nevertheless, it is important to distinguish that the *Companies Act* of 2005, still does not attend specifically the issue regarding small and medium sized companies.[133] This, being a legislative requisite present in all other States.

The share capital requirements of Japan are identical to that of the 2014 Directive. Consequently, if the removal of share capital requirements in Japan did not result in creditor fraud, it would not be of a surprise that the 2014 Directive is going to have the same outcome. Finally, it is important to note that Japan is consistently shaping its Corporate Law to resemble that of the United States.[134] This, since —for example— the phenomena of takeover bids arrived to this State in 2005.[135]

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[123] *Id* at 154.
[124] *Id.*
[125] CATÁ BACKER, *supra* note 114, at 806.
[126] *Id.* (these tests were discussed in part II (D).
[127] *See* Armour, *supra* note 59, at 7.
[128] CATÁ BACKER, *supra* note 114, at 967 (citation omitted).
[129] Tomotaka Fujita, *Regulation on Simplified and Foreign Companies in Japan*, 33 ARIZ. J. INT'L & COMP. L. 93 (2016).
[130] *Id.* at 100 (emphasis added).
[131] *Id.*
[132] *Id.* at 101.
[133] *Id.* at 93–94.
[134] Michael Cody, *Hostile Takeover Bids in Japan? Understanding Convergence using the Layered Approach*, 9 RICH J. GLOBAL L. & BUS. 1, 1 (2010).
[135] *Id.*

C. The People's Republic of China

The People's Republic of China's Corporate Law has the particularity of having a substantial socialist influence.[136] Consequently, the Chinese share capital requirements differ greatly from the other States we have examined. Hence, the People's Republic of China employs serious share capital requirements in its Company Law. It is important to note that the previous Chinese Company Law *explicitly prohibited single member companies*. Under the previous Company Law, limited liability companies were required to have at least two shareholders.[137]

Steven Dickinson provides an analysis of the share capital requirements required by the Chinese law, which was enacted only ten years ago.[138] On one point, the author suggest that the minimum capital requirement of the People's Republic of China is due to its primitive credit reporting system.[139] On another point, the author states that the new capital requirement, which was drastically decreased, aimed at making "the corporate form available to more individual investors and to more investors from China's less developed regions."[140] In this sense, the previous Company Law of China imposed different capital requirements from companies depending in the type of business activities these were to incur. For example, 100,000 Chinese Yuan[141] were required to incorporate businesses that provided services.[142] The new Company Law of China imposes a minimum share capital requirement of 30,000 Chinese Yuan[143] to limited liability companies with two or more shareholders, without distinction of the type of business and of 100,000 Chinese Yuan for companies with a single shareholder.[144] It is to say, that for the new Company Law of the People's Republic of China, instead of using the type of business as the criteria for share capital required, it now uses the number of share-holders as a determinant factor.[145]

Single-member LLCs are also subject to restrictions under the new Company Law of China.[146] To this effect, Dickinson clarifies that the said law requires single members to pay the capital requirement in a single installment and these are proscribed from organizing another single-member LLCs.[147] In other words, in addition to the substantial minimum capital required, the sole shareholder of a single-member LLCs cannot have more than one single-member LLC.

D. European Union

Member States from the European Union have different national minimum capital requirements.[148] Nevertheless, Piere-Henri Conac indicated that, by the time of the 2014 Directive, only *eleven* Member States had share capital requirements above one euro.[149] In other word, the author identified how in only twelve years the European Community has initiated a trend toward

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[136] CATÁ BACKER, *supra* note 114, at 973.
[137] *See* Steven M. Dickinson, *Introduction to the New Company Law of the People's Republic of China*, 16 PAC. RIM. L. & POL'Y J. 1, 4 (2007).
[138] *Id.* at 3.
[139] *Id.*
[140] *Id.*
[141] This is equivalent to 15,500 U.S. dollars.
[142] *See* Dickinson, *supra* note 136, at 3.
[143] This is equivalent to 4,500 U.S. dollars.
[144] *See* Dickinson, *supra* note 136, at 3–4.
[145] *Id.*
[146] *Id.* at 4.
[147] *Id.*
[148] *See* CATÁ BACKER, *supra* note 114, at 881.
[149] Conac, *supra* note 7, at 150.

the abolition of share capital requirement.[150] Specifically, he identified Member States such as Poland, Spain, Greece, and Luxembourg that since 2012 have initiated or enacted legislation for the establishment of companies without any share capital requirement.[151] From the insight brought by Conac, it is clear that the reality in Member States concerning share capital in SMEs does not differ greatly from that contained in the 2014 Directive. Moreover, it is important to consider the expressions made by Advocate General La Pergola in the case of *Centros*.[152] In said case, La Pergola sustained that "in the absence of [harmonization], competition among rules must be allowed free play in corporate matters."[153] Moreover, the author argues that this *trend* is not an issue regarding harmonization of legislation, but a recognition of the consequences of the rivalry between nations.[154]

In short, as we exposed, share capital requirement throughout the Member States have drawn a uniform trend towards eliminating said requirements. Thus, it is evident for us that the share capital requirement proposed in the 2014 Directive does not differ from the already present trend.

E. Comparative Analysis: Findings

When Catá Backer wrote his book, *Comparative Corporate Law: United States, European Union, China, and Japan*, it seems that the world had a different view on share capital requirement from nowadays. It is evident that, prior to 2002, share capital requirements were an indispensable tool for creditor protection and corporate solvency. Nevertheless, from 2002 to the present day, this view has drastically changed. As discussed previously, these States do not have minimum share capital requirements nowadays. We understand that this is the product understanding that share capital requirements were not an efficient means for creditor protection. Also, it would be no surprise that the *trends* that influenced the European and Western community could have spread through the entire world. Consequently, this has caused States to modify the tools they use to protect creditors and ensure capital structure health.[155] Nonetheless, from the States examined, it is important to distinguish the circumstances of China. As we explained, China has a socialist influence and background. Taking this factor into account, we understand that this has caused China to lack the innovation other States have integrated into their national laws. However, it would not be of any surprise that in a near future China will succumb to the *trend* other States have gone into, and eliminate share capital requirements. This, given that China has "experienced a gradual opening to capitalist initiatives."[156]

V. Conclusion

Without a doubt, the 2014 Directive would prove successful at achieving the goal it states concerning the economic development of the Member States of the European Union. It is our conclusion that the way said Directive is structured provides SUPs the flexibility needed to facilitate cross border investments.

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[150] *Id.*
[151] *Id.*
[152] Case C-212/97, Opinion of AG La Pergola in Centros Ltd. v. Erhversus-og Selkabssyrelsen, 1999 E.C.R. I-1459, at I-1461.
[153] *Id.* at ¶ 20.
[154] Conac, *supra* note 7, at 150.
[155] These tools were described in part II. D.
[156] Yves Dezalay & Bryant G. Garth, *Corporate Law firms, NGOS, and Issues of Legitimacy for a Global Legal Order*, 80 FORDHAM L. REV. 2309, 2319 (2012).

Nevertheless, despite our thesis and evidence that show that low share capital requirements do not reduce creditor protection, some Member States *still* argue the contrary. It is to say, they still view share capital requirement as a tool for protecting creditors. The reason for this is not completely clear. However, we can speculate that this is a mere protectionist measure, albeit extreme. A more rational explanation is that States that support high capital requirements suffer from poor development in the accounting and financial sector.[157] Likewise, since minimum capital requirements serve as the "easy way out" for States who do not have complex and developed accounting and financial sectors.[158] Therefore, States that support high share capital requirements do not acknowledge nor recognize the advantages brought by other more efficient alternatives. Nonetheless, we see no other justification for imposing such burdensome requirements, since there are more efficient alternatives available for States.

Regarding this last issue, other tests provide better measures for creditor protection. The solvency and liquidity tests provide more assurance as to the risks faced by the debtor. One measure is not enough though. Thus, a more holistic approach should be ideal to quantify and clearly identify these risks. This approach should evaluate the following: (1) debtor's business and industry,[159] (2) cash flow of the debtor, (3) debt to equity and debt to asset ratios, (4) future cash flow projections, and (5) debtor's credit history. This would provide a more comprehensive and holistic analysis to determine if distributions may be made.

Notwithstanding, some issues still require attention to provide the best possible solution. Although SUPs are a great vehicle for investments across border given their limited liabilities, the European Economic and Social Committee have serious concerns regarding said limited liability.[160] To this effects, they establish that given that SUPs cannot build up reserves, this may cause creditors to require personal guarantees. Hence, losing the limited liability.[161] Accordingly, the European Economic and Social Committee sustained that SUPs should be able to build up reserves, since this may permit them to prevent long-term undercapitalization in subsequent years.[162] This issue should be reevaluated, since the requirement of personal guarantees has become a common practice between creditors.

Nevertheless, as linked capital markets continue to develop and grow, these requirements will continue to be no more.[163] Noting the present trend among Member States regarding share capital requirement, we see no obstacle nor opposition for the implementation of this proposal. Accordingly, the world is moving towards an era where share capital is becoming more of a primitive concept, the European Union has not been the exception in this movement.

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[157] MANNING & HANKS, *supra* note 57, at 20–23.
[158] *Id.* at 20.
[159] Within this, risk and nature of the industry should be evaluated.
[160] *See Opinion of the European Economic and Social Committee on the "Proposal for a Directive of the European Parliament and of the Council on Single-Member Private Limited Liability Companies*, 2014 O.J. (C 458) 19, *available at* http://eur-lex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:52014AE2794&qid=1491869699244&from=EN (last visited Apr. 5, 2017).
[161] *Id.* at ¶ 1.3.
[162] *Id.* at ¶ 1.4.
[163] *See* CATÁ BACKER, *supra* note 114, at 794.

DEFINING MATERIALITY: DRAFTING ENFORCEABLE MAC PROVISIONS IN BUSINESS COMBINATION AGREEMENTS FOLLOWING *IBP V. TYSON*

JOHN PRINZIVALLI*

I. INTRODUCTION

Much of commercial contracting involves the allocation of risk among transaction parties. Parties have a vested interest in strategically structuring deals so as to maximize their potential gain while minimizing loss. However, deal risk is not homogeneous nor monolithic; rather, it is diverse and case specific. Such risk can be conceptualized as encompassing systemic risk (e.g., changes in the broader economy), indicator risk (e.g., failure to reach performance targets), agreement risk (e.g., negative externalities from the deal making process), and business risk (e.g.,

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consequences of ordinary operations).[1] Traditionally, parties may leverage a litany of contract provisions, such as representations and warranties, covenants, and indemnification, to allocate deal risk both efficiently and equitably. Parties assume risk as a function of these provisions' scope, often manifest in how broadly or narrowly such clauses are drafted.[2] Even marginal changes in syntax shift risk between deal participants.[3]

Business combination agreements present unique challenges to drafters – warranting more nuanced contractual solutions. In corporate acquisitions, there is often an interim period between the time of deal signing and closing to comply with regulatory and securities laws, obtain antitrust and regulatory approval, and confirm all requisite third party consents.[4] This non-simultaneous signing and closing allows for the occurrence of intervening events that may impair the target's value before the final payment of consideration and transfer of ownership – which is of acute worry to buyers. Various risk-sharing devices exist to indirectly ameliorate buyers' concerns, including bring-down representations and warranties at the time of closing (allowing remedy for breach) and earn-out provisions (conditioning partial deal consideration on post-closing target performance).[5]

Additionally, parties may directly allocate pre-closing adverse change risk (risk that a material development will negatively impact the value of target during the interim period) using "material adverse change" ("MAC") or "material adverse effect" provisions ("MAE").[6] These terms are interchangeable and will be subsequently referred to as MAC clauses. MAC provisions allow a party in the agreement, often the buyer, to exit the deal free of cost and penalty upon the occurrence of such a materially adverse event. Though ubiquitous and heavily negotiated, MAC clauses are subject to a tradition of vague drafting and the near unanimous preference of courts to apply a strict standard for determining the existence of a MAC.[7] Finding of MAC occurrence is rare, particularly in Delaware, where courts have established a materiality standard[8] so rigorous that no buyer has successfully proven the existence of a MAC sufficient to terminate a deal to date.[9]

In addition to reflecting on the MAC materiality standard established by the Delaware Chancery Court, this article will discuss drafting solutions to facilitate MAC clause enforceability. Due to the Delaware Court's high materiality standard and parties' traditional preference for vague MAC clause drafting, the historical probability of deal cancellation from MAC provisions is low. Therefore, this article will weigh the marginal cost and benefit of vague MAC clause drafting relative to the alternative, with greater specificity. The article will argue that despite benefits from strategically vague drafting, MAC provision specificity, in the form of

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[1] Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2073 (2009).
[2] TINA L. STARK, DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO 19 (2nd ed. 2014).
[3] *Id.* at 138.
[4] Miller, *supra* note 1, at 2017–18.
[5] Adam B. Chertok, *Rethinking the U.S. Approach to Material Adverse Change Clauses in Merger Agreements*, 19 U. MIAMI INT'L & COMP. L. REV. 99, 102 (2011).
[6] The term *material adverse effect* is often used as an alternative to the defined term *material adverse change*. *See* Kenneth A. Adams, *A Legal Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 17 (2004); *see also* David Cheng, *Interpretation of Material Adverse Change Clauses in an Adverse Economy*, COLUM. BUS. L. REV. 564, 568 n.20 (2009).
[7] Bryan Monson, *The Modern MAC: Allocating Deal Risk in the Post-IBP v. Tyson World*, 88 S. CAL. L. REV. 769, 771 (2015).
[8] See further discussion *infra* Section III.
[9] Cheng, *supra* note 6, at 598.

explicit benchmarks and quantifiable thresholds, offers the most effective and efficient drafting strategy for both buyers and sellers in business combination agreements.

In sum, this article will provide a comprehensive review of Delaware's interpretation of MAC provisions since *IBP, Inc. v. Tyson Foods, Inc*. The *Tyson* case represents the seminal treatment of MAC provisions in Delaware and the logical anchor for discussion of the subject . Part II will set forth the general purpose of the standard MAC clause, by discussing the history, common syntax, and evolving application of the provision in business combination agreements . Part III will review Delaware case law interpreting MAC clauses, focusing on the seminal *Tyson* case and its lasting comment on the threshold for MAC clause materiality. This discussion will include a survey of cases subsequent to *Tyson* where parties attempted to thwart a previously signed deal by exercising a MAC clause. Part IV will discuss criticisms and consequences of modern MAC provision case law. Part V will outline practitioner best practices going forward, by offering solutions for the effective drafting of future MAC provisions from the perspective of both buyers and sellers. Part VI will conclude.

II. DEVELOPMENT AND PURPOSE OF MATERIAL ADVERSE CHANGE PROVISIONS

A. Deal Risk and Use of MAC Provisions to Ameliorate Risk Concerns

In many corporate acquisitions,[10] there is delay (the duration of which is deal-specific) between the time parties agree to deal terms (the signing) and the time the transaction is effectuated, ownership transferred, and consideration paid (the closing).[11] Various factors may drive this lag in deal finalization. Depending on deal structure, corporate and securities laws often require shareholder approval prior to transaction completion.[12] Target shareholders may have the right to vote on pending deals, particularly with regard to mergers and the sale of all or substantially all of the target's assets, while acquirer's shareholders retain similar approval power in certain stock-for-stock and cash-for-stock deals.[13] Such shareholder approval may take between forty to ninety days, depending on transaction structure.[14] Additionally, deal closing is conditional on antitrust and regulatory approvals.[15] The government is empowered through the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HRS") to vet business combinations where the parties meet guidelines with regard to the size of the transaction and the parties' net assets and sales.[16] Depending on the seriousness of the antitrust concern and the complexity of the pending transaction, deal closing can be delayed by as little as thirty days to over a year (though parties typically can roughly estimate this duration in advance).[17] Further, parties generally must obtain approval from requisite government agencies if operating in a regulated

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[10] Not all business combination transactions have an interim period between deal signing and closing . Particularly with small business combinations, the transaction may be completed with simultaneous signing and closing . *See* JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 439 (1975).

[11] Robert T. Miller, *Cancelling the Deal: Two Models of Material Adverse Change Clauses in Business Combination* Agreements, 31 CARDOZO L. REV. 99, 108 (2009).

[12] Miller, *supra* note 1, at 2017.

[13] *Id.* at 2024-48.

[14] *Id.* at 2018-19.

[15] *Id.* at 2019.

[16] Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (2006).

[17] Miller, *supra* note 1, at 2021.

industry.[18] Length of the vetting process is transaction specific; however, delay for regulatory approval is often longer than delays due to corporate, securities, or antitrust laws.[19] Finally, the process of seeking third party consents may further necessitate an interim period between deal signing and closing.[20] Many commercial contracts include clauses that provide that a party may not execute a future business combination without the consent – or approval – of the counterparty.[21] These clauses are designed to empower counterparties to affirmatively control whether they honor past contracts when the character of the other side to the deal changes through business combination.[22] As part of a pending transaction, parties to the business combination must either: (1) seek the consent of all contractual counterparties; or (2) breach the prior agreements.[23] Obtaining these third party consents requires time between signing and closing, though less time than incurred by previously mentioned legal and regulatory compliance.[24] Regardless of source, delayed performance is commonplace with business combination agreements — particularly with public companies.[25]

During this interim period, intervening events may occur that affect a party's desire to complete the deal.[26] Because no actor in the transaction — acquirer, seller, target — nor any external influence (e.g., industry trend) is static, such delay confers risk.[27] Parties are therefore burdened with allocating deal risk stemming from the interim period between signing and close.[28] Parties apply standard contract concepts to allocate risk, including representations and warranties, covenants, and closing conditions.[29] Further, parties may strategically include deal protection measures such as no-shop provisions (prohibiting seller from soliciting offers from other bidders) and termination fees (penalties paid by target to buyer if target walks from the deal prior to close) to prevent third parties from interfering with the pending transaction.[30] Perhaps the most direct attempt to allocate the risk stemming from this interim period, and the clause most heavily negotiated is the MAC provision.[31] This clause triggers a party's right to walk from a pending deal with the occurrence of a negative event not otherwise accounted for in the contract

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[18] For example, a deal involving cable television companies may require approval from the Federal Communication Commission, while the Federal Reserve may have the authority to approve a deal between banks . *See* Miller, *supra* note 1, at 2021-22.
[19] Freund, *supra* note 10, at 437-39.
[20] Miller, *supra* note 1, at 2023.
[21] Freund, *supra* note 10, at 435-439.
[22] *Id.*
[23] Miller, *supra* note 1, at 2024.
[24] *Id.*
[25] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 93 (7th ed. 2007).
[26] Richard A. Posner and Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 93 (1977).
[27] Note that in cash deals, interim deal risk is only an issue for buyers, while in stock-for-stock and cash-for-stock deals, deal risk is an issue for both buyer and seller . This is because consideration paid in target's stock saddles seller with an interest in the long term viability of the target past deal close, thus aligning buyer and sellers' interests . Such nuance aside, this article focuses on the most common scenario in which a buyer will claim that the target suffered a MAC as means of exiting a deal . *See* Miller, *supra* note 11, at 108–09.
[28] Kari K. Hall, *How Big is the MAC? Material Adverse Change Clauses in Today's Acquisition Environment*, 71 U. CIN. L. REV. 1061, 1062 (2003).
[29] Jeffrey Thomas Cicarella, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423, 426 (2007).
[30] *Id.*
[31] *Id.*

that threatens the target's value.[32] Rather than triggering liquidated damages, MAC clauses grant a contractual right that permits a party to exit a deal, theoretically without additional cost or penalty.[33] In practice, buyers either: (1) attempt to abandon the pending transaction; or (2) use a MAC clause as leverage to negotiate more favorable deal terms.[34] These provisions are ubiquitous in business combination agreements, particularly in public-company mergers.[35] Thus, MAC provisions serve as a tool to allocate pre-closing deal risk that is most often borne by the target or seller.[36]

B. Evolution of the Modern MAC Provision

Historically, MAC provisions were mere boilerplate.[37] Used since at least 1947, MAC clauses originally were not the subject of nuanced focus nor protracted negotiation in the crafting of business combination agreements – they were brief and easily replicated.[38] A typical clause would allow a party to exit the deal before closing due to the occurrence of "any change, occurrence or state of facts that is materially adverse to the business, financial condition or results of operations" of the seller (i.e., the target).[39] These traditional MAC clauses were both broad and ambiguous (e.g., they often would contain lack of clarity regarding the sufficiency of adverse changes to prospective cash flows).[40] Despite these potential drafting issues and the high stakes of the transactions for which they were crafted, traditional MAC clauses were rarely invoked and litigated.[41]

In time, the marginalization of the MAC provision by practitioners pivoted to enhanced attention as buyers embraced the clause as an important risk mitigation tool . By the late 1980s, MAC clauses became the subject of increased litigation amid macroeconomic instability.[42] Volatility in the capital and product markets of the 1990s prompted further use and negotiation.[43] These changes were observable in substantial growth in the modification of the traditional MAC clause, particularly in the sophistication of exceptions and carve-outs (an approach that continues today).[44] This trend in MAC provisions – reflected in practitioners' substantial focus on their drafting and negotiation – fully materialized in the early 2000s.[45] Three developments drove the maturation of MAC provision approach and construction.[46] First, the recession of 2001

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[32] Chertok, *supra* note 5, at 102.
[33] Miller, *supra* note 1, at 2012.
[34] Dennis J. Block & Jonathan M. Hoff, *Material Adverse Change Provisions in Merger Agreements*, N.Y.L.J., Aug. 23, 2001, at 1.
[35] Chertok, *supra* note 5, at 102.
[36] Cicarella, *supra* note 29, at 426.
[37] It would not be until the 1990s that the elements constituting a MAC (and the exceptions thereof) would expand substantially . *See* Andrew C. Elken, *Rethinking the Material Adverse Change Clause in Merger and Acquisition Agreements: Should The United States Consider the British Model*, 82 S. CAL. L. REV. 291, 292 (2009).
[38] Ronald J. Gilson and Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 331 (2005).
[39] *Id.* (citing Freund, *supra* note 10, at 259–61).
[40] *Id* .
[41] *Id.*
[42] *See, e.g.*, Bear Stearns Cos., Inc. v. Jardine Strategic Holdings Ltd., No. 31731/-87, slip op. (N.Y. Sup. Ct. June 17, 1988), *aff'd mem.*, 533 N.Y.S.2d 167 (App. Div. 1988); Borders v. KRLB, Inc., 727 S.W.2d 357 (Tex. App. 1987).
[43] Gilson & Schwartz, *supra* note 38, at 339.
[44] Molly Brooks, *The "Seller-friendly" Approach to MAC Clause Analysis Should Be Replaced by a "Reality-friendly" Approach*, 87 U. DET. MERCY. L. REV. 83, 85 (2010).
[45] *Id.*
[46] Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 846 (2002).

– with the deterioration of equity markets and slowed economic growth – cooled merger and acquisition deal flow and drove renewed interest in, and motivation for, transaction termination.[47] MAC provisions were an obvious tool to pursue this goal. Second, the Delaware Chancery Court released the seminal *Tyson* decision that June, binding parties to a contested deal through the imposition of an elevated MAC materiality standard.[48] Among other consequences, the *Tyson* decision intensified debate among practitioners about the proper use of MAC provisions.[49] And finally, the terrorist attacks of September 11, 2001, caused lawyers to rethink the context of MAC provisions, leading to painstaking provision drafting, new carve-outs and carve-ins, and further stress on pending transitions by parties attempting to exercise their contractual rights under existing provisions to exit deals.[50] Parties responded to these exogenous pressures by increasingly contesting the negotiation of MAC provisions – which is reflected in the growth of the length and nuance of the modern MAC clause as well as the burgeoning professional literature on the subject.[51]

Even with the rebound of the economy and the passage of time from September 11, 2001, the developments of the early 2000s ushered in lasting change with regard to MAC provision construction and debate. Current MAC clauses serve as complex risk-allocation devices, including increasingly nuanced carve-outs that allow for the granular balancing of deal uncertainty between buyer and seller.[52] Their use and debate remains as topical as ever. For example, the credit crisis of 2007-2008 brought renewed attention to MAC provisions.[53] During this period, thirteen major MAC disputes arose, the largest of which involved deals valued from $1.5 billion to $25.3 billion.[54] If anything, these disputes publicized the modern approach to MAC provision drafting and further clarified the MAC clause materiality standard as one challenging, and if not impossible, for buyers to meet in a court of law.[55] Despite the difficulty in enforcing these clauses, MAC provisions remain hotly contested and central to the debate over acquisition risk allocation – giving rise to more disputes and litigation than "any other provision of business combination agreements."[56]

C. Function of the Modern MAC Provision

Again, MAC provisions are designed to protect buyers (and the target in stock-for-stock and cash-and-stock deals) from the negative contingencies that may arise before closing.[57] "Material adverse change" definitions exist in virtually every business combination agreement,

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[47] *Id.*
[48] *Id.* at 846–47. –47 . See further discussion *infra* in Section III.A.
[49] See further discussion *infra* in Section V.B; *see also* . *In re* IBP, Inc. *S'holders Litig.* v. Tyson Foods, Inc., 789 A.2d 14, 68 (Del. Ch. 2001) (commenting that "even where a Material Adverse Effect condition is . . . [broadly written . . .], that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner").
[50] Galil, *supra* note 46, at 847.
[51] Gilson & Schwartz, *supra* note 38, at 331.
[52] Elken, *supra* note 37, at 292.
[53] *Id.* at 291–-92.
[54] Chertok, *supra* note 5, at 105.
[55] *Id.*
[56] Daniel Gottschalk, *Weaseling Out of the Deal: Why Buyers Should Be Able to Invoke Material Adverse Change Clauses in the Wake of a Credit Crunch*, 47 HOUS. L. REV. 1051, 1058 (2010).
[57] MAC provisions exclude deliberate wrongdoing by target's management, which is addressed by interim covenants . Miller, *supra* note 1, at 2045.

despite the contentiousness of their negotiation and their penchant for litigation.[58] Though the specifics of the definition's construction is deal-specific, scholars can generalize common terms via empirical survey of publicly available provisions.[59] Today, a common MAC definition may read:

> [A]ny event, fact, circumstance, development, or change that, either singly or in the aggregate, would reasonably be expected to have a material adverse effect on various items, which usually include the business, financial condition, and results of operations of the company and its subsidiaries taken as whole, as well as the assets, liabilities, condition, properties, and prospects of the party.60

Such continuity in MAC definition is observable industrywide across the past five years (see Table 1 below). Despite such standardization, sellers generally advocate for narrow MAC definitional elements and broad exceptions in an effort to shift risk to buyers.[61] Such behavior is designed to increase the probability of transaction close and preserve the deal price even if the value of the target declines in the interim period. Conversely, buyers aim to shift such risk to sellers by expanding the elements of the MAC definition and minimizing carve-outs (exceptions to the definition).[62] These efforts effectively increase the probability of deal exit or term renegotiation in the event a target's value is threatened.

Table 1. Frequency of MAC Provision Elements/Exceptions (% of all deals >$100m)[63]

	2014	2013	2012	2011	2010
MAC on business, operations, financial condition	95	98	89	90	86
MAC on target's ability to close deal	55	56	44	51	43
MAC on bidder's ability to close deal	31	12	13	10	10
Losses over a specified threshold deemed to be a MAC	0	1	n/a	5	1

[58] *Id.*
[59] *Id.*
[60] *Id.* at 2045–46.
[61] *Nixon* PEABODY LLC,*MAC Survey:* MAC SURVEY 2014 at, NIXON PEABODY LLP, 4, http://www.nixonpeabody.com/files/171839_NP_MAC_SURVEY_2014.pdf (last visited Aug. 1, 2017) (hereinafter, the "NIXON PEABODY 2014 MAC SURVEY").
[62] *Id.*
[63] *Id.*; *id.* at 4; 6 (defining the sample as drawing from "publicly filed acquisition agreements for transactions with values in excess of $100 million that were dated between June 1 of the preceding year and May 31 of the current year . For this survey, [Nixon Peabody] generated a list of deals executed between June 1, 2013, and May 31, 2014, from publicly available information filed with the U.S. Securities and Exchange Commission") and *Nixon Peabody MAC Surveys* circa 2010, 2011, 2012, and 2013.

MAC on the benefits contemplated by the agreement	0	0	n/a	n/a	1
Ability of bidder to maintain continuity in operations pre/post closing	1	2	1	1	1
Ability of target to maintain continuity in operations pre/post closing	1	2	2	1	1
MAC on target prospects	2	1	4	5	1
MAC on agreement validity or enforceability	0	0	2	1	1

Structurally, MAC provisions, building on their initial definition, generally function as: 1) representation and warranties; or 2) closing conditions in a business combination agreement.[64] As a representation and warranty, parties can assert the nonoccurrence of a MAC since a given date (e.g., "since January 1, no MAC has occurred").[65] Further, MAC provisions can modify an exogenous representation, to serve as a seller assurance that a MAC has not occurred or as qualification to other representations and warranties (e.g., "no seller is a party to any litigation that would reasonably be expected to result in a MAC").[66] The effect of such clause is to cause minor breaches to become irrelevant . Additionally, a MAC definition may be incorporated as a stand-alone clause among the conditions precedent to closing (colloquially deemed a "MAC out").[67] Such provisions delineate circumstances that would empower seller to exit the transaction without liability; however, such drafting can be redundant.[68] Business combination agreements are often drafted with a "bringdown" of representations, where parties verify that representations claimed at signing remain accurate at closing – effectively duplicating the work of closing conditions.[69] Regardless of syntax or redundancy, there is much latitude in MAC definition and application to accommodate creative bargaining among parities for the facilitation of efficient risk allocation.

Though scholars observe some continuity in MAC definitions across transaction agreements, carve-outs are subject to intense negotiation and frequent deal-specific customization. Targets often include carve-outs in an attempt to isolate systemic or industry risk from the MAC definition as well as to exclude risks know by parties at the time of contracting.[70] The most common carve-outs cover general economic or business conditions, industry and financial market developments, force majeure events like war, terrorism, change in law, or changes in GAAP, or announcement of the agreement itself (along with concurrent actions taken in furtherance of the agreement).[71] Carve-outs addressing failure to meet internal financial projections or the estimates of industry analysts are also observed, though with less regularity.[72]

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[64] Adams, *supra* note 6, at 10-12.
[65] *Id.* at 10.
[66] *Id.* at 11.
[67] Chertok, *supra* note 5, at 106.
[68] Adams, *supra* note 6, at 11-12.
[69] *Id.*
[70] Chertok, *supra* note 5, at 108.
[71] Miller, *supra* note 1, at 2047 (providingMiller provides empirical data regarding the granular frequency of MAC provision elements, including carve-outs, in a study of 353 business combination agreements occurring between July 1, 2007 and June 30, 2008).
[72] *Id.*

Use and application of such MAC provision carve-outs has mirrored market, social, and economic events.[73] The period following September 11, 2001 was marked by buyer-friendly MAC provision drafting, with significant expansion of carve-outs for acts of terrorism, war, and broad market-wide volatility.[74] Seller-friendly drafting grew in the years following, reflected in growing lists of enumerated exceptions during the cycle of economic recovery between 2004 and 2007.[75] The credit crisis of 2008 abruptly halted this trend; however, as deal flow returned from 2010 to 2012, sellers regained negotiating strength.[76] Today, a more balanced dynamic exists – indicating cautious optimism regarding economic stability and sustained growth.[77] Thus, the drafting of MAC provisions, like the larger business combination agreements of which they are part, are as much a function of macro factors (such as the strength of credit markets to finance large acquisitions) as they of party-specific considerations. With that said, practitioners still have incentive to draft MAC provisions that are thoughtful, nuanced, and enforceable – an exercise made difficult by MAC jurisprudence that is at times ambiguous.

D. Conceptual Motivations for MAC Provisions

Before addressing the case law, the conceptual underpinnings of the MAC provision warrant review. Though the function of a MAC clause is to allocate risks associated with changes in the target's business, various factors may motivate parties – both buyers and sellers – to bargain for and agree to MAC provisions. Three main motivations help explain the behavior of contracting parties. First, MAC provisions provide an incentive for parties to share information.[78] Buyers may be concerned about information asymmetry – for the seller, through proximity and experience, is more informed about the target – which could depress transaction price or prevent an offer altogether (this is colloquially referred to as the "lemon problem").[79] MAC provisions can alleviate these worries by encouraging the seller to share information . In return for shifting pre-closing risk, rational buyers are potentially willing to pay more to complete the deal.[80]

Second, MAC provisions may incentivize sellers to preserve target value between signing and closing.[81] Illustrative examples of such investment include allocations for research and development, maintenance of human capital, and preservation of customer or supplier relationships.[82] Buyers may fear that seller, post signing, has less incentive to maintain the target absent a long term interest in the target's upside.[83] Thus, the target is susceptible to actions or omissions that may impair value.[84] This "investment theory" argues that MAC provisions help

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[73] *Nixon Peabody* 2014 *MAC Survey*, *supra* note 61, at 1; Karlee Weinmann, *Wary M&A Buyers Up Use Of Performance-Based MAC Clauses*, LAW360 (Oct. 22, 2012, 6:58 PM EDT), https), http://www.law360.com/mergersacquisitions/articles/388430/wary-m-a-buyers-up-use-of-performance-based-mac-clauses (where David Martland, head of Nixon Peabody's global and business transactions practice, commented that "in studying MAC clauses, [Nixon Peabody has] consistently found that their use and interpretation are strong indications of market conditions").

[74] NIXON PEABODY 2014 MAC SURVEY, *supra* note 61, at 1.

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] Galil, *supra* note 46, at 849.

[79] *Id.*

[80] Brooks, *supra* note 44, at 89.

[81] Gilson &and Schwartz, *supra* note 38, at 337.

[82] *Id.*

[83] *Id.*

[84] Brooks, *supra* note 44, at 89.

realign incentives in order to facilitate efficient operation and management of the target during the interim period.[85] And third, MAC provisions encourage competitive deal consideration by providing symmetrical price adjustments to buyers.[86] Prospective buyers may be wary of committing to a deal, for though they are bound at signing, sellers potentially could walk from the transaction if a more compelling offer arose.[87] Under the "symmetry theory," MAC provisions empower buyers with the same capacity to terminate the transaction between signing and closing under requisite circumstances.[88] Absent this symmetrical right, buyers have less incentive to contract, depressing deal prices.[89] Thus, MAC provisions may be employed to properly align incentives for the facilitation of deal signing and consideration maximization . Though no explanation is alone dispositive, each of these three theories provide insight into the ubiquity of MAC provisions and parties' continued affinity for their inclusion in business combination agreements.

III. DELAWARE CASE LAW INTERPRETING MAC PROVISIONS

Though seemingly empowering buyers with a tool to allocate greater deal risk to sellers, MAC provisions have increasingly been interpreted by the Delaware Chancery Court with growing suspicion when used to exit a pending transaction. This aversion is reflected in the fact that the court has never once found facts sufficient to terminate a deal under a MAC provision.[90] In Delaware, buyers must meet a high standard of materiality to establish MAC occurrence in business combination agreements[91] – rendering enforcement of these provisions limited and calling into question the time and expense incurred in the negotiation and drafting of these provisions.

A. *IBP, Inc. v. Tyson Foods, Inc.*

In the seminal case *IBP, Inc. v. Tyson Foods, Inc.*, the Delaware Chancery Court, interpreting New York law, reinforced this elevated threshold – rejecting Tyson's claim that intervening events permitted termination of the pending $4.7 billion deal.[92] By acquiring IBP (the

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[85] Gilson &and Schwartz, *supra* note 38, at 337.
[86] *Id.* at 335.
[87] For example, per *Revlon*, in certain circumstances where sale or firm break up is inevitable, the fiduciary duties of the target's directors are narrowed so that the targettarget's board's sole responsibility is to maximize immediate stockholder value by securing the highest deal price available . *See id.*; *see also*, *Id.* and Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,. 506 A.2d 173, 184 (Del. 1986).
[88] Gilson &and Schwartz, *supra* note 38, at 335-336.
[89] *Id.*
[90] Hexion Specialty Chems.,*Chemicals* Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).
[91] MAC provisions are also utilized in contracts other than business combination agreements, including as conditions precedent to funding via loan agreements and commitment letters . Few courts have developed a standard test to determine when a MAC has occurred with these agreements, mirroring uncertainty in the Delaware Chancery Court's treatment of business combination agreement MAC provisions . Douglas S. Buck, Elizabeth L. Corey, and Erick S. Harris, *CMBS Lenders Begin Invoking MAC Clauses with Investors*, FOLEY & LARDNER LLP (, Feb. 5, 2008), https://www.foley.com/cmbs-lenders-begin-invoking-mac-clauses-with-investors-02-05-2008., at 3. Courts have often found these non-acquisition MAC provisions to be ambiguous as drafted. *See* Capitol Justice LLC v. Wachovia Bank, N.A., 706 F. Supp. 2d 23, 29 (D.D.C. 2009) (rejectingwhere the court rejected Wachovia's efforts to distinguish from the Delaware Chancery Court's decision in Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008), deferring to a fact-finder to determine whether Wachovia used– *see* Section III.C – Wachovia's use of a MAC provision to avoid loan agreement obligations). , deferring to a fact-finder to determine whether a MAC occurred) .
[92] *IBPTyson*, 789 A.2d at 47.

largest American beef producer and second-largest pork producer), Tyson (the nation's largest chicken producer) attempted to become the world's preeminent meat products company.[93] Despite the fact that both firms were incorporated under the laws of Delaware, the merger agreement included a New York choice of law provision (which neither party contested in the litigation).[94] Part of the pending merger agreement included a broad MAC provision, permitting buyer exit with the:

> ...occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect...on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole.[95]

Note that IBP failed to include exceptions for general changes to the economy or either party's industry, seemingly shifting the majority of deal risk from buyer Tyson to seller IBP.[96] Despite this construction, the court looked beyond this explicit language in rendering its decision, narrowing the board provision through judicial interpretation .

Tyson asserted that target IBP's performance decline after deal signing (measured by drop in realized EPS relative to projected EPS) constituted an adverse change under the broadly negotiated MAC provision.[97] Specifically, Tyson claimed that the target's revised projections deviated materially from performance in past years, so much so that the upcoming year, 2001, would be the entity's worst since 1997.[98] The court acknowledged this performance was sub-optimal; however, failed to distinguish this decline in projections from the cyclical nature of the industry.[99] Specifically, in the near term, the court commented that such financial performance "for the next two years would not be out of line with its historical performance during troughs in the beef cycle."[100]

Ultimately, the court held that target IBP had not suffered a MAC (despite decline in bottom-line performance and accounting irregularities), and, that as a result, buyer Tyson was obligated to complete the transaction.[101] The court reasoned that a MAC must be a long term negative effect rather than a mere short-term downturn in prospects.[102] Specifically, Vice Chancellor Strine asserted that:

> A short-term hiccup in earnings should not suffice [to invoke a Material Adverse Effect exception to its obligation to close]; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.[103]

The court argued that a MAC is best understood as a "backstop" protecting the buyer from unknown events that "substantially threaten" the target's earning potential in a "durationally-significant manner."[104] The court speculated that this period of adverse effect should be measured

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[93] *Id.* at 21–22.
[94] *Id.Tyson*, 789 A.2d at 54.
[95] *Id.*
[96] *Id.* at 65–67.
[97] *Id.* at 65–66.
[98] *IBP*, 789 A.2d*Id.* at 69.
[99] *Id.* at 71.
[100] *Id.*
[101] *Id. Tyson*, 789 A.2d at 71.
[102] *Id.* at 68.
[103] *Id.*
[104] *IBP*, 789 A.2d at 68. *Id .*

in years – not months.[105] Vice Chancellor Strine affirmed this position by drawing a distinction between strategic and financial buyers, arguing that though short-term declines in target value may be material to a financial buyer, a strategic buyer (with an inherently longer investment horizon) should lack this sensitivity.[106] Further, the Court stressed that both buyer and seller were equally sophisticated parties, bargaining at arms length with the aid of "expensive and highly skilled" advisors.[107] As Vice Chancellor Strine remarked: "*caveat emptor* is still the basic law of New York, and it applies with full force in [this case]."[108] Thus, general economic and industry downturns observed in the near term are insufficient to trigger deal exit or representation breach – imposing a high materiality threshold on buyers attempting to invoke a MAC provision to exit a deal.

B. *Frontier Oil Corp. v. Holly Corp.*

Later decisions reinforced the holding from *Tyson*. The bar for triggering a MAC provision in Delaware is high and acquirers should be cautious about relying on such a provision to avoid transaction completion. Although the decision in *Tyson* was analyzed under New York law, its analytical framework was adopted soon after by the Delaware Chancery Court, applying Delaware law in *Frontier Oil Corp. v. Holly Corp.*[109] Factually *Frontier Oil* was different from *Tyson*. In Frontier Oil, the parties amended the agreement, post signing, to include a representation and warranty that no event was pending or threatened against the firm or a subsidiary that would constitute a MAC.[110] Soon after the amendment, activist Erin Brockovich brought a series of toxic tort lawsuits against a subsidiary.[111] The court estimated that potential legal costs would range from $15 to $20 million from these suits with potential liability between $500 million and $1 billion.[112] Experts estimated Frontier Oil's enterprise value at $338 million.[113] Though Frontier Oil took efforts to avoid liability as parent, they ultimately were pulled into the litigation through a commitment to guarantee the obligations of the subsidiary through a lease agreement.[114]

In the litigation, buyer Holly asserted that target Frontier breached its representation and warranty, arguing that the filing of a toxic tort lawsuit against the target constituted a MAC.[115] The court held that the acquirer failed to meet its burden of demonstrating that a MAC had occurred or would reasonably be expected to occur despite the fact that the litigation posed "serious" risks to the target that could be financially "catastrophic."[116] The court reasoned that there was insufficient quantification of the litigation's probability of adverse outcome or projected financial impact.[117] However, the court reserved the right to find that in some future cases, "litigation can be so certain, the outcome so predictable, and the likely consequences…so negative,

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[105] *Id*.
[106] *Id.* at 67.
[107] *Id.* at 72–73.
[108] *Id.* at 73.
[109] Frontier Oil Corp. v. Holly Corp., C.A. No. 20502, 2005 WL 1039027, 34 (Del. Ch. 2005).
[110] *Id.* at 4–5.
[111] *Id.* at 2.
[112] *Id.* at 21, 36.
[113] *Id.* at 37 n.230.
[114] *Id.* at 2, 11.
[115] *Frontier Oil*, 2005 WL 1039027 at 35.
[116] *Id.Frontier Oil,* C.A. No. 20502, 2005 WL 1039027 at 35–36.
[117] *Id.* at 36–37.

that an observer could readily conclude that the impact that one would reasonably expect to result from the litigation would be material and adverse."[118] Beyond rejecting the acquirer's attempt to claim an adverse change, the ruling reinforced the central holding of *Tyson* (despite its application of New York law) by adopting *Tyson's* language that confined MAC provisions to situations where the overall earning potential of the target is impaired in a "durationally-significant manner," under Delaware law.[119]

C. *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*

Three years later, in *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, the Delaware Chancery Court again reinforced the poor track record of acquirers invoking MAC provisions – asserting that Delaware courts have never found a MAC to have occurred with regard to a merger agreement.[120] *Hexion* involved a merger between two chemical firms, whereby Hexion would acquire target Huntsman for a purchase price of $10.6 billion.[121] The agreement contained a MAC provision, qualifying the definition with two carve-outs, excluding from "material adverse effect": 1) adverse changes to general economic or financial market conditions; and 2) conditions affecting the chemical industry generally.[122] Prior to closing, Huntsman reported quarterly earnings much lower than expected. Huntsman's first-half 2008 EBITDA (earnings before interest, taxes, depreciation, and amortization) was down 19.9% year-over-year from its first-half 2007 EBITDA.[123] This served as catalyst for the resultant litigation and grounds for the claim of MAC breach by Hexion.

The court rejected the acquirer Hexion's contention that target Huntsman's disappointing EBITDA, five percent increase in net debt, and underperformance in two secondary business lines following deal signing triggered the MAC provision.[124] The court held that target fell short of MAC realization, thus binding the acquirer to complete the closing.[125] The court reasoned that a year-over-year comparison of EBITDA rendered the financial results disappointing, though not sufficiently compelling to sustain a MAC claim, debt increase was immaterial, and the poor performance of several business lines responsible for a minority of firm EBITDA was too narrow an adverse change for MAC determination.[126] Like *Frontier Oil*, *Hexion* relied upon *Tyson* to assert that several poor quarters of performance are an insufficient MAC trigger.[127] Thus, *Hexion* confirms the high materiality standard necessary for successful MAC claim in Delaware, though leaves outstanding what events may be sufficiently material so as to trigger this threshold.

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[118] *Id.* at 35.
[119] *Id.* at 34.
[120] *Hexion*, 965 A.2d at 715, 738..
[121] *Id.*
[122] *Id.* at 736.
[123] *Id.* at 725, 740.
[124] *Id.* at 741.
[125] *Id.* at 740-44.
[126] *Id.*
[127] *Id.* at 738.

Table 2. Summary of Delaware MAC Case Law

Case	Adverse Change(s)	Sufficiently Material
IBP v. Tyson (2001)	Missed short-term revenue projections; 64% decline in year-over-year earnings; $60m charge due to fraud.	No: target impairment was cyclical and only significant in the short-term (which is of secondary concern to a strategic buyer).
Frontier Oil v. Holly (2005)	$15-20m litigation costs projected at firm with $338m enterprise value.	No: litigation exposure can be absorbed due to scale and financial strength of the firm.
Hexion v. Huntsman (2008)	20% EBITDA decline last six months; net debt increased $178m (vs. expectation of $1b reduction)	No: decline in EBITDA and other financial metrics in line with historical, cyclical trend.

Ultimately, by choosing Delaware law to govern an acquisition agreement, parties make it difficult for acquirers to successfully terminate a deal between signing and closing by invoking the high threshold for MAC realization imposed by the state's chancery court. Currently, the state's MAC provision standard allows the acquiring company to back out of a deal when events covered by the MAC clause, "significantly impair the long term earning potential of the target."[128] Determination of the requisite degree of materiality is fact intensive, and thus ambiguous . With that said, no decision – neither *Tyson*, *Frontier Oil*, nor *Hexion* – has resulted in the finding that a MAC has occurred . Nor has the Delaware court ever found a MAC occurrence derivative from a merger agreement . Importantly, the court has provided little guidance as to what constitutes a MAC occurrence . Taken in the aggregate, this line of cases calls into question the value of MAC provisions and the wisdom in expending finite resources on their drafting and negotiation if they ultimately are to be rendered inoperative by the court . Practitioners need to be mindful of alternative methods of ensuring their ex ante allocation of deal risk is executed in practice .

IV. CRITICISMS AND CONSEQUENCES OF MODERN MAC CASE LAW

A. Criticism – Materiality Standard Unclear and Buyer's Burden of Proof Too High

IBP, Inc. v. Tyson Foods, Inc. still resonates today as the seminal case treating MAC provisions. Specifically, *Tyson* (and its progeny), established a general framework for MAC provision interpretation in Delaware. While prior case law was inconsistent with regard to what constituted sufficient materiality and whether short term declines in target value could trigger deal exit, *Tyson* spoke definitively (though the lack of precision in this line of cases is problematic). Taken together, *Tyson*, *Frontier Oil*, and *Hexion* reveal the modern MAC standard as requiring a highly fact-intensive and case-specific determination of materiality.[129] Further, the burden of proof borne by buyers attempting to walk from deals is substantial – so much so that "no Delaware court has ever found a MAC…in the acquisition context."[130] Thus, it is clear that the

[128] Cicarella, *supra* note 29, at 424.
[129] Monson, *supra* note 7, at 798.
[130] *Hexion*, 965 A.2d 715 at 738.

Delaware Chancery Court strongly disfavors parties abandoning pending transactions . However, the case law: 1) fails to provide clarity as to what events are sufficiently adverse so as to trigger a finding of materiality, and 2) imposes a burden of proof too stringent to provide buyers relief in the event of legitimate pre-closing hardship.

Specifically, the *Tyson* decision can be read as establishing a four-part test of MAC provision materiality. To constitute a MAC, an event must:

> (1) "substantially threaten" (2) "the overall earnings potential" of the acquired company; (3) "in a durationally-significant manner" (measured in years, not in months); and (4) be proved to have been a change, not an event known when the acquisition agreement was signed.[131]

However, in practice, this test lacks sufficient clarity to provide lawyers guidance in drafting and negotiating agreements. The degree of abject subjectivity involved in this definition provides latitude for disagreement among even the most seasoned of practitioners. For example, a conference of bankers at the law firm Clifford Chance was asked to vote on which of the following events were sufficiently damaging so as to constitute a MAC: 10% drop in the target's EBITDA, 25% drop in EBITDA, destruction of a high profit-margin factory responsible for the production of 20% of inventory turnover, and regulatory change constituting significant negative financial impact on the firm.[132] Though the pool of practitioners generally discounted the initial scenario, the audience was split evenly as to whether alternative events were sufficiently material so as to trigger the MAC provision.[133] Though case law delineates a standard for MAC materiality, the standard lacks sufficient granularity so as to provide parties and practitioners adequate direction – which is to the determinant of their corporate clients and the shareholders for whom they operate.

Such uncertainty as to the definition of the term "material" is troubling for practitioners seeking to draft future provisions – for lawyers lack workable legal definition from which to predictably guide the allocation of deal risk. As is discussed further in Section V.A, this uncertainty is partly the fault of the parties themselves, due to their general reluctance to specifically define the parameters of the term "material" as it relates to MAC provisions. However, the Delaware courts shoulder partial blame for this uncertainty by failing to develop clear guidelines or quantitative benchmarks for discerning when adverse events are sufficiently material. Rather, Delaware courts defer to case-specific analyses that lead to unpredictable results and, in conjunction with the steep threshold upheld in the case law to date, render MAC provisions practically ineffective at terminating deals – no matter how legitimate the impairment in target value.

B. Consequence – Negative Externalities from MAC Claims

Various negative externalities are observable as a result of Delaware's modern MAC materiality standard. Bereft of clarity and imposing an onerous burden of proof, the modern MAC standard generates dispute between parties that otherwise could have been avoided with specific materiality benchmarks (albeit from judicial precedent or defined by the parties' agreements). Even though deal disillusion is unlikely under the modern MAC standard, a seller's mere claim of

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[131] Gottschalk, *supra* note 56, at 1062.
[132] Jamie Ivey, *Takeover Ruling Fuels Adverse Change Debate*, CORP. FIN., at 1 (Nov. 2001).
[133] *Id.*

a MAC may have detrimental effects on the target – regardless of the ultimate judicial decision regarding the matter.[134]

Specifically, the mere act of claiming a MAC through a public forum like litigation imposes significant systemic risk on the target, for the public exposure required by response to a MAC claim is more damaging than merely suffering the adverse event's immediate ramifications.[135] Such negative externalities are far reaching.[136] Public dispute as to whether a MAC has occurred: 1) exacerbates preexisting business disruption due to the pending transaction; 2) threatens the target's relations with employees, customers, creditors, rating agencies, and other business partners; 3) publicly disseminates negative information about the firm that, but-for, would have remained confidential, and 4) exposes the target to disparagement by the counterparty (who is incentivized to make the target's impairment look as severe as possible, even if the claims are unfounded). Perhaps most damaging, is that if the dispute is litigated, cause of action to enforce a MAC can lead to the court's public certification that the company is effectively "damaged goods."[137] Further, most firms operate in markets less efficient than capital markets.[138] As a result, MAC claims not only generate more negative publicity than would otherwise be realized by the adverse change alone, but such negative publicity reaches a broader audience than would have been familiar with the target's performance but-for.[139] In the event MAC provisions are invoked for purposes of renegotiation of deal consideration, it should be noted that the target's negative exposure will flow through to the buyer upon deal close as the target is subsumed into the buyer. In short, when attempt is made to abandon a deal due to a MAC clause, it is "big news in the business world" – manifest as a "doomsday scenario" for targets.[140] A subjective MAC materiality standard lacking in specificity provides broader latitude for buyer's MAC claims, unnecessarily increasing targets' exposure to this system risk.

Additionally, the modern MAC standard may impose systemic change in the acquisition market – as reflected in deal prices and efforts to forum shop . First, buyers' limited ability to abandon transactions by claiming a MAC due to the seller-friendly nature of *Tyson* and other Delaware rulings may drive up the purchase price in certain deals.[141] Further, buyers may forum shop by negotiating for agreements to be governed by the law of jurisdictions more buyer-friendly with regard to MAC provisions, such as Tennessee.[142] Regardless, the externalities observed in response to the modern MAC standard potentially impact parties at both the firm and market level.

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[134] Chertok, *supra* note 5, at 124.
[135] Miller, *supra* note 1, at 2009.
[136] *Id.*
[137] *Id.*
[138] *Id.* at 2077.
[139] *Id.*
[140] *Id.* at 2077–78.
[141] Chertok, *supra* note 5, at 128.
[142] *See, e.g.*, Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), slip op. (Tenn. Ch. Dec. 27, 2007) (holding2008) (In *Genesco*, the Tennessee Chancery Court, applying Tennessee law, held that under state law, Genesco's drop in earnings over two consecutive quarters– – predicted to be the worst in the firm's past ten years of operation– – was durationally significant and constituted a MAC).. Despite this determination, the Court compelled the acquirer Finish Line to specifically perform with its acquisition of Genesco, concluding. The Court concluded that though sufficiently material, the drop in target's performance was protected by a carve-out in the MAC provision that exempted MAC realization resulting from changes in "*general economic conditions*.." Thus, *Genesco* represents a finding of sufficient MAC materiality, despite facts insufficient to actually unwind the pending deal..).

C. Consequence – Increased Use of MAC as Tool for Renegotiation

Though the modern MAC standard is seller-friendly with regard to deal invalidation, buyers have increasingly used the subjective standard as leverage to renegotiate deal terms between signing and close. Often, the threat of termination alone is sufficient for buyers to extract additional concessions–independent of whether the buyer actually has a viable claim under the terms of the MAC provision.[143] The modern MAC standard can be criticized on policy grounds for robbing buyers of an essential risk allocation strategy by requiring such a rigorous burden of proof to exercise their termination rights. This is particularly galling considering both parties – buyer and seller – are often sophisticated entities employing informed advisors throughout the transaction process. This trend toward buyer renegotiation of deal consideration via leverage of MAC provisions thus can be viewed as an attempt by buyers to reclaim a risk allocation measure blunted by Delaware's recent MAC jurisprudence. Conversely, sellers could perceive such action as inefficient rent-seeking behavior, whereby buyers exploit sellers' risk-aversion to the collateral damage inherent in public MAC claims – claims often independent of merit (see further discussion in Section IV.B). Such behavior seems to cheapen the value of agreement signing, as closing is treated more like a call option rather than the culmination of a deal consummation. Regardless, current trend is to view MAC provisions not as an "out instrument," but as means of leverage for renegotiation of deal consideration.[144]

Perhaps the most public example of such deal renegotiation through MAC provision occurred during Bank of America's $50 billion acquisition of Merrill Lynch in 2008.[145] Soon after entering into merger agreement in September, Merrill Lynch incurred substantial losses in the following two months – beyond either parties' expectations.[146] Bank of America's CEO Ken Lewis would later testify before a House committee that when the firm became aware of losses at Merrill Lynch, it "strongly considered [claiming a] MAC and thought [they] actually had one."[147] Rather than use the MAC provision to renegotiate the deal, Bank of America used leverage derived from the MAC provision and the importance of the deal to the greater economy amid the throes of recession to exact concessions from the federal government.[148] Ultimately, Bank of America was able to receive $20 billion in additional bailout funds and gain protection against losses on approximately $118 billion in toxic assets – marginal gain extracted after the signing of the initial merger agreement.[149] Though this deal reflects the unique circumstances of the credit crisis, it remains illustrative of the way in which buyers are increasingly using MAC provisions to gain and deploy post-signing leverage in acquisition agreements.[150]

V. DRAFTING SOLUTIONS TO FACILITATE EFFICIENT MAC ENFORCEABILITY

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[143] COMMERCIAL CONTRACTS: STRATEGIES FOR DRAFTING AND NEGOTIATING §9.04[[F], at 2 (Vladimir R. Rossman & Morton Moskin eds., Supp. 2015) (hereinafter COMMERCIAL CONTRACTS, the "*Strategies for Drafting and Negotiating*").

[144] Sherri L. Toub, *"Buyer's Regret" No Longer: Drafting Effective MAC Clauses in a Post-IBP Environment*, 24 CARDOZO L. REV. 849, 888–89-889 (2003).

[145] Chertok, *supra* note 5, at 125.

[146] *Id.*Chertok, *supra* note 5, at 126.

[147] William D. Cohan, *An Offer He Couldn't Refuse*, THE ATLANTIC, (Sept. 2009,), at 62, 65.

[148] *Id.*

[149] Chertok, *supra* note 5, at 126.

[150] For a thorough*Id.* at 127-138 (see discussion of more conventional examples of MAC- induced leverage, including deals between Sallie Mae and J.C. Flowers & Co.,. as well as Home Depot, Inc. and Pro Acquisition Corp., see *id.* at 127–38..).

In light of *Tyson* and its progeny, modern MAC provisions provide buyers with limited means of deal termination . As discussed in Section II.A and II.D, MAC provisions are rational, mutually-beneficial tools for buyers and sellers to both allocate adverse change risk and to internalize that risk through other deal parameters (e.g., deal consideration, etc.). Delaware jurisprudence does transaction parties (and their practitioners) a disservice by imposing a MAC standard that is uncertain (see Section IV.A) and practically impossible to achieve.[151] The elevated burden of proof requirement weakens the utility of MAC provisions as a tool for risk allocation by eliminating deal terminations in practice. And the lack of a clearly delineated judicial standard itself imposes additional systemic risk on parties through haphazard judicial application of MAC doctrine and the usurious externality of deal renegotiation (as discussed in Section IV.B). However, transaction parties are not blameless nor helpless. In light of these inefficient judicial developments, practitioners would benefit from reimagining the conventions of MAC provision drafting. Alternative drafting approaches could help combat these perceived shortcoming in the Delaware case law and enhance MAC provision effectiveness at effectuating the intent of the contracting parties and efficiently allocating deal risk .

A. Background – Intentional Ambiguity in Contracting

Traditionally, practitioners have avoided specificity in the drafting of MAC provisions – to the puzzlement of some commentators.[152] Particularly during recessions, practitioner commentators have predicted movement from vague MAC provision drafting toward greater precision and specificity through quantifiable metrics.[153] Vice Chancellor Strine affirmed as much in *Tyson* with his acknowledgement of risks stemming from "capacious" MAC provisions.[154] Further, due to the fact vague MAC drafting has never provided fodder for deal termination in Delaware[155] and specificity helped substantiate the finding of MAC occurrence in a non-Delaware jurisdiction,[156] such an approach offers more potential for MAC enforcement than current convention . Despite this, parties generally draft MAC provisions vaguely.[157]

As a threshold issue, intentional ambiguity in contracting is not prima facie flawed; however, offers mixed value-add . As downside, vague drafting invites self-interested and conflicting contact interpretations.[158] This may stimulate greater conflict between contracting parties, increasing litigation costs and judicial uncertainty.[159] Added litigation and uncertainty may result in unnecessary gamesmanship between parties, threatening more acrimony and deal

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[151] *Hexion*, A.2d 715 at 738.
[152] *2010 Nixon Peabody MAC Survey: A Nixon Peabody Study of Current Negotiation Trends of Material Adverse Change Clauses in M&A Transactions*, NIXON PEABODY LLP, 1, http://www.nixonpeabody.com/linked_media/publications/MAC_Survey_2010.pdf (last visited Nov. 7, 2015).
[153] Peter S. Golden, Arthur Fleischer Jr. and David N. Shine, *Negotiated Cash Acquisitions of Public Companies in Uncertain Times*, M&A LAW,LAW., Feb. 2009, at 6.
[154] *IBP v. Tyson*, 789 A.2d at 65.
[155] *Hexion*, 715 A.2d at 738.
[156] *Nip v. Checkpoint Sys. Inc.*, 154 S.W.3d 767, 769–70 (Tex. App. 2004) (finding that observed loss was in excess of the $50,000 threshold established contractually as MAC trigger).
[157] Albert Choi and George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 881 (2010).
[158] *Id.* at 854.
[159] *Id.* at 882.

risk than but-for inclusion of the ambiguous provisions.[160] Consequently, vague drafting is viewed as antithetical to efficiency.[161]

With that said, scholars have argued that vagueness may be justified when expected litigation costs are outweighed by perceived lower drafting costs during contract formation.[162] Ambiguity may facilitate deal making generally, for both sides can plausibly sell the resultant agreement back to their constituents as advancing their interests.[163] At least theoretically, this vague drafting insulates buyers from the risk a MAC may fall outside the bounds of a quantifiable MAC definition due to an unforeseen or unanticipated manifestation . Contractual vagueness, depending on the provision, adheres to convention, so avoids the negative signaling (e.g. that litigation is anticipated, etc.) potentially communicated as subtext by advocacy for specificity. Further, one could argue that increased litigation costs associated with vague drafting can have a downward pressure on actual litigation, as parties are incentivized to renegotiate outside the formal legal system in the event later conflicts arise so as to avoid legal fees and distraction.[164] Despite instances when ambiguity may confer strategic value, greater specificity with regard to MAC provisions may help alleviate the structural issues derivative from the modern MAC standard – empowering parties to efficiently allocate deal risk through preemptive contracting.

B. Solution – Include Specific Benchmarks and Quantifiable Thresholds for MAC Materiality

To alleviate concerns attributable to the subjective and uncertain MAC standard in Delaware, practitioners should consider drafting MAC provisions with specificity . In particular, drafters should construct MAC provisions to include objective benchmarks and quantifiable thresholds as definitions for MAC materiality, whereby risk allocation may be reclaimed from the court by contracting parties . Materiality benchmarks and thresholds may take a variety of forms – for example, a predetermined decline in EBITDA over a set time period or the occurrence of a particular class of event (measured objectively by exposure, share price decline, etc.) . Because of the inherent variation in structure and operation between businesses and across industries, a general bright-line test for materiality may be imprudent due to a lack of narrow tailoring . However, the contracting process, by definition, is granular and deal-specific . If materiality meant the same thing in every deal, there would be no need for practitioners to tailor boilerplate contracts to meet the expectations of specific parties.[165] By providing the precision and definition otherwise lacking in Delaware's MAC provision case law, practitioners can reclaim the theoretical intent of MAC provisions as efficient allocators of pre-closing adverse change risk . Absent benchmarks and thresholds, the Delaware court has proven time and again that the MAC materiality standard is too high to trigger deal termination (as discussed in Section III) . Such deal-specific quantifiable standards would rectify this judicial circumvention of contracted terms . Though MAC provisions are a tool for buyers to shift risk to sellers, they are not per se buyer-friendly; rather, they are tools to equitably balance and shift risk, risk that, assuming information symmetry, is ultimately internalized in the final deal consideration. Thus, specificity in MAC provision drafting is efficient, empowering parties by conferring a tool for risk allocation that maximizes its function (plausibly permitting deal termination) while internalizing costs (theoretically reflected in an increase in purchase price).

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[160] *Id.*
[161] *Id.*
[162] *Id.* 854.
[163] Choi & Triantis, supra note 157, at 884–85.
[164] *Id.* at 891.
[165] Toub, *supra* note 144, at 896–97.

Such an approach is not without downside – as reflected in the industry convention for ambiguously drafted MAC provisions. Bargaining for granular benchmarks and thresholds could lead to significant up-front cost by complicating negotiation – threatening agreement in the most hostile of scenarios. Courts could also read these quantitative guidelines as minimums, which may be too rigid of a baseline for interpretation given that certain benchmarks may be based on firm projections or pro forma that, by definition, are volatile, imprecise, and bound to change . Most troublesome is the risk that courts could read these benchmarks as excluding potential adverse events not falling within quantifiable guidelines, though subjectively impairing similar value in the target. Such criticism is not without merit; however, some issues can be partially ameliorated with thoughtful contract language (for example, the inclusion of "including, without limitation" in conjunction with the latter issue).[166] Critics could also argue that MAC provisions, that by language create a mechanism to terminate deals, in practice and intent, are designed to merely trigger deal renegotiation in the event of MAC allegation (see discussion in Section IV.C). Thus, critics may conclude that the court's failure to find occurrence of a MAC is a red herring, as the true policy concern – negotiated purchase price reduction to account for the intervening event – is preserved by the current standard . Though renegotiation may in fact be efficient in its own right (avoiding costs incurred by deal termination, including productivity losses and unrealized due diligence and negotiation),[167] there is no reason why the viable possibility of deal termination cannot work in tandem with renegotiation . Further, the time and expense expended to negotiate MAC provision would be extraneous if mere renegotiation were the ultimate intent of the provision.

Even if practitioners are ignorant of, or unconcerned by, the lack of MAC provision enforceability (content to merely rely on triggered renegotiation in the event of an adverse development), buyers run the risk of declining renegotiation leverage as MAC provisions are increasingly viewed as unenforceable by the Delaware Chancery Court . Buyers retain some leverage from sellers' aversion to the negative publicity stemming from a MAC claim; however, renegotiation leverage is primarily rooted in the risk of litigation to unwind the deal . Unless buyers draft enforceable provisions, buyers (collectively) run the risk of squandering their leverage to renegotiate as sellers come to view the threat of MAC litigation as baseless – due to the Delaware Chancery Court's elevated MAC materiality standard and the implausibility of buyers' efforts to void a deal . Ultimately, though imperfect, defining MAC provision materiality with specific benchmarks and quantifiable thresholds is prudent relative to the alternative – ambiguously drafted MAC provisions which Delaware courts have never found sufficient to trigger deal termination.[168]

C. Solution – Binding Arbitration by Financial Experts

Central to criticism of the modern MAC standard, aside from rendering MAC provisions ineffective, is the belief that the subjectivity with which Delaware defines materiality empowers judges with too much latitude in allocating deal risk . Imposition of quantifiable thresholds empowers the parties themselves to control materiality definition. However, they are still subject to judges and a court system that are unpredictable and at times unsophisticated with regard to financial minutia (though admittedly, the Delaware Chancery Court is more quantitatively sophisticated than most due to the nature of its docket and the resulting selection bias in judge appointment) . Thus, it would be prudent for practitioners to negotiate dispute resolution clauses

[166] Chertok, *supra* note 5, at 136.
[167] Eric L. Talley, *On Uncertainty, Ambiguity, and Contractual Conditions*, 34 DEL. J. CORP. L. 755, 788 (2009).
[168] *Hexion*, 715 A.2d at 738.

whereby MAC materiality disputes would be arbitrated by a panel of financial experts rather than conventional judges. Such predetermined experts would offer more explicit subject matter expertise and the forum of binding arbitration may be marginally more cost effective than conventional litigation. Arguments for such a structure thematically echo those in favor of quantitative benchmarks for MAC materiality – as binding arbitration with experts is efficient and would facilitate a more transparent allocation of deal risk between parties in business combination agreements.

VI. CONCLUSION

The modern MAC materiality standard – defined by subjective uncertainty and an onerous burden of proof on buyers – is deficient. However, practitioners are not without recourse. By defining MAC materiality contractually with specific benchmarks and quantifiable thresholds and brokering binding arbitration by financial experts, practitioners may dictate materiality terms in a clear, informed, and objective fashion. In doing so, parties may regain control over a powerful tool for allocating deal risk, while efficiently internalizing related burdens through adjustment to the purchase price. Such clarity with regard to risk allocation in business combination agreements would further the interest of both buyers and sellers.