REGENT UNIVERSITY LAW REVIEW

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REGENT UNIVERSITY LAW REVIEW

ISSN 1056-3962. The *Regent University Law Review* is published at Regent University and is produced and edited by the students of the Regent University School of Law under the supervision of the faculty. The domestic subscription rate is $14.00 per issue. Third class postage paid at Virginia Beach, Virginia. POSTMASTER: Send address changes to Editor-in-Chief, Law Review, Regent University School of Law, Virginia Beach, VA 23464-9800. Absent receipt of notice to the contrary, subscriptions to the *Law Review* are renewed automatically each year. Claims for issues not received will be filled for published issues within one year before the receipt of the claim. Subscription claims for issues beyond this limitation period will not be honored.

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REGENT UNIVERSITY LAW REVIEW

Volume 25 **2012–2013** **Number 2**

PLURALISM IN CORPORATE FORM: CORPORATE LAW AND BENEFIT CORPS.

*Lyman Johnson**

INTRODUCTION

Social enterprise has generated widespread interest in recent years.[1] Sometimes called "social entrepreneurship," social enterprise is a general term used to describe an approach to business that, while aiming to produce profits, also seeks in a significant way to advance one or more social or environmental goals—i.e., a so-called "dual mission."[2] The social enterprise movement has spawned legal as well as business reform, and several states have enacted laws authorizing new forms of business entities to accommodate these emergent "hybrid" companies.[3] These novel legal–business arrangements include low-profit limited liability companies ("L3Cs"),[4] flexible purpose corporations,[5] and benefit corporations ("Benefit Corps.").[6]

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1 Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 61–62 (2010).

2 Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1361 (2011).

3 These laws are well summarized by Professor Haskell Murray. J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012).

4 As of this writing, nine states and two federal jurisdictions have adopted statutes permitting the creation of L3C limited liability companies. *Laws*, AMERICANS FOR COMMUNITY DEV., http://www.americansforcommunitydevelopment.org/legislation.html (last visited Mar. 4, 2013). For various critical treatments of L3Cs, see J. William Callison

Pioneered by Maryland in 2010,[7] Benefit Corp. statutes subsequently sailed through the New York and New Jersey legislatures without a single dissenting vote.[8] Later proposals, however, such as one currently stalled in Colorado, for example,[9] have sometimes faced

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& Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273 (2010); David S. Chernoff, *L3Cs: Less than Meets the Eye*, 22 TAX'N EXEMPTS, May–June 2010, at 3; Daniel S. Kleinberger & J. William Callison, *When the Law is Understood—L3C No* (William Mitchell Coll. of Law Legal Studies Research Paper Series, Working Paper No. 2010-07, 2010), *available at* http://ssrn.com/abstract=1568373; Rick Cohen, *L3C: Pot of Gold or Space Invader?*, BLUE AVOCADO (Sept. 30, 2009), http://www.blueavocado.org/content/l3c-pot-gold-or-space-invader. For more laudatory treatments, see CARYN CAPRICCIOSO ET AL., INTERSECTOR PARTNERS, L3C, WHO IS THE L3C ENTREPRENEUR? 24–26 (2012) (on file with Regent Unviersity Law Review); J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 51 (2011); Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163, 167–68 (2010); Nancy Artz et al., Low-Profit Limited Liability Companies (L3Cs) 9 (Mar. 1, 2012) (unpublished paper), *available at* http://ssrn.com/abstract=2022342; Brett A. Seifried, Mind the Gap: Using the History and Theory of Profit and Nonprofit Corporations to Remedy the Problems of Social Enterprise in Low-Profit Limited Liability Companies—A Theory and Practice Approach 38–63 (June 13, 2012) (unpublished article), *available at* http://ssrn.com/abstract=2083827.

[5] Only California has enacted a flexible purpose corporation statute. WILLIAM H. CLARK, JR. ET AL., THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION: WHY IT IS THE LEGAL FORM THAT BEST ADDRESSES THE NEEDS OF SOCIAL ENTREPRENEURS, INVESTORS, AND, ULTIMATELY, THE PUBLIC, app. c, at 5 (Benefit Corporation White Paper, Jan. 26, 2012), *available at* http://benefitcorp.net/storage/The_Need_and_Rationale_for_Benefit_Corporations_-_April_2012.pdf [hereinafter White Paper]; *see also* Corporate Flexibility Act of 2011, CAL. CORP. CODE §§ 2500–3503 (West Supp. 2013).

[6] As of this writing, twelve states have enacted statutes authorizing benefit corporations: California, CAL. CORP. CODE §§ 14600–14631 (West Supp. 2013); Hawaii, HAW. REV. STAT. §§ 420D-1 to -13 (West Supp. 2011); Illinois, S. 2897, 98th Gen. Assemb., Reg. Sess. (Ill. 2012); Louisiana, LA. REV. STAT. ANN. §§ 12:1801 to :1832 (Supp. 2013); Maryland, MD. CODE ANN., CORPS. & ASS'NS §§ 5-6C-01 to -08 (West Supp. 2012); Massachusetts, MASS. GEN. LAWS ch. 156E, §§ 1–16 (Supp. 2012); New Jersey, N.J. STAT. ANN. §§ 14A:18-1 to -11 (West Supp. 2012); New York, N.Y. BUS. CORP. LAW §§ 1701–1709 (McKinney Supp. 2013); Pennsylvania, H.R. 1616, 196th Gen. Assemb., Reg. Sess. (Pa. 2012); South Carolina, S.C. CODE ANN. §§ 33-38-110 to -600 (Supp. 2012); Vermont, VT. STAT. ANN. tit. 11A, §§ 21.01–.14 (2010 & Supp. 2012); Virginia, VA. CODE ANN. §§ 13.1-782 to -791 (2011). Maryland also authorizes benefit LLCs. MD. CODE ANN., CORPS. & ASS'NS §§ 4A-1101 to -1108 (West Supp. 2012). For excellent descriptions, and some criticisms, of these statutes, see Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form Of Organization?*, 46 WAKE FOREST L. REV. 591, 593–95 (2011); Murray, *supra* note 3, at 22–24.

[7] *See* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01 (West Supp. 2012).

[8] *See* Mark A. Underberg, *Benefit Corporations vs. "Regular" Corporations: A Harmful Dichotomy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 13, 2012, 8:31 AM), http://blogs.law.harvard.edu/corpgov/2012/05/13/benefit-corporations-vs-regular-corporations-a-harmful-dichotomy/.

[9] *Compare* S. 12-182, 68th Gen. Assemb., 2d Reg. Sess. (Colo. 2012) (introduced bill), *with* S. 12S-003, 68th Gen. Assemb., 1st Extraordinary Sess. (Colo. 2012)

tougher sledding.[10] Moreover, legal commentators have leveled strong criticisms at all legal forms of hybrid companies, particularly L3Cs,[11] but also Benefit Corps.[12] These critiques are frequently of a business or financial nature and range, for example, from grave doubts about the prospects for meaningful capital formation to concerns over the likely success of the socially responsible "branding" strategy aimed at consumers.[13] But thoughtful scholars have raised very pointed legal criticisms as well.[14]

For example, in April 2012, the ABA Business Law Section, on behalf of the Committee on Limited Liability Companies, Partnerships, and Unincorporated Entities and the Committee on Nonprofit Organizations, submitted a letter and attachment making a number of highly critical legal points about L3Cs, using such words as "misleading" and "serious risk" and "dangerously."[15] Clearly, for many, the legal jury is, at best, still out on the new hybrid forms, particularly the L3C version, while for others, the verdict already is in and a quick death is the suggested sentence.

This Article addresses selected issues raised by Benefit Corps. It begins critically, faulting Benefit Corp. legislation, like all hybrid form statutes, for misunderstanding that traditional for-profit corporations

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(reengrossed bill). Benefit Corp. legislation has also been introduced into eleven other jurisdictions: Alabama, Arizona, Connecticut, Florida, Iowa, Montana, Nevada, New Mexico, North Carolina, Oregon, and the District of Columbia. For a current look at pending and approved legislation, visit *State by State Legislative Status*, BENEFIT CORP INFO. CENTER, http://www.benefitcorp.net/state-by-state-legislative-status (last visited Mar. 4, 2013).

[10] According to Colorado lawyer J. William Callison, the Colorado legislature has considered Benefit Corp. legislation for over two and one-half years and has not yet passed a statute as of July 2012. J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, 2 AM. U. BUS. L. REV. 85, 92 n.20 (2012). Notwithstanding the stalled legislation in Colorado, Illinois, Massachusetts, and Pennsylvania enacted Benefit Corp. legislation in 2012. *See* MASS. GEN. LAWS ch. 156E, §§ 1–16 (Supp. 2012); S. 2897, 98th Gen. Assemb., Reg. Sess. (Ill. 2012); H.R. 1616, 196th Gen. Assemb., Reg. Sess. (Pa. 2012).

[11] *See supra* note 4.

[12] *See, e.g.*, Brakman Reiser, *supra* note 6, at 617; Murray, *supra* note 3, at 27–33; Underberg, *supra* note 8; *see also* Ann E. Conaway, *The Global Use of the Delaware Limited Liability Company for Socially-Driven Purposes*, 38 WM. MITCHELL L. REV. 772, 801 (2012); Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 761 (2009–2010); *B Corps: Firms with Benefits*, ECONOMIST, Jan. 7, 2012, at 57, 58.

[13] *See, e.g.*, Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 366–70 (2009).

[14] *See generally* Brakman Reiser, *supra* note 6; Murray, *supra* note 3, at 27–33.

[15] Letter from Linda J. Rusch, Chair, ABA Bus. Law Section, to Steve Simon, Assistant Minority Leader, Minn. House of Representatives (Apr. 19, 2012), *available at* http://ssrn.com/abstract=2055823.

(like LLCs) are legally free to pursue social or environmental goals and, except in limited circumstances in Delaware most notably, are not required to maximize corporate profits and/or shareholder wealth. But from there the Article, although making a number of critical points and suggestions for statutory change, takes a more positive stance on Benefit Corps. and argues that they usefully disrupt the current business landscape and shed instructive light on certain unexamined premises in corporate law. Consequently, for both legal and business reasons, it is premature to conclude that they will not play an important role, both culturally and intellectually. Moreover, Benefit Corps. closely resemble early American corporations that largely were formed to advance public-serving purposes, not private gain, and thus, historically, they represent a return to early practices as well as a seeming ultra-modern innovation in corporate form. In addition, they exemplify the growing phenomenon of institutional pluralism in which a diverse array of organizations serves to mediate between the individual and the state and to advance a variety of social goals, but without statist control. This pluralism is serving to overcome longstanding and overly stark dichotomies that simplistically categorize activity (and actors) as either profit *or* nonprofit, and as either public *or* private.

A further "benefit" of Benefit Corps. is that they usefully illuminate, but only partially meliorate, deep confusion within traditional corporate law over the relationship of three core concepts—fiduciary duties, corporate purpose, and the corporation's best interests. Still, although conceptually Benefit Corps. move from a shareholder-centric toward a stakeholder-centric model of corporateness, they stop short of a truly new "corporate," mission-centric model and theory of corporateness. Instead, reflecting doctrinal and theory failures in corporate law generally, they embody an alloy of shareholder and stakeholder elements. This is true at the organizational level of theory and the individual level of theory. As to the latter, Benefit Corps., following prevailing corporate law and theory generally, fail to move beyond an individualistic, self-interested anthropology of business participants to one where their role is to serve the larger, common good. And although Benefit Corps., for a variety of reasons, could set back efforts to bolster corporate responsibility in the traditional for-profit sector, as this Article acknowledges, there also are reasons to believe, at this stage, that they might enhance it. Or, at least, it is too early to tell whether Benefit Corps. will bring a net advance in corporate responsibility or simply lead to a migration of such efforts away from the traditional corporate sector and into the social enterprise segment.

This Article is organized into five parts. Part I describes the faulty but understandable premise of Benefit Corps. as a legal reform movement. Part II sets Benefit Corps. into the broader context of

evolving institutional pluralism in American society. Part III explains how Benefit Corps. provide a useful lens for spotlighting the continuing muddle in traditional corporate law over fiduciary duties and their relationship to corporate purpose and a corporation's best interests. Here, Benefit Corps. illuminate the problem but offer only a partial and less than satisfactory fix, one that reflects the current lack of a truly "corporate" theory of the corporation. Part IV considers various arguments as to why Benefit Corps. might or might not adversely affect corporate responsibility in the for-profit sector more generally. This Article ends with a brief conclusion.

I. THE LEGALLY FAULTY, BUT UNDERSTANDABLE AND COMMENDABLE, PREMISE OF BENEFIT CORPS.

The foundational "White Paper" on Benefit Corps. states that a significant rationale for them is "the default position [within corporate law that] tends to favor the traditional fiduciary responsibility to maximize returns to shareholders over the company's social mission."[16] Later, the White Paper summarily and sweepingly states that the U.S. legal system governing business corporations is not structured to address companies that solve social problems.[17] This Part of this Article now briefly explains how the White Paper's first assertion is wrong, or at least highly debatable, as a positive law matter and how the second statement appears to be unmindful of corporate law history. Nonetheless, the positions in the White Paper are perfectly understandable given widespread beliefs about legal mandates on corporate purpose, and the White Paper commendably seeks to "work around" those widely held, if mistaken, perceptions.

A. Current Law and Corporate Purpose

This author and others have addressed the law of corporate purpose before,[18] and this author currently is preparing more extensive articles on that specific subject.[19] What is striking about various contemporary writings on corporate purpose is that so many commentators believe the

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[16] White Paper, *supra* note 5, at 6.

[17] *Id.* at 7.

[18] *See* Lyman Johnson, *A Role for Law and Lawyers in Educating (Christian) Business Managers About Corporate Purpose* (Univ. of St. Thomas Sch. of Law Legal Studies Research Paper Series, Working Paper No. 08-22, 2008), *available at* http://papers.ssrn.com/abstract=1260979. A newly published 2012 book treats this subject fully. LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012).

[19] *See, e.g.*, Lyman Johnson, *Unsettledness in Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP L. (forthcoming 2013). For a balanced treatment of the debate within the corporate law community over whether the law requires profit maximization, see Murray, *supra* note 3.

law does not clearly mandate shareholder wealth or profit maximization.[20] Instead, the better view is that the law is (and should be) agnostic on the subject of corporate purpose. After all, the positive law cited in support of a shareholder wealth maximization stricture is remarkably thin and highly ambiguous. The so-called "leading case" of *Dodge v. Ford Motor Co.* is from 1919 and in dictum expressed a shareholder-centric purpose, but the decision itself, although mandating payment of yet additional dividends, did nothing to alter Henry Ford's avowed strategy of attending to the wellbeing of employees and consumers.[21] Moreover, Ford had already paid returns to the plaintiffs of a magnitude that would make a modern hedge fund manager green with envy,[22] thereby undercutting any suggestion that Ford was not taking excellent care of investors,[23] even as he sought to serve other worthy goals as well. In ordering additional dividends, the case provided the plaintiff-investors with a remedy of an even greater financial return but not a remedy of altering corporate purpose. And even there, in interfering with directorial business judgment regarding dividends, the case is an outlier.[24] The case is of dubious and lonely authority for other reasons as well.[25]

In Delaware, the 2010 *eBay* decision[26] is touted by some, including the White Paper, as mandating shareholder primacy.[27] Yet, the opinion cited no authority for its assertions on that point and, as in *Dodge,* did

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[20] *See* Murray *supra* note 3, at 5–8 (collecting commentary); Underberg, *supra* note 8 ("The problem is that its primary rationale rests on the mistaken, though widely-held, premise that existing law prevents boards of directors from considering the impact of corporate decisions on other stakeholders, the environment or society at large.").

[21] 170 N.W. 668, 684–85 (Mich. 1919).

[22] The plaintiffs owned 10% of the outstanding stock of Ford Motor Company and contributed $200,000 of the original $2 million in invested capital. *Id.* at 669–70. From 1903 through 1915, the Ford Motor Company paid $41 million in special dividends, plus a regular quarterly dividend. *Id.* at 670. Thus, the plaintiffs received $4.1 million in special dividends alone, representing a stunning return of approximately twenty times their initial investment.

[23] *Id.* at 684 (referring to "incidental benefit of shareholders").

[24] *See* FRANKLIN A. GEVURTZ, CORPORATION LAW § 2.3.1, at 154 (2d ed. 2010) ("[C]ourts have been hesitant to find an abuse of discretion [with respect to dividends] in the absence of fairly extraordinary facts.").

[25] *See* Johnson, *supra* note 18, at 9–11.

[26] eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010).

[27] *See, e.g.*, Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 148–55 (2012); White Paper, *supra* note 5, at 11. Delaware itself is considering enactment of a Benefit Corp. statute in 2013. *Significant Proposed Amendments to the General Corporation Law of the State of Delaware in 2013: Ratification, Second-Step Mergers, Public Benefit Corporations and Other Matters*, RICHARDS, LAYTON & FINGER (Mar. 20, 2013), http://www.rlf.com/knowledgecenter/ealertsnewsletters/4606#public.

nothing to alter craigslist's business focus strategy.[28] In addition, it is remarkable that, lacking any statutory predicate for doing so, a public judge would order a business to pursue (or not pursue) a corporate strategy that was thoughtfully established by the company's own lawfully constituted governance body. Outside Delaware, moreover, over half of the states have expressly permitted consideration of non-shareholder constituencies in a way that blunts judicially prescribed shareholder primacy.[29]

Some commentators, on the other hand, think the law does so mandate.[30] Thus, at best, unlike so many core subjects in corporate law that are utterly noncontroversial,[31] the foundational issue of corporate purpose remains, in the year 2013, legally unsettled. Non-law factors, including business and educational lore, business conventions and norms, and faulty understandings of law, for example, are the chief influencers of today's thinking on corporate purpose.[32]

If the law does not definitively require shareholder wealth or profit maximization—and certainly no statute does so—but there is nonetheless a widely held perception that the law does so dictate, then the White Paper assertion noted above[33] becomes more understandable, both legally and pragmatically. As does this statement about the legal effect of Benefit Corp. statutes: "[They] would ease or eliminate the risk of suit by shareholders for failure to maximize financial returns."[34] And Etsy company's recent and highly illustrative statement as to why it had chosen to become a Benefit Corp. also becomes clear: "We believe that the best long-term stewards of Internet-based networks and marketplaces will focus on value creation for all participants instead of solely on shareholders. B corporations provide a legal foundation

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[28] The opinion struck down certain anti-takeover measures as a remedy, but it did not mandate a change in the business strategy of craigslist. *eBay*, 16 A.3d at 41. The *eBay* opinion is more fully discussed in Johnson, *supra* note 19.

[29] *See* 1 JAMES D. COX & THOMAS LEE HAZEN, THE LAW OF CORPORATIONS § 4:10, at 245 (3d ed. 2010).

[30] *See* Murray, *supra* note 3, at 5–6 (citing commentary); *see also* Strine, *supra* note 27, at 155.

[31] Countless topics could be noted. For example, shareholders elect directors, *e.g.*, DEL. CODE ANN. tit. 8, § 141(d) (2011), and the board of directors issues stock, *see, e.g.*, *id.* § 152, both of which are fundamental matters clearly addressed by statute.

[32] *See* Johnson, *supra* note 18, at 2; Murray, *supra* note 3, at 18 & n.76 (citing Loizos Heracleous & Luh Luh Lan, *The Myth of Shareholder Capitalism*, HARV. BUS. REV. (Apr. 2010), http://hbr.org/2010/04/the-myth-of-shareholder-capitalism/ar/1 (citing a study that found directors believe they must maximize shareholder wealth)).

[33] *See supra* text accompanying note 16.

[34] Kelley, *supra* note 13, at 369.

perfectly supporting this much more comprehensive outlook."[35] Surely, behind that statement lurks the ghost of Chancellor Chandler's statement about the errant ways of "Internet-based" craigslist in the 2010 *eBay* decision.[36]

As this author has earlier noted, the above statements about the need for Benefit Corp. legislation result from "the perception . . . that for-profit corporations must/should serve shareholder interests exclusively or primarily."[37] And consequently, these perceptions, which stem from "conventional wisdom," however faulty or ill-founded that wisdom may be, "are the key for law reform."[38] Law reform, after all, typically takes place against a perception of need for corrective action, whether grounded rightly or wrongly.[39]

B. History and Corporate Purpose

Whatever one believes the purpose of corporate endeavor is (or should be) today, it is helpful to remember that social expectations of U.S. corporations are fluid, and that they can and have changed.[40] Prior to the nineteenth century, for example, many corporations were charged with carrying out public-serving functions.[41] "Thus, colleges, guilds, and municipalities were often organized as corporations, as were such public-serving transportation ventures as canals or turnpikes."[42] During the colonial period, colonial legislatures had chartered a mere seven

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[35] Michelle Traub, *Etsy Joins the B Corporation Movement*, ETSY NEWS BLOG (May 9, 2012), http://www.etsy.com/blog/news/2012/etsy-joins-the-b-corporation-movement/. Professor Murray's post rightly notes Etsy's initial confusion about being a Benefit Corp. and being a "certified" B corporation. *See* Haskell Murray, *Etsy Becomes a Certified B Corporation,* CONGLOMERATE (May 9, 2012), http://www.theconglomerate.org/2012/05/etsy-becomes-a-certified-b-corporation.html.

[36] eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) ("[T]he craigslist directors are bound . . . to promote the value of the corporation for the benefit of its stockholders.").

[37] Johnsonlp, Comment to *Benefit Corporations: Traditional Paradigm*, CONGLOMERATE (May 3, 2012), http://www.theconglomerate.org/2012/05/benefit-corporations-corporate-purpose.html [hereinafter Johnson Blog Comment]; *accord* Murray, *supra* note 3, at 10.

[38] Johnson Blog Comment, *supra* note 37; *accord* Murray, *supra* note 3, at 17–19.

[39] *See* L.H. LaRue, *Statutory Interpretation: Lord Coke Revisited*, 48 U. PITT. L. REV. 733, 745–46 (1987) (describing an approach to statutory interpretation that begins with legislative identification of a defect needing correction).

[40] As succinctly stated by Holmes, "The first requirement of a sound body of law is, that it should correspond with the actual feelings and demands of the community, whether right or wrong." O.W. HOLMES, JR., THE COMMON LAW 41 (London, MacMillan & Co. 1887).

[41] *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870–1960, at 112 (1992); *see also* Lyman Johnson, *Law and Legal Theory in the History of Corporate Responsibility: Corporate Personhood*, 35 SEATTLE U. L. REV. 1135, 1144–45 (2012) (describing early history).

[42] Johnson, *supra* note 41, at 1145.

business corporations.[43] By 1800, only about 335 business corporations had been chartered, and most were organized in just the last few years of the eighteenth century.[44] In short, the business corporation formed primarily for private gain—as we know it today—was *not* a predominant figure in this country's early social landscape. Moreover, during this period, there appears to have been a special correlating of corporateness with public-oriented service of a sort that did not exist with business activity more generally. An illustrative statement of the early "public-serving" belief about the legal quality of corporateness can be seen in an 1809 Supreme Court of Appeals of Virginia opinion affirming the legislative chartering of an insurance company. Referring specifically to acts of incorporation, the court noted the following:

> [T]hey ought never to be passed, but in consideration of services to be rendered to the public. . . . It may be often convenient for a set of associated individuals, to have the privileges of a corporation bestowed upon them; but if their object is merely *private* or selfish; if it is detrimental to, or not promotive of, the public good, they have no adequate claim upon the legislature for the privilege.[45]

In this portion of the opinion, the court referred twice to the privileges of corporate status and twice to the element of public service. This judicial opinion exemplifies the belief that, in the early nineteenth century, there was no inherent legal right (or settled expectation) to carry on business in the corporate form for the chief purpose of private financial gain.

Thus, Benefit Corps. in one sense represent a twenty-first century return to early U.S. expectations of corporate activity, as leavened by a long period from the early nineteenth century to the present when corporations organized for private gain became predominant due to undoubted overall social utility. And this turn toward the "private" corporation was because the corporation was an ideal social as well as business and legal vehicle for propelling industrial growth in a society that organized the bulk of its economic activity in the private sector.[46] Thus, the pure "for profit" corporation never has been legally mandated

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[43] LESLIE A. WHITE, MODERN CAPITALIST CULTURE 355 (Burton J. Brown et al. eds., 2008).

[44] *Id.*

[45] Currie's Adm'rs v. Mut. Assurance Soc'y, 14 Va. (4 Hen. & M.) 315, 347–48 (1809) (emphasis added); *see also* Johnson, *supra* note 41, at 1146. Interestingly, while the Virginia Supreme Court referred to "associated individuals," it still insisted that such a notion of corporateness supports a public-serving function. The Virginia Bill of Rights of 1776 explicitly stated that "no man, or set of men, is entitled to exclusive or separate emoluments or privileges from the community, but in consideration of public services." VA. CONST. art. 1, § 4. The Virginia Supreme Court applied this provision to corporations in its 1809 decision. *See Currie's Adm'rs*, 14 Va. (4 Hen. & M.) at 347.

[46] *See* Johnson, *supra* note 41, at 1153–54 (describing corporate features undergirding nineteenth-century business growth).

but rather evolved as a permitted (and desired) legal form to efficiently serve social and economic functions. Historically, then, the for-profit corporate form stands between early corporations, most of which chiefly advanced public-serving purposes, and Benefit Corp. statutes, which likewise expressly permit (but do not require) the pursuit of profits while mandating the advancement of purposes other than pure profit maximization.

The White Paper, therefore, may have forgotten corporate history, just as it may have misjudged today's law of corporate purpose. But the position it advances—to legally enable beneficial corporations to serve mixed purposes—reconnects twenty-first century corporation law to early American law and permits corporations that are not nonprofit in nature to seek profits without having to maximize those profits. In this way, Benefit Corps. introduce a greater measure of institutional pluralism into law and business, the subject of the next Part.

II. INSTITUTIONAL PLURALISM AND BENEFIT CORPS.

Over the last two decades, there has been a seeming proliferation of new forms of business association. We have witnessed the rise of the limited liability company ("LLC"),[47] the limited liability partnership ("LLP"),[48] the limited liability limited partnership ("LLLP"),[49] and the statutory trust.[50] Consequently, few business persons, lawyers, scholars, and judges—not to mention law students—are likely to desire yet one more type of business entity to contend with.

But in reality, the only truly revolutionary breakthrough was the LLC. To be sure, the LLP and LLLP reversed a longstanding personal liability rule for general partners,[51] but that rule change took place within an existing, if admittedly evolving, form of business-entity framework.[52] And all of those types of business associations are noncorporate in form. In the corporate arena, although certain features of the law have changed over time,[53] no dramatically new forms have emerged. In fact, the Model Close Corporation Supplement was

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[47] *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 18-101 to -1109 (Supp. 2012).

[48] *See, e.g., id.* §§ 15-1001 to -1105 (2005 & Supp. 2012).

[49] *See, e.g., id.* § 17-214.

[50] *See, e.g., id.* tit. 12, §§ 3801–3863 (2007 & Supp. 2012).

[51] *See, e.g., id.* tit. 6, §§ 15-307(c), 17-403(d) (Supp. 2012).

[52] For example, both the Uniform Partnership Act and the Uniform Limited Partnership Act were revised. *See* UNIF. P'SHIP ACT (1997); UNIF. LTD. P'SHIP ACT (2001).

[53] For example, changes of various kinds have been made to the Model Business Corporation Act and to Delaware's Corporate Code over the years. *See, e.g.*, MODEL BUS. CORP. ACT, at xi–xxvii (2010).

withdrawn.[54] Thus, the addition of Benefit Corp. statutes does not exactly overpopulate the menu of corporate business forms but, rather, adds just one entree to the prior slim pickings. Furthermore, the Benefit Corp. statutory provisions, although separate, are melded with the general incorporation statute,[55] and that statute applies except where specifically displaced by the Benefit Corp. sections.[56] Thus, Benefit Corp. legislation is built on a standard corporate law platform even as it legally reengineers it in novel ways. As aptly observed by the Supreme Court of Delaware: "[I]t is hardly absurd for the General Assembly to design a system promoting maximum business entity diversity."[57]

At a more general and theoretical level than business organizational form, the addition of the Benefit Corp. option represents an example of what Professor Stephen Monsma has called "structural pluralism."[58] Writing in the specific context of faith-based organizations, Monsma notes how, today, these organizations provide an array of social services of a type the government might typically supply, thereby blurring somewhat an overly dichotomous understanding of the "public" and "private" spheres of action.[59] Similarly, certain traditional for-profit entities deliver government-like prison, foster care, and welfare services.[60] In a parallel way, given that Benefit Corps., although "private" corporations, must seek to provide a "public" benefit,[61] we see a similar blurring and converging of the "public" and "private" character in what might be called "benefit-based" organizations. The result is greater pluralism in corporate form and law.

> Structural pluralism, Monsma observes, insists on the unavoidable existence and crucial importance in all human societies of a diversity of social institutions and structures. Human beings do not exist purely as autonomous, [discrete] individuals nor as individuals united only by belonging to a national political community. All human

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[54] *See* ROBERT W. HAMILTON ET AL., CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 391 (11th ed. 2010) (describing withdrawal of the supplement due to belief that few corporations elected close corporation status).

[55] *See, e.g.*, VA. CODE ANN. §§ 13.1-782 to -791 (2011).

[56] *See id.* § 13.1-783; Brakman Reiser, *supra* note 6, at 595–96 & n.25.

[57] CML V, LLC v. Bax, 28 A.3d 1037, 1043 (Del. 2011). Delaware currently lacks a Benefit Corp. statute. *See State by State Legislative Status*, *supra* note 9. As noted in *supra* note 27, that may change in 2013.

[58] STEPHEN V. MONSMA, PLURALISM AND FREEDOM: FAITH-BASED ORGANIZATIONS IN A DEMOCRATIC SOCIETY 117 (2012).

[59] *Id.* at 42–43.

[60] *See* Lisa M. Fairfax, *Achieving the Double Bottom Line: A Framework for Corporations Seeking To Deliver Profits and Public Services*, 9 STAN. J.L. BUS. & FIN. 199, 200, 207 (2004).

[61] *See infra* Part III.

> societies are marked by a multiplicity of intermediate social structures that lie between individuals and the national political community: families, religious congregations, neighborhood groups, social clubs, nonprofit social service organizations, universities, businesses, labor unions, athletic leagues, and a host of other such social structures.[62]

A variety of scholars, including John Dewey, Robert Nisbet, and several communitarian thinkers, have noted that numerous and quite diverse social groups and forms of voluntary association "mediate" between the individual and the state.[63] In essence, structural pluralism places great "weight on the social nature of human beings"[64] and "emphasizes the existence of a plurality of social structures in society."[65] And there is no reason why, with respect to business corporations, there cannot be a pluralism of market-oriented entities designed to advance different purposes. Here, it is useful to recall conservative sociologist Robert Nisbet's emphasis on how mediating social structures grow out of shared "communities of purpose," and how the free market itself is dependent on such social structures and has never "rested upon purely individualistic drives."[66]

There seems to be no good reason to have only an organizational biculture in which, on the one hand, no profit may inure to private persons in a nonprofit corporation and, on the other hand, the singular purpose in a for-profit corporation must be to zealously maximize profits. On a spectrum where those two institutional objectives occupy polar ends, there lies an intermediate range of possible business purposes that combine some level of return to "private" investors with the simultaneous pursuit of more "public" or "social" benefits. As noted in a 2009 report, as corporations become increasingly active in the social sphere, we will likely witness a "wider array of structural options and a greater willingness to experiment."[67] The law should facilitate, not impede, the design of ever more refined firm structures.

Pluralism is important at the individual level as well as the institutional level. Many persons—whether out of philosophical or

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[62] MONSMA, *supra* note 58, at 124. There are others as well, of course, such as producer and consumer co-operatives and private schools.

[63] *Id.* at 125–27.

[64] *Id.* at 123.

[65] *Id.* at 127.

[66] *Id.* at 126–27.

[67] Heather Gowdy et al., *Convergence—How Five Trends Will Reshape the Social Sector*, JAMES IRVINE FOUND., 5 (Nov. 2009), http://www.irvine.org/images/stories/pdf/eval/convergencereport.pdf. For a penetrating review of current organizational design and a conclusion that, currently, firm ownership typically remains in the hands of persons "with highly homogeneous interests," see Henry Hansmann, *Ownership and Organizational Form*, *in* THE HANDBOOK OF ORGANIZATIONAL ECONOMICS 891, 915 (Robert Gibbons & John Roberts eds., 2013).

religious convictions or other beliefs—seek work (and a workplace) where meaning beyond material gain for investors can be pursued and where vocation puts principle into practice.[68] Work can be a way to serve fellow humans, worship one's God, and derive personal fulfillment, as well as gain a livelihood. Creating different sorts of institutional "space" for these endeavors would seem as socially (and personally) useful as providing a statutory vehicle designed to maximize returns to capital providers. And as to capital providers themselves, law should acknowledge the possible heterogeneity of preferences rather than assume a shared taste for "maximizing" at all costs.

Consequently, although the new Benefit Corp. form of business organization is a standard, ready-made *legal* arrangement, it is to be expected that there will be a vast array of different Benefit Corp. *businesses* serving myriad *purposes*. Thus, Benefit Corp. statutes do not simply create one additional way of doing business; they facilitate a host of possible ways to creatively pursue, in varying degrees no doubt, both private gain and public benefit. That is the pluralism of institutional pluralism.[69] The Benefit Corp., in other words, is a legal genre in which various "species" of social enterprise may experiment and operate. This not only helps dissolve simplistic, categorical thinking about profit/nonprofit and public/private organizational forms, it enriches the available ecology of business ventures. That state legislatures would act to enable such enhanced pluralism is, as the Delaware Supreme Court noted, "hardly absurd."[70]

III. ILLUMINATING THE CONFUSION OVER THE CORPORATION'S BEST INTERESTS, CORPORATE PURPOSE, AND FIDUCIARY DUTIES

Besides enhancing corporate pluralism, Benefit Corps. illuminate, and partially meliorate, the continuing confusion over three related subjects in corporate law: the corporation's best interests, corporate purpose, and fiduciary duties. This Part will begin with a brief description of general corporate law's disjointed treatment of these subjects and then turn to how Benefit Corp. statutes handle them in an improved but still unsatisfactory manner. This stems from Benefit Corp. statutes adopting a somewhat more "corporate-centric" than shareholder-centric focus, while also confusingly including elements of a multi-stakeholder approach. This reflects, and perpetuates, a continued

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[68] *See* Lyman P.Q. Johnson, *Faith and Faithfulness in Corporate Theory*, 56 CATH. U. L. REV. 1, 35–37 (2006).

[69] MONSMA, *supra* note 58, at 124.

[70] CML V, LLC v. Bax, 28 A.3d 1037, 1043 (Del. 2011) ("[I]t is hardly absurd for the General Assembly to design a system promoting maximum business entity diversity.").

theoretical and doctrinal failure in corporate law to articulate a truly "corporate" theory of the business corporation.

A. Traditional Corporate Law

Corporate law doctrine frequently refers to the "best interests of the corporation" and to fiduciary duties,[71] but only infrequently to corporate purpose. Cases like *Dodge* and *eBay* are, after all, few and far between.[72] And no corporate statute states that a corporation must maximize profits or shareholder wealth.[73] Rather, all corporate statutes are silent and agnostic on purpose,[74] speaking to "purpose" only by way of permitting a corporation to conduct "any lawful business or purposes."[75]

The issue of how corporate purpose relates to the legal mainstays of fiduciary duties and a corporation's best interests arises because the corporation is a legal person distinct from its various constituencies.[76] Being a distinctive person, but not human, the corporation does not govern itself. It is governed by a board of directors,[77] the body charged with directing the corporation's business and affairs. Given that this governing body must oversee the business and affairs of the "corporation," not those of the shareholders, it is routinely stated that the "best interests of the corporation" should be the directors' focus.[78] The Model Business Corporation Act states this explicitly,[79] and Delaware, in lacking a statutory standard of care, states this through its formulation of the duty of loyalty and the business judgment rule.[80]

But that invites this question: As these governing officials navigate the corporate entity, where are they headed with it? What is the

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[71] There are countless such cases in Delaware. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006); Brehm v. Eisner, 746 A.2d 244, 264 & n.66 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d. 244.

[72] *See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010); Dodge v. Ford Motor Co., 170 N.W. 668, 684–85 (Mich. 1919). For other cases, see William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 825 n.33 (2012).

[73] Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 738 (2005).

[74] *See* Lyman Johnson et al., *Teaching the Purpose of Business in Catholic Business Education*, J. CATH. HIGHER EDUC. (forthcoming 2013).

[75] *See, e.g.*, DEL. CODE ANN. tit. 8, § 101(b) (2011).

[76] *See generally* Lyman Johnson, *Law and Legal Theory in the History of Corporate Responsibility: Corporate Personhood*, 35 SEATTLE U. L. REV. 1135 (2012).

[77] *See, e.g.*, § 141(a).

[78] *See supra* note 71 and accompanying text; *see also* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004?: A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1431 (2005).

[79] MODEL BUS. CORP. ACT § 8.30(a) (2010).

[80] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

"direction" in which the company is to be steered as they "direct" its affairs? In other words, what goal or purpose(s) are directors striving to attain for the corporation? One possible answer is that these officials should advance and "maximize" the interests of the corporation *qua* corporation, that is, as a business enterprise that should succeed and flourish as an enterprise.[81] Another possible answer is that a corporation's best interests, and so too its purpose, are to proficiently serve the consumers of the products and/or services produced by the company. Some support for this interpretation of corporate purpose is found in the statutory provision permitting a corporation to pursue "any lawful business or purposes."[82] Designed to combat ultra vires concerns if a company's charter did not expressly permit entry into a particular line of business,[83] the provision suggests "purpose" means type of business. Thus, the best interests and purpose of an automobile company, organized to manufacture and sell automobiles, are to serve well the interests of auto consumers. Only by succeeding (and surviving) in that endeavor can the auto company itself, as a consequence, flourish, as well as provide returns to all who contribute to its corporate success. And with many firms in many industries in many markets, different corporations, by serving different consumers, have very particularized "best interests" and purposes.

In these views, corporate profits and wealth for shareholders are an outcome, or an "effect," not the initial, essential purpose of the business. And they are a pre-condition for continued long-term enterprise success, but not, as such, the purpose pursued by the corporation, nor are they equivalent to the corporation's best interests. This point was captured by Mark Zuckerberg, the Facebook founder, in his letter to shareholders accompanying the filing of Facebook's registration statement with the Securities and Exchange Commission. There, he stated that Facebook did not "build services to make money; we make money to build better services."[84] Today, there may be no mandatory corporate purpose under corporate law or even a clearly delineated default purpose. The law, it seems, is rightly agnostic on corporate purpose, permitting anything

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[81] For example, the Official Comment to § 8.30(a) of the Model Business Corporation Act states that in "[t]he phrase 'best interests of the corporation' . . . [t]he term 'corporation' is a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body." § 8.30(a) cmt.

This concept of "entity maximization" as the appropriate governance focus is developed by British corporate scholar Andrew Keay. *See* ANDREW KEAY, THE CORPORATE OBJECTIVE 173–275 (2011).

[82] *See, e.g.*, DEL. CODE ANN. tit. 8, § 101(b) (2011); *see also supra* text accompanying note 75.

[83] § 124; *see, e.g.*, Jacksonville, Mayport, Pablo Ry. & Navigation Co. v. Hooper, 160 U.S. 514, 523 (1896).

[84] Facebook, Inc., Registration Statement (Form S-1) 68 (Feb. 1, 2012).

"lawful." It might be preferable, as a matter of statutory drafting, to specify a default purpose—likely profit maximization, given current business norms—coupled with language clearly permitting pursuit of some other purpose or combination of purposes. Oregon, for example, currently allows a provision in a corporation's articles of incorporation that authorizes or directs the conducting of the business in an environmentally and socially responsible manner.[85] The American Law Institute's *Principles of Corporate Governance* states that such a limitation on a pure profit-making objective would be permissible.[86]

Former Chancellor William Chandler, in the *eBay* decision,[87] however, and current Chancellor Leo Strine, in defending the *eBay* opinion,[88] take a different approach. According to them, the fiduciary duties of those who are, statutorily,[89] required by law to direct and advance the best interests of the "corporation," not shareholders, are said to obligate directors, as a matter of "corporate" purpose, to promote the interests of just one stakeholder, i.e., the "stockholders."[90] As former Chancellor Chandler stated: "Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form," including "acting to promote the value of the corporation for the benefit of its stockholders."[91] And Chancellor Strine states bluntly, if matter of factly, that "the corporate law requires directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders."[92] Strine does not even

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[85] OR. REV. STAT. § 60.047(2)(e) (2011).

[86] PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 2.01 reporter's n.6 (1994). The American Law Institute's reporter's note indicates that "all" of the shareholders would have to agree to such a provision, but it is hard to see why that would be necessary given a state's reserved power to amend its corporate statute. The election should then be by the usual required statutory vote to amend the articles or certificate of incorporation.

[87] *See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010). *eBay* is more fully assessed in Johnson, *supra* note 19.

[88] Strine, *supra* note 27.

[89] *See* DEL. CODE ANN. tit. 8, § 141(a) (2011).

[90] *See* sources cited *supra* notes 87–88. By way of contrast, in Canada, the fiduciary duty of loyalty is owed to the corporation. Canada Business Corporations Act, R.S.C. 1985, c. C-44, § 122(1)(a). In discharging that duty, directors may consider the impact of decisions on shareholders or other stakeholders. BCE Inc. v. 1976 Debentureholders, [2008] 3 S.C.R. 560, paras. 81–84 (Can.).

[91] *eBay*, 16 A.3d at 34. He goes on to state that "[d]irectors of a for-profit Delaware corporation cannot . . . defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law." *Id.* at 35.

[92] Strine, *supra* note 27, at 155. He also states that, "as a matter of corporate law, *the* object of the corporation is to produce profits for the stockholders." *Id.* at 151 (emphasis added).

mention the corporation in this sentence or explain the shift from a "corporate" focus to one centered on "shareholders." Like Chandler, he leapfrogs from fiduciary duties over the corporation and its best interests to reach shareholders as the ultimate recipient of those duties. The "corporation," despite being a separate legal entity and meaningful institutional body, and despite the legal touchstone of its "best interests,"[93] becomes, as to purpose, a mere cipher or semantic stand-in for shareholders. This stands in contrast to Canada, for example, where the duty of loyalty runs to the corporation itself, not directly to the shareholders.[94]

Neither Chandler nor Strine—following *Dodge* here[95]—cite any persuasive authority for their assertions. And it is odd, given statutory agnosticism on corporate purpose,[96] that judges could mandate a singular objective for all businesses, even one not chosen by the company's governing officials. Moreover, to fault directors for failing to do what Chandler and Strine state they must do also would seem to revive the ghost of ultra vires—the widely thought dead, but apparently only slumbering, doctrine that a corporation has acted outside its permitted scope,[97] a doctrine put to rest statutorily.[98] In other words, in Chancellor Chandler's view, craigslist's directors charted craigslist toward a prohibited destination, a sort of legal "no fly" zone.[99] Yet no court actually has ordered a company's directors to abandon the business strategy it criticizes; a lesser remedy is imposed.[100] In part, this reflects the nature of the judicial function. Judges address only the particular claims and desired relief that are brought before them. They cannot and do not mandate that governing officials maximize shareholder wealth. They can only prohibit them from taking particularized actions. In *Dodge*, the plaintiffs sought more dividends.[101] In *eBay*, the plaintiffs sought the nullification of certain anti-takeover measures.[102] Neither plaintiff sought an injunction or other remedy that would have prohibited directors from pursuing the criticized business strategy, and

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93 *See supra* text accompanying notes 78–80.

94 *See supra* note 90.

95 Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

96 *See* Elhauge, *supra* note 73, at 738; *see also supra* text accompanying notes 74–75.

97 *See supra* note 83 and accompanying text.

98 *See* DEL. CODE ANN. tit. 8, § 124 (2011); MODEL BUS. CORP. ACT § 3.04 (2010).

99 *See supra* note 91 and accompanying text.

100 The *Dodge* court ordered Ford Motor Company to distribute additional dividends, and the *eBay* court nullified certain anti-takeover defensive measures adopted by craigslist. *See supra* notes 23–28 and accompanying text.

101 Dodge v. Ford Motor Co., 170 N.W.668, 673 (Mich. 1919).

102 eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 6–7 (Del. Ch. 2010).

neither the *Dodge* nor the *eBay* court altered corporate strategy. For judges who routinely recite the vaunted business judgment rule,[103] moreover, one core rationale for which is that directors, not judges, govern corporations,[104] the granting of such extraordinary and meddlesome relief would seem quite unlikely. Judges may be expressing their views about a corporate purpose as they fashion remedial relief, but they leave that purpose intact.

Moreover, the unelected judges in Delaware have been, historically speaking, very reluctant to equate corporate purpose with stockholder wealth, as the turbulent takeover era of the 1980s revealed.[105] In fact, only when the demise of the corporation is at hand or control over its direction shifts away from dispersed shareholders does stockholder wealth become the sole purpose.[106] But those scenarios are essentially either a corporate dissolution setting, where assets always are supposed to be liquidated for the best price and claimants are all paid accordingly, or a setting where control over the direction of the enterprise is fundamentally changing. Those are very different contexts than an ongoing business pursuing an identified corporate purpose.

The key point here is simply to show how, in those few cases where corporate purpose is even addressed, certain judges transmute the statutory mandate (and the corresponding fiduciary duties of directors) to direct and advance the best interests of the corporation—whatever its line of business and business products or services may be—into the singular goal of advancing one stakeholder's interests, that of stockholders.[107] In this way, the corporation, as a distinct legal form of

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[103] *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 & n.66 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d 244.

[104] DEL. CODE ANN. tit. 8, § 141(a) (2011). *See generally* Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625 (2000) (describing rationales for the business judgment rule).

[105] *See* Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 934 (1990) (noting Delaware's "doctrinal expression of ambivalent social expectations of corporate behavior").

[106] Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 50 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

[107] Professor Stephen Bainbridge makes a similar move in stating he does not think "it's useful to ask the question of 'what purpose does the law mandate the corporation pursue?'" Stephen Bainbridge, *Is It Useful to Think About Corporations as Having a "Purpose"?*, PROFESSORBAINBRIDGE.COM (May 6, 2012, 1:56 PM), http://www.professorbainbridge.com/professorbainbridgecom/2012/05/is-it-useful-to-think-about-corporations-as-having-a-purpose.html. Bainbridge goes on to say that "it is far more preferable to operationalize this discussion as a question of the fiduciary duties of corporate officers and directors rather than as a corporate purpose." *Id.* A recent article on Benefit Corps. similarly collapses corporate purpose into the separate issue of fiduciary duties. *See* Justin Blount & Kwabena Offei-Danso, *The Benefit Corporation: A Questionable Solution to a Non-existent Problem*, 44 ST. MARY'S L.J. (forthcoming 2013).

organization and as a meaningful social-economic institution distinguishable from its constituencies, is disregarded. And the corporation's role as a social institution aiming to serve, as Peter Drucker observed it must,[108] some purpose outside itself also remains unacknowledged. It also confuses the fiduciary duties of directors—i.e., an admonition to be careful and loyal in how they act—with the more fundamental issue of what their job even is as they direct and navigate corporate affairs.

There is much in 2013 that remains legally murky and conceptually odd about all this in modern corporate law and theory, and more can and should be said.[109] What is instructive from a comparative organizational-form vantage point, however, is to shift attention to Benefit Corp. statutes to see how they handle the interrelationship of fiduciary duties, best interests of the corporation, and corporate purpose.

B. Benefit Corps.

Concerned about what they believe to be a legal requirement for corporations to maximize shareholder wealth as a matter of corporate purpose—and regarding it as a fiduciary duty—proponents of social enterprise crafted Benefit Corp. statutes to avoid that supposed mandate.[110] As to corporate purpose, the statutes require that one purpose of a Benefit Corp. must be to advance a "general public benefit." That phrase typically means a "material positive impact on society and the environment, taken as a whole."[111] Noticeably, the corporate purpose has a general "external" focus rather than a particular stakeholder focus. It would seem an improvement in this regard to permit a focus on society "or" the environment, rather than both, to allow the pursuit of socially useful benefits having no particular benefit to the environment or vice versa.[112] The statutes also permit the pursuit of one or more "specific

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The issue is not, however, the second-order issue of fiduciary duties; it is a first-order question of what the directors' *job* is. How can directors or the governing officials of any institution know what they are supposed to do—and hence the quest to which they must be loyal—if they have no idea what the institution's overall purpose is?

[108] Peter Drucker stated that "[i]f we want to know what a business is we have to start with its *purpose*. And its purpose must lie outside of the business itself. In fact, it must lie in society since a business enterprise is an organ of society." PETER F. DRUCKER, THE PRACTICE OF MANAGEMENT 37 (HarperCollins 2006) (1954).

[109] *See* sources cited *supra* note 19.

[110] *See* White Paper, *supra* note 5, at 7–14; Clark & Babson, *supra* note 72, at 825.

[111] *See, e.g.*, CAL. CORP. CODE § 14601(c) (West Supp. 2013). *But see* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01(c) (West Supp. 2012) (omitting the "taken as a whole" language).

[112] Haskell Murray, *Benefit Corporations: "General Public Benefit,"* CONGLOMERATE (May 10, 2012), http://www.theconglomerate.org/2012/05/benefit-corporations-general-public-benefit.html. In this regard and others, California's flexible purpose statute may

public benefits."[113] Thus, a general public benefit is a required corporate purpose, and one or more specific public benefits are permitted corporate purposes. The statutes do not preclude pursuit of additional corporate purposes, such as making profits and paying dividends to shareholders. Consequently, as a theoretical matter at least, a Benefit Corp. that pursued a public benefit could also seek to enhance corporate profits and shareholder wealth, perhaps to a considerable degree. The difference is both that Benefit Corps. need not maximize profits and must advance a public benefit.

Turning from corporate purpose to the issue of the "best interests of the corporation," Benefit Corp. statutes generally link that issue to corporate purpose in a coherent and ingenious way. They typically provide that the creation of a general public benefit or a specific public benefit *is* deemed to be in the best interests of the corporation.[114] This alignment of corporate purpose with corporate best interests does more than simply reject traditional corporate law's not-so-subtle leap from a directorial obligation to serve the corporation's best interests to shareholder wealth maximization as a corporate purpose. Having initially rejected shareholder wealth maximization as a required corporate purpose in favor of advancing general/specific public benefits, Benefit Corp. statutes then go on to posit a legal congruence between the corporation's best interests and its public benefit corporate purpose.[115] Consistently, and keeping the focus on the corporation rather than on one stakeholder within the corporation, the statutes thus coherently

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accord more "flexibility" with respect to corporate purpose. CAL. CORP. CODE § 2602(b)(2)(A)–(B) (West Supp. 2013). Such corporations may advance the interests of specified stakeholders and/or the community and society and/or the environment. *Id.*; *see also* Brakman Reiser, *supra* note 6, at 595 n.22; Murray, *supra* note 3, at 24.

[113] *See* CAL. CORP. CODE § 14610(b) (West Supp. 2013). These "specific public benefits" include, among other benefits, "[p]roviding low-income or underserved individuals or communities with beneficial products or services," "[p]reserving the environment," "[i]mproving human health," and "[t]he accomplishment of any other particular benefit for society or the environment." CAL. CORP. CODE § 14601(e) (West Supp. 2013). Note that in the last phrase the benefit can be to society "or" the environment, unlike the "and" in the general public benefit requirement.

[114] *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06(c) (West Supp. 2012); VA. CODE ANN. § 13.1-787(B) (2011).

[115] This equating of the corporation's best interests with the corporation's public benefit purpose(s) does, however, mean that other corporate purposes, such as pursuing profits or shareholder wealth, are not likewise equated with the corporation's best interests in the statute. Thus, to create financial benefits of whatever magnitude for investors without creating a public benefit would not fall within the statutory definition of the corporation's best interests. In this way, although a Benefit Corp. can pursue financial purposes along with public benefit purposes, only the latter are equated with the corporation's best interests.

align the *corporation's* best interests with the ongoing pursuit of the purpose(s) for which the *corporation* was formed.[116]

So far, this linkage avoids the category shift from a corporate focus to a shareholder focus seen in such cases like *Dodge* and *eBay* that address corporate purpose.[117] As to fiduciary duties, then, one might think they also would be aligned accordingly in Benefit Corp. statutes. That is, the fiduciary duties of directors should be to carefully and loyally advance the best interests of the corporation, and, since the best interests of the corporation relate to its public benefit, the duties would be to pursue the avowed public benefits—i.e., to advance the corporation's purpose(s). This would deftly harmonize fiduciary duties, corporate purpose, and the best interests of the corporation.

Instead, with respect to director duties, most Benefit Corp. statutes take an odd turn. The statutes typically require directors, in considering the best interests of the corporation, to consider the effects of any action (or decision not to act) on a number of stakeholders.[118] Thus, in contrast to the constituency statutes embedded in many traditional corporate statutes, which simply permit consideration of stakeholder interests,[119] Benefit Corp. statutes mandate it.[120] In doing so, however, these laws seem to formulate fiduciary duties in stakeholder terms, not in terms of the *corporation's* best interests or furthering *corporate* purposes.

To be sure, most statutes include in the list of factors that directors must consider the interest of the Benefit Corp. itself and its ability to accomplish its general/specific public benefit.[121] Indeed, Hawaii coherently focuses only on the latter, along with shareholders, and dispenses with mandatory consideration of any other stakeholders.[122]

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[116] *See* statutes cited *supra* note 114.

[117] *See supra* Part III.A.

[118] *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1) (West Supp. 2012); VA. CODE ANN. § 13.1-788(A)(1) (2011).

[119] *See supra* note 29 and accompanying text.

[120] *See* statutes cited *supra* note 118. This faulty move is only heightened in the recent amendments to the Model Benefit Corporation legislation. There, a business judgment rule is codified for directors and officers. MODEL BENEFIT CORP. LEGISLATION §§ 301(a), 303(a) (Bill Clark Jan. 26, 2012). Each group is to act in the "best interests of the benefit corporation." *Id.* Yet, in comments to those sections, it is stated that a determination of the corporation's best interests requires consideration of stakeholder interests. *Id.* §§ 301 cmt, 303 cmt. This undermines the correlation between corporate purpose and corporate best interests noted earlier. *See supra* notes 114–16 and accompanying text. Moreover, for officers, who are agents of the corporation itself, their duty is to the entity. It is not clear what the theoretical rationale is for requiring them to consider interests other than those of their principal, as agency principles require.

[121] *See, e.g.*, VT. STAT. ANN. tit. 11A, § 21.09(a)(1) (2010); VA. CODE ANN. § 13.1-788(A)(1) (2011). Oddly, Maryland does not include these. *See* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1) (West Supp. 2012).

[122] *See* HAW. REV. STAT. § 420D-6(a)(1) (West Supp. 2011).

After all, if the statutory policy goal were mandatory consideration of stakeholders, one could simply make existing constituency statutes mandatory and state that maximizing stakeholder wellbeing of some sort is the corporate purpose,[123] or a Benefit Corp. could make the wellbeing of one or more particular stakeholder groups an avowed "specific" benefit. Maryland, by contrast, does not even include within enumerated factors the ability to accomplish the corporation's avowed public benefits.[124] In Maryland, consequently, directors must consider various stakeholders but need not consider the company's ability to accomplish its very purpose, a purpose defined as being in the company's best interests.[125]

The upshot is a missed opportunity to bring conceptual and doctrinal harmony to the interrelationship of corporate purpose, a corporation's best interests, and fiduciary duties that has long been missing in corporate law. Instead, Benefit Corps. usefully equate the first two, but most do not then go on—as, notably, Hawaii does[126]—to synchronize them with the third. Instead, most seem to adopt a multi-stakeholder focus, not a truly "corporate" focus. And this illuminates the root problem with those theoretical proposals (and now laws) that seek to displace a shareholder-centric view of fiduciary duties with a stakeholder-centric view. Doing so simply adds to the number of individual interests clamoring for the attention and duties of directors. Instead of attending solely to stockholder wellbeing, directors are required to consider the wellbeing of multiple interests, whereas they should attend exclusively to the corporation's best interests and to advancing its avowed institutional purposes.

The point here is not simply that this is troubling on the grounds that to serve many interests directors really serve none, as many argue,[127] a typical critique of stakeholder theories dating back to Adolf Berle.[128] The point instead is that in renouncing shareholder primacy, and having invoked the "corporation" and its public benefits as the apparent organizational and legal focus, Benefit Corp. statutes then

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[123] Confusingly, some proponents apparently do believe the objective of Benefit Corps. is to maximize stakeholder value. *See* Murray, *supra* note 3, at 30 (citing example).

[124] *See* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1).

[125] *Id.*

[126] HAW. REV. STAT. § 420D-6(a)(1); *see also supra* text accompanying note 122.

[127] *See, e.g.*, Murray, *supra* note 3, at 27–29; Briana Cummings, Note, *Benefit Corporations: How To Enforce a Mandate To Promote the Public Interest*, 112 COLUM. L. REV. 578 (2012).

[128] *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1012 (1992); A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932). For an extensive consideration of various concerns raised by multi-stakeholder approaches to fiduciary duties, see KEAY, *supra* note 81, at 173–230.

seemingly abandon that larger institutional objective on the fiduciary duties issue.[129] These statutes, in other words, renounced shareholder primacy as to corporate purpose but did not carry through on a fully corporate-centered, mission-oriented focus on fiduciary duties. There is no necessary reason why a corporation cannot usefully advance a public benefit without also requiring the board to consider a range of individual stakeholders. They can be linked of course, but they are conceptual horses of a different color. If certain stakeholder interests were truly deemed to be "corporately" important, they should be included in the definition of public benefit (general or specific), and thereby they would be an element of the corporate purpose.

Benefit Corp. laws thus fail to fully advance a new institutional model of the corporation as representing a larger common good of shared values and mutual commitments—with no mandatory consideration of any interest not identified as advancing that particular corporate purpose—as opposed to an association of a now larger but still fragmented group of stakeholding individuals.[130] Beyond failing at the level of firm theory, these statutes also fail to move us beyond the individualistic, self-interested anthropological understanding of constituencies we see in traditional corporate law and its neoclassical premises.[131] Lacking is a conception of business participants as motivated by, and playing the role of serving, the larger, common good of the institution. This may stem from the nebulous nature of "public benefit," and so corporate purpose in these statutes simply leaves an array of stakeholders as a somewhat more tangible directorial focus. Nonetheless, it obscures the manner in which all stakeholder interests should be secondary to overall corporate purpose. Benefit Corps. would be well advised to articulate more fully what their corporate mission/purpose really is, in a way going beyond the statutory bare bones.

The lack of a fully conceptualized theory of corporateness or of an anthropology of corporate constituencies in Benefit Corp. statutes is seen as well in the liability and remedial provisions of those laws. Most statutes—New York and Maryland being exceptions[132]—provide for a

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[129] In Canada, the fiduciary duty of loyalty is owed to the corporation itself. *See supra* note 90.

[130] The theoretical distinction between conceiving of corporations as an "association of individuals" and as a mission-centered "corporate community" is elaborated on in Johnson et al., *supra* note 74.

[131] *Id.*

[132] These statutes do not provide for such an enforcement proceeding, unlike the laws of the other states. *See* Christopher Lacovara, *Strange Creatures: A Hybrid Approach to Fiduciary Duty in Benefit Corporations*, 2011 COLUM. BUS. L. REV. 815, 831 (2011).

"benefit enforcement proceeding" cause of action,[133] the exclusive remedy.[134] California specially provides for no director, officer, or corporate liability for monetary damages.[135] Hawaii, Maryland, and Virginia, by contrast, absolve directors of monetary liability so long as they comply with the generally applicable standards for directors of all corporations.[136] Moreover, no duty is owed to beneficiaries of the public benefit purpose of the Benefit Corp.,[137] and, notwithstanding that directors must consider many stakeholder interests,[138] apparently no duty is owed to them.[139] This latter point, that there is no correlative ability of stakeholders to claim a breach of a duty owed to them that would mirror the directors' duty to consider their interests, reveals the conceptual muddle.

A benefit enforcement proceeding may be brought only by persons specified in the statute, typically the corporation itself, directors, and shareholders.[140] No statute confers standing to bring such an action on those stakeholders—except shareholders—whose interests must be considered by directors. Thus, nonshareholder stakeholders neither are said to be owed a fiduciary duty—even though their interests must be considered by directors[141]—nor do they have standing to begin an enforcement proceeding. A shareholder, however, may bring an enforcement proceeding on the ground, among others, that directors failed to consider stakeholder interests.[142] Shareholders alone, therefore, are the policing mechanism in this regard, not any other stakeholders.[143] Consequently, Benefit Corps. are only partially, but not fully, predicated on a multi-stakeholder conception of the corporate firm even with

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[133] *See, e.g.*, VA. CODE ANN. § 13.1-790 (2011).

[134] *Id.*

[135] CAL. CORP. CODE §§ 14620(f), 14622(c), 14623(c) (West Supp. 2013).

[136] HAW. REV. STAT. § 420D-6(b) (West Supp. 2011); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(c) (West Supp. 2012); VA. CODE ANN. § 13.1-788(C) (2011).

[137] MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(b) (West Supp. 2012); VT. STAT. ANN. tit. 11A, § 21.11(e) (2010).

[138] *See supra* note 118 and accompanying text.

[139] *See, e.g.*, VT. STAT. ANN. tit. 11A, § 21.09(e) (2010) (creating a director duty only to those persons who are entitled to bring an enforcement proceeding).

[140] *E.g.*, HAW. REV. STAT. § 420D-10 (West Supp. 2011); VT. STAT. ANN. tit. 11A, § 21.13(b) (2010).

[141] *See supra* note 118 and accompanying text.

[142] N.J. STAT. ANN. § 14A:18-10(b)(2)(a) (West Supp. 2012); VT. STAT. ANN. tit. 11A, § 21.13(b)(1).

[143] Shareholders of Benefit Corps. can also, presumably, bring an action for director failure to comply with duties owed to shareholders, as in all corporations. And of course, shareholders alone vote for directors and can remove directors, usually with or without cause. Contrary to a suggestion made by Blount and Offei-Danso, Blount & Offei-Danso, *supra* note 107, it is extremely unlikely that the shareholders' right to elect and remove directors would be impeded by a court order mandating that a director be reinstated.

respect to fiduciary duties and enforcement actions. They truly are hybrid vehicles, combining a novel mandatory consideration of stakeholders with the more traditional enforcement rights of directors and shareholders. Thus, Benefit Corp. statutes neither adopt a full-fledged, exclusively corporation-focused model that aligns corporate purpose, best interests, and fiduciary duties, nor do they adopt a fully rendered stakeholder model.

Benefit Corp. statutes reflect a deep clash between an exclusively "external" focus with respect to corporate purpose and public benefit, on the one hand, and a partially "internal" multi-stakeholder focus, on the other hand. This clash is not unexpected given current corporate theory's failure to reconcile a theory of the corporation as a firm with the corporation's overarching purpose in the larger society. To be somewhat more faithful to a true "corporate" and mission-centered approach to fiduciary duties, however, Benefit Corp. statutes could follow the example of Hawaii. Hawaii provides that directors and shareholders may bring direct or derivative actions to enforce the corporate purposes and to enforce the public benefit purposes as well as the director standard of conduct.[144] Given that in Hawaii the directors must consider only how an action affects shareholders and the avowed public benefits[145]—not any other stakeholders—this adopts a truer "corporate" conception of a firm that more sensibly aligns fiduciary duties with corporate purpose and the best interests of the corporation. All three of these in Hawaii have a coherent corporate, mission-centered thrust. To be sure, shareholder interests must still be considered and shareholders may bring enforcement proceedings,[146] but that is because Benefit Corps. also have a corporate purpose of helping shareholders, in addition to advancing a public benefit purpose.

IV. ARE BENEFIT CORPS. GOOD FOR OTHER CORPORATIONS' SOCIAL RESPONSIBILITY?

Numerous points have been made in the debate over whether social enterprise generally—and Benefit Corps. in particular—will enhance

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[144] HAW. REV. STAT. § 420D-10 (West Supp. 2011). Every other state similarly appears to permit an enforcement proceeding on the ground of not creating a public benefit but couples that with mandatory consideration of various stakeholders, even though nonshareholder stakeholders are said not to be owed duties and cannot bring enforcement proceedings. *See, e.g.*, N.J. STAT. ANN. § 14A:18-10 (West Supp. 2012); VA. CODE ANN. § 13.1-790 (2011). New Jersey and Virginia also provide that directors do not have personal monetary liability for failure to actually create a public benefit. N.J. STAT. ANN. § 14A:18-6(d) (West Supp. 2012); VA. CODE ANN. § 13.1-788(C)(2) (2011).

[145] HAW. REV. STAT. § 420D-6(a)(1) (West Supp. 2011).

[146] *Id.* § 420D-10.

corporate responsibility.[147] Concerns include whether investors will fund hybrid ventures that afford them neither a tax deduction, as do charitable contributions to certain nonprofit entities, nor a market rate of return.[148] The supposed considerable size of the market for socially responsible investing—disputed by Professor Benjamin Richardson[149]—leads some to argue that many investors will "blend the desire for profits with the desire for social good."[150] Tranches of debt or equity offering returns ranging from a market rate for one or more layers of debt/equity, but below market rates to other senior and less risky layers provided by more mission-driven "social" investors, might aid in capital formation.[151] Certainly, providing ex ante an option to exit at some point would facilitate attracting capital, either via a market for the securities or contractually bargained for liquidity rights. More generally, the entire social investment phenomenon must address whether such investing is a business-driven strategy to make profits or is grounded on broader social and ethical criteria.[152]

Concerns also have been raised about the size of the consumer market for Benefit Corp. goods and services.[153] Many people, responding to surveys or polls, report that a purveyor's social responsibility matters to them,[154] but whether they actually behave in accordance with their responses is less clear.[155] David Vogel, a professor at Haas School of Business (Berkeley), concludes that what he calls the "market for virtue" is "best understood as a niche rather than a generic strategy."[156] And he believes that "few consumers, investors, and employees are actually willing to 'vote' for [corporate social responsibility] in the marketplace."[157]

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[147] *See generally* Brakman Reiser, *supra* note 6; Murray, *supra* note 3.

[148] Kelley, *supra* note 13, at 354–55.

[149] Benjamin I. Richardson, *Are Social Investors Influential?*, 9 EUR. COMPANY L. 133, 134 (2012) (arguing the social investment market is much smaller than many report).

[150] Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1, 39 (2011). *But see* Steven J. Haymore, Note, *Public(ly Oriented) Companies: B Corporations and the Delaware Stakeholder Provision Dilemma*, 64 VAND. L. REV. 1311, 1337, 1343 (2011) (observing that social responsibility-related shareholder proposals draw little support and that institutional investors shy away from alternative entities).

[151] *See* Katz & Page, *supra* note 1, at 93.

[152] This is very ably described by Professor Benjamin I. Richardson. *See generally* Richardson, *supra* note 149.

[153] Katz & Page, *supra* note 1, at 81–82.

[154] *See* Cummings, *supra* note 127, at 583 n.35; *see also* Katz & Page, *supra* note 1, at 93.

[155] *See generally* DAVID VOGEL, THE MARKET FOR VIRTUE: THE POTENTIAL AND LIMITS OF CORPORATE SOCIAL RESPONSIBILITY (2006).

[156] *Id.* at 3.

[157] *Id.* at 14.

As with activity in the capital markets, at this stage we do not have sufficient experience and empirical data on consumer behavior in the Benefit Corp. market segment to know whether mission-customer loyalty, "branding," or other features of Benefit Corp. marketing strategy will succeed.[158] It also may be challenging for legitimate Benefit Corps. to truly and convincingly distinguish themselves from traditional companies making similar claims, whether or not those companies actually behave in that manner.[159] At the start-up stage, moreover, a Benefit Corp. is going to be limited in geographic distribution and, within that area, in consumer segments. Thus, a Benefit Corp. must be fairly certain it can succeed in its niche, probably more so than the average corporation, because there is a decided potential for consumer confusion/misinformation. But when a company does succeed in a niche, it may gain a snowballing edge with consumers who wish to be *au courant* in their purchases, as they acquire status along with a good or service. And if consumers generally begin to associate corporate social responsibility with Benefit Corps., and social irresponsibility with more traditional corporations, that may have spillover benefits for using the Benefit Corp. form of business.

These and related concerns about the viability of social enterprise and Benefit Corps., given market realities, all focus on their ability to directly influence corporate responsibility through their own behavior. But another slant on the larger corporate responsibility issue is to ask whether and how entry of Benefit Corps. into the marketplace will influence corporate responsibility as engaged in by traditional for-profit firms. Will such behavior be negatively affected, actually increase, or not be altered at all?

Ultimately, this too is an empirical question as to which greater longitudinal data is needed. There are some reasons at this stage to conjecture that the impact will be adverse. For example, to the extent Benefit Corps. represent a segmenting of the market, some traditional firms might be glad to abandon at least some of their social responsibility initiatives—if not the rhetoric—on the rationale that now those "are for Benefit Corps. to do." This view might be accompanied by the legal argument that legislation authorizing special vehicles for social enterprise—i.e., Benefit Corps.—implies that traditional corporations should maintain, if not heighten, their predominant focus on profits and shareholder wealth.[160] Corporate responsibility that does not harm

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[158] *See* Brakman Reiser, *supra* note 6, at 621–24.

[159] *Cf.* White Paper, *supra* note 5, at 3–5 (making an argument for Benefit Corps. in this regard).

[160] *See* Callison, *supra* note 10 (arguing that Benefit Corp. legislative history could have negative and unintended consequences for understandings of what traditional

profits would therefore be fine, but not such activity as might reduce profits. Social responsibility activity would then become a niche in the larger market rather than exist pervasively, if modestly, in many businesses. Also, if Benefit Corps. flounder, or simply fail to be real game changers, management at traditional corporations might interpret that as a signal from the consuming and investing public that social enterprise is more honored in those markets by the breach than the observance.[161]

These and other arguments suggest Benefit Corps. might set back traditional corporate responsibility. But at this early stage there also are reasons to think Benefit Corps. will have a positive effect on social responsibility in the traditional sector. For example, whatever their time horizon, savvy investors in Benefit Corps. likely will, ex ante, contemplate their "exit strategy." Some might see the Benefit Corp. simply as an incubator for the social enterprise strategy. If and when the company demonstrates the existence of a significant market, the Benefit Corp. might be sold to a traditional company seeking to enter that market, possibly growing it through leveraging certain economies of scale.[162]

In this absorption strategy, some Benefit Corps. at least would vie to demonstrate profitability along with public benefit. Admittedly, these purposes may clash. But they currently clash in all Benefit Corps. whether or not they sell because Benefit Corps. are multipurpose ventures that seek profits and public benefit.

It is possible that acquisition-minded companies will tend to purchase those Benefit Corps. whose strategy is somewhat skewed toward earning profits over advancing a public benefit. If that strategy by the acquired Benefit Corp. found a favorable market reception, however, there would be no rational reason to abandon it. It would simply reveal a range of strategies within the social enterprise sector itself, the "pluralism" noted earlier.[163] Moreover, there remains an overall net increase in socially responsible behavior.

And if post-acquisition a somewhat "less responsible" but more profitable Benefit Corp. target proves nonetheless to be a bad fit, the company could be restructured along more responsible lines or divested

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corporations must do); Underberg, *supra* note 8 (same). This interpretation of what Benefit Corp. legislation means for traditional for-profit corporations seems dubious, but given the role of perception, as noted earlier in *supra* Part I, this interpretation cannot be ruled out.

[161] *See* WILLIAM SHAKESPEARE, HAMLET act 1, sc. 4.

[162] Professors Katz and Page report that, after purchasing Ben and Jerry's, Unilever continued certain socially responsible business practices of that company. Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211, 211–12, 214 (2010).

[163] *See supra* Part II.

to someone who could refocus the business. In both the success and failure settings, at least a traditional company has entered social enterprise and sought to grow the activity. And the acquirer, in communicating that it has entered this area, may find it experiences a "halo effect" in which consumers form a positive impression of the acquirer that will extend to its other products and services.

For the "purist" Benefit Corps. and their investors who eschew the sale exit option, success by the Benefit Corp. will nonetheless demonstrate to traditional corporations that a viable market exists. The traditional company may then enter the market and compete against the Benefit Corp. To the extent it delivers the same kind of product or service, albeit to generate meaningful profits, it has advanced the same consumer goal as the pathbreaking Benefit Corp. Benefit Corps. here, then, will have produced a positive "externality" in this market segment.

Moreover, Benefit Corps. that do not sell, but later find themselves competing with larger for-profit companies, must innovate to maintain (or increase) their market share. Their smaller size and sharper, local focus may permit quicker adaptation, thereby outmaneuvering larger but slower-footed organizations.

Finally, the existence of Benefit Corps. might encourage traditional companies to increase their level of contributions to "quasi-philanthropic" organizations. Currently, for-profit corporations make various contributions to charity or other social service organizations, typically formed as nonprofit organizations.[164] Benefit Corps. might afford an additional outlet where companies, without reducing contributions to nonprofits, could invest to support the Benefit Corps.' social missions while also expecting some sort of positive financial return. Moreover, news of the traditional company's support of social enterprise might once again garner it a useful "halo effect" for its other products or services.

CONCLUSION

Benefit Corp. legislation may stem from faulty and debatable understandings of corporate law and history, but it usefully advances pluralism in corporate forms of organization. These statutes facilitate, but do not mandate, the formation of for-profit companies to promote a larger societal objective. Neither corporate governance itself nor the essential architecture of corporation statutes is significantly altered in this reform. These statutes, by linking corporate activity to a larger, external purpose, can help legitimate corporate power in the broader society at a time of widespread disenchantment with most things

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[164] *See* Steve Lohr, *First, Make Money. Also, Do Good.*, N.Y. TIMES, Aug. 14, 2011, § BU (Sunday Business), at 3.

corporate. Whether Benefit Corps. make real inroads with capital providers and consumers, and alter the overall type and amount of corporate responsibility, remains to be seen.

At the doctrinal and theory level, Benefit Corp. statutes illuminate the unresolved muddle in corporate law doctrine and theory concerning the inter-relationship among corporate purpose, a corporation's best interests, and fiduciary duties. Benefit Corp. statutes harmonize the first two areas, but, reflecting persistent failures to articulate a truly compelling corporate theory, they confusingly and half-heartedly invoke elements of stakeholder theory instead of fully promoting an overarching, corporate-centric approach that makes neither shareholders nor a medley of stakeholders the ultimate focal point of corporate endeavor.

TO BE OR NOT TO BE (A SECURITY): FUNDING FOR-PROFIT SOCIAL ENTERPRISES

Joan MacLeod Heminway[*]

INTRODUCTION

Interest in for-profit social enterprise in the United States may be seen as, among other things, a reaction to perceptions about the focus of fiduciary duty law in for-profit entities, especially corporations. The labeling and parsing of fiduciary duties owed by constituents of the firm has been a major task of entity law over the years. The task is important because these fiduciary duties both reflect and foster trust among the constituents in a business enterprise. This undertaking has gotten the most attention in the area of for-profit corporate director fiduciary duties.

Some corporate law scholars claim that the fiduciary duties of for-profit corporate directors—the group, constituted as a board of directors, that manages or directs the management of the business of the corporation under state corporate law norms[1]—have evolved to the point that they no longer are truly owed to the firm, but (instead) are owed to shareholders and, in any event, serve the primary objective of enhancing shareholder value.[2] This general understanding of the fiduciary duties of

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[1] Corporate directors manage a spectrum of financial interests and instruments that require regulation. DEL. CODE ANN. tit. 8, § 141(a) (2011); MODEL BUS. CORP. ACT § 8.01(b) (2011).

[2] *See, e.g.*, Richard A. Booth, *Who Owns a Corporation and Who Cares?*, 77 CHI.-KENT L. REV. 147, 147 (2001) ("Most commentators would likely agree that a corporation is owned by its stockholders and that management has a duty to maximize stockholder wealth."); Tamara R. Piety, *Against Freedom of Commercial Expression*, 29 CARDOZO L. REV. 2583, 2623 (2008) ("Pursuant to conventional interpretations of black letter corporate law, the corporation's officers and directors have primarily one duty—to enhance shareholder value."). No doubt all would acknowledge that the fiduciary duties of corporate directors may, in certain factual contexts (notably, the adoption of takeover defenses in certain situations), require the board to give primary consideration to the accretion of shareholder wealth. *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1425 (2008) ("Delaware has made clear that 'absent a limited set of circumstances' in which the corporation literally has no long-term future because its demise has become inevitable, 'a board of directors . . . is not under any *per se* duty to maximize shareholder value in the short term.'" (quoting Paramount Commc'ns,

corporate directors has been identified as the shareholder wealth maximization norm.[3] The shareholder wealth maximization norm may be seen as a manifestation or element of shareholder primacy theories of the firm[4] or as the aim of director primacy in corporate decision-making.[5]

The shareholder wealth maximization norm has been the subject of significant academic debate.[6] Scholars disagree about whether

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Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989)); Brian JM Quinn, *Re-Evaluating the Emerging Standard of Review for Matching Rights in Control Transactions*, 36 DEL. J. CORP. L. 1011, 1030–31 (2011) ("In a sale of control boards 'have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders.'" (quoting Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994)). This is, however, a narrow view on the operation of the norm.

[3] *See generally, e.g.*, Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 504 (2008) ("In the absence of actual expressions of preferences, the shareholder wealth maximization norm serves as a theoretical stand-in for shareholder preferences.").

[4] *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003) [hereinafter Bainbridge, *Director Primacy*] ("As a theory of the firm, shareholder primacy embraces two distinct principles: (1) the shareholder wealth maximization norm . . . ; and (2) the principle of ultimate shareholder control."); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 637 (2006) ("The shareholder primacy norm defines the objective of the corporation as maximization of shareholder wealth."); Hayden & Bodie, *supra* note 3, at 447 ("The notion that shareholder interests should be pursued as the ultimate ends of the corporation is known as shareholder primacy theory, or the shareholder wealth maximization norm."); Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 73 (2010) ("It should be noted that some ambiguity surrounds use of the term 'shareholder primacy,' which can refer to both the shareholder wealth maximization norm (the vertical axis) *and* to the view that the balance of power in corporate governance should be set in favor of greater shareholder control (the horizontal axis)."); David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 901 (2002) ("Shareholder primacy is the idea that corporate management's primary duty is to maximize shareholder wealth."); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 819 (2008) ("[M]anagers should manage the firm with a view to maximizing shareholder value. This shareholder primacy norm harnesses the zest for private wealth maximization to serve the broader goal of social wealth maximization.").

[5] *See* Bainbridge, *Director Primacy*, *supra* note 4, at 551 ("In the director primacy theory, however, the board of directors has a contractual obligation to maximize the value of the shareholders' residual claim. In other words, the director primacy theory embraces the shareholder wealth maximization norm even as it rejects the theory of shareholder primacy."); Hayden & Bodie, *supra* note 3, at 503–04 (summarizing Bainbridge's argument in this regard).

[6] *Compare, e.g.*, Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 785 (2006) ("[C]hief among the shareholders' contractual rights is one requiring the directors to use shareholder wealth maximization as their principal decision-making norm."), *with* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249 (1999) ("[W]e take issue with both the prevailing principal-agent model of the public corporation and the shareholder

shareholder wealth maximization is, in fact, a legal or practical norm and, if it is either type of norm, the conditions under which it operates.[7] Postmodern corporate law scholars question the universal operation of all but the broadest interpretation of the shareholder wealth maximization norm (which would include nonfinancial elements of wealth in the shareholder wealth calculation), with one scholar noting that the shareholder wealth maximization norm "is the dominant position in American corporate law scholarship, although I do not personally share it."[8] In fact, the law in many contexts, as played out in different jurisdictions, is not altogether clear on the existence and application of the norm.[9] Some who believe that corporate law has evolved to support a unitary (or near unitary) corporate objective to maximize shareholder wealth perceive that development as negative.[10]

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wealth maximization goal that underlies it."). For further evidence of this debate, see LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 2–8 (2012) (describing and countering the shareholder wealth maximization norm); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers.").

[7] *See generally* J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 35 (2011) ("Academics debate whether the law guides directors to pursue shareholder wealth maximization (primarily or exclusively), or, more generally, advises directors to seek the health and welfare of the corporation as a whole.").

[8] Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 146 (2009).

[9] One scholar makes the case that Delaware corporate law, the most well developed body of law on the subject, is ambiguous on the point.

> Ambivalence regarding the degree to which shareholder wealth maximization ought to be the aim of corporate decision-making manifests itself in the lack of a clear duty to maximize shareholder wealth in any but the most limited circumstances; a hostile takeover regime that—in addition to permitting interference with shareholder decision-making—actually permits boards some degree of latitude to consider the interests of other constituencies; and a somewhat murky statement of fiduciary duties owed simultaneously "to the corporation and its stockholders."

Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 21–22 (2011).

[10] *See, e.g.*, STOUT, *supra* note 6, at vi ("Put bluntly, conventional shareholder value thinking is a mistake for most firms—and a big mistake, at that."); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1378–79 (1993) ("'[C]ommunitarians' more readily look to legal rules to structure relations among the corporation's diverse constituent groups, believing that corporate law must confront the harmful effects on nonshareholder constituencies of managerial pursuit of shareholder wealth maximization."); *see also* Peter C. Kostant, *Team*

Concern about an excessive corporate focus on generating shareholder wealth in the traditional corporate form has led creative business and legal experts to develop and implement a growing number of ways to foster both shareholder wealth and public (social, environmental, etc.) benefit within a single business entity. The term "social enterprise" has come to describe a business with these dual central foci.

> Social enterprises integrate philanthropy into their business models at a more basic level than companies that make corporate contributions or practice [corporate social responsibility]. Social entrepreneurs pursue social and business goals together, viewing them as synergistic and mutually reinforcing, as equal partners in their business vision. This deep and particular commitment to philanthropic endeavor is the thrust of the social enterprise ideal.[11]

In effect, social enterprise businesses combine doing well (by generating profits and distributing them to investors) with doing good (by serving broader social and environmental objectives). Social enterprise also may be described as "social entrepreneurship," "creative capitalism," or the "fourth sector."[12]

Businesses that have this "deep and particular commitment to philanthropic endeavor" and want to enhance owner wealth face significant hurdles. Among these hurdles is the difficult matter of choosing the right legal structure for housing and conducting the business of the firm. Many observers believe that neither the legal rules and norms that operate in traditional for-profit forms of business association nor those that operate in not-for-profit forms of business association are well-suited to social enterprise.[13] Shareholder wealth maximization in the for-profit corporate form is not the only challenge for social enterprise businesses. The non-distribution constraint (which

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Production and the Progressive Corporate Law Agenda, 35 U.C. DAVIS L. REV. 667, 670 (2002) ("Too much of corporate law's rhetoric of shareholder wealth maximization undercuts incentives for corporations to consider legal and ethical issues.").

[11] Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2450 (2009); *see also* MARJORIE KELLY, OWNING OUR FUTURE: THE EMERGING OWNERSHIP REVOLUTION 8 (2012) ("[S]*ocial enterprises* . . . serve a primary social mission while they function as businesses . . . .").

[12] *See* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 340 (2009); Murray & Hwang, *supra* note 7, at 6–7; Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 756 (2009–2010).

[13] *See* Keren G. Raz, *Toward an Improved Legal Form for Social Enterprise*, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 286 (2012) ("Many lawyers, policymakers, and social entrepreneurs argue that traditional legal forms, such as the limited liability company and the § 501(c)(3), hinder the impact of social enterprises by closing grant-funding opportunities and barring revenue generation.").

limits profit distributions) and, for tax-exempt not-for-profit firms, the prohibition on private inurement, for example, also are challenges in that they present barriers to the kind of profit-sharing ownership interest or revenue-sharing ownership rights that social enterprise typically seeks to establish.[14]

Although for-profit limited liability companies ("LLCs") and corporations may not be wholly welcoming legal entities for social enterprise, these forms of organization have provided a foundation for innovation.[15] For-profit firms engaging in social enterprise, including those organized as LLCs or corporations, may be certified as B Corporations—entities that have certain attributes consistent with social enterprise status.[16] In particular, in taking any action on behalf of the business, managers of entities that are certified as B Corporations are required to consider, e.g., "the long-term prospects and interests" of both the business and its owners "and the social, economic, legal, or other effects of any action" on employees (current and retired), suppliers, customers, and "the communities and society in which the firm or its subsidiaries operate."[17] In addition, some states have introduced new

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[14] *See* Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 607–08 (2011) ("[I]f formed as a tax-exempt nonprofit, a social enterprise will be prohibited from distributing net profits by the inurement, private benefit, and excess benefit transaction rules under federal tax law. Therefore, if a social entrepreneur wishes to distribute profits to investors, a nonprofit form is a nonstarter." (footnote omitted)); *id.* at 617 ("Due to the nondistribution constraint, equity capital will not be available to social enterprises formed as nonprofits . . . ."); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2018–19 (2007) (describing a social enterprise venture that would not qualify for organization as a tax-exempt not-for-profit firm). Other detriments to using non-profit forms for social enterprise businesses also exist. *See* Brakman Reiser, *supra*, at 607–08, 617–18.

[15] *See generally* Murray & Hwang, *supra* note 7, at 8–22 (summarizing and analyzing the drawbacks of existing business entities and structures).

[16] *See, e.g.*, Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 637–43 (2010) (describing B-Corporation certification); Cassady V. ("Cass") Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (a/k/a "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 682–83 (2012) (same); Jaclyn Cherry, *Charitable Organizations and Commercial Activity: A New Era: Will the Social Entrepreneurship Movement Force Change?*, 5 J. BUS. ENTREPRENEURSHIP & L. 345, 354–55 (2012) (same); Jason C. Jones, *Environmental Disclosure: Toward an Investor Based Corporate Environmentalism Norm?*, 20 B.U. PUB. INT. L.J. 207, 222–24 (2011) (same); Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1368–70 (2011) (same); Taylor, *supra* note 12, at 759–61 (same). It is wise to highlight and reinforce here that a "B corporation," unlike a benefit corporation, is a traditional form of entity (e.g., a corporation or LLC) certified as a specific kind of social enterprise and not a separate statutory form of social enterprise entity in and of itself. *See* Murray & Hwang, *supra* note 7, at 20 n. 101.

[17] *Legal Roadmap for Corporations*, CERTIFIED B CORP., http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/1061-corporation-legal-roadmap (last visited

forms of for-profit business entity that, like B-Corporation certification, recognize in direct ways the dual central foci of social enterprise firms. These include low-profit limited liability companies ("L3Cs"), benefit corporations, and other specialized corporate forms of entity (like California's flexible purpose corporation or Washington's social purpose corporation).[18]

As a result of these innovations, distinctions among forms of business entity and among financial interests in business entities and projects have blurred. For-profit social enterprise business entities occupy a space somewhere between the traditional for-profit and not-for-profit legal structures for business enterprises, as ordained principally by state statutes. Similarly, the governance and financial interests in for-profit social enterprise ventures may occupy a somewhat uncertain middle ground between charitable donations and traditional equity and debt investment interests.

To date, little has been said about the actual and desired nature of these interests—and the instruments that embody them—under federal and state securities laws. This issue has significance to the lawyer-as-*ex ante*-advisor, as well as the lawyer-as-*ex post*-enforcement-advocate. An understanding of the legal positioning of debt, equity, and other financial interests in social enterprise businesses (under, e.g., state entity law, federal and state tax laws, and federal and state securities laws) both enables legal advisors to better guide social enterprises and their funders in cost-effective choice-of-entity decision-making and fundraising and also facilitates the assessment of actual and possible legal claims by social enterprise and their funders. In addition, more specifically, an appreciation for the application of securities regulation to financial

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Feb. 24, 2013) (noting the need for charter amendment language to this effect to achieve B-Corporation certification); *see also LLC Legal Roadmap*, CERTIFIED B CORP., http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/1065-llc-legal-roadmap (last visited Feb. 24, 2013) (noting the need for similar language in the relevant LLC governing documents).

[18] *See, e.g.*, Kelley, *supra* note 12, at 366–76 (describing new forms of legal entity available for social enterprises); J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 19–24 (2012) (same); Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TRANSACTIONS: TENN. J. BUS. L. 221, 224–25 (2012) (same); *see also* John Tozzi, *Patagonia Road Tests New Sustainability Legal Status*, BLOOMBERG.COM (Jan. 4, 2012), http://www.bloomberg.com/news/2012-01-04/patagonia-road-tests-new-sustainability-legal-status.html (describing benefit corporations and flexible purpose corporations in the State of California); John Tozzi, *Washington State Tailors 'Social Purpose Corporation' to Sustainable Business*, BUSINESSWEEK.COM (Mar. 16, 2012), http://www.businessweek.com/articles/2012-03-16/washington-state-tailors-social-purpose-corporation-to-sustainable-business (describing social purpose corporations in the State of Washington).

instruments issued by new hybrid for-profit forms of social enterprise entity may be of use to policymakers in evaluating and establishing legal principles applicable in that context.

To that end, this Article explores the federal securities law status of financial interests in for-profit social enterprise entities.[19] When analyzed through the lens of the Securities Act of 1933, as amended (the "1933 Act"),[20] and the Securities Exchange Act of 1934, as amended (the "1934 Act"),[21] financial interests in social enterprise businesses raise both concerns and opportunities. Observations include reflections founded in theory, policy, and doctrine. Ultimately, the federal securities regulation status of interests in for-profit social enterprise ventures is important for choice-of-entity reasons (since the regulatory framework may impose different costs on interests in different structural business forms), for capital-structuring reasons within individual forms of entity, and for risk-management reasons at the entity level. In addition, an inquiry into the applicability of federal securities regulation to the funding of social enterprise also serves as a catalyst for further thought on the optimal applicability of federal securities regulation to interests in business entities and projects.

This brief exploration of social enterprise through the lens of federal securities law proceeds in four parts. Specifically, after a brief description of social enterprise in context in Part I, Part II of this Article analyzes whether different types of instruments representing financial interests in for-profit social enterprises are securities under the 1933 Act and the 1934 Act. The analysis shows that these instruments typically are securities under federal law—the lynchpin being whether instrument holders have the right to a financial return. Part II then identifies the implications of this insight. Part III questions whether the current treatment of for-profit social enterprise debt, stock, and investment contracts makes sense by identifying legal touchstones relating to the treatment of securities issued by for-profit and not-for-profit business associations. Principally, this Part asks whether and, if so, when an investment interest in a social enterprise that is a security is or should be designated as an exempt security or excused from compliance with registration or other substantive regulation under the 1933 Act or the 1934 Act. Part IV offers a brief summary conclusion

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[19] This Article focuses on federal securities regulation. However, parallel analyses under state securities regulation—as well as examinations of related issues under state entity laws and federal and state tax laws—also are important to the assembly of a full picture of financial interests in social enterprise firms. Analyses of these additional perspectives must, however, wait for another day.

[20] 15 U.S.C. §§ 77a–77aa (2006 & Supp. V 2011).

[21] 15 U.S.C. §§ 78a–78pp (2006 & Supp. V 2011).

emphasizing the importance of the interplay between for-profit social enterprise and securities regulation in ongoing conversations about the utility of hybrid forms of business association and the nature and extent of securities regulation.

I. FOR-PROFIT SOCIAL ENTERPRISE IN CONTEXT

Interest in social enterprise—and recently in new forms of for-profit social enterprise entity—is significant and seems likely to continue.[22] Over the past few years, the adoption and serious consideration of new, hybrid forms of business association by state legislatures has increased.[23] These new hybrid forms of entity, as they multiply in type and number, add complexity to the market for legal entities and to the markets associated with business finance.[24]

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[22] *See* Kelley, *supra* note 12, at 352 ("[T]he world of hybrid social enterprise has grown rapidly and has expanded from nonprofits engaging in market-oriented work to for-profits doing essentially charitable work."); Steven Munch, *Improving the Benefit Corporation: How Traditional Governance Mechanisms Can Enhance the Innovative New Business Form*, 7 NW. J.L. & SOC. POL'Y 170, 176 (2012) ("Interest in social enterprise and its related principles has increased in recent years in the wake of fresh corporate scandals and growing societal concerns."); Page & Katz, *supra* note 16, at 1361 ("The idea of social enterprise has been embraced by a growing number of influential leaders and institutions.").

[23] *See* Murray, *supra* note 18, at 1 ("In the past four years, nineteen states have passed at least one of five different types of social enterprise statutes and many additional states are considering similar legislation."); Anne Field, *A Corporate Status for the Crunchy Set*, CRAIN'S N.Y. BUS., Mar. 12–18, 2012, at 12 ("While there's no official count of social enterprises . . . , the number is growing . . . .").

[24] *See* Dennis R. Young & Jesse D. Lecy, *Defining the Universe of Social Enterprise: Competing Metaphors* 12–13 (Andrew Young Sch. of Policy Studies, Working Paper No. 12-25, 2012), *available at* http://ssrn.com/abstract=2166459 (employing a zoo metaphor to illuminate management, governance, and financial issues in social enterprise). The zoo metaphor adopted by Professors Young and Lecy expresses this complexity in a useful way, highlighting problems with research on social enterprise.

> The zoo metaphor is also helpful in guiding the study of how social enterprises are best managed, governed and financed. Clearly the answers to this question are different for different animals in the social enterprise zoo. For example, they don't all have the same diets. The zoo metaphor recognizes this and hence prescribes a customized approach to good practices. Governance and finance offer the clearest application of this realization. Governance and ownership structures differ markedly among business corporations, cooperatives and nonprofit organizations, for example. Similarly, revenue portfolios of these different kinds of entities are significantly different as well, relying to widely varying degrees on member contributions, philanthropy, and market revenues, and so on. By acknowledging the different animals in the social enterprise zoo, management, governance and financing strategies can be studied and developed with appropriate sensitivity to these distinctions.

Id. at 22.

This growth in interest and increased complexity has easily identifiable benefits and detriments attendant to corporate finance. New players in the markets for social enterprise finance (e.g., certification organizations, specialized intermediaries, new breeds of investor) are emerging, which may result in an expansion in the number of business markets or the size of those markets (including through, e.g., net job creation).[25] Other new market opportunities may result as the size and nature of the markets connected to for-profit social enterprise develop and become clearer.

For example, for-profit social enterprise ventures may have access to new and different sources of financial capital. These ventures may help to generate and sustain an investor market focused on blending financial return with altruistic return.[26] Social enterprise advocates believe that "[w]ith the right financial innovations, these enterprises can access a much deeper pool of capital than was previously available to them, allowing them to greatly extend their social reach."[27]

The potential may exist for a lower cost of capital for certain investors in social enterprise businesses, although that potential may be illusory. The L3C form of entity was designed in part to achieve this result through its envisioned investment tranches that blend philanthropic and traditional financial investment capital.[28] The L3C's potential in this regard has not yet been realized, however, in part because expected assurances from the U.S. Internal Revenue Service on the tax treatment of foundation investments have not been forthcoming.[29] Even outside the L3C area, the market for social enterprise capital is relatively undeveloped and suffering from growing pains.[30] Most agree that the cost of social enterprise capital remains

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[25] *See generally* Murray, *supra* note 18, at 46–52 (describing various potential capital raising and other financial benefits related to social enterprise).

[26] *See* Brakman Reiser, *supra* note 14, at 619 ("The benefit corporation form . . . may attract potential investors or lenders who are interested in combining their financial contributions with a purchase of social good.").

[27] Antony Bugg-Levine et al., *A New Approach to Funding Social Enterprises*, HARV. BUS. REV., Jan.–Feb. 2012, at 118, 120; *see also id.* at 122 ("It isn't hard to imagine that at some point social enterprises will have an even broader universe of funding options than conventional businesses do.").

[28] *See* Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 884–85, 894–96 (2010) (describing and analyzing the finance rationale underlying the L3C).

[29] *See* Murray, *supra* note 18, at 47.

[30] *See* Timothy Ogden, *The True Cost of Social Capital*, STAN. SOC. INNOVATION REV. (Mar. 7, 2012), http://www.ssireview.org/blog/entry/the_true_cost_of_social_capital (describing and illustrating various problems with the social capital market).

quite high when compared with the cost of traditional financial investment capital.[31]

There may be a number of different costs that offset any finance-related benefits as social enterprise markets grow. For example, it may be hard for many social enterprise businesses to find funding. Social enterprise (like other commerce) often is conducted through small businesses (despite the notoriety of larger, better-established social enterprise firms like Patagonia, Inc.[32]). Absent the engagement of an interested fund investor or market intermediary to help them find more potential funders, small businesses typically have a hard time identifying funders and attracting and securing funding after friends and family are tapped out. The federal securities laws have been unfriendly to small business finance in this context because of, among other things, restrictions on general solicitation and advertising in connection with the offer and sale of securities and the potential application of both federal and state securities laws to offers and sales of securities.[33] Although the Jumpstart Our Business Startups Act ("JOBS Act")[34] and, more specifically, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("CROWDFUND Act") included as Title III of the JOBS Act,[35] have the potential to make the federal securities laws more friendly to small firm capital-raising, this potential may or may not be realized in the wake of forthcoming Securities and Exchange Commission ("SEC") regulations and ensuing market reactions.

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[31] *See id.* ("[S]ocial capital is usually significantly more expensive than commercial capital."); Bugg-Levine et al., *supra* note 27, at 120 ("The social value of providing poor people with affordable health care, basic foodstuffs, or safe cleaning products is enormous, but the cost of private funding often outweighs the monetary return.").

[32] Patagonia, Inc., as a better-established firm engaged in social enterprise, converted to a California benefit corporation. *See B Corps: Firms with Benefits*, ECONOMIST, Jan. 7, 2012, at 57; Marc Lifsher, *Businesses Seek State's New 'Benefit Corporation' Status*, L.A. TIMES (Jan. 4, 2012), http://articles.latimes.com/2012/jan/04/business/la-fi-benefit-corporations-20120104.

[33] *See, e.g.*, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5–7 (2012); Rutheford B Campbell, Jr., *Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses*, 50 WASHBURN L.J. 573, 573 (2011); Rutheford B Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L. Q. 407, 407 (2000); Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 36 (2007); *see also* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 918 (2011).

[34] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

[35] *Id.* §§ 301–305.

The capital markets for investment in social enterprise businesses may be smaller than advocates anticipate. Certain sources of funding for not-for-profit (especially charitable) organizations are not readily available to for-profit social enterprise organizations.[36] Also, not all traditional sources of investment capital are interested in financing or able to invest in for-profit social enterprise.[37] Although investment firms and funds have emerged (and likely will continue to emerge) to focus on for-profit social enterprise investments,[38] it is unclear how many firms and funds will concentrate on the emergent fourth sector. With an increased number of entrants in these markets, increased competition for available funds may discourage market entrants and limit prospects for those who choose to participate.

Uncertainty also may increase transaction costs in the market for investment interests in social enterprise entities.[39] Although investors are no doubt becoming more familiar with for-profit social enterprise as the number of ventures engaged in creative capitalism increase, the business and regulatory landscapes for the fourth sector are unsettled, and questions about the operation, regulation, and sustainable profitability of these firms remain.

> For-profit public benefit ventures raise several questions. Are they charities? Are they a new phenomenon? Are they more efficient and effective than traditional charities? Are social enterprises permanent entities or merely reflections of transitory stock market success or rising earnings? Should they receive tax benefits? If so, under what circumstances? Do social enterprise organizations live up to their hype?[40]

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[36] *See* Brakman Reiser, *supra* note 14, at 618–19 ("A social enterprise organized as a for-profit will also have limited access to donated funds."); Kelley, *supra* note 12, at 354 ("Social entrepreneurs' . . . capitalization problems are not entirely solved by choosing to launch as for-profit ventures. As an initial matter, for-profit social entrepreneurs generally cut themselves off from the sources that traditionally have funded socially beneficial activities—private foundations and governments.").

[37] *See* Kelley, *supra* note 12, at 354 ("[T]he practices and the expectations of the normal sources of for-profit capital—venture capitalist and institutional investors such as pension funds—do not line up neatly with the needs of hybrid social enterprises.").

[38] *See* James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 FORDHAM L. REV. 567, 599 (2007) ("[B]usinesses and entrepreneurs, such as private equity funds, have also formed large pools of capital for social purposes outside of charitable tax-exempt structures.").

[39] *See* Murray, *supra* note 18, at 42–44; *see also* Michael P. Van Alstine, *The Costs of Legal Change*, 49 UCLA L. REV. 789, 822–36 (2002) (describing uncertainty costs as one of the costs associated with legal change).

[40] Fishman, *supra* note 38, at 599–600 (footnote omitted).

These types of uncertainty are only likely to be resolved over an extended period of time. In the interim, the availability and cost of capital may be adversely affected.

The net bottom line? "[I]f you talk to people who have attempted to raise commercial and social capital at different points in their career, they will routinely tell you that raising social capital takes two to four times as much time and effort as raising commercial capital."[41] Regulatory and other transaction costs have been and may continue to be uncertain, and some contend that "the real cost of social capital, when you take into account the amount of effort and time the average entrepreneur has to put in to find and meet the demands of social investors, is much higher than it would be with commercial investors."[42]

Together with state-based entity law and federal and state tax law, federal and state securities regulation plays an important and under-appreciated role in the ongoing viability of for-profit social enterprise. Specifically, securities regulation establishes critical rules of the game for social enterprise financed through the issuance of securities and, in doing so, imposes various types of costs on for-profit social enterprise. Accordingly, it is important to the future of for-profit social enterprise to resolve uncertainties in securities regulation, especially (but not exclusively) at the key and leading federal level.[43]

II. FUNDING INTERESTS IN SOCIAL ENTERPRISE AS "SECURITIES" UNDER FEDERAL SECURITIES LAW

Among the regulatory uncertainties associated with for-profit social enterprise firms is the status of various forms of financial instrument as securities under federal law. The categorization of different instruments as securities is meaningful because it triggers the application of federal

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[41] Ogden, *supra* note 30.

[42] *Id.*

[43] Although this Article focuses on a federal securities law analysis, it is important to note that state securities law may be applicable even when federal securities law is inapplicable. For example, the definition of a "security" under state regulatory frameworks is often more all-inclusive than the federal definition. In other words, financial instruments that are not securities under federal law may, in fact, be securities under applicable state law. Moreover, state law exemptions from securities registration requirements are different from federal law exemptions. Accordingly, an examination of federal securities law principles is necessary but insufficient in analyzing resolving specific transactional issues. *See, e.g.*, Keith Paul Bishop, *Are There Silver Hills in Other States?*, CAL. CORP. & SEC. L. (Feb. 27, 2013), http://calcorporatelaw.com/2013/02/are-there-silver-hills-in-other-states/; Keith Paul Bishop, *Is Crowdfunding Subject to the UCC?*, CAL. CORP. & SEC. L. (Mar. 14, 2013), http://calcorporatelaw.com/2013/03/is-crowdfunding-subject-to-the-ucc/?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+CaliforniaCorporateLaw+%28California+Corporate+Law%29.

securities laws (including the 1933 Act and the 1934 Act), as a distinct body of regulation, to the instrument, the issuer, investors, and various market intermediaries (among others).

> If the interests being issued are not securities, the federal statutes do not apply at all. There would, for instance, be no possibility of a cause of action under the federal securities laws for fraud or misrepresentation, although it is always possible that state securities laws or the common law might apply to the transaction. On the other hand, if the interests are classified as securities, at the very least the anti-fraud provisions of the federal securities laws will apply, even if the securities are technically "exempt." Beyond that, it is also possible that the registration and other requirements will be imposed, depending on . . . the often-demanding requirements of the applicable statutory exemptions.[44]

Although the current status of most financial instruments as securities is relatively well settled, there is opportunity (and there may be appetite) for innovation in the regulation of investment interests in for-profit social enterprise ventures. This Part locates various forms of investment in for-profit social enterprise in the current federal securities regulation landscape and assesses the current categorization of these investment interests as securities for federal law purposes.

A. The Current Federal Securities Law Status of Financial Instruments Issued by For-Profit Social Enterprise Ventures

As a general matter, instruments that comprise financial interests in business associations with a profit-sharing or revenue-sharing component are securities under the 1933 Act and the 1934 Act.[45] Both the 1933 Act and the 1934 Act define a "security" by reference to a listed group of instruments, "unless the context otherwise requires."[46] The listed instruments are substantially the same under each statutory definition.[47] The issuer's identity as a particular form of business association having a particular tax status is not relevant in determining the federal securities law status of interests in the issuer's business. The definition of a security is meant to be expansive. "Congress . . . did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually

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[44] Carol R. Goforth, *Application of the Federal Securities Laws to Equity Interests in Traditional and Value-Added Agricultural Cooperatives*, 6 DRAKE J. AGRIC. L. 31, 46 (2001) (footnote omitted).

[45] *See infra* notes 52, 60 & 73 and accompanying text (identifying an element of profit as a characteristic of debt, stock, and investment contracts that is associated with security status).

[46] 15 U.S.C. § 77b(a)(1) (2006); 15 U.S.C. § 78c(a)(10) (2006).

[47] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 & n.12 (1975).

any instrument that might be sold as an investment."[48] However, not every investment interest in a business is a security.

Specifically, both the 1933 Act and the 1934 Act define a security (absent a context that requires a different conclusion) as "any note, stock, . . . bond, debenture, . . . [or] investment contract."[49] These words delineate the three principal types of financial instruments likely to be issued by for-profit social enterprise entities: debt, equity, and investment contracts that may be in the nature of unequity—a short-term profit-sharing or revenue-sharing interest without governance rights.[50] The status of each of these three instruments as a security under federal law has been explored in decisional law.

1. Debt

As debt instruments, notes, bonds, and debentures are presumed to be securities, but that presumption may be rebutted by a showing either that the instrument at issue is or has a strong resemblance to an instrument on a list of judicially created exceptions or that the instrument should be added to that list of judicial exceptions.[51] To gauge that resemblance or make that addition to the judicial list, the Supreme Court assesses (and directs the assessment of) four factors.

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine whether some factor such as the

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[48] Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (footnote omitted).

[49] § 77b(a)(1); § 78c(a)(10).

[50] *See* Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 360–61 (2012) (defining the concept of "unequity").

[51] *See Reves*, 494 U.S. at 63–64.

> existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[52]

The overall test is known as the "family resemblance" test.[53] The test, including the four factors, applies broadly across all issuers.

Although one might suspect that application of the factors would not differ substantially as applied in the context of for-profit social enterprise entities, several factors give cause for pause. Because a debt investor in a for-profit social enterprise may not be primarily interested in profit—instead, being equally interested in profit and the issuer's social or environmental objectives (or even less interested in profit than in social or environmental objectives)—the first factor may weigh against security status. Although the Court identifies commercial or consumer purposes as a contrast to a profit objective in articulating the family resemblance test, its focus on interest "primarily in the profit [of] the note" may be at issue in the social enterprise context.[54] Similar questions might be raised in specific issuances with respect to a speculation or investment motive for common trading of debt instruments issued by a for-profit social enterprise entity and with respect to the reasonable expectations of the investing public as to debt instruments issued by a for-profit social enterprise.[55] In most circumstances, however, despite these concerns, a court is likely to determine that a debt instrument other than a bank loan (including, e.g., a mortgage loan note or a note for installment purchase indebtedness) is a security under the 1933 Act and the 1934 Act.

A for-profit social enterprise issuer also may contend that "another regulatory scheme significantly reduces the risk of the instrument" such

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[52] *Id.* at 66–67 (citations omitted).

[53] *Id.* at 63–64.

[54] *Id.* at 66.

[55] These and related questions have been raised with respect to debt issued by cooperatives, starting with the debt at issue in the seminal debt-as-a-security case, *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

> The Supreme Court . . . has held that promissory notes issued by a cooperative may be securities in certain circumstances. The offering of notes by a cooperative to nonmembers at market or above-market interest rates clearly is a security based on *Reves*. If a cooperative solicits loans only from current members at interest rates that are at or below market, however, a strong argument can be made that these notes are not securities. A member making such a loan to his or her cooperative clearly is not motivated to do so by profit, is not making the loan for investment purposes, and has no reasonable expectation that a profit will be derived as a result of the activities of others.

Kathryn J. Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment for Nonagricultural Cooperatives*, 46 DRAKE L. REV. 259, 283 (1997) (footnotes omitted).

that the protection of the federal securities laws is "unnecessary."[56] The entity law statute under which the for-profit social enterprise firm is organized or another system of regulation applicable to the social enterprise entity may serve this function if, for example, it requires disclosure to the debt-holders of information substantially similar to that required in an applicable 1933 Act registration statement or 1934 Act report and allows for private enforcement for fraud, misstatements, or misleading omissions or if it offers another form of protection against risk.[57] Common forms of contractual protection include insurance or collateralization.[58] Absent these types of risk reduction, however, a court is more likely to find a debt instrument to be a security. Basic federal and state law protections for debt-holders, taken alone, are insufficient to contravene security status under this factor.[59]

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[56] *Reves*, 494 U.S. at 67.

[57] A benefit corporation does have disclosure obligations under state law—specifically, it is required to file an annual report with the state that includes disclosures relating to its general public benefit.

> A benefit corporation is required to deliver an annual benefit report to the shareholders and to post it on its website so it is available to the public. Some states require filing the report with a department of the state. The report must include a narrative description of the ways in which the benefit corporation pursued a general public benefit and the extent to which it was created; the ways the benefit corporation pursued any specific benefit (if stated in the company's articles) and the extent to which it was created; and any circumstances that may have hindered creation of either such benefit. In recently passed legislation in California and New York, the narrative description must also include the process and rationale for selecting the third-party standard.

William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 842–43 (2012) (footnotes omitted); *see also* Brakman Reiser, *supra* note 14, at 603–04. However, these disclosure mandates are not tantamount to, or an adequate investor-protection substitute for, the disclosure obligations under the federal securities laws.

[58] *See Reves*, 494 U.S. at 69.

[59] *See, e.g.*, Delgado v. Ctr. on Children, Inc., No. 10-2753, 2012 WL 2878622, at *5 (E.D. La. July 13, 2012) ("Although state law relief for breach of the promissory notes or relief through federal bankruptcy law may be available to Plaintiffs, this relief falls short of the comprehensive regulatory schemes that have exempted notes from classification as securities in other cases."); Nat'l Bank of Yugoslavia v. Drexel Burnham Lambert, Inc., 768 F. Supp. 1010, 1016 (S.D.N.Y. 1991) ("As for the federal bankruptcy and common law, such protections are available in any transaction, including ones that are clearly securities transactions, and they existed at the time Congress perceived the need for the additional protections of the 1933 and 1934 Acts."). The analysis of debt instruments issued by a not-for-profit entity is, again, useful here.

> One could argue that a member's involvement in the cooperative through voting rights, election of the board of directors, and attendance at annual meetings where financial information is provided are factors that reduce the risk of the loan. While there is no public market for the notes nor other

2. Stock

Decisional law also determines when stock (as another item in the list of instruments that are, unless the context otherwise requires, securities) is not a security. In the leading case on this issue, the Supreme Court of the United States found that stock, as a security, has the following attributes:

- "the right to receive 'dividends contingent upon an apportionment of profits'";[60]
- negotiability;[61]
- the capacity to "be pledged or hypothecated";[62]
- "voting rights in proportion to the number of shares owned";[63] and
- the ability to "appreciate in value."[64]

The Court later reaffirmed and restated these attributes of stock as a security.[65] Other courts have applied the attributes to various different types of corporate stock, including stock in closely held corporations.[66] In these opinions, the courts focused on the foundational principle that "Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."[67]

These economic realities dictate that stock is a security if it represents a profit-sharing interest in a for-profit business (because it is an investment for profit). This core economic reality has, for example, been the key touchstone in cases involving the analysis of agricultural and certain other cooperative memberships as securities.[68] To avoid the

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> regulatory scheme, this factor should not be determinative. Stock or equity credits sold to nonmembers should be treated as any other security would be—coverage of the Acts would apply unless some other exemption applies. There are no policy reasons that would compel other treatment.

Sedo, *supra* note 55, at 283 (footnote omitted).

[60] United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975).

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).

[66] *See* Sulkow v. Crosstown Apparel, Inc., 807 F.2d 33, 36 (2d Cir. 1986); Fong v. Oh, 172 P.3d 499, 508 (Haw. 2007).

[67] *Forman*, 421 U.S. at 849.

[68] *See* Goforth, *supra* note 44, at 74 ("[M]embership interests in such co-ops are not usually treated as securities—they lack the essential attributes of an 'investment' seeking 'profits,' and instead are more in the nature of a purchase for use."). The *Forman* case—the seminal case involving the analysis of stock as a security—involved stock in a cooperative public housing project. *See Forman*, 421 U.S. at 840 ("The issue in these cases is whether

characterization of stock as a profit-sharing interest (and, potentially, as a security), a for-profit social enterprise corporation could manipulate some of the acknowledged core attributes of stock. For example, a for-profit social enterprise firm organized as a benefit corporation could designate a class or series of nonvoting stock that is not entitled to dividends and carries transfer restrictions and limits on pledging and hypothecation. Even in this event, however, the stock may not avoid security status if it can appreciate in value, is tradable in some way, and has a claim on assets in liquidation.[69]

The Supreme Court identifies the context of a stock transaction as a key factor in determining the status of stock as a security, and it notes that a sale of stock as equity in a corporation is a classic context favoring security status.[70] In general, "[w]hen an instrument is both called stock and bears the usual characteristics of stock, . . . a purchaser may justifiably assume that the federal securities laws apply."[71] As one commentator observed a number of years ago, "'[S]tock' cases no longer are making their way into print. Presumably, defendants have given up the ghost in light of the clear-cut plaintiff success rate in this area."[72] In all likelihood, stock representing an equity interest in a for-profit social enterprise is a security.

3. Investment Contracts

Similarly, investment contracts issued by for-profit social enterprises are likely to be securities, although the matter may not be

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shares of stock entitling a purchaser to lease an apartment in Co-op City, a state subsidized and supervised nonprofit housing cooperative, are 'securities' within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934.").

[69] Again, the cases relating to analyses of equity interests in cooperatives as securities may be instructive here.

> While the laws and court decisions have provided a safe harbor for certain forms of cooperatives, such as agricultural cooperatives, and for certain forms of cooperative securities, such as membership and patronage dividend stock or equity, other problem areas remain. Some problem areas that remain are transferable stock, stock that pays dividends, stock not issued to evidence membership or patronage rebates, and notes issued by a cooperative.

Sedo, *supra* note 55, at 282.

[70] *Landreth*, 471 U.S. at 687 ("[T]he context of the transaction . . .—the sale of stock in a corporation—is typical of the kind of context to which the Acts normally apply. It is thus . . . likely here . . . that an investor would believe he was covered by the federal securities laws.").

[71] Lewis D. Lowenfels & Alan R. Bromberg, *What Is a Security Under the Federal Securities Laws?*, 56 ALB. L. REV. 473, 520 (1993) (referencing the Supreme Court's decision in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985)).

[72] Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 J. CORP. L. 307, 345 (2000) (footnote omitted).

free from doubt. An investment contract, as that term is used in the definitions of a "security" in the 1933 Act and the 1934 Act, is

> 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.[73]

Membership interests in LLCs, including L3Cs, typically are securities under this definition.[74] However, the analysis will be different for each investment tranch in an L3C, and those differences may lead to different outcomes.[75]

In certain contexts, a funder of social enterprise may be seen to have both an altruistic and investment interest in the business and may not have been led to expect profits to the exclusion of social or environmental good.[76] In fact, in the crowdfunding era that preceded the JOBS Act, social enterprises were among the businesses that chose to venture into crowdfunding, raising a potential argument that these crowdfunded interests were not securities.[77] However, the investment contract definition typically has been broadly interpreted to encompass profit-sharing and revenue-sharing interests in social enterprise entities.[78]

4. Bottom Line

When a for-profit social enterprise firm issues debt, stock, or other financial instruments that include profit-sharing or revenue-sharing interests, it should be cognizant of the probable application of the federal securities laws, since these instruments are securities unless the context otherwise requires. There is an abundance of decisional law construing these instruments in context. This body of law is rich and continues to get richer. "[N]otwithstanding many settled interpretations and accepted conventions, there also are standing invitations for creativity and

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[73] SEC v. W. J. Howey Co., 328 U.S. 293, 298–99 (1946).

[74] *See* Kelinberger, *supra* note 28, at 902.

[75] *See id.* ("For an L3C, the securities law determination will be especially complicated because nominally, at least, the foundations will not be investing with any expectation of profit and yet will need some fundamental control over the enterprise. Depending on how fundamental that control is, its existence could increase the likelihood that the other investors are purchasing a security from the L3C when they become members (co-owners) of the L3C. In any event, the securities determination will differ for each tranch of investors." (footnote omitted)).

[76] *See Howey*, 328 U.S. at 300 (noting that the purchasers were "attracted *solely* by the prospects of a return on their investment" (emphasis added)).

[77] *See* Heminway & Hoffman, *supra* note 33, at 897.

[78] *See id.* at 897–902.

transformation."[79] Accordingly, while a court is likely to determine that non-bank debt, stock, and investment contracts that afford holders the right to financial return are securities under the 1933 Act and 1934 Act, there may be some room for argument to the contrary in specific cases.

B. Implications of the Status of Financial Instruments Issued by For-Profit Social Enterprise Ventures as Securities

The presumptive categorization of non-bank debt, stock, and investment contracts issued by for-profit social enterprises as securities when those instruments include profit-sharing or revenue-sharing interests has implications for the capital-raising process for social enterprise entities and the cost of capital for social enterprise. As a general matter, for-profit social enterprise entities selling securities should be able to tap funds from the same group of investors that finance other for-profit business ventures.[80] However, a social enterprise entity enjoys unique benefits and detriments in attracting traditional forms of investment capital from conventional sources of investment capital; "the dual mission embedded in the form may or may not prove advantageous."[81] Traditional for-profit venture investors may not be interested in funding the dual bottom line that exists in social enterprise.[82] Conversely, "socially motivated" entrepreneurial investors may be attracted to social enterprise.[83] Securities issued by social enterprise entities may not operate in investment markets the same way that securities issued by more traditional for-profit ventures operate.

Regardless, the classification of profit-sharing or revenue-sharing instruments issued by social enterprises as securities under federal law means that the vast scheme of federal securities regulation, with its attendant costs, will add expense to the capital-formation process for social enterprise firms.[84] Under the 1933 Act, offers and sales of securities must be registered absent an exemption,[85] and public company

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[79] Gabaldon, *supra* note 72, at 347.

[80] *See* Brakman Reiser, *supra* note 14, at 619 (noting that "benefit corporations can pursue the funding sources available to traditional for-profits"); Bugg-Levine et al., *supra* note 27, at 121 (describing financing alternatives for social enterprise ventures that are "analogous to the way conventional companies are financed").

[81] Brakman Reiser, *supra* note 14, at 619.

[82] *See id.* at 618 ("[F]or diligent investors or lenders who closely examine the business plan of a social entrepreneur, the mix of social and profit purposes may raise eyebrows . . . .").

[83] *See id.* at 619.

[84] *See generally* Heminway & Hoffman, *supra* note 33, at 907–11 (describing these costs in the context of crowdfunded securities).

[85] *See* 15 U.S.C. §§ 77d, 77e (2006 & Supp. V 2011) (requiring registration of offers and sales of securities unless an exemption is available).

status under the 1934 Act obligates issuers to periodic and transactional reporting.[86] The costs associated with producing these filings are significant and may be slightly higher for social enterprise issuers than for other issuers until there is a critical mass of disclosure for publicly held social enterprise issuers that satisfies regulators and is litigation-tested for accuracy and adequacy. In the interim, these issuers and their counsel will be drafting and refining disclosures about the social enterprise aspects of the entities from scratch, creating new precedent disclosures for social enterprise in the public-company realm, and defending these nascent disclosures in legal actions stemming from offers, sales, and other transactions in (and activities relating to) their securities.

The classification of financial instruments issued by for-profit social enterprise ventures as securities discourages the generation of social capital through these forms of entity. The "security" label is not a perfect fit for some of these instruments, enhancing investor uncertainty (in the form of confusion, concern, etc.). Moreover, for-profit social enterprise issuers must bear the transaction costs associated with registering offers and sales of these instruments or finding an applicable exemption and may also be required to assume the costs of complying with stringent periodic and transactional reporting requirements. If for-profit social enterprise is to be a meaningful proposition, these disincentives should be acknowledged and addressed.

III. DOES IT MAKE SENSE TO CATEGORIZE AND REGULATE FINANCIAL INSTRUMENTS ISSUED BY FOR-PROFIT SOCIAL ENTERPRISE ENTITIES AS SECURITIES?

It seems appropriate to question the status of for-profit social enterprise debt, stock, and investment contracts as securities. For-profit social enterprise firms and their securities can be located somewhere between other for-profit issuers and their funding interests and not-for-profit issuers and their funding interests. Accordingly, at least two comparative perspectives on this issue seem relevant: a comparative perspective based on other for-profit issuers and financial interests, and a comparative perspective based on not-for-profit issuers and financial interests.

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[86] *See, e.g.*, 15 U.S.C. §§ 78m(a), (e), 78n(a), (e) (2006 & Supp. V 2011) (requiring the filing of quarterly and annual reports and proxy, going private, and tender offer statements).

A. For-Profit Social Enterprise Issuers as Compared to Other For-Profit Issuers

On the one hand, for-profit social enterprise businesses are for-profit businesses with risk profiles similar in nature to other forms of business association. Each exists to create profits and provide goods or services to a target population. Funders provide financial capital and, in return, may be promised some form of financial return. They provide funding to the firm based on, among other things, the business it conducts and how it conducts that business.

But the business of a for-profit social enterprise venture or the way it conducts that business (or both), is distinctive in that it integrally engages social or environmental objectives. Funders, therefore, assume a specific risk that management of the social enterprise may act (indeed, perhaps may be compelled to act) in a manner that advances the firm's articulated social or environmental purpose and adversely affects the firm's profitability.[87] Should this distinction make a difference under federal securities law? In other words, is the nature of a debt, stock, or investment contract instrument issued by a for-profit social enterprise venture sufficiently different from a debt, stock, or investment contract instrument issued by another for-profit venture that it should not constitute a security?

An assessment of the foundational policy considerations underlying the security definitions in the 1933 Act and the 1934 Act leads to the inescapable conclusion that financial instruments issued by for-profit social enterprises should be treated the same as those issued by other for-profit entities for purposes of that definition. The concept of a security under the two federal statutes is, and should be, a broad one.[88] To protect investors, help maintain the integrity of the federal securities markets, and encourage capital formation,[89] the statute requires

> full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." It embodies a flexible rather than a static

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[87] Said differently, social enterprises do not behave in accordance with the shareholder wealth maximization norm. *See supra* notes 3–10 and accompanying text.

[88] *See* Gabaldon, *supra* note 72, at 311 ("Without a doubt, perusal of the statutory language defining a security conveys a firm sense that Congress intended broad coverage of the '33 and '34 Acts."). Professor Gabaldon goes on to add that "[t]his sense is confirmed by an explicit expression of congressional policy: legislative history announces that the term 'security' is defined 'in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Id.* (quoting H.R. REP. NO. 73-85, at 11 (1933)).

[89] These three objectives are well-acknowledged policy underpinnings of the federal securities laws. *See* Heminway, *supra* note 50, at 337 & n.5.

> principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.[90]

This breadth, however, only extends to investment instruments. "Congress was concerned with regulating the investment market, not with creating a general federal cause of action for fraud."[91] Unless the aggregation of interests represented by a financial instrument issued by a for-profit social enterprise firm represents something other than an investment (e.g., a donation, a gambling interest, a consumption interest, an insurance or commodities contract, or a commercial banking arrangement), the instrument is, and should be, classified as a security.

B. For-Profit Social Enterprise Issuers as Compared to Not-For-Profit Issuers

For-profit social enterprise entities and the financial instruments they issue also share characteristics with not-for-profit entities and their financial instruments. Instruments that afford profit-sharing or revenue-sharing rights to holders are securities under the tests set forth *supra* in Part II.A, regardless of whether they are issued by for-profit or not-for-profit entities.[92] Because of the non-distribution constraint and, in the case of tax-exempt not-for-profit entities, private inurement restrictions, not-for-profit entities typically issue debt when seeking financial capital.[93] As a security, the offer and sale of this debt would be subject to the registration requirements of the 1933 Act.[94]

However, not-for-profit issuers are favored under the 1933 Act and the 1934 Act.[95] This is part of a larger legal avoidance of placing undue regulatory burdens on not-for-profit organizations.

> Federal and state governmental agencies generally attempt to avoid regulation of nonprofit organizations by granting them privileges and exemptions not available to others. The securities laws

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[90] SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946) (citation omitted) (quoting H.R. REP. NO. 73-85, at 11).

[91] Reves v. Ernst & Young, 494 U.S. 56, 65 (1990).

[92] Timothy L. Horner & Hugh H. Makens, *Securities Regulation of Fundraising Activities of Religious and Other Nonprofit Organizations*, 27 STETSON L. REV. 473, 473 (1997) ("Nonprofit organizations that engage in fundraising activities involving the offer and sale of securities must comply with the federal securities laws.").

[93] *Id.* ("Nonprofit organizations engage in a wide variety of fundraising activities that involve the issuance of securities. Such organizations may issue notes, bonds, and other debt instruments to raise funds for general operations or for the construction or purchase of churches, schools, hospitals, retirement homes, or other facilities.").

[94] 15 U.S.C. §§ 77d, 77e (2006 & Supp. V 2011).

[95] *See* Horner & Makens, *supra* note 92, at 527 ("Nonprofit organizations have always received favorable treatment under the federal and state securities laws and have been entitled to a variety of exemptions not available to other organizations.").

> follow this pattern by exempting nonprofit organizations from many securities regulatory requirements.[96]

For example, under the federal securities laws, certain securities issued by not-for-profit entities are exempt from the registration requirements of the 1933 Act and the 1934 Act, and certain not-for-profit organizations, together with those who solicit funds for them, are excluded from various definitions of market intermediaries (e.g., brokers and dealers).[97] The registration exemption under each act is only available for securities of an issuer "organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of" specified persons.[98] The definitional exclusions from coverage as brokers, dealers, and other similar statuses under the 1934 Act apply generally to a not-for-profit organization and each trustee, director, officer, employee, or volunteer engaged in buying, selling, or trading securities

> for its own account in its capacity as trustee or administrator of, or otherwise on behalf of or for the account of: (a) a charitable organization; (b) a charitable income fund; (c) a trust or other donative instrument for which the assets are permitted in a charitable income fund; or (d) the settlors (or potential settlors) or beneficiaries of any such charitable trusts or donative instrument. This exclusion is broad enough to cover most securities sales activities of nonprofit organizations.[99]

Notably, the definitional exclusions only apply to solicitors of funds for the not-for-profit who are volunteers or comprehensive fundraisers who receive no commission or special compensation based on the donations received.[100]

These exemptions and exclusions do not completely deregulate the securities of not-for-profit organizations.

> [D]ue to concerns for actual or potential investment fraud or mismanagement in conjunction with the sale of securities, nonprofit

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[96] *Id.* at 474 (footnote omitted); *see also* Bradley J.B. Toben & Carolyn P. Osolinik, *Nonprofit Student Lenders and Risk Retention: How the Dodd-Frank Act Threatens Students' Access to Higher Education and the Viability of Nonprofit Student Lenders*, 64 BAYLOR L. REV. 158, 185–86 (2012) ("[A] number of other laws also provide nonprofit organizations with more funds and easier access to capital. For instance, tax-exempt nonprofit organizations that issue securities may do so without being constrained by many provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934." (footnote omitted)).

[97] *See* Horner & Makens, *supra* note 92, at 478–82.

[98] 15 U.S.C. § 77c(a)(4) (2006 & Supp. V 2011); 15 U.S.C. § 78*l*(g)(2)(D) (2006).

[99] Horner & Makens, *supra* note 92, at 481 (footnote omitted); *see also* 15 U.S.C. § 78c(e)(1) (2006).

[100] 15 U.S.C. § 78c(e)(2) (2006); *see also* Horner & Makens, *supra* note 92, at 481.

> organizations are never exempt from the anti-fraud provisions of the federal and state securities laws. Each issuer of securities is required to make full and fair disclosure to its investors and is prohibited from engaging in manipulative, deceptive, or fraudulent conduct in connection with the sale of securities.[101]

Accordingly, while the mandatory disclosure regime under federal securities law (effectuated through the registration and reporting requirements of the 1933 Act and 1934 Act) and certain forms of substantive regulation (including proxy, going-private, and tender-offer regulation under the 1934 Act) may not apply to not-for-profits who issue exempt securities, antifraud rules exist to help protect investors in those securities from, for example, the inaccurate and incomplete disclosure of material facts in connection with investment transactions in the securities.[102] These antifraud rules exist under both the 1933 Act and the 1934 Act, and claims may relate to registered or unregistered securities.[103] In general, these fraud rules encourage not-for-profit issuers of exempt securities to produce offering materials (e.g., a private placement memorandum or offering circular) to help ensure the accurate and complete disclosure of all material facts in connection with offers and sales of securities.[104]

The policy rationale for the light regulatory treatment of securities issued by not-for-profit entities is somewhat unclear. In discussing the exemption from 1933 Act registration, one group of coauthors offer a helpful explanation:

> Various policy justifications may support this exemption. Arguably, individuals do not "invest" in eleemosynary organizations and therefore are not in need of extensive disclosures about the economic aspects of the operations of such issuers. Further, to subject nonprofit organizations to the costs of registering securities offered to the public would severely limit the ability of the organizations to raise capital needed to achieve the purposes for which they were formed.[105]

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[101] Horner & Makens, *supra* note 92, at 474–75; *see also id.* at 528 ("[E]ven if the program is exempt from all registration requirements, nonprofit organizations are never exempt from the anti-fraud provisions of the federal or state securities laws.").

[102] *Id.* at 479 ("Section 3(a)(4) provides only an exemption from registration of securities. It does not provide an exemption from the anti-fraud provisions of the Securities Act."); *id.* at 480 ("The exemption under sections 12(g) and 3(a)(12)(A) are only exemptions from registration. The anti-fraud provisions of the Exchange Act continue to apply to the purchase and sale of securities that are exempt from registration.").

[103] *See id.* at 489 (describing, generally, the nature of antifraud protections under the 1933 Act and the 1934 Act).

[104] *Id.* at 528.

[105] JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 432 (6th ed. 2009); *see also* SEC v. Children's Hosp., 214 F. Supp. 883, 891 (D. Ariz. 1963) ("Section 3(a)(4) of the Securities Act is intended to facilitate the raising of funds by eleemosynary

Generally, these policy justifications reflect an "unstated premise that the eleemosynary character of the issuer obviates the need for disclosure to investors"[106] and a prioritization of the social good of nonprofits over the need for enhanced disclosure to investors—disclosure in excess of that required for not-for-profits under federal tax law, state entity law, and state charitable donation regulation (as applicable). These rationales may apply with almost equal force to social enterprise firms organized as for-profit entities.

For example, funders of for-profit social enterprise ventures, like funders of public charities, may not understand themselves to be investors in the classic financial sense. The return that they seek typically is not wholly pecuniary. The psychological and emotional benefits of investing in the public good are usually a driving force and may, in fact, be the funder's primary motivation. The possibility of a financial return may be a secondary—even an incidental—motivation for the investment. Accordingly, these funders may not need the same type or extent of disclosures about the financial condition and results of operations of the firm that investors in non-social enterprise for-profit ventures require.

This may be especially true for social enterprise investors whose financing is provided through innovative investment contracts like unequity.[107] Unequity includes a profit-sharing or revenue-sharing interest and is, therefore, a security.[108] But the profit-sharing or revenue-sharing interest exists over a short term—a few years at most—and does not include any governance (management or voting) rights. In the run-up to the passage of the JOBS Act (signed into law in April 2012), crowdfunding web sites and the projects they promoted innovated a number of different types of financial interests. Some of the crowdfunding interests offered at this time were unequity and other forms of investment contract. These interests were securities, and the offer and sale of them should have been registered under then-existing federal law. Some crowdfunding interests offered at that time did not offer a financial return to funders, preferring instead to solicit financial contributions in the form of donations (with or without a product, product discount, or other reward as an incentive) or interest-free

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issuers."); Kevin E. Davis & Anna Gelpern, *Peer-to-Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. J. INT'L L. & POL. 1209, 1254 (2010) ("[C]harities are exempt from disclosure and registration aspects of securities laws in part because the cost of compliance is out of proportion with nonprofit finances.").

[106] COX ET AL., *supra* note 105, at 463.

[107] *See supra* note 50 and accompanying text.

[108] *See generally* Heminway & Hoffman, *supra* note 33, at 890–905 (assessing the security status of investment contracts of this kind in the pre-JOBS Act era).

loans.[109] If for-profit social enterprise firms offer unequity (or other securities with minimal profit-making potential) to investors, whether through crowdfunding or otherwise, costly, time-intensive disclosures (including those associated with, e.g., 1933 Act registration) may discourage the formation of for-profit social enterprise entities.

Moreover, a social enterprise firm, like the archetypal not-for-profit public charity, exists in part for public benefit (half of its "double bottom line"). If that public benefit is to be promoted, policymakers should consider whether an exemption from the disclosure requirements under the 1933 Act and 1934 Act (like that provided to charitable entities) is necessary or desirable. In other words, the law may want to affirmatively encourage social enterprise by decreasing the cost of raising capital from the public.

This analysis puts pressure on at least two salient matters that arguably deserve more attention and robust debate: (1) the propriety and desirability of the existing regulatory exemptions applicable to not-for-profit issuers and securities, and, (2) assuming the appropriateness and value of the existing regulatory exemptions applicable to not-for-profit issuers and securities, the nature and extent of the public good served by for-profit social enterprise entities as compared to not-for-profit public charities. Both matters involve difficult—and arguably non-objective—judgments. It may be profitable, however, for advocates, detractors, and policymakers to focus on identifying and gauging the net social utility of not-for-profit public charities and for-profit social enterprise entities and comparing and contrasting them as a means of reaching reasoned judgments about the incentives and disincentives created by the existing system of securities regulation in this context. The hybrid nature of social enterprise, the blurred lines between not-for-profit and for-profit social enterprise entities, and the wide variety of statutes that may be used to charter social enterprise entities under state law make this task challenging. Not all not-for-profit entities or for-profit social enterprise firms are created equally, and social enterprise businesses (however organized) may not be easily comparable. Although the adoption by states of standardized forms of entity for social enterprises may better enable, over time, an assessment of whether securities issued by those entities should be treated more like standard not-for-profit or for-profit securities, difficult policy questions likely will remain.

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[109] *See* Bradford, *supra* note 33, at 14–15 (offering a taxonomy of different crowdfunding forms).

CONCLUSION

New hybrid forms of entity for use by social enterprise firms (e.g., L3Cs and benefit corporations) may or may not be a long-term part of our state-based system of entity law. As a general matter, however, social enterprise appears to be here to stay and continues to evolve in a space between the public and the private; between the traditional for-profit and not-for-profit forms of entity. This evolution is occurring in a broader environment of political, social, and economic transformation.

> Significant changes are occurring in the field of social enterprise, including major developments in the flow of funding, growing but often untapped philanthropic resources, and a shift in the role of government, as well as new social investment models and impact measurement tools. All of these phenomena are occurring against a larger backdrop of demographic and market change as boundaries blur among the traditional nonprofit, for-profit, and public-sector silos.[110]

The development of social enterprise entity law is important to the overall development of entity law as a means of differentiating for-profit social enterprise firms from traditional for-profit business ventures on the basis of, e.g., their corporate purpose and the substantive focus of managerial fiduciary duties.

The regulation of securities, together with entity law and tax law, affects the continued viability of these social enterprise entities through the incentives and disincentives it creates for different funding models and strategies. Given the evolving social enterprise landscape, legal counselors of all kinds are well advised to devote attention to the legal aspects of social enterprise finance, including the nature of the funding interests and instruments that individual social enterprise ventures offer and sell to investors and the regulation of those interests and instruments in context. These matters are important to *ex ante* advice on the appropriate legal form, capital structure, and acceptable risk profile for a social enterprise venture. They also are important to *ex post* assessments in advisory and advocacy contexts.

However, just as securities regulation influences social enterprise, social enterprise also impacts the regulation of securities. The changing nature of the firm, among other things, renders the very concept of a security somewhat elusive. In the brave new world of L3Cs, benefit corporations, and crowdfunding, the conception and regulation of securities is becoming increasingly complex. The current financial regulatory system depends on labeling interests and instruments by

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[110] V. Kasturi Rangan et al., *The Future of Social Enterprise* 9 (Harvard. Bus. Sch., Working Paper No. 08-103, 2008), *available at* www.hbs.edu/faculty/Pages/download.aspx?name=08-103.pdf.

their specific type as a means of determining the form and manner of regulation as well as the regulatory body that exercises control over the applicable rules of finance.

Yet the task of identifying and labeling securities in the age of social enterprise and crowdfunding is increasingly difficult. As new financial interests and instruments are created, the once-clear lines between different forms of instrument—debt versus equity, common stock versus preferred stock, etc.—become increasingly blurred. As policymakers consider restructuring the system of financial regulation in the United States, a more comprehensive understanding and analysis of the nature of securities issued by social enterprises will be valuable in locating these securities in the spectrum of regulated financial interests and instruments. This understanding and analysis is important not only to normalizing the establishment and funding of social enterprise, but also to solving the overall financial regulatory puzzle.

FROM KANSAS TO THE CONGO: WHY NAMING AND SHAMING CORPORATIONS THROUGH THE DODD–FRANK ACT'S CORPORATE GOVERNANCE DISCLOSURE WON'T SOLVE A HUMAN RIGHTS CRISIS

Marcia Narine[*]

ABSTRACT

The Securities and Exchange Commission ("SEC") serves to protect investors, maintain fair and efficient markets, and facilitate capital formation. With the passage of Section 1502 of the Dodd–Frank Act regarding conflict minerals corporate governance disclosure, the agency has entered into the human rights arena. Any company, regardless of size, that files reports with the SEC must now ensure that they are not funding rebel groups engaged in rape, torture, the use of child soldiers, exploitation of child labor, or other activities that have, in part, led to one of the world's largest and most protracted humanitarian crises. This "name-and-shame" law, which does not actually make it illegal to source minerals from the Congo, aims to provide transparency to consumers and investors so that they can make informed choices about the companies with which they choose to do business. On the surface, this makes sense in an era in which companies are hyper-vigilant about their reputations. Whether a corporation takes a shareholder or stakeholder-centric point of view, no firm can afford to be associated with conscription of child soldiers or the rape of women and children.

This Article outlines corporate motivations for social responsibility programs; the various voluntary industry corporate citizenship initiatives; the state of corporate liability for human rights abuses prior to the Dodd–Frank Act; the level of sexual violence in the Congo which led to the legislation; the legislative history behind the conflict mineral rule, including the involvement of civil society groups; the legal

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[*] Marcia Narine is a Visiting Assistant Professor of Law at the University of Missouri-Kansas City. I would like to thank Dean Ellen Suni for the generous research grant which enabled me to attend a conference at the University of Glasgow on Protecting Human Rights: Duties and Responsibilities of States and Non-State Actors and for UMKC's support both as a new scholar at the 2012 SEALS conference and at the Regent University School of Law Social Enterprise Symposium, where an early version of the CSR portion of this Article was presented. I would also like to thank andré douglas pond cummings for his mentorship during the SEALS conference, and Debbie Brooks, Rana Lehr-Lehnardt, and Tim Lynch for their insightful comments on this Article. I would also like to thank my research assistants Ashley Miller, Patrick Verstraete, and Latoya Brown. A special thanks to Cecilia Martin for her tireless hours of work on this and other Congo-related articles that provided background material for this project.

challenges to the rule; and some alternatives to the rule. The Article contends that in a well-intentioned effort to help the people of the Congo, the drafters of the law oversimplified the causes of the violence and failed to adequately consider appropriate alternatives. Additionally, the implementer of the law—the SEC—failed to adequately consider costs and benefits. Companies, however, will conduct their own cost–benefit analyses as it relates to reputation and legal risk. Many companies will likely determine that pulling out of the Congo is in their best interest. As a result, the Dodd–Frank Act may likely cause a de facto boycott of buying minerals from the Congo, even if they are not tainted. Consumers and investors will ultimately determine whether name-and-shame really works.

The Article concludes that the Dodd–Frank conflict minerals rule is a poor choice for the United States' first foray into human rights legislation for corporations because the law's flaws will lead to unintended and devastating consequences for the very beneficiaries it intends to help—the Congolese people.

INTRODUCTION

For decades, academics and courts have debated the proper role of corporations in society. To many, the corporation serves only to maximize shareholder value.[1] Others criticize that definition as both one-dimensional and outdated. To them, the corporation owes duties to a broader group—the stakeholders, including employees, creditors, and consumers.[2] Still others argue that states need to enact legislation creating new corporate entities such as benefit corporations, low-profit limited liability companies ("L3Cs"), and flexible purpose corporations.[3]

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[1] *See generally* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); Leo E. Strine, Jr., *Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135 (2012); Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32.

[2] *See* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 4, 6–7, 34–35 (2012).

[3] *See* Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 593–606 (2011) (describing benefit corporations); William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 838 (2012) (describing the need for benefit corporations); Susan Mac Cormac & Heather Haney, *New Corporate Forms: One Viable Solution to Advancing Economic Sustainability*, J. APPLIED CORP. FIN., Spring 2012, at 49, 55 (supporting the flexible purpose corporation); J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012) (examining whether benefit

They base their contentions in part on the fear that the pursuit of a social mission over profit-maximization subjects directors to additional liability, notwithstanding the existence of constituency statutes in several states and the fact that the law generally allows corporations to pursue lawful purposes including social benefits.[4]

In recent years, however, even the more traditional firms have spent significant sums publicizing their social missions through the use of corporate social responsibility ("CSR") programs.[5] In 1999, corporations issued about 500 nonfinancial reports, but, in 2003, corporations produced more than 1,500 such reports.[6] By 2010, nearly 5,500 corporate responsibility reports were being published each year.[7]

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corporations are really useful and proposing some improvements); J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 4 (2011).

[4] *Compare* Clark & Babson, *supra* note 3, at 848–50 (describing how benefit corporations give directors flexibility to pursue social goals while simultaneously holding them accountable to those goals), *with* Murray & Hwang, *supra* note 3, at 35–36 (describing the latitude that directors have to act in favor of non-shareholders due to the business judgment rule and various constituency statutes).

[5] This Article defines CSR as the "commitment [of a business] to contribute to sustainable economic development, working with employees, their families, the local community, and society at large to improve their quality of life." WORLD BUS. COUNCIL FOR SUSTAINABLE DEV., CROSS-CUTTING THEMES 5 (2003), *available at* http://www.wbcsd.ch/DocRoot/7ApjAG0YjGBKx83eok6O/cross-cutting.pdf; *see also* Henri Servaes & Ane Tamayo, *The Impact of Corporate Social Responsibility on Firm Value: The Role of Customer Awareness*, MGMT. SCI. (forthcoming 2013), *available at* http://mansci.journal.informs.org/content/early/2013/01/08/mnsc.1120.1630.full.pdf (discussing various definitions of CSR but adopting the definition by the World Business Council for Sustainable Development). Another appropriate definition is "a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships." Noam Noked, *Investing in Corporate Social Responsibility to Enhance Customer Value*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 28, 2011, 9:31 AM), http://blogs.law.harvard.edu/corpgov/2011/02/28/investing-in-corporate-social-responsibility-to-enhance-customer-value/ (quoting Donna J. Wood, *Corporate Social Performance Revisited*, 16 ACAD. MGMT. REV. 691, 693 (1991)).

[6] ASS'N OF CHARTERED CERTIFIED ACCOUNTANTS & CORPORATEREGISTER.COM, TOWARDS TRANSPARENCY: PROGRESS ON GLOBAL SUSTAINABILITY REPORTING 2004, at 8, *available at* http://www.corporateregister.com/pdf/TowardsTransparency.pdf. Nonfinancial reports include reports concerning CSR, the environment, sustainable development, and other social or community issues. *Id.* at 5.

[7] Press Release, CorporateRegister.com, Voting Opens for CR Reporting Awards 2012 (Oct. 24, 2010), *available at* http://www.corporateregister.com/crra/help/CRRA12PressRelease.pdf.

To varying degrees, these firms have tried to find a way to pursue a societal benefit while creating economic value.[8] Perhaps in recognition of the public benefit of adopting more of a stakeholder view, the CEO of one of the world's largest hospitality groups began his corporate responsibility report for 2011 by asking the question, "What is the role of hotels in 21st century society?"[9]

CSR programs vary by industry and may tout sustainable economic development, ethical sourcing, community engagement, fair working conditions, and other factors that either cause employees, consumers, and members of the public to have positive feelings about the corporation or help the firm rehabilitate a bruised corporate image.[10] At least publicly, CSR is now the "[n]ew [b]usiness [n]orm."[11]

Cynical observers have labeled some of these efforts "faux CSR,"[12] while others have studied the CSR "halo effect" in which consumers blindly make decisions about a company based solely on what they have heard about one aspect of a company's CSR program.[13] This halo effect may cause consumers, for example, to assume that a company that bottles its products in recycled plastic also treats its employees more fairly than other employers.[14]

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[8] *See* Michael E. Porter & Mark R. Kramer, *Creating Shared Value: How to Reinvent Capitalism—and Unleash a Wave of Innovation and Growth*, HARV. BUS. REV., Jan.–Feb. 2011, at 62, 64–65 (arguing that "societal needs, not just conventional economic needs, define markets" and that companies should have societal issues at the "core," not the "periphery").

[9] INTERCONTINENTAL HOTELS GRP., CORPORATE RESPONSIBILITY REPORT 1 (2012), *available at* http://www.ihgplc.com/files/pdf/2011_cr_report.pdf.

[10] *See generally* WORLD BUS. COUNCIL FOR SUSTAINABLE DEV., CORPORATE SOCIAL RESPONSIBILITY: MAKING GOOD BUSINESS SENSE 6–7, 10–11, 19 (2000), *available at* http://www.wbcsd.org/web/publications/csr2000.pdf.

[11] *See* Markus Funk & Elizabeth Banzhoff, *Corporate Social Responsibility: The New Business Norm*, CORP. COMPLIANCE INSIGHTS (Dec. 14, 2012), http://www.corporatecomplianceinsights.com/corporate-social-responsibility-the-new-business-norm/ (observing that, in addition to bribery and corruption laws, companies need to contend with the Executive Order on Strengthening Protections Against Trafficking in Persons in Federal Contracts, SEC conflict minerals rules, and the California Transparency in Supply Chains Act).

[12] *See, e.g.*, Miriam A. Cherry & Judd F. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster*, 85 TUL. L. REV. 983, 985, 999–1009 (2011) (discussing corporate social responsibility and greenwashing in the context of the BP oil spill).

[13] *See* N. Craig Smith et al., *Consumer Perceptions of Corporate Social Responsibility: The CSR Halo Effect* 4, 16–17 (INSEAD Soc. Innovation Ctr., Working Paper No. 16, 2010), *available at* http://ssrn.com/abstract=1577000.

[14] *See id.* at 17 ("The CSR halo effect suggests consumers might extrapolate from a small number of examples of CSR-related practices.").

Despite questions from some skeptics about the motivations for CSR efforts and the fact that the literature is inconclusive as to the extent of the benefits, corporations generally gain some public relations advantage from discussing how they address the triple bottom line—people, profits, and planet.[15] But sometimes that effort may not be enough. Notwithstanding its comprehensive global responsibility reports touting awards for pursuing sustainability, respecting employees, and benefitting the environment,[16] Wal-Mart, the nation's largest employer,[17] has been besieged by employment lawsuits, foreign bribery investigations, and opposition from grassroots organizations against its antiunion stance and its opening of new stores.[18] Nonetheless, Wal-Mart still remains one of the most profitable companies in the world, and it is

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[15] *See* John Elkington, *Enter the Triple Bottom Line, in* THE TRIPLE BOTTOM LINE: DOES IT ALL ADD UP? 1, 1–2 (Adrian Henriques & Julie Richardson eds., 2004) (discussing the origin of the term "triple bottom line"). For example, some research indicates that businesses gain increased customer loyalty, the ability to charge higher prices, and lower reputational risk, which aids them in times of crisis, as a result of their CSR efforts, leading to increased profitability in the long run. Noked, *supra* note 5; *see also* Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board's Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 664–65 (2007) (reviewing studies measuring the relationship between CSR and consumer reactions to the company); Servaes & Tamayo, *supra* note 5, at 2 (observing that CSR and firm value are positively correlated for firms with high customer awareness based on advertising expenditures and that, for firms with low customer awareness, the relation is either negative or insignificant); Robert G. Eccles et al., *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance* 5–7 (Harvard Bus. Sch., Working Paper No. 12-035, 2011) (comparing ninety *"High Sustainability"* companies that were early and voluntary adopters of environmental and social policies and that use these measures as governance practices with ninety *"Low Sustainability"* companies or traditional companies, and finding that, over an eighteen-year period, sustainable firms outperform traditional firms in terms of both stock market and accounting performance).

[16] *See* WALMART, BEYOND 50 YEARS: BUILDING A SUSTAINABLE FUTURE 114–15 (2012) (listing Wal-Mart's 2011 awards and recognitions, including ones for environmental care, social responsibility, and sustainability).

[17] Lesley Wexler, *Wal-Mart Matters*, 46 WAKE FOREST L. REV. 95, 95 (2011).

[18] *See* GEOFFREY HEAL, WHEN PRINCIPLES PAY: CORPORATE SOCIAL RESPONSIBILITY AND THE BOTTOM LINE 113, 116, 128 (2008); *see also, e.g.*, Wal-Mart v. Dukes, 131 S. Ct. 2541, 2547 (2011) (addressing a class action suit against Wal-Mart); David Barstow, *Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle*, N.Y. TIMES, Apr. 22, 2012, at A1 (discussing allegations of bribery within Wal-Mart's Mexican subsidiary); Andrew Martin, *Female Wal-Mart Employees File a New Bias Case*, N.Y. TIMES, Oct. 28, 2011, at B3 (discussing discrimination cases against Wal-Mart). Wal-Mart products have also been linked to factories with sub-par safety standards resulting in the deaths of factory employees from fires. Steven Greenhouse, *Documents Indicate Walmart Blocked Safety Push in Bangladesh*, N.Y. TIMES, Dec. 6, 2012, at A16.

likely that its investments in CSR have benefited it.[19] Further, the evidence is mounting that despite what consumers say about their desires to do business with socially responsible enterprises, convenience and price eventually win out when it comes to actual purchasing decisions.[20]

Perhaps because of the public pressure to do more, many of the world's most powerful transnational corporations ("TNCs") engage in a number of voluntary initiatives on their own or with industry peers either to win public and consumer support or to forestall more onerous legislation in home or host countries. TNCs that sign on to voluntary industry initiatives, however, have no accountability other than public scrutiny or expulsion from the voluntary initiative.[21]

International human rights laws generally have focused on protecting citizens from their states, but we are now seeing a shift to focusing on TNCs' roles in protecting human rights.[22] Legally, at least, the states—not TNCs—have traditionally been charged with the main responsibility for protecting human rights.[23] But observers, such as nongovernmental organizations ("NGOs"), socially responsible investors controlling trillions in assets under management,[24] activists, media

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[19] *See* HEAL, *supra* note 18, at 114, 128–30 (discussing Wal-Mart's efficiency and recent steps toward social responsibility).

[20] *See* GUARDIAN, CONSUMER ATTITUDES AND PERCEPTIONS ON SUSTAINABILITY 8 (2010), *available at* http://image.guardian.co.uk/sys-files/Guardian/documents/2010/06/11/GSiJun2010.pdf (indicating that environmental factors are important, but that price, availability, and quality matter more to consumers).

[21] When reputation is an asset, firms are especially susceptible to pressure and scrutiny from activist groups. *See* VIRGINIA HAUFLER, A PUBLIC ROLE FOR THE PRIVATE SECTOR 27 (2001). The U.N. Global Compact, for example, has expelled over 3,000 companies for failing to report on their progress towards achieving the Compact's ten principles. *See UN Global Compact Has Expelled over 3,000 Companies*, UNITED NATIONS GLOBAL COMPACT (Feb. 9, 2012), http://unglobalcompact.org/news/188-02-09-2012. This, however, is a purely voluntary initiative, and there are no civil, criminal, or monetary penalties. *See infra* notes 83–87 and accompanying text.

[22] *See* SAMUEL MOYN, THE LAST UTOPIA: HUMAN RIGHTS IN HISTORY 3 (2010).

[23] Eric de Brabandere, *Non-state Actors and Human Rights: Corporate Responsibility and the Attempts to Formalize the Role of Corporations as Participants in the International Legal System*, *in* PARTICIPANTS IN THE INTERNATIONAL LEGAL SYSTEM: MULTIPLE PERSPECTIVES ON NON-STATE ACTORS IN INTERNATIONAL LAW 268, 271 (Jean d'Aspremont ed., 2011).

[24] *See* SOC. INV. FORUM FOUND., 2010 REPORT ON SOCIALLY RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES 8 (2010), *available at* http://www.socialinvest.org/resources/pubs/trends/documents/2010TrendsES.pdf (noting that one out of every eight dollars invested in the United States is geared toward sustainable and socially responsible investing). The simplest form of socially responsible investing is portfolio-screening whereby an investor identifies ethically unacceptable investments and excludes those investments from her portfolio. Maria O'Brien Hylton, *"Socially*

outlets, consumers, and labor organizations, have long called on TNCs to re-examine their behavior in the states in which they operate.[25] Some use cooperative initiatives and some employ public "name-and-shame" campaigns.[26] Intergovernmental organizations, such as the Organisation for Economic Co-operation and Development ("OECD") and the United Nations ("U.N."), have issued influential, albeit nonbinding, guidance to TNCs as well.[27] While NGOs and intergovernmental organizations' focus on TNCs have typically been for environmental regulations, the spotlight has more recently turned to garnering TNC participation in human rights issues.[28]

TNCs no longer have the luxury of choosing to volunteer to be socially responsible, at least as it relates to human rights, because those that file reports under Sections 13(a) or 15(d) of the Securities Exchange Act ("Exchange Act")[29] and that meet certain other criteria described in this Article must now enter a new realm between the hard and soft law[30] governance. Prodded by former U.S. Senator Sam Brownback of Kansas,[31] the U.S. government recently enacted a law legislating human

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Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 AM. U. L. REV. 1, 7 (1992).

[25] *See* HAUFLER, *supra* note 21, at 11, 107 (discussing the power of activists and socially conscious consumers to influence businesses); DAVID VOGEL, THE MARKET FOR VIRTUE: THE POTENTIAL AND LIMITS OF CORPORATE SOCIAL RESPONSIBILITY 9–10 (2005) (mentioning the shift of NGOs from lobbying politicians to lobbying executives).

[26] For example, change.org has launched several highly publicized online campaigns to promote citizen activism against well-known firms. *See* CHANGE.ORG, http://www.change.org (last visited Mar. 8, 2013). In another example, European NGOs have asked Apple, Samsung, and others to disclose how they source their tin from Indonesia's Bangka Island because of the potential deforestation and the effect on the local fishermen's livelihoods following a six-month investigation by Friends of the Earth. FRIENDS OF THE EARTH, MINING FOR SMARTPONES: THE TRUE COST OF TIN 3–4 (2012), *available at* http://www.foe.co.uk/resource/reports/tin_mining.pdf.

[27] *See infra* Part I.B–C. The OECD has thirty-four member countries, including the United States, and supports policies improving the social and economic conditions of people worldwide, including people of nonmember states. Org. for Econ. Co-operation & Dev. [OECD], *Better Policies for Better Lives: The OECD at 50 and Beyond*, at 8 (2011), *available at* http://www.oecd.org/about/47747755.pdf. The U.N. currently has 193 member states. *Membership of Principal UN Organs*, UNITED NATIONS, http://www.un.org/en/members/pomembership.shtml (last visited Mar. 8, 2013).

[28] *See* Beth Stephens, *The Amorality of Profit: Transnational Corporations and Human Rights*, 20 BERKELEY J. INT'L L. 45, 78 (2002).

[29] Securities Exchange Act of 1934 §§ 13(a), 15(d), 15 U.S.C.A. §§ 78m(a), 78o(d) (West 2009; Supp. 2012 & Supp. 1A 2012).

[30] Soft laws are neither legally binding "nor completely void of any legal significance." MARK W. JANIS, AN INTRODUCTION TO INTERNATIONAL LAW 52–53 (4th ed. 2003). Soft law is meant to be transitory, but when it hardens, it becomes customary international law. *See id.*

[31] 156 CONG. REC. S3,655–56 (daily ed. May 12, 2010).

rights through corporate governance disclosure—Section 1502 of the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd–Frank Act").[32] Unrelated to the Dodd–Frank Act's broader goal of preventing financial crisis, the conflict mineral provisions of the Dodd–Frank Act are meant to focus investor and consumer attention on potential corporate complicity in human rights abuses primarily in the Democratic Republic of the Congo ("DRC" or "Congo"),[33] a country with the world's largest concentration of U.N. Peacekeeping troops.[34]

On August 22, 2012, the United States Securities and Exchange Commission ("SEC") finalized Rule 13p-1, which requires domestic and foreign companies (regardless of size) that already file reports with the SEC to conduct due diligence and report on Form SD the origin of certain minerals in their products if those minerals originated in the DRC or adjoining countries.[35] The purpose of the reporting is to ensure that they are not funding dangerous rebel groups that engage in rape, torture, the use of child soldiers, exploitation of children, and other activities that have, in part, led to one of the world's largest and most protracted humanitarian crises.[36] This law, which went into effect on November 13, 2012,[37] aims to provide transparency to consumers and investors so that they can make informed choices about companies.[38]

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[32] *See* Dodd–Frank Wall Street Reform and Consumer Protection Act § 1502, 15 U.S.C. § 78m(p) (Supp. V 2011) [hereinafter Dodd–Frank Act].

[33] *See id.* § 1502(a); Conflict Minerals, 77 Fed. Reg. 56,274, 56,275 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240 & 249b). The Democratic Republic of the Congo will be called the "DRC" or "Congo" in this Article and is not to be confused with the adjacent country called the Republic of Congo.

[34] *Peacekeeping Fact Sheet*, UNITED NATIONS (Jan. 31, 2013), http://www.un.org/en/peacekeeping/resources/statistics/factsheet.shtml [hereinafter Peacekeeping Fact Sheet].

[35] Conflict Minerals, 77 Fed. Reg. at 56,275, 56,362, 56,356. The term "adjoining country" is defined in the Act as "a country that shares an internationally recognized border with the [DRC]." Dodd–Frank Act § 1502(e)(1). Presently, the adjoining countries of the DRC include Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia. Conflict Minerals, 77 Fed. Reg. at 56,275 n.7.

[36] *See* Dodd–Frank Act § 1502(a); Conflict Minerals, 77 Fed. Reg. at 56,275–76, 56,365.

[37] Conflict Minerals, 77 Fed. Reg. at 56,274. Compliance with the rule must begin on January 1, 2013. *Id.*

[38] One article has called Section 1502 "a regulatory experiment in information extraction" because companies operating in the DRC may have to go all the way through their supply chains to get information because they themselves may lack the crucial information about the source of minerals in their products. Christiana Ochoa & Patrick J. Keenan, *Regulating Information Flows, Regulating Conflict: An Analysis of United States Conflict Minerals Legislation*, 3 GOETTINGEN J. INT'L L. 129, 140, 147–48 (2011) (noting also that, when companies discover that their minerals may contribute to the conflict, they may have disincentives to fully comply with reporting initiatives given the consequences,

Section 1502 of the Dodd–Frank Act was predicted to affect an estimated 6,000 companies[39]—almost half of all U.S. publicly traded companies directly subject to SEC regulation[40]—and hundreds of thousands of suppliers because almost every consumer product that requires electronics uses one of the four regulated minerals collectively known as the "3Ts+G."[41] Specifically, these are: (1) columbite-tantalite, from which tantalum may be extracted, which is used for cell phones, computers, surgical implants, and wind turbines; (2) cassiterite, from which tin may be extracted, which is used in coating for food cans, solders, catalysts, and stabilizers; (3) wolframite, from which tungsten may be extracted and used for light bulbs, aerospace components, and machine tools; or (4) gold, which is used as an electronic conductor, for jewelry, and in medical equipment and anti-lock brakes.[42] Large companies must make their first disclosures in May 2014 for activities occurring in calendar year 2013.[43] The reporting will have a dramatic effect on the companies because some companies can have 10,000 to 50,000 suppliers and several layers in their supply chains.[44]

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including, among other things, consumer boycotts, and that even though over time Section 1502 may eventually improve conditions in the DRC, companies may choose to divest from the region, which may lead to even more conflict).

[39] Conflict Minerals, 77 Fed. Reg. at 56,336.

[40] *See* KPMG INT'L, CONFLICT MINERALS AND BEYOND: PART TWO: A MORE TRANSPARENT SUPPLY CHAIN 1 (2012), *available at* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/conflict-minerals/Documents/conflict-minerals-beyond-part-two.pdf. The law did not make de minimis exceptions for the metals; accordingly, many more companies are affected than would otherwise have been impacted by the legislation. *See* MORGAN LEWIS, SEC ADOPTS RULES IMPLEMENTING THE DODD–FRANK REQUIREMENT FOR CONFLICT MINERALS REPORTING 2 (2012), *available at* http://www.morganlewis.com/pubs/Securities_WhitePaper_ConflictMineralsReporting_Sep2012.pdf.

[41] JOE DILEO ET AL., DELOITTE & TOUCHE LLP, CONFLICT MINERALS—THE SUPPLY CHAIN'S WEAKEST LINK? 3 (2011), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Content/Articles/AERS/Financial%20Statement%20&%20Internal%20Control%20Audit%20%28FSICA%29/Accounting-Standards-Communications/us_aers_headsup_112911.pdf.

[42] *See* Conflict Minerals, 77 Fed. Reg. at 56,275; Opening Brief of Petitioners 6–7, Nat'l Ass'n of Mfrs. v. SEC, No. 12-1422 (D.C. Cir. Jan. 16, 2013); Edward Wyatt, *Behind the Blood Money: Debate Grows over Use of Minerals Mined in Strife-Torn Areas*, N.Y. TIMES, Mar. 20, 2012, at B1. Apple alone has identified 218 of its suppliers that use the affected minerals to manufacture components and the 175 smelters that those minerals come from. *See* APPLE, APPLE SUPPLIER RESPONSIBILITY: 2012 PROGRESS REPORT 11 (2012), *available at* http://www.apple.com/supplierresponsibility/pdf/Apple_SR_2012_Progress_Report.pdf.

[43] Conflict Minerals, 77 Fed. Reg. at 56,274.

[44] Opening Brief of Petitioners 9–11, *Nat'l Ass'n of Mfrs.*, No. 12-1422.

Additionally, their suppliers can have multiple levels and subcontractors themselves within their own supply chains.[45]

Significantly, the law does not *prohibit* the use of conflict minerals. It merely requires companies to *disclose* whether they are using them and, if so, perform a due diligence examination of the source of those minerals and provide a description of the products manufactured that are not "DRC conflict free."[46] This "name-and-shame" law depends on consumers and investors to pressure the firms—especially those that depend on CSR programs to enhance their images—to change their business practices.[47] Many industry groups representing businesses have sued the SEC, arguing, among other things, that the agency failed to take into account the appropriate cost–benefit analysis.[48]

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[45] *Id.*

[46] Dodd–Frank Act § 1502; Conflict Minerals, 77 Fed. Reg. at 56,274, 56,281, 56,363–64 (providing a temporary transition period during which issuers may use the term "DRC conflict undeterminable" if they cannot make the determination for one of two specified reasons).

[47] *See* DUDLEY W. MURREY ET AL., ANDREWS KURTH LLP, SEC ADOPTS DODD–FRANK CONFLICT MINERALS RULE 1 (2012), *available at* http://www.andrewskurth.com/assets/pdf/article_920.pdf. Naming and shaming has had mixed success in other contexts. Naming and shaming countries that enable human trafficking has been largely ineffective. *See* Karen E. Bravo, *Follow the Money? Does the International Fight Against Money Laundering Provide a Model for International Anti-human Trafficking Efforts?*, 6 U. ST. THOMAS L.J. 138, 140 (2008). California's Transparency in the Supply Chains Act of 2010 § 3, CAL. CIV. CODE § 1714.43 (West Supp. 2013), which examines slave labor and human trafficking in the supply chain, requires online disclosures, though a study found that one-quarter of apparel companies are noncompliant, and the majority make valueless vague disclosures. Univ. of Del., *Apparel Industry Study*, UDAILY (Apr. 12, 2012, 8:08 AM), http://www.udel.edu/udaily/2012/apr/ apparel-compliance-041212.html. As an example of naming and shaming being an ineffective means of deterrence, sex offender registries may actually increase crime by making a noncriminal lifestyle less appealing. *See* J.J. Prescott & Jonah E. Rockoff, *Do Sex Offender Registration and Notification Laws Affect Criminal Behavior?*, 54 J.L. & ECON. 161, 192 (2011) (identifying sex offenders to local residents may increase recidivism, although mere registration of offenders might decrease crime). In fact, JohnTV (an organization that attempts to discourage street prostitution by filming and posting Johns with prostitutes online), *About*, JOHNTV.COM, http://johntv.com/about (last visited Mar. 8, 2013), is a particularly poor tool for rehabilitation and specific deterrence. *See* Courtney Guyton Persons, *Sex in the Sunlight: The Effectiveness, Efficiency, Constitutionality, and Advisability of Publishing Names and Pictures of Prostitutes' Patrons*, 49 VAND. L. REV. 1525, 1547 (1996). But hygiene grade cards in Los Angeles County were successful in decreasing food-borne illness by thirteen percent. *E.g.*, Paul A. Simon et al., *Impact of Restaurant Hygiene Grade Cards on Foodborne-Disease Hospitalizations in Los Angeles County*, J. ENVTL. HEALTH, Mar. 2005, at 32, 34. Public shame was also useful in changing international consensus for landmines. Lesley Wexler, *The International Deployment of Shame, Second-Best Responses, and Norm Entrepreneurship: The Campaign to Ban Landmines and the Landmine Ban Treaty*, 20 ARIZ. J. INT'L & COMP. L. 561, 572–74 (2003).

[48] *See* Petition for Review at 1–2, *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Oct. 19, 2012). On November 21, 2012, the petitioners filed a Preliminary Statement of Issues.

This Article will proceed in four parts. Part I briefly discusses the current duties that U.S. corporations have in the human rights context and the quasi-legal landscape in which TNCs operated until the passage of the Dodd–Frank Act. Part II describes the human rights crisis in the DRC and the history behind the legislation. Part III argues that the law's flaws make it a poor choice for the United States' first foray into human rights legislation for corporations. This Part also outlines the legal challenges filed by business groups and the intervention by NGOs, and it points out that the SEC's failure to conduct an appropriate cost–benefit analysis will lead to severe unintended consequences that will harm the very people that the law was designed to help. As other countries and U.S. cities and college campuses are considering how they can help stem the tide of violence, they would do well to consider the impact that their solutions could have on the recipients of their assistance. Part IV concludes that a name-and-shame governance disclosure is a well-intentioned but wrong solution for a country as volatile as the DRC, due to the instability of the region, the fragility of the host state, and the failure of the international community to implement a comprehensive, multi-pronged sustainable approach to a humanitarian crisis.

Notably, to date, the European Union has not yet passed a similar law, nor have any Asian countries, which house many of the world's largest smelters and which play an integral role in the supply chain of the conflict minerals process. The lack of a coordinated global effort with measurable incentives for corporations to move beyond voluntary initiatives will also undermine the intent of the law.[49] If corporations are

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Preliminary Statement of Issues at 1–3, *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Nov. 21, 2012). The petitioners argue that the SEC failed to meet its statutory obligations to consider the effects of its rule; misinterpreted the statute and arbitrarily rejected alternatives that would have significantly reduced costs; and enacted a rule that compels speech in violation of the First Amendment. *Id.*

The business groups succeeded on this cost–benefit analysis argument in a proxy-access case in 2011 when the United States Court of Appeals for the D.C. Circuit found that the SEC's rule was arbitrary and capricious under the Administrative Procedure Act. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011). The author has signed on to an amicus brief in support of the petitioners in the conflict minerals litigation specifically as it relates to the unintended adverse effects on the Congolese people and not as it relates to the commercial interests of the business community. *See* Brief of *Amicus Curiae* Experts on the Democratic Republic of the Congo in Support of Petitioners, *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Jan. 23, 2013).

[49] The European Union, however, will be meeting to consider Dodd–Frank Act type regulation of conflict minerals; moreover, for audit purposes, if the European Union imposes due diligence standards, it may allow the use of the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. *See Resolution of 13 December 2012 on the Situation in the Democratic Republic of*

to have a role in stemming a humanitarian crisis, the role should be commensurate with the responsibility. Although the popular narrative surrounding the Dodd–Frank Act has focused on corporate and consumer demand for minerals that fund rebel forces engaged in rape, pillage, and conscription of child soldiers, the situation is much more complex, which makes the SEC's failure to have conducted the cost–benefit analysis all the more critical. If the government chooses to engage in future human rights governance legislation for businesses, the Dodd–Frank Act should not serve as the model.

I. LIFE FOR TNCS BEFORE THE DODD–FRANK ACT

A. Soft Law Governance and Corporate Responsibility for Human Rights

Forty-two out of the top 100 economic entities in the world are corporations,[50] yet they do not bear the responsibilities of nation-states. In many instances, TNCs have as much power and influence as a nation-state vis-á-vis the local population; yet, as one scholar has observed, they have the ability to act as mere bystanders.[51] When corporations, at least in the United States, enjoy some of the legal benefits of "personhood"[52] and the power of nation-states, what level of responsibility should they have for human rights abuses? Without specific laws to bind them, are voluntary industry initiatives or notions of moral responsibility enough to change corporate behavior? What is the role of the private, non-state

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the Congo, EUROPEAN PARLIAMENT (Dec. 13, 2012), http://www.europarl.europa.eu/document/activities/cont/201301/20130109ATT58700/20130109ATT58700EN.pdf. *See generally* OECD, *OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* (2d ed. 2012), *available at* http://www.oecd.org/daf/inv/mne/ GuidanceEdition2.pdf.

Canada is also looking to legislate the use of conflict minerals. In March 2013, the New Democratic Party proposed a bill based on the OECD Guidelines and which aims to improve and build on the Dodd–Frank Act. Iain Marlow, *NDP to Introduce Federal Bill on Conflict Minerals*, GLOBE & MAIL (Mar. 26, 2013, 12:42 PM), http://www.theglobeandmail.com/technology/tech-news/ndp-to-introduce-federal-bill-on-conflict-minerals/article10319230/. A similar bill failed to pass in 2011. *Id.*

[50] This is based on an estimate from a 2010 study. *See* TRACEY KEYS & THOMAS MALNIGHT, GLOBAL TRENDS, CORPORATE CLOUT DISTRIBUTED: THE INFLUENCE OF THE WORLD'S LARGEST 100 ECONOMIC ENTITIES 2 (2010), *available at* http://www.globaltrends.com/?Itemid=87.

[51] *See* Jena Martin Amerson, *What's in a Name? Transnational Corporations as Bystanders Under International Law*, 85 ST. JOHN'S L. REV. 1, 5 (2011) (arguing that, at its heart, the TNC's bystander strategy maintains that TNCs, in the wake of accusations from human rights advocates, are merely bystanders (i.e., innocent third parties) to the underlying events, helpless to stop the tragedy from occurring).

[52] *See, e.g.*, Citizens United v. FEC, 130 S. Ct. 876, 900 (2010) (treating corporations as persons for the purpose of First Amendment free speech).

frameworks (also known as "civil regulations") relying on market-based penalties in governing TNCs and their supply chains?

While the states have duties to protect their citizens, under a minimalist approach, corporations are often seen as having negative duties to do no harm.[53] Prior to the Dodd–Frank Act, domestic law had less power to regulate these entities from a human rights perspective, notwithstanding the great power that the TNCs wielded overseas.[54] Similarly, international law provides no real answers for corporate culpability because TNCs have no direct obligations under international law.[55] Further, corporations cannot be prosecuted in international criminal courts, and currently there are no provisions in treaties creating international criminal courts for the prosecution of corporations.[56] The lack of accountability, particularly in developing

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[53] Florian Wettstein, *Silence as Complicity: Elements of a Corporate Duty to Speak out Against the Violation of Human Rights*, 22 BUS. ETHICS Q. 37, 38 (2012).

[54] *See* Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631, 674 (2009) ("The growing dominance of multinational corporations has also given greater importance to issues of social responsibility. Multinational corporations have become as integral as states in protecting and respecting the rights of individuals."); Stephens, *supra* note 28, at 54 ("Multinational corporations have long outgrown the legal structures that govern them, reaching a level of transnationality and economic power that exceeds domestic law's ability to impose basic human rights norms."). In 2012, the Supreme Court of the United States had the opportunity to rule as a substantive matter on whether corporations could be held liable for human rights abuses abroad under the Alien Tort Statute, 28 U.S.C. § 1350 (2006), but chose to carry the case over to the following term for briefing on broader jurisdictional grounds. *See* Kiobel v. Royal Dutch Petroleum Co., 132 S. Ct. 1738, 1738 (2012) (mem.). The plaintiffs in this case claim that because international oil companies aided and abetted the Nigerian military's human rights abuses, those companies should face charges and civil liability in a U.S. court. Brief for Petitioners at 2–3, 8–9, *Kiobel*, 132 S. Ct. 1738 (Dec. 14, 2011). As of the time of this writing the case has not yet been decided. *See Docket for* Kiobel v. Royal Dutch Petroleum Co., SUP. CT. U.S., http://www.supremecourt.gov/Search.aspx?FileName=%2fdocketfiles%2f10-1491.htm (last visited Mar. 8, 2013). By 2010, in the United States, plaintiffs had filed more than 140 lawsuits against corporations under the Alien Tort Statute. *See* Jonathan Drimmer, *Human Rights and the Extractive Industries: Litigation and Compliance Trends*, 3 J. WORLD ENERGY L. & BUS. 121, 122 (2010).

[55] *See* Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, *Protect, Respect and Remedy: A Framework for Business and Human Rights*, ¶ 1, Human Rights Council, U.N. Doc. A/HRC/8/5 (Apr. 7, 2008) (by John Ruggie) [hereinafter *Ruggie Report*] ("The international community is still in the early stages of adapting the human rights regime to provide more effective protection to individuals and communities against corporate-related human rights harm."); de Brabandere, *supra* note 23, at 271–72.

[56] Doug Cassel, *Corporate Aiding and Abetting of Human Rights Violations: Confusion in the Courts*, 6 NW. U. J. INT'L HUM. RTS. 304, 315 (2008). Historically, individual culpability has been required for criminal prosecution. For example, after World War II, prosecutors tried officials from the German firms Farben and Krupp for war crimes

nations, allows some TNCs, which have the economic power of nation-states, to take advantage of the fact that the host-state government has lax or unenforced labor, freedom of association, and antidiscrimination laws. While, presumably, international law would apply to the TNC wherever it is, the domestic law in the host country may provide for fewer obligations or sanctions. Particularly in a weak or failing state, the host country may have less resources or political will to prosecute a large and powerful TNC that provides significant revenue and jobs for the local population.[57] Firms may choose to do business in the nations that are the most lax and that have in fact won the regulatory "race to the bottom."[58]

To be fair, TNCs can provide desperately needed employment, which would otherwise not exist for the local citizens.[59] But when a fire broke out in a Bangladesh factory in 2012 killing over a hundred workers sewing garments for Sears, Wal-Mart, and other well-known American and European companies, those firms, cognizant of their public images, rushed to distance themselves from the factory's poor safety practices and their own suppliers, which they claimed subcontracted the work without the knowledge or approval of the client companies.[60] Despite hundreds of workers being killed over the past decade, Bangladeshi garment factories have over four-million employees, and the industry is critical to the Bangladeshi economy.[61]

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related to strengthening the Nazi regime. Kyle Rex Jacobson, *Doing Business with the Devil: The Challenges of Prosecuting Corporate Officials Whose Business Transactions Facilitate War Crimes and Crimes Against Humanity*, 56 A.F. L. REV. 167, 183–89 (2005). The court required evidence of personal involvement and knowledge and held that liability needed to be predicated on evidence that "establishes some positive conduct" that "constitutes ordering, approving, authorizing or joining" in criminal acts. *Id.* at 183, 189. In doing this, the court refused to hinge individual convictions on the companies' actions as a whole. *Id.* at 184, 188–89.

[57] *See* de Brabandere, *supra* note 23, at 270 (describing powerful corporations in weak states).

[58] The regulatory race to the bottom is often considered a pejorative term assigned to nations that may or may not be member states of the World Trade Organization ("WTO"), where governments want to attract businesses to their jurisdictions and, therefore, lower taxes and relax environmental and labor regulations. *See* JOSEPH E. STIGLITZ, MAKING GLOBALIZATION WORK 196 (1st ed. 2006).

[59] *See* JOHAN NORBERG, IN DEFENSE OF GLOBAL CAPITALISM 211, 216–18 (Roger Tanner & Julian Sanchez trans., rev. ed. 2003) (discussing how multinational corporations provide important wage-earning opportunities).

[60] *See* Jim Yardley, *Recalling Fire's Horror and Exposing Global Brands' Safety Gap*, N.Y. TIMES, Dec. 7, 2012, at A1.

[61] Julfikar Ali Manik & Jim Yardley, *Bangladesh Finds Gross Negligence in Factory Fire*, N.Y. TIMES, Dec. 18, 2012, at A4.

The CSR efforts in the host countries may mask or compensate for more deeply entrenched or historical abuses. For example, ExxonMobil, one of the largest companies in the world,[62] has made the eradication of malaria in Africa and the empowerment of women in Africa (particularly in Chad) two of its social mission priorities.[63] However, some of ExxonMobil's past dealings in Africa belie its support of nation-building abroad. In 2006, it reportedly cooperated with the government of Chad to break funding covenants with both the World Bank and the U.S. government, which had sought to prohibit Chad from buying weapons with outside aid, because ExxonMobil's interests were better served by preventing a disruption to its supply of oil.[64] That year, ExxonMobil transferred about $774 million to the Chadian government.[65] By comparison, the entire U.S. budget for aid to Chad was only about one percent of ExxonMobil's revenue stream to the African nation.[66]

Firms operate with impunity in weak or fragile states because these host states do not have the power or will to respect their own citizens' rights or to enforce labor or environmental laws (to the extent they exist) against powerful TNCs.[67] Because the TNCs have such power and influence, many argue that TNCs should have commensurate responsibility regarding social issues, especially related to human rights.[68] In some instances, TNCs have entered into agreements with industry groups, intergovernmental organizations, or NGOs—nonbinding initiatives, which may not do as much as they should to help the indigenous peoples that are actually affected in the long term.[69]

CSR is rooted in the 1970s, when activists advocated greater government control of corporations to ensure responsibility.[70] Outside

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62 *The Global 2000*, FORBES, May 7, 2012, at 99, 99–100, 102.

63 *See* EXXONMOBIL, 2011 CORPORATE CITIZENSHIP REPORT 29 (2011), *available at* http://www.exxonmobil.com/Corporate/Files/news_pub_ccr2011.pdf; Community & Development, *Our Focus Areas*, EXXONMOBIL, http://www.exxonmobil.com/Corporate/community_women_focusarea.aspx (last visited Mar. 8, 2013).

64 *See* STEVE COLL, PRIVATE EMPIRE: EXXONMOBIL AND AMERICAN POWER 358, 362 (2012).

65 *Id.* at 352–53.

66 *Id.*

67 *See* de Brabandere, *supra* note 23, at 270.

68 *See supra* note 54 and accompanying text.

69 *See* VOGEL, *supra* note 25, at 155–56 (discussing financial companies that adopted voluntary principles to protect indigenous peoples).

70 *See* HAUFLER, *supra* note 21, at 15 (discussing the international trend towards regulating corporations in the 1970s); URSULA MÜHLE, THE POLITICS OF CORPORATE SOCIAL RESPONSIBILITY: THE RISE OF A GLOBAL BUSINESS NORM 18–19 (2010) (noting failed attempts in the 1970s to institutionalize CSR); Douglas M. Branson, *Corporate Governance*

forces also pressured companies to affect social change. For example, in one of the first CSR initiatives, companies opposed to apartheid in South Africa adopted the Sullivan Principles in the late 1970s and 1980s, and in 1999 the code evolved into the Global Sullivan Principles by which companies agreed to treat all employees the same regardless of race, color, or gender.[71] Around the same time, college students began pressuring universities to divest from companies that conducted business in South Africa, and cities and states began passing selective purchasing laws ending contracts with companies doing business in South Africa.[72] Today, the Global Sullivan Principles apply to economic situations worldwide.[73]

B. OECD Guidelines and National Contact Points

Companies also adhere to the OECD Guidelines for Multinational Enterprises, which are voluntary principles consistent with internationally recognized standards for governments to encourage responsible business practices.[74] Areas the guidelines cover include employment and industrial relations, human rights, environment, information disclosure, bribery, consumer interests, science and technology, competition, and taxation for participating governments and multinational enterprises operating in or from adhering countries.[75]

"Reform" and the New Corporate Social Responsibility, 62 U. PITT. L. REV. 605, 611 (2001) (discussing the origins of the CSR movement).

[71] *See* HAUFLER, *supra* note 21, at 17–18.

[72] *E.g.*, David G. Savage, *Students Favor Divestment but Shun Boycott of Products: Scope of S. Africa Protests Questioned*, L.A. TIMES, Apr. 16, 1986, Part II, at 1 (noting that thirty-nine colleges "divested themselves of all stock in companies" operating in South Africa and that some cities and states distanced themselves from South African products as well).

[73] Henry J. Richardson III, *Reverend Leon Sullivan's Principles, Race, and International Law: A Comment*, 15 TEMP. INT'L & COMP. L.J. 55, 70 (2001). The standards of other well-regarded soft law voluntary initiatives to which companies subscribe include those found in the Universal Declaration of Human Rights, ILO Conventions, and ISO 26000, but, due to space limitations, this Article will not discuss them. For an overview discussing businesses and human rights, see Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, *Addendum: Business Recognition of Human Rights: Global Patterns, Regional and Sectoral Variations*, ¶ 14, Human Rights Council, U.N. Doc. A/HRC/4/35/Add.4 (Feb. 8, 2007); ADRIAN HENRIQUES, STANDARDS FOR CHANGE?: ISO 26000 AND SUSTAINABLE DEVELOPMENT 31 (2012), *available at* http://pubs.iied.org/pdfs/16513IIED.pdf.

[74] *See* OECD, *Guidelines for Multinational Enterprises*, at 3 (2011) [hereinafter OECD, *Guidelines*], *available at* http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/48004323.pdf.

[75] *Id.* at 27–63.

Adhering governments must provide National Contact Points, which serve as an avenue of redress for stakeholders.[76] Although the National Contact Points may conduct voluntary mediations or facilitate conciliations between parties, critics complain that there are no consequences for failing to comply and that TNCs often demand strict confidentiality in mediations, which means that the Guidelines are largely ineffective. Further, there are no global standards or uniform processes for National Contact Points. Critics contend that the OECD process, therefore, provides ample opportunity for some TNCs to appear socially responsible without true accountability.[77]

C. U.N. Global Compact, Draft Norms, and the Ruggie "Protect, Respect and Remedy" Framework

As early as 1972, the U.N. Economic and Social Council solicited a study on the role of the corporation and its impact on development.[78] In 1998, the U.N. Norms Working Group on the Working Methods and Activities of Transnational Corporations was established "[t]o make recommendations and proposals relating to the methods of work and activities of transnational corporations in order to ensure that such methods and activities are in keeping with the economic and social objectives of the countries in which they operate."[79] In January 1999, U.N. Secretary General Kofi Annan issued a call at the World Economic Forum in Davos, Switzerland for leaders to "initiate a global compact of shared values and principles, which will give a human face to the global market."[80] The resulting U.N. Global Compact became the world's largest corporate citizenship initiative, focusing on ten principles related

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[76] *Id.* at 68. In the United States, the national contact point is within the Bureau of Economic and Business Affairs. OECD, *OECD Guidelines for Multinational Enterprises: National Contact Points*, at 4 (Nov. 2012), *available at* http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/2012NCPContactDetails.pdf.

[77] *See* EUROPEAN CTR. FOR CONSTITUTIONAL & HUMAN RIGHTS, A COMPARISON OF NATIONAL CONTACT POINTS—BEST PRACTICES IN OECD COMPLAINTS PROCEDURES 3, 9–10 (2011), *available at* http://www.ecchr.de/index.php/ecchr-publications/articles/a-comparison-of-national-contact-points-best-practices-in-oecd-complaints-procedures-1333.html (discussing different procedures at different National Contact Points); de Brabandere, *supra* note 23, at 275–76.

[78] E.S.C. Res. 1721 (LIII), ¶ 1, U.N. ESCOR, 53d Sess., Supp. No. 1, U.N. Doc. E/5209, at 3–4 (July 28, 1972).

[79] *See* Sub-Comm'n on Prevention of Discrimination & Prot. of Minorities Res. 1998/8, Rep. on its 50th Sess., Aug. 2–28, 1998, U.N. Doc. E/CN.4/1999/4–E/CN.4/Sub.2/1998/45, at 31–32 (Sept. 30, 1998).

[80] *See* Press Release, Secretary-General, Secretary-General Proposes Global Compact on Human Rights, Labour, Environment, in Address to World Economic Forum in Davos, U.N. Press Release SG/SM/6881 (Feb. 1, 1999).

to human rights, labor, the environment, and anticorruption.[81] The Global Compact has over 10,000 signatories from 145 countries around the world.[82]

But like the "greenwashing" initiatives in the environmental arena,[83] many companies signed on to U.N. compacts and engaged in "bluewashing" to appear as though they had official intergovernmental approval for their CSR programs, including those relating to labor and human rights.[84] In fact, the Global Compact's own Executive Director has publicly acknowledged that only fifteen percent of the Global 1000[85] companies participating in the program are likely "sincere" or "serious[]" about sustainability.[86] Further, critics complain that the core requirements are not stringent enough and that there are no independent monitoring requirements.[87]

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[81] *See* U.N. Secretary-General, *Rep. of the Secretary-General on the Work of the Organization*, ¶ 217, U.N. Doc. A/61/1 (Aug. 16, 2006); United Nations Global Compact, After the Signature: A Guide to Engagement in the United Nations Global Compact 13–14, 16–17 (Jan. 2012), http://www.unglobalcompact.org/docs/news_events/8.1/after_the_signature.pdf.

[82] United Nations Global Compact, Annual Review of Business Policies & Actions to Advance Sustainability: 2011 Global Compact Implementation Survey 3 (2012), http://www.unglobalcompact.org/docs/news_events/8.1/2011_Global_Compact_Implementation_Survey.pdf.

[83] Greenwashing refers to environmental claims made by companies that are false or misleading. RINA HORIUCHI ET AL., BSR & FUTERRA, UNDERSTANDING AND PREVENTING GREENWASH: A BUSINESS GUIDE 6 (2009), *available at* http://www.bsr.org/reports/Understanding_Preventing_Greenwash.pdf. The Federal Trade Commission has issued guidelines to help marketers avoid misleading claims. Guides for the Use of Environmental Marketing Claims, 77 Fed. Reg. 62,122, 62,124 (Oct. 11, 2012) (to be codified at 16 C.F.R. pt. 260).

[84] *See* Daniel Berliner & Aseem Prakash, *From Norms to Programs: The United Nations Global Compact and Global Governance*, 6 REG. & GOVERNANCE 149, 162 (2012) ("[V]oluntary programs which do not impose real obligations on firms or do not back them with sufficient monitoring—'bluewashes' or 'Astroturfs'—have a greater chance of failure."). For an early use of the term "bluewashing," see KENNY BRUNO & JOSHUA KARLINER, TRANSNATIONAL RES. & ACTION CTR., TANGLED UP IN BLUE: CORPORATE PARTNERSHIPS AT THE UNITED NATIONS 7 (2000), *available at* http://s3.amazonaws.com/corpwatch.org/downloads/tangled.pdf (discussing how corporations may participate in the Global Compact in order to appear socially responsible).

[85] These are the top 1000 performing companies in the world. Consider, for example, Russell Investment's "Global 1000 Index." RUSSELL INVS., RUSSELL GLOBAL INDEXES: CONSTRUCTION AND METHODOLOGY 52–53 (2012), *available at* http://www.russell.com/indexes/documents/Global_Indexes_Methodology.pdf.

[86] *See Only Fifteen Percent of Multinationals Serious About Sustainability*, CORP. CRIME REP., Apr. 23, 2012, at 3, 3.

[87] *See* Daniel Berliner & Aseem Prakash, Good Norm, Weak Program: Cross-National Diffusion of the United Nations Global Compact 36 (Sept. 2–5, 2010) (paper prepared for presentation at the annual meeting of the American Political Science Association, Washington, D.C.), *available at* http://papers.ssrn.com/sol3/

In light of the criticism of the nonbinding nature of the Global Compact, it is not surprising the U.N. tried to legally bind corporations for human rights violations in 2004; however, the U.N. was unsuccessful.[88] The U.N. Draft Norms attempted to legislate against corporate human rights abuses at the supranational level, so as to apply regardless of where TNCs operated.[89] The Draft Norms would have established positive duties to promote human rights and to assess human rights impacts, and would have forbade corporations from directly or indirectly contributing to or benefitting from human rights abuses or otherwise undermining efforts to promote human rights.[90] The NGOs, which had criticized the voluntary initiatives, applauded these efforts.[91] Not only did corporations object,[92] but even the United States itself objected, asserting that states—not corporations—are the traditional subjects of international law.[93] Others suggested that the Norms as drafted were vague and unenforceable.[94]

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papers.cfm?abstract_id=1642076 (observing that some believe the Compact represents "excessive compromise" and requires "only marginal 'beyond compliance' requirements on firms").

[88] KENAN INST. FOR ETHICS, DUKE UNIV., THE U.N. GUIDING PRINCIPLES ON BUSINESS AND HUMAN RIGHTS: ANALYSIS AND IMPLEMENTATION 4–5 (2012), *available at* http://kenan.ethics.duke.edu/wp-content/uploads/2012/07/UN-Guiding-Principles-on-Business-and-Human-Rights-Analysis-and-Implementation.pdf.

[89] *See* U.N. Econ. & Soc. Council [ECOSOC], Comm'n on Human Rights, Sub-Comm'n on the Promotion & Prot. of Human Rights, Economic, Social and Cultural Rights: Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, ¶ 1, U.N. Doc. E/CN.4/Sub.2/2003/12/Rev.2 (Aug. 26, 2003) ("Within their respective spheres of activity and influence, transnational corporations and other business enterprises have the obligation to promote, secure the fulfillment of, respect, ensure respect of and protect human rights recognized in international as well as national law, including the rights and interests of indigenous people and other vulnerable groups.").

[90] *See id.*; ECOSOC, Comm'n on Human Rights, Sub-Comm'n on the Promotion & Prot. of Human Rights, Economic, Social and Cultural Rights: Commentary on the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, ¶ 1 cmt. b, U.N. Doc. E/CN.4/Sub.2/2003/38/Rev.2 (Aug. 26, 2003).

[91] *See* Isabella D. Bunn, *Global Advocacy for Corporate Accountability: Transatlantic Perspectives from the NGO Community*, 19 AM. U. INT'L L. REV. 1265, 1270–71, 1285 (2004).

[92] *See* ECOSOC, Comm'n on Human Rights, Sub-Comm'n on the Promotion & Prot. of Human Rights, Economic, Social and Cultural Rights: Joint Written Statement Submitted by the International Chamber of Commerce and the International Organization of Employers, Non-Governmental Organizations in General Consultative Status, at 3, U.N. Doc. E/CN.4/Sub.2/2003/NGO/44 (July 29, 2003) (stating that voluntary corporate action is superior to regulation as a means of achieving social progress).

[93] *See* United States Mission to International Organizations, Response from the Gov't of the U.S. to Dzidek Kedzia, Chief of Research and Right to Dev. Branch, Office of the United Nations High Comm'r for Human Rights, Note Verbale from the OHCHR of

In 2005, the U.N. appointed John Ruggie as its Special Representative on the Issue of Human Rights, Transnational Corporations, and Other Business Enterprises.[95] In that capacity, Ruggie issued two critical reports that have shaped the way in which TNCs view their obligations overseas. In 2008, Ruggie issued his "Protect, Respect and Remedy" framework in which he posited that (1) the state has a "duty to protect against human rights abuses by third parties" or non-state actors, including business entities; (2) the corporation has a "responsibility to respect human rights," including conducting due diligence, impact assessments, and auditing processes; and (3) there is a "need for more effective access to remedies" beyond the "patchwork" of flawed mechanisms.[96] In 2011, Ruggie responded to calls to "operationalize" his recommendations and issued the *Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework* ("Ruggie Guidelines"), which provided principles that were again voluntary and nonbinding,[97] but which were actually praised by the business and intergovernmental community, including the OECD, which ultimately adopted the U.N.'s recommendations.[98] Again, his efforts were criticized by some for not going far enough and for their nonbinding nature.[99]

August 3, 2004 (GVA 2537), at 2–3 (Sept. 30, 2004), *available at* http://www2.ohchr.org/english/issues/globalization/business/docs/us.pdf ("This exercise . . . circumvents all recognized law making processes by attempting to impose international obligations on entities that have neither accepted them nor played a part in their creation."); *see also* Carlos M. Vázquez, *Direct vs. Indirect Obligations of Corporations Under International Law*, 43 COLUM. J. TRANSNAT'L L. 927, 929 (2005) (observing that the U.S. Council for International Business believed "that the Norms would 'represent a fundamental shift in responsibility for protecting human rights—from governments to private actors, including companies—effectively privatizing the enforcement of human rights laws'").

[94] *See* Special Representative of the Secretary-General, *Promotion and Protection of Human Rights: Interim Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises*, ¶¶ 59, 66–67, U.N. Doc. E/CN.4/2006/97 (Feb. 22, 2006) (by John Ruggie).

[95] *See* Press Release, Secretary-General Appoints John Ruggie of United States Special Representative on Issue of Human Rights, Transnational Corporations, Other Business Enterprises, U.N. Doc. SG/A/934 (July 28, 2005).

[96] *See Ruggie Report*, *supra* note 55, ¶¶ 9, 17, 25, 61, 63, 87.

[97] Special Representative of the Secretary-General, *Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework*, intro. ¶ 9, U.N. Doc. A/HRC/17/31 (Mar. 21, 2011) (by John Ruggie) [hereinafter *Ruggie Guidelines*].

[98] *See* Jena Martin Amerson, *"The End of the Beginning?": A Comprehensive Look at the U.N.'s Business and Human Rights Agenda from a Bystander Perspective*, 17 FORDHAM J. CORP. & FIN. L. 871, 874–75 (2012). In 2011, the OECD updated its own Guidelines for Multinational Enterprises, adding a chapter on human rights consistent with the Ruggie

Both the Ruggie and OECD 2011 Guidelines stressed the importance of TNCs conducting due diligence, monitoring, auditing, and exerting pressure on their supply chains to prevent labor and human rights abuses.[100] These guidelines also foreshadowed key elements of Section 1502 of the Dodd–Frank Act.[101]

But despite these attempts, one study indicates that while 28% of 2,508 companies surveyed apply a human rights policy to their supply chains and 21% have plans to implement their policies, only 6% claim to monitor their supply chains for compliance and only 7% have enforcement mechanisms.[102] Further, TNCs often do not have as much leverage with their suppliers as one would think. Companies often lack bargaining power in their own supply chain because the supplier is under pressure from the TNC to keep costs low and may be operating in a host country with lax laws. Suppliers can often find another buyer with less onerous requirements that is not concerned about good business practices or audits. Switching suppliers is also very costly and time-consuming for the TNC and could impact local employees and, by extension, the local economy.[103]

In summary, corporations balance their various interests, including their public images and shareholder value. Prior to the passage of the Dodd–Frank Act, they were able to make the decisions that seemed sensible to them. Those that source minerals from the Congo or adjoining countries are now faced with additional choices as the Dodd–Frank Act adds new complications.

Guidelines. *See* OECD, *Guidelines*, *supra* note 74, at 3–4; *see also* Lene Wendland, Advisor on Bus. & Human Rights, Office of the U.N. High Comm'r for Human Rights, Statement at the OECD Roundtable on Corporate Responsibility 2 (June 29, 2011), *available at* http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/48365284.pdf.

[99] *See* Amerson, *supra* note 98, at 877 (suggesting that although the Guidelines are weak, they are better than nothing at all).

[100] *See Ruggie Guidelines*, *supra* note 97, at Annex ¶¶ 4, 5 & cmt., 20 & cmt.; OECD, *Guidelines*, *supra* note 74, at 20, 22, 31, 33.

[101] *See supra* notes 46–47 and accompanying text (discussing the supply-chain monitoring that the Act and regulations require).

[102] *See* Aaron Bernstein & Christopher Greenwald, Benchmarking Corporate Policies on Labor and Human Rights in Global Supply Chains 11, 14 (Pensions & Capital Stewardship Project Labor & Worklife Program, Harvard Law Sch., Occasional Papers No. 5, 2009), *available at* http://www.law.harvard.edu/programs/lwp/pensions/publications/occpapers/occasionalpapers5.pdf.

[103] *See* U.N. Conference on Trade and Development, World Investment Report 2012 Overview: Towards a New Generation of Investment Policies 21–22 (July 2012), http://www.unctad-docs.org/files/UNCTAD-WIR2012-Overview-en.pdf.

II. THE HUMAN RIGHTS CRISIS IN THE CONGO—IS THE CONFLICT OVER MINERALS?

A. Background

> The conflict in the Democratic Republic of the Congo has become mainly about access, control and trade of five key mineral resources: coltan, diamonds, copper, cobalt and gold. The wealth of the country is appealing and hard to resist in the context of lawlessness and the weakness of the central authority.[104]

The DRC lies in central Africa and is the size of Western Europe. The country's "resource curse" is nothing new and is not unique.[105] Under this theory, resource-rich countries tend to be poorer than countries without natural abundance due to shortsightedness of policymakers, instability of international commodity markets, the dominance of foreign multinationals in resource extraction, poor linkages between the resource and non-resource sectors of the economy, "Dutch Disease" (the hardship associated with exports), and/or the state's inability to enforce property rights.[106]

The country has vast mineral riches including oil, rubber, gold, copper, uranium, diamonds, cassiterite, wolframite, tantalum, and cobalt.[107] Despite its natural resources, the DRC ranked as the poorest country in the world in 2008, 2009, and 2010.[108] Additionally, notwithstanding a gross domestic product ("GDP") of $15.66 billion (USD) in 2011, its per capita GDP was only $216 (USD).[109] In fact, only Somalia ranks worse than the DRC on the 2012 Failed State Index, which compares 177 states by considering twelve primary social,

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[104] U.N. Secretary-General, Letter dated Apr. 12, 2001 from the Secretary-General addressed to the President of the Security Council, ¶ 213, U.N. Doc S/2001/357 (Apr. 12, 2001).

[105] The term was popularized by Richard Auty. *See* RICHARD M. AUTY, SUSTAINING DEVELOPMENT IN MINERAL ECONOMIES: THE RESOURCE CURSE THESIS 1 (1993).

[106] *See* Michael L. Ross, *The Political Economy of the Resource Curse*, 51 WORLD POL. 297, 298 (1999) (summarizing various economic and political theories of the resource curse).

[107] Laura E. Seay, *What's Wrong with Dodd–Frank 1502? Conflict Minerals, Civilian Livelihoods, and the Unintended Consequences of Western Advocacy*, at text accompanying n.3 (Ctr. for Global Dev., Working Paper No. 284, 2012), *available at* http://www.cgdev.org/content/publications/detail/1425843/.

[108] *The Poorest Countries in the World*, GLOBAL FIN., http://www.gfmag.com/tools/global-database/economic-data/12147-the-poorest-countries-in-the-world.html#axzz2NGd46kog (last visited Mar. 8, 2013).

[109] *Report for Selected Countries and Subjects*, INT'L MONETARY FUND, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/weorept.aspx?pr.x=78&pr.y=9&sy=2011&ey=2011&scsm=1&ssd=1&sort=country&ds=.&br=1&c=636&s=NGDPD%2CNGDPDPC&grp=0&a= (last visited Mar. 8, 2013).

economic, and political indicators.[110] The DRC ranks 155th out of 167 countries in the 2010 Democracy Index[111] and lies at the bottom of the 2011 U.N. Human Development Index.[112]

The DRC is not only a failed state. It has been called a "predatory" structure in which the government abuses the citizenry "to maintain power and control[] the resources of the state for the benefit of a few" rather than for the benefit of the citizens collectively.[113] But this is not a recent phenomenon. Over one hundred years ago, Belgium's King Leopold II annexed the Congo Free State, as he called it, as his own personal fiefdom.[114] From 1880 to 1920 during King Leopold's reign and its immediate aftermath, an estimated 10 million Africans died after having been beaten to death, having their hands chopped off for failing to meet quotas, starving, or succumbing to disease as Leopold earned today's equivalent of $1 billion (USD) trading in ivory, rubber, and other resources mined through slave labor.[115] Belgium maintained control of the colony until 1960.[116]

Since achieving independence from Belgium in 1960, a series of corrupt leaders have ruled the country. Despite the moniker of a "democratic" republic, observers note that the government is dysfunctional; there is a lack of rule of law; corruption runs rampant through all branches of government; and the country has a poor human rights record, particularly related to gender-based and sexual violence.[117]

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[110] NATE HAKEN ET AL., THE FUND FOR PEACE, FAILED STATES INDEX 2012, at 3–4 (2012), *available at* http://www.fundforpeace.org/global/library/cfsir1210-failedstatesindex2012-06p.pdf. "Failed states" are those generally unable or unwilling to provide their citizens with the basic functions typically associated with government, such as protection, basic public services, and essential infrastructure. *Id.* at 12. The Failed State Index assesses 177 countries. *Id.* at 3.

[111] THE ECONOMIST, DEMOCRACY INDEX 2010: DEMOCRACY IN RETREAT 7 (2010), *available at* http://graphics.eiu.com/PDF/Democracy_Index_2010_web.pdf.

[112] U.N.D.P., Human Development Report 2011: Sustainability and Equity: A Better Future for All, at 134 (2011), *available at* http://hdr.undp.org/en/media/HDR_2011_EN_Contents.pdf.

[113] ARVIND GANESAN & ALEX VINES, *Engine of War: Resources, Greed, and the Predatory State*, *in* HUMAN RIGHTS WATCH, WORLD REPORT 2004: HUMAN RIGHTS AND ARMED CONFLICT 301, 305 (2004) (discussing the creation of predatory governments in resource-rich countries).

[114] ADAM HOCHSCHILD, KING LEOPOLD'S GHOST: A STORY OF GREED, TERROR, AND HEROISM IN COLONIAL AFRICA 87 (1998).

[115] *Id.* at 225–27, 230, 233, 277, 301.

[116] *Id.* at 301.

[117] *See* BERTELSMANN STIFTUNG, BTI 2012: CONGO, DR COUNTRY REPORT 4, 11, 17 (2012), *available at* http://www.bti-project.de/fileadmin/Inhalte/reports/2012/pdf/BTI%202012%20Congo%20DR.pdf (evaluating 128 developing countries); ABI DYMOND, THE SCOTTISH CATHOLIC INT'L AID FUND, ENDING MASS RAPE IN THE DEMOCRATIC REPUBLIC OF CONGO: THE ROLE OF THE INTERNATIONAL COMMUNITY 6, *available at* http://

In 2011, the country held only its second multiparty election—a process tainted by allegations of illegitimacy from around the world—in which President Joseph Kabila was re-elected.[118]

One of the difficulties facing the DRC government in maintaining order is that the capital, Kinshasa, is 1600 kilometers away from one of the most important cities, Goma, in the eastern part of the country, which has been ravaged by war since the 1990s. The government has never had complete control over the eastern part of the country, particularly the Kivu region, where Goma is located, due to distance and occupation from various armed groups.[119] Since 1998, as a result of wars (at one time involving up to eleven neighboring nations), millions of people have been displaced, and over 5 million people have died from malnutrition, disease, and violence, making it the deadliest conflict since World War II.[120] Although the war officially ended in 2003, the U.N.'s peacekeeping presence in the DRC is one of the largest in the world with over 19,000 uniformed personnel as of January 2013.[121] The force has

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www.congoweek.org/pdf/ending_mass_rape.pdf; HUMAN RIGHTS WATCH, THE WAR WITHIN THE WAR: SEXUAL VIOLENCE AGAINST WOMEN AND GIRLS IN EASTERN CONGO 8 n.3 (2002) [hereinafter THE WAR WITHIN THE WAR], *available at* http://www.hrw.org/reports/2002/drc/Congo0602.pdf (defining the difference between gender-based and sexual violence as human rights abuses in the DRC).

[118] *See, e.g.*, Adam Nossiter, *President of Congo Denies Reports of Election Fraud*, N.Y. TIMES, Dec. 13, 2011, at A15 (noting widespread criticism of the presidential results); *Chaotic Congo Vote Count Mars Credibility of Result: EU Says Congo Results Lack Transparency*, REUTERS, Dec. 13, 2011, *available at* http://www.reuters.com/article/2011/12/13/congo-democratic-election-idUSL6E7ND6472011 1213; *DR Congo Election: Joseph Kabila 'Re-elected': President Joseph Kabila Has Won the Democratic Republic of Congo's Election, Provisional Results Show*, BBC NEWS (Dec. 9, 2011), http:www.bbc.co.uk/news/world-africa-16114824 (noting general international protests and, specifically, European Union observer mission reports that the polls contained "numerous irregularities, sometimes serious").

[119] *See* DYMOND, *supra* note 117, at 3, 6.

[120] JASON K. STEARNS, DANCING IN THE GLORY OF MONSTERS: THE COLLAPSE OF THE CONGO AND THE GREAT WAR OF AFRICA 4–5 (2011); Simon Robinson, *The Deadliest War in the World*, TIME, June 5, 2006, at 38, 39. For comprehensive descriptions of the history of the Congo and the Congolese wars, see generally SÉVERINE AUTESSERRE, THE TROUBLE WITH THE CONGO: LOCAL VIOLENCE AND THE FAILURE OF INTERNATIONAL PEACEBUILDING (Christian Reus-Smit & Nicholas J. Wheeler eds., 2010); PETER EICHSTAEDT, CONSUMING THE CONGO: WAR AND CONFLICT MINERALS IN THE WORLD'S DEADLIEST PLACE (2011); HOCHSCHILD, *supra* note 114.

[121] *See* Peacekeeping Fact Sheet, *supra* note 34.

officially extended its mission until June 2013.[122] As of the end of June 2012, over 2.2 million people remain displaced in the DRC.[123]

Notwithstanding the significant number of peacekeepers and the spotlight of the world, local and international rebel groups have continued to attack military and civilians alike, causing the DRC to remain in a state of war. These armed groups include the National Congress for the Defense of the People ("CNDP");[124] the Lord's Resistance Army ("LRA");[125] the Hutu rebels involved in the Rwandan genocide known as the Forces Démocratiques de Libération du Rwanda ("FDLR");[126] the citizen militia Mai-Mai;[127] the M23, purportedly backed by the Rwandan government (which denies involvement);[128] and other groups.[129] Armed groups fight for a number of reasons including

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[122] Press Release, Security Council, Security Council Extends Mandate of UN Mission in Democratic Republic of Congo Until 30 June 2013, Unanimously Adopting Resolution 2053 (2012), U.N. Press Release SC/10687 (June 27, 2012).

[123] UNICEF, UNICEF Humanitarian Action Update: Democratic Republic of the Congo, at 2 (Aug. 4, 2012), http://www.unicef.org/hac2012/files/UNICEF_DRC_Humanitarian_Action_Update_2012.pdf.

[124] Chair of the Security Council Committee Concerning the Democratic Republic of the Congo, Letter dated Nov. 29, 2011 from the Chair of the Security Council Committee Concerning the Democratic Republic of the Congo to the President of the Security Council, ¶ 36, U.N. Doc. S/2011/738 (Nov. 29, 2011) [hereinafter Nov. 29, 2011 Letter].

[125] *Id.* ¶¶ 66–68.

[126] *Id.* ¶ 69; Int'l Refugee Rights Initiative & Soc. Sci. Research Council, *Who Belongs Where? Conflict, Displacement, Land and Identity in North Kivu, Democratic Republic of Congo* (Open Soc'y Inst., Working Paper No. 3, 2010), *available at* http://www.refugee-rights.org/Publications/Papers/2010/Who%20Belongs%20Where.EN.March2010.pdf.

[127] Nov. 29, 2011 Letter, *supra* note 124, ¶¶ 160–61.

[128] *See* Coordinator of the Group of Experts on the DRC, Letter dated Nov. 26, 2012 from the Coordinator of the Group of Experts on the DRC to the Chairman of the Security Council Committee Concerning the Democratic Republic of the Congo, U.N. Doc S/AC.43/2012/COMM.64 (Nov. 27, 2012) (stating publicly that the Rwandan government, with assistance from the government of Uganda, has backed and financed the M23 rebel forces, which captured the key city of Goma in the eastern part of Congo on November 20, 2012); Press Release, Security Council, Sanctions Committee Concerning Democratic Republic of Congo Adds Two Individuals, Two Entities to Sanctions List, U.N. Press Release SC/10876 (Dec. 31, 2012) (adding M23 to the U.N. official Sanctions List on December 31, 2012, stating that the group "has been complicit in and responsible for committing serious violations of international law involving the targeting of women and children in situations of armed conflict in the DRC including killing and maiming, sexual violence, abduction, and forced displacement"). In February 2013, eleven African leaders signed a U.N.-backed peace agreement aimed at stabilizing Eastern Congo, reforming the Congolese state, and ending regional interference. *See DR Congo: African Leaders Sign Peace Deal*, BBC (February 24, 2013, 5:57 ET), http://www.bbc.co.uk/news/world-africa-21563949. The peace deal did not address the armed groups, however, and the fighting between rebel forces persisted.

[129] Nov. 29, 2011 Letter, *supra* note 124, ¶¶ 41, 219, 238.

disputes over land, identity (who is Congolese and who is not), and citizenship rights.[130] The international community has focused on the fight for access to the vast mineral resources as the primary cause of the violence, although not all commentators agree.[131]

B. The Use of Rape as a Weapon of War

Margot Wallström, the U.N.'s Special Representative on Sexual Violence in Conflict, has branded the DRC as the "rape capital of the world."[132] In fact, the scale of sexual violence in the DRC qualifies the actions as crimes against humanity under Article 7(1)(g) of the Rome Statute of the International Criminal Court.[133]

There are a number of reasons that perpetrators in the DRC engage in gender-based and sexual violence, and a comprehensive analysis is beyond the scope of this Article. Because, however, the NGO community and key legislators tied the fight over conflict minerals to the pervasiveness of rape (as this Article discusses in Part III), it is important to discuss the scope of the problem in some detail.

Because Congolese society values virginity, marriage, and childbearing, sexual violence weakens and destroys community bonds and leaves the community in constant fear.[134] Perpetrators often gang-rape women and girls, use crude objects to penetrate them in full view of their family members, or force family members to participate in the rape in an effort to dehumanize the family as well as the survivors.[135] Rapists beat, stab, or mutilate women and children, and an estimated 22% of rape survivors contract HIV.[136] In many instances, rape of the local

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[130] *See* Int'l Refugee Rights Initiative & Soc. Sci. Research Council, *supra* note 126, at 5, 17.

[131] Seay, *supra* note 107, at text accompanying n.1 ("In the United States, the issue of conflict minerals has become one of the dominant narratives about the crisis.").

[132] U.N. Secretary-General, *Women and Peace and Security: Rep. of the Secretary-General*, at 4, U.N. Doc. S/PV.6302 (Apr. 27, 2010).

[133] Rome Statute of the International Criminal Court, art. 7(1)(g), *opened for signature* July 17, 1998, 2187 U.N.T.S. 3.

[134] *See* Marleen Bosmans, *Challenges in Aid to Rape Victims: The Case of the Democratic Republic of the Congo*, 4 ESSEX HUM. RTS. REV. 1, 4–6 (2007) (discussing the fact that "child victims of rape . . . los[e] whatever possibilities for marriage they may have"); DYMOND, *supra* note 117, at 5 ("The deeply intimate nature of the violence . . . weakens and destroys community bonds. Sexual violence provokes tension within and between communities and leaves behind long lasting fear and suspicion.").

[135] Gaëlle Breton-Le Goff, *Ending Sexual Violence in the Democratic Republic of the Congo*, 34 FLETCHER F. WORLD AFF. 13, 16–17 (2010).

[136] Special Rapporteur on Violence Against Women, Its Causes and Consequences, *Promotion and Protection of All Human Rights, Civil, Political, Economic, Social and Cultural, Including the Right to Development: Rep. of the Special Rapporteur on Violence Against Women, Its Causes and Consequences, Addendum: Mission to the Democratic*

women provides a means of creating more children belonging to the perpetrators' ethnic group, thus altering the region's national, ethnic, and religious identities.[137] Systematic rape also serves as a form of ethnic cleansing by driving people from their homes and villages.[138]

Some rapists kidnap women on the way to the market or the forests where they gather wood to serve as sex slaves and laborers often for days or even months.[139] Many survivors avoid returning to their farms or the markets to avoid future rapes,[140] which compounds family and community poverty given the fact that women's economic activity has a substantial effect on the overall economic development of the community.[141] The average age of rape survivors is dropping, and rapes of girls aged eight to thirteen are extremely common.[142]

It is difficult to obtain accurate and definitive data on sexual violence in part because many survivors are afraid to report rape due to stigma and the nonfunctioning Congolese justice system.[143] Further,

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Republic of the Congo, ¶ 55–56, 58, Human Rights Council, U.N. Doc. A/HRC/7/6/Add.4 (Feb. 28, 2008) (by Yakin Ertürk).

[137] M. Melandri, *Gender and Reconciliation in Post-Conflict Societies: The Dilemmas of Responding to Large-Scale Sexual Violence*, 5 INT'L PUB. POL'Y. REV. 4, 9–10 (2009), *available at* http://www.ucl.ac.uk/ippr/journal/downloads/vol5-1/M_Melandri.pdf.

[138] *Id.* at 10.

[139] *See, e.g.*, Ahuka Ona Longombe et al., *Fistula and Traumatic Genital Injury from Sexual Violence in a Conflict Setting in Eastern Congo: Case Studies*, 16 REPROD. HEALTH MATTERS 132, 132 (2008).

[140] *See* HUMAN RIGHTS WATCH, SOLDIERS WHO RAPE, COMMANDERS WHO CONDONE: SEXUAL VIOLENCE AND MILITARY REFORM IN THE DEMOCRATIC REPUBLIC OF CONGO 30 (2009) [hereinafter SOLDIERS WHO RAPE, COMMANDERS WHO CONDONE], *available at* http://www.hrw.org/sites/default/files/reports/drc0709web.pdf; Coco McCabe, *In Congo, Women Face Sexual Violence and Its Legacy of Shame and Hardship*, OXFAM INT'L (July 2008), http://www.oxfam.org/en/development/congo-women-face-sexual-violence-and-its-legacy-shame-and-hardship; *see also, e.g.*, Mark Tran, *"It Was Like Dying": A Raped Woman in Congo DRC Speaks Out*, GUARDIAN (Feb. 14, 2013), http://www.guardian.co.uk/global-development/2013/feb/14/dying-raped-woman-congo-drc.

[141] MARGOT WALLSTRÖM, ADDRESSING CONFLICT-RELATED SEXUAL VIOLENCE: AN ANALYTICAL INVENTORY OF PEACEKEEPING PRACTICE 23 (2010) (noting that women's economic activity can have "a powerful multiplier effect for recovery and development"); D. E. Tempelman, *Rural Women and Food Security: Current Situation and Perspectives*, FAO CORP. DOCUMENT REPOSITORY, tbl.1 (1998), *available at* http://www.fao.org/docrep/003/W8376E/w8376e03.htm.

[142] Michael Maya, *Reflections on ABA ROLI's Efforts to Combat the Rape Crisis in War-Torn Eastern Congo*, AM. BAR ASS'N (June 2011), http://www.americanbar.org/advocacy/rule_of_law/where_we_work/africa/democratic_republic_congo/news/news_drc_reflections_aba_roli_efforts_to_combat_the_rape_crisis_0611.html.

[143] Helen Liebling et al., *Women and Girls Bearing Children Through Rape in Goma, Eastern Congo: Stigma, Health and Justice Responses*, 4 ITUPALE ONLINE J. AFR. STUD. 18, 19 (2012), *available at* http://www.cambridgetoafrica.org/resources/Liebling_Slegh_and_Ruratotoye_Itupale_2012.pdf.

while there is no one source that compiles these statistics, according to the U.N. Population Fund, "an estimated 200,000 women and girls have been assaulted over the past 12 years, with more than 18,000 cases reported between January and February 2008 alone."[144] South Kivu alone recorded 45 rapes per day in 2008.[145] In the Shabunda region, researchers estimate that 70% of the females have been raped.[146] In 2011, a study estimated that between 1.69 to 1.80 million Congolese women aged fifteen to forty-nine had experienced rape in their lifetime.[147] Given the state of women's rights in the DRC and the fact that so many women have been displaced, have migrated, or have died since the conflict began, the number may be much higher than reported.

C. Government, U.N., and Civilian Involvement in Sexual and Gender-Based Violence

Despite Congo's riches, the central government does a poor job of compensating its employees. Police officers, judges, and members of the military sometimes work for months without receiving salaries.[148] Members of the military and the police often prey upon the citizens they are sworn to protect, while judges often accept bribes to compensate for the lack of salary.[149] Police officers and prison wardens often rape or prostitute women with impunity.[150] While militias, particularly the FDLR, commit a large number of the reported rapes, many rapists come from the Congolese military ("FARDC") or from the police force. The U.N. estimated in 2007 that the FARDC and the Congolese National Police Force committed 20% of the sexual violence.[151] Many members of the military do not have barracks and sleep outside or raid civilian homes for shelter, and they may commit rape as a crime of

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[144] *Secretary-General Calls Attention to Scourge of Sexual Violence in DRC*, UNFPA (Mar. 1, 2009), http://www.unfpa.org/public/News/pid/2181.

[145] DYMOND, *supra* note 117, at 3.

[146] *Id.* at 4.

[147] AMBER PETERMAN ET AL., IF NUMBERS COULD SCREAM: ESTIMATES AND DETERMINANTS OF SEXUAL VIOLENCE IN THE DEMOCRATIC REPUBLIC OF CONGO 1 (2011), *available at* http://www.stonybrookmedicalcenter.org/system/files/INCS_Congo_Brief_r6%20%281%29.pdf.

[148] *See* SOLDIERS WHO RAPE, COMMANDERS WHO CONDONE, *supra* note 140, at 44.

[149] *See* BUREAU OF DEMOCRACY, HUMAN RIGHTS AND LABOR, U.S. DEP'T OF STATE, COUNTRY REPORTS ON HUMAN RIGHTS PRACTICES FOR 2011: DEMOCRATIC REPUBLIC OF THE CONGO 8–11 (2011), *available at* http://www.state.gov/documents/organization/186395.pdf.

[150] *See* Breton-Le Goff, *supra* note 135, at 19.

[151] *See* Press Release, U.N. Expert on Violence Against Women Expresses Serious Concerns Following Visit to Democratic Republic of Congo (July 30, 2007), http://www.unhchr.ch/huricane/huricane.nsf/0/B5D0053875B01B8CC1257328003A8FEE?opendocument [hereinafter Press Release, July 30, 2007].

opportunity.[152] Others commit rapes to penalize those they believe support rebel groups.[153]

In 2008, in the provinces of North and South Kivu, the U.N. registered 7703 cases of soldiers and others committing sexual violence, but judges convicted only twenty-seven soldiers of crimes of sexual violence.[154] In October 2010, the U.S. Department of State estimated that members of armed groups, the police, and the Congolese military were responsible for 81% of all reported cases of sexual violence in the conflict zones and almost a quarter of the rapes in non-conflict zones.[155]

The U.N. itself does not have clean hands—U.N. peacekeepers have reportedly sexually exploited the Congolese through "survival" and "transactional" sex.[156] Further, survivors have accused civilians, members of the clergy, and teachers of rape.[157] According to one estimate, 30% of the perpetrators of child rape were civilians.[158] In some cities such as Shabunda and Fizi, a study found that civilians committed approximately 70% of the reported sexual violence.[159] Further, researchers report civilians joining in with the military on "rape raids."[160] Some believe that the reintegration of armed forces into the civilian population with impunity for past crimes, coupled with the complete lack of rule of law and normalization of rape, has led to the increase in civilian criminality.[161]

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[152] *See* SOLDIERS WHO RAPE, COMMANDERS WHO CONDONE, *supra* note 140, at 44.

[153] Press Release, July 30, 2007, *supra* note 151.

[154] SOLDIERS WHO RAPE, COMMANDERS WHO CONDONE, *supra* note 140, at 6.

[155] *Congo (Kinshasa) (10/08/10)*, U.S. DEPT. OF STATE (Oct. 8, 2010), http://www.state.gov/outofdate/bgn/congokinshasa/160840.htm.

[156] CITIZENS FOR GLOBAL SOLUTIONS, THE UNITED NATIONS RESPONDS TO SEXUAL ABUSE BY PEACEKEEPERS IN THE DEMOCRATIC REPUBLIC OF CONGO (2005) (reporting allegations that U.N. personnel used "survival sex" to exploit "Congolese girls as young as 11 years of age in exchange for small amounts of money and scraps of food"); *UN Probing Charges of Sex Abuse in DR of Congo, Peacekeeping Official Says*, UNITED NATIONS NEWS CENTRE (Nov. 23, 2004), http://www.un.org/apps/news/story.asp?Cr=democratic&Cr1=congo&NewsID=12623#.UT5lNtF1808.

[157] *See* DYMOND, *supra* note 117, at 6 (accusing civilians of rape); THE WAR WITHIN THE WAR, *supra* note 117, at 21 (accusing teachers of rape).

[158] Breton-Le Goff, *supra* note 135, at 16.

[159] *See* DYMOND, *supra* note 117, at 7 (reporting a study that ran from January to March 2008).

[160] Bosmans, *supra* note 134, at 7.

[161] *See* OPEN SOC'Y INITIATIVE FOR S. AFR., HELPING TO COMBAT IMPUNITY FOR SEXUAL CRIMES IN DRC: AN EVALUATION OF THE MOBILE GENDER JUSTICE COURTS 17 (2012) (addressing the need to change the "normalization" of rape committed predominately by civilians), *available at* http://www.osisa.org/sites/default/files/open_learning-drc-web.pdf; Breton-Le Goff, *supra* note 135, at 19, 29 (noting that the reintegration of ex-militia members into the community and general corruption are aggravating factors of the violence in the DRC). Congo does have laws protecting women.

Combatants have used rape as a weapon of war throughout history, including most recently in Rwanda, Sierra Leone, Uganda, and the former Yugoslavia.[162] The DRC is no different, although the scale is reported to be unprecedented. The worldwide attention devoted to the use of rape by militias, coupled with the militias' involvement in the mineral trade, led to legislation in the United States to address the problem.

D. The Conflict over Minerals

By some estimates, mining "accounts for 80% of the exports, 72% of the national budget and 28% of [Congo's] GDP," and thus, for many families, particularly in the eastern part of the country, it is the only source of income.[163] But the amount of Congo's minerals as a percentage of worldwide totals has been wildly overstated by supporters of conflict mineral legislation. Although many claim that the Congo has 70 to 80% of the world's supply of coltan, studies indicate that the number is closer to 10%.[164]

But clearly, the country's riches have made its people vulnerable for over a hundred years, and, today, rebels, warlords, and corrupt members of the military extort "taxes" from the artisanal miners who dig the

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In 2006, the DRC, along with other states in the region, passed the seminal Protocol on the Prevention and Suppression of Sexual Violence against Women and Children, which prohibits forced pregnancy, sexual slavery, genital mutilation, forced prostitution, statutory rape, and forced sterilization. Protocol on the Prevention and Suppression of Sexual Violence Against Women and Children, International Conference of the Great Lakes Region, art. (1)(2)(g), Nov. 30, 2006, *available at* http://www.internal-displacement.org/8025708F004BE3B1/(httpInfoFiles)/381B8D820A51C229C12572FB002C0C5B/$file/Final%20protocol.Sexual%20Violence%20-%20En.pdf.

[162] *See* CASSANDRA CLIFFORD, RAPE AS A WEAPON OF WAR AND IT'S [SIC] LONG-TERM EFFECTS ON VICTIMS AND SOCIETY (2008) (listing countries where rape has been used as a weapon of war); WORLD HEALTH ORG., VIOLENCE AGAINST WOMEN AND HIV/AIDS: CRITICAL INTERSECTIONS: SEXUAL VIOLENCE IN CONFLICT SETTINGS AND THE RISK OF HIV 1, *available at* http://www.who.int/gender/en/infobulletinconflict.pdf.

[163] Aloys Tegera, Dir. of Research, Pole Inst., A Congolese Perspective on US Conflict Minerals Legislation, Keynote Speech to Roundtable Hosted by Judith Sargentini, Member of European Parliament (May 26, 2011), *in* ROUNDTABLE ON CONFLICT MINERALS LEGISLATION: TOWARDS PREVENTION OF TRADE IN CONFLICT MINERALS AND PROMOTION OF TRADE IN CLEAN MINERALS FROM CONGO 8, 8 (2011).

[164] *Compare The Devastating Crisis in Eastern Congo: Hearing Before the Subcomm. on Afr., Global Health, & Human Rights of the H. Comm. on Foreign Affairs*, 112th Cong. 3 (2012) (statement of Rep. Christopher H. Smith, Chairman, Subcommittee on Africa, Global Health, and Human Rights, Committee on Foreign Affairs) (claiming that DRC has 70% of the world's coltan and 30% of the world's diamond reserves), *with* EICHSTAEDT, *supra* note 120, at 140 (noting that the Congo only supplies about 10% of the world's coltan).

minerals by hand from the ground with their own tools.[165] Rebels and members of the military reportedly smuggle minerals through neighboring countries.[166] A U.N. group of observers has reported that rebels in the Congo's neighboring countries have in fact backed rebel forces.[167] Rebels loot, pillage, rape, and murder innocent civilians for a host of complex reasons, including for their minerals.[168] Reportedly, many civilians also fear the Congolese army as much as or more than the rebels.[169]

After decades of war involving international peacekeepers and significant international aid, NGOs and the U.S. government finally sought a legislative solution to the crisis in the Congo.

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[165] Nov. 29, 2011 Letter, *supra* note 124, at 113–14.

[166] *See id.* (noting that smuggling through illegal border crossings is a common problem in the DRC and that ex-CNDP commanders, the FARDC, and other officers and members of the police continue to smuggle minerals across borders).

[167] Coordinator of the Group of Experts on the DRC, *supra* note 128 ("[T]he Group [of Experts] has repeatedly concluded that the Government of Rwanda (GoR), with the support of allies within the Government of Uganda, has created, equipped, trained, advised, reinforced and directly commanded the M23 rebellion.").

[168] The standard narrative given for the reason behind the conflict minerals law is that consumer demand for electronics drives corporations to source minerals from DRC, which has mines controlled by rebels who use revenues from corporations to fund their rebellions, often involving child soldiers, and who engage in raping, pillaging, and looting. However, there are other possible hypotheses for M23's motives, including "historic grievances, ethnic tensions, economic gain, and political control." INT'L PEACE INFO. SERV., MAPPING CONFLICT MOTIVES: M23, at 4 (2012) [hereinafter MAPPING CONFLICT MOTIVES]. The International Peace Information Service ("IPIS") compiles comprehensive research to analyze the complex motives driving wars and conflicts. *Mapping Conflict Motives in War Areas*, INT'L PEACE INFO. SERV., http://www.ipisresearch.be/mapping.php (last visited Mar. 8, 2013). In analyzing M23's motives, IPIS noted that although M23's initial push was to implement an agreement between the CNDP and the Congolese government, M23 has consistently moved in the direction of advocating for national political control. MAPPING CONFLICT MOTIVES, *supra*, at 9–10. IPIS research revealed that control over minerals seemed not to be a driving factor for M23 because, although many important mining sites are within M23's reach, none of M23's recent operations have sought control over these important mining sites. *Id.* at 14. M23 has political motivations both within the DRC and without. Within, M23 has sought the support of other Congolese armed groups and President Kabila's opposition. *Id.* at 16. Outside the DRC, M23 has received backing from rebels in Rwanda and Uganda. Coordinator of the Group of Experts on the DRC, *supra* note 128. In March 2013, a key leader of the head of M23, ex-Congolese army general Bosco Ntaganda, turned himself in to the International Criminal Court, where he was sought for war crimes. *Bosco Ntaganda in the ICC: Profile of the Terminator*, TELEGRAPH (Mar. 26, 2013, 10:15 AM), http://www.telegraph.co.uk/news/worldnews/africaandindianocean/democraticrepublicofcongo/9953920/Bosco-Ntaganda-in-the-ICC-profile-of-the-Terminator.html.

[169] *See, e.g.*, Gregory Warner, *Congo Fighting Leaves a Fragile City on Edge*, NPR, Dec. 31, 2012, http://www.npr.org/2012/12/31/168345346/congo-fighting-leaves-a-fragile-city-on-edge (observing that while some people in a displaced persons camp fled the M23 rebel group, others fled the Congolese army).

III. THE CONSTITUENCY OF CONSCIENCE: HOW THE "NAME-AND-SHAME" LEGISLATION WAS BORN

A. Early Measures

American lawmakers have tried for years to stop the bloodshed in the Congo. In 2005, then U.S. Senator Barack Obama introduced the DRC Relief, Security, and Democracy Promotion Act of 2006 ("DRC Act"),[170] which was signed into law by President Bush.[171] The legislation established fifteen U.S. policy objectives addressing humanitarian needs, social development, economic and natural resource management, and governance and security sector reform concerns in the DRC.[172] The DRC Act highlighted the Congo's strategic importance as a large country that had been destabilized by a number of wars and that was located in the center of Africa surrounded by a number of other countries that were either also unstable or could capitalize on DRC's instability.[173] The American government was primarily focused on fighting terrorism, which was closely linked to addressing the humanitarian crisis of internally displaced persons, disease, war, and poverty.[174]

Although the DRC Act did not use the term "conflict minerals," mindful of the connection between mineral riches and funding of rebel forces, it did require the DRC's commitment to manage its natural resources responsibly, "to hold accountable individuals who illegally exploit the country's natural resources," and "to implement the Extractive Industries Transparency Initiative by enacting laws requiring disclosure and independent auditing of company payments and government receipts for natural resource extraction."[175] As required by the Act, approximately 70% of the hundreds of millions of dollars of U.S.

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[170] Democratic Republic of the Congo Relief, Security, and Democracy Promotion Act of 2005, S. 2125, 109th Cong. (2005). Hillary Clinton, during the time she was a senator, also supported the bill and later joined as a co-sponsor of the Act. 152 CONG. REC. 9, 11,699 (2006).

[171] Democratic Republic of the Congo Relief, Security, and Democracy Promotion Act of 2006, Pub. L. No. 109-456, § 102, 120 Stat. 3384, 3385–87.

[172] *Id.* (indicating that one of the policy objectives of "assisting the Government of the Democratic Republic of the Congo to establish a viable and professional national army and police force that respects human rights and the rule of law, is under effective civilian control, and possesses a viable presence throughout the entire country").

[173] *Id.* at § 101(3)–(4).

[174] *Id.* at § 101(1)–(2).

[175] *Id.* at § 102(8)(B)(ii)–(iii). The Extractive Industries Transparency Initiative is globally developed and implemented by "a coalition of governments, companies, civil society groups, investors and international organisations" and promotes transparency of revenue payments for natural resources at the local level. *What is the EITI?*, EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE, http://eiti.org/eiti (last visited Mar. 8, 2013).

funding in the fiscal years 2006 and 2007 went toward humanitarian and social efforts, and 30% went toward economic and natural resource management, governance, and security objectives.[176] According to the Government Accountability Office ("GAO"), which was tasked with reviewing whether programs met the policy objectives, corruption, failed governance, lack of basic infrastructure, and mismanagement of natural resources hampered reform efforts.[177]

The U.S. government, of course, was not alone in trying to resolve issues in the Congo. NGOs around the world were also working to solve the crisis in the Congo. Ironically, Congo has been called both the rape and international humanitarian aid capital of the world.[178] For years, organizations such as the Eastern Congo Initiative,[179] Human Rights Watch,[180] Oxfam,[181] Amnesty International,[182] and Global Witness[183] have highlighted the lack of government infrastructure, the need for

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[176] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-562T, THE DEMOCRATIC REPUBLIC OF THE CONGO: MAJOR CHALLENGES IMPEDE EFFORTS TO ACHIEVE U.S. POLICY OBJECTIVES; SYSTEMATIC ASSESSMENT OF PROGRESS IS NEEDED 7 (2008).

[177] *Id.* at 12.

[178] Personal internet conversation on December 10, 2012, with Vava Tampa, founder of Save the Congo, a U.K.-based campaigning organization working to "raise awareness of, and tackle the impunity, insecurity, institutional failure and [i]llicit trade of minerals that funds the wars in Congo." *See* SAVE THE CONGO, http://www.savethecongo.org.uk/ (last visited Mar. 8, 2013).

[179] *About ECI*, E. CONGO INITIATIVE, http://www.easterncongo.org/about (last visited Mar. 8, 2013); *What We Do*, E. CONGO INITIATIVE, http://www.easterncongo.org/about/what-we-do (last visited Mar. 8, 2013) (explaining that Eastern Congo Initiative funds local Congolese organizations for survivors of sexual and gender-based violence, funds peace and reconciliation programs, promotes children's health, and also works to effect policy change in Washington); *see also The Democratic Republic of the Congo: Securing Peace in the Midst of Tragedy: Hearing Before the Subcomm. on Afr., Global Health & Human Rights of the H. Comm. on Foreign Affairs*, 112th Cong. 50–54, 88–89 (2012) (noting that the founder of the Eastern Congo Initiative, actor Ben Affleck, has testified before Congress on Congo).

[180] *About Us*, HUM. RTS. WATCH, http://www.hrw.org/about (last visited Mar. 8, 2013); *DR Congo: US Should Urge Rwanda to End M23 Support: Sanction Rwandan Officials Backing Abusive Congolese Rebels*, HUM. RTS. WATCH (Nov. 8, 2012), http://www.hrw.org/news/2012/11/20/dr-congo-us-should-urge-rwanda-end-m23-support (reporting on its investigations into human rights abuses and its recent focus on the M23 rebel group and calling on the United States to publicly support sanctions against the Rwandan government).

[181] *Democratic Republic of Congo*, OXFAM INT'L, http://www.oxfam.org/drc (last visited Mar. 8, 2013) (focusing on short-term emergency relief and longer-term development projects in Congo, particularly involving internally displaced persons).

[182] *Democratic Republic of Congo*, AMNESTY INT'L, http://www.amnestyusa.org/our-work/countries/africa/democratic-republic-of-congo (last visited Mar. 8, 2013) (focusing on human rights violations by the military and armed groups and promoting compliance with mineral regulation legislation).

[183] *Our Work*, GLOBAL WITNESS, http://www.globalwitness.org (last visited Mar. 8, 2013) (focusing on natural-resources related to human rights issues).

security sector reform, the health crisis, and the plight of the internally displaced persons. The most vocal and successful advocate for the conflict mineral legislation, Enough Project, was founded in 2007 to work on issues related to Africa and, through its Raise Hope for Congo campaign, has worked with activists around the world.[184] The various entities are well aware of the complexities of Congo's multilayered problems and know that the blame does not lie solely with rebel forces. As Oxfam pointed out, "government soldiers, armed rebels, police, and civilian authorities are all vying for the right to exploit local communities and extort money or goods from [citizens], pushing people further into poverty and undermining their efforts to earn a living."[185]

Nonetheless, although earlier strategy papers focused on broader issues similar to those raised in the DRC Act, from a CSR perspective, Enough Project eventually realized that tying rape to electronics was a simpler and more media-savvy method of focusing international media, governments, corporations, and consumers on the complex and intractable crisis in the Congo.

> In April 2009, Enough Project released a report, declaring that [t]he time has come to expose a sinister reality: Our insatiable demand for electronics products such as cell phones and laptops is helping fuel waves of sexual violence . . . . There are few other conflicts in the world where the link between our consumer appetites and mass human suffering is so direct.[186]

Enough Project developed and publicized a company ranking system holding the twenty-four leading electronics companies publicly accountable for their progress on ridding their products of conflict minerals, spearheaded a conflict-free campus initiative, and advocated

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[184] *See About Us*, ENOUGH PROJECT, http://enoughproject.com/about (last visited Mar. 8, 2013); *see also About the Campaign*, RAISE HOPE FOR CONGO, http://www.raisehopeforcongo.org/content/about/about-the-campaign (last visited Mar. 8, 2013). John Prendergast, Enough Project's co-founder, testified on Congo-related matters on Capitol Hill at the House Foreign Affairs Subcommittee on Africa on March 8, 2011, advocating for a special envoy to the Congo and reporting on the realized benefits in the DRC since implementation of the Dodd–Frank Act. *The Democratic Republic of the Congo: Securing Peace in the Midst of Tragedy: Hearing Before the Subcomm. on Afr., Global Health & Human Rights of the H. Comm. on Foreign Affairs*, 112th Cong. 79–88 (2011) (statement of John Prendergast, Co-founder, Enough Project). Prendergast also testified again before Congress on December 11, 2012. *The Devastating Crisis in Eastern Congo: Hearing Before the Subcomm. on Afr., Global Health & Human Rights of the H. Comm. on Foreign Affairs*, 112th Cong. 47–57 (2012) (statement of John Prendergast, Co-founder, Enough Project).

[185] STEVEN VAN DAMME, OXFAM INT'L, COMMODITIES OF WAR: COMMUNITIES SPEAK OUT ON THE TRUE COST OF CONFLICT IN EASTERN DRC 1 (2012), *available at* http://www.oxfam.org/en/policy/commodities-war-drc.

[186] JOHN PRENDERGAST, ENOUGH PROJECT, CAN YOU HEAR CONGO NOW? CELL PHONES, CONFLICT MINERALS, AND THE WORST SEXUAL VIOLENCE IN THE WORLD 1 (2009).

for "conflict-free" cities.[187] Companies that engaged with Enough Project and its mission were favorably featured in its social media and other campaigns.[188]

Video campaigns by other activists went viral through social media, including a British documentary entitled "Blood in the Mobile," which encouraged interested viewers to contact Raise Hope for Congo and other NGOs and encourage them to take action.[189] Raise Hope for Congo worked with socially responsible investors and companies to argue that the only way to solve the crisis in the Congo was to change corporate and consumer behavior and to stop the funding of rebel groups through the purchase of conflict minerals.[190] NGOs also pressured lawmakers in Washington for legislative action to stop corporate complicity.[191]

Meanwhile, because the DRC Act did not focus solely on minerals, some legislators in Congress also wanted freestanding conflict mineral legislation, perhaps prodded by NGOs, but also based upon personal experience in the region. Former Senator Sam Brownback of Kansas had traveled to Congo with Senator Dick Durbin of Illinois in the past, and in the same month as the Enough Project cell phone campaign, Brownback introduced the Congo Conflict Minerals Act of 2009 ("Brownback Bill"), co-sponsored by Senator Dick Durbin and Senator Russ Feingold of Wisconsin.[192] In his press release announcing the legislation, Brownback explained,

> Metals derived from inhumanely mined minerals go into electronic products used by millions of Americans. In the Democratic Republic of Congo, many people—especially women and children—are victimized by armed groups who are trying to make a profit from mining 'conflict minerals.' The legislation introduced today brings accountability and transparency to the supply chain of minerals used in the manufacturing of many electronic devices. I hope the legislation will help save lives.[193]

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[187] *Our Programs*, RAISE HOPE FOR CONGO, http://www.raisehopeforcongo.org/content/our-programs (last visited Mar. 8, 2013).

[188] *See* ENOUGH PROJECT, GETTING TO CONFLICT-FREE: ASSESSING CORPORATE ACTION ON CONFLICT MINERALS 1–4 (2010) ("These rankings [of companies by their conflict mineral engagement] are an effort to provide consumers with the information they need to purchase responsibly, as well as a means of encouraging companies to continue to move forward in good faith.").

[189] *See The Power Is in Your Pocket—Take Action*, BLOOD MOBILE, http://bloodinthemobile.org/take-action (last visited Mar. 8, 2013).

[190] *See supra* note 184 and accompanying text.

[191] *See supra* notes 180, 184 and accompanying text.

[192] Congo Conflict Minerals Act of 2009, S. 891, 111th Cong. (2009).

[193] *Brownback, Durbin, Feingold Introduce Conflict Minerals Act: Press Release*, PROJECT VOTE SMART (Apr. 24, 2009), http://votesmart.org/public-statement/419962/brownback-durbin-feingold-introduce-congo-conflict-minerals-act#.UOfaYInjlpk.

This press release came only days after members of his campaign staff participated in the "RAISE Your Voice Activist Conference Call," led by field managers of Enough Project, to discuss upcoming conflict mineral legislation.[194]

The Brownback Bill began by discussing the prevalence of rape as a weapon of war in Congo and the fact that the mismanagement of natural resources has contributed to conflict among rebel forces and the militias.[195] The Brownback Bill also referred to U.N. Security Council Resolution 1857,[196] which encouraged member countries to ensure that companies exercise due diligence when sourcing minerals from the DRC.[197] Among other things, the Brownback Bill directed the Secretary of State to produce a Conflict Minerals Map, showing which mines were under control of rebel forces,[198] and to

> work with other member states of the United Nations and local and international [NGOs] to provide guidance to commercial entities seeking to exercise due diligence on their suppliers to ensure that the raw materials used in their products do not—
>
> (1) directly finance armed conflict;
>
> (2) result in labor or human rights violations; or
>
> (3) damage the environment.[199]

Notably, the Brownback Bill proposed amending Section 13 of the Exchange Act[200] to require companies to disclose to the SEC "the country of origin of columbite-tantalite, cassiterite, or wolframite" if the country of origin is the DRC or an adjoining country or involves the funding of the armed groups perpetuating the human rights violations described in the Act.[201]

Nonetheless, the Brownback Bill died[202] even though Secretary of State Hillary Clinton clearly believed there was a connection between

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[194] *Raise Your Voice Activist Conference Call*, ENOUGH PROJECT (Apr. 15, 2009), http://www.enoughproject.org/events/congo-challenge-advocacy-training-call.

[195] S. 891, § 2(4)–(5).

[196] S.C. Res. 1857, ¶ 15, U.N. Doc. S/RES/1857 (Dec. 22, 2008) (renewing measures on arms embargo against all nongovernmental entities and individuals operating in the DRC).

[197] S. 891, § 9.

[198] This provision survived within Section 1502 of the Dodd–Frank Act, but the most recent State Department map is from May 2012 as of March 2013. HUMANITARIAN INFO. UNIT, U.S. DEP'T OF STATE, DEMOCRATIC REPUBLIC OF THE CONGO MINERAL EXPLOITATION BY ARMED GROUPS & OTHER ENTITIES (2012), *available at* https://hiu.state.gov/Products/DRC_Conflict Minerals_2012May23_HIU_U540.pdf.

[199] S. 891, § 4(b)–(c).

[200] 15 U.S.C. § 78m (Supp. V 2011).

[201] S. 891, § 5.

[202] *See Congo Conflict Minerals Act of 2009*, GOVTRACK.US, http://www.govtrack.us/congress/bills/111/s891 (last visited Mar. 8, 2013).

minerals and human rights abuses. In August 2009, Secretary Clinton visited the DRC and explicitly linked conflict minerals to rape when she noted that the conflict in the DRC was over illegal mining of minerals and then declared, "Women are being turned into weapons of war."[203]

Meanwhile, members of the U.S. House of Representatives also wanted a freestanding bill focused solely on conflict minerals. Representative Jim McDermott of Washington had served as a medical officer in the Foreign Service in central Africa in the 1980s and then in 2007, and he was astounded by the human rights abuse when he visited the Congo and talked with rape victims.[204] In November 2009, he introduced the Conflict Minerals Trade Act (the "McDermott Bill").[205] The McDermott Bill, among other things, was strikingly similar to the Brownback Bill but would have prohibited the import of certain articles and would have imposed penalties under Section 592 of the Tariff Act of 1930.[206] There were no SEC disclosure requirements under the McDermott Bill. Enough Project, through its parent organization, Center for American Progress, supported the McDermott Bill, as did Human Rights Watch, other NGOs, and the Information Technology Industry Council.[207] This bill also failed to pass.[208]

Despite the setbacks, these resolute lawmakers finally found an opportunity through a very unlikely vehicle to achieve what had been so elusive. Representative Jim McDermott summed up their philosophy by saying, "You get bills passed any way you can."[209]

B. The Dodd–Frank Act and Corporate Disclosures

The financial crisis of 2008 became the unlikely vehicle for Brownback, McDermott, and the NGO community to achieve their respective ends. In 2010, Congress passed the Dodd–Frank Act.[210] The

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[203] Jeffrey Gettleman, *Clinton Presses Congo on Minerals*, N.Y. TIMES, Aug. 11, 2009, at A7.

[204] *See* Ben Protess, *Dodd–Frank Strays Far from Street*, N.Y. TIMES, July 14, 2011, at B1.

[205] Conflict Minerals Trade Act, H.R. 4128, 111th Cong. (2009).

[206] *Id.* § 9(a); *see also* Tariff Act of 1930 § 592, 19 U.S.C. § 1592 (2006 & Supp. V 2012).

[207] Seay, *supra* note 107.

[208] *See Conflict Minerals Trade Act*, GOVTRACK.US, http://www.govtrack.us/congress/bills/111/hr4128 (last visited Mar. 8, 2013).

[209] Protess, *supra* note 204.

[210] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The Act includes corporate governance and executive compensation reforms, new rules for credit rating agencies, new registration requirements for hedge fund and private equity fund advisers, heightened regulation of over-the-counter

Dodd–Frank Act contained a number of sleeper provisions that most investors did not notice. A conflict minerals provision was one of them, inserted days before the Dodd–Frank Act was passed.[211] Another related provision was Section 1504, the resource-extraction provision, which was also heavily promoted by the NGO community.[212] Known as "publish what you pay," this provision requires affected companies to disclose to the SEC all payments above $100,000 made to either the United States or a foreign government for the extraction of oil and minerals.[213]

In adding Section 1502 as a human rights provision to the financial reform law, legislators explained that "[i]t is the sense of Congress that the exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo is helping to finance conflict characterized by extreme levels of violence . . . particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation therein."[214] Congress, therefore, sought to "reduce funding for the armed groups contributing to the conflict" and "put pressure on such groups to end the conflict."[215] Essentially, Section 1502 requires the SEC to promulgate rules forcing issuers to disclose pertinent facts regarding the origin of minerals.[216] Section 1502 adopted much of what Brownback proposed but was not without controversy, and the Act took two years for final passage.

When the SEC published its proposed rules, it received over 400 comment letters, and it held 130 meetings with interested investors, business groups, NGOs, and members of the public.[217] Although the

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derivatives and asset-backed securities, and significantly increased oversight and regulation of banks and other financial institutions. *Id.*

[211] Brownback attached Section 1502 as an amendment, which was adopted by the Senate by voice vote. 156 CONG. REC. S3865–66 (daily ed. May 18, 2010).

[212] *See* PUBLISH WHAT YOU PAY, COMMENTS ON SECTION 1504 OF THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 1, 7 (Nov. 22, 2010), *available at* http://www.sec.gov/comments/df-title-xv/specialized-disclosures/specializeddisclosures-82.pdf (commenting, with the support of 600 organizations, that "Section 1504 of the Act embodies a significant contribution to the development of a global standard that will build upon the efforts elsewhere and help address some lingering gaps").

[213] 15 U.S.C. § 78m(q)(2)(A) (2006 & Supp. V 2011); Disclosure of Payments by Resource Extraction Issuer, 77 Fed. Reg. 56,365, 56,368 (Sept. 12, 2012) (to be codified at 17 C.F.R pts. 240, 249).

[214] Dodd–Frank Act § 1502(a), 124 Stat. at 2213.

[215] Conflict Minerals, 77 Fed. Reg. 56,274, 56,276 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240, 249b).

[216] Dodd–Frank Act § 1502(b), 124 Stat. at 2213.

[217] *See Proposed Rule: Conflict Minerals*, SEC. & EXCH. COMM'N, http://www.sec.gov/comments/s7-40-10/s74010.shtml (last visited Mar. 8, 2013). Many of the comment letters were form letters signed on behalf of thousands of "concerned consumers." *E.g.*, Letter from 13,660 Concerned Consumers to the U.S. Securities and

business groups that objected to the law almost universally lauded the goal of stemming the tide of violence in the Congo,[218] their concerns generally focused on the perceived vagueness of the requirements and the costs of compliance.[219]

While lobbyists and NGOs argued about the law's details in Washington, DRC President Joseph Kabila initiated a mining embargo from September 2010 to March 2011, which devastated the artisanal miners and the surrounding communities, even after the embargo was lifted.[220] In fact, in the DRC, President Obama and the "Obama Law," as the Dodd–Frank Act was called, took the blame for the plunging fortunes of the miners.[221]

Exchange Commission (Feb. 17, 2011), *available at* http://www.sec.gov/comments/s7-40-10/s74010-305.pdf.

[218] For example, one of the most vocal critics of the law and a petitioner in the lawsuit, the National Association of Manufacturers ("NAM"), began its comment letter to the SEC stating, "We support the underlying goal of Sec. 1502 to address the atrocities occurring in the Democratic Republic of Congo (DRC) and adjoining countries and are actively working with other stakeholders to help address the problem." Letter from Stephen Jacobs, Senior Dir., Int'l Econ. Affairs, Nat'l Ass'n of Mfrs., to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n (Mar. 2, 2011), *available at* http://www.nam.org/~/media/DE6DA95D7CA5475BB24F80869A643CD3/NAM_Comments_on_Conflict_minerals_3_2_11_as_submitted.pdf.

[219] Many critics cite the report by Chris Bayer and Dr. Elke de Buhr. *See generally* CHRIS BAYER & ELKE DE BUHR, A CRITICAL ANALYSIS OF THE SEC AND NAM ECONOMIC IMPACT MODELS AND THE PROPOSAL OF A 3RD MODEL IN VIEW OF THE IMPLEMENTATION OF SECTION 1502 OF THE 2010 DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 3 (2011), *available at* http://lawprofessors.typepad.com/files/tulane-study.pdf (concluding that the SEC's $71.2 million figure underestimated the cost of implementation and did not "take into account the range of actors affected by the statutory law," while NAM's figure of $9–16 billion overstated the costs and did not take efficiencies into account, and estimating the true cost of compliance at closer to $7.93 billion for affected companies and first-tier suppliers); Letter from Erik O. Autor, Vice President, Int'l Trade Counsel, Nat'l Retail Fed'n, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n (Nov. 1, 2011), *available at* http://www.sec.gov/comments/s7-40-10/s74010-386.pdf.

[220] *See* David Aronson, *How Congress Devastated Congo*, N.Y. TIMES, Aug. 8, 2011, at A19 (arguing that the Dodd–Frank Act caused a de facto embargo on mineral mining even before the final law had passed); Seay, *supra* note 107, at text accompanying n.24.

[221] Editorial, *Africa and 'Obama's Embargo,'* WALL ST. J., July 18, 2011, at A12; *see also* Laura Heaton, *Congolese Living in Mining Region Blame 'Obama's Law' for Economic Struggles*, CHRISTIAN SCI. MONITOR (Apr. 25, 2011), http://www.csmonitor.com/World/Africa/Africa-Monitor/2011/0425/Congolese-living-in-mining-region-blame-Obama-s-law-for-economic-struggles (indicating that, even though the Dodd–Frank Act was not yet in effect and did not call for an embargo, Kabila enacted an embargo "to show that he was doing something" and that local Congolese blamed Obama and were "living in misery" during the ban).

Under the final rule promulgated on August 22, 2012, affected companies[222] must compile data for calendar year 2013 and file their first report by May 31, 2014.[223] Although every SEC reporting company must determine whether it uses conflict minerals, the rule applies to companies only if "conflict minerals are necessary to the functionality or production of a product" that a public company manufactures or contracts to be manufactured.[224] First, a company must determine if its products rely on conflict minerals.[225] Next, a company must determine, using a "reasonable country of origin inquiry," if minerals it uses may have originated in the DRC or an adjoining country.[226] If the metals did not originate in the covered nations or are considered scrap or recycled, a company still must report how it determined that the metals were scrap or recycled in a new specialized disclosure Form SD and provide a link to the company's website providing the disclosure.[227] If a company has reason to believe that the minerals may have come from a covered nation, then the company must disclose on the Form SD whether the company has determined the source to be "DRC conflict free," "not DRC conflict free," or, for the next two years, "DRC conflict undeterminable."[228] In addition, the company must obtain an independent, private-sector, third-party audit of its conflict mineral report of (1) the facilities used to process the conflict minerals; (2) the country of origin; (3) the efforts used to determine the mines with specificity; (4) the steps the company took to mitigate the risk that its use of conflict minerals will benefit armed groups; and (5) any steps it has taken to improve its due diligence process.[229] At this time, the OECD Guidance is considered an acceptable third-party standard for due diligence.[230] Because these reports are filed with the SEC, firms could be

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[222] The law provides important roles for the State and Commerce Departments as well, but in the interest of space, this Article does not discuss those provisions.

[223] Conflict Minerals, 77 Fed. Reg. 56,274 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240, 249b).

[224] *Id.* at 56,290. For the purposes of this Article, only a very brief description follows of the law's requirements.

[225] *Id.* at 56,310.

[226] *Id.* at 56,275, 56,310.

[227] *Id.* at 56,312, 56,315.

[228] *Id.* at 56,333–34.

[229] *Id.* at 56,320–21. The SEC has granted a two-year transition period for companies that cannot determine the country of origin or if the due diligence process cannot determine if the minerals came from armed groups. These products would be considered "DRC conflict undeterminable." For smaller companies, the SEC has granted a four-year transition period. The company must still file a conflict mineral report but is not required to file an audit report. *Id.* at 56,334.

[230] *Id.* at 56,324.

held liable for "false or misleading" statements under Section 18 of the Exchange Act.[231]

IV. WILL THE CONFLICT MINERALS LEGISLATION SUCCEED, AND ARE THERE MORE EFFECTIVE WAYS TO END THE HUMANITARIAN CRISIS?

A. The Law of Unintended Consequences

The SEC exists to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[232] When Congress passed comprehensive securities legislation reform in 1933 and 1934, it intended to ensure that publicly traded companies disclosed material information to investors.[233] But as discussed above, Section 1502's legislative history makes it clear that the conflict mineral law is not designed to protect or inform investors of material information but, rather, to stop a humanitarian crisis.

The Dodd–Frank Act, however, is not the first time that the agency has tackled social issues. In February 2010, the SEC issued guidance regarding exposure and expenditures related to climate change.[234] Although some public figures believed that the SEC had overstepped its bounds then,[235] investors clearly have a right to know whether firms face significant environmental regulation, litigation, or liabilities.

In the case of conflict minerals, although the Dodd–Frank Act does not prohibit the use of these minerals, the law does require companies to disclose whether they use them by May 2014.[236] One company, Cisco, has already received a shareholder's resolution asking for a feasibility study to determine whether the minerals can be removed from Cisco's entire

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[231] Securities Exchange Act of 1934, 15 U.S.C. § 78r(a) (2006).

[232] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 8, 2013).

[233] *See* Securities Act of 1933, chap. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)); Securities Exchange Act of 1934, chap. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a (2006)).

[234] *See* Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106, Exchange Act Release No. 61469, FR-82, 75 Fed. Reg. 6290 (Feb. 8, 2010); *see also* 17 C.F.R § 229.101(c)(1)(xii) (2011).

[235] *See, e.g.*, John Broder, *S.E.C. Adds Risk Related to Climate to Disclosure List*, N.Y. TIMES, Jan. 28, 2010, at B1 (quoting Commissioner Kathleen L. Casey as saying, "I can only conclude that the purpose of this release is to place the imprimatur of the commission on the agenda of the social and environmental policy lobby, an agenda that falls outside of our expertise and beyond our fundamental mission of investor protection"); Editorial, *Climate Change and the S.E.C.*, N.Y. TIMES, Jan. 31, 2010, at WK9 (expressing the frustrations of Representative Joe Barton that the SEC should be focusing on "investor protection" instead of promoting environmental groups' "social agendas").

[236] Conflict Minerals, Release No. 67716 (Nov. 13, 2012).

supply chain altogether.[237] This question posed by Cisco's shareholders will not be the last as more socially responsible investors examine their portfolios and the conflict minerals reports filed in 2014 and beyond. The question compounds the fears of many of the law's opponents that firms will determine that it is easier to source the minerals elsewhere, thereby leaving artisanal miners with no livelihood whatsoever—similar to what occurred during the 2010 Kabila embargo. Boards and executive managers exercising appropriate risk management over the enterprise must ask the question as to whether they should and could source their minerals from other parts of the world.

As for return on shareholder value, the first academic study to consider the issue found that legislators' and stakeholders' demands for increased social transparency can have tangible costs to shareholders when the disclosure rules induce significant changes in management and customer decision making.[238] Again, assuming that similar results from this preliminary study are replicated, responsible board members may use this as another reason to source their materials elsewhere, removing the source of income from the Congolese miners. Indeed, according to the head of a regional mining provision in Congo, tens of thousands of miners have already lost their jobs as companies have left the country, and an architect of the U.N. due diligence procedures has admitted that smuggling was still a problem as late as the end of 2012.[239] Even the OECD reported that many of the participants in its due diligence pilot program found that many of its suppliers wanted to boycott the Congo because of the law's requirements.[240]

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[237] *See* Cisco Sys., Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Sch. 14A), 27 (Sept. 26, 2012).

[238] *See* PAUL A. GRIFFIN ET AL., SUPPLY CHAIN SUSTAINABILITY: EVIDENCE ON CONFLICT MINERALS, at ii (2012) ("Based on companies with conflict minerals disclosures . . . and a size- and industry-matched control sample of non-disclosers, . . . shareholder value decreases for both samples for up to three weeks following the event dates of the discloser companies."). It is too early to tell whether this will be replicated with other companies as more companies make these disclosures, but these early findings may raise concerns with board members.

[239] *See* Katrina Manson, *Central Africa: The Quest for Clean Hands*, FIN. TIMES (Dec. 18, 2012, 8:40 PM), http://www.ft.com/intl/cms/s/0/b69124a4-394f-11e2-8881-00144feabdc0.html#axzz2HlfyFe5G.

[240] OECD, *Downstream Implementation of the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas Supplement on Tin, Tantalum, and Tungsten*, 16 (2013), *available at* http://www.oecd.org/daf/inv/mne/DDguidanceTTTpilotJan2013.pdf.

B. Does Complying with the Dodd–Frank Act Raise Other Compliance Risks?

Even if Congo was not plagued with dozens of rebel groups and was not in a state of civil war, corporations and their agents, auditors, and suppliers attempting to comply in good faith with the Dodd–Frank Act must contend with underpaid police officers, members of the military, and bureaucrats who often expect to supplement their meager salaries with bribes because they go for months without pay.[241] Transparency International ranks Congo as the 160th most corrupt country out of 176 countries in the world.[242]

Firms must also comply with both Section 1504, requiring TNCs to publish what they pay to governments for access to oil, gas, and minerals,[243] and the Foreign Corrupt Practices Act ("FCPA"), which has no affirmative defense for the actions of a rogue agent or employee even if a company has provided explicit training or instructions to comply with the law.[244] Section 1504 ostensibly covers both legal and illegal payments. The FCPA has two main provisions. First, it prohibits bribery of foreign officials.[245] Second, it requires companies to keep accurate books and records.[246] Some TNCs must also comply with the United Kingdom's Bribery Act of 2010, which imposes strict liability for bribing a "foreign public official."[247]

Given all of the steps and all of the people involved within the supply chain, there are significant risks that TNCs acting in good faith will have agents who, in following local customs, may violate U.S., U.K., and other laws just to get clients' products out of the country, regardless of the TNC's instructions to the contrary. Even with exercising due diligence, ensuring that bribes are not used may be practically impossible when tracing the route of gold, for example, from artisanal miners digging gold by hand from river beds or minerals from the mines to the middle men and those transporting bags of minerals from villages to cities through various countries to boats to refineries or smelters in

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[241] Even the U.N. peacekeepers are not immune. During a research trip to Bukavu, DRC, in September 2011, the author personally witnessed U.N. personnel trading bags of minerals for donated clothes with miners. The clothes were supposed to be given to the miners and local villagers for free.

[242] *Corruption by Country: Democratic Republic of the Congo*, TRANSPARENCY INT'L, http://www.transparency.org/country#COD (last visited Mar. 8, 2013).

[243] Dodd–Frank Act § 1504, 15 U.S.C. § 78m(q)(2)(A) (2006 & Supp. V 2011).

[244] Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78m, 78dd-1 to -3, 78ff (2006).

[245] § 78dd-1(a).

[246] *Id.* § 78m(b)(2)(A).

[247] Bribery Act, 2010, c. 23, §§ 6(1), 7(1) (U.K.).

Asia (where there may also be corruption issues).[248] It is unlikely that these kinds of payments would constitute the "facilitating payments" allowed under certain circumstances by the FCPA, but which are still frowned upon by the OECD and illegal in almost every country in the world.[249]

Violating the FCPA has significant civil and criminal penalties that can also lead to debarment from government contracts as well as worldwide jurisdictional enforcement.[250] The Department of Justice and the SEC have made enforcement of the anti-bribery statutes a key priority and have even allowed a whistleblower "bounty" of 10–30% of recoveries over one million dollars.[251] Thus, boards considering the best interests of their shareholders would likely weigh the risks of being able to get accurate certifications and disclosures to their investors and consumers and the reputational concerns of doing business in the Congo. Again, they may determine that it is in their best interests to do business elsewhere, further exacerbating the plights of the local Congolese.[252]

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[248] This is a such a well-founded concern that companies like KPMG, an audit, tax and advisory firm, warn clients of the stages during the mining and transportation processes at which bribery and smuggling can occur based on OECD and other sources. *See, e.g.*, KPMG INT'L, CONFLICT MINERALS AND BEYOND: PART TWO: A MORE TRANSPARENT SUPPLY CHAIN 6–7 (2012), *available at* http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/more-transparent-supply-chain.pdf.

[249] Facilitating payments for routine, nondiscretionary tasks is allowed under 15 U.S.C. § 78dd-2(b) (2006). However, only Australia, Canada, South Korea, the United States, and New Zealand allow them. TRACE ANTI-BRIBERY COMPLIANCE SOLUTIONS, TRACE FACILITATIONS PAYMENTS BENCHMARKING SURVEY 2 (2009), *available at* https://secure.traceinternational.org/data/public/documents/FacilitationPaymentsSurveyResults-64622-1.pdf. In November 2009, the OECD called for a ban on them to help prevent and detect foreign bribery. *See* OECD, *Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions*, at § VI(ii) (2009), *available at* http://www.oecd.org/dataoecd/11/40/44176910.pdf. The United States is a signatory to the OECD Convention Against Bribery, and, therefore, the use may be limited even further in the future.

[250] *See* Marcia Narine, *Whistleblowers and Rogues: The Urgent Call for an Affirmative Defense to Corporate Criminal Liability*, 62 CATH. U. L. REV. (forthcoming fall 2013).

[251] *Welcome to the Office of the Whistleblower*, SEC. & EXCH. COMM'N, http://www.sec.gov/whistleblower (last visited Mar. 8, 2013).

[252] European and Asian companies that do not issue securities in the United States would have no such constraints and could still do business in the Congo. The European Union is likely to implement legislation in the near future on conflict minerals using the OECD Guidance under pressure from NGOs. *See supra* note 49 and accompanying text.

C. The Kimberley Process and the Clean Diamond Trade Act

A number of critics of Section 1502 have argued that a better solution for the crisis in the Congo would have been something akin to the Kimberley Process[253] and the Clean Diamond Trade Act ("CDTA").[254] In 2000, the U.N. adopted a process to unite the worldwide community to eradicate the funding of rebels in Angola and Sierra Leone through conflict diamonds.[255] In response, the Kimberley Process began in 2003 as a joint initiative by governments, civil society organizations, and industries to stem the flow of conflict diamonds into commerce and, like conflict minerals legislation, is meant to stop funding to rebel groups.[256] There are fifty-four participants from eighty countries, and each participant must implement legislation and controls, which have, according to the founders, reduced the number of conflict diamonds to 1% of diamonds in international trade.[257] The United States has enacted the CDTA, which prevents importation and exportation of any diamond that does not come through the Kimberley Process and subjects violators to civil and criminal penalties.[258]

Neither of these, however, are an ideal substitute for the Dodd–Frank Act. First, like many of the initiatives discussed earlier, membership in the Kimberley Process is voluntary. Although countries can be expelled if they do not comply, they must agree to be reviewed, there are no real penalties for transgressions, and there is no international enforcement.[259] The GAO has also determined that the

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[253] KIMBERLEY PROCESS, http://www.kimberleyprocess.com (last visited Mar. 8, 2013) ("The Kimberley Process (KP) is a joint government[], industry and civil society initiative to stem the flow of conflict diamonds—rough diamonds used by rebel movements to finance wars against legitimate governments.").

[254] Clean Diamond Trade Act, Pub. L. No. 108-19, 117 Stat. 631 (2003) (codified at 19 U.S.C. §§ 3901–3913 (2006)) (stating that one of the Acts purposes is "to stop trade in conflict diamonds"); *see also* Karen E. Woody, *Conflict Minerals Legislation: The SEC's New Role as Diplomatic and Humanitarian Watchdog*, 81 FORDHAM L. REV. 1315, 1345–51 (2012) (arguing that the Dodd–Frank Act will cause more harm than good and that more efficient regulatory models include the Clean Diamond Trade Act and Kimberley Process Certification Scheme); Shannon Raj, Note, *Blood Electronics: Congo's Conflict Minerals and the Legislation That Could Cleanse the Trade*, 84 S. CAL. L. REV. 981, 994–1000 (2011) (claiming that the government should have followed a customs-based approach similar to a Kimberley Process-style certification instead of using the SEC to enforce conflict minerals).

[255] G.A. Res. 55/56, U.N. Doc. A/RES/55/56 (Dec. 1, 2000).

[256] *See KP Basics*, KIMBERLEY PROCESS, http://www.kimberleyprocess.com/web/kimberley-process/kp-basics (last visited Mar. 8, 2013).

[257] *Id.*

[258] 19 U.S.C. § 3903(a) (2006).

[259] *See* Shannon K. Murphy, *Clouded Diamonds: Without Binding Arbitration and More Sophisticated Dispute Resolution Mechanisms, the Kimberley Process Will Ultimately Fail in Ending Conflicts Fueled by Blood Diamonds*, 11 PEPP. DISP. RESOL. L.J. 207, 218–

United States does not adequately enforce the CDTA or inspect diamond shipments under the Kimberley Process.[260] Global Witness, one of the advocates for the conflict minerals legislation and a co-nominee for the Nobel Prize for its work on conflict diamonds in 2003,[261] disassociated itself with the Kimberley Process in 2011 because the NGO determined that "[t]he Kimberley Process's refusal to evolve and address the clear links between diamonds, violence and tyranny has rendered it increasingly outdated."[262] Global Witness was particularly frustrated with the failure of the Kimberley Process in Venezuela, Cote d'Ivoire, and Zimbabwe, which it believed were still involved in inappropriate smuggling activities.[263]

At first blush, there is an appeal to rallying the world community to take action, particularly the European Union, which has not yet acted on conflict minerals legislation. While some action is better than none, the Kimberley Process and the CDTA have achieved less than optimal effectiveness.[264] Accordingly, there is no reason to believe that a multinational or customs-based regime modeled on existing schemes would be any more effective in enforcing a conflict minerals law.

D. Legal Challenges to the Law's Ultimate Success

In October 2012, the National Association of Manufacturers, Business Roundtable, and the Chamber of Commerce petitioned the D.C. Circuit for a review of the SEC's rule.[265] The parties argued, among other things, that the agency (1) failed to conduct an appropriate cost benefit

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20 (2011) (expressing concern over the voluntary nature of the Kimberley Process and the fact that countries face no repercussions for ignoring recommendations). *But see* Joseph Hummel, *Diamonds Are a Smuggler's Best Friend: Regulation, Economics, and Enforcement in the Global Effort to Curb the Trade in Conflict Diamonds*, 41 INT'L LAW. 1145, 1160 (2007) ("If a country does not comply with the Kimberley Process . . . , that country could be made subject to an investigation or face expulsion from certain diamond industry institutions.").

[260] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-978, CONFLICT DIAMONDS: AGENCY ACTIONS NEEDED TO ENHANCE IMPLEMENTATION OF THE CLEAN DIAMOND TRADE ACT 21 (2006).

[261] *Nobel Prize*, GLOBAL WITNESS, http://www.globalwitness.org/node/4097 (last visited Mar. 8, 2013).

[262] Press Release, Global Witness, Global Witness Leaves Kimberley Process, Calls for Diamond Trade to be Held Accountable (Dec. 5, 2011), *available at* http://www.globalwitness.org/sites/default/files/library/KPexity.pdf.

[263] *See id.*

[264] *See* Raj, *supra* note 254, at 997 ("In sum, without accountability, without a private right of action, and critically, without an independent monitoring system to ensure compliance, the Kimberley Process remains far less effective than it could and should be.").

[265] Petition for Review, Nat'l Ass'n of Mfrs. v. SEC, No. 12-1422 (D.C. Cir. Oct. 19, 2012).

analysis as required under the Administrative Procedures Act; (2) failed to exercise appropriate judgment by arbitrarily refusing to impose less burdensome requirements; (3) erroneously concluded that it could not create a de minimis exception to the rule; (4) created an unreasonably stringent "reasonable country of origin inquiry"; (5) should not have extended the rule to those who contract with others for the manufacture of products; (6) should have extended the same longer phase in period to larger companies as it did to smaller companies since the larger companies depend on smaller companies for disclosure purposes; and (7) created a rule that violated the First Amendment by requiring companies to stigmatize themselves by implicating themselves in human rights abuses.[266] An amicus brief filed by the author, Ambassador Jendayi Frazer, and Dr. Peter Pham argued that the law would negatively impact the Congolese people for many of the reasons stated in this Article, among others.[267] An industry coalition filed an amicus brief in support of the Petitioners citing examples of the kinds of problems caused by the failure to allow a de minimis exception and the lack of definitional certainty around certain terms both for themselves and their suppliers.[268] The SEC responded to the Petitioners and amici's arguments asserting that the agency does not have the authority to second guess congressional judgment about the humanitarian crisis in Congo or to propose alternatives that reduce costs that would undermine Congress's intent.[269]

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[266] Opening Brief of Petitioners at 23–24, *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Jan. 16, 2013).

[267] *See* Brief of *Amicus Curiae* Experts on the Democratic Republic of the Congo in Support of Petitioners, *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Jan. 23, 2013).

[268] *See* Industry Coalition Amici Brief in Support of Petitioners, *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Jan. 23, 2013).

[269] *See* Initial Brief of the SEC, Respondent 2–3. *Nat'l Ass'n of Mfrs.*, No. 12-1422 (D.C. Cir. Mar. 1, 2013). Nonetheless, as the Petitioner's Brief notes, the dissents of Commissioners Gallagher and Paredes during the rulemaking process belie this argument. *See* Opening Brief of Petitioners, *supra* note 266, at 22–23. Commissioner Gallagher stated, "The statutory framework that establishes the SEC's economic analysis obligations does not permit the agency to infer benefits." *Statement at SEC Open Meeting: Proposed Rule to Implement Section 1502 of the Dodd-Frank Act—the "Conflict Minerals" Provision by Commissioner Daniel M. Gallagher*, U.S. SEC. & EXCH. COMM'N (August 22, 2012), http://www.sec.gov/news/speech/2012/spch082212dmg-minerals.htm. In his dissent, Commissioner Paredes noted that "the agency still must base its final rule on a reasoned assessment that considers the potential consequences of its judgments. Otherwise, one cannot determine whether the rule is likely to do more good than harm." *Statement at Open Meeting to Adopt a Final Rule Regarding Conflict Minerals Pursuant to Section 1502 of the Dodd-Frank Act by Commissioner Troy A. Paredes*, U.S. SEC. & EXCH. COMM'N (August 22, 2012), http://www.sec.gov/news/speech/2012/spch082212tap-minerals.htm. As of the time of this writing, the case had not been decided.

Many companies, perhaps hoping that the two-year delay in implementation would lead to the law's demise or at least significant compromise, have made little to no effort to comply.[270] On the other hand, some companies have made significant progress in bringing transparency to mineral sourcing.[271] Many TNCs also participate in "the Public-Private Alliance for Responsible Minerals Trade, a joint initiative by the Department of State and the United States Agency for International Development (USAID), formed on November 15, 2011," to harmonize strategies between stakeholders in order to promote a conflict-free supply chain for minerals.[272]

Some TNCs are members of socially conscious industry groups such as the Electronics Industry Citizenship Coalition ("EICC")[273] and the Global e-Sustainability Initiative ("GeSI").[274] EICC and GeSI have been working toward developing industry-wide schemes to implement Section 1502. Because some of these member companies are simultaneously members of the Petitioners in the action for review of the conflict minerals legislation, organizations such as Global Witness have argued that their membership is at odds with their participation in addressing conflict minerals issues and have called on them to clarify their positions regarding the lawsuit.[275] As of the time of this writing, the D.C. Circuit Court had not ruled on the merits of the lawsuit, and affected companies were moving forward with the implementation of the rule's requirements.

In any event, corporations should expect questions about transparency in their supply chains because consumers, investors, and municipalities will continue to demand it regardless of the success of

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[270] SASHA LEZHNEV & ALEX HELLMUTH, ENOUGH PROJECT, TAKING CONFLICT OUT OF CONSUMER GADGETS: COMPANY RANKINGS ON CONFLICT MINERALS 2012, at 1 (2012), *available at* http://www.enoughproject.org/files/CorporateRankings2012.pdf.

[271] *Id.*

[272] *Launch of Public-Private Alliance for Responsible Minerals Trade*, U.S. INST. PEACE, http://www.usip.org/events/launch-public-private-alliance-responsible-minerals-trade (last visited Mar. 8, 2013).

[273] EICC is a coalition of electronics companies that works to improve social, environmental, and ethical responsibility. *About Us*, ELECTRONIC INDUSTRY CITIZENSHIP COALITION, http://www.eicc.info/about_us.shtml (last visited Mar. 8, 2013).

[274] GeSI provides "resources and best practices for achieving integrated social and environmental sustainability" to information and communication technology companies. *Overview*, GLOBAL E-SUSTAINABILITY INITIATIVE, http://gesi.org/About_ICT_sustainability (last visited Mar. 8, 2013).

[275] *Companies Must Take Clear Position on Legal Threat to Conflict Minerals Provision*, GLOBAL WITNESS (Nov. 14, 2012), http://www.globalwitness.org/library/companies-must-take-clear-position-legal-threat-conflict-minerals-provision.

Section 1502.[276] A number of cities and dozens of college campuses have indicated their "preference" to do business with companies that are "conflict-free" or to consider that status as a factor in purchasing.[277] The age of name-and-shame is clearly here to stay, and there will continue to be consequences in the human rights arena even beyond the Dodd–Frank Act.

CONCLUSION

Many well-meaning advocates in civil society and Congress have tried to bring attention to the deadliest conflict since World War II for years but to no avail. Perhaps faced with no other options to get the world's attention, the NGO community has done an effective job of repackaging the crisis in the Congo into a simple narrative of rape as a weapon of war perpetrated by rebels, fueled by consumer demand for electronics, and funded by corporations buying minerals.[278] This oversimplified narrative has led to a number of proposed "solutions," one of which is the well-intentioned, but misguided, Dodd–Frank conflict minerals legislation. Fortunately, those NGOs and legislators have not given up on other proposals, and they argue that, while the Dodd–Frank Act may not be perfect, at least it is a start. NGOs know that reputation-sensitive corporations that spend millions building their brands can ill-afford to be affiliated with rebel forces raping innocent women and children.

Whether a firm's board of directors uses a shareholder or stakeholder view, it must conduct a cost–benefit analysis, even if, as the petitioners who have filed suit against the SEC allege, the agency failed

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[276] Even if the litigation does not succeed, the President may also terminate the requirements of Section 1502 after 2015 upon a determination "that no armed groups continue to be directly involved and benefitting from commercial activity involving conflict minerals." 15 U.S.C. § 78m(p)(4) (Supp. V 2011).

[277] Pittsburgh, Pennsylvania; Edina, Minnesota; and St. Petersburg, Florida, have passed conflict-free city resolutions indicating their preference to buy from companies that have conflict-free products. *Conflict-Free Cities*, RAISE HOPE FOR CONGO, http://www.raisehopeforcongo.org/content/conflict-free-cities (last visited Mar. 8, 2013). A number of colleges have also passed resolutions or made public statements that they have a preference for purchasing from companies that have conflict-free products, but they have not made divestment decisions yet. *Participating Schools*, RAISE HOPE FOR CONGO, http://www.raisehopeforcongo.org/content/participating-schools (last visited Mar. 8, 2013). It remains to be seen what effect the official conflict minerals reports will have on the university investment decisions once those are released.

[278] *But see* Séverine Autesserre, *Dangerous Tales: Dominant Narratives on the Congo and Their Unintended Consequences*, 111 AFR. AFF. 202, 204 (2012) ("While . . . the interveners had good reasons for adopting dominant, simple narratives, and for focusing on three of them [illegal exploitation of resources, sexual abuse, and extension of state authority], . . . this adoption had some positive results, but was damaging overall.").

to thoroughly conduct its own. Under a more restrictive shareholder view, reasonable board members may seek to source minerals elsewhere as they consider the actual monetary costs of compliance; the legal risks related to ensuring that agents conform to their mandates related to the FCPA, the U.K. Bribery Act, and Section 1504 of the Dodd–Frank Act; and the calls for greater transparency from socially responsible investors.

Under a more expansive stakeholder view, looking at the affected community of the local Congolese, the firm needs to ask itself a few questions. Assuming that consumers will pay attention to the disclosures and will actually change their purchasing decisions (and that is not at all clear), can the firm withstand a boycott? What will the reputational risk be to the CSR program? Is it more socially responsible to source minerals in the Congo and to try to solve an intractable crisis that the international community seems unable or unwilling to resolve when the evidence shows that the legislation has already had adverse effects and the corruption leaves doubts as to the viability of the process? Will the firm become complicit in the human rights crisis, given the evidence that civilians, members of the military, the police force, and the rebels participate in rape, looting, and violence and that members of the military also profit from trafficking in minerals? Is the socially responsible action to source the minerals from other countries even if it devastates the livelihoods of local Congolese if the companies no longer source their minerals from the DRC?

The final question is for Congress and the SEC. Is a corporate governance disclosure the right solution to a human rights crisis? Here the government has asked the SEC to address a geopolitical agenda that it is not equipped to manage.[279] While well-intentioned members of Congress capitalized on the Dodd–Frank Act to pass their stand-alone bills on conflict minerals, they would have better served the Congolese by focusing on true implementation of the DRC Act, which most of the NGOs advocating for the Dodd–Frank Act would have preferred. Delaying the implementation of the Dodd–Frank Act would be the responsible and humane thing to do given what is at stake. The delay would allow time for: (1) an appropriate cost–benefit analysis; (2) the European Union and Canada to develop their own parallel legislation; and (3) a re-evaluation to be conducted with the input of affected groups in the Congo. If the court allows the law to stand as it is, this law will

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[279] *See generally* Celia R. Taylor, *Conflict Minerals and SEC Disclosure Regulation*, 2 HARV. BUS. L. REV. ONLINE 105 (2012), http://www.hblr.org/wp-content/uploads/2012/01/Taylor-Conflict-Minerals.pdf (discussing the role of disclosure regulation and why the Dodd–Frank Act goes too far).

not "save lives" as Senator Brownback had hoped. To the contrary, it may continue to cost both livelihoods and lives.

SEVEN WAYS TO STRENGTHEN AND IMPROVE THE L3C

*Cassady V. ("Cass") Brewer**

INTRODUCTION

The *raison d'être* for the low-profit limited liability company ("L3C") is to encourage program-related investments ("PRIs") by private foundations.[1] PRIs are special types of investments that can be both charitable and profitable.[2] A classic example of a PRI is a low-interest rate loan made by a private foundation to spur economic growth in an economically depressed community.[3] Due to certain tax risks and added compliance burdens, PRIs remain underutilized.[4] One report indicates that during the 2006–2007 timeframe, PRIs amounted to less than one percent of charitable dollars distributed by U.S. private foundations.[5] Nevertheless, knowledgeable scholars, practitioners, and foundation managers believe that encouraging PRIs is a laudable goal,[6] and apparently even the U.S. Department of the Treasury agrees, as evidenced by recently issued regulations with new examples of PRIs.[7] Thus, the L3C would seem to be in the right place at the right time and should have the full support of the charitable sector, practitioners, and lawmakers.

Yet, after a fast start, adoption of L3C legislation across the United States has stalled.[8] In fact, at least eighteen states have considered the

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1 Professor Carter Bishop is credited for coining this very apt phrase in describing the purpose of the L3C. *See* Carter G. Bishop, *Sectorization & L3C Regulatory Arbitrage of Joint Ventures with Nonprofits* 5 (Suffolk Univ. Law Sch. Legal Studies Research Paper Series, Research Paper No. 12-19, 2012), *available at* http://ssrn.com/abstract=2045034.

2 *See* I.R.C. § 4944(c) (2006).

3 *See* Treas. Reg. § 53.4944-3(b) ex. 1 (1973).

4 Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 257–59 (2010).

5 Steven Lawrence, *Doing Good with Foundation Assets: An Updated Look at Program-Related Investments*, *in* THE PRI DIRECTORY, at xiii, xiii (3d ed. 2010), *available at* http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf.

6 *See, e.g.*, Ofer Lion & Douglas M. Mancino, *PRIs—New Proposed Regulations and the New Venture Capital*, 24 TAX'N EXEMPTS, Sept.–Oct. 2012, at 3, 3.

7 Prop. Treas. Reg. § 53.4944-3(b) exs. 11–19, 77 Fed. Reg. 23,430, 23,430–32 (Apr. 19, 2012).

8 Vermont was the first state to adopt L3C legislation in 2008. AMS. FOR CMTY. DEV., WHAT IS THE L3C? (2011), *available at* http://americansforcommunity development.org/downloads/What%20is%20the%20L3C%20080711-1.pdf. By 2010, seven more states had authorized L3Cs. *Id.* Then, in 2011, Rhode Island became the ninth state

L3C and deferred passing legislation.[9] Many highly regarded scholars and practitioners adamantly oppose the L3C, even though those scholars and practitioners generally endorse PRIs.[10] The ABA Business Law Section's Committee on Limited Liability Companies, Partnerships, and Unincorporated Entities and Committee on Nonprofit Organizations jointly oppose L3Cs.[11] Going even further, the North Carolina Bar is advocating repeal of its state's L3C statute.[12] This strong opposition and inconsistent pattern of adoption of L3C legislation contrasts sharply with the virtually uniform adoption of limited liability company ("LLC") and limited liability partnership legislation roughly twenty years ago.[13] Moreover, despite a later start, legislation authorizing the formation of another type of "social enterprise"[14] entity, the benefit corporation, has been enacted by twelve states and the District of Columbia[15] and rapidly appears to be gaining traction in many other jurisdictions.[16]

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to adopt L3C legislation. *Id.*; *see also Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, L3C (Jan. 18, 2013), http://www.intersectorl3c.com/l3c_tally.html (reporting the number of L3Cs organized in each state). As of the date of publication of this Article, no other states have adopted L3C legislation since Rhode Island in 2011. *See id.*

[9] *See* Carter G. Bishop, *Fifty State Series: L3C & B Corporation Legislation Table* 57 (Suffolk Univ. Law Sch. Legal Studies Research Paper Series, Research Paper No. 10-11, 2013), *available at* http://ssrn.com/abstract=1561783.

[10] *See, e.g.*, Bishop, *supra* note 4, at 244, 26; J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 274 (2010); Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 909 (2010).

[11] Letter from Linda J. Rusch, Chair, Am. Bar Ass'n Bus. Law Section, to Steve Simon, Assistant Minority Leader, Minn. House of Representatives (Apr. 19, 2012), *available at* http://ssrn.com/abstract=2055823.

[12] Email from Warren P. Kean, Chair, N.C. Bar Ass'n Joint Task Force on Ltd. Liab. Cos., to William J. Callison (Oct. 14, 2012, 1:16 PM) (on file with the Regent University Law Review).

[13] *Compare* Letter from Linda J. Rusch, *supra* note 11 (arguing against the enactment of L3C legislation), *with* Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1065 (1995) (noting the rapid adoption of LLP statutes), *and* Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 1 (1995) (noting the rapid adoption of LLC legislation and the uniformity of the state statutes).

[14] "Social enterprise" has no legally recognized definition, but it can loosely be described as "using traditional business methods to accomplish charitable or socially beneficial objectives." Cassady V. ("Cass") Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (a/k/a "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2012); *see generally* J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012).

[15] *State by State Legislative Status*, BENEFIT CORP INFO. CTR., http://www.benefitcorp.net/state-by-state-legislative-status (last visited Mar. 11, 2013).

[16] *See id.* (noting other states have introduced benefit corporation legislation).

Why is L3C legislation languishing? Because the L3C suffers from the following fundamental defects: (1) except in name, the L3C is indistinguishable from a regular LLC; (2) without any type of statutory enforcement mechanism, the L3C lacks accountability and transparency; and (3) the L3C promises more than it can deliver absent new federal legislation, thus failing its essential purpose of encouraging PRIs. Under current law, the L3C is nothing more than a brand,[17] and even that brand lacks any type of independent certification or approval process.[18] Thus, the L3C lacks credibility, and, unless improvements to its statutory framework are made, the L3C is not likely to gain much acceptance or use.

Given its defects, opponents argue that the L3C should be abolished.[19] These opponents rightly point out that regular LLCs are more than sufficient to accommodate PRIs.[20] Therefore, there is no need for the L3C, so the form is confusing at best and misleading and harmful at worst. Thus, the opponents maintain that the L3C is a well-intentioned but nonetheless failed experiment that should be abandoned.[21]

Even though the author generally agrees with the opponents' assessment of the L3C *in its current form*, the L3C should not be abandoned. The L3C is salvageable if the current statutory framework is strengthened and improved. To survive, the L3C must become substantively distinguishable from a regular LLC. Further, the L3C must become substantively distinguishable in a manner uniquely suited to its use by tax-exempt organizations, especially as a vehicle for PRIs. If the L3C becomes more than just a brand, then perhaps the L3C can fulfill its *raison d'être*.

With the foregoing premise in mind, this Article proposes seven relatively simple but impactful changes to the L3C statutory framework. These seven changes are designed to strengthen and improve the L3C

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[17] On the other hand, John Tyler has persuasively argued that the L3C does indeed change the law regarding fiduciary duties among managers and members of an LLC and that the L3C, therefore, is useful in this regard even if it may be no better than a regular LLC for accommodating PRIs. *See* John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 121–22, 146–53 (2010). The author agrees with Mr. Tyler, but, in the author's opinion, a carefully crafted operating agreement for a regular LLC likewise could modify fiduciary duties among managers and members, thus eliminating even this distinction.

[18] *See* Callison & Vestal, *supra* note 10, at 291.

[19] *See* Kleinberger, *supra* note 10, at 893–910.

[20] *See, e.g.*, David S. Chernoff, *L3Cs: Less There than Meets the Eye*, TAX'N EXEMPTS, May–June 2010, at 3, 4–5.

[21] *See* Bishop, *supra* note 4, at 243–46; Callison & Vestal, *supra* note 10, at 291–92; Kleinberger, *supra* note 10, at 881.

with respect to its use by tax-exempt organizations, including but not limited to its use for PRIs. If the changes proposed herein are adopted in future L3C legislation, then the L3C potentially could become *both* a brand and a valued tool for tax-exempt organizations and PRIs.

SEVEN PROPOSED CHANGES FOR L3CS

The seven proposed changes to the L3C statutory framework are as follows:

1. First and foremost, require every L3C to have at least one bona fide economic member that is a qualified tax-exempt charitable or educational organization within the meaning of I.R.C. § 501(c)(3).
2. Related to the first change, make a technical but important correction to the L3C statutes to clarify that only "one or more limited liability company interests" must be charitable in nature, not the entire company as currently stated in the existing L3C-enabling legislation.[22]
3. Similar to reporting obligations imposed by federal law upon I.R.C. § 501(c)(3) organizations,[23] require L3Cs to report their PRIs (including detailed financial information) on an I.R.S.-approved information return that must be made public.
4. Similar to requirements imposed by state law upon many nonprofits, require L3Cs to register under state charitable solicitation acts.[24]
5. Similar to requirements imposed by state law upon many nonprofits, require L3Cs with certain minimum revenues or assets (for example, one million dollars) to obtain annual, audited financial statements and provide those statements to the state agency responsible for regulating nonprofits.[25]
6. Provide a "free transferability" default rule for L3Cs so that a tax-exempt member may assign its membership interest at any time, with the exempt member's transferee being automatically admitted as a substitute member with full economic and membership participation rights in the L3C.
7. Provide a default rule so that at any time and for any reason a tax-exempt member unilaterally may withdraw from an L3C, whereupon the L3C must repay the exempt member's unreturned capital contribution (unless the L3C is

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[22] *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(B) (2010).

[23] *See* I.R.C. § 6033(a)–(b) (2006 & Supp. IV 2010).

[24] *See, e.g.*, GA. CODE ANN. § 43-17-5(b) (2011).

[25] *See, e.g., id.* § 43-17-5(b)(4).

simultaneously liquidated, in which case the exempt member would participate in the liquidating proceeds).

The foregoing seven proposed changes are explained in greater detail below.

1. Require Every L3C to Have at Least One Tax-Exempt Member

The Vermont L3C statute, which is typical of statutes in other adopting states,[26] imposes the following special requirements in order for a regular LLC to be formed and qualify as an L3C:

- *Charitable or Educational Purpose*: The L3C must further the accomplishment of a charitable or educational purpose within the meaning of I.R.C. § 170(c)(2)(B).
- *"But For" Relationship to Charitable or Educational Purpose*: But for its relationship to the accomplishment of a charitable or educational purpose, the L3C would not be formed.
- *Production of Income or Appreciation of Property Not a Significant Purpose*: The production of income or the appreciation of property must not be a significant purpose of the L3C.
- *No Political Campaign Activity and No Lobbying*: The L3C must not engage in political or lobbying activity within the meaning of I.R.C. § 170(c)(2)(D).[27]

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[26] *See, e.g.*, ME. REV. STAT. ANN. tit. 31, § 1611 (2011); R.I. GEN. LAWS § 7-16-76 (Supp. 2012).

[27] VT. STAT. ANN. tit. 11, § 3001(27). Specifically, the Vermont statute defines a "low-profit limited liability company" as follows:

> (A) The company:
>
> (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and
>
> (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
>
> (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
>
> (C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D).
>
> (D) If a company that met the definition of this subdivision (27) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit limited liability company, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company. The name of the company must be changed to be in conformance with subsection 3005(a) of this title.

The foregoing state-law requirements for L3Cs are intended to dovetail with the unique federal income tax rules defining a valid PRI. As mentioned above, PRIs[28] are special types of charitable, yet potentially profitable, investments made by I.R.C. § 501(c)(3) tax-exempt private foundations.[29] The purpose of the federal income tax rules defining and limiting PRIs is to ensure that private foundation dollars are used consistently with their tax-exempt status.[30] In other words, even though a PRI is an *investment* by a private foundation, the primary motive behind the investment must be charitable or educational, not the potential for profit. Moreover, the invested funds must not be used for political or lobbying activities because private foundations essentially are prohibited from engaging in such activity directly.[31]

Id.

[28] *See generally* Lion & Mancino, *supra* note 6, at 3 (explaining the usefulness of PRIs for private foundations under new proposed regulations).

[29] Organizations that are organized and operated exclusively for charitable, religious, educational, or other specified purposes are generally exempt from federal income tax under I.R.C. § 501(a) as organizations described in I.R.C. § 501(c)(3). I.R.C. § 501(a) (2006). I.R.C. § 509(a) divides I.R.C. § 501(c)(3) organizations into two subcategories: private foundations and organizations that are not private foundations, which are commonly known as public charities. *See id.* § 509(a). To be categorized as a public charity, and not a private foundation, an organization must be described in I.R.C. § 509(a). *Id.* To be described in I.R.C. § 509(a)(1) or (2), an organization must receive a substantial amount of broad-based public support to fund its operations. I.R.C. § 509(a)(1) and (2) contain certain rules that test whether an organization's support is broad-based and, therefore, "public." *Id.* § 509(a)(1)–(2). To be described in I.R.C. § 509(a)(3), an organization must have a particular type of structural relationship with a publicly supported § 501(c)(3), (4), (5) or (6) organization. *See id.* § 509(a).

[30] *See* Treas. Reg. § 53.4944-3 (1973).

[31] Regarding the general requirements for PRIs, see I.R.C. § 4944(c) and Treas. Reg. § 53.4944-3(a). Regarding the limitations upon and excise taxes imposed with respect to political and lobbying expenditures by private foundations, see I.R.C. §§ 501(c)(3), 4945(d). Paradoxically, if a private foundation makes an investment that expressly is not a PRI but instead is an investment intended to make a profit as part of the foundation's regular endowment, there is no prohibition on the issuer's use of all or a portion of the invested funds to engage in lobbying or political campaign activity. (As would almost always be the case, the immediately preceding sentence assumes that the private foundation's invested funds are to be used for general corporate purposes and are not earmarked for political or lobbying expenditures.) Thus, a private foundation could purchase newly issued IBM preferred stock as a part of the private foundation's regular endowment, yet IBM would not be prohibited from using all or part of the investment proceeds to engage in lobbying or political campaign activity. This is true even though the private foundation itself would face a heavy excise tax and possible loss of exempt status if it used the same dollars to engage in lobbying or political campaign activity. In the author's view, this odd result is illustrative of a fundamental disconnect within all of the excise tax rules applicable to private foundations. That is, the excise tax rules are based upon the assumption that, from a financial standpoint, every private foundation does and should operate paradoxically. In other words, the excise tax rules presume that a private foundation's endowment funds will be invested exclusively and entirely to make a profit by any legitimate means necessary,

Neither federal law nor state L3C statutes, however, require an L3C to have an I.R.C. § 501(c)(3) tax-exempt organization as a member,[32] even though the L3C should not have been formed "but for" its relationship to the accomplishment of a federally defined charitable or educational purpose.[33] Further, except perhaps in Illinois where L3Cs are subject to the Illinois Charitable Trust Act and Attorney General supervision,[34] there is no governmental or other enforcement mechanism in place to hold L3Cs accountable against a stated charitable or educational purpose.[35] Thus, unscrupulous founders could form an L3C to masquerade as charitable or educational even though their true purpose is purely profit-taking for their own private benefit. This lack of an enforcement mechanism and potential for abuse has led many state regulators and leaders of some nonprofit organizations to oppose the L3C.[36]

On the other hand, if an L3C were required to have an I.R.C. § 501(c)(3) tax-exempt organization as an economic member, then an

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but then the private foundation annually must give away (that is, grant) at least five percent of those assets to charitable organizations and pursuits. Private foundations do indeed operate financially in this schizophrenic manner. Their endowment assets typically are invested with a myopic focus upon profit only so that they can give away a portion of the assets in their charitable mission. Federal tax law encourages this arguably nonsensical behavior. For example, nothing in federal tax law prohibits a private foundation with a mission of promoting healthcare from investing in publicly traded tobacco companies, so long as that investment is sound from a purely investment management standpoint. If, however, the same private foundation desires to invest in a risky, privately held start-up company developing a safe cigarette, the foundation could be hit with an excise tax and possibly even lose its exempt status unless the investment qualifies as a PRI. *See id.* § 4944(c). Again, this odd tax regime that encourages conflicting uses of a private foundation's assets does not make sense, but it clearly is the law.

[32] *See* I.R.C. § 4944(c); Treas. Reg. § 53.4944-3(a); *see also, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27) (2010).

[33] *See, e.g.*, R.I. GEN. LAWS § 7-16-76(a) (Supp. 2012); VT. STAT. ANN. tit. 11, § 3001(27)(A)(ii).

[34] *See* 805 ILL. COMP. STAT. 180/1-26(d) (2010). The Illinois statute goes too far by imposing trustee-like fiduciary duties on managers and officers of an L3C. *See id.* That approach might be appropriate if an L3C was itself intended to be a charitable organization, but that is not the intended purpose of an L3C. Instead, the L3C is intended to be an *instrument* through which charitable purposes indirectly may be accomplished, not a charitable organization directly engaged in charitable activities.

[35] *Compare, e.g., id.* (requiring officers, managers, and directors to have trustee duties to pursue the charitable or educational purpose), *with* VT. STAT. ANN. tit. 11, § 3001(27) (lacking an enforcement mechanism to ensure that the L3C pursues a charitable or educational purpose).

[36] *See, e.g.*, Chernoff, *supra* note 20; Letter from Chris Cash, President, Nat'l Ass'n of State Charity Officials, to Senator Max Baucus & Senator Charles Grassley (Mar. 19, 2009), *available at* http://data.opi.mt.gov/legbills/2009/Minutes/Senate/Exhibits/jus65b04.pdf.

evolving body of federal tax law would force the exempt member to exercise some degree of control over the L3C, thereby safeguarding the L3C's charitable or educational purpose. This evolving body of law consists of a number of cases and several published I.R.S. rulings defining and constraining the use of LLCs by exempt organizations in joint ventures and so-called "ancillary" joint ventures.[37]

As a preliminary matter, note that the joint venture and ancillary joint venture rules presumably apply only if the tax-exempt organization is an *economic* member of an L3C (or LLC).[38] An L3C, like an LLC, generally permits members to have at least two distinct bundles of rights with respect to their membership interest. Members have an economic interest—the right to allocations and distributions of cash or other property from the L3C—*and* members have a participation interest—the right to information and to consent or object to certain actions.[39] Most often, members of an LLC or L3C have both an economic interest and a participation interest, but it is possible to have one type of interest without the other. If a tax-exempt member only had a participation interest in an LLC or L3C without having an economic interest, then theoretically the joint venture and ancillary joint venture rules would not be implicated. The joint venture rules presumably would not be implicated because the tax-exempt organization would have no charitable assets or property rights at risk via the LLC or L3C. The author is not aware of any I.R.S. guidance regarding a tax-exempt organization holding only participation rights in an LLC, but it is certainly true that the joint venture and ancillary joint venture rules were developed to protect a tax-exempt organization's charitable assets, property rights, and activities from improperly benefiting private interests.[40] Thus, it generally should be necessary for a tax-exempt organization to have an *economic* interest in an LLC or L3C in order to bring into play the rules developed by the cases and I.R.S. rulings regarding joint ventures with tax-exempt organizations.

A full discussion of tax-exempt joint venture cases and I.R.S. rulings is beyond the scope of this Article, but in general they establish the

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[37] *See* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.09 [2][b]–[c] (2012) (discussing the use of LLC by exempt organizations for joint ventures and ancillary joint ventures).

[38] *See id.* ¶ 1.09, 1.09[2][d].

[39] *Id.* ¶ 8.06[1][a] (2012).

[40] *See, e.g.*, Rev. Rul. 2004-51, 2004-1 C.B. 975, 975–76 (attributing "insubstantial" activities of an ancillary LLC joint venture to an exempt member to determine the effect on the tax-exempt status of a member); Rev. Rul. 98-15, 1998-1 C.B. 718, 719–20 (attributing "substantial" activities of a whole hospital LLC joint venture to exempt a member to determine the effect on the tax-exempt status of the member).

following guidelines[41]: If a "substantial" part of an I.R.C. § 501(c)(3) tax-exempt organization's[42] activities and assets are held through an LLC, then the LLC must further an exempt purpose *and* the exempt member must retain control over the LLC.[43] Otherwise, the tax-exempt member seriously risks losing its I.R.C. § 501(c)(3) status.[44] In fact, for "substantial" activities and assets held through an LLC, the exempt member must possess control even if the assets contributed to the LLC by the exempt member are proportionately less than assets contributed by non-exempt members.[45]

On the other hand, if an "insubstantial" part of an I.R.C. § 501(c)(3) tax-exempt organization's activities and assets are held through an LLC, then the organization generally can maintain its exempt status without retaining control over the LLC.[46] Upon a finding of an "insubstantial" interest in an LLC, a secondary analysis then applies. If the "insubstantial" activity conducted through the LLC is related to the member's exempt purpose, then the income generated by the LLC typically will not be taxable as unrelated business income.[47] If the "insubstantial" activity conducted through the LLC is unrelated to the member's exempt purpose, then the income may be taxable as unrelated business income depending upon the nature of the income and the application of numerous other technical rules.[48]

Caveat: Even in connection with an "insubstantial" activity conducted through an LLC, if the value of the assets contributed to the LLC by the exempt organization member is proportionately greater than the value of the assets contributed by non-exempt members, to safeguard I.R.C. § 501(c)(3) status, the exempt member should retain control over the LLC.[49] If the exempt member contributes proportionately greater value than other non-exempt members but does not retain control over the LLC, the I.R.S. may challenge the arrangement as constituting

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41 *See generally* BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09. The use of the word "guidelines" here is intentional. There are no hard and fast rules in this area, and, as noted by the commentators, the I.R.S. historically has taken inconsistent positions. *Id.* ¶ 1.09[2].

42 This summary excludes discussion of private foundations because they are subject to separate rules—the excess business holdings rules—that severely limit a private foundation's ability to invest in an arrangement that even remotely resembles a "joint venture" or even an "ancillary joint venture." *See* I.R.C. § 4943 (2006).

43 *See* Rev. Rul. 2004-51, 2004-1 C.B. 975; Rev. Rul. 98-15, 1998-12 C.B. 718.

44 Rev. Rul. 2004-51, 2004-1 C.B. 975.

45 *See* Rev. Rul. 98-15, 1998-12 C.B. 718, 721.

46 *See id.*

47 *See* Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) (as amended in 2008).

48 *Id.* § 1.501(c)(3)-1(e).

49 *See* BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[2][c][iii].

impermissible private benefit even when the LLC's activity is "insubstantial" with respect to the exempt member.[50]

The preceding paragraph describes the I.R.S.'s position with respect to "insubstantial" activities conducted through an LLC, but the law is not settled. An exempt member could take a more aggressive but supportable position that, even where it contributes a proportionately greater share of the LLC's assets, the exempt member is not required to retain control for an "insubstantial" activity conducted through an LLC.[51] This is a potentially dangerous position to take, however, because, as noted above, the I.R.S. may challenge the member's tax-exempt status.[52]

To complicate matters more, for purposes of the above general guidelines, there is no clear definition of when an exempt organization's activities and assets held through an LLC are considered "substantial" versus "insubstantial."[53] If the question is litigated, the "substantial" versus "insubstantial" dividing line apparently is open to interpretation and hindsight by the I.R.S. and the courts. Thus, the uncertainty both as to whether an exempt member of an LLC must have control and whether its activities and assets held through an LLC are "substantial" or "insubstantial" makes tax-exempt joint ventures and ancillary joint ventures extremely delicate undertakings.[54]

Moreover, just to muddy the waters further, it is well established that, as part of its regular endowment management, an exempt organization may hold passive investments in an LLC similar to passively holding corporate stock.[55] Such passive investment, certainly if it is only a small fraction of an exempt organization's assets, apparently is not considered by the I.R.S. to be subject to the joint venture or ancillary joint venture rules.[56] Presumably such passive investment in

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[50] *See* St. David's Health Care Sys. v. United States, 349 F.3d 232, 239 (5th Cir. 2003) ("[W]hen a non-profit organization forms a partnership with a for-profit entity, the non-profit should lose its tax-exempt status if it cedes control to the for-profit entity."); Redlands Surgical Servs. v. Comm'r, 113 T.C. 47, 92–93 (1999) (holding a non-profit organization under I.R.C. § 501(c)(3) did not operate "exclusively for exempt purposes . . . by ceding effective control over its operations to for-profit parties" because it "impermissibly serve[d] private interests").

[51] BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[2][c][iii].

[52] *See id.* (providing a thorough discussion of the guidelines for tax-exempt members of LLC joint ventures).

[53] *Id.* ¶ 1.09[2][d].

[54] *See id.*

[55] *See* Trinidad v. Sagrada Orden, 263 U.S. 578, 582 (1924); BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[1][c][i]–[ii].

[56] *See* I.R.C. § 512(b)(13) (2006); BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[1][d][v].

an LLC is not a "joint venture" even though the LLC generally would be treated as a partnership for tax purposes.[57] Put differently, as far as the author is aware, there is no clear rule as to when a passive investment in an LLC either is so large or borders so closely on being "active" that the joint venture rules are implicated.[58]

Given all of this uncertainty in the law and given the potential threat to exempt status, any I.R.C. § 501(c)(3) organization with an economic interest in an L3C would insist upon exerting substantial influence over the L3C to safeguard the organization's exempt status. Arguably, this influence by any I.R.C. § 501(c)(3) member would result in L3Cs truly behaving differently in commerce, rather than just pretending to be charitable or educational as a marketing ploy. In effect, requiring at least one I.R.C. § 501(c)(3) member of any L3C would result in indirect regulation of the L3C due to the I.R.S.'s direct regulation of the tax-exempt member of the L3C. This indirect regulation would bring credibility to the L3C.

Lastly, if an I.R.C. § 501(c)(3) tax-exempt member of an L3C is a private foundation, then unless the investment is merely part of the private foundation's normal endowment assets—like an investment-grade real estate LLC or a bona fide hedge fund LLC—the restrictive PRI rules also would come into play. The PRI rules (at least insofar as the private foundation's investment was intended to qualify as a PRI) would require the L3C to use the private foundation's investment for charitable or educational purposes, to report annually on the expenditure of the investment, and to refrain from using the investment for political or lobbying activity. Again, this additional layer of indirect regulation would add credibility to a PRI-motivated L3C.

2. Correct a Technical Flaw in the L3C Statutes

As has been noted by the critics, if the L3C's *raison d'être* is to facilitate PRIs, then the L3C legislation arguably contains a technical flaw.[59] Specifically, the L3C statutes uniformly provide that the "company" must "further[] the accomplishment of one or more charitable or educational purposes within the meaning of [I.R.C.] Section 170(c)(2)(B)."[60] The regulations defining PRIs, however, only require that the "investment[]"—not the company—have "the primary

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[57] *See* Thompson v. United States, 87 Fed. Cl. 728, 738–39 (2009); Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 LOY. U. CHI. L.J. 55, 62 n.38, 87–88 (1993).

[58] *See* BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[2][d].

[59] *See, e.g.*, Kleinberger, *supra* note 10, at 908.

[60] *See id.* at 882–83.

purpose . . . to accomplish one or more of the [charitable or educational] purposes" within the meaning of I.R.C. § 170(c)(2)(B).[61] If, as the enabling statutes seem to state, the entire L3C must fulfill a charitable or educational purpose, then that would run counter to the notion that the company as a whole may pursue a pure profit-making activity. It is absolutely clear, though, that a private foundation can make an investment into a pure profit-making enterprise—such as an established, publicly traded company that is "financially secure"—and that, under the right circumstances, such an investment may qualify as a PRI.[62] Similarly, the entire L3C should not be required by statute to further a "charitable or educational" purpose. Rather, it would be more accurate to require only that one or more investments (that is, membership interests) in the L3C must further a "charitable or educational" purpose.

This technical glitch in the L3C statutes should be corrected, and the correction is an easy one. In particular, in each case where the L3C statutes provide that the "company" must further a charitable or educational purpose,[63] the language should be revised simply to state that "one or more low-profit limited liability company interests in the company" must further a charitable or educational purpose. This change in the statutory language would align the L3C more closely with its *raison d'être* of facilitating PRIs. Furthermore, because under most state statutes LLCs may pursue any "lawful purpose" (not just a "business purpose"), one could still form an L3C (or for that matter a regular LLC) that is 100% focused upon charitable or educational pursuits. Put differently, fixing the technical flaw in the statutes would more closely align the L3C with the requirements for PRIs without compromising the ability to use an L3C *entirely* for charitable or educational activities. Thus, a tax-exempt hospital or school might choose to use a wholly owned L3C or a joint venture L3C to conduct some of its charitable activities without regard to the L3C's particular suitability for PRIs and without any particular membership interest qualifying as a PRI (because PRIs are endemic to private foundations only).

3. Require L3Cs to Report Their PRIs (if Any)

Another way to add credibility to the L3C, as well as to PRIs generally, would be to require any entity that receives PRI funds

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[61] I.R.C. § 4944(c) (2006); *see also id.* § 170(c)(2)(B).

[62] *See* Treas. Reg. § 53.4944-3(b) ex. 5 (2012) (discussing the use of a below market-rate interest loan to induce a "financially secure" public company to establish a new plant in a deteriorated urban area).

[63] *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(B) (2010).

(whether via equity, loan, or loan guaranty) to disclose and report annually to the I.R.S. the terms and conditions and financial performance of the PRI. Such I.R.S. information reporting, similar to reporting already done by entities taxed as partnerships and S corporations,[64] could be accomplished via a separate schedule required to be included with the PRI recipient's regularly filed income tax return. This schedule also could be required to be made available for public inspection, similar to the annual I.R.S. Form 990 filed by tax-exempt organizations.[65]

Proposed federal legislation, introduced in Congress on November 14, 2011, by Representative Aaron Schock of Illinois, took just such an approach with respect to information-reporting for PRIs.[66] In particular, the Philanthropic Facilitation Act ("Act") proposed a process, similar to the process used for applying for and obtaining tax-exempt status, to pre-clear an entity to accept PRIs.[67] Under the procedure established by the Act, an intended PRI recipient would apply to the I.R.S. for approval to receive such investments.[68] Upon approval, the I.R.S. would issue an official determination that the applicant presumptively qualifies to receive PRIs.[69] A safe harbor, thereby, would be established so that an investing private foundation would have some assurance from the I.R.S. that the foundation's investment qualifies as a PRI.[70]

The Act also would have created a new I.R.C. § 6033A that would require each recipient of a PRI to report the following information to the I.R.S. on a to-be-developed tax return: (1) the recipient's gross income for the year; (2) the recipient's expenses for the year; (3) the recipient's charitable, educational, or other similar disbursements for the year; (4) a balance sheet; (5) a list of each private foundation holding a PRI in the recipient; (6) the portion of the recipient's capital obtained via the PRI; (7) the amounts paid (such as interest, dividends, or distributions, if any) with respect to each PRI; and (8) any additional information (if any) required by the expenditure responsibility rules.[71] This last requirement

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64 *See* I.R.C. §§ 6031, 6037.

65 *See id.* § 6033.

66 Philanthropic Facilitation Act, H.R. 3420, 112th Cong. §§ 4–5 (2011).

67 *Compare id.* (proposing that organizations provide a balance sheet and information necessary for public disclosure), *with* INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, NO. 17132z, INSTRUCTIONS FOR FORM 1023, at 5, 13 (rev. June 2006) (requiring organizations applying for charitable exempt status to provide a balance sheet and information necessary for public disclosure).

68 H.R. 3420 § 2(3).

69 *Id.*

70 *Id.*

71 *Id.* § 4.

would allow the annual information return provided by the recipient to satisfy the obligation of each investing private foundation to report on the PRI under the expenditure responsibility rules of I.R.C. § 4945.[72]

Unfortunately, this bill was referred to the Ways and Means Committee and never taken up again.[73] Perhaps asking the I.R.S. to pre-clear an entire enterprise to receive PRIs is overreaching. Under the regulations, every PRI requires a detailed facts and circumstances analysis with respect to the particulars of the investment itself, not the activities of the whole enterprise. On the other hand, in the author's opinion, there is at least some chance that a more rigorous PRI reporting and disclosure regime, such as that contained within the Act, would be practical and could be approved by the IRS and therefore enacted by Congress. This limited but practical reporting and disclosure regime would promote transparency and accountability not only for L3Cs, but for any entity that accepts PRI funds.

4. Require L3Cs to Register Under State Charitable Solicitation Acts

Most jurisdictions already require charities that solicit contributions in the state to register with a designated state agency.[74] For example, subject to certain exceptions, the Georgia Charitable Solicitations Act requires all individuals and organizations that solicit contributions from the public for charitable purposes to register with the Georgia Secretary of State.[75] Furthermore, as discussed in greater detail below, charities subject to the Georgia Charitable Solicitations Act are also required to make certain financial disclosures.[76] These charitable registration and disclosure laws typically are not limited to nonprofit organizations but may apply to private, for-profit fundraising entities as well.[77] Although the charitable solicitations rules may not automatically

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[72] *See* I.R.C. § 4945(h) (2006).

[73] 157 CONG. REC. H7578 (daily ed. Nov. 14, 2011) (showing the introduction of the bill); *H.R. 3420 (112th): Philanthropic Facilitation Act*, GOVTRACK.US, http://www.govtrack.us/congress/bills/112/hr3420 (last visited Mar. 12, 2013) (noting the bill died).

[74] NAT'L ASS'N OF ATTORNEYS GEN. & NAT'L ASS'N OF STATE CHARITIES OFFICIALS, STANDARDIZED REGISTRATION FOR NONPROFIT ORGANIZATIONS: UNDER STATE CHARITABLE SOLICITATION LAWS 1 (version 4.01 2010), *available at* http://www.multistatefiling.org/urs_webv401.pdf.

[75] GA. CODE ANN. § 43-17-5(b)(1) (2011). Some charities, such as churches, schools, and emergency rescue departments, and political parties are exempt from registration. *Id.* § 43-17-9(a).

[76] *Id.* § 43-17-5(b)(4).

[77] Memorandum from the Office of the Sec'y of State of Ga. on Charitable Org. Registration Info. Pursuant to the Ga. Charitable Solicitations Act of 1988, as Amended

apply to every L3C operating within a state, in the proper circumstances, the laws conceivably could apply to an L3C. If so, then even under current law, the L3C would be required to register and disclose financial information just as any other charitable or fundraising organization.

Some states go even further to require registration of "commercial coventurers" with charities.[78] These laws were enacted in response to certain fundraising and marketing arrangements frequently used by charities and for-profit firms. These fundraising and marketing arrangements also are known as "cause marketing."[79]

For example, in 1999, General Mills advertised nationwide that it would donate $0.50 to the Breast Cancer Research Foundation for every Yoplait Yogurt sold by and corresponding container lid returned to General Mills during the period of January through March.[80] The slogan for the ad campaign was "Save Lids to Save Lives."[81] This was a classic "cause marketing" campaign. Subsequently, though, the Georgia Secretary of State launched an investigation into the Yoplait Yogurt cause marketing campaign.[82] As a result of that investigation, the Georgia Secretary of State concluded that the General Mills/Breast Cancer Research Foundation Promotion was misleading to consumers because it did not adequately disclose that General Mills's total charitable commitment limit was $100,000 during the relevant time period.[83] If General Mills's obligation to the Breast Cancer Research Foundation had not been so limited, the Georgia Secretary of State's investigation contended that General Mills would have been obligated to donate $4.7 million to the Breast Cancer Research Foundation.[84] Accordingly, based upon the percentage of sales of Yoplait Yogurt in Georgia, the settlement with the Georgia Secretary of State required General Mills to donate an additional $63,000 to the Breast Cancer Research Foundation.[85]

(July 2003), *available at* http://sos.georgia.gov/acrobat/Securities/forms_2006/Charity%20Org%20Info%20Release.pdf.

78 GA. CODE ANN. § 43-17-6(a).

79 Scott M. Smith & David S. Alcorn, *Cause Marketing: A New Direction in the Marketing of Corporate Responsibility*, 5 J. SERVICES MARKETING 21, 21 (1991).

80 Press Release, Cathy Cox, Ga. Sec'y of State, Secretary Cox: Agreement with General Mills to Conclude Investigation into Yoplait Charitable Promotion Results in Additional $63,000 for Breast Cancer Research (Dec. 21, 1999), *available at* http://sos.georgia.gov/pressrel/pr991221.htm.

81 *Id.*

82 *Id.*

83 *Id.*

84 *Id.*

85 *Id.*

The provision of the Georgia Charitable Solicitations Act pertaining to commercial coventurers, such as the General Mills/Breast Cancer Research Foundation Promotion, imposes certain rules upon such cause marketing arrangements.[86] In particular, the applicable statute: (1) requires a written agreement between the charity and the commercial coventurer; (2) sets minimum standards for such charitable cause marketing agreements; (3) imposes record-keeping requirements; and (4) permits the Georgia Secretary of State to examine such agreements and related records.[87] Like the registration and financial disclosure requirements mentioned above, the commercial coventure statute does not expressly apply to an L3C operating in Georgia, but it could depending upon the particular circumstances.

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[86] *See* GA. CODE ANN. § 43-17-6 (2011).

[87] *Id.* Specifically, the statute provides:

(a) Every charitable organization which agrees to permit a charitable sales promotion to be conducted in its behalf shall obtain, prior to the commencement of the charitable sales promotion within this state, a written agreement from the commercial coventurer which shall be available to the Secretary of State upon request. The agreement shall be signed by an authorized representative of the charitable organization and the commercial coventurer and it shall include, at a minimum, the following:

(1) The goods or services to be offered to the public;

(2) The geographic area where, and the starting and final date when, the offering will be made;

(3) The manner in which the charitable organization's name will be used, including the representation to be made to the public as to the actual or estimated dollar amount or percent per unit of goods or services purchased or used that will benefit the charitable organization;

(4) If applicable, the maximum dollar amount that will benefit the charitable organization;

(5) The estimated number of units of goods or services to be sold or used;

(6) A provision for a final accounting on a per unit basis to be given by the commercial coventurer to the charitable organization and the date by which it will be made;

(7) A statement that the charitable sales promotion is subject to the requirements of this chapter; and

(8) The date by when, and the manner in which, the benefit will be conferred on the charitable organization.

(b) The final accounting for the charitable sales promotion shall be kept by the commercial coventurer for three years after the final accounting date.

(c) All records of charitable organizations and commercial coventurers pertaining to such sales promotion are subject to such reasonable periodic, special, or other examinations by representatives of the Secretary of State, within or outside this state, as the Secretary of State deems necessary or appropriate in the public interest or for the protection of the public, provided that the Secretary of State shall not disclose this information except to the extent necessary for investigative or law enforcement purposes.

Id.

Instead of hinging registration on circumstances such as fundraising or cause marketing, Georgia should require every L3C conducting any business whatsoever in the state to register under the Georgia Charitable Solicitations Act. Similar measures should also be passed in other states. Moreover, the governing documents of the L3C (such as the articles of organization and operating agreement) could be subject to comparable record-keeping and examination requirements mandated for commercial coventure arrangements across the fifty states. This would allow the secretary of state for each state (or other appropriate state agency) to inspect the governing documents of the L3C. Imposing such registration and record-keeping requirements on every L3C conducting business in a state would heighten the level of transparency and accountability that currently is lacking for L3Cs.

5. Require Audited or Reviewed Financial Statements for L3Cs

In addition to registration and record-keeping requirements, state charitable solicitation acts also generally require charities to disclose detailed financial information to an appropriate state agency.[88] The Georgia Charitable Solicitations Act, for instance, requires charitable organizations[89] that collect more than one million dollars in either of the organization's two preceding fiscal years to obtain and submit to the Georgia Secretary of State independently audited financial statements along with the organization's annual registration form.[90] Financial disclosure also is required for smaller organizations. Specifically, charitable organizations that collect between $500,000 and $1 million during the preceding two-year period must submit independently reviewed financial statements, while organizations collecting less than $500,000 during the period need only submit non-reviewed financial statements.[91] If no contributions have been collected by the organization during the preceding two-year period, then Georgia law requires an officer of the charity to confirm that fact in a signed statement submitted with the annual registration form.[92]

It should be simple enough to require any L3C with similar revenue levels or assets to likewise submit audited, reviewed, or non-reviewed financial statements to a designated state agency along with their

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[88] Typically, this involves a filing with the secretary of state. *See, e.g.*, *id.* §§ 43-17-5(b)(4), -6.

[89] That is unless the organization is covered by a specific exemption. *See id.* §§ 43-17-9(a).

[90] *Id.* § 43-17-5(b)(4).

[91] *Id.*

[92] *See id.*

annual registrations (as proposed above). This would serve two worthwhile purposes. First, it would promote transparency and accountability to the state agency charged with monitoring and regulating charitable activity. Second, for those L3Cs reaching the $500,000 and greater revenue or assets threshold, it would create an added cost associated with L3Cs—the cost of preparing a financial statement. This cost likely would deter those unscrupulous owners who would form an L3C in name only without actually planning to serve a charitable purpose. The added cost would be a deterrent because, in the author's experience, average fees for reviewed financial statements range from $5,000 to $10,000 even for small organizations, while fees for audited financial statements typically range from $12,000 to $20,000 *or more* depending upon an organization's size. Such added costs generally would be a deterrent to improper use of an L3C.

6. Permit Free Transferability for an Exempt Member's Interest in an L3C

In general, most state LLC acts follow a familiar pattern: the LLC statute provides a number of "default rules" regarding rights and obligations that members have vis-à-vis each other and the LLC itself, but then the members have virtually unlimited flexibility to modify the default rules in the LLC's operating agreement.[93] In most cases, the operating agreement will modify the default rules, but in the absence of agreement otherwise, the default rules govern.[94]

One common default rule across the various LLC statutes restricts a member's ability to freely transfer its membership interest in the LLC. The LLC default rule with respect to transferability usually provides that a member may freely transfer its *economic* rights in the LLC (that is, rights to allocations and distributions) but not membership participation rights (that is, rights to vote or consent, inspect books and records, etc.) without approval of the other members.[95] Thus, by default under most state LLC acts, an unapproved transferee of a membership interest does not become a full member of the LLC. Instead, such unapproved transferee becomes an un-admitted assignee of the former member's economic rights only, with no right to vote or consent or right to information from the LLC.[96] This contrasts sharply with the default rule for corporations whereby corporate stock generally is freely transferable and the transferee obtains all rights of a shareholder absent

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93 *See* BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.08.

94 *See id.*

95 *Id.* ¶ 8.06[1][a].

96 *Id.* ¶ 8.06[2][a].

a contrary provision in a shareholders' agreement or some other legally binding agreement.[97]

The contrasting default rules for LLCs versus corporations stem from the LLC's partnership heritage. In particular, with regard to membership rights, LLCs more closely resemble partnerships than corporations.[98] Partnership law typically restricts transfers because holding a partnership interest is considered akin to a consensual, contractual relationship with a co-owner, whereas holding corporate stock is considered more like outright ownership of a distinct, intangible, and essentially fungible asset.[99] Put differently, the LLC/partnership paradigm values the relationship between and among the owners over the separate property rights of each owner, while the corporate paradigm values the separate property rights of each owner over any relationship with other owners.

Generally speaking, with respect to transferability, an exempt organization would prefer the corporate stock paradigm (that is, free transferability) over the LLC/partnership paradigm (that is, limited transferability). An exempt organization would prefer free transferability because, if the exempt member becomes concerned or dissatisfied with the financial performance or activities of the LLC, the exempt member unilaterally may divest itself of its membership interest at any time.[100] In the context of a joint venture LLC, for example, if at any time an LLC's activities pose a threat to an exempt member's tax status, free transferability would allow the exempt member to terminate its relationship with the LLC unilaterally by simply selling its membership interest. The viability of such a unilateral transfer by an exempt member, however, could only be facilitated if, as is the case in the corporate paradigm, the transferee obtains full economic *and* participation rights in the LLC as a result of the transfer.

If the corporate paradigm with respect to transfers is preferable for exempt organizations, then perhaps the L3C statutes in the various adopting states could reverse the normal LLC default rule on free transferability. In particular, the L3C acts could provide as a default rule that a tax-exempt member of an L3C is permitted to freely transfer its entire membership interest in the LLC, and that the transferee shall

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[97] *Id.* ¶ 8.06[1][a].

[98] *See id.* ¶ 5.04[2][a][iv] (explaining that an LLC likely cannot admit members unless they have economic and governance rights).

[99] *See id.* ¶¶ 5.04[2][a], 8.06[1][a].

[100] Of course, the demand for an interest in the LLC may be severely limited or even nonexistent, but that is a consequence of the available market, not limited transferability at law. Closely held corporate stock suffers from the same, limited demand in the market. Rev. Rul. 59-60, 1959-1 C.B. 237.

be admitted as a full member unless the LLC's articles or operating agreement expressly provides otherwise. This free-transferability default rule for L3Cs would distinguish them dramatically from regular LLCs, which have a limited-transferability default rule. Due to the free-transferability default rule, exempt organizations likely would favor L3Cs over regular LLCs.

7. Provide an Exempt Member of an L3C with a Unilateral Right to Withdraw

By default, most LLC statutes restrict a member's right to withdraw from an LLC, or if the right to withdraw is not restricted, then the statutes provide that withdrawal has no significant legal or economic implications for the continuing operation of the LLC.[101] Further, at least in the author's experience, most written operating agreements (as they are permitted to do under the LLC statutes) go further to either expressly prohibit withdrawal or to provide that if a member nonetheless unilaterally withdraws, then such member is in breach and loses all rights as a member. These operating agreements then further provide that a withdrawing member forfeits its membership interest (unless, due to the particular circumstances involved, the member's withdrawal is permitted by the express terms of the operating agreement). In slightly less extreme cases, the operating agreement provides that a withdrawing member loses all voting, inspection, and similar membership participation rights, but retains rights to allocations and distributions from the LLC (like an un-admitted assignee).[102]

In this regard, the author proposes to reverse the default rule so that an exempt member of an L3C unilaterally may withdraw for any reason and at any time. Further, by default, such withdrawal by an exempt member should trigger a right to distribution of the exempt member's unreturned capital contributions. Like transferability, this reversal of the normal LLC default rule for withdrawal would favor the use of L3Cs by exempt organizations.

In addition, with respect to L3Cs being used for PRIs, a state-law default rule permitting unilateral withdrawal by an exempt member would align more closely with applicable federal law. Specifically, the regulations governing PRIs require that any funds not used for exempt purposes be repaid to the investing private foundation "to the extent permitted by applicable law concerning distributions to holders of equity

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[101] *See* BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.08 tbl. 1.2.

[102] *See* THOMAS A. HUMPHREYS, LIMITED LIABILITY COMPANIES § 3.01[1], at 3–4 (10th release 2004).

interests."[103] A rule allowing unilateral withdrawal from an L3C by a private foundation would be a veritable "trump card" because the other members (by default) would not possess such right. Therefore, if the L3C misappropriated any PRI funds or otherwise misbehaved, the private foundation member could withdraw and demand repayment of the unreturned portion of its investment. This repayment right due to withdrawal would prioritize the private foundation member's economic rights in the L3C over the other members' economic rights.

If the non-exempt members object to allowing the private foundation such a powerful economic priority, then the operating agreement could soften the adverse economic consequences to those members by providing the L3C a choice: either repay the foundation member's unreturned PRI capital or dissolve the L3C according to the terms of the operating agreement. In the case of dissolution, the private foundation and the non-exempt members would participate in liquidating proceeds according to the priorities originally set forth in the L3C's operating agreement. Nevertheless, even though the adverse economic impact to the non-exempt members would be softened by such an approach, the private foundation's ability via unilateral withdrawal to compel dissolution at any time and for any reason would be an extremely powerful right.

Providing a default rule that allows an exempt member at any time and for any reason to withdraw unilaterally and receive a distribution of its unreturned capital from an L3C would be a very meaningful, distinguishing feature from a regular LLC. A unilateral withdrawal right could safeguard an exempt member's tax status, and, in the case of a private foundation member, it would dovetail with certain federal-law requirements for PRIs.

CONCLUSION

The L3C is languishing. In an effort to salvage the form, this Article proposes seven changes to the L3C's statutory framework. The seven proposed changes are designed to promote accountability and transparency and to favor the use of the L3C by tax-exempt organizations. If L3Cs become the favored vehicle for tax-exempt organizations to use in circumstances in which a regular LLC otherwise would be appropriate, then the L3C might flourish alongside benefit corporations as part of the social enterprise movement. If L3Cs remain indistinguishable (except in name only) from regular LLCs, then, in the author's opinion, L3Cs likely will not (and arguably should not) survive. Regardless of whether L3Cs survive, some of the proposals suggested by

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[103] Treas. Reg. § 53.4945-5(b)(4)(i) (as amended in 2008).

the author in this Article (that is, free transferability and a unilateral right of withdrawal) also could be useful in an operating agreement for a regular LLC that has a tax-exempt member.

LOSS CAUSATION, MUTUAL FUNDS, AND SECURITIES ACT CLAIMS: AN UNCERTAIN FUTURE FOR SHAREHOLDERS

INTRODUCTION

Imagine you are an investor in a mutual fund portfolio. Your mutual fund's prospectus states that it will invest in "low-risk products with steady growth." For the purpose of this example, the fund invests half of its portfolio in apples priced at $5 per share and the other half in oranges priced at $6 per share. The fund owns 100 shares total in its portfolio, with $250 worth of apples and $300 worth of oranges. Then the fund manager deviates from the investment strategy in the prospectus, and instead invests three-quarters of the 100 shares in an extremely high-risk apple market, the price of which has recently dropped from $10 to $5 per share, and one-quarter of the fund's shares in oranges. Now the fund owns $375 worth of apples and $150 worth of oranges.[1] At first glance, it would seem like you should be able to recover any loss that might have resulted from the change in investment strategy. Some courts, however, would not allow mutual fund shareholders to recover for misrepresentations made on a registration statement or prospectus.[2] These courts would find that, whether you discovered the misstatement before a drop in value or after, the price would have remained the same.[3] That would make it impossible for investors who purchase shares of a mutual fund[4] to recover for any misstatements or omission of material fact in a registration statement or prospectus. On the other hand, some courts would reach the opposite outcome and find that the misstatement or omission "touched upon" the loss (if any) and allow mutual fund shareholders to recover.[5]

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[1] The totals added together, minus the liabilities (none in this example), and divided by the number of outstanding shares, equals a value of $5.25 per share. *See* discussion *infra* Part I.B.

[2] *See* discussion *infra* Part IV.

[3] The price per share would remain the same because it is calculated based on what the fund *actually* holds as assets at the time the net asset value is calculated. *See* discussion *infra* Part I.B.

[4] For the purposes of this Note, all references to mutual funds are limited to registered open-end management investment companies. *See* Mercer E. Bullard, *Insider Trading in Mutual Funds*, 84 OR. L. REV. 821, 823–26 (2005) (defining "mutual fund" and discussing operation and pricing of mutual funds). This Note also excludes reference to exchange-traded funds, which are a kind of mutual fund that trades on an exchange.

[5] In the example above, recovery would be the difference in value between the price per share before the misstated investment ($5.50) and the price per share after the misrepresented investments became known ($5.25).

This Note discusses the current state of the law regarding fund shareholder claims for misstatements or omissions of material fact in a registration statement or prospectus. Part I provides a brief history of the importance of mutual funds as an investment tool in the United States, as well as a basic understanding of how mutual funds are valued under a statutory formula to calculate the fund's price per share or net asset value ("NAV"). Part II of this Note addresses the parties that are liable under Section 11 and Section 12(a)(2), lists the procedural steps to bring a claim, and introduces the concept of loss causation as an affirmative defense, which may prevent recovery for fund shareholders. Part III discusses the differences between transactional causation and loss causation. Part IV discusses the different conclusions courts have reached when analyzing loss causation for Section 11 and Section 12(a)(2) claims brought by mutual fund shareholders. Part V proposes a congressional amendment to the Securities Act of 1933 ("Securities Act") to provide mutual fund shareholders with a remedy for Section 11 and Section 12(a)(2) claims.

I. BRIEF BACKGROUND ON MUTUAL FUNDS

A. Mutual Fund Investment in U.S. Markets

Investment in mutual funds has grown considerably over the last thirty years. In 1980, only 5.7% of U.S. households owned mutual funds.[6] By 2000, that number skyrocketed to 44.5%.[7] In 2010, the number of households owning mutual funds held steady despite an economic downturn, dipping only slightly to 43.9% or a total of 51.6 million U.S. households.[8] In fact, by 2010, "an estimated 90 million individual investors owned mutual funds and held 87 percent of total mutual fund assets,"[9] with households making up the largest group of investors.[10] Furthermore, at year-end in 2010, the U.S. mutual fund market had $11.8 trillion in assets under management.[11] Needless to say, mutual funds are a very important investment tool for Americans, especially

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[6] INV. CO. INST., 2011 INVESTMENT COMPANY FACT BOOK 80 (51st ed. 2011), *available at* http://www.ici.org/pdf/2011_factbook.pdf; *see also* Ali Hortaçsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, 119 Q.J. ECON. 403, 403 n.1 (2004) (noting mutual fund investment statistics in the United States over the last thirty years).

[7] INV. CO. INST., *supra* note 6, at 80.

[8] *Id.*

[9] *Id.* Investor demand for mutual funds is influenced by a variety of factors, including diversification of assets, steady long-term growth, and low-risk investing, which assist investors in achieving their investment objectives.

[10] *Id.* at 8.

[11] *Id.* at 23.

those who seek to diversify their investment portfolios and pursue low-risk investments in preparation for retirement.

B. Calculating the Net Asset Value

To calculate damages under Section 11 and Section 12(a)(2), it is important to understand the way a mutual fund's price per share is valued. When most people first encounter mutual funds, they believe that mutual fund shares are "subject to the same market forces as shares of stock."[12] This is incorrect, however, because the number of shares outstanding will vary depending on the amount of sales and purchases that are made by the fund and its investors,[13] making the traditional rules of supply and demand not applicable.[14] Whereas the value of a typical security is determined on an exchange market where buyers and sellers engage in transactions to form a price at which an investor is willing to purchase the security, mutual funds are valued differently and are not subject to market forces.

Mutual funds are generally regulated under the Investment Company Act of 1940.[15] A key difference between mutual funds and other securities is that the per-share price of a mutual fund is calculated by a statutory formula called the "net asset value" ("NAV").[16] To calculate a fund's NAV, its underlying assets (securities, cash, and other assets) must be valued at current market price.[17] Then the fund will take its total underlying assets—at market price—subtracted by the total liabilities—including management fees and other fees—divided by the total number of shares outstanding for that particular day to reach its NAV or price per share.[18] Each day, a fund will price its shares according to this formula.[19]

For example, suppose a fund's portfolio contains four investments—apples, oranges, bananas, and mangos—with each investment

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[12] *Changes in NAV*, YOUR COMPLETE GUIDE TO INVESTING IN MUTUAL FUNDS, http://www.investing-in-mutual-funds.com/changes-in-nav.html (last visited Mar. 8, 2013) [hereinafter *Changes in NAV*].

[13] *Id.*

[14] *Id.*

[15] LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 14 (3d ed. 2007).

[16] Bullard, *supra* note 4, at 824; *see also* David M. Geffen, *A Shaky Future for Securities Act Claims Against Mutual Funds*, 37 SEC. REG. L.J. 20, 23–24 (2009) (discussing how a mutual fund's NAV is calculated).

[17] Bullard, *supra* note 4, at 824.

[18] Geffen, *supra* note 16.

[19] Funds may choose the time or times during the day at which to value their shares. However, most funds value their shares at 4:00 p.m. eastern standard time. Bullard, *supra* note 4, at 824.

representing 25% of the total assets of the portfolio. The total outstanding shares of the fund are 100, and the liabilities are set at $100. The total market value of the fund's assets (apples, oranges, bananas, and mangos) is $1,025 each or $4,100 total. The fund's per-share NAV would be the total market value of the underlying assets, $4,100, minus the fund's liabilities, $100, to equal $4,000, divided by the number of outstanding shares, 100, to equal $40 per share. That per-share NAV is determined each day based solely on the assets the fund holds in its portfolio at the time the value is calculated. Moreover, unlike stocks, which are traded on an exchange, shares in a mutual fund do not have a secondary market, and instead are continuously offered for sale by the fund and may be redeemed by the fund when a shareholder desires.[20]

II. AN OVERVIEW OF SECTION 11 AND SECTION 12(A)(2)

While mutual funds are generally regulated under the Investment Company Act of 1940,[21] most courts have denied mutual fund shareholders relief for private causes of action based on sections 12(b), 12(d)(1), 17(j), 22, 26(f), 27(i), 34(b), 36(a), and 48(a) of that Act.[22] Additionally, several courts have also expressly required that claims under sections 13(a)(3), 17(d), 17(e), 17(j), 18(f), 34(b), and 36(a) of that Act must be brought derivatively, because the harm alleged is to the fund and not to individual shareholders.[23] Therefore, to obtain relief for

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[20] Geffen, *supra* note 16, at 24.

[21] *See supra* note 15 and accompanying text.

[22] Mercer E. Bullard, Dura, *Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. CIN. L. REV. 559, 559 n.4 (2008); *see, e.g.*, Olmsted v. Pruco Life Ins. Co. of N.J., 283 F.3d 429, 431 (2d Cir. 2002) (finding no private cause of action under sections 26(f) and 27(i)); *In re* Eaton Vance Mut. Funds Fee Litig., 380 F. Supp. 2d 222, 233 (S.D.N.Y. 2005) (finding no private right of action under sections 34(b), 36(a), and 48(a)); DH2, Inc. v. Athanassiades, 359 F. Supp. 2d 708, 714–15 (N.D. Ill. 2005) (finding no private cause of action under Section 17(j)); Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 WL 645529, at *7 (N.D. Cal. Mar. 7, 2005) (finding no private cause of action under Section 12(b)); MEVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners, L.P., 260 F. Supp. 2d 616, 622 (S.D.N.Y. 2003) (finding no private cause of action under Section 12(d)(1)); White v. Heartland High-Yield Mun. Bond Fund, 237 F. Supp. 2d 982, 986 (E.D. Wis. 2002) (finding no private cause of action under sections 22 and 34(b)). *But see In re* Nuveen Fund Litig., No. 94 C 360, 1996 WL 328006, at *4–6 (N.D. Ill. June 11, 1996) (acknowledging a private right of action under sections 34(b) and 36(a)).

[23] Bullard, *supra* note 22, at 560 n.4; *see, e.g.*, Lapidus v. Hecht, 232 F.3d 679, 684 (9th Cir. 2000) (holding that a Section 18(f) claim must be brought derivatively, but that direct claims under sections 13(a)(2) and 13(a)(3) are permitted); Rohrbaugh v. Inv. Co. Inst., No. Civ.A. 00 1237, 2002 WL 31100821, at *7 (D.D.C. July 2, 2002) (holding that claims under Section 17(d) must be derivative); *In re* Dreyfus Aggressive Growth Mut. Fund Litig., No. 98 Civ. 4318(HB), 2000 WL 10211, at *4 (S.D.N.Y. Jan. 6, 2000) (holding

false or misleading statements made in a fund's registration statement or prospectus, mutual fund investors have turned to Section 11 and Section 12(a)(2) of the Securities Act.

To maintain public confidence in the marketplace, Congress enacted, *inter alia*, Section 11 and Section 12(a)(2) of the Securities Act to provide investors with a private right of action to recover for losses in investments caused by misstatements in a registration statement or prospectus.[24] The Securities Act lays out a basic framework in which "a security must be sold in a registered offering, unless the security or the transaction is exempt from registration."[25] A registered offering generally requires a significant amount of disclosure in the form of a registration statement, which contains a prospectus.[26] Section 11 and Section 12(a) provide a civil remedy to investors who have been misled by a material misstatement in either the registration statement or the prospectus.[27]

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that claims under sections 13(a)(3), 17(e), 17(j), 34(b), and 36(a) must be brought derivatively).

[24] MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW § 1.02, at 1 (5th ed. 2009). In response to the stock market crash of 1929, Congress enacted the Securities Act and the Securities Exchange Act of 1934 ("Exchange Act"), both of which gave private investors a right of action against fraudulent sales of securities. These two Acts have become the principal bodies of law regulating the securities markets. *Id.*

[25] Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 5 (2002).

[26] *Id.* "A key policy underlying this requirement is to enable prospective purchasers to make informed investment decisions based upon the disclosure of adequate and truthful information regarding the issuer, its associated persons, and the offering." STEINBERG, *supra* note 24, § 7.02, at 206.

[27] *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: THE ESSENTIALS 256, 287 (2008). The purpose of these sections is to protect investors who purchase securities pursuant to registration statements that contain false or materially misleading information. When the Securities Act was enacted by Congress, many believed that Section 11 would be the driving force of inducement for officers and directors to comply with disclosure requirements of securities for sale on primary markets. Horwich, *supra* note 25, at 1. Section 11 provides a civil remedy for a registration statement that contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Securities Act of 1933 § 11, 15 U.S.C. § 77k(a) (2006). Liability extends to registration statements for traditional securities sold on a market as well as to a mutual fund's registration statement. Geffen, *supra* note 16, at 21–22. Similarly, Section 12(a)(2) provides recovery for any investor who purchases shares pursuant to a prospectus that includes a material misstatement of fact or omission of fact when the omitted fact is necessary to make the statements not misleading. *Id.* at 22.

A. Procedural Advantages

Both Section 11 and Section 12(a)(2) provide an express private right of action for investors[28] who have purchased securities on a primary market.[29] Moreover, Section 11 liability is not associated with trading on a secondary market.[30] This means that an investor must have purchased a security in the initial offering itself or must be able to trace the specific shares purchased to that offering.[31] This standing requirement is important because mutual funds, by definition, do not trade on a secondary market.[32]

Section 11(a)(1)–(5) provides a straightforward list of those who could potentially be liable.[33] Similarly, Section 12(a)(2) may subject to

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[28] A private right of action also exists under Securities and Exchange Commission ("SEC") Rule 10b-5 for purchasers of securities on a secondary market; however, that private right of action is implied through judicial interpretation. *See* W. Barton Patterson, Note, *Defining the Reach of the Securities Exchange Act: Extraterritorial Application of the Antifraud Provisions*, 74 FORDHAM L. REV. 213, 216 (2005); *see, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (affirming that there is "an implied private right of action under" Rule 10b-5); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b)."). *Kardon v. National Gypsum Co.* was the first case to hold that a private right of action exists under Section 10(b) based on the broad purposes of the Exchange Act. 69 F. Supp. 512, 514 (E.D. Pa. 1946).

[29] CHOI & PRITCHARD, *supra* note 27, at 256, 288. Primary market transactions are sales by an issuer (generally a corporate issuer) to investors. *Id.* at 13. Primary market transactions generally take the form of a public offering or initial public offering (IPO) to "raise capital to fund business operations and expansion." *Id.* These offerings carry a disclosure requirement in which companies must complete annual Form 10-K and quarterly Form 10-Q filings. *Id.* at 14. The disclosure requirements are strict because primary transactions pose a large amount of risk and uncertainty to investors. *Id.* In an offering, the issuers seek to convince investors to pay top dollar for the offered securities, thereby maximizing the proceeds received. Additionally, in IPOs, the stock being sold is generally from companies that are unknown to the market, making investors highly susceptible to attempts to inflate the value of the offered securities. *Id.*

[30] *Id.* at 257.

[31] Horwich, *supra* note 25, at 7. Therefore, investors who purchase directly from underwriters in an offering have standing, but a party who purchases shares (through brokers generally) on a secondary market will not be able to sufficiently trace their claim under Section 11 and must turn to Rule 10b-5 to impose liability. CHOI & PRITCHARD, *supra* note 27, at 259.

[32] Bullard, *supra* note 4, at 822.

[33] Securities Act of 1933 § 11, 15 U.S.C. § 77k(a)(1)–(5) (2006) (explaining that potential defendants include: (1) those who signed the registration statement (which under Section 6(a) includes each issuer, principle executive officer (or officers), principal financial officer, comptroller, principal accounting officer, and a majority of the board of directors or persons performing similar functions); (2) every director or partner at the time the registration is challenged; (3) experts who certified or prepared all or part of the registration statement; and (4) the underwriters). Thus, Section 11 only imposes liability on a seller if it is among those listed.

liability any person who offers or sells a security by way of a prospectus or oral communication.[34] Section 12(a)(2) also suggests that a claimant cannot recover if he or she knew about the misstatement complained of before investing.[35]

Therefore, every person who signs a fund's registration statement[36] and any person who offers or sells a security by means of a prospectus may be liable to purchasers.[37] Additionally, a shareholder bringing a claim under Section 11 or Section 12(a)(2) does not need to prove reliance to prevail,[38] and the shareholder need not prove scienter.[39] Instead, the issuer is strictly liable provided a plaintiff can prove that the registration statement contained a material misstatement or omission. At that point, the burden shifts to the defendants to provide an affirmative defense, such as due diligence or loss causation.[40] The burden-shifting provision increases a plaintiff's chances of prevailing on motion for summary judgment or dismissal, which also increases the settlement value of the case.[41]

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[34] *Id.* § 12(a)(2), 15 U.S.C. § 77*l*(a)(2) (2006). The Supreme Court has defined "prospectus" as "a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder." Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995); *see also* SODERQUIST & GABALDON, *supra* note 15, at 112.

[35] § 12(a)(2); *see also* SODERQUIST & GABALDON, *supra* note 15, at 112.

[36] The methods of registration are provided in Section 6(a). Securities Act of 1933 § 6(a), 15 U.S.C. § 77f(a) (2006).

[37] Additionally, there is no privity requirement between the purchaser and the seller. Pinter v. Dahl, 486 U.S. 622, 647 & n.23 (1988); CHOI & PRITCHARD, *supra* note 27, at 281–82.

[38] Penn Mart Realty Co. v. U.S. Fin., Inc. (*In re* U.S. Fin. Sec. Litig.), 64 F.R.D. 443, 455 (S.D. Cal. 1974). The only exception is when the plaintiff "has acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement." Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006); Horwich, *supra* note 25, at 10.

[39] *See* Securities Act of 1933 §§ 11, 12(a)(2), 15 U.S.C. §§ 77k, 77*l*(a)(2) (2006). In contrast, to prevail on a Rule 10b-5 claim, a plaintiff has the burden of proving "'a strong inference'" of scienter. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 321 (2007) (quoting 15 U.S.C § 78u-4(b)(2) (2006)). This hurdle requires a showing of "'intent to deceive, manipulate, or defraud.'" *Id.* at 319 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976)).

[40] Due diligence defenses are also provided in Section 11(b)(3). Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (2006). However, due diligence defenses are only available to persons liable under Section 11(a) other than the issuer. *Id.* § 11(b). Generally, the issuer is strictly liable and may avoid liability only by establishing "the purchaser's knowledge of the misstatement or omission, lack of materiality, lack of causation, equitable defenses . . . , and expiration of the statute of limitations." STEINBERG, *supra* note 24, § 7.02[C][1], at 209.

[41] *See* Geffen, *supra* note 16, at 22. This means that, because a plaintiff does not have to show scienter, claims under Section 11 and Section 12(a)(2) are not subject to the

B. The Statutory Damages Formula

The measure of recovery under Section 11 and Section 12(a)(2) is statutorily defined by a price depreciation formula. For Section 11 claims, a plaintiff may only recover

> [s]uch damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought . . . .[42]

This language can be read to serve as a cap on the damages that can be recovered by a plaintiff in a Section 11 claim.[43]

This makes sense because the Securities Act, particularly Section 11 and Section 12(a)(2), is designed to provide adequate means of disclosure in the primary market of a public offering.[44] The price of a new issue or security may increase in the secondary market or aftermarket after the initial offering.[45] Those who purchase at the initial offering price may sell their holdings for three or four times more than what they paid for them.[46] But, under Section 11(e), these original purchasers who sell a security above the offering price do not suffer any damages and are therefore barred from recovery even if the registration statement contained a misstatement that inflated the initial price.[47] Additionally, damages are not recoverable to the extent that "the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security *resulting from* such part of the

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heightened pleading standards required by Federal Rule of Civil Procedure 9(b), which requires a party to plead "with particularity the circumstances constituting fraud or mistake," FED. R. CIV. P. 9(b), as opposed to Federal Rule of Civil Procedure 8(a), which merely requires "a short and plain statement of the claim showing that the pleader is entitled to relief," FED. R. CIV. P. 8(a)(2).

[42] Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006).

[43] This measure of damages is distinct from that found in Rule 10b-5, which does not have a statutorily determined price-depreciation formula. Instead, Rule 10b-5 is meant to be a catch-all provision that, because of its more stringent burden of proof, is more flexible in the amount of damages that may be recovered. Geffen, *supra* note 16, at 38–39.

[44] *Hochfelder*, 425 U.S. at 195; Matt Silverman, Note, *Fraud Created the Market: Presuming Reliance in Rule 10b-5 Primary Securities Market Fraud Litigation*, 79 FORDHAM L. REV. 1787, 1793 (2011).

[45] Horwich, *supra* note 25, at 12.

[46] *Id.*

[47] *Id.* at 12–13.

registration statement, with respect to which his liability is asserted."[48] This means that if the defendant can show that any recoverable loss suffered by the plaintiff *resulted from* factors other than a misstatement in the registration statement, then the damages will be reduced by the amount attributable to other factors that did not result from the misstatement.

Similarly, the Private Securities Litigation Reform Act of 1995 ("PSLRA") amended the Securities Act to include Section 12(b),[49] which allows a defendant to avoid liability in Section 12(a)(2) claims for "any portion or all of the amount" of depreciation in value of the subject security that resulted from factors other than the misstatement or omission.[50]

Together, these provisions provide a negative causation or loss causation affirmative defense.[51] Under these defenses, the defendant has the burden of proving that the loss in value of the security resulted from factors other than the misstatements or omission of material facts.

C. A Rescission Option for Section 12(a)(2) Claims

Section 12(a)(2) provides that a plaintiff "may sue either at law or in equity . . . to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the

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[48] Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006) (emphasis added).

[49] Section 12(b) provides that,

> [I]f the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

Id. § 12(b), 15 U.S.C. § 77*l*(b) (2006).

[50] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (codified at 15 U.S.C. § 77*l*(b) (2006)); *see also* STEINBERG, *supra* note 24, §7.09[G], at 236.

[51] Under Section 12(a)(2), the defendant may also avoid liability by proving that he or she did not know of the material misrepresentation or, through the use of reasonable care, could not have known. The standard of reasonable care, however, may be higher than similar standards in other areas of law such as torts. *See* Dannenberg v. Painewebber Inc. (*In re* Software Toolworks Inc.), 50 F.3d 615, 621 (9th Cir. 1994) (holding that the standard of reasonable care under Section 12(a)(2) is similar to the standard of a reasonable investigation under Section 11).

security."[52] Therefore, a plaintiff has two options: either sell the security and sue for damages, or keep the security and sue for rescission.[53]

Rescission is an equitable remedy that serves to undo the sale of the security and place the buyer in the same position as if no transaction occurred.[54] The general principle is that an investor suing for rescission must be put, as close as possible, in the same position as before the transaction occurred. The rescission action in Section 12(a)(2) serves "'to prevent further exploitation of the public'" and "'to place adequate and true information before the investor.'"[55] The theory of rescission in securities fraud dates back to an 1890 decision by the Court of Appeals of New York in *Vail v. Reynolds*.[56] The court held that "[a] person who has been induced by fraudulent representations to become the purchaser of property . . . may rescind the contract absolutely, and sue in an action at law to recover the consideration parted with upon the fraudulent contract."[57] By enacting Section 12(a)(2) of the Securities Act, Congress sought to put the common law rescission remedy in statutory form.[58] Further, "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud."[59]

Congress did, however, add Section 12(b) in the PSLRA which requires a causal link between a misstatement under Section 12(a)(2) and a rescission action, thereby creating a loss causation affirmative

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[52] Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77*l*(a)(2) (2006).

[53] This Note does not address the full scope of rescission suits. Specifically, this Note does not analyze the timing of a rescission suit, interest for rescission, tax benefits, or calculation of consideration. This portion of the Note merely serves to provide a brief background of rescission actions and to show that defendants have a loss causation affirmative defense for rescission actions. *See* Securities Act of 1933 § 12(b), 15 U.S.C. § 77*l*(b) (2006).

[54] *See* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 440 (7th Cir. 1987) ("Rescission entails the undoing of the deal, the return of the parties to the position they occupied before."); Burgess v. Premier Corp., 727 F.2d 826, 837 (9th Cir. 1984) (citing Prescott v. Matthews, 579 P.2d 407, 409 (Wash. Ct. App. 1978)) ("Rescission voids the transaction and returns to both parties the consideration they paid.").

[55] Randall v. Loftsgaarden, 478 U.S. 647, 659 (1986) (quoting S. REP. NO. 73-47, at 1 (1933)).

[56] 23 N.E. 301 (N.Y. 1890); *see also* Michael L. Bell, Casenote, *Securities Law—Rescissionary Recovery Under Federal Securities Law—Tax Offset Rule Struck Down. Randall v. Loftsgaarden, 106 S.Ct. 3143 (1986)*, 17 CUMB. L. REV. 275, 278–79 (1986–1987) (tracing the history of rescissionary remedies for securities fraud actions).

[57] *Vail*, 23 N.E. at 302–03.

[58] Bell, *supra* note 56, at 282.

[59] *Randall*, 478 U.S. at 659.

defense for defendants.[60] By adding this provision, Congress specifically rejected the traditional theory of rescission that courts had been applying previously and noted that the traditional approach created "an unfair windfall to shareholders who have not in any way been harmed by the misstatement or omission."[61] Therefore, since Congress has enacted the PSLRA, defendants can use loss causation as an affirmative defense in actions both for damages and for rescission.

III. DISTINGUISHING BETWEEN TRANSACTIONAL CAUSATION AND LOSS CAUSATION

As noted above, loss causation is an element of recovery[62] or an affirmative defense in private securities fraud claims. Recovery under Section 11 and Section 12(a)(2) is based on a tort formula for damages, whereby a plaintiff can recover losses that are proximately caused by fraud or a misstatement.[63] Specifically, to overcome a defendant's loss causation defense, a plaintiff must prove "a causal connection between a defendant's misstatements and the plaintiff's harm."[64] However, it is important to distinguish between the two types of causation that are required in securities fraud claims: loss causation and transactional causation.[65] While loss causation is rooted in the tort concept of proximate cause, transactional causation is essentially the same concept as traditional tort "but for" causation.[66] Distinguishing between the two types of causation is critical because there can be no legal liability absent loss causation.[67]

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[60] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (codified at 15 U.S.C. § 77*l*(b) (2006)).

[61] S. REP. NO. 104-98, at 23 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 702; *see also* H.R. REP. NO. 104-369, at 42 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 741 (noting the windfall effect that can take place when calculating damages for securities fraud cases); ALAN R. PALMITER, SECURITIES REGULATION: EXAMPLES & EXPLANATIONS 249 (4th ed. 2008).

[62] Although Rule 10b-5 has a heightened scienter requirement unlike Section 11 and Section 12, a plaintiff under Rule 10b-5 must also prove loss causation as an element of recovery.

[63] Geffen, *supra* note 16, at 23; *see also* Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 360 (2007) (noting that modern day securities fraud claims share some of the same elements of traditional common law fraud or deceit claims).

[64] Geffen, *supra* note 16, at 23.

[65] First Nationwide Bank v. Gelt Funding Corp., 27 F.3d 763, 769 (2d Cir. 1994) (noting that a securities fraud plaintiff "must prove both transaction and loss causation").

[66] Geffen, *supra* note 16, at 23.

[67] *Id.*

A. Transactional Causation

Transactional causation "is akin to reliance and requires only an allegation that 'but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction.'"[68] This requirement "(merely) means that the misstatement caused the plaintiff to engage in the transaction for which the plaintiff seeks redress."[69] Transactional causation is essentially the same thing as the tort law concept of "but for" causation, meaning that the plaintiff must establish that he or she would not have entered into the transaction "but for" the misstatement.[70] In a famous loss causation case, *Huddleston v. Herman & MacLean*, the United States Court of Appeals for the Fifth Circuit illustrated the difference between transactional causation and loss causation:

> [A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.[71]

In sum, transactional causation is analogous to reliance or "but for" causation and is fairly easy to establish and rarely ever contested.

B. Loss Causation

In *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court of the United States defined loss causation for securities fraud litigation.[72] In that case, investors that purchased stock in a pharmaceutical company brought a 10b-5 claim[73] against the company for false statements

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[68] Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005) (quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d. Cir. 2003)). Courts analogize transactional causation to reliance and require it for securities fraud claims, yet, under Section 11 and Section 12(a)(2), reliance is not required to recover. CHOI & PRITCHARD, *supra* note 27, at 263, 291–92.

[69] Geffen, *supra* note 16, at 23.

[70] *Lentell*, 396 F.3d at 172.

[71] 640 F.2d 534, 549 n.25 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

[72] 544 U.S. 336, 338, 345–46 (2005).

[73] Rule 10b-5 is a regulation that "forbids, among other things, the making of any 'untrue statement of a material fact' or the omission of any material fact 'necessary in order to make the statements made . . . not misleading.'" *Id.* at 341 (quoting 17 CFR § 240.10b-5 (2004)). The courts have read into the regulation an implied private right of

regarding approval of a new asthmatic spray device by the Food and Drug Administration ("FDA").[74] The investors alleged that the purchase price was artificially inflated because the pharmaceutical company had falsely claimed that the FDA would approve of the new asthmatic spray, which could cause drug sales, and thus profits, to increase.[75] The Court held that the investors failed to adequately allege loss causation[76] because they did not "claim that Dura's share price fell significantly after the truth became known."[77] The Court noted that "securities fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions."[78] Thus, loss causation is similar to a standard of proximate cause in traditional tort actions in that (1) the alleging party must have suffered an actual economic or pecuniary loss, (2) the fraud or misrepresentations must have been the proximate cause of the loss suffered, and (3) simply purchasing shares of stock at an inflated price does not meet this standard.[79]

Similarly, in *Lentell v. Merrill Lynch & Co.*, the Second Circuit noted that the analogy to "the tort-law concept of proximate cause" is imperfect because, unlike a foreseeable injury proximately caused by a defendant, "it cannot ordinarily be said that a drop in the value of a security is 'caused' by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated."[80]

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action "which resembles, but is not identical to, common-law tort actions for deceit and misrepresentation." *Id.*

[74] *Id.* at 339.

[75] *Id.*

[76] *Id.* at 346.

[77] *Id.* at 347.

[78] *Id.* at 343.

[79] *See id.* at 342; Bullard, *supra* note 22, at 565 ("The Court explained that merely purchasing shares at an inflated price did not satisfy the common law standard of proximate cause in which the loss causation element is rooted."). Some academics have criticized *Dura* as ambiguous and overly complex. *See, e.g.*, Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 155 (2006) ("*Dura* did not address the problems of applying the [fraud on the market] theory in noisy markets. When markets are irrational, it may not be clear how much, if any, damages connect to defendants' misstatements."); John C. Coffee, Jr., *Loss Causation After 'Dura': Something for Everyone*, N.Y. L.J., May 19, 2005, at 5, 8 (claiming that the court's ambiguous dicta leaves the door open for "phantom losses," which are those "that have no corroboration in actual market movements"). *But see* Matthew L. Fry, *Pleading and Proving Loss Causation in Fraud-on-the-Market-Based Securities Suits Post-*Dura Pharmaceuticals, 36 SEC. REG. L.J. 31, 31 (2008) (noting that the *Dura* court clarified the broad application of proximate cause for securities fraud claims by "requiring that the defendant's fraud caused the plaintiffs' economic loss").

[80] 396 F.3d 161, 172–73 (2d Cir. 2005); *see also In re* Vivendi Universal, S.A. Sec. Litig., 634 F. Supp. 2d 352, 363 (S.D.N.Y. 2009) ("[S]tock prices decline in reaction to

The court went on to state that the loss must be foreseeable and "be caused by the materialization of the concealed risk."[81] The materialization of the risk deals with the relationship between the misstatement and its subsequent disclosure to the public, and it is similar to what is known as the "corrective disclosure-price drop" paradigm whereby the price of the security is "corrected" by the disclosure of a misstatement to the market causing the price to drop.[82]

For example, suppose an investor purchases a security for $20. Later, it becomes known that the price of that security is inflated because of a misstatement or misrepresentation. The misstatement is then disclosed to the market and the price of the security drops from $20 to $5. The market "corrected" the inflated price of the security and returned it to its true market value. The investor is then able to prove a causal connection between the misstatement and the loss in economic value (price) of the security that he or she purchased. Accordingly, the investor is able to recover the difference in the price paid for the security ($20) and the price of the security after the disclosure of the misstatement ($5). Therefore, a misstatement alone is not sufficient to establish legal liability for a securities fraud claim. The misstatement must conceal information from the market, which when disclosed or materialized would "cause" the price of the security to drop.[83] This concept generally requires a secondary market or aftermarket to disclose the fraud whereby the price of the share will be corrected. However, in the context of mutual funds, there is no secondary market or aftermarket for shareholders to prove loss causation.[84]

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information released into the market rather than in reaction to the fraudulent statements themselves.").

[81] *Lentell*, 396 F.3d at 173. Under this theory, liability on a securities fraud claim can extend if

> the decline in a security's price is not caused by the market's reaction to a corrective disclosure revealing precisely the facts concealed by the fraud, as they existed at the time of the defendant's misstatements. Under the theory, the plaintiff may prove loss causation by showing, instead, that the materialization of a fraudulently concealed risk caused the price inflation induced by the concealment of that risk to dissipate.

Hubbard v. BankAtlantic BanCorp., Inc., 688 F.3d 713, 726 (11th Cir. 2012).

[82] *Hubbard*, 688 F.3d at 726–27. Both the "materialization of the risk" and the "corrective-disclosure-price-drop" theories act as price-correction mechanisms whereby damages can be calculated.

[83] *Dura*, 544 U.S. at 343 ("To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires."); *see also Lentell*, 396 F.3d at 173 (noting that the law requires "that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk").

[84] Bullard, *supra* note 4, at 822.

IV. THE SPLIT OF AUTHORITIES ON SECTION 11 & SECTION 12(A)(2) CLAIMS BROUGHT BY MUTUAL FUND SHAREHOLDERS

Since *Dura*, courts have interpreted loss causation requirements differently in cases involving Section 11 and Section 12(a)(2) claims brought by mutual fund shareholders. Some courts have found that a decrease in share price cannot be a direct result of the disclosure of a misrepresentation.[85] Other courts have applied a less stringent standard, which demands only a causal connection between the misrepresentation and the loss.[86] Three recent cases highlight the confusion over how to analyze loss causation for mutual fund shareholder claims.

A. In re Charles Schwab Corp. Securities Litigation

The United States District Court for the Northern District of California in *In re Charles Schwab Corp. Securities Litigation* ("*Charles Schwab*") interpreted loss causation broadly and found that it was adequately pleaded by mutual fund shareholders.[87] In that case, investors brought a putative class action suit under Section 11 and Section 12(a)(2), alleging that the defendants had misrepresented the fund's risk profile and mix of assets by changing investment policies and, specifically, had invested heavily in risky mortgage-backed securities which declined in value—thus, they overstated the value of the fund's holdings.[88] The defendants claimed that the court should follow precedent and find that the plaintiffs lacked loss causation.[89] Specifically, the defendants argued that the plaintiffs were investors in mutual funds rather than individual securities and, because the NAV is calculated by statutory formula, that it is impossible for the misrepresentations to cause a decline in the value of the portfolio's

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[85] *See, e.g.*, D.E.&J. P'ship v. Conway, 133 F. App'x 994, 1001 (6th Cir. 2005) (finding that the plaintiffs had not adequately pled loss causation because they alleged only that prices were inflated and did not allege that the market's acknowledgement of the misrepresentation caused the price to drop); Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.").

[86] *See, e.g.*, Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 WL 2355411, at *12 (N.D. Cal. Aug. 14, 2006) (finding that a plausible theory of causation exists when secret paybacks were made to broker-dealers from mutual fund assets); *In re* Mutual Funds Inv. Litig., 384 F. Supp. 2d 845, 864 (D. Md. 2005) ("Loss causation simply 'is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.'" (quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc. 343 F.3d 189, 197 (2d Cir. 2003))).

[87] 257 F.R.D. 534, 547–48 (N.D. Cal. 2009).

[88] *See id.* at 542–44.

[89] *Id.* at 546.

holdings.[90] The court rejected this defense as too narrow,[91] and determined that a plaintiff need only show "that the *subject* of the fraudulent statement or omission" caused the loss suffered.[92]

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[90] *Id.*

[91] *Id.* at 547 ("Defendants' narrow formulation of loss causation would effectively insulate mutual fund companies from claims for a wide range of material misrepresentations regarding fund policies, risks and investment decisions. Defendants would immunize a scheme that purported to invest in low-risk government bonds but in fact invested in legitimate but high-risk treasure-hunting expeditions. Loss causation, however, is not limited to the common 'corrective disclosure-price drop' scenario.").

[92] *Id.* (quoting Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005)). The court cited *In re Morgan Stanley & Van Kampen Mutual Fund Securities Litigation*, No. 03 Civ. 8208(RO), 2006 WL 1008138, at *9 (S.D.N.Y Apr. 18, 2006), *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 171, 183 (2d. Cir. 2007), *In re Mutual Funds Investment Litigation*, 590 F. Supp. 2d 741, 748 (D. Md. 2008), and *Lentell*, 396 F.3d at 173, 177, yet came to the opposite conclusion. *Charles Schwab*, 257 F.R.D. at 546–48. In fact, the court quoted *In re Merrill Lynch & Co., Research Reports Securities Litigation*, 568 F. Supp. 2d 349, 359 (S.D.N.Y. 2008), which also cited *Lentell*, to support its reasoning:

> [T]he Second Circuit has made clear that in order "[t]o plead loss causation, the complainant must allege facts that support *an inference* that [defendants'] misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud."

Charles Schwab, 257 F.R.D. at 547 (emphasis added) (quoting *In re Merrill Lynch*, 568 F. Supp. 2d at 359). Furthermore, the court went on to state that other theories, such as a "run on the fund" scenario (analogous to a fraud-on-the-market theory), would be conceivable. "[A]s losses mounted, more an[d] more investors sought to withdraw their investments, forcing the fund to liquidate assets at low prices, which in turn contributed to the share-price decline." *Id.* at 547–48. Similarly, in *Rafton v. Rydex Series Funds*, the Northern District of California reiterated its broad interpretation of loss causation. No. 10 CV 01171 LHK, 2011 WL 31114, at *10 (N.D. Cal. Jan. 5, 2011). In that case, plaintiffs brought claims under Section 11 and Section 12(a)(2). *Id.* at *6. The defendants presented the same (almost exact) argument as was brought in *Charles Schwab*: that mutual funds and exchange traded funds are valued according to their NAV, not a public market. *Id.* at *10. The court rejected the argument stating that it "would lead to the absurd result that such funds could even *intentionally* misrepresent material facts with impunity." *Id.* at *11. The court relied heavily on *Charles Schwab* and *In re Daou Systems, Inc.*, 411 F.3d 1006, 1025 (9th Cir. 2005), to reach its conclusion. *Rafton*, 2011 WL 31114, at *11 ("'[A] plaintiff is not required to show that a misrepresentation was the sole reason for the investment's decline in value in order to establish loss causation'" (quoting *In re Daou*, 411 F.3d at 1025)). *In re Evergreen Ultra Short Opportunities Fund Securities Litigation* is a similar case out of the District of Massachusetts in which the fund shareholders alleged that the defendants made misrepresentations about the riskiness of the fund's investments, that they artificially inflated the NAV, and that, when the misrepresentations were revealed, the NAV declined in value. 705 F. Supp. 2d 86, 89–90 (D. Mass. 2010). The court noted that these claims "are sufficient to demonstrate that there is a colorable claim of loss causation which is all that is required to survive a motion to dismiss." *Id.* at 95. The *Evergreen* conclusion stretched the *Charles Schwab* conclusion to the limits.

B. In re State Street Bank & Trust Co. Fixed Income Funds Investment Litigation

In contrast, in *In re State Street Bank & Trust Co. Fixed Income Funds Investment Litigation* ("*State Street*"), the Southern District of New York dismissed the shareholders' claim for insufficiently pleading loss causation.[93] In that case, the shareholders alleged that their fund managers misrepresented the nature, extent, and potential consequences of the fund's investments in mortgage-backed securities.[94] In defense of these allegations, the defendants made the same argument that was used in *Charles Schwab*; however, in this case, it was successful. The court "somewhat reluctantly" agreed with the analysis the defendants provided (the same as in *Charles Schwab*) and drew support for that argument by looking to the text of Section 11(e).[95] The court noted that the statutory scheme "envisions material misrepresentations in the prospectus inflating the market price of the security at the time of the statement" and that when the misrepresentation is revealed, the market "corrects the price."[96] The court relied on *Dura*, *Lentell*, and the specific language of the statute to apply the corrective disclosure-price drop test.[97] The court did note that the plaintiff's theory of the case was substantially similar to the theories relied on in *Charles Schwab*, yet it rejected those conclusions.[98]

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[93] 774 F. Supp. 2d 584, 595–96 (S.D.N.Y. 2011).

[94] *Id.* at 585. Specifically, the plaintiffs alleged that (1) the prospectus's statement claiming a "diversified portfolio" was misleading; (2) the prospectus's statement that the fund sought liquidity was misleading because the fund abandoned its objective of liquidity; and (3) the prospectus's statement that it would only invest in high quality debt securities was misleading. *Id.* at 586–87.

[95] *Id.* at 592–93. Section 11(e) reads:

> The suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought . . . .

Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006).

[96] *State Street*, 774 F. Supp. 2d at 593.

[97] *Id.* (noting that "the statute awards as damages the difference between the two prices—the purchase price reflecting the inflation associated with the material misstatement and the latter reflecting the market correction after disclosure").

[98] *Id.* at 591–92. The theories were also similar to those asserted in *Rafton* and *Evergreen*. As in *Charles Schwab*, the court relied on *Lentell* to reach its conclusion. *Id.* at 588–90; *see also In re* Morgan Stanley & Van Kampen Mut. Fund Sec. Litig., No. 03 Civ.

Specifically, the court used a simple example to show why the plaintiffs' theories were incorrect:

> Suppose two individuals, P1 and P2, purchase shares of a mutual fund for $50 a share at the same time. The fund's prospectus contains a material misrepresentation. P1 sells his shares on Tuesday for $55 a share. On Wednesday, the shares of the fund fall to $25. On Thursday, P2 sells his shares for $25 a share. P1 and P2 are analytically indistinct, except that P2 suffered a loss and P1 did not. If we say that the material misrepresentation "caused" P2's losses, this leads to a paradox: both P1 and P2 are subject to the same "proximate cause," yet one has a legal cause of action and one does not. Indeed, the measure of P1's damages under Section 11 would result in a negative number.[99]

How is this paradox solved? It is solved by noting the difference between transaction causation and loss causation.[100] Both P1 and P2 share the same transaction causation, but they do not share the same loss causation.[101] By requiring the price of the share to be corrected by the revelation of the misrepresentation (corrective-disclosure price drop) P1 and P2 become distinct. When the misrepresentation was revealed on Wednesday, the price dropped to $25 a share. Thus, the misrepresentation has proximately caused P2's loss; it is the revelation of the misrepresentation that creates the difference in P1 and P2's selling prices and marks the measure of damages awarded to P2.[102]

This example marks the distinction between mutual funds and ordinary stock traded on a market. Using the same example, in the mutual fund context, both P1 and P2's shares would be valued according to their NAV at the end of the day on Tuesday. But, on Wednesday, after the misrepresentation, the value of the shares would still be the value of the underlying assets that the mutual fund holds minus liabilities and divided by the number of outstanding shares. A misrepresentation in the nature, extent, and mix of the fund cannot correct the value of the shares. Whether the disclosure of the misrepresentation would have happened on Wednesday (when the NAV is calculated) or not, the fund

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8208(RO), 2006 WL 1008138, at *9 (S.D.N.Y. Apr. 18, 2006) (holding that the value of a mutual fund is calculated by a statutory formula and that "[p]laintiffs explain[ed] no mechanism by which a mutual fund share's price could differ from its objective 'value'"). The Southern District of New York in *In re Salomon Smith Barney Mutual Fund Fees Litigation* came to its conclusion based on reasoning similar to *In re Morgan Stanley*. 441 F. Supp. 2d 579, 589–90 (S.D.N.Y. 2006) (holding that the loss suffered is the "diminution of value of the mutual fund share" and that it was impossible to show that the misstatements, in that case, affected the NAV).

[99] *State Street*, 774 F. Supp. 2d at 593.

[100] *Id.* at 593–94.

[101] *Id.*

[102] *Id.* at 594.

still holds the same shares which are used to calculate the per share price. The *State Street* court noted this complex distinction, and, despite the obvious reluctance to rule in favor of the defendants, the court stated "that it is bound by the text of sections 11 and 12"[103] and made a plea to the legislature to correct this problem:

> It seems likely that Congress never considered that it might be creating a loophole for fraudulent misrepresentations by mutual fund managers when enacting these provisions. But if this is so, closing the loophole requires legislative action. Here, where the NAV does not react to the any [sic] misstatements in the Fund's prospectus, no connection between the alleged material misstatement and a diminution in the security's value has been or could be alleged.[104]

This distinction makes a mutual fund that misleads or omits statements on its registration statement or prospectus potentially immune from suit for damages or rescission under Section 11 and Section 12(a)(2) of the Securities Act.[105]

C. In re Oppenheimer Rochester Funds Group Securities Litigation

In *In re Oppenheimer Rochester Funds Group Securities Litigation* ("*Oppenheimer*"), the District of Colorado denied the defendants' motion to dismiss[106] and criticized the *State Street* opinion as "dense and provocative."[107] In *Oppenheimer*, the shareholders brought thirty-two class action claims against the defendants,[108] alleging that the "Fund Prospectuses and offering statements were materially misleading and rendered investors' capital extremely vulnerable to changing market conditions."[109] The defendants relied heavily on *State Street* to assert the

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[103] *Id.* at 595.

[104] *Id.* at 595–96 (internal citation omitted).

[105] *But cf.* Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 92–93 (2d. Cir. 2010) (holding that investors can adequately plead loss causation when bringing a 10b-5 claim when the investment advisors and their affiliates (1) failed to disclose to investors that a transfer agent would perform limited services, and instead, a subcontractor would perform a majority of transfer agent functions, but (2) still charged a fraction of the transfer agent fees while the subsidiary would pocket the difference).

[106] 838 F. Supp. 2d 1148, 1180 (D. Colo. 2012).

[107] *Id.* at 1176.

[108] *Id.* at 1152. It should be noted that the court dismissed the plaintiffs' claims under Section 13(a) of the Investment Company Act because it found that Section 13(a) did not provide a private right of action. *Id.* at 1159; *see* Investment Company Act § 13(a), 15 U.S.C. § 80a-13(a) (2006).

[109] *Oppenheimer*, 838 F. Supp. 2d at 1152. The shareholders claimed that "[a]ll of the Funds pitched themselves as vehicles for generating high yields of tax-free interest income from municipal bond portfolios that would be carefully assessed and monitored," when in fact they engaged in risky strategies, "relying on low quality, unrated, and/or illiquid bonds, or on highly-leveraged derivative instruments known as 'inverse floaters,'" which

same loss causation defense[110] and argued that the "absence of loss causation [was] apparent on the face of the complaint."[111] The court, however, emphatically rejected the *State Street* analysis as "both hypertechnically narrow and sweepingly broad" because it focused "too narrowly" on the NAV as an objective valuation of a mutual fund's long-term holdings.[112] Instead, the court looked at the underlying assets and noted that they had "taken a hit" only when the holdings had to eventually be liquidated.[113] Thus, "the Funds' unconventional and negatively-leveraged holdings moved both *with* and *counter to* market forces resulting in rapid and accelerated declines . . . and declines in NAV that *were* related to Fund disclosures that obscured or misrepresented these risks."[114] The court stated that "*State Street* neither supports the assertion that diminution in mutual fund asset value can 'never' be causally related to fund registration statements" and noted that the "[p]laintiffs' claims are not premised on 'the common "corrective disclosure-price drop" scenario' in which a security's value declines after negative or corrective disclosures unrelated to misrepresentations or omissions in offering statements."[115] Rather, their claims were premised on "the price-volatility and risk associated with aggressive and highly leveraged investment strategies"—risks that they did not know they were undertaking due to misleading statements—"that resulted in" devaluation of the fund's NAV,[116] thus making the

made their investments vulnerable to changing conditions in the market. *Id.* Specifically, when the credit crisis of 2008 occurred, the plaintiffs' NAVs fell 30–50%, while other similar funds fell only 10–15%. *Id.* at 1155.

[110] *Id.* at 1174–75. The defendants argued that a decline in mutual fund value is "*always* the result of things 'other than' prospectus representations because open-end mutual funds are not traded on secondary markets." *Id.*

[111] *Id.* at 1174; *see also In re* DoubleClick Inc. Privacy Litig., 154 F. Supp. 2d 497, 508 (S.D.N.Y. 2001) ("[A] court may properly dismiss a claim on the pleadings when an affirmative defense appears on its face."). *But see In re* Giant Interactive Grp., Sec. Litig., 643 F. Supp. 2d 562, 572 (S.D.N.Y. 2009) (refusing to dismiss Section 11 and Section 12(a)(2) claims because "the affirmative defense of negative causation is generally not properly raised" at the pleading stage); Levine v. AtriCure, Inc., 508 F. Supp. 2d 268, 272–73 (S.D.N.Y. 2007) (observing that a loss causation affirmative defense is generally raised at the summary judgment stage due to the fact-intensive nature of the defense).

[112] *Oppenheimer*, 838 F. Supp. 2d at 1175.

[113] *Id.*

[114] *Id.* (first and second emphases added).

[115] *Id.* at 1175; *see also In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 866–67 (D. Md. 2005) (noting that the only damages that are recoverable under Section 11 and Section 12(a)(2) are based on the price difference damages formula in the statute).

[116] *Oppenheimer*, 838 F. Supp. 2d at 1175.

"[p]laintiffs' losses . . . plausibly linked to those misleading statements and omissions."[117]

D. Analysis

To recover on a Section 11 or Section 12(a)(2) claim, the statutory language requires some kind of price-correction mechanism whereby damages directly caused by the misrepresentation can be calculated. The lack of a secondary market in mutual fund cases necessarily means that it is impossible for traditional methods of calculation such as "materialization of the risk" or "corrective disclosure-price drop" to apply to calculate damages. The revelation of a misrepresentation would not affect the NAV because it is only calculated by what the fund actually holds at the time of valuation.[118] Therefore, under the statutory damages formula of Section 11 and Section 12(a)(2), it is impossible for any misrepresentation in a fund's holdings to cause a decline or loss in the fund's NAV. Specifically, because of the unique way in which a fund's NAV is calculated, the requirement of a corrective-price mechanism or materialization of the risk to show that a misrepresentation has caused the loss complained of is impossible for mutual fund shareholders to prove to overcome a defendant's affirmative loss causation defense.

Accordingly, the *State Street* court determined "that it is bound by the text of sections 11 and 12"[119] and that it would be up to the legislature to correct the problem.[120] In contrast, the *Oppenheimer* court took a different view of interpreting the statutory language, noting that "the argument that purveyors of mutual funds . . . are immune from suit under [Sections] 11 or 12(a)(2) because NAV is a rote mathematical calculus that cannot be impacted" by misstatements or omissions "is sweepingly broad," and it is "one for lawmakers to make express as a matter of policy, not for trial courts to declare on motions to dismiss."[121]

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[117] *Id.*

[118] Geffen, *supra* note 16, at 23–24 (noting the distinction between NAV and market valuation); *see also* Bullard, *supra* note 22, at 560–61 ("Because of the way that funds are priced, there is no public disclosure of information that could ever affect a fund's net asset value.").

[119] *In re* State St. Bank & Trust Co. Fixed Income Funds Inv. Litig., 774 F. Supp. 2d 584, 595 (S.D.N.Y. 2011); *see also In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 866 (D. Md. 2005) (noting that the only damages that are recoverable under Section 11(a) and Section 12(a)(2) are based on the price difference damages formula in the statute).

[120] *State Street*, 774 F. Supp. 2d at 595–96.

[121] *Oppenheimer*, 838 F. Supp. 2d at 1176; *see also* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188 (1994) ("Policy considerations cannot override our interpretation of the text and structure of [an act], except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it.").

The court went on to state that "[u]nless and until Congress defines mutual fund offering statements out of the category of registration statements . . . [it] will take the statute's language at face value and consider Defendants' loss causation arguments within its confines."[122] To provide support for its position, the *Oppenheimer* court noted that "*State Street* is the only decision to date that stands for the sweeping proposition that open-end mutual funds are categorically excluded from Congress's reach under the [Securities Act],"[123] and that the "restrictive view of liability" in *State Street* "is simplistic" and runs counter to the much broader common view of liability.[124]

However, "if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary 'to examine the additional considerations of "policy."'"[125] Under Rule 10b-5, courts generally afford plaintiffs more flexibility in proving loss causation.[126] But Rule 10b-5 does not contain a statutory damages formula.[127] As the Northern District of California in *In re Worlds of Wonder Securities Litigation* recognized, the measure of

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[122] *Oppenheimer*, 838 F. Supp. 2d at 1176.

[123] *Id.* The court called the *State Street* decision "dense and provocative." *Id.*

[124] *Id.* The court criticized *State Street*, stating,

> As intriguing as I may find the *State Street* court's persistence in testing plaintiffs' pleadings and in contrasting pleading requirements in 1934 and 1933 Act cases, I am unconvinced by its holding that misrepresentations in open-end mutual fund prospectuses are categorically excluded from investors' reach under the 1933 Act or that Plaintiffs' allegations in this case fall outside its purview. If I am ultimately persuaded *State Street* applies and constitutes the better-reasoned of the various decisions reaching Defendants' loss-causation argument, it will be after Plaintiffs have had an opportunity to marshal evidence to counter an affirmative defense premised upon it. I will not follow the *State Street* court's lead and apply its holding preemptively.

Id. at 1176–77.

[125] Aaron v. SEC, 446 U.S. 680, 695 (1980) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976)); *see also* Versyss Inc. v. Coopers & Lybrand, 982 F.2d 653, 657 (1st Cir. 1992) (noting that Section 11's "very stringency suggests that, whatever the usual rule about construing remedial securities legislation broadly, some care should be taken before section 11 is extended beyond its normal reading" (internal citation omitted)).

[126] *See, e.g.*, Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (stating that "'the plaintiff need not show that the defendant's act was the sole and exclusive cause of the injury he has suffered; "he need only show that it was 'substantial,' i.e., a significant contributing cause"'" (quoting Bruschi v. Brown, 876 F.2d 1526, 1531 (11th Cir. 1989))).

[127] *Compare* Rule 10b-5, 17 C.F.R. § 240.10b-5 (2012) (providing no statutory damages formula), *with* Securities Act of 1933 § 11, 15 U.S.C. § 77k(e) (2006) (outlining a specific damages formula), *and* Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77*l*(a)(2) (2006) (outlining a specific damages formula).

damages for Section 11 and Rule 10b-5 are different for a reason.[128] Rule 10b-5 is meant to be a "catch-all" to protect investors from fraud.[129] In contrast, Section 11 is not an anti-fraud provision; rather, it attempts to balance its own strict liability provisions. Therefore, Congress expressly implemented a damages formula to limit damages directly caused by the misleading conduct. Thus, the damages formula must be followed by the court to achieve the purposes of liability under Section 11 and Section 12(a)(2).

Furthermore, a fund's NAV is the most reasonable reflection of "value" for purposes of determining damages in Section 11 and Section 12(a)(2) cases. The theory that a fund's NAV is "a *substitute* for the actual sale or purchase 'price' of a security that trades individually on secondary markets on a daily basis and no more,"[130] and that the value of the underlying assets can still be affected by the "materializations of risk" which have misled fund shareholders,[131] does not take into account the dynamics of market forces or the role of the NAV in limiting investment risks from market forces.

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[128] 814 F. Supp. 850, 876–77 (N.D. Cal. 1993), *aff'd in part, rev'd in part*, 35 F.3d 1407 (9th Cir. 1994) ("[I]t is no accident that the measures of damages for Section 11 violations and Rule 10b-5 violations are different. Rule 10b-5 is a catch-all provision that provides a remedy for any misleading conduct made in connection with the purchase or sale of securities, provided that the defendant possessed fraudulent intent, or scienter. The broad 'loss causation' standard applied in the Rule 10b-5 cases cited by plaintiffs is judicially created to deter fraudulent conduct. The measure of damages, the difference between the price paid for the security and its 'true value', is similar to any misleading statements that appear in a prospectus. Section 11 does not require the plaintiff to prove fraudulent intent, or even negligence, on the part of the defendant. In order to balance the harsh, strict liability features of Section 11, Congress expressly has limited the damages to those directly caused by the defendant's misleading conduct. The remedy and the loss causation defense are provided by statute, and stand in stark contrast to the judge-made remedy for Rule 10b-5 violations.").

[129] *See, e.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 174 (1994) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("Although limited in scope, § 11 places a relatively minimal burden on a plaintiff. In contrast, § 10(b) is a 'catchall' anti-fraud provision . . . ."); Chiarella v. United States, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catchall clause to prevent fraudulent practices.").

[130] *In re* Oppenheimer Rochester Funds Grp. Sec. Litig., 838 F. Supp. 2d 1148, 1176 (D. Colo. 2012) (emphasis added).

[131] *Id.* However this argument runs counter to what some scholars and observers have noted in the mutual fund context. *Compare* Bullard, *supra* note 22, at 561 (noting that loss causation requires a corrective price-drop after disclosure of the misstatement), *and* Geffen, *supra* note 16, at 22 (same), *with* Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 821 (2009) (arguing that loss causation is difficult to determine in securities fraud cases because there are many factors that affect the value of a security).

While it may be correct that the NAV acts as a substitute for a secondary market, it does not take into consideration the differences between a statutorily calculated formula and the dynamics of an open secondary market as a price-correction mechanism.[132] In other words, statutorily calculated values are different than values determined on an open market. As noted above, on a traditional open market, "stock prices decline in reaction to *information* released into the market."[133] However, in the mutual fund context, the fund's underlying assets are affected by market forces, but the information released about the make-up of the fund itself does not affect the underlying assets that determine the NAV. Therefore, while the NAV might be a "substitute" for a secondary market, it does not have the same effect on the price per share of a mutual fund as a secondary market.[134] However, as the case law illustrates, some courts are reluctant to follow this analysis. That reluctance leaves mutual fund shareholders in an uncertain position and could serve as a deterrence from bringing claims under Section 11 and Section 12(a)(2).

V. A PROPOSED SOLUTION FOR MUTUAL FUND SHAREHOLDERS

It is unlikely that Congress intended to create a loophole for mutual fund managers to be immune from suit for making false or misleading statements on a registration statement and prospectus. To remedy this situation, Congress should amend Section 12(b) of the Securities Act to provide an exception—from the loss causation defense—for mutual fund shareholders who have purchased shares in a fund based on false or misleading statements in a fund's registration statement or prospectus to rescind absolutely and recover the consideration paid for the shares in

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[132] *See In re* Direxion Shares ETF Trust, 279 F.R.D. 221, 233 (S.D.N.Y. 2012) (distinguishing *State Street* on the grounds that exchange-traded funds can be traded in a secondary market); *Changes in NAV*, *supra* note 12.

[133] *In re* Vivendi Universal, S.A. Sec. Litig., 634 F. Supp. 2d 352, 363 (S.D.N.Y. 2009) (emphasis added).

[134] Additionally, calling the NAV a "substitute" for a secondary market does not take into consideration the unique objectives and role the NAV plays in valuing mutual funds. Mutual funds are meant to provide a low-risk, diversified investment with the value not determined directly by the market forces (like an ordinary security) but instead by the NAV to assume a portion of the investment risk. Furthermore, the court fails to take into consideration the unique objectives of calculating the value of mutual funds shares. Mutual funds are meant to assume a portion of the risk of changing market forces. A traditional secondary market and the statutory formula for calculating the NAV have different objectives and perform different functions for investors.

the fund.[135] The author suggests that Section 12(b) be amended to read as follows:

> In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable, *except for the person who sues in equity to recover the consideration paid for such securities as valued according to their net asset value as defined by 17 C.F.R. § 270.2a-4(a)(1)–(5).*[136]

As noted above, because of the lack of a secondary market, a price-correction mechanism is not present, and, therefore, a rescission remedy should be available for shareholders. Under the PSLRA, Congress amended the Securities Act to include Section 12(b), requiring plaintiffs to prove loss causation in claims for rescission, thus rejecting the pure rescission theory of recovery for traditional fraud claims. Congress added Section 12(b) to avoid windfalls, in rescissionary actions, to shareholders who were not directly harmed by the misstatement.[137] However, in a mutual fund context, the problem of windfalls to shareholders is outweighed by the dangers of a potential windfall going to fund managers. Specifically, without a method of recovery, fund managers in violation of Section 12(a)(2) would get an unfair windfall because managers could potentially have misstatements in a prospectus, which cause an investor to purchase shares, and then receive management fees even though an investor may not have purchased shares "but for" the misstatement. Because there is no price-corrective mechanism for fund shareholders under the statutory damages formula, shareholders should be provided a rescissionary remedy (the value originally paid for the securities) to avoid a windfall to fund managers. Admittedly, this solution potentially creates a windfall in favor of the shareholders, which is what Congress sought to avoid.[138] The distinction, however, is that a shareholder of traditional securities would still have the option to collect damages under the price depreciation formula in Section 12(a)(2). But,

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[135] Rescission would be subject to a three-year period provided by Section 13 of the Securities Act. *See* Securities Act of 1933 § 13, 15 U.S.C. § 77m (2006) (showing that the statute of limitations is virtually the same for both Section 11 and Section 12(a)(2) claims).

[136] *See id.* § 12(b), 15 U.S.C. § 77*l*(b) (author's alterations in italics); 17 C.F.R. § 270.2a-4(a)(1)–(5) (2012).

[137] *See* sources cited *supra* note 61.

[138] *See* sources cited *supra* note 61.

as explained above, mutual fund shareholders do not have that option. Therefore, while mutual fund shareholders may receive a windfall, the effect would be capped at the price that was initially paid for the funds, whereas shareholders of traditional securities traded on a market have two options: damages or rescission.

Additionally, because both Section 11 and Section 12(a)(2) already provide a private right of action, courts should interpret Section 11(e) and Section 12(b) to allow shareholders to recover the management fees paid to a fund manager[139] under a common law unjust-enrichment or disgorgement theory.[140] If a shareholder can prove transactional causation, a shareholder could argue that the manager has received a measurable benefit that has been unjustly retained because of a misstatement.[141] Specifically, the manager would not have received the management fees awarded without the misstatement because the shareholder would not have invested in the fund "but for" a material misstatement or omission. These damages are measureable and not subject to the above loss causation analysis because management fees are calculated after the value of the underlying assets is calculated and are subsequently subtracted from the value of the underlying assets, making the fees measurable and directly related to a misstatement in a registration statement or prospectus.[142] Therefore, a shareholder can claim that all fees awarded to a fund manager unjustly enriched the manager by way of a misstatement that caused the shareholder to invest in the fund.

Furthermore, shareholders should be able to elect to either rescind (under the proposed congressional amendment) or keep their shares in the fund. To avoid any unfair windfalls[143] to shareholders or excessive

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[139] *See* George P. Roach, *How Restitution and Unjust Enrichment Can Improve Your Corporate Claim*, 26 REV. LITIG. 265, 294 (2007) (noting the distinctions between unjust enrichment claims brought in equity and at law, and stating that unjust enrichment for a defendant's profits is a claim at law).

[140] *See* Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204, 217 (2002) (acknowledging unjust enrichment as a distinct cause of action in equity).

[141] *See generally* JAMES F. HOGG ET AL., CONTRACTS: CASES AND THEORY OF CONTRACTUAL OBLIGATION 116–19 (2008) (discussing the theory of restitution and unjust enrichment).

[142] *See* Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 93 (2d. Cir. 2010) (noting a distinction in damages when shareholders' claims are based on misrepresentations with regard to management fees); Geffen, *supra* note 16, at 23–24 (describing how to calculate the NAV).

[143] This scenario could create a windfall whereby shareholders would be able to keep their shares at a lower risk and then sue for rescission if the price falls. Admittedly, this creates a complex problem; however, when balancing the equities, a free ride for a short period—before the statute of limitations runs—is not as problematic as a fund manager receiving management fees by way of a misrepresentation.

punishment to a fund manager, if a shareholder elects to keep their shares in the fund, the manager should be allowed to keep all the fees that would normally be paid once the misstatement or omission becomes known to the shareholders. The manager should be able to keep those fees because, at that point, the shareholders know of the misstatement and have—from that point on—consciously elected to continue their investment in the fund and receive benefit of the services of the fund manager, who should be fairly compensated for the services provided. This solution also follows the purposes of the existing statutory language because the shareholders are not receiving a windfall for damages not caused by the misstatement, and the shareholders are able to use unjust enrichment claims as insurance to avoid the risk of prior investments because the damages are simply the fees awarded and not the difference in value of the price per share of the fund.[144]

Alternatively, if a shareholder elects to pursue an unjust enrichment or disgorgement claim combined with a rescission action (under the proposed congressional amendment), the shareholder would be placed as close as reasonably possible to the position the shareholder was in before investing in the fund. Therefore, an equitable outcome would be achieved for shareholders without having an onerous negative impact on fund managers, while also providing a deterrence against false or misleading statements made in a mutual fund's registration statement or prospectus.

CONCLUSION

In sum, mutual funds are an important and popular investment tool for individual investors and many U.S. households. Section 11 and Section 12(a)(2) of the Securities Act provide broad legal recourse for shareholders trading on a primary market. However, under the damages formula in Section 11(e) and Section 12(b), mutual fund shareholders are barred from recovery because a fund's price per share is calculated by statutory formula, the NAV, and not traded on a secondary market. Because of the way the NAV is calculated, the damages formula under Section 11(e) and Section 12(b) or rescission under Section 12(b) makes it impossible for fund shareholders to overcome a defendant's loss causation defense. Therefore, Congress should amend Section 12(b) to allow shareholders a rescissionary action for false or misleading statements in a fund's prospectus. Additionally, courts should interpret

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[144] *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 345 (2005) ("[T]he statutes make these . . . actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.").

Section 11(e) and Section 12(b) to allow shareholders to recover fees paid to a fund manager based on an unjust enrichment or disgorgement theory so that mutual fund shareholders are provided with an equitable outcome.

Samuel L. Moultrie[145]

[145] The Author would like to thank the Honorable Thomas L. Moultrie, Senior Circuit Court Judge for the State of Oregon, for his support and encouragement, Professor J. Haskell Murray for his guidance and mentorship, and the members of the *Regent University Law Review* for their hard work on this Note. The opinions expressed and any errors made are those of the author.

IN MEMORIAM: REMEMBRANCES FROM THE LEGACY OF CHIEF JUSTICE LEROY ROUNTREE HASSELL, SR.

Gloria Whittico[*]

INTRODUCTION

On February 9, 2011, Chief Justice Leroy Rountree Hassell, Sr. went home to be with the Lord.[1] The Norfolk, Virginia native, a child of educators, attended the University of Virginia, graduating in 1977.[2] In 1980, he graduated from Harvard Law School,[3] going on to become a partner at the Richmond, Virginia office of McGuire, Woods, Battle & Booth.[4] He was subsequently appointed to the Supreme Court of Virginia in 1989 by Governor Gerald L. Baliles,[5] eventually appointed chief justice, and served in that capacity until January 31, 2011.[6] This Essay is offered in his memory and to the glory of God.[7]

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[1] "Leroy R. Hassell Sr., 55, a lawyer and civic leader who became the first black chief justice of the Virginia Supreme Court and who launched a commission that helped modernize the state's mental health care system, died Feb. 9 in Richmond." Adam Bernstein, *Moderate Jurist Served as First Black Chief Justice in Va.*, WASH. POST, Feb. 10, 2011, at B7.

[2] *Id.*

[3] *Id.*

[4] *Id.* ("A Virginia native, Justice Hassell (pronounced ha-SELL) was a Harvard Law School graduate who began his legal career in Richmond. He advanced rapidly to a partnership at McGuire, Woods, Battle & Boothe, one of the nation's largest law firms. While working at the firm in the 1980s, he chaired the Richmond School Board and became involved in other civic activities.").

[5] *Id.*

[6] *Id.*

[7] The final weekend of October 2012 marked the occasion of the Twelfth Annual National Constitutional Law Moot Court Competition being held here at Regent University School of Law. The Competition has been re-named the "Leroy R. Hassell, Sr. National Constitutional Law Moot Court Competition," in honor of our late friend and brother in Christ. When I received the request from the Regent Law Moot Court Board to serve as a competition judge, I felt compelled by the Holy Spirit to answer that call to service. I was moved to do so by the profound recognition that this request was not mere happenstance or serendipity; when the Lord called me to write this piece, and given the enthusiasm with which this project was met by the members of Regent University Law Review, I felt as if I had been given the opportunity both to serve, as well as to immerse myself in an environment in which I would be able to reflect upon Chief Justice Hassell's legacy and the profound effect that he had on the students of this school. It is somehow sweet and fitting

Chief Justice Hassell will be remembered in the many capacities in which he served others as a man of God, a jurist, an educator, a mentor, and a humanitarian. First and foremost, Chief Justice Hassell was a God-fearing man whose deeply-rooted love of Our Lord informed the many facets of his complex and abundant life.[8] To be sure, because his faith defined his existence, it is predominantly through this lens that this Essay explores his life.

As a jurist, Chief Justice Hassell architected many improvements to the judiciary of the Commonwealth of Virginia. In his capacity as a jurist, he authored numerous opinions in which he sought to do justice and to instruct. These opinions are remarkable in their elegance of form and relative simplicity of language. Part I of this Essay includes, among other things, a review of his articles and speeches, in which he discussed the role of the dissenting opinion and its significance in the rule of law. Part II explores Chief Justice Hassell as an educator. It examines his intellectual legacy and includes reflections from students, professors, and others who interacted with him at this level. Part III describes how he served as a mentor to many, including his former law clerks, several of whom offer their remembrances of the many ways in which he influenced their lives and careers. Finally, Part IV observes the ways in which he revealed a supreme humanitarianism. In so doing, this Essay

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that the graduating class of 2013 is the last class to be touched by the "Chief," a loving soubriquet bestowed upon him by at least one of his former law clerks. E-mail from Noelle James, Former Law Clerk to Chief Justice Hassell, to author (Oct. 24, 2012, 11:55 AM) (on file with the Regent University Law Review). This work is a tribute to him from those of us who were privileged to interact with him. As I took my seat on the bench in the courtroom in Robertson Hall room 221 at Regent University School of Law and prepared to consider the oral arguments that had been prepared by the students in the competition, I could not help thinking that this was just the kind of event for which the Chief would have so enjoyed serving as a judge. Although the then-passed Chief did not judge, he nonetheless was present and presided in spirit over each of the courtrooms in which the various rounds of the competition were held.

[8] A managing partner at McGuireWoods LLP, Richmond, Virginia, and close friend of the late Chief Justice wrote,

> Every public address Leroy Hassell gave as chief justice began or ended by giving honor to God. The chief justice loved his God with all his heart. He felt that God was the source of all his extraordinary abilities, and he humbly gave God credit for his accomplishments. Like George Washington Carver, he believed that with the blessing of great abilities came the obligation to use them to their fullest. He also felt a responsibility to assist others, particularly the less fortunate, and he did so in ways great and small. He gave leadership to the boards of several local charities. His position as an usher at his church allowed him to quietly minister to many in need of help, both spiritual and temporal.

George Keith Martin, *Tribute to Chief Justice Leroy R. Hassell, Sr.*, 46 U. RICH. L. REV. 5, 6 (2011).

explores the persistence and courage he exhibited in connection with his efforts to reform the mental health commitment laws in the Commonwealth of Virginia, as well as his efforts to increase the level and improve the quality of pro bono legal services available to the people of the Commonwealth. This Essay concludes with a number of proclamations that provide an eloquent summary of his legacy, especially as that legacy relates to his strong commitment to the people of the Commonwealth of Virginia.

Admittedly, this is not a typical academic article. In an effort to honestly reflect the impact of Chief Justice Hassell's stirring legal career and devoted personal life, this Essay includes a substantial amount of personal recollections from the individuals who knew him best. Nothing can better depict the life and principles of this great man than the words of his closest acquaintances. It has been my intention to provide the venue for their words to shine and, in so doing, to better memorialize Chief Justice Hassell's powerful legacy.

I. THE "DUTY" TO DISSENT: A JURISPRUDENCE OF "YIELDING TO HIGHER PRINCIPLES"

From the time that Chief Justice Hassell took the bench of the Virginia Supreme Court in 1989 until the time of his death in 2011, he authored 297 opinions, 12 concurrences, and 23 dissents.[9] In six cases, he dissented in part and concurred in part.[10] The subject-matter of his judicial writings encompass a wide variety of legal topics. His opinions are written with an elegance and simplicity that reveal his mastery of the complex legal matters that came before the court. Despite the elegance of his writing, however, the decisions he handed down bear the hallmark of a jurist who intentionally wrote for his audiences. During an October 9, 2003 speech he delivered at Howard University School of Law, he described each of the three distinct "audiences" for which an appellate judge writes:

> Keep in mind that an appellate judge must write first to persuade his or her colleagues. Therefore, the appellate judge's immediate audience consists of the members of the court who will participate in the decision-making process.

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[9] These numbers were determined by running a search on LexisNexis. Note that there is some overlap between the concurrences and dissents representing the instances when Chief Justice Hassell would concur in part and dissent in part.

[10] *See* Atkins v. Commonwealth, 534 S.E.2d 312 (Va. 2000), *rev'd*, 536 U.S. 304 (2002); Arlington Cnty. v. White, 528 S.E.2d 706 (Va. 2000); Williams v. Williams, 501 S.E.2d 417 (Va. 1998); Jackson v. Commonwealth, 499 S.E.2d 538 (Va. 1998); Greater Richmond Transit Co. v. Wilkerson, 406 S.E.2d 28 (Va. 1991); Gay v. Va. State Bar, 389 S.E.2d 470 (Va. 1990).

> The second audience a judge must address when writing any type of opinion consists of the litigants who are before the court. Appellate judges must be mindful that we are required to adjudicate the legal principles of the case that [are] pending before the court. Therefore, the scope of the appellate opinion should not exceed the boundaries of the issues as framed by the litigants. Appellate courts are not legislative bodies; rather, appellate courts should confine their decisions to a resolution of the issues before the court. Appellate judges should not, ought not, and must not, act as a "super" legislative body.
>
> The appellate judge must also consider, as his or her audience, the Bar and the public. Lawyers will advise their clients to undertake certain acts or to refrain from certain acts because of judicial precedent. The public will govern its behavior and rely upon the advice of counsel based upon decisional law.[11]

After making these observations about the process by which appellate court judges author opinions, Chief Justice Hassell then turned to the true purpose of his speech—what he referred to as "the propriety of dissent"[12] in the appellate courts.

After describing the doctrine of stare decisis[13] and its "significant role in the orderly administration of justice,"[14] Chief Justice Hassell discussed the functions of appellate court dissenting opinions:

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[11] Leroy Rountree Hassell, Sr., *Appellate Dissent: A Worthwhile Endeavor or an Exercise in Futility?*, 47 HOW. L.J. 383, 386–87 (2004). The Chief Justice delivered this lecture on the occasion of the Fourteenth Annual Clarence Clyde Ferguson, Jr., Lecture Series. The Chief Justice described Professor Ferguson as "the first black tenured professor at the Harvard Law School." *Id.* at 383. Of Professor Ferguson, Justice Hassell wrote:

> When I attended Harvard Law School, I had a few, but not many, conversations with Professor Ferguson. He was friendly and kind. He had a gentle spirit of encouragement. Professor Ferguson, as well as Professor Derrick A. Bell, Jr., the other black tenured professor at Harvard Law School when I was a student, made special efforts to serve as mentors to black students. I, for one, will always be indebted to these men because I can say, without equivocation, that they had a significant impact upon my development as a lawyer and as a jurist.
>
> As I prepared for this lecture, I spent a great deal of time in an effort to learn more about the life of Professor Ferguson. As a result of this endeavor, my esteem for Professor Ferguson continued to increase and, yet, I was somewhat saddened because I wish that I had spent more time with him.

Id. at 384. As I will discuss below, I did not get to know our beloved Chief Justice as well as his former law clerks, friends, fellow jurists, and other colleagues. I, too, have been saddened as I researched and wrote this Essay, wishing, as Chief Justice Hassell did of Professor Ferguson, that I had been able to spend more time with the Chief Justice himself.

[12] *Id.* at 385.

[13] Much has been written on the question of the propriety and decorum of the dissenting opinion. Many scholars and jurists have offered their thoughts on the subject. For example, Justice William J. Brennan, Jr. stated,

> Our strong adherence to the doctrine of *stare decisis* does not, however, compel us to perpetuate what we believe to be an incorrect application of the law; neither will we be compelled by the doctrine of *stare decisis* to ignore our *duty* to develop the orderly evolution of the common law of this Commonwealth. Indeed, this Court's obligation to reexamine critically its precedent will enhance confidence in the judiciary and strengthen the importance of *stare decisis* in our jurisprudence. Although we have only done so on rare occasions, we have not hesitated to reexamine our precedent in proper cases and overrule such precedent when warranted.[15]

Having thus situated the act of authoring a dissenting opinion within a normative context, the Chief Justice then elaborated on the notion of dissent as a duty.[16] He offered the following illuminating declaration that further refined his initial observations:

> I believe that in the appropriate case, a judge has the *duty* to dissent if, in the opinion of that judge, the majority has failed to properly apply the law or to correctly interpret the constitution. And, even though I have the utmost respect for the role of *stare decisis* and the

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> Dissent for its own sake has no value, and can threaten the collegiality of the bench. However, where significant and deeply held disagreement exists, members of the Court have a responsibility to articulate it. This is why, when I dissent, I always say why I am doing so. Simply to say, "I dissent," I will not do.

William J. Brennan, Jr., *In Defense of Dissents*, 37 HASTINGS L.J. 427, 435 (1986). Another distinguished jurist has examined the reasons judges offer separate opinions.

> Why and when do judges write separately? The question is easiest to answer in the case of a dissenting judge. She is driven publicly to distance herself from her colleagues out of profound disagreement, frustration, even outrage. A dissenter is admitting she has not been able to convince her colleagues, and because she herself cannot be convinced by their logic, she can be seen as implicitly criticizing them for being obtuse, lazy, bullheaded or some variation on those qualities—before she ever writes a word. Most judges dissent reluctantly. A dissent makes no new law; it highlights one's difference from a majority of colleagues, and it means extra, self-assigned work.

Patricia M. Wald, *The Rhetoric of Results and the Results of Rhetoric: Judicial Writings*, 62 U. CHI. L. REV. 1371, 1412 (1995). Justice Ginsburg has observed,

> What is right for one system and society may not be right for another. In civil-law systems, the nameless, stylized judgment, and the disallowance of dissent are thought to foster the public's perception of the law as dependably stable and secure. The common-law tradition, on the other hand, prizes the independence of the individual judge to speak in his or her own voice, and the transparency of the judicial process.

Ruth Bader Ginsburg, *The Role of Dissenting Opinions*, 95 MINN. L. REV. 1, 3 (2010).

[14] Hassell, *supra* note 11, at 392 (quoting Selected Risks Ins. Co. v. Dean, 355 S.E.2d. 579, 581 (Va. 1987)).

[15] *Id.* (third emphasis added) (quoting Nunnally v. Artis, 492 S.E.2d 126, 129 (Va. 1997)).

[16] *Id.*

> application of that doctrine, I remain convinced that on rare occasions, that doctrine must yield to *higher principles*.[17]

These "higher principles" are addressed more fully below. The next Section of this Essay discusses a number of Chief Justice Hassell's dissenting opinions as selected from a full survey of all the opinions from which he felt compelled to dissent. The discussion involves an analysis of some of his more significant dissents, with an eye toward revealing the "higher principles" that provided him with guidance as he discharged his "duty" to dissent.

A. The Chief Justice and the Dissenting Opinion as Imperative

Chief Justice Hassell believed that, under certain circumstances, a duty arises to author a dissenting opinion.[18] He further refined this notion by arguing that this "duty"[19] is confined to the "appropriate case."[20] This Section articulates, based upon a close reading of his dissents, the circumstances that, from Chief Justice Hassell's perspective, command an appeal to the "higher principles"[21] that justify abrogation of the doctrine of stare decisis.[22]

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[17] *Id.* (first and third emphases added).

[18] *Id.*

[19] Normative principles in the context of dissenting opinions in the appellate courts are outlined in the American Bar Association's *Canons of Judicial Ethics*. In 1959, Karl ZoBell wrote,

> [W]hen the American Bar Association adopted its Canons of Judicial Ethics, in 1924, it did not ignore the subject of separate opinions. Canon 19 reads, in part:
>
> > It is of high importance that judges constituting a court of last resort should use effort and self-restraint to promote solidarity of conclusion and the consequent influence of judicial decision. A judge should not yield to pride of opinion or value more highly his individual reputation than that of the court to which he should be loyal. Except in case of conscientious difference of opinion on fundamental principle, dissenting opinions should be discouraged in courts of last resort.

Karl M. ZoBell, *Division of Opinion in the Supreme Court: A History of Judicial Disintegration*, 44 CORNELL L.Q. 186, 210 (1959). This formulation of the jurist's duty in this context has certainly passed the test of time. Eighty-nine years since its adoption, this section of Canon 19 still holds sway in identical language. *See* CANONS OF JUDICIAL ETHICS Canon 19 (1924).

[20] Hassell, *supra* note 11, at 392.

[21] *Id.*

[22] As will be discussed at length below, there is arguably a special set of circumstances that may compel a jurist beyond a mere application of the governing principles of precedent toward the development of a "categorical imperative" of judicial dissent. This imperative might provide the basis for the postulation of a transformational notion of the duty to dissent within the common law tradition. In a more general context, Immanuel Kant observes,

Providing a brief review of the history of appellate courts in early America in his speech at Howard University School of Law, Chief Justice Hassell remarked:

> As you are undoubtedly aware, the Supreme Court of Virginia was created before the Supreme Court of the United States, and the Supreme Court of Virginia served as a model for the United States Supreme Court. However, during the formative years of both courts, the two courts had a significant difference of opinion regarding the propriety of dissent.[23]

He then described the differences among the philosophies of dissent with an emphasis on the origins of the differing approaches—the philosophy that involved paying fealty to the notion of unanimous opinions or the approach that favored an encouragement of disagreement among the jurists who heard a particular case.[24] In doing so, he made the following observations:

> Before John Marshall served as Chief Justice of the Supreme Court of the United States, the Justices announced the Court's decisions "through the seriatim opinions of its members." This practice was consistent with the custom of the King's Bench. Chief Justice John Marshall changed this tradition and implemented the procedure of the announcement of the Court's judgments in one opinion. Dissent was discouraged, and the opinions were virtually unanimous. . . .

> *Duty is the necessity of acting from respect for the law.* I may have *inclination* for an object as the effect of my proposed action, but I cannot have *respect* for it, just for this reason, that it is an effect and not an energy of will. Similarly, I cannot have respect for inclination, whether my own or another's; I can at most, if my own, approve it; if another's, sometimes even love it; *i.e.* look on it as favourable to my own interest. It is only what is connected with my will as a principle, by no means as an effect—what does not subserve my inclination, but overpowers it, or at least in case of choice excludes it from its calculation—in other words, simply the law of itself, which can be an object of respect, and hence a command. Now an action done from duty must wholly exclude the influence of inclination, and with it every object of the will, so that nothing remains which can determine the will except objectively the *law*, and subjectively *pure respect* for this practical law, and consequently the maxim that I should follow this law even to the thwarting of all my inclinations.

IMMANUEL KANT, *Fundamental Principles of the Metaphysics of Morals*, *in* BASIC WRITINGS OF KANT (1785) 143, 158–59 (Allen W. Wood ed., Thomas K. Abbott trans., Modern Libr. 2001) (footnote omitted). Kant defines a "maxim" as "the subjective principle of volition. The objective principle (*i.e.* that which would also serve subjectively as a practical principle to all rational beings if reason had full power over the faculty of desire) is the practical *law*." *Id.* at 159 n.1. Based upon the foregoing, the question of whether a jurist should dissent can be resolved by an appeal to Kantian principles. In other words, the desire to dissent can be converted into a "categorical imperative" under which the requirement of offering a dissent comes within the purview of the practical law. For the intuitional basis of the "categorical imperative," see *id.* at 210–11.

[23] Hassell, *supra* note 11, at 385.

[24] *Id.*

> The practice of the Supreme Court of Virginia, at that time known as the Supreme Court of Appeals, was remarkably different.[25]

Chief Justice Hassell continued by articulating the role of dissent and his own philosophy regarding the importance of dissenting opinions.[26] In doing so, he provided a conceptual jumping-off point for moving into a discussion regarding a selection of his dissenting opinions:

> The intellectual historical debate about the propriety of the use of a dissenting opinion is interesting, but I do not believe that any jurist would seriously disagree that a judge has both the duty and responsibility to dissent in the appropriate case. The dissenting opinion can be a powerful and persuasive device that can shape and influence the development of the law in the judicial, executive, and legislative branches of government.[27]

B. Toward the Identification of the "Appropriate Case" that Gives Rise to the "Duty" to Dissent: An Analysis of Selected Virginia Supreme Court Dissenting Opinions by Chief Justice Hassell

Karl ZoBell writes, "The argument most frequently advanced by proponents of Dissent is that by forcefully registering disapproval of what the Court declares to be the law today, a Justice may have a positive effect upon the law as it develops tomorrow."[28] An example of the operation of this principle is Chief Justice Hassell's reflections on cases in his speech at Howard Law School demonstrate this principle.[29] He observed, "Sometimes, a dissent may form the basis of a later decision to overrule the opinion that was the subject of the dissent. I have written dissents that in later opinions formed the basis of the rationales used to overrule prior cases."[30] One of these cases in particular provides an interesting insight into Chief Justice Hassell's articulation

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[25] *Id.* (footnotes omitted).

[26] *Id.* at 386.

[27] *Id.* (emphasis added). As ZoBell's article confirms, the questions of the unanimity in judicial opinions are most assuredly not merely a matter of modern controversy. Zobell, *supra* note 19, at 187–95. Many decades ago, the topic served as the subject matter of law review articles. *See, e.g.*, Evan A. Evans, *The Dissenting Opinion—Its Use and Abuse*, 3 MO. L. REV. 120 (1938); Alex. Simpson, Jr., *Dissenting Opinions*, 71 U. PA. L. REV. 205 (1923). The question remains the concern of modern legal scholarship. *See generally* Robert Post, *The Supreme Court Opinion as Institutional Practice: Dissent, Legal Scholarship, and Decisionmaking in the Taft Court*, 85 MINN. L. REV. 1267, 1274–75 (2001); Richard A. Primus, *Canon, Anti-Canon, and Judicial Dissent*, 48 DUKE L.J. 243, 247 (1998); Adam S. Hochschild, Note, *The Modern Problem of Supreme Court Plurality Decision: Interpretation in Historical Perspective*, 4 WASH. U. J.L. & POL'Y 261, 261–62 (2000).

[28] ZoBell, *supra* note 19, at 211.

[29] Hassell, *supra* note 11, at 388–91 (citing Atkins v. Commonwealth, 534 S.E.2d 312 (Va. 2000), *rev'd*, 536 U.S. 304 (2002)).

[30] *Id.* at 391.

of the "higher principles" upon which he founded his imperative of dissent.

As I prepared this Essay, I read each of Chief Justice Hassell's dissenting opinions. Each was well-written, and in each he carefully articulated the reasons for his dissent. He propounded his arguments persuasively, and he adduced in support of each proposition the logic undergirding his position. The corpus of his dissenting opinions is voluminous.[31] As I read his work, I was struck by a number of key cases in which singular, prominent themes arose.

In *Hagan v. Antonio*, the Virginia Supreme Court considered the question of

> whether alleged improper sexual conduct by a physician during his [pre-employment physical] examination of a patient was "based on health care or professional services rendered," within the meaning of the Virginia Medical Malpractice Act (the Act), thus obligating the patient to give a notice of claim under the Act prior to instituting a common-law action for damages against the physician.[32]

The trial court sustained the defendant's demurrer and motion.[33] In ruling that the trial court did not err, the Virginia Supreme Court held,

> When the statutory definitions are applied to the facts alleged, the conclusion must be that defendant's conduct, legitimate or improper, was "based on" an "act" by a health care provider to "a patient during the patient's medical . . . care." In other words, the defendant's conduct, according to the allegations, stemmed from, arose from, and was "based on" the performance of a physical examination.[34]

Chief Justice Hassell dissented. "I dissent because I do not believe that the Medical Malpractice Act applies to acts of sexual molestation committed by a health care provider when such acts would constitute the crime of sexual assault."[35] His analysis of the court's opinion turned on the evaluation of the logical extension of the application of the court's holding to a number of related instances.[36]

> The majority's literal construction of the Act will create illogical results which the General Assembly did not intend. For example, under the majority's holding, a physician who commits an act of sexual molestation on a young boy during the course of a urological

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[31] *See supra* note 9 and accompanying text.

[32] 397 S.E.2d 810, 810 (Va. 1990). In the action at trial, the defendant/physician "filed a demurrer and motion to dismiss, asserting that the plaintiff's motion for judgment was insufficient in law because [she] had failed to allege that she had given the defendant notice 'of the alleged malpractice in writing' prior to commencement of the action." *Id.*

[33] *Id.*

[34] *Id.* at 812.

[35] *Id.* (Hassell, J., dissenting) (citation omitted).

[36] *Id.* at 813.

> examination would be entitled to the protection of the Act. Similarly, an obstetrician who sexually assaulted a female patient during a pelvic examination would also be entitled to the protection of the Act. Certainly, the General Assembly did not intend such a broad interpretation of the Act.[37]

In examining the logical implications of the court's decision, Chief Justice Hassell observed,

> The tort alleged by [the plaintiff] was not a tort based upon the provision of health care but rather a tort arising out of [the physician's] prurient interests and actions. This alleged tort falls outside of the scope of the Act. Accordingly, I would reverse the judgment of the trial court and remand the case for a trial on the merits.[38]

If this had been the majority opinion of the court, there is no way to know whether the plaintiff might have prevailed on remand. Had Chief Justice Hassell's logic, available because he yielded to the command of the "duty to dissent," ruled the day, the plaintiff would at least have had the opportunity to be heard.

In *Taylor v. Worrell Enterprises, Inc.*, the Virginia Supreme Court considered the question of "whether an itemized list of long distance telephone calls placed by the Governor's office must be disclosed when requested pursuant to the Freedom of Information Act."[39] In its opinion, the court stated,

> Viewing the Act as a whole, and presuming that the General Assembly acted within constitutional parameters, we conclude that the General Assembly intended to exclude from mandatory disclosure information which, if required to be released, would unconstitutionally interfere with the ability of the Governor to execute the duties of his office. Therefore, the information at issue here must fall within [the statutory] exemption and is not subject to compelled disclosure under the Act.[40]

Chief Justice Hassell dissented. The language he chose to introduce his argument again revealed a fundamental concern for those citizens of the Commonwealth who seek access to the court in search of "justice."

> This Court has an obligation to apply its procedural rules impartially and uniformly to all litigants. Uniform application of procedural rules, *regardless of the status of the litigant who appears before the bar of this Court*, is an *indispensable component of justice*. I dissent because the plurality ignores this Court's procedural rules and

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[37] *Id.*

[38] *Id.*

[39] 409 S.E.2d 136, 137 (Va. 1991).

[40] *Id.* at 139–40.

> precedent and decides a constitutional issue that a majority of the Justices of this Court believe is not properly before this Court.[41]

Here, Chief Justice Hassell yielded to his perception of higher principles—in this case, the principle of justice[42]—for all citizens of the Commonwealth.

In *Kelly v. First Virginia Bank-Southwest*, the Virginia Supreme Court considered a case of alleged sexual harassment from a plaintiff who claimed she suffered at the hands of her immediate supervisor.[43] She alleged that she reported to his supervisors that he had "engaged in repeated acts and statements of a sexual nature that were offensive, humiliating, embarrassing, distressing, and harassing."[44] She also alleged that his supervisors, instead of issuing a reprimand, "further intimidated and embarrassed" her.[45] Essentially, the court affirmed that the operation of the exclusivity provision of the Virginia Worker's Compensation Act barred the plaintiff's claim, in that the actions of which she complained "'arose out of her employment.'"[46] Then-Justice Hassell dissented: "I dissent because I do not believe that [the plaintiff's] claims are barred by the Workers' Compensation Act . . . ."[47] He elaborated as follows:

> I believe that under the facts of the present case, sexual harassment cannot and should not be considered "a natural incident of work" contemplated by a reasonable person familiar with the whole situation as a result of the exposure occasioned by the nature of the employment. Additionally, a supervisor's intentional acts of sexual harassment against an employee are not acts "in furtherance of the employer's business."[48]

Chief Justice Hassell further articulated his fealty to "higher principles" as he expressed a profound concern for the women of the Commonwealth who are employed in the workplaces of Virginia: "As I understand the majority's order in this case . . . female employees in Virginia are deemed to have accepted the risk of being victimized by sexual assaults committed by their supervisors if those assaults happen to occur in the work place. I do not agree with this premise."[49]

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41 *Id.* at 140 (Hassell, J., dissenting) (emphasis added).

42 "But let justice roll on like a river, righteousness like a never-failing stream!" *Amos* 5:24 (New International Version).

43 404 S.E.2d 723, 723 (Va. 1991).

44 *Id.*

45 *Id.*

46 *See id.* at 724.

47 *Id.* at 726 (Hassell, J., dissenting).

48 *Id.* at 727–28 (citation omitted).

49 *Id.* at 728.

In *Bethea v. Commonwealth*, the Virginia Supreme Court "consider[ed] whether a police officer violated the Fourth Amendment rights of a passenger in a motor vehicle when the officer requested the passenger to get out of the vehicle during a lawful traffic stop."[50] In his dissent, then-Justice Hassell wrote concerning the court's opinion that the police officer's request did not violate the passenger's rights:

> The majority, applying the totality of circumstances test . . . , states:
>
> > The totality of the circumstances we consider here . . . included a traffic stop in a high-crime area; similar traffic stops two days earlier in the same neighborhood in which weapons were discovered in a car; [the passenger's] actions immediately prior to the stop; [the police officer's] 22 years of experience and his statements that [the passenger's] actions "startled" and "scared" him; and [the police officer's] concern that [the passenger] might have weapons in the car. These circumstances constitute "specific and articulable facts" which show that [the police officer] was reasonably concerned for his safety and believed that [the passenger] might have had access to weapons with which to assault him. These facts justified the intrusion on [the passenger's] Fourth Amendment rights that occurred when [the police officer] asked him to get out of the car.[51]

In accordance with an appeal to "higher principles" of justice, then-Justice Hassell wrote,

> I disagree with the majority's holding and logic for several reasons. I do not believe that it is the law in this Commonwealth, or in this nation, that one's Fourth Amendment rights are lessened simply because one happens to live or travel in a high-crime area. Certainly, the Fourth Amendment does not accord a greater degree of protection to people who do not live in impoverished communities or neighborhoods that experience high crime rates.[52]

In *Stern v. Cincinnati Insurance Co.*, the Virginia Supreme Court heard a case that arose out of the following facts:

> On March 21, 1995, Elena [Seroka Stern], age 10, was waiting at her usual school bus stop on the east side of Sandusky Drive, a two-lane road, in the City of Lynchburg. Elena's bus approached from the north and stopped to allow her to board. The driver activated the bus' flashing red lights and safety stop sign and extended its safety gate, and Elena began to cross the road in front of the gate. When she was

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[50] 429 S.E.2d 211, 212 (Va. 1993).

[51] *Id.* at 214 (Hassell, J., dissenting) (internal citation omitted).

[52] *Id.*

> two or three feet east of the center line of the road and several feet from the front of the bus, a car struck and injured her.[53]

The court addressed two issues in the case.[54] In affirming the trial court's conclusion, the court held "that Elena was neither 'occupying' nor 'using' the bus at the time of the accident and, therefore, was not entitled to underinsured motorist coverage" under the automobile driver's uninsured motorist provision of his insurance policy.[55] The court, in holding that there was no coverage under the insurance policy, stated that it did "not think that Elena, who was near the center line of the road when she was struck, was in . . . close proximity to the school bus."[56] Based upon this analysis, the court denied Elena coverage under the automobile driver's automobile insurance policy.

The court then turned to the second issue, which involved the interpretation of the Virginia uninsured motorist statute.[57] In holding that the child was not "using" the school bus at the time the automobile struck her, the court explained that "[s]he had not been a passenger in the bus, and, although the school bus was utilized by its driver to create a safety zone for Elena to cross the street, the safety measures did not constitute a use of the bus *by Elena*."[58]

Later reflecting on the foundation for his dissenting opinion, Chief Justice Hassell said,

> The majority [in *Stern*] held that [Elena] was not using the bus within the intendment of Code § 38.2-2206 and, therefore, she was not entitled to underinsured motorist coverage under a liability policy.
>
> The implications of the majority's holding were significant because that holding affected all children who rode buses to school daily in Virginia.[59]

In dissent, Chief Justice Hassell drew not solely upon his knowledge of insurance law, the rules of contract interpretation, and the

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[53] 477 S.E.2d 517, 518 (Va. 1996).

[54] Two issues were certified to the court by the Fourth Circuit Court of Appeals. *Id.* at 519. The first issue involved inquiry into whether Elena was, as a matter of law, considered to be "occupying" the school bus as defined under the terms and conditions of the motor vehicle liability insurance policy of the driver who struck Elena. *Id.* The second issue, involving statutory construction of the governing provision of the applicable Virginia code, *id.*, is discussed below, *infra* note 56.

[55] *Id.* at 518–19.

[56] *Id.* at 519. The court construed the "clear and unambiguous" provisions of the insurance policy, based upon the "plain and ordinary meaning" of the relevant terms, to conclude that the circumstances under which Elena was struck did not satisfy the "close proximity" standard. "She was merely approaching the bus, and we cannot say that she was getting in or on the bus, as contemplated in the [insurance] policy." *Id.*

[57] *Id.*

[58] *Id.* at 520.

[59] Hassell, *supra* note 11, at 391 (footnotes omitted).

canons of statutory interpretation, but also upon his experiences as a parent. In a dissenting opinion joined by Justices Lacy and Keegan, he wrote,

> I write separately because I believe that Elena Stern was "getting on" the school bus as that term is set forth in the . . . policy of insurance.
>
> The . . . policy of insurance defines "occupying" as "in, upon, getting in, on, out or off." As the majority points out, Elena was waiting for the public school bus at her designated bus stop when the bus approached from the north and stopped, allowing her to board. The bus driver activated the bus' flashing red lights and safety stop sign and extended the bus' safety gate. Elena began to cross the road in front of the gate. She was several feet from the front of the bus when a car struck her. *My experiences, as well as those of thousands of parents throughout this Commonwealth who accompany children to bus stops daily*, lead me to the inescapable conclusion that, based upon the aforementioned facts, Elena clearly was getting on the bus when she was injured.[60]

In his speech at Howard Law School, Chief Justice Hassell reminded his audience that "*stare decisis* . . . plays a significant role in the orderly administration of justice by assuring consistent, predictable, and balanced application of legal principles."[61] Despite his obvious recognition of the importance of stare decisis, Chief Justice Hassell, likely in recognition of his duty to incorporate a human element in the application of legal strictures, dissented.[62] Having taken into account the competing arguments of whether the laws of the Commonwealth of Virginia entitled Elena and her parents to relief, Chief Justice Hassell appealed to his life experiences, to those of other parents, and to his knowledge of human nature, to conclude that Elena and her parents should have prevailed on their claim. As a father, Chief Justice Hassell saw, through the lens of a parent, the factual circumstances of the case of a little girl attempting to cross a road to catch her school bus. His

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[60] *Stern*, 477 S.E.2d at 520–21 (Hassell, J., dissenting) (emphasis added).

[61] Hassell, *supra* note 11, at 392 (quoting Selected Risks Ins. Co. v. Dean, 355 S.E.2d 579, 581 (Va. 1987)).

[62] In the context of the process by which judges are selected, Professor Joseph Raz has commented,

> When discussing appointments to the Bench, we distinguish different kinds of desirable characteristics judges should possess. We value their knowledge of the law and their skills in interpreting laws and in arguing in ways showing their legal experience and expertise. We also value their wisdom and understanding of human nature, their moral sensibility, their enlightened approach, etc.

JOSEPH RAZ, THE AUTHORITY OF LAW: ESSAYS ON LAW AND MORALITY 48 (2d ed. 2009). In offering this dissent, Hassell exhibited the kind of understanding of human nature that, it may be argued, trumps the mechanical application of legal principles.

vision of the legal questions presented empowered him to speak in terms that compelled looking beyond the strictures of insurance, contract, and statutory canons of interpretation. In his dissent, Chief Justice Hassell commented,

> [C]ontrary to the majority's holding, I believe that Elena was using the bus within the intendment of Code § 38.2-2206. The school bus driver had stopped the bus for the sole purpose of allowing the children to get onto the bus, and, as the majority admits, the driver activated the bus' flashing red lights and safety stop sign, and extended its safety gate. The majority also admits that after the driver had activated the bus' safety features, Elena began to cross the road "in front of the gate." The majority's own factual summary indicates to me that Elena was, at the very least, using the bus' safety devices. The sole purpose of such devices is to protect school children. Therefore, I am at a loss to understand the majority's conclusion that "the safety measures did not constitute a use of the bus *by Elena*."[63]

Although Elena and her parents did not prevail, nearly identical facts returned to the docket of the Virginia Supreme Court in 1998.[64] Chief Justice Hassell later reflected,

> Two years later, in *Newman v. Erie Insurance Exchange*, the Supreme Court of Virginia, in a strikingly similar case, overruled its decision in *Stern*. The court held that a child struck by a motor vehicle while walking across a street to get on a bus whose driver had stopped the bus and activated the warning lights and stop arm was in the process of using the bus within the intendment of Code § 38.2-2206.[65]

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[63] *Stern*, 477 S.E.2d at 521 (Hassell, J., dissenting). Of particular interest here is the language Hassell employed as he reflected later on his occasions of disagreement with the majority of the court. He appears to have been mindful of his own admonition that

> Collegiality is an important characteristic necessary for an effective appellate court. Mutual respect and admiration, camaraderie, and good feelings toward fellow judges can only enhance and strengthen the deliberation process. On the other hand, harsh words uttered in a dissent may be disruptive and counterproductive to the harmony and goodwill within the small group setting of an appellate court.

Hassell, *supra* note 11, at 387. Although it is obvious that Chief Justice Hassell had a fundamental disagreement with the court's opinion, he did not employ any of the verboten phraseology that Judge Patricia M. Wald has described. Wald, *supra* note 13, at 1382–83 (urging judges not to use such words as "facile," "simplistic," "contrary to common sense," and "blind" to describe one another's opinions). Although Judge Wald's observations relate to studies of the United States Supreme Court, it may be argued that her counsel is applicable by logical extension to, and should inform the decorum of, any court of last resort.

[64] *See* Newman v. Erie Ins. Exch., 507 S.E.2d 348, 349 (Va. 1998).

[65] Hassell, *supra* note 11, at 391–92.

In *Newman*, after a thorough review of precedent interpreting the applicable statute,[66] the court opined,

> In light of [precedent], we are compelled to overrule the holding in *Stern* that a child injured under the facts presented was not "using" the school bus, within the meaning of Code § 38.2-2206. Thus, under the facts now before us, we conclude that [the child] was using the school bus as a vehicle at the time he was injured, based on his use of the bus' specialized safety equipment and his immediate intent to become a passenger in the bus. Those facts establish the required causal relationship between the accident and [the child's] use of the bus as a vehicle.
>
> In reaching this decision, we have given deliberate consideration to the critical role that the doctrine of *stare decisis* serves in insuring the stability of the law. However, we have a duty of equal dignity to reexamine critically our precedent and to acknowledge when our later decisions have presented an irreconcilable conflict with such precedent.
>
> Under *Stern*, only children who have exited a school bus under the protection of the bus' safety equipment could be entitled to [uninsured and underinsured motorist] coverage when injured in a lane opposite the lane in which the bus was stopped. Yet, children injured in the *same* location while walking across the street to board the *same* bus under the protection of the *same* specialized safety equipment would be denied such coverage. Our action today also is taken to eliminate this paradox resulting from the application of *Stern*.[67]

This decision vindicated the logic and wisdom of human experience embodied in Chief Justice Hassell's dissent in *Stern*. By virtue of the "higher principles" articulated in his dissent, he was able to

> appeal to the brooding spirit of the law, to the intelligence of a future day, when a later decision may possibly correct the error into which the dissenting judge believes the court to have been betrayed.
>
> Nor is the appeal always in vain. In a number of cases dissenting opinions have in time become the law.[68]

In his speech at Howard Law School, Chief Justice Hassell described the most critical objective of dissenting opinions:

> The most important function of a dissent, in my view, is to expose the perceived error or weaknesses in the logic that the majority has chosen to employ in its decision. Sometimes, particularly when federal

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[66] *Newman*, 507 S.E.2d at 351. The court noted that "[t]he coverage mandated by the statute is limited to injuries that the permissive user sustained while actually using the insured vehicle." *Id.* (citing Edwards v. GEICO, 500 S.E.2d 819, 821 (Va. 1998); Randall v. Liberty Mut. Ins. Co., 496 S.E.2d 54, 55 (Va. 1998); Ins. Co. of N. Am. v. Perry, 134 S.E.2d 418, 421 (Va. 1964)).

[67] *Id.* at 352–53 (internal citations omitted).

[68] ZoBell, *supra* note 19, at 211 (quoting CHARLES EVANS HUGHES, THE SUPREME COURT OF THE UNITED STATES 68 (1936)).

> constitutional rights are implicated, a well-written dissent will attract the attention of the United States Supreme Court and influence that Court's decision to grant certiorari. For example, consider the case of *Atkins v. Commonwealth*.[69]

Regarding that case, and in the same speech at Howard, the Chief Justice remembered,

> I dissented for the following reason: Virginia Code § 17.1-313 requires that the Supreme Court of Virginia review a sentence of death and that the court consider, among other things, "whether the sentence of death is excessive or disproportionate to the penalty imposed in similar cases, considering both the crime and the defendant." I believed that the evidence presented to the jury indicated that defendant Atkins had an I.Q. of 59, the mental age of a child between the ages of nine and twelve, and that he was mentally retarded. Therefore, in my opinion, the imposition of the death penalty was excessive and disproportionate to the penalty imposed in similar cases, considering both the crime and the defendant. I concluded in my dissenting opinion that, "the imposition of the sentence of death upon a mentally retarded defendant with an I.Q. of 59 is excessive . . . considering both the crime and the defendant.[70]

Chief Justice Hassell also joined Justice Koontz's dissenting opinion in the case. Justice Koontz, reflecting Chief Justice Hassell's own opinion, wrote,

> [I]t is indefensible to conclude that individuals who are mentally retarded are not to some degree less culpable for their criminal acts. By definition, such individuals have substantial limitations not shared by the general population. A moral and civilized society diminishes itself if its system of justice does not afford recognition and consideration of those limitations in a meaningful way.[71]

In *Atkins v. Virginia*, the United States Supreme Court considered Atkins's appeal from the Virginia Supreme Court decision upholding his capital conviction.[72] Justice Stevens, writing for the Court, determined the following:

> Those mentally retarded persons who meet the law's requirements for criminal responsibility should be tried and punished when they commit crimes. Because of their disabilities in areas of reasoning, judgment, and control of their impulses, however, they do not act with the level of moral culpability that characterizes the most serious adult criminal conduct. Moreover, their impairments can jeopardize the reliability and fairness of capital proceedings against mentally

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[69] Hassell, *supra* note 11, at 388 (citing Atkins v. Commonwealth, 534 S.E.2d 312 (Va. 2000), *rev'd*, 536 U.S. 304 (2002)).

[70] *Id.* at 389 (footnote omitted) (quoting *Atkins*, 534 S.E.2d at 321).

[71] *Atkins*, 534 S.E.2d at 325 (Koontz, J., dissenting).

[72] 536 U.S. 304, 321 (2002).

> retarded defendants. Presumably for these reasons, in the 13 years since we decided *Penry v. Lynaugh*, the American public, legislators, scholars, and judges have deliberated over the question whether the death penalty should ever be imposed on a mentally retarded criminal. The consensus reflected in those deliberations informs our answer to the question presented by this case: whether such executions are "cruel and unusual punishments" prohibited by the Eighth Amendment to the Federal Constitution.[73]

Chief Justice Hassell observed that the United States Supreme Court, in that opinion, "overruled its prior decision in *Penry v. Lynaugh*. The Court held that the execution of a mentally retarded defendant violated the Eighth Amendment's prohibition against cruel and unusual punishment."[74] As the Court did so, it pointed to the dissenting opinions of Chief Justice Hassell and Justice Koontz, and stated that "[b]ecause of the gravity of the concerns expressed by the dissenters, and in light of the dramatic shift in the state legislative landscape that has occurred in the past 13 years, we granted certiorari to revisit the issue that we first addressed in the *Penry* case."[75] *Atkins* is an excellent example of the profound effect a judge can have upon the rule of law by answering the call to dissent in appropriate circumstances.

Next, in *Black v. Commonwealth*, the Virginia Supreme Court heard a case involving Virginia's cross-burning statute:

> In these appeals, we consider whether Code § 18.2-423, which prohibits the burning of a cross with the intent of intimidating any person or group of persons, impermissibly infringes upon constitutionally protected speech. The case of *Black v. Commonwealth* involves a Ku Klux Klan rally on private property with the permission of the owner, where a cross was burned as a part of the ceremony. The companion cases of *O'Mara v. Commonwealth* and *Elliott v. Commonwealth* involve the attempted burning of a cross in the backyard of the home of . . . an African-American, without permission. We conclude that, despite the laudable intentions of the General Assembly to combat bigotry and racism, the selectivity of its statutory proscription is facially unconstitutional because it prohibits otherwise permitted speech solely on the basis of its content, and the statute is overbroad.[76]

Once again, Chief Justice Hassell dissented. His tone was strident as he voiced his opposition to the position advanced in the majority opinion:

> I dissent. The majority opinion invalidates a statute that for almost 50 years has protected our citizens from being placed in fear of

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[73] *Id.* at 306–07 (internal citation omitted).

[74] Hassell, *supra* note 11, at 390 (footnote omitted).

[75] *Atkins*, 536 U.S. at 310.

[76] 553 S.E.2d 738, 740 (Va. 2001), *aff'd in part, rev'd in part*, 538 U.S. 343 (2003).

> bodily harm by the burning of a cross. The majority concludes that the Constitution of the United States prohibits the General Assembly from enacting this statute. I find no such prohibition in either the Constitution of Virginia or the Constitution of the United States. Without question, the framers of the First Amendment never contemplated that a court would construe that Amendment so that it would permit a person to burn a cross in a manner that intentionally places citizens in fear of bodily harm.
>
> I am concerned about the fair application of our jurisprudence to every citizen and the proper interpretation of our Federal and State Constitutions. These same concerns for fairness and the safety of our citizens were the very basis for the General Assembly's decision to enact Code § 18.2-423 almost 50 years ago.
>
> I stand second to none in my devotion to the First Amendment's mandate that most forms of speech are protected, irrespective of how repugnant and offensive the message uttered or conveyed may be to others. However, contrary to the view adopted by the majority in these appeals, the First Amendment does not permit a person to burn a cross in a manner that intentionally places another person in fear of bodily harm.[77]

The United States Supreme Court subsequently affirmed the unconstitutionality of this statute.[78] However, it may be argued that had Chief Justice Hassell's approach prevailed, the powerful public policy argument inherent in his dissent would have fostered increased justice in the Commonwealth of Virginia. Such a result was arguably the goal of the Virginia General Assembly a half-century ago. In any event, the case represents yet another instance where the Chief Justice yielded to "higher principles" and voiced a powerful dissent. When Chief Justice Hassell raised his voice in dissent, he did so frequently in favor of the less powerful, and always on behalf of the citizens of the Commonwealth he loved and served so well.[79]

II. THE CHIEF JUSTICE AS EDUCATOR

As I researched and prepared to write this Essay, I corresponded with many individuals who knew Chief Justice Hassell intimately and who interacted with him in many facets. The remainder of this Essay

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[77] *Id.* at 748 (Hassell, J., dissenting).

[78] Virginia v. Black, 538 U.S. 343, 347–48 (2003).

[79] The Chief Justice was a true son of the Commonwealth of Virginia. He commented: "'I do not wish to serve, however, because I happen to be black . . . .' 'Rather, I desire to serve because I am a Virginian by birth who has a strong affection and love for the [C]ommonwealth and its people.'" Anita Kumar, *UPDATED: Former Supreme Court Chief Justice Hassell Dies*, WASH. POST (Feb. 9, 2011, 10:31 AM), http://voices.washingtonpost.com/virginiapolitics/2011/02/former_supreme_court_justice_h.html.

shares the words of those individuals who knew Chief Justice Hassell much better than I.

It is important to note that the Chief Justice was indeed a true polymath and advocate for education.[80] Jeffrey A. Brauch, Dean of Regent University School of Law offered this observation:

> Chief Justice Hassell was a natural teacher. He loved students and fervently sought their success. He spent a week with us at Regent every spring, and in that week he guest-lectured in 10-12 classes. He was prepared for every one of those classes. He had spent the months leading up to his visit collecting cases and making notes on the different subjects he taught. He loved to teach. Justice Hassell was concerned that students pursue excellence in everything they did, particularly in their legal writing. He regularly offered to work one-on-one with students on their writing skills.
>
> Chief Justice Hassell may not have realized it, but he taught all of us—students and faculty—just through his character. He pursued and personally displayed excellence, professionalism, and faith. We learned from his words; we learned even more from his life.[81]

Indeed, Regent University School of Law was privileged to enjoy a special relationship with Chief Justice Hassell. As Dean Brauch further explains,

> [f]or over fifteen years, Justice Hassell served as Jurist-in-Residence at Regent University School of Law. He spent a week on campus each spring with students and faculty teaching in many settings. He taught classes, met with students individually and in groups over meals, provided counsel and advice, mooted competition teams, among a host of other things. In the last three years he visited the school one day per month in addition to his week-long visit. During those visits he met with student leaders, faculty, and staff, and gave a series of presentations on career preparation—from clerkship opportunities to displaying professionalism and civility in the practice of law.[82]

By virtue of his sincere interest in the students and faculty of the law school, illustrated by Dean Brauch's comments, it is readily evident

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[80] *See* Martin, *supra* note 8, at 6 ("The child of teachers, Chief Justice Hassell had a lifelong passion for education. While he was at McGuireWoods he served as chairman of the Richmond School Board, the youngest person to do so. He enjoyed teaching and took a personal interest in his students at the University of Richmond School of Law and Regent University School of Law, always challenging them to strive for greatness. He kept in touch with them after graduation, following their personal and professional development and taking great delight in their achievements.").

[81] E-mail from Jeffrey A. Brauch, Dean, Regent Univ. Sch. of Law, to author (Nov. 28, 2012, 12:27 PM) (on file with the Regent University Law Review).

[82] Jeffrey A. Brauch, *Leroy Hassell the Teacher*, EDUC. & PRAC., Spring 2011, at 1, 3.

that Chief Justice Hassell was a consummate educator.[83] I learned personally of his dedication to student scholarship when he served as a guest lecturer in my spring 2009 Race and the Law seminar. Ahead of his visit to our class (45 minutes had been allotted for his session),[84] he sent a list of thirteen cases, requesting that the students read them in preparation for his lectures.[85] The cases he selected for his lecture dealt with diverse areas of the law, and several were authored by the Chief Justice himself. For example, part of the assigned material were Virginia Supreme Court cases of special historical importance to the cause of civil rights. In *Lockhart v. Commonwealth Education Systems Corp.*, a civil rights case involving a claim of unjust dismissal, Chief Justice Hassell underscored the importance of equality by writing,

> We do not retreat from our strong adherence to the employment-at-will doctrine. We merely hold that the narrow exception to that doctrine . . . includes instances where, as here, employees are terminated because of discrimination based upon gender or race. The discharges [of the plaintiffs] are allegedly tortious not because they have a vested right to continued employment, but because their employers misused the freedom to terminate the services of at-will employees by purportedly discriminating against their employees on the basis of race and gender. [86]

Chief Justice Hassell assigned two of these cases, in my opinion, in order to permit the students to develop a better appreciation of the rule of law, especially the role of stare decisis. The first of these, *Loving v. Commonwealth*,[87] was a case in which the Virginia Supreme Court held that the sections of the Virginia Code[88] proscribing miscegenation violated neither the Constitution of the Commonwealth of Virginia nor of the United States.[89] He also had the students read *Loving v. Virginia*, a case in which the United States Supreme Court held that the Virginia statutes violated the Fourteenth Amendment rights of Mr. and Mrs.

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[83] "Justice Hassell was above all a teacher. That was evident from the amount of time he spent with students." *Id.* at 3. "Each year, Justice Hassell would ask for a (seemingly) crazy number of hours of student time—in class and out. . . . He arrived [on campus] with a gigantic binder of cases and notes he had prepared in the weeks leading up to the visit and got to work." *Id.*

[84] E-mail from author to Race and the Law Students (March 4, 2009, 9:51 AM) (on file with the Regent University Law Review).

[85] E-mail from Peggy Lacks, Admin. Assistant to Chief Justice Leroy Rountree Hassell, Sr., to Natt Gantt, Assoc. Dean, Regent Univ. Sch. of Law (Mar. 3, 2009, 3:40 PM) (on file with the Regent University Law Review).

[86] 439 S.E.2d 328, 322 (Va. 1994).

[87] 147 S.E.2d 78 (Va. 1966).

[88] VA. CODE ANN. §§ 20-58, -59 (1950).

[89] *Loving*, 147 S.E.2d at 82.

Loving.[90] These cases offer powerful object lessons in the way in which the rule of law can be seen as an instrument for true justice.

Chief Justice Hassell had a profound influence on his students. As one student unabashedly remarked, "Chief Justice Hassell impacted not only my performance as a law school student but essentially my entire legal career, for which I am forever grateful."[91]

III. THE CHIEF JUSTICE AS MENTOR

Although Chief Justice Hassell tirelessly contributed so much to so many as a jurist[92] and educator, he nonetheless found the time to serve

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[90] 388 U.S. 1, 12 (1967).

[91] E-mail from Rebekah Kaylor, Exec. Editor, Regent Univ. Law Review, Class of 2013, to author (Sept. 24, 2012, 10:19 PM) (on file with the Regent University Law Review). In her email, Ms. Kaylor recounts an experience with Chief Justice Hassell that had a profound influence on her as a student.

> In my first semester of law school, I was desperately trying to figure out ways to study and retain what appeared to be an impossible amount of information. The final exams seemed daunting as most of them were comprehensive finals that were 100% of my grade for each of the classes. In my desperation to figure out how to succeed in law school, I went to the meeting . . . via Skype with Chief Justice Hassell on the topic of how to do well in law school. . . . The thought of asking the Chief Justice questions was intimidating, but I understood what an honor it was to have the Chief Justice talk with us, so I tried to think of some questions. I finally found the nerve to ask the only question that came to mind. I asked the Chief Justice, "Do you have any tips on how to memorize the large amount of information we need to know?" His response forever changed my perspective on studying. He had been leaning back in his chair, and after I asked the question, he sat up in his chair, leaned forward, and then using his index finger to punctuate his statement, said, "You NEVER memorize, you MASTER the information." After he made this statement, I realized that I had been focused on the wrong thing. My focus on trying to remember information actually hamstrung my study efforts because it prevented me from internalizing the information. I took his challenge to heart and focused in on working with the material to master it rather than just trying to memorize a bunch of information. This was one of the key moments that shaped my approach to studying and I believe has had a great impact on my work product during law school. I plan on taking this same attitude into the work field after law school.

Id.

[92] It is important to remember that before Chief Justice Hassell became a distinguished jurist, he was first a distinguished lawyer. A colleague here at Regent Law School offers the following recollection.

> I joined Hunton & Williams in 1986. Hunton & Williams and Justice Hassell's firm, then known as "McGuire, Woods, Battle & Booth" (later shortened to "McGuire Woods") were the two largest law firms in Virginia, likely in this region. From the outside, one may not realize that lawyers in firms seemingly in competition with each other often end up working together with lawyers from the other large firm. The reason often is that plaintiffs will sue more than one defendant and, in large cases such as these[,] two firms

as an inspiring mentor to many. He served as a role model and source of encouragement, and did so with excellence and professionalism.[93] In the words of one who knew him,

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tended to handle, we would be co-defendants. At times our firms would go head to head, but more often we worked together.

Justice Hassell was already a well-respected senior associate at McGuire Woods when I joined the firm as an associate. Within a couple of years . . . he was elected partner in a shorter time period than usual for a lawyer to become a partner in a large firm. Of course, associates at both firms talked with each other. When we learned that Leroy Hassell had been elected a partner earlier than the time most associates take, that accomplishment created something of a legend within the associate community. Firms like Hunton & Williams and McGuire Woods apply the most rigorous criteria to those who they elect to the partnership. Thus, a lawyer who became a partner "earlier than usual" certainly drew the attention of my peers and me.

I began to ask friends at McGuire Woods and those who had cases with Leroy Hassell what it was about him that would lead [to] his being elected to partnership on a fast track. Here are the kinds of responses I received: "Leroy is a natural trial lawyer because he is intellectually gifted but also has common sense"; "Leroy is one of the most decent lawyers I know—a lawyer who is tough but fair and whose word you can count on"; and "Leroy was functioning as a partner several years into law practice because he was a natural leader, clients respected him, opposing counsel respected him, judges respected him, and juries respected him."

I wish I had more experiences with Leroy Hassell before he became Justice Hassell and, later, Chief Justice Hassell. Working with other counsel who displayed excellence and respect for everyone helped me to improve my own approach to law practice. If I had to identify one characteristic I most admired, it would be Leroy Hassell's integrity. I saw that same integrity when Justice Hassell came to talk to my classes at Regent Law School after I had become a professor. He told students, in a down-to-earth way, about the right way to practice law. I think the students enjoyed our joking with each other about the friendly rivalry between our two firms. However, I always told the students after Justice Hassell had gone back to Richmond that, though we were in rival firms, both my fellow Hunton & Williams partners and I held Leroy Hassell in the highest regard. His was a life well lived—not only as a lawyer, but later as one of the most influential Chief Justices on the Virginia Supreme Court. Our system of justice in Virginia will benefit for many years from reforms he instituted. I only hope that his successors are as strong in leading the cause for justice as was "the Chief."

E-mail from Benjamin Madison, Professor, Regent Univ. Sch. of Law, to author (Nov. 21, 2012, 7:05 PM) (on file with the Regent University Law Review).

[93] The Norfolk, Virginia native had a profound effect on others as well. As one contemporary remembers,

> [t]he Chief was always and still remains a source of motivation for me. As a young student filling out law school applications or as a young attorney trying to compete and establish myself in the local legal market, I was always encouraged by the man I knew better as Mrs. Hassell's son, Leroy. The Chief shared the same church, Shiloh Baptist Church in Norfolk, Virginia. Even though he had been residing in Richmond for several years, several members of his family still attended Shiloh. I sang in the church choir and his mother also

sang in the choir, one row ahead of me. When the news got out that I was considering and heading to law school, I was constantly reminded about Mrs. Hassell's boy, Leroy, a lawyer who had done well for himself up in Richmond. Unlike so many other young black men, I knew that someone that looked like me and that sat on the same pews that I had had become a partner in a big firm and now was a judge. I didn't appreciate the significance of the Chief's accomplishments as a 20 year-old senior in college in 1999, but I do now as a 35 year- old attorney in Hampton Roads.

What I remember the most about the Chief was an uncompromising work ethic and intellect. He would begin his day in the gym, as he called himself a "gym rat", and then jump in the car with a book bag full of files headed for Virginia Beach. He spent the ride down reading, on the phone, and emailing from his Blackberry. I would frequently meet him in the parking lot as he packed away his files or phone and he would say, "Where are we off to today?" Another administrator or I would whisk him into the building through a series of tightly scheduled appointments. A walk between classrooms or offices would be frequently infused with additional emails and phone calls. I could remember thinking to myself that this guy never stops. If he had a break in his schedule he would schedule outside appointments in the local courts or just drop in on local judges. He said that he always had to take care of his judges so he made it a point to go see them in action.

He was a highly intelligent man. In between the scheduled appointments throughout the law school, I never saw him prepare for whatever speaking engagement or task that was next, but he was always ready. He could randomly walk into a Criminal Law class, Evidence class, or a Uniform Commercial Code class and always have brilliant, on-point insight to add to any discussion. It was clear that he was not talking around a subject, but that he knew the law inside and out. The depth of his legal knowledge was amazing.

Even when he was very sick he still made an effort to honor his commitments. There was one program where he called and said that he may not be able to make it down. We talked for a moment and he decided that he would Skype instead. He didn't have to, but he wanted to. The day of that program I saw what only a few had seen as his staff prepped him for his appearance. He was physically weak but mentally ready. He was unable to fully position himself in his chair and his staff propped him up, situated his head and arms and, adjusted the cameras. When he was ready, I turned on the projector for a class of law students waiting to hear him talk about the importance of written communication. He gave one of the best programs he ever had. I had introduced him numerous times before, so many times that I had memorized his brief but impressive resume. I didn't know that that was the last time. I still have his resume taped to my desk where I used to quickly refer to it prior to introducing him.

I'm not a judge, legislator, senior partner, or law school dean, but the Chief seemed to always make a little time for me. He never said that he was making time, but he was there a lot. The Chief participated in a career services professional development program for me once every month during the school year. Every time I taught a class during his Jurist-in-Residence week, he always was a guest lecturer in my Administrative Law or Secured Transactions class. Additionally, he would pop into my office for 10-15 minutes and encourage me to get some litigation experience if I could or just talk about church, life, the job market or legal practice. Most of the time I felt as if I didn't deserve the attention of someone of his stature or I didn't know quite what to

> Chief Justice Hassell was always thinking of ways to help those around him better themselves professionally. He truly modeled servant leadership in his role with the Supreme Court; he was constantly looking for opportunities he could share with others so that they could grow and develop in their professional capacities. He thought of others before he thought of himself.
>
> This other-centeredness was evident in his relationship with the Regent community. He blessed so many in our community, including me, by mentoring us and encouraging us to be all that we were called to be.[94]

Fellow jurist, Justice Bernard S. Goodwyn, also remembers Chief Justice Hassell's efforts in furtherance of the professional education and empowerment of others:

> I met the Chief Justice during the summer of 1985. I was working as a summer associate at the Richmond, Virginia office of what is now McGuireWoods, LLP. He was a 5th year associate at the firm. We became friends, and he let me tag along with him to several court hearings during that summer.
>
> When he became Chief Justice of the Supreme Court of Virginia, I was a circuit court judge. The Chief appointed me to the Judicial Council. Thereafter, he appointed me to numerous committees, commissions and task forces dealing with a wide array of matters that the Chief thought would improve the administration of justice in Virginia.

> say when he was there, but he always made the time to stop by and talk without the rest of the world peering in. This attention was not just limited to his time at Regent. Early on I can recall attending a function one night where he was speaking. Many other important people in the room wanted his attention and I timidly approached to say hello at the conclusion of his remarks. As I approached, his body guard turned in my direction and the Chief quickly motioned for him to stand down and waived me over. That night he gave me his phone number, told me to call him, and to always stop by whenever I was in Richmond. I knew all of the clerks in his chambers, so I stopped by a few times; however, now I wish I had stopped by more. I figured there would always be more time. While he was there, I always felt welcome and that I had a place to stop when I was in Richmond.
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> The Chief was also a man of deep faith. He showed me that an individual could be a public figure and a person of unapologetic faith while not alienating or offending individuals in the process. His faith was deep but respectful. It was personal and not political. The last time he spoke to us, he spoke about the importance of obedience and how Adam caused the fall of man through an act of disobedience, but Jesus saved us through an act of obedience. Since Jesus gave his life for us, we must now give our lives back to him.

E-mail from Darius K. Davenport, Dir. of Career & Alumni Servs., Regent Univ. Sch. of Law, to author (Nov. 26, 2012, 8:24 PM) (on file with the Regent University Law Review).

[94] E-mail from L.O. Natt Gantt, Assoc. Dean, Regent Univ. Sch. of Law, to author (Nov. 27, 2012, 12:26 AM) (on file with the Regent University Law Review). I am indebted to Dean Gantt for his constant encouragement and sage advice during the writing of this Essay.

> In 2007, when there was a vacancy on the Supreme Court of Virginia, the Chief pulled me aside and told me that with my background he thought I would be a strong candidate to fill that position. As I reflect on my work on the various committees to which the Chief appointed me, I realize that the Chief purposefully involved me in efforts that would benefit my professional growth and development. Although I did not realize it at the time, those appointments were part of his mentorship.
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> Once I was on the Court, the Chief continued to be a mentor to me, doing anything he possibly could to smooth my transition onto the Court. Even when we disagreed about the law or about issues of judicial administration, he always took every opportunity to be of assistance and to help me to become a better Justice. He always emphasized the importance of the institution of the Supreme Court and our collective obligation to serve as stewards and protectors of the rule of law and justice in the Commonwealth. He also shared his tremendous and unshakable faith in God. He became much more than a person who had helped me in my career. He was a spiritual mentor, an excellent role model, and a dear friend. For that, and much more, I will always be grateful.[95]

Reflections of Law Clerks: The Chief Justice as Mentor and Much More[96]

Chief Justice Hassell had a remarkable impact on the lives of his law clerks. This impact was of a professional, spiritual, and personal nature. It is apparent that he cared very deeply for each of them, and the influence he exerted is profound to relate.

Consider, for example, the words of Judge Stephen R. McCullough, Chief Justice Hassell's law clerk from 1997–1999:

> He set a very high standard early on for me to emulate. He was extremely hard working. He treated colleagues, staff and litigants with dignity. He maintained good humor under at times stressful conditions. He emphasized the importance of rigorous research and analysis, attention to detail and the lasting value of a reputation for thoroughness and integrity. He was a devoted father and husband, and his spiritual walk animated his thoughts and conduct. He spoke of his faith often. For him, individual persons and relationships were important, not just abstract legal principles.[97]

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[95] E-mail from Justice S. Bernard Goodwyn to author (Apr. 1, 2013) (on file with the Regent University Law Review).

[96] This Section of the Essay contains the reflections of four of Chief Justice Hassell's law clerks.

[97] E-mail from Judge Stephen R. McCullough, law clerk to Chief Justice Hassell from 1997 to 1999, to author (Oct. 31, 2012, 12:30 PM) (on file with the Regent University Law Review).

Likewise, Crystal Twitty, another former law clerk to Chief Justice Hassell, remembered her time with him to be incredibly rewarding. In her words,

> [t]he "Chief" (as folks commonly referred to him) influenced my life professionally, spiritually and personally. As a professional, he improved my legal writing skills. Early on during my clerkship I was so timid about redlining or editing the Chief's draft opinions or memoranda. I will never forget the first time I was asked to edit an opinion and upon returning my comments to the Chief, he jokingly remarked, "It's okay to actually edit it. I value your opinion." In that moment, I realized he sincerely wanted my input, but also desired to mentor me. Also, while serving as the Chief Justice he frequently traveled throughout the Commonwealth for speaking engagements. In preparation, he would always ask me to visit the Library of Virginia to check-out books on each county or city he was scheduled to visit, in an effort to understand the historical context. I was so impressed with his tireless work ethic and zeal for knowledge. Both of those attributes have influenced my career and dedication to the law.
>
> As for my spiritual and personal life, the Chief was an amazing source of strength and encouragement. During my clerkship, my father was diagnosed with Lou [Gehrig]'s disease and ultimately passed away in a relatively short period of time. It was an extremely difficult time for me and my family. But, through every step of the way the Chief was there to share a kind word or prayer and allowed me to spend time with my family during very critical moments. The Chief was essentially a "God" father, and a blessing in so many ways during that season of my life. After my clerkship ended, the Chief and I remained in touch and he was always intently concerned about my family's well-being. Despite his hectic schedule, he still made time to check-in with me and others.[98]

Similarly, Noelle James fondly recalled Chief Justice Hassell's encouraging nature:

> [P]robably most impactful to all aspects of my life was how he chose me to be his summer intern and then his law clerk (there are a lot of details to this but I'll try to keep it succinct). I first met Chief Justice Hassell in the Spring of my 2L year at Regent. As the Chief did every year, he visited the law school for several days to teach classes, speak to the students, and visit faculty. A law student was assigned each day to accompany the Chief Justice to each of his events/classes, and I was lucky enough to be one of those students. During that day, we would chat in 5 minute intervals as I walked him from place to place. However, each of these 5 minutes was never small talk; he asked pointed questions about me, my classes, my goals, etc. At that time, I [was] struggling with how I would use my legal education, and even

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[98] E-mail from Crystal Y. Twitty, law clerk to Chief Justice Hassell from 2004 to 2006, to author (Oct. 22, 2012, 4:47 PM) (on file with the Regent University Law Review).

> those brief conversations with the Chief Justice were helpful and encouraging. In that short time, I could tell the Chief Justice was genuinely interested and concerned for my professional development, which was astounding to me. I realized later that the Chief Justice was like that toward so many individuals—it is amazing how much he supported new (and longtime) attorneys in their careers through his wisdom and connections. After that visit, he made a place for me as an additional summer intern, and then that led to my clerkship with him. I am grateful to this day that Chief Justice Hassell saw something in me that I did not, and from that he ended up steering my career and really my life's direction.[99]

From yet another perspective, Farnaz Farkish recalled,

> Chief Justice Hassell helped increase my confidence in my professional and personal judgment. I struggled with perfectionism and had a tendency to doubt my legal recommendations and conclusions in the research memoranda that I submitted to him. I often sought to learn whether he agreed with my recommendations. One afternoon I asked Chief Justice Hassell whether he agreed with a particular recommendation, but he did not have time to answer me as he was running late for a meeting. As he was driving to the meeting, he called me on his cellular telephone to admonish me not to doubt my legal ability. He jokingly warned me that I was allowing the demon of doubt to steal my confidence. While he and I sometimes disagreed, he always respected my legal recommendations. He gave me confidence in my legal ability.
>
> Chief Justice Hassell also taught me to respect formalities. He despised colloquialisms in legal briefs and research memoranda. For example, he would prefer the word telephone as opposed to phone. He never used telephone as a verb. He also disliked when attorneys referred to a Justice solely by his or her last name instead of by his or her full title.
>
> Spiritually, he taught me to never separate the spiritual and the secular. He was the same man in the Courtroom, in his chambers, and in his home with his family. He practiced his faith in all aspects of his personal and professional life. He would always expressly honor God in his public speeches or in his visits with students in a respectful manner.[100]

The law clerks also offered their assessments of Chief Justice Hassell's impact on the legal profession and how he accomplished his mission. In Judge McCullough's words,

> One of the recurring threads in his thoughts and actions was his concern for the less fortunate, the poor who could not afford an

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[99] E-mail from Noelle James, law clerk to Chief Justice Hassell from 2006 to 2008, to author (Oct. 24, 2012, 11:55 AM) (on file with the Regent University Law Review).

[100] E-mail from Farnaz Farkish, law clerk to Chief Justice Hassell from 2008 to 2011, to author (Nov. 27, 2012, 12:59 PM) (on file with the Regent University Law Review).

> attorney, the mentally ill, inner city school children, and hospice patients. This concern carried over into his work on the Court with regard to his admonitions to lawyers to conduct pro bono work, and his priority for the courts. He also spent considerable time as a volunteer with various organizations and in working with the community.[101]

As former clerk Crystal Twitty phrased it,

> In sum, the Chief was brilliant. He was a zealous advocate and compelling writer. Despite all of his own professional undertakings, he was mostly concerned about those less fortunate and unable to afford legal services. He was passionate about pro bono services and frequently encouraged new lawyers to serve those in need. The Chief's efforts inspired a number of local and state Bar groups to increase the number of pro bono efforts throughout the Commonwealth.[102]

In much the same vein, Noelle James recalled Chief Justice Hassell's concern for those around him:

> While the Chief could give a speech, in many ways, Chief Justice Hassell was a doer, not a talker. The Chief was always running a little late, but that was because he had set out to accomplish so many things in his day. One of the important objectives the Chief had was to see that those without a voice were heard. He had a deep care for individuals who were underrepresented within the legal system. He accomplished this mission through both how he lived his life and how he directed the state judiciary. No one was too unimportant for the Chief to talk to—we couldn't walk 2 blocks to lunch without the Chief stopping to talk to several people on the street. When the Chief swore in new members of the Virginia State Bar, he always reminded these new attorneys of the importance of representing those who were less fortunate than them. At the General Assembly, he worked tirelessly (early mornings and late at night) to encourage the legislature to create laws that were just and fair.[103]

Farnaz Farkish writes,

> Chief Justice Hassell was a champion of the rule of law. In his public speeches, he often commented that society would still function if all the doctors, accountants, social workers, and other professionals died. He emphasized that all order in society would crumble if judges and attorneys died. He believed in the role of attorneys and judges in upholding the rule of law and setting a standard of professionalism.[104]

Finally, the law clerks offered some of their favorite remembrances of Chief Justice Hassell. Their comments reveal that, behind the hardened exterior of a man committed to the rule of law, Chief Justice

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[101] E-mail from Judge Stephen R. McCullough, *supra* note 97.

[102] E-mail from Crystal Y. Twitty, *supra* note 98.

[103] E-mail from Noelle James, *supra* note 99.

[104] E-mail from Farnaz Farkish, *supra* note 100.

Hassell was a real man—compassionate, prone to humor, and constantly mindful of the importance of family.

> For example, "As a fitness fanatic," Judge McCullough recalled, he would occasionally take his clerks to the gym where he would often put much younger clerks to shame. He also did a fair amount of public speaking and often took his clerks to inner city schools and other public appearances to stress to the students the importance of education.[105]

It was Chief Justice Hassell's personality that Crystal Twitty recalled.

> I remember the Chief's great laugh and smile. He was humorous and quick-witted. There were countless occasions where the Chief would crack a joke or lighten the mood if things were getting too intense. The Chief also loved the joy of birthdays, and would often call his clerks into chambers surprising us with a humorous card and birthday cake. Those moments were disarming and unforgettable. The Chief also loved "Mr. Goodbar" chocolate bar[s], and presenting him with one could always turn a bad day into a good one. I also enjoyed traveling with the Chief when he had occasions to speak. During those times we would catch up on life and enjoy some laughs.[106]

In turn, Noelle James remembered Chief Justice Hassell's amazing work ethic and love for family. She wrote,

> I loved working on the Chief's opinions with him. For a first draft, the Chief usually liked to hammer it out in one day, which generally meant it would be a late night. I fondly remember knowing it was an opinion day when the Chief brought in a full bag of Oreos. I enjoyed and was always challenged by his opinion drafting process—he was tough, always striving for excellence, but also a kind teacher. During my first week as a law clerk, I recall Chief Justice Hassell taking me aside and explaining that he would always second guess my research and analysis and that he expected me to do the same to him. He viewed his position as a writer and preserver of the law with great respect and humility, and that was reflected in his opinion writing. That premise always made our interactions over and development of an opinion fun and challenging, especially for a brand new attorney like myself. When I disagreed with the Chief Justice on something, even if it was just the grammatical structure of a sentence, I knew I had better have evidentiary support or a well-reasoned explanation for my position. I recall one time debating over the placement of an adverb, which ended in me dragging Strunk and White's Elements of Style and Webster's Third New International Dictionary into his office for him to reach a decision.

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[105] E-mail from Judge Stephen R. McCullough, *supra* note 97.

[106] E-mail from Crystal Y. Twitty, *supra* note 98.

> A bittersweet memory comes to mind from May 2007. My mom in one week was diagnosed with breast cancer and scheduled for immediate surgery in Ohio. Law clerks don't get formal vacation time and the Chief Justice was out of town so I did not have the opportunity to share the information with him. I recall the day of surgery arriving and I was sitting in my office in Richmond, aching to be with my mom. All of a sudden, the Chief Justice, still in his coat and hat from arrival, came and sat down in my office. He told me his secretary had relayed my mom's health to him and that I needed to leave right that minute. He simply said "you need to be with your mom." There were no conditions, no limitations, no questions about my work assignments, he just said go. I cannot recall how many times the Chief emphasized the importance of family, and this was just one example of how he made sure I could be there for mine.[107]

Lastly, Farnaz Farkish understood Chief Justice Hassell as a forgiving man of honor.

> Chief Justice Hassell modeled meekness which I define as strength under control. He knew how to choose his battles and would not tolerate any disrespect for the judiciary. During my clerkship, the Supreme Court of Virginia, including Chief Justice Hassell, required an attorney to explain a critical, disrespectful comment that this attorney made about the Supreme Court during an argument to a circuit court. The attorney approached the Justices trembling and fearful of the ramifications of his actions. I remember that the male attorney was near tears as he apologized to the Justices for his poor judgment and disrespectful comment. Chief Justice Hassell accepted the attorney's apology and did not publicly reprimand him. While Chief Justice Hassell would not tolerate any form of disrespect towards himself or towards any member of the Court, he was always merciful.[108]

In closing, the law clerks offered moving reflections on Chief Justice Hassell as a man of God, a jurist, an educator, a mentor, and a humanitarian. Judge McCullough writes,

> With regard to his faith, Justice Hassell shone by his example. He lived his life in a way that would lead any impartial observer to say ["]there goes a disciple of Jesus Christ,["] not only because of his good deeds but through his inner life. He was not reluctant to share his faith, but never in an obnoxious way. It was not unusual for him to pause during the day and read from the Bible.
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> As a jurist, he was very conscientious, hardworking, and devoted to a vision of the law as an instrument that served the needs of all.
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> As a teacher, he brought his tremendous energy and experience into the classroom. He spoke with an authority few professors can convey.

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[107] E-mail from Noelle James, *supra* note 99.

[108] E-mail from Farnaz Farkish, *supra* note 100.

> As a mentor, he was all a law clerk could hope for. He provided an outstanding example of the characteristics that lead to success as a lawyer, and he took time to work with his clerks to help them improve their skills.[109]

Crystal Twitty noted the important role that family played in Chief Justice Hassell's life:

> The Chief's family was very important to him. I observed personally how he would prioritize his schedule to make time for family. He was also loyal to serving his Church, and I remember several occasions where he would bring his Bible with him and read while on road trips. It was always so refreshing to watch him deliberately prioritize time for family, church, and community service.
>
> The Chief also enjoyed speaking to young students and freshly minted lawyers. I recall visiting his former elementary school in Norfolk, Virginia, where he was invited to speak, and the students lit up when the Chief shared stories of growing up and the importance of education in achieving their goals. The Chief had such a passion for justice that carried over in all that he did. I miss him dearly and fond memories will remain with me forever.[110]

Perhaps capturing Chief Justice Hassell's devotion to his faith most clearly is Noelle James' recollection of Chief Justice Hassell's morning ritual.

> Something I always respected about Chief Justice Hassell was his morning routine when he arrived at chambers. No matter how many important tasks were waiting for him or messages I had to relay, he would always go straight to his office, black bible in hand, and shut the door to take some time alone with God. I think this simple act reflects how the Chief lived out his life. Jesus and His word were the foundation for each day the Chief lived.[111]

Farnaz Farkish's recollections reflect much of what the other clerks remembered.

> Chief Justice Hassell would always say, "God is my source." He meant that Jesus Christ was his source of strength, wisdom, ability, and success.
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> I remember working longer hours with Chief Justice Hassell during the beginning of my clerkship. Towards the end of my clerkship, Chief Justice Hassell would stop by my office and force me to leave the office with him at 5:30 p.m. While he was efficient with his time and achieved more in 55 years than most people achieve in a lifetime, he said that he did not rest enough. The legacy that he left me was not to undermine the need for and power of rest.

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[109] E-mail from Judge Stephen R. McCullough, *supra* note 97.

[110] E-mail from Crystal Y. Twitty, *supra* note 98.

[111] E-mail from Noelle James, *supra* note 99.

> Chief Justice Hassell stressed the importance of preparation. He would write his speeches weeks in advance of an event and would also memorize his speeches. As a trial attorney, he would create note cards, memorize whatever he wrote on the note cards, and practice his arguments in front of a mirror.[112]

Based upon the very words of those who knew and loved him, Chief Justice Hassell had a profound and positive impact on so many of the individuals with whom he worked. Many of those so influenced are young attorneys and jurists. May Chief Justice Hassell's legacy live on through the lives and practices of these young professionals, and may they in turn influence the next generation of lawyers and judges.[113]

IV. THE CHIEF JUSTICE AS HUMANITARIAN

The enormous number and sheer variety of the contributions and innovations that Chief Justice Hassell made are too voluminous to document here. The Appendix to this Essay provides three of the proclamations offered in his honor. These proclamations testify to the proposition that Chief Justice Hassell was a humanitarian without parallel.

Of the enumerable efforts of Chief Justice Hassell, two stand out as illustrations of his strong commitment to serving the people of the Commonwealth of Virginia. Chief Justice Hassell himself wrote concerning the first of these efforts:

> There are numerous issues that affect the provision of mental health services in Virginia and the administration of justice. When I began my tenure as Chief Justice, one of my most important priorities was to contribute to the discussion of reform of Virginia's mental health statutes and processes. The judicial branch of government is committed to improving the quality of mental health services provided to Virginians and the judicial processes attendant to civil commitments. All persons and institutions that are involved in Virginia's mental health system and processes—mental health practitioners; law enforcement personnel, including sheriffs; judges and court personnel; attorneys; magistrates; special justices; patients; patients' families and friends—have a stake in improving this area of law.[114]

This humanitarian act of reforming this system was to be gargantuan. Chief Justice Hassell turned to a law professor Richard J.

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[112] E-mail from Farnaz Farkish, *supra* note 100.

[113] "For the LORD gives wisdom, and from his mouth come knowledge and understanding." *Proverbs* 2:6 (New International Version).

[114] Leroy R. Hassell, Sr., *Reforming Virginia's Mental Health Statutes & Processes*, VA. LAW., Apr. 2006, at 35, 37.

Bonnie at the University of Virginia who he knew was critical to the success of this effort.

> In July 2005, Chief Justice Hassell called me to discuss his plans to initiate reform in the mental health laws of the Commonwealth of Virginia. Based upon a previous unsuccessful effort to overhaul civil commitment laws in the 1980s, I informed him that accomplishing such reforms would take a significant amount of time and resources, and that it would require a consensus-building involving the branches of government as well as the various stakeholders who were often critical of each other and lacked strong habits of collaboration. I stressed that none of this could be accomplished overnight. The Chief Justice seemed undaunted and asked if I would be willing to serve as chair of a Commission charged with reforming Virginia's mental health laws. I told him that I was reluctant to do so because of the time commitment and the considerable risk of failure. The Chief Justice did not take "no" for an answer. After our telephone conversation, he travelled to my office in Charlottesville, and asked me what he could do to convince me to work with him on this project. He assured me that he was willing to do whatever was necessary to bring the effort to a successful conclusion. Although I do not know the precise source of his passion and commitment to this cause, he did mention the many complaints that he had heard about the civil commitment process. I know he was particularly horrified by the experiences of families with elderly parents who initiated the commitment process only to discover that law enforcement officers soon arrived in marked vehicles to transport the elderly person—in handcuffs—to a mental health facility for evaluation. He was also appalled by the increasing numbers of people with mental illness in the Commonwealth's jails. He was passionate and persistent. How could I say no?
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> For the next 5 years, I worked closely with the Chief Justice on this important and complex project. I admired his persistence and courage, as he helped to build coalitions, overcame opposition, and inspired all of the participants. As I remarked on the occasion of his death in 2011:
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> > Chief Justice Hassell cared so deeply about addressing these problems that he made reforming Virginia's mental health laws a signature initiative of his leadership of the Supreme Court and persevered in those efforts in the face of occasional resistance and criticism. Every constituency and stakeholder group affected by mental health services (including consumers, families, police officers and mental health providers alike) was grateful for his commitment to justice, his courage and his independence of mind—the attributes we seek in all who don the judicial robe. I am

> personally grateful to have had the opportunity to know Chief Justice Hassell and to assist him in his noble quest.[115]

Another area of humanitarian reform that was close to Chief Justice Hassell was ensuring that affordable legal services were available to all, including those involved with child custody matters.[116]

CONCLUSION

This Essay provides a road map for anyone who seeks to appreciate the legacy of our great Chief Justice Hassell, and it documents some of the many sources of information about his life for anyone who desires to learn more about him. It has been a labor of love. I only wish I had been able to spend more time with Chief Justice Hassell. He was a mighty warrior for justice. May he rest in peace.

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[115] E-mail from Richard J. Bonnie to author (Nov. 30, 2012 5:53 PM) (on file with the Regent University Law Review) (quoting *Bonnie Recalls Former Va. Chief Justice Leroy Rountree Hassell*, UNIV. VA. SCH. L. (Feb. 10, 2011), http://www.law.virginia.edu/html/news/2011_spr/hassell.htm). Richard J. Bonnie of the University of Virginia School of Law is the Harrison Foundation Professor of Medicine and Law, Professor of Psychiatry and Neurobehavioral Sciences Director, Institute of Law, Psychiatry and Public Policy, and Professor of Public Policy, Frank Batten School of Leadership and Public Policy. I am grateful to Professor Bonnie for his contributions to this Essay, and for his recollections of the Chief Justice as a "persistent and courageous" humanitarian.

[116] The Local Bar Connection reported,

> On numerous occasions . . . Chief Justice Leroy R. Hassell, Sr., has underscored the need for attorneys to help make affordable legal counsel available to parties in child custody cases. He delivered the message during his swearing-in ceremony in February, in his inaugural speech in May before the Judicial Conference of Virginia and, more recently, in less formal settings across the Commonwealth where he has been sharing his thoughts on the subject in meetings with representatives of law firms, bar associations and legal services providers.

Chief Justice Seeks Bar Leaders Input for Volunteer Program, LOC. B. CONNECTION, Summer 2003, at 1, 1, *available at* http://www.vsb.org/docs/conferences/clba/lbc_su03.pdf. I wish to thank Justice John Charles Thomas for reading this Essay's introduction and for suggesting that this topic should be included in this portion of the Essay.

APPENDIX A

The following is a collection of statements and resolutions made in honor of Chief Justice Leroy Rountree Hassell, Sr.

A. Statement in the United States House of Representatives

Mr. Speaker, I rise today to honor the distinguished life and achievements of the Honorable Leroy R. Hassell Sr., former Chief Justice of the Supreme Court of Virginia, who passed away this week at the very young age of 55. While he left us in the prime of his life, his compassion and commitment to justice will leave a lasting impression on the judicial system and the world beyond the bench.

A Norfolk native, he grew up in Broad Creek and attended Norview High School. He graduated from the University of Virginia and earned his law degree from Harvard Law School. He then returned to Richmond where he quickly rose through the ranks to become partner at McGuire Woods, one of Virginia's largest law firms.

After graduating from William & Mary Law School and passing the Virginia bar, I remember when Governor Gerald Baliles nominated him to the Virginia Supreme Court in 1989. At the age of 34, Justice Hassell became the second African American justice on the court after John Charles Thomas. In 2002, his colleagues elected him to serve as Chief Justice, making him Virginia's first African American Chief Justice. Remarkably, he was the first leader of the high court chosen by his peers rather than through seniority. At the time, he was also the youngest serving member of the court.

Chief Justice Hassell always had a great love of law. He was a man of faith and deep personal convictions. He cared deeply about the people of the Commonwealth and was passionate about helping others. He was a tireless advocate for the poor and the mentally ill and fought hard to make the courts more accessible and more equitable.

Mr. Speaker, please join me in remembering Justice Hassell, a life-long public servant and powerful voice for all Virginians.[117]

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[117] 157 CONG. REC. E196 (daily ed. Feb. 10, 2011) (statement of Rep. Eric Cantor).

B. Virginia Senate Joint Resolution No. 421

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., a Justice on the Supreme Court since 1989 and Chief Justice since February 1, 2003, concluded his second term as Chief Justice on January 31, 2010; and

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., the 24th Chief Justice of the Supreme Court of Virginia, was the first African American to serve as Chief Justice; and

WHEREAS, as Chief Justice, Leroy Rountree Hassell, Sr. served as the administrative head of the judicial system ensuring its efficient and effective operation, while striving to administer a judicial system in which "all Virginians are treated fairly with dignity, equality and respect"; and

WHEREAS, during his tenure, Chief Justice Leroy Rountree Hassell, Sr., served with distinction as chair of the Judicial Council and the Committee on District Courts and as president of the Judicial Conference of Virginia and the Judicial Conference of Virginia for District Courts, making certain that committees and commissions under his direction reflected the geographical, racial, and gender diversity of the Commonwealth; and

WHEREAS as Chief Justice, Leroy Rountree Hassell, Sr., established the "Commission on Virginia Courts in the 21st Century: To Benefit All, To Exclude None," to make recommendations to ensure that Virginia's court system continues to effectively and impartially deliver justice to all Virginians; and

WHEREAS, as Chief Justice, Leroy Rountree Hassell, Sr., established an annual Indigent Defense Training seminar to provide free continuing legal education to practitioners of indigent defense, and with his support the General Assembly increased compensation paid to court-appointed criminal defense attorneys and public defenders; and

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., worked to increase the availability of pro bono legal services, challenging the Virginia Bar Association and other statewide bar associations, local bar associations and the Virginia State Bar to work together to expand services for indigent persons and ensure that all Virginians have access to high-quality legal representation; and

WHEREAS, under the leadership of Chief Justice Leroy Rountree Hassell, Sr., the Office of the Executive Secretary established an annual course on the management of capital murder cases for circuit court judges, providing additional tools for the efficient administration of justice in these cases; and

WHEREAS, as Chief Justice, Leroy Rountree Hassell, Sr., secured funding from the General Assembly to create a foreign language interpreter program and hire full-time foreign language interpreters to serve the courts of the Commonwealth thereby improving the services provided and reducing the cost of interpreter services; and

WHEREAS, as Chief Justice, Leroy Rountree Hassell, Sr., appointed the Commission on Mental Health Law Reform to conduct a comprehensive examination of Virginia's mental health laws and services and to recommend reforms to Virginia's mental health laws, many of which were enacted by the General Assembly, including improvements to the involuntary commitment process; and

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., successfully worked with the General Assembly to reform and restructure the magistrate system, improving oversight of and standards for magistrates; and

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., successfully obtained increased compensation for all judges and judicial branch staff from the General Assembly allowing Virginia's courts to benefit from the retention of experienced employees and the attraction of highly qualified applicants; and

WHEREAS, with the guidance of Chief Justice Leroy Rountree Hassell, Sr., the General Assembly created the Courts Technology Fund, which supports improvement of the courts' information technology systems and the use of technology to improve case processing for litigants and the courts, including online services such as electronic filing and online payments; and

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., established the Electronic Filing Committee, composed of judges, attorneys, clerks of court, and staff members of the Office of the Executive Secretary, to guide the judicial system's electronic filing initiative; and

WHEREAS, under the leadership of Chief Justice Leroy Rountree Hassell, Sr., online legal research through the Fastcase system was made available, without charge, to all members of the Virginia State Bar; and

WHEREAS, as Chief Justice, Leroy Rountree Hassell, Sr., established the Supreme Court of Virginia Historical Commission to preserve the oral histories of members of the bench, the bar and court administration, and archive historical records and artifacts of Virginia's Judicial System; and

WHEREAS, under the direction of Chief Justice Leroy Rountree Hassell, Sr., the Journey Through Justice website was created, which provides an interactive website with supplemental educational materials on the judiciary, allowing students and teachers to virtually experience the courtroom; and

WHEREAS, a native of Norfolk, Chief Justice Leroy Rountree Hassell, Sr., has served and continues to serve Virginia proudly in many professional and civic roles with an enduring commitment to the people of the Commonwealth, and with an emphasis on the importance of faith and humility in such service; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That the General Assembly hereby commend Chief Justice Leroy Rountree Hassell, Sr., for his dedicated service and inspired leadership as Chief Justice of the Supreme Court of Virginia; and, be it

RESOLVED FURTHER, That the Clerk of the Senate prepare a copy of this resolution for presentation in honor of Chief Justice Leroy Rountree Hassell, Sr., as an expression of the General Assembly's gratitude and appreciation.[118]

[118] S.J. Res 421, 2011 Gen. Assemb., Reg. Sess. (Va. 2011).

C. A Resolution Drafted by a Former Law Clerk

A Resolution
In Honor of the Chief Justice Leroy Rountree Hassell, Sr.

WHEREAS, Chief Justice Leroy Rountree Hassell, Sr., is a son of the Most High God, a loving husband and father, and a skilled jurist; and

WHEREAS, Chief Justice Hassell loves Jesus Christ with all of his heart, soul, body, and mind; and

WHEREAS, Chief Justice Hassell administers justice with mercy in the Commonwealth of Virginia; and

WHEREAS, Chief Justice Hassell shares the Word of God boldly and fearlessly with persons entrusted to uphold the rule of law in the Commonwealth of Virginia; and

WHEREAS, Chief Justice Hassell encourages newly admitted attorneys to serve the poor; and

WHEREAS, Chief Justice Hassell shares the Gospel with and without words with the students at the University of Richmond School of Law, with the students at Regent University School of Law, with the Justices of the Supreme Court of Virginia, and with his staff; and

WHEREAS, Chief Justice Hassell always cares for his family members and answers telephone calls from his wife and children at work; and

WHEREAS, Chief Justice Hassell always keeps his wife's vehicle in good condition; and

WHEREAS, Chief Justice Hassell gave Farnaz Farkish confidence in her legal skills and ability; and

WHEREAS, Chief Justice Hassell has a great sense of humor and is kind; and

NOW, THEREFORE, BE IT RESOLVED, on behalf of Chief Justice Hassell's many friends and admirers and the Host of Heaven, we express our gratitude to Chief Justice Hassell for his continued service, counsel, and leadership.

ADOPTED on this 4th day of February, 2011.

Drafters: Farnaz Farkish and Jesus Christ

Exodus 33:14 (NIV) The Lord replied, "My Presence will go with you, and I will give you rest."[119]

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[119] Farnaz Farkish, A Resolution: In Honor of the Chief Justice Leroy Rountree Hassell, Sr. (2011), www.regent.edu/acad/schlaw/blogs/docs/hassell.pdf.

LIVING IN THE MATERIAL WORLD: WHY INTELLIGENT DESIGN IN PUBLIC SCHOOLS IS NO THREAT TO THE ESTABLISHMENT CLAUSE

INTRODUCTION

The topic of biological origins is rife with conflict largely because proponents of differing theories cannot understand how their opponents' side can be getting it so wrong. Adherents to different theories often mistake their own presuppositions for conclusions based on evidence, with both sides frequently misunderstanding the foundational principles to which the other side adheres. Consequently, the conversations on the topic often consist of people talking directly past each other and wondering how their opponents can completely miss the point. The intellectual and emotional stakes run high in such debates, especially when they impact children in public schools through statutes that require or prohibit the teaching of different biological theories of origin such as Darwinism or Intelligent Design ("I.D."). The Supreme Court of the United States noted that it is "particularly vigilant" regarding alleged Establishment Clause violations in elementary and secondary schools because "[s]tudents in such institutions are impressionable and their attendance is involuntary."[1] This enhanced vigilance, however, does not require the barring of I.D. from the classroom.

The teaching of alternative origins in the classroom has been the subject of several Supreme Court decisions. In *Epperson v. Arkansas*, the Supreme Court struck down an Arkansas statute that forbade public schools from teaching evolution.[2] The Court determined the evolution prohibition existed solely because the teaching conflicted "with a particular religious doctrine"[3] and this violated the First Amendment, which "mandates governmental neutrality between religion and religion, and between religion and nonreligion."[4] In *Edwards v. Aguillard*, the Court struck down a Louisiana statute that demanded balanced treatment between creation-science[5] and evolution.[6] Here, the Court applied the three-prong *Lemon* test.[7] The *Lemon* test requires that

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1 Edwards v. Aguillard, 482 U.S. 578, 583–84 (1987).

2 393 U.S. 97, 98, 101, 109 (1968).

3 *Id.* at 103.

4 *Id.* at 103–04.

5 Creation-science is a biblically based scientific model with tenets that "parallel the Genesis story of creation." *Edwards*, 482 U.S. at 603 (Powell, J., concurring).

6 *Id.* at 581–82 (majority opinion).

7 *Id.* at 582–83.

"[f]irst, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion;"[8] and, third, "the statute must not foster 'an excessive government entanglement with religion.'"[9] Using this test, the Court held that there was no secular purpose identified for the act and, in fact, "[t]he preeminent purpose of the Louisiana Legislature was clearly to advance the religious viewpoint that a supernatural being created humankind."[10] The Court has, therefore, spoken clearly on creation-science. The theory's ties to Christianity render its teaching a violation of the Establishment Clause.[11]

A more recent alternative to Darwinism is I.D.[12] While creation-science has as its foundation a religious text, I.D. has as its foundation traditional scientific observation.[13] I.D. posits that life developed as a result of an intentional selection process, requiring a selective guidance for which traditional Darwinism cannot account.[14] I.D., generally defined, is "a scientific theory which argues that [the] best explanation for some natural phenomena is intelligence, especially when the phenomenon has certain informational properties which in our observation-based experience are caused by intelligence."[15] In its methodology, I.D. "studies present-day causes and then applies them to explain the historical record to *infer* the best explanation for the origin of the natural phenomenon being studied."[16]

The Supreme Court has not ruled on the constitutionality of teaching I.D. in the classroom; therefore, it is open to speculation whether such a case in front of the Court would be treated in a similar

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[8] Lemon v. Kurtzman, 403 U.S. 602, 612 (1971) (citing Board of Education v. Allen, 392 U.S. 236, 243 (1986)).

[9] *Id.* at 613 (quoting Walz v. Tax Comm'n, 397 U.S. 664, 674 (1970)).

[10] *Edwards*, 482 U.S. at 585, 591.

[11] *See id.* at 596–97.

[12] *See* Francis J. Beckwith, *Public Education, Religious Establishment, and the Challenge of Intelligent Design*, 17 NOTRE DAME J.L. ETHICS & PUB. POL'Y 461, 461–62 (2003).

[13] *See* David K. DeWolf et al., *Intelligent Design Will Survive* Kitzmiller v. Dover, 68 MONT. L. REV. 7, 27 (2007).

[14] *See, e.g.*, Beckwith, *supra* note 12, at 462 ("The main thrust of this new movement, known as Intelligent Design (ID), is that intelligent agency, as an aspect of scientific theory-making, has more explanatory power in accounting for the specified, and sometimes irreducible, complexity of some physical systems, including biological entities, and/or the existence of the universe as a whole, than the blind forces of unguided and everlasting matter") (footnote omitted).

[15] Casey Luskin, *Intelligent Design*, CASEY LUSKIN.COM, http://www.caseyluskin.com/id.htm (last visited Mar. 13, 2013).

[16] *Id.*

fashion to creation-science. The most thorough treatment of teaching I.D. in the classroom occurred in the district court case *Kitzmiller v. Dover Area School District*.[17] In *Kitzmiller*, the court held that requiring high school biology teachers to portray I.D. as an alternative to evolution was a violation of the Establishment Clause.[18] The court applied the *Lemon* test and found that the school board's purpose was to promote religion[19] and that the requirement had the effect of endorsing religion.[20]

The *Kitzmiller* court also analyzed the requirement under the endorsement test, an alternative analysis to the *Lemon* test for violations of the Establishment Clause.[21] Justice O'Connor had first proposed the endorsement test in *Lynch v. Donnelly*,[22] and it was later applied by the majority in *County of Allegheny v. ACLU, Greater Pittsburgh Chapter*.[23] Under this test, a court analyzes what is meant to be communicated by the proponent and what is understood by the recipient.[24] The question is whether the communication "in fact conveys a message of endorsement or disapproval" regarding religion,[25] with the "reasonable, objective observer being the hypothetical construct to consider this issue."[26] The *Kitzmiller* court found that teaching I.D. had

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[17] 400 F. Supp. 2d 707 (M.D. Pa. 2005).

[18] *Id.* at 708–09, 765. The Dover Area School District passed a resolution in 2004 that stated the following: "Students will be made aware of gaps/problem in Darwin's theory and of other theories of evolution including, but not limited to, intelligent design. Note: Origins of Life is not taught." *Id.* at 708. The board subsequently stated that it would require teachers to read a statement to students that encouraged students to keep an "open mind" regarding the theories, and that Intelligent Design was an alternative to Darwinism, a theory with "[g]aps . . . for which there is no evidence." *Id.* (internal quotation marks omitted).

[19] *Id.* at 763.

[20] *Id.* at 764. The plaintiffs did not claim the third prong of the *Lemon* test, excessive entanglement between government and religion. *Id.* at 746 n.19. This Note only analyzes the purpose and effect prongs, as many of the considerations between the effect and the excessive entanglement prongs are similar, and many courts combine "the last two prongs 'into a single effect inquiry.'" Todd R. Olin, *Fruit of the Poison Tree: A First Amendment Analysis of the History and Character of Intelligent Design Education*, 90 MINN. L. REV. 1107, 1110 (2006) (quoting Selman v. Cobb Cnty. Sch. Dist., 390 F. Supp. 2d 1286, 1299 (N.D. Ga. 2005)).

[21] *Kitzmiller*, 400 F. Supp. 2d at 714 n.4, 714–46.

[22] *See* 465 U.S. 668, 687–89 (1984) (O'Connor, J., concurring); *see also Kitzmiller*, 400 F. Supp. 2d at 714.

[23] 492 U.S. 573, 592–601 (1989).

[24] *See, e.g.*, *Lynch*, 465 U.S. at 690.

[25] *Id.*

[26] *Kitzmiller*, 400 F. Supp. 2d at 715. One commentator notes that the various tests used by the Supreme Court (such as the *Lemon* test and the endorsement test) "have failed to provide any consistent basis for evaluating establishment clause cases." PATRICK M. GARRY, WRESTLING WITH GOD: THE COURT'S TORTUOUS TREATMENT OF RELIGION 55 (2006).

violated the endorsement test from the standpoint of both an adult community member and a student observer.[27]

This Note challenges the *Kitzmiller* holding and disputes the general proposition that I.D.'s claim to science is nothing more than a sham concealing a religious purpose. Also, this Note shows that I.D. is a legitimate scientific theory, and a rejection of the theory on religious grounds is unwarranted. Furthermore, the required teaching of any scientific theory (such as I.D.) should be impervious to an Establishment Clause analysis or should at least be given much greater deference than current Establishment Clause tests provide. For this reason, any required teaching of I.D. in public schools should not be held to violate the Establishment Clause. Part I of this Note argues that the courts' definition of science is unnecessarily restrictive and that a more logical definition of science includes I.D. Part II argues that I.D. is not inherently religious, and that, as an objective theory, it should not be hindered by any potential religious implications that flow from it. Part III discusses I.D. under *Lemon*, arguing that the required teaching of I.D. should not be susceptible to invalidation under the purpose and effect prongs. Part IV discusses I.D. under an endorsement test analysis, likewise suggesting that the required teaching of I.D. should not be invalidated under the endorsement framework.

I. INTELLIGENT DESIGN AND SCIENCE

The definition of science is by no means agreed upon.[28] In nearly all scientific definitions, the importance of experimentation and observation is stressed, with legitimate conclusions limited to those that can be inferred from observable data.[29] The *Kitzmiller* court found I.D. failed to meet this standard, asserting that I.D. "requires supernatural

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This Note mirrors the court's analysis in *Kitzmiller*, which applied the *Lemon* and endorsement tests. *See supra* text accompanying notes 18–21.

[27] *Kitzmiller*, 400 F. Supp. 2d. at 734.

[28] *See, e.g.*, Jana R. McCreary, *This Is the Trap the Courts Built: Dealing with the Entanglement of Religion and the Origin of Life in American Public Schools*, 37 SW. U. L. REV. 1, 5–6 (2008).

[29] Quoting from the National Academy of Sciences, the court in *Kitzmiller* used the following definition:

> Science is a particular way of knowing about the world. In science, explanations are restricted to those that can be inferred from the confirmable data—the results obtained through observations and experiments that can be substantiated by other scientists. Anything that can be observed or measured is amenable to scientific investigation. Explanations that cannot be based upon empirical evidence are not part of science.

400 F. Supp. 2d at 735–36 (internal quotation marks omitted).

creation."[30] Similarly, in *Edwards v. Aguillard*, the Supreme Court declared creationism to be religious because it requires the supernatural.[31]

I.D. does not, however, require supernatural causation: "Design theory does not try to address questions about whether the designer is natural or supernatural because such questions lie outside of the empirical domain of science."[32] Rather than addressing the issue of supernatural versus natural causation, I.D. claims that design is detectable because there are "tell-tale features of living systems and the universe that are best explained by an intelligent cause."[33] I.D.'s claim to be able to detect design is not a principle that is foreign to other areas of science. For example, the Search for Extraterrestrial Intelligence Project ("SETI") scans for radio signals among the stars that may indicate non-human intelligent life based on the principle that certain patterns in the material universe can only arise from an intelligent source.[34] While something non-material may not be immediately observable, it can leave "fingerprints" that imply its existence.[35]

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[30] *Id.* at 721, 735.

[31] 482 U.S. 578, 591–92 (1987).

[32] DeWolf et al., *supra* note 13.

[33] *Id.* at 25 (quoting Stephen C. Meyer, *Not by Chance: From Bacterial Propulsion Systems to Human DNA, Evidence of Intelligent Design Is Everywhere*, NAT'L POST, Dec. 1, 2005, at A22.

[34] *Id.* at 26 ("Implicit in [SETI astronomers'] research is the assumption that signals produced by intelligent agents differ from radio emissions resulting from natural phenomena.").

[35] The example of symbolic communication may be useful to illustrate one of these "fingerprints." Symbolic forms of communication, which use arbitrary signals to indicate real world information, have only been observed to arise from the choices of intelligent actors. *See* WERNER GITT, IN THE BEGINNING WAS INFORMATION: A SCIENTIST EXPLAINS THE INCREDIBLE DESIGN IN NATURE 61, 67, 96 (2006); *see also* PERCIVAL DAVIS & DEAN H. KENYON, OF PANDAS AND PEOPLE: THE CENTRAL QUESTION OF BIOLOGICAL ORIGINS 7 (Charles B. Thaxton ed., 2d ed. 1993). Imagine landing on the surface of a previously unexplored planet and discovering a tablet of hieroglyphs or any sort of symbolic notation such as sheet music or mathematical equations. The idea that these symbols did not come from an intelligence would not be taken seriously because we know that symbolic, arbitrary notation (such as the alphabet used to write this Note) does not occur without preexisting intelligences to assign meaning to the symbols. DAVIS & KENYON, *supra*; GITT, *supra*, at 61, 67. "Chair" means to the reader what it does to the writer because our society has agreed that the arbitrary symbols of "C," "H," "A," "I," and "R" correspond to the real world concept of the object on which we sit. *See* GITT, *supra*, at 60–61, 67. The letters in "chair" theoretically could be used to indicate anything, such as a bed or a table. *See id.* at 60–61. In that respect, the symbols are arbitrary. *See id.* We only know what real world concept they signify because of previous linguistic agreement. *Id.* at 67, 71. DNA utilizes a similar arbitrary alphabet, with the "words" being composed of sequences of chemical letters. DAVIS & KENYON, *supra*, at 57; *see also* STEPHEN C. MEYER, SIGNATURE IN THE CELL: DNA

Modern science arbitrarily subscribes to the tenet that observations cannot infer "extra-material"[36] causes. This tenet incorporates the unjustified axiomatic assumption that there is nothing outside of the material universe, at least nothing that materially interacts with it.[37] A more expansive view of science accepts any rational conclusions based on material evidence that reflect what is true.[38] One commentator criticizes I.D. by writing that "intelligent design is more than an alternative theory of origins; it is an attempt to reformulate science in a way that allows the use of religion to explain patterns found in nature."[39] Setting aside the definition of "religion" for now, this statement presumes that religion (as that author defines it) is not the explanation for the patterns in nature. How does the author know this? How does he know that the limits he has placed on science are the correct ones for ascertaining truth? He, of course, does not, as a commitment to materialism is an a

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AND THE EVIDENCE FOR INTELLIGENT DESIGN 248–49 (2009). This is much like "1" and "0" in the computer programming language of binary code. *See* GITT, *supra*, at 61. I.D. theorists posit that such an arbitrary symbolic code in DNA is necessarily the product of conscious choice. *See, e.g.*, GITT, *supra*, at 96; MEYER, *supra*, at 246–49, 332–34.

[36] The term "extra-material" is used here in lieu of the word "supernatural." This is not meant as a way to "split hairs" and avoid the association of the supernatural with I.D. It is merely an attempt to avoid the religious implications that accompany the term "supernatural." "Supernatural" is a term laden with predetermined constructs of meaning that can bias an objective discourse.

[37] For example, renowned evolutionary biologist Richard Lewontin has stated,

> We take the side of science *in spite* of the patent absurdity of some of its constructs, *in spite* of its failure to fulfill many of its extravagant promises of health and life, *in spite* of the tolerance of the scientific community for unsubstantiated just-so stories, because we have a prior commitment, a commitment to materialism. It is not that the methods and institutions of science somehow compel us to accept a material explanation of the phenomenal world, but, on the contrary, that we are forced by our *a priori* adherence to material causes to create an apparatus of investigation and a set of concepts that produce material explanations, no matter how counter-intuitive, no matter how mystifying to the uninitiated.

Richard Lewontin, *Billions and Billions of Demons*, 44 N.Y. REV. BOOKS 28, 31 (1997) (book review). This quote is not used to imply that Lewontin is a proponent of I.D. or that he thinks that the modern scientific commitment to materialism is misguided. It is used only to help illustrate that materialism is the arbitrary starting point for modern science and is not the only rational option.

[38] Michael Behe, an I.D. proponent, writes in his response to the *Kitzmiller* decision that "'science' is an unrestricted search for the truth about nature based on reasoning from physical evidence." Michael J. Behe, *Whether Intelligent Design Is Science: A Response to the Opinion of the Court in* Kitzmiller vs Dover Area School District, DISCOVERY.ORG (2006), http://www.discovery.org/scripts/viewDB/filesDB-download.php?command=download&id=697.

[39] David R. Bauer, *Resolving the Controversy over "Teaching the Controversy": The Constitutionality of Teaching Intelligent Design in Public Schools*, 75 FORDHAM L. REV. 1019, 1057 (2006).

priori requirement for science in its modern conception.[40] Anything extra-material that might be involved in the origin of life is ruled out because of the predetermined, arbitrary limitation of materialism placed on modern science, not because of any objective reason.

The nature of the theoretical extra-material force is not a part of I.D. theory.[41] Answering this ultimate question is outside the purpose of the I.D. movement,[42] but to disregard the possibility of such specified intent in life is to be blatantly illogical. The classic example of the watch is illustrative.[43] Consider the following hypothetical scenario: Walking into a room, an observer finds pieces of a watch. Leaving the room, the observer returns later to find the watch assembled into a working timepiece. If the observer presupposes that any explanation for the assemblage of the watch has to come from the room in its current state, and the room has no intelligent actors in it, then the presupposition that ties the origin of the watch to the current state of the room necessitates the conclusion that there is a materialistic, non-intelligent explanation for the construction of the watch. This presupposition thus leads to a

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[40] The National Council for Science Education has espoused the requirement that science deny the supernatural, stating, "Science cannot be neutral on this issue. . . . The assumption that 'the only explanations that count are those that rely on nature' is indeed an important part of science; in fact, this is a foundational axiom for any rational thinking. It needs to be said clearly: All educated people understand there are no forces outside of nature." Casey Luskin, *Zeal for Darwin's House Consumes Them: How Supporters of Evolution Encourage Violations of the Establishment Clause*, 3 LIBERTY U. L. REV. 403, 476 (2009) (quoting Steven Newton, Preparatory Materials for Speakers at the 21 January 2009 Texas SBOE Meeting, 32, 44, *available at* http://www.discovery.org/scripts/viewDB/filesDB-download.php?command=download&id=4411 (internal quotation marks omitted)).

[41] Behe, *supra* note 38. ("To reach to a conclusion of God or the supernatural requires philosophical and other arguments beyond science. . . . I have repeatedly affirmed that I think the designer is God, and repeatedly pointed out that that personal affirmation goes beyond the scientific evidence, and is not part of my scientific program.").

[42] DeWolf et al., *supra* note 13.

[43] The watchmaker analogy, which is meant to illustrate the existence of God, was first used by William Paley in his book, *Natural Theology*. *See* WILLIAM PALEY, NATURAL THEOLOGY 7–8, 35 (Matthew D. Eddy & David Knight eds., Oxford Univ. Press 2006) (1802). The simplest explanation of the argument is that watches are complicated and so require a watchmaker to assemble them, and life is analogously complicated and thus requires a deity to create it. *Id.* A similar argument by the thirteenth-century monk, Thomas Aquinas, was discussed in *Kitzmiller*, in which an expert witness explained that Aquinas's argument was: "Wherever complex design exists, there must have been a designer; nature is complex; therefore nature must have had an intelligent designer." Kitzmiller v. Dover Area Sch. Dist., 400 F. Supp. 2d 707, 718 (M.D. Pa. 2005). The watch argument has admittedly become a bit of a cliché and is also not completely applicable to the life context because watches do not reproduce and do not have DNA, which are necessary components for evolution, according to Darwinism. However, the watch example is useful as an illustration to expose unjustified scientific assumptions and is not used as a scientific argument.

conclusion that is clearly not the case (or is so unlikely that to espouse such a conclusion would be irrational in the face of more likely alternatives). In this scenario, it is patently absurd that natural processes within the confines of the room somehow constructed the watch. This *reductio ad absurdum* demonstrates the point that, while an intelligent actor may not be currently present (i.e. not scientifically observable), there may be inescapable conclusions in the observable world that point to such an actor.[44] I.D. does not attempt to qualify this alleged "assembler."[45] It merely points out the improbability that such assemblage can take place without a conscious choice.[46]

Materialistic explanation is the starting point for all Darwinian science,[47] and this materialistic presupposition is a starting point that serves most of the scientific disciplines very well.[48] Eyeglasses, satellites, and internal combustion engines—all have been made as a result of observational hypothesizing and testing in a world with predictable methods of operation. But this strategy does not apply in the same way to the origins of the biological world. The emergence of life from non-life, the emergence of new biological structures, and the corresponding genetic design necessary to perpetuate these structures are not observable[49] as such occurrences take vast amounts of time or have already occurred in the unobservable past. Some commentators draw the distinction here between "operation science" and "origin science."[50] "Operation science is an empirical approach to the world that focuses on repeatable, regularly recurring events or patterns in nature."[51] "[O]rigin science focuses on past singularities that are not repeatable (e.g., the

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[44] DeWolf et al., *supra* note 13, at 25.

[45] DAVIS & KENYON, *supra* note 35.

[46] Casey Luskin, *Finding Intelligent Design in Nature*, *in* INTELLIGENT DESIGN 101: LEADING EXPERTS EXPLAIN THE KEY ISSUES 67, 71 (2008) ("'The principal characteristic of intelligent agency is directed contingency, or what we call choice.' By observing the sorts of choices that intelligent agents commonly make when designing systems, we can make a positive case for intelligent design, using predictable, reliable indicators of design.") (quoting WILLIAM A. DEMBSKI, THE DESIGN INFERENCE: ELIMINATING CHANCE THROUGH SMALL PROBABILITIES 62 (Brian Skyrms et al. eds., 1998) (emphasis omitted)).

[47] *See* Lewontin, *supra* note 37.

[48] Eugenie C. Scott, *"Science and Religion", "Christian Scholarship", and "Theistic Science": Some Comparisons*, 18 REP. NAT'L CENTER FOR SCI. EDUC., Mar.–Apr. 1998, at 30, 31.

[49] Stephen C. Meyer, *The Scientific Status of Intelligent Design: The Methodological Equivalence of Naturalistic and Non-naturalistic Origins Theories*, *in* 9 THE PROCEEDINGS OF THE WETHERSFIELD INSTITUTE: SCIENCE AND EVIDENCE FOR DESIGN IN THE UNIVERSE 151, 170–71 (2000).

[50] J.P. MORELAND, CHRISTIANITY AND THE NATURE OF SCIENCE: A PHILOSOPHICAL INVESTIGATION 225 (1989).

[51] *Id.*

origins of the universe, life, various life forms, and mankind)."[52] Materialism is an assumption that makes sense with the former type of science and not the latter, according to these commentators.[53]

Materialistic presuppositions are less applicable to origin science (such as I.D. and Darwinism) because origin science deals with situations that cannot be repeated under observation.[54] The materialistic origin of life is presupposed in Darwinism in the same way that it is presupposed in all of the observable sciences (chemistry, physics, etc.).[55] But the fact that the existing material world currently *operates* under naturalistically explainable processes says nothing about the *origin* of the material world or the variety of biological structures within it. The internal combustion engine, for example, operates under observable, testable, and repeatable processes. But it says nothing of the origin of the device. The complexity of the engine would defy naturalistic explanation even if we did not know that the hands of men made it.[56] With the origin and development of life, it is relevant to ask how many explanations under Darwinian theory are based on observation and rational inference, and how many are based on "just-so" stories[57] created within the self-imposed confines of materialism.[58] Scientific theories that allow for a potential conscious design to the universe "better satisf[y] the epistemic value of being able to account for a wider variety of actual or potential phenomena."[59] I.D. not only qualifies as science, but its lack of an arbitrary materialist assumption puts it in a better position than

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[52] *Id.*

[53] *Id.*

[54] *Id.*

[55] Scott, *supra* note 48.

[56] It is not my intention to "short change" any aspect of Darwinian theory through mechanistic analogies. Eyeglasses and satellites cannot do something that biological organisms can, which is reproduce. The genetic mutations in subsequent generations provide the raw material for evolution under Darwinism, and mechanistic analogies do not take this reproductive process into account. Such analogies are used only to explain the fundamental differences in the theories.

[57] *See* Lewontin, *supra* note 37.

[58] The very fact that there is a debate, while not conclusive by any means, is evidence that there is a legitimate conflict regarding biological origins. There is virtually no dispute over observable material processes, such as gravity or the hydrologic cycle because there is really no rational way to dispute that they act under natural processes. The biological past, however, is open to conjecture as it is only observable by inference. If naturalistic Darwinism is so obviously proven that it is among the likes of gravity and the hydrologic cycle, why is it even possible to have a logical debate on the subject? Of course, the converse is also true that, because biological origins are not directly observable, they are subject to religious bias and wishful interpretations. But this would apply to both sides of the argument.

[59] MORELAND, *supra* note 50, at 223.

traditional Darwinism to accurately describe the truth of life's origins and developments.

II. I.D. AND RELIGION

A. I.D. Is Not Inherently Religious

The *Kitzmiller* court held that I.D. was a religious teaching and, therefore, not a scientific one.[60] The court's definition, however, mischaracterized I.D. by mistaking the logical inferences of the theory for religious dogma. I.D. should not be classified as religious simply because it argues for the possibility of an intelligent creative agent. I.D. does not attempt to institute the comprehensive system of morality, worship, and belief that should be the criteria for a court's religious analysis.[61]

The Supreme Court has applied an evolving set of standards to what constitutes a religion. Beginning in 1890, the Supreme Court gave a traditionally theistic definition of religion by stating, "The term 'religion' has reference to one's views of his relations to his Creator, and to the obligations they impose of reverence for his being and character, and of obedience to his will."[62] This more traditional theistic viewpoint eroded as society's conception of religion changed, as evidenced by the Court's decision in *Torcaso v. Watkins*, which stated that "[a]mong religions in this country which do not teach what would generally be considered a belief in the existence of God are Buddhism, Taoism, Ethical Culture, Secular Humanism and others."[63] This language reflects a broad interpretation of what can constitute a religion, but it is not without limits. The Court held in *Wisconsin v. Yoder* that "the very concept of ordered liberty precludes allowing every person to make his own standards on matters of conduct in which society as a whole has important interests."[64] As the Court moved away from the traditional theistic approach to defining religion (with a distinct God-like creator and the corresponding requirements that accompany belief in this deity), the standard for what constituted a religion was not so subjective as to qualify any set of personal standards as "religion" as defined under the Constitution. The Supreme Court further developed its approach in *United States v. Seeger* with the "parallel positions" test, which

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[60] Kitzmiller v. Dover Area Sch. Dist., 400 F. Supp. 2d 707, 720–21 (M.D. Pa. 2005). In doing so, the court followed *Edwards*, which recognized the belief in supernatural creation as being inherently religious. *See* Edwards v. Aguillard, 482 U.S. 578, 591 (1987).

[61] *See* Malnak v. Yogi, 592 F.2d 197, 207–09 (3d Cir. 1979) (Adams, J., concurring).

[62] Davis v. Beason, 133 U.S. 333, 342 (1890).

[63] 367 U.S. 488, 495 n.11 (1961).

[64] 406 U.S. 205, 215–16 (1972).

determines "whether a given belief that is sincere and meaningful occupies a place in the life of its possessor parallel to that filled by the orthodox belief in God."[65] With these evolving definitions, it is difficult to apply exact standards to differentiate between what is secular and what is religious. One commentator said, "[H]istorically, courts have been reluctant to adopt a universal definition of religion to avoid the obvious danger that an arbitrary demarcation as to what constitutes religion could lead to unfair decisions and judicial bias."[66]

Federal circuit courts have applied their own definitions of religion, utilizing the principles outlined by the Supreme Court.[67] In *Malnak v. Yogi*, Judge Arlin Adams, in his concurrence, isolated principles used in the Supreme Court's parallel positions test and created a test for religion that looked at the existence of three indicia: whether the nature of the ideas involved addresses fundamental or "ultimate concerns"; whether the ideas reflect comprehensiveness; and whether there are formal or external signs analogized to religion.[68] Judge Adams determined that the three indicia "are basic to our traditional religions and . . . are themselves related to the values that undergird the first amendment."[69] Judge Adam's definition has been used by other federal courts and is arguably the most influential definition of religion used by federal courts.[70] It is thus a logical test to apply to I.D. The application of the *Malnak* test serves to illustrate the difference between the religious ideas (or lack thereof) inherent in I.D. and religious implications that are outside of the theory.

The *Malnak* concurrence suggested that the Big Bang theory "may be said to answer an 'ultimate' question" because it is an "astronomical interpretation of the creation of the universe."[71] By analogy, I.D. can answer a similar question by positing that life was designed. The concurrence next stated that the Big Bang theory is not a religious idea because it lacks the second indicia of comprehensiveness by lacking a

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[65] 380 U.S. 163, 165–66 (1965).

[66] Bauer, *supra* note 39, at 1025.

[67] *See, e.g.*, United States v. Meyers, 95 F.3d 1475, 1482–84 (10th Cir. 1996); Fleischfresser v. Dirs. of Sch. Dist. 200, 15 F.3d 680, 688 n.5 (7th Cir. 1994); United States v. Sun Myung Moon, 718 F.2d 1210, 1227 (2d Cir. 1983); Africa v. Pennsylvania, 662 F.2d 1025, 1032 (3d Cir. 1981); Founding Church of Scientology v. United States, 409 F.2d 1146, 1160 (D.C. Cir. 1969).

[68] 592 F.2d. 197, 207–09 (3d Cir. 1979) (Adams, J., concurring).

[69] *Id.* at 207–08.

[70] Andrew Koppelman, *Secular Purpose*, 88 VA. L. REV. 87, 133–34 (2002); *see also* Alvarado v. City of San Jose, 94 F.3d 1223, 1230 (9th Cir. 1996) (utilizing the *Malnak* factors as a synthesis of the parallel positions test).

[71] *Malnak*, 592 F.2d. at 209.

broad enough scope to render it a "comprehensive belief system."[72] Similar to the Big Bang theory, I.D. is not comprehensive because it is only concerned with the rational conclusion of design that follows from observable data.[73] There is no attempt to define or limit this designer, nor is there an attempt to create a comprehensive system of belief due to the existence of this designer. The designer may be disinterested, the designer may no longer exist, or the designer may be outside of current theorizations because humans have not observed a parallel concept in our universe from which to extrapolate a working concept of it.[74] I.D. is not a moral or social alternative to Darwinian theory, but an evidentiary one.[75] Both theories attempt to accurately categorize the engine of creation for biological organisms and structures and account for why they appear designed.[76] Neither theory attempts to link these to a fundamental human concern, such as the purpose of existence or the definition of morality.[77]

The third *Malnak* prong, that there are formal and external signs, is not relevant to I.D., as no sort of behavior or ritual is associated with the theory.[78]

B. Any Religious Implications of I.D. Should Not Be Relevant to an Establishment Clause Analysis as They Are Not Intrinsic to the Theory

It must be admitted that I.D. may have religious, moral, and philosophical implications that extend beyond the intended scope of the theory and would qualify as both "comprehensive" and addressing "fundamental questions" (to use *Malnak*'s terminology).[79] The term "intelligent" implies a mind, and the necessary ability to design

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[72] *Id.*

[73] Behe writes, "If I think it is implausible that the cause of the Big Bang was natural, as I do, that does not make the Big Bang Theory a religious one, because the theory is based on physical, observable data and logical inferences. The same is true for ID." Behe, *supra* note 38.

[74] *See id.* at 10.

[75] *See id.* at 3.

[76] DAVID K. DEWOLF ET AL., INTELLIGENT DESIGN IN PUBLIC SCHOOL SCIENCE CURRICULA: A LEGAL GUIDEBOOK 17 (1999), *available at* http://www.arn.org/docs/dewolf/guidebook.htm ("[D]esign theory seeks to answer a question raised by Darwin as well as contemporary biologists: How did biological organisms acquire their appearance of design? Design theory, unlike neo-Darwinism, attributes this appearance to a designing intelligence . . . .").

[77] *Id.*

[78] *Id.* ("Design theorists have formed organizations and institutes, but these resemble other academic or professional associations rather than churches or religious institutions.").

[79] *Id.* at 18 (paraphrasing Malnak v. Yogi, 592 F.2d 197, 208–09 (3d Cir. 1979) (Adams, J., concurring)).

biological life implies an extreme degree of power and skill. With these attributes in mind, this imagined designer starts to sound like a supernatural deity. But implications of I.D., just like the implications of evolutionary theory or any valid scientific theory for that matter, are not the theory's "fault."[80] As stated previously, much of the basis for placing I.D. in the realm of religion comes not from the empirical claims of I.D., but from the possible interpretation of these claims as evidence that God exists.[81] This interpretation is then used as a categorical denial of I.D. as science.[82] But the knee-jerk reaction to the possibility of a designer automatically equaling an unscientific proposition is based on the unjustified assumption that it is categorically impossible for rational science to point to a creator. As previously discussed, the categorical denial of the possibility of a designer is a needlessly restrictive qualification to place on science. In the minds of many evolutionary proponents, the concept of a designed universe automatically equates with everything that accompanies religion; therefore, discussing the universe as a design is automatically religious and not possibly "true" in the evidentiary sense.[83] The courts seem to support this proposition, treating the presence of a supernatural creator as a *per se* reason to classify a school of thought as inherently religious.[84]

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[80] Behe, *supra* note 38. ("The [*Kitzmiller*] [c]ourt's opinion ignores . . . the distinction between an implication of a theory and the theory itself. As I testified, when it was first proposed the Big Bang theory struck many scientists as pointing to a supernatural cause. Yet it clearly is a scientific theory, because it is based entirely on physical data and logical inferences. The same is true of intelligent design.").

[81] DEWOLF ET AL., *supra* note 76, ("[I.D.] requires neither a belief in divine revelation nor a code of conduct; nor does it purport to uncover the underlying meaning of the universe or to confer inviolable knowledge on its adherents. It is simply a theory about the source of the appearance of design in living organisms. It is a clear example of an 'isolated teaching,' one that has no necessary connections to any spiritual dogma or church institution.").

[82] *Id.* at 9.

[83] *See, e.g.*, Kitzmiller v. Dover Area Sch. Dist., 400 F. Supp. 2d 707, 721 (M.D. Pa. 2005). For example, the court in *Kitzmiller* notes that "not one defense expert was able to explain how the supernatural action suggested by ID could be anything other than an inherently religious proposition." *Id.* This is, of course, using the definition of religion that equates anything extra-material with religion, regardless of the comprehensive nature of the belief. If I.D. is a religious proposition, it is one without any indicia of religion as it has been known throughout human history—a religion in which you are not required to do, worship, or believe anything.

[84] *See, e.g.*, Edwards v. Aguillard, 482 U.S. 578, 592 (1987) (noting that teaching supernatural creation is religious); McLean v. Ark. Bd. of Educ., 529 F. Supp. 1255, 1266 (E.D. Ark. 1982) ("The argument . . . that teaching the existence of God is not religious unless the teaching seeks a commitment, is contrary to common understanding and contradicts settled case law.").

Jay D. Wexler says that I.D. "is concerned with addressing such fundamental questions as the origins and meaning of life and our role in the universe."[85] The use of the word "concerned" here is only accurate if it is meant to say that I.D. does not directly address these issues but rather indirectly touches upon them. Wexler, however, makes the claim that these are central concerns to the theory. What is the "meaning of life" according to I.D.? What is our "role in the universe" according to I.D.? There are no answers to these questions because I.D. is silent on these issues. Arguments, such as Wexler's, reflect the assumption that the mere idea of an intelligent creation is on the same level as a moral duty or a defined reason for existence.[86] In his assumption, he arbitrarily decrees that any discussion of what is outside the material world is automatically religious.

I.D., however, discusses an extra-material entity as creative force only.[87] Without worship, purpose, or moral demands, this proposition remains in the scientific realm of "true or not true," and it remains out of the religious realm that First Amendment jurisprudence seeks to avoid endorsing. Recognizing the likelihood that the watch has been purposefully assembled is much different than deciding that the watchmaker should be worshipped because he has given us the gift of a watch (or for some other reason). Worship is a personal, ephemeral decision that will change from person to person. What does not change from person to person are the dimensions of the watch hands and the complexity of the internal gears. Similarly, the claim of design in the universe should not be confused with any religious paradigms that are grafted onto it.

Furthermore, the case can be made that even the concept of a "God" is not an inherently religious one. In his dissent in *Edwards*, Justice Scalia pointed out that the Aristotelian concept of a "prime mover" or original cause to the universe was not a religious concept.[88] J.P. Moreland writes that when "God" is used as a religious term, "it is involved in moral and spiritual exhortation, and it is surrounded by

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[85] Jay D. Wexler, Note, *Of Pandas, People, and the First Amendment: The Constitutionality of Teaching Intelligent Design in the Public Schools*, 49 STAN. L. REV. 439, 461 (1997).

[86] *Compare id.* at 462, *with* Jay W. Richards, *Why Are We Here?: Accident or Purpose?*, *in* INTELLIGENT DESIGN 101: LEADING EXPERTS EXPLAIN THE KEY ISSUES 131, 133 (H. Wayne House ed., 2008) (urging readers to look at evidence apart from assumptions).

[87] *See* Eddie N. Colanter, *Philosophical Implications of Neo-Darwinism and Intelligent Design*, *in* INTELLIGENT DESIGN 101: LEADING EXPERTS EXPLAIN THE KEY ISSUES 153, 164 (H. Wayne House ed., 2008); *see also* Behe, *supra* note 38.

[88] *Edwards*, 482 U.S. at 629–30 (Scalia, J., dissenting).

ritual and other forms of religious devotion."[89] Moreland goes on to describe how the term "God" can also be used as "a mere philosophical concept or theoretical term denoting an explanatory theoretical entity needed in some sort of explanation."[90] The point here is not that the term "God" should be used in connection with I.D., but rather that there are different aspects to what we would typically refer to as "deity" that must be parsed out if one is to treat the subject accurately. If I.D. touches on deity, it is only on the aspects that are suggested by materialistic observations. The terms "designer," "creator," or even "God" in such a context are more like theoretical placeholders, or labels, to be put onto the decision-making force that is suggested by I.D. proponents. All of the other aspects that are traditionally associated with deity, such as worship and moral requirements, are not present within I.D.'s conceptualization of the designer.

For the third *Malnak* prong, it is difficult to see how either theory incorporates formal and external signs of adherence to a religion, unless the espousal of both theories is somehow considered to be a formal sign of adherence to its religious tenets. But again, neither theory requires the hearer to do anything.

III. I.D. AND THE *LEMON* TEST

A. The Lemon *Test's Purpose Prong Is Needlessly Subjective*

The *Kitzmiller* court held that the school district in question violated the first prong of the *Lemon* test by having a religious purpose in enacting the statute, which required I.D. to be taught in the classroom.[91] This type of application reflects the misguided principle that

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89 MORELAND, *supra* note 50, at 221.

90 *Id.*

91 Kitzmiller v. Dover Area Sch. Dist., 400 F. Supp. 2d 707, 763 (M.D. Pa. 2005). The court cites a long litany of evidence meant to catalogue the religious motivations of the Dover School Board. *Id.* at 746–53. Without commenting on the school board's religious motivation, this Note deals with the topic more generally by arguing that the objective content of the I.D. policy and its application are much more relevant to an Establishment Clause inquiry whether the board members had a "religious" motive or not.

In a law review article, John Calvert argues that the school board's written I.D. policy is in fact evidence of a secular purpose, writing that the policy "seeks to add information to a curriculum that artificially restricts or excludes it" and that "[i]ts effect is to add information relevant to the adequacy of an existing natural/material cause only orthodoxy." John H. Calvert, Kitzmiller's *Error: Defining "Religion" Exclusively Rather than Inclusively*, 3 LIBERTY U. L. REV. 213, 323 (2009). Thus, Calvert argues that the purpose of the school board is secular because it seeks to broaden the informational landscape available to students in an effort to counteract the religious orthodoxy of materialism.

It should also be noted that the Supreme Court has used language supporting at least the potential of a legitimate secular purpose of teaching alternative theories on

religious motivations are somehow incompatible with good government.[92] It is similar to the rejection of I.D. based on secondary correlations to religion rather than the objective tenets of the theory. With I.D., as with the first *Lemon* prong, subjective factors that should be outside of the realm of rational analysis are mistakenly incorporated into the court's substantive assessments.[93]

The superfluous assessment of subjective intent in the *Lemon* test is addressed in Justice Scalia's dissent in *Edwards v. Aguillard*, in which he writes, "Today's religious activism may give us the Balanced Treatment Act, but yesterday's resulted in the abolition of slavery, and tomorrow's may bring relief for famine victims."[94] Justice Scalia points out the difficulty and absurdity of trying to ascertain the subjective views of every legislator.[95] Scalia also analyzes past applications of the *Lemon* test, saying that all that is needed to satisfy the first *Lemon* prong is any secular purpose, even one alongside a religious one.[96] Overall, Scalia would abandon the purpose prong entirely.[97]

It would certainly be easier for I.D. to pass the first *Lemon* prong with the lessened purpose standard advocated by Scalia. Stephen Marshall argues that a legitimate secular purpose can be found in teaching I.D. by fostering "scientific literacy by teaching all of the

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biological origins. *See Edwards*, 482 U.S. at 594 ("[T]eaching a variety of scientific theories about the origins of humankind to schoolchildren might be validly done with the clear secular intent of enhancing the effectiveness of science instruction."). This was in the context of a statute requiring the teaching of biblical creationism, however, and the Supreme Court found the Louisiana legislature in the case to be acting with a religious purpose. *Id.* at 592.

92 McCreary Cnty. v. ACLU of Ky., 545 U.S. 844, 887 (2005) (Scalia, J., dissenting) ("[R]eason and experience both forbid us to expect that National morality can prevail in exclusion of religious principle." (quoting George Washington, Farewell Address (1796), *in* 35 THE WRITINGS OF GEORGE WASHINGTON 229 (John C. Fitzpatrick ed., 1940))).

93 *See Kitzmiller*, 400 F. Supp. 2d at 745, 747.

94 482 U.S. 578, 615 (1987) (Scalia, J., dissenting); *see also* Michael W. McConnell, *Five Reasons to Reject the Claim That Religious Arguments Should Be Excluded from Democratic Deliberation*, 1999 UTAH L. REV 639, 647–48 ("I do not see how we can embrace the principle of secular rationale. Unless we regret the religiously-motivated activism of Sam Adams, Isaac Backus, William Lloyd Garrison, Harriet Beecher Stowe, Sojourner Truth, William Jennings Bryan, Dorothea Dix, and Martin Luther King, Jr., how can we say that presenting religious arguments in political debate is an act of bad citizenship?").

95 *Edwards*, 482 U.S. at 637.

96 *Id.* at 614; *see also* FRANCIS J. BECKWITH, LAW, DARWINISM, & PUBLIC EDUCATION: THE ESTABLISHMENT CLAUSE AND THE CHALLENGE OF INTELLIGENT DESIGN 172 n.69 (2003) (noting that the statute in *Edwards* was invalidated because there was *no* secular purpose, not because there was a religious one).

97 *See Edwards*, 482 U.S. at 636.

evidence and explanatory theories."[98] This echoes reasoning in *Edwards* in which the Court stated that teaching different scientific theories about origins "might be validly done with the clear secular intent of enhancing the effectiveness of science instruction."[99]

On a general level, it is unclear why a statute's enactment cannot be religiously motivated even if neither the terms nor the implementation of the statute constitute an "establishment" in the court's assessment. By the reasoning of the *Lemon* test, if a statute is enacted to keep a rural area free from development for the purpose of environmental protection, it is legitimate. But if the same statute is enacted to keep the area undeveloped so citizens can learn how beautiful God made the world, the statute likely fails the test. In both hypotheticals, assuming that there are no overt signs that the legislature is attempting to indoctrinate citizens one way or the other, it makes little sense that the legislator's subjective thoughts should invalidate a government act that is legitimate on its face. If the government forces citizens to read a prayer to God before they enter a park or some other action is forced, then it would be a violation of the Establishment Clause because the government action would clearly link the statute's implementation with the endorsement of religion. But the first *Lemon* prong could conceivably rule out statutes that have nothing to do with religion in their form or implementation. According to the terms of the First Amendment as applied under *Lemon*, the government has somehow established religion even if the only religious connection of the statute is the potential threat of religiously minded legislators seeing a religious purpose in an objectively secular application.[100]

Professor Michael McConnell finds the exclusion of religious motivations contrary to the spirit of the First Amendment, noting that "no one can claim that the principle of secular rationale is logically entailed by American democracy, or by First Amendment principles. America has enjoyed a pretty good democracy for over 200 years without any limitations on religious participation in politics."[101] The secular purpose prong reflects a disturbing trend of an argument being discounted because it is "religious" almost as if this term is a synonym

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[98] Stephen L. Marshall, Note, *When May a State Require Teaching Alternatives to the Theory of Evolution? Intelligent Design as a Test Case*, 90 KY. L.J. 743, 768 (2002).

[99] *Edwards*, 482 U.S. at 594.

[100] This does not necessarily mean that religious motives should not play a role in an Establishment inquiry. They may have some probative value in the determination of a statute's effect on the populace. In other words, blatantly religious motives might make it easier to find an advancement or inhibition of religion under the effect prong but should not be taken as a threshold inquiry in their own right.

[101] McConnell, *supra* note 94, at 647.

for "wrong." This association is very similar to the scientific arguments for I.D. being rejected on the basis that it has religious implications. Saying that "an argument is religious" is, to many ears, the equivalent of saying that "an argument is illogical" or that "an argument does not reflect the facts."[102] Whereas I.D. arguments are treated unfavorably for the potential religious conclusions that may occur as a result of learning the theory, religious arguments are treated unfavorably because of their religious origin.[103] Some are discounted because of their potential end result, the others because of their starting point, but they amount to the same principles of ignoring objective data and instead relying on an unfounded anti-religious assumption that religion and practical truth are fundamentally incompatible. Saying that an argument is "religious" and, therefore, flawed in some way, is an easy way of bypassing the merits of the argument; if it is said loud enough and long enough it will start to sound like "that argument is wrong" without anyone stopping to realize that the merits of the argument have not been discussed.[104]

Regarding the sciences, it would be constitutionally unacceptable for a school board to require the teaching of religious indoctrination that was masquerading as science.[105] It should be acceptable, however, for religious people to require the teaching of a scientific theory even when the theory harmonizes with their religious beliefs.[106] Acceptable, of course, so long as the required science curriculum is legitimate. In either scenario, the deciding factor should be the legitimacy of the science, not

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[102] The type of objection that discounts an argument solely because of its religious basis is an example of the "genetic fallacy." The genetic fallacy is "the mistake of confusing the origin of a claim with its evidential warrant and undermining the claim by calling attention to its origin." MORELAND, *supra* note 50, at 229.

[103] *See* Phillip Johnson, *Bringing Balance to a Fiery Debate*, *in* INTELLIGENT DESIGN 101: LEADING EXPERTS EXPLAIN THE KEY ISSUES 21, 39 (H. Wayne House ed., 2008) ("[Darwinian] strategy is to link anything that questions evolution back to religious fundamentalism to discredit it.").

[104] Favoring secular reasons over religious reasons "rests on a flawed dichotomy between reason and religion. Secular political arguments are not based on 'reason' (though they may employ reason, just as religious arguments may employ reason); they are based on ideological positions, or points of view." McConnell, *supra* note 94 at 653. Similarly, I.D. and Darwinism both rest on axioms, or "ideological positions." Darwinism rests on the axiom of materialism, while I.D. rests on the axiom that a designer of biological life is logically possible. Darwinism should not gain an advantage merely because its axiom is more harmonious with a secular rationale.

[105] *See* Lemon v. Kurtzman, 403 U.S. 602, 625 (1971).

[106] Edwards v. Aguillard, 482 U.S. 578, 605 (1987) (Powell, J., concurring) ("A decision respecting the subject matter to be taught in public schools does not violate the Establishment Clause simply because the material to be taught 'happens to coincide or harmonize with the tenets of some or all religions.'" (quoting Harris v. McRae, 448 U.S. 297, 319 (1980)).

the subjective intent of the government actor. It is difficult to see the harm that could come from religious motivation if it is cabined by relevant scientific inquiry.

B. As a Scientific Theory, the Teaching of I.D. Should Not Be Susceptible to a Challenge Under the Effect Prong of the Lemon *Test.*

The second *Lemon* prong states that a government action may neither advance nor inhibit religion as its primary effect.[107] As previously explained, I.D. does not qualify as the status of a religion.[108] However, this does not mean that a statute allowing or requiring the teaching of I.D. automatically passes the religious effect prong, as a statute involving the teaching of I.D. could still conceivably have the function of endorsing religion even though I.D. is not religious in and of itself.

The scientific aspects of I.D. make an effect prong assessment more complex. For statutes involving prayer in schools or the religious iconography of a public landmark, there is no real "objective" truth to be analyzed, at least in the sense of the truth of the material world. These statutes involve human decisions and human constructs *applied* to the material world, but they ultimately have their origin in human decision. If a teacher decides to pray in class, or if a school board puts up a cross in a cafeteria, there is always the question of whether it is appropriate for the action to be taken. I.D. and the rest of the scientific field simply tries to see the world *as it is* without shaping it according to an internal belief (or as much as objectively possible in the realm of human affairs).[109] For this reason, the effect of any such theory under the effect prong should be granted much more leeway for its religious implications, or the second prong should be discarded altogether in the case of statutes involving the teaching of science. To hold science to the same standards under the effect prong is to hold that, *even if true*, the teaching of such a theory would not be allowed. This cannot logically hold as a rationale of the court; surely the freedom from established religion does not go so far as to discard scientific truth. If gravity offended people's notions of religious propriety, it would be madness to inhibit its teaching for fear of

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[107] *Lemon*, 403 U.S. at 612.

[108] *See supra* Part II. The *Kitzmiller* court, of course, held the opposite, stating essentially that because I.D. is not science, the effect of the policy must have the effect of advancing religion. Kitzmiller v. Dover Area Sch. Dist., 400 F. Supp. 2d 707, 764 (M.D. Pa. 2005). ("[S]ince ID is not science, the conclusion is inescapable that the only real effect of the ID Policy is the advancement of religion.").

[109] *See* J.P. Moreland, *Intelligent Design and the Nature of Science*, *in* INTELLIGENT DESIGN 101: LEADING EXPERTS EXPLAIN THE KEY ISSUES 41, 45 (H. Wayne House ed., 2008) ("ID theory does not attempt to identify the designer nor does it make explicit reference to God."); Luskin, *supra* note 46, at 110.

establishing or hindering religion because gravity is an objective truth that exists whether it is taught or not. It is much more logical to speak of "establishing" religion in terms of human choice and preference. Science does not advocate action or belief; it simply describes what is,[110] and for this reason it should be free from Establishment Clause concerns.

The presumable constitutionality of the teaching of evolution[111] shows that courts agree with the principle that science is impervious to Establishment Clause violations. Much of *Lemon*'s jurisprudence goes to determine whether a government action has established religion, but the test is also geared towards those actions that hinder or inhibit religion.[112] Evolution, despite having many of the same religious implications of I.D.,[113] gets a "pass" on its potential violation of the effect prong, even though it arguably has the effect of hindering religion. Evolution clearly is a hindrance on certain monotheistic religions such as Christianity.[114] While many Christians attempt to form a synthesis between evolution and biblical teachings, no such synthesis is consistently possible, at least without a radical reformulation of biblical truth.[115] Even a Christian that sees the entire Old Testament as allegorical must still deal with one of the basic, if not the most basic, teachings of the Bible: that man is responsible for sin and consequently death,[116] which necessitates the need for a savior. Under evolutionary teaching, organisms lived and died millennia before man even appeared on the scene.[117] The Bible thus makes no sense, literally or allegorically, if man is not the originator of death and generations of animals lived and died before evolution brought him into existence. On a more general level, evolution provides an explanation for the origin of life (and the universe, if we are to take into

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[110] Moreland, *supra* note 109, at 49.

[111] *See, e.g.*, Epperson v. Arkansas, 393 U.S. 97, 109 (1968) (holding that a state statute prohibiting the teaching of evolution because of conflicts with the Bible is against the Constitution); Malnak v. Yogi, 592 F.2d 197, 209 n.41 (3d Cir. 1979) ("[Evolution] is offensive to some religious groups, but it is not in itself religious.").

[112] Edwards v. Aguillard, 482 U.S. 578, 616 (1987) (Scalia, J., dissenting).

[113] Colanter, *supra* note 87, at 157 (explaining that evolution has implications undermining morality).

[114] Evidence that practitioners of Christianity saw evolution as antithetical to their beliefs can be seen with the proliferation of anti-evolution laws in the first half of the twentieth century. *See* McCreary, *supra* note 28, at 37–38.

[115] The author of this Note does not intend to criticize Christians who synthesize their beliefs with evolution, but rather to show that there is at least one valid interpretation of the biblical text that renders evolution as antithetical to Christianity.

[116] *Genesis* 3:7, 3:19.

[117] CHARLES DARWIN, THE ORIGIN OF SPECIES 297 (Gramercy Books 1979) (1859).

account cosmic and chemical evolution) that does not include a creator.[118] There are few conclusions that are as antithetical to a monotheistic religion such as Christianity, in which the created universe is one of the primary ways that man can know who God is.[119]

The Constitution has been found to "'forbid[]. . . the prohibition of theory which is deemed antagonistic to a particular dogma.'"[120] At the same time, the State should not favor "one religious or anti-religious view over another."[121] The Supreme Court cites the general principle of neutrality that the government should hold between religion and irreligion.[122] So, the mere fact that evolution may be "antagonistic" to beliefs in Christianity is no reason to forbid its teaching. But evolution is more than antagonistic to Christianity because it actively provides an alternative metaphysical perspective.[123] If the designer in I.D. is automatically supernatural and therefore considered to be religious, then the advocacy by the state of a theory that posits no designer is more than antagonism to religions with a creative deity—it is a metaphysical replacement of them, answering all of the same "religious" questions

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[118] Strangely, and perhaps for this reason, many evolutionary proponents deny that evolution is a theory of origins. According to the National Center for Science Education, "it is not a 'theory of origins' about how life began." *Evolution Education*, NAT'L CTR. FOR SCI. EDUC., http://ncse.com/evolution (last visited Mar. 14, 2013). But this statement is patently absurd because there is an entire field of science dedicated to determining how life could arise from non-life through material processes. This particular subset of biology (or more accurately biochemistry) is called abiogenesis. The subject is addressed in many, if not most, biology textbooks. *See, e.g.*, ELI C. MINKOFF, EVOLUTIONARY BIOLOGY 404 (1983) (discussing the origin and early evolution of life on Earth).

[119] *Romans* 1:20.

[120] Edwards v. Aguillard, 482 U.S. 578, 593 (1987) (quoting Epperson v. Arkansas, 393 U.S. 103, 106–07 (1968)).

[121] *Epperson*, 393 U.S. at 113 (Black, J., concurring).

[122] *See, e.g.*, Everson v. Bd. of Educ., 330 U.S. 1, 18 (1947).

[123] BECKWITH, *supra* note 96, at 165 ("[I]f a scientific research program is 'religious' because it supports and is consistent with a belief in a higher intelligence or deity, it would follow that a research program is 'irreligious' because it supports and is consistent with the nonexistence of such a being."). Many evolutionists claim that their theory is compatible with belief in a God, designer, or creator. *See, e.g.*, Peter M.J. Hess, *How Do I Read the Bible? Let Me Count the Ways*, NAT'L CTR. FOR SCI. EDUC. (July 26, 2009), http://ncse.com/religion/how-do-i-read-bible-let-me-count-ways. However, "to say that belief in God's existence is not inconsistent with naturalistic evolution is to imply that God is not really an object of knowledge. For if it were, the existence of a God (and/or any other nonmaterial reality, e.g. mind, moral properties, numbers) . . . would be allowed to count against methodological naturalism." BECKWITH, *supra* note 96, at 152. So ultimately God is allowed to "exist," but there cannot be a rational or material basis for such existence, and God can serve no material role in the universe's operations. Put more colloquially: God is fine, as long as he doesn't do anything. This rational sounds like a fundamentally opposite viewpoint to that of most monotheistic religions and rises above the level of mere antagonism.

that I.D. does. This presupposition should render evolution in violation of the effect-prong of the *Lemon* test.

Why, then, is the teaching of evolution constitutional if it serves to contradict such basic teachings of the Bible (and other monotheistic religions)? One possibility is that evolution is allowed to hinder religion because the court "knows" it to be true, or at least the court cannot question it because it has attained the mantle of "science," which trumps any religious concern. This may be why the court in *Kitzmiller*, after concluding that the school board's mandating the teaching of I.D. was religiously motivated, did not stop its analysis.[124] The court went on to demonstrate that I.D. is not science, even though that determination is not necessary to its holding.[125] To let the decision stand merely on a violation of the purpose prong, however, would allow the implication that I.D. was valid science, prohibited for its religious connotations. The court had to demonstrate that I.D. was not science,[126] as it would have been unacceptable for it to seem like a legitimate science was kept out of the classroom, whether it had religious implications or not. "Real" science, in other words, cannot violate the Establishment Clause because it reflects the truth (whether this principle is articulated by the court or not). This is why I.D. had to be shown to be the opposite of science, a religion, at least in the court's view.

And rightly so. Far different from the human choices of praying or putting up a monument, science tells us about the real world in which we live,[127] and if something that it tells us has religious implications, it should not be hindered from telling the truth because of those religious implications. This is a necessary principle. Should we still believe that the sun revolves around the earth because such a proposition hindered the religious understandings of the time? Surely not. The scientist who is willing to stand up to the religious bigotry of his day and confront it with the truth should be lauded. The problem is that because of inaccurate conceptions of science and religion, a court, such as *Kitzmiller*, can deny the teaching of I.D. because of its religious implications while allowing evolution to be taught, even though it has comparably significant religious implications. Such a holding, if mirrored in other circuits or eventually by the Supreme Court, would reflect a general judicial

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[124] Kitzmiller v. Dover Area Sch. Dist., 400 F. Supp. 2d 707, 764 (M.D. Pa. 2005).

[125] *Id.* at 764; DeWolf et al., *supra* note 13, at 16 ("[J]udicial findings and inquiries on the scientific status of the theory in question and the effect of teaching it are neither necessary nor appropriate if a court finds that the acting government agents had predominantly religious motivations.").

[126] *See Kitzmiller*, 400 F. Supp. 2d at 716, 737–38.

[127] MORELAND, *supra* note 50 (explaining science as focused on "patterns in nature" and "life").

favoritism towards naturalism, as opposed to an allowance for the teaching of alternate theories of origins that the neutrality principle would seem to require.[128] As a legitimate science, I.D. should be afforded the same sort of Establishment Clause immunity, or neither theory should be taught.

IV. I.D. AND THE ENDORSEMENT TEST

In its endorsement analysis, the *Kitzmiller* court used a reasonable observer who is familiar with "the policy's language, origins, and legislative history, as well as the history of the community and the broader social and historical context in which the policy arose."[129] The court traced the history of the I.D. movement, linking it historically with creation-science[130] and Christianity, ultimately concluding that "I.D. aspires to change the ground rules of science to make room for religion, specifically, beliefs consonant with a particular version of Christianity."[131] Here, we see the same anti-religious bias at play that allowed I.D. to be attacked for allowing a "supernatural" conclusion: Even though it is not part of the theory, I.D. cannot be taught because of a connotation with religion. Even if such a connotation were true, the real test of science should be whether the science stands or falls. The reasonable observer should not be allowed to perpetuate ignorance because he associates religion with a legitimate scientific theory.[132]

Associating I.D. with Christianity, as *Kitzmiller* does,[133] reflects an inherent prejudice that religious people cannot espouse theories that are objectively true.[134] For example, the court relied on expert testimony that I.D.'s argument for design is actually an old religious argument that dates back to the thirteenth-century monk, Thomas Aquinas.[135] The court also relied on testimony that many of the proponents of I.D. believe the designer to be God.[136] In relying on this type of inference, once again

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[128] Edwards v. Aguillard, 482 U.S. 578, 594 (1987) ("[T]eaching a variety of scientific theories about the origins of humankind to schoolchildren might be validly done with the clear secular intent of enhancing the effectiveness of science instruction.").

[129] *Kitzmiller*, 400 F. Supp. 2d at 715.

[130] *Id.* at 716–21.

[131] *Id.* at 720. The court also concluded that requiring the teaching of I.D. failed the endorsement test because it requires a supernatural creator. *Id.* at 721. See *supra* Part II for an analysis of the supernatural and I.D.

[132] This reasonable observer would also invalidate the teaching of chemistry and astronomy because "they have their historical origin in the religiously oriented practices of astrology and alchemy." BECKWITH, *supra* note 96, at 154.

[133] *Kitzmiller*, 400 F. Supp. 2d at 720.

[134] *See* discussion *supra* Part III.A.

[135] *Kitzmiller*, 400 F. Supp. 2d at 718.

[136] *See* discussion *supra* Part II.B.

subjective factors influence what should be an objective inquiry. Whatever personal assessments Aquinas made as to the actual nature of the designer, the only relevant inquiry is whether his arguments for design are valid.[137] The historical aspect of the endorsement test is only meant to gauge the reaction of an objective observer (as opposed to measuring the actual merits of the theory),[138] but in the realm of science, where propositions stand or fall on their own merit, subjective assessments such as this are superfluous. By the *Kitzmiller* court's rationale, we would rather have a society denied scientific truth than forced to encounter what an observer considers to be a religious viewpoint.

Even if the potential correlation between I.D. proponents and Christianity is a real one, this should not affect the theory's validity any more than a potential connection between evolution and atheism.[139] It is true that certain scientific viewpoints correspond to certain personal philosophies. But the statements "You believe that because you are Christian" and "You believe that because you are atheist" have very little probative worth from an argumentative standpoint. They are not provable propositions, and, even if true, they say nothing as to the validity of the propositions at hand.[140] If you believe something because you are an atheist, or because you are a Christian, your reason for believing says nothing about whether you are right or wrong. The only way to determine who is right is through an objective evidentiary evaluation.[141] It is a fallacy to think that subjective starting points

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[137] Casey Luskin, *Any Larger Philosophical Implications of Intelligent Design, or Any Religious Motives, Beliefs, and Affiliations of ID Proponents, Do Not Disqualify ID from Having Scientific Merit*, DISCOVERY INST. (Sept. 8, 2008), http://www.discovery.org/a/7081 ("[I]n science, the motives or personal religious beliefs of scientists don't matter; only the evidence matters. For example, the great scientists Johannes Kepler and Isaac Newton were inspired to their scientific work by their religious convictions that God would create an orderly, rational universe with comprehensible physical laws that governed the motion of the planets. They turned out to be right—not because of their religious beliefs—but because the scientific evidence validated their hypotheses. (At least, Newton was thought to be right until Einstein came along.) Their personal religious beliefs, motives, or affiliations did nothing to change the fact that their scientific theories had inestimable scientific merit that helped form the foundation for modern science.").

[138] *Kitzmiller*, 400 F. Supp. 2d at 714–15.

[139] *See* Luskin, *supra* note 40, at 471, 473, 476 (demonstrating the linkage between evolutionary proponents and atheism).

[140] *See* MORELAND, supra note 50, at 229 (discussing the genetic fallacy).

[141] *See* H. Wayne House, *Preface* to INTELLIGENT DESIGN 101: LEADING EXPERTS EXPLAIN THE KEY ISSUES 17, 17 (H. Wayne House ed., 2008) ("Contrary to popular belief, this struggle is not simply between science and religion, or even between science and philosophy. It is about competing scientific explanations of the data.").

necessarily lead to incorrect (or "religious") conclusions. All areas of human inquiry have axioms and starting points.

CONCLUSION

Science makes claims to objective truth in our society, and any form of legitimate science should not be stifled due to judicial or societal fears of establishing religion. A true scientific theory could never establish "religion," as science attempts to describe the intrinsic nature of things. Religion, on the other hand, deals with subjective beliefs, such as moral imperatives and requirements to worship. There may be philosophical consequences to any scientific theory, especially when it comes to biological origins, but such consequences are not intrinsically part of the science, and, as such, these consequences should not factor into an establishment analysis. Indeed, the religious and philosophical consequences that arise out of the theory of evolution are allowed to survive an establishment inquiry because of the perceived scientific legitimacy of the theory. I.D. should be afforded the same immunity; otherwise, the judicial conceptions of science and religion have the danger of barring legitimate science from classrooms and turning the process of education into one of indoctrination.

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[142] The Author would like to thank Professor Eric DeGroff for his patience and guidance in overseeing this Note.