

SOUTH CAROLINA JOURNAL
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ARTICLES

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A CRITIQUE OF *AGAR V. JUDY* AND THE STANDARD OF REVIEW
PROBLEM IN MANIPULATION OF STOCKHOLDERS' FIRST
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SOUTH CAROLINA JOURNAL OF INTERNATIONAL LAW & BUSINESS

VOLUME 14

FALL 2017

CONTENTS

ARTICLES

- THE BATTLE OVER STOCKHOLDERS VOICE:
A CRITIQUE OF *AGAR V. JUDY* AND THE STANDARD
OF REVIEW PROBLEM IN MANIPULATION OF
STOCKHOLDERS' FIRST AMENDMENT RIGHTS
Yair Y. Even-Tal 1
- LEGAL FRAMEWORK AND ECONOMIC CRITIQUE:
TRUMP'S TRADE AUTHORITY AND POLICY
Noah Glazier 27
- REFORMS OF CORPORATE GOVERNANCE:
COMPETING MODELS AND EMERGING TRENDS IN THE
UNITED KINGDOM AND THE EUROPEAN UNION
Akio Otsuka 71

SOUTH CAROLINA JOURNAL OF INTERNATIONAL LAW & BUSINESS

VOLUME 14

FALL 2017

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THE BATTLE OVER STOCKHOLDERS VOICE:
A CRITIQUE OF *AGAR V. JUDY* AND THE STANDARD OF
REVIEW PROBLEM IN MANIPULATION OF
STOCKHOLDERS' FIRST AMENDMENT RIGHTS

Yair Y. Even-Tal*

INTRODUCTION

Wars have many fronts. The battle lines in the fight between the director and stockholder control models of the world have evolved dramatically since the early days of the shareholder activism movement.¹ The past few years have seen a remarkable proliferation not only in the amount of stockholder engagements, but also in the sophistication of their attacks on corporations. Specifically, public communication of grievances about intracorporate issues has become a prevalent approach through which the more active stockholders privately police director performance on a real-time basis and seek to influence corporate policy. Objectives for stockholder public engagement vary, but typically include (1) executive compensation

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¹ See generally Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. Applied Corp. Fin. 55 (2007) (tracing history of the U.S. stockholder activism); L. Talner, *The Origins of Shareholder Activism*, at 2 (Investor Responsibility Research Center, 1983); see also R. Maren, *Investing Corporate Governance: The Mid-Century Emergence of Shareholder Activism*, 8(4) J. Bus. & Mgmt. 371, 373 (2002).

reforms; (2) capital structure changes; (3) new business strategy; (4) business combinations (e.g., merger, sale, spin off, termination of a transaction); (5) governance initiatives; (6) board representation; and (7) management changes.² This once rarely employed model of stockholder engagement, using extra-judicial communication activism to exert pressure on managements to bring leadership and operational changes and asking the target company's stockholders to rally around them, signaled a marked change in the dynamic of the governance landscape that may become a significant concern for incumbent managements. The response of corporate America was swift. Consistent with the tendency of practitioners to push the limits of the acceptable, boards of directors sought to block both the front (electoral) and back door (negotiated solution) to stockholders' engagement, using litigation under the guise of purported libel against those stockholders who voiced their opposition.

The libel litigation tactic posed two questions previously unanswered by the Delaware courts, or the judiciary in general. The first question was jurisdictional, in a sense: put colloquially, should boards be authorized to engage in defensive action—even if the action is taken in the absence of actual, subjective improper motive—that potentially adversely affect stockholders' communication with other stockholders, as well as stockholders voting rights? Second, if so, by what standard of review should the courts evaluate the actions of directors that might impair stockholders franchise and First Amendment rights?

In early 2017, the Delaware Court of Chancery faced these two fundamental questions in the momentous decision of *Agar v. Judy*,³

² Decisions regarding these matters are exclusively within corporate boards' managerial power. See DEL. CODE ANN. tit. 8, § 141(a) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"). Whether stockholders should be permitted to interfere with a firm's operations and business decision-making has provoked intense debate, but that is for another article.

³ *Agar v. Judy*, 151 A.3d 456 (Del. Ch. 2017).

but did not address the need for balancing the competing policies of stockholders' corporate-law right to stockholder franchise against the incumbent boards' tort law rights. Similarly, the Court did not adopt a standard of review in regard to fiduciaries' inequitable inhibitions of the right to communicate with other stockholders of the company.

In a first treatment by the judiciary about when a fight letter can give rise to a defamation claim, the *Judy* litigation involved defamation claims brought by incumbent directors of a small-cap company for contentious statements made by a group of dissident stockholders amidst contest for control.⁴ Explaining that directors are public figures for electoral-related communication purposes, the Court held that as the party challenging the stockholders' statements, the directors bore the evidentiary burden of demonstrating that the purported statements were false and made with malice.⁵

While the *Judy* ruling is significant in that it appears to give stockholders, of privately and publicly-owned corporations alike, broader leeway in exercising their First Amendment rights in regard to intra-corporate communications,⁶ the decision did not relieve much of the risk of gamesmanship and concerns about abuse and intimidation by boards of directors. That is, in its decision, the Chancery Court focused only on after-the-fact case-specific review of the director-plaintiffs' conduct by balancing their tort law right to reputation against the constitutional First Amendment rights of the dissident stockholder group, without addressing the necessity of a normative duty that would ensure good faith conduct and safeguard stockholders' ability to police inequitable inhibitions before the fact, or, alternatively, an enforceable standard of review to hold fiduciaries accountable if their maneuver results in wrongful interference with stockholders' free speech and voting rights.⁷ This failure to impose a

⁴ *Agar v. Judy*, 151 A. 3d 456 (Del. Ch. 2017).

⁵ *See id.* at 459.

⁶ I refer interchangeably to forms of discourse between a company's investors and exercising their First Amendment rights as "stockholders' communications".

⁷ *See id.*

further requirement to safeguard stockholders' right to communicate with other stockholders against, or penalize the incumbent directors for wrongfully suing stockholders for statements that were mere opinion, creates a pervasive incentive for impinging stockholders' First Amendment rights and highlights the danger of undermining the integrity of the stockholder vote given that such impermissible behavior would not give rise to liability.

In the pages that follow, I argue that these policy concerns emphasize that a stricter approach to regulation of fiduciary conduct involving manipulations of First Amendment rights is warranted given the potential for unfair exploitation of the stockholder electorate. Specifically, this article calls on the courts to engage in a substantive evaluation of actions by directors that effectively cut off stockholders' exercise of their First Amendment rights using threats of defamation litigation. The heightened form of judicial scrutiny would focus on whether *objective* circumstances establish that management acted for requisite improper purpose to interfere with the stockholders' First Amendment rights, without the need of proof of actual, subjective improper motive on the part of the board. This proposed approach would allow the courts to consider the dynamic factors in play and achieve a sensible balance between tort law rights against defamation and ensuring that directors are in fact accountable to stockholders at the ballot box, and do not inequitably interfere with their right to communicate with other stockholders of the company.

Before examining high-salience contexts that reflect the justification for the proposed stricter approach to fiduciary regulation, it is helpful to review the public policy values that warrant imposing the additional safeguards when such potential for abuse emerges.

THE (IN)ESCAPABLE COLLUSION COURSE:
THE TENSION BETWEEN STOCKHOLDERS ENGAGEMENT AND
OUR CORPORATE GOVERNANCE SYSTEM

Efforts of those who thrust themselves into a spotlight to quash criticism, fair or unfair, are nothing new. One manner to achieve the desired goal of deterring a targeted section of the public from exercising their constitutional right of free speech is through litigation and its associated rents. The oppressive tactic of initiating

a libel action against those who expressed “disfavored” viewpoints has long been recognized as giving rise to “chilling effects” not only among the individuals at which the threat of litigation has been directed, but also among the targeted audience at large.⁸ The tactical approach of bringing defamation litigation with the intent to intimidate and silence had thus posed risks to the societal interests and public policy values that our courts have been vigilant to protect.

This type of gamesmanship gives rise to policy concerns to a greater extent when employed by corporate fiduciaries given their unique relationship and duties owed to their beneficiaries. It is not surprising then that unduly libelous actions brought by incumbent directors to inhibit stockholders’ criticism of management through communication with other stockholders of the company have been attracting a great deal of interest from the media, practitioner and academy.

Investors, unlike other groups of the general public or unaffiliated corporate stakeholders—such as controllers, officers and directors of a company—commit their capital indefinitely to the firm, but yet retain limited mechanisms to effectively and timely monitor managerial conduct⁹ and its accompanied ever-present risk of

⁸ See Frederick Schauer, *Fear, Risk and the First Amendment: Unraveling the Chilling Effect*, 58 B.U. L. REV. 685, 692 (1978); see also Leslie Kendrick, *Speech, Intent and the Chilling Effect*, 54 WM. & MARY L. REV. 1633, 1649-50 (2013); Henry P. Monaghan, *Constitutional Fact Review*, 85 COLUM. L. REV. 229, 268 (1985); Daniel J. Solove, *The First Amendment as Criminal Procedure*, 82 N.Y.U. L. REV. 112, 142 (1997); Note, *The Chilling Effect in Constitutional Law*, 69 COLUM. L. REV. 808, 832-40 (1969).

⁹ Often cited corporate accountability devices include: (1) intra-corporate regulation in the form of independence and governance rules that regulate director conduct; (2) intensive surveillance of large institutional shareholders; (3) prominence of “proxy advisory” firms, such as Institutional Shareholder Services; (4) reputation, social, personal, and professional constraints; (5) state corporation law, the concomitant risk of shareholder litigation, and the threat (even if, nevertheless, is still rare) of real personal liability.

disloyal or careless actions. Policing director behavior on a real-time basis, as well as protecting against misappropriation of stockholder wealth and other improper fiduciary interference with stockholders' rights, are subject to even greater difficulties in privately-held corporations; which are subject only to minimum disclosure regulatory state regimes, thus creating a unique asymmetry information problem.¹⁰ This gap of adequate and oversight mechanism devices mechanisms to ensure managerial corporate accountability that gave rise to the emerging role of exercising the constitutional right of free speech as a potent safeguard against the omnipresent specter of director misconduct. Indeed, entrusted with the exclusive authority to manage the business and affairs of the corporation,¹¹ equity developed a modern accountability regime backed by fiduciary principles for addressing the acute power asymmetries in relations between managers of the firm and its beneficiaries, the company's stockholders. Directors'¹² and officers' actions have thus been subjected to pervasive duties of loyalty and care when exercising their broad powers over corporate property and processes. Yet, while legal actions against corporate fiduciaries

¹⁰ *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998) (“in the absence of a request for shareholder action, the Delaware General Corporation Law does not require directors to provide shareholders with information concerning finances or affairs of the corporation.”).

¹¹ DEL CODE ANN. tit. 8, § 141(a); *See McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000) (“One of the fundamental principles of the Delaware General Corporation Law statute is that the business affairs of a corporation are managed by or under the direction of its board of directors.” (citing DEL CODE ANN. tit. 8, § 141(a))); *see also* Polk v. Good, 507 A.2d 531, 536 (Del. 1986); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981); *TW Servs., Inc. v. SWT Acquisition Corp.*, 1989 WL 20290, at *8 n.14 (Del. Ch. 1989) (“[A] corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation”).

¹² *See* Amir Licht, *Lord Eldon Redux: Information Asymmetry, Accountability and Fiduciary Loyalty*, OXFORD J.L. STUD., 1 (Apr. 06, 2017) <https://doi.org/10.1093/ojls/gqx003>.

serve as partial, imperfect traditional mechanism to redress unfaithful conduct and deter improper managerial behavior,¹³ these ex-post judicial reviews are often outweighed by excessive litigation costs and substantial uncertainty, and thus far from providing investors adequate protection against fiduciary misconduct. Similarly, other mechanisms for making those at the helm of the corporate enterprise accountable for failing to serve the stockholders interests, namely replacing directors via the ballot box, are rare themselves, due to hurdles such as multi-class capital structures, costs,¹⁴ limited access to the ballot,¹⁵ and staggered boards,¹⁶ stockholders seeking a change in the management team must cross.¹⁷

¹³ *In re Anderson Clayton S'holder Litig.*, 1988 WL 97480, at *5 (Del. Ch. 1988) (“[t]he significant institutional role of class and derivative actions in the enforcement of the fiduciary duties assumed by corporate officers and directors.”); *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993) ((quoting Aronson, 473 A.2d at 811 (observing that “[t]he machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid and unfaithful management.”)).

¹⁴ *N. Gantchev*, “*The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*,” 107 *J. Fin. Econ.* 610 (2013) (finding evidence that costs associated with dueling consent solicitations average \$10.7 million); *Hills Stores Company v. Bozic*, 769 A.2d 88, 100 (Del. Ch. 2000) (dismissing challenge by the winning slate in a proxy contest to the payment of severance upon the change of control to certain executives of the company).

¹⁵ DEL. CODE ANN..tit. 8, §§ 112, 113 (codifying proxy access rules for Delaware corporations). These rules authorize corporations to adopt bylaws that include procedures and conditions to stockholders nominations in director elections, which may include: (1) minimum stock ownership and duration of ownership by the nominating stockholder; (2) limitation on the number of directors that may be nominated; (3) preclusion of nominations by persons who have acquired a certain percentage of stock ownership, or who have publicly proposed to acquire such a percentage. See also Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017) (amending ownership stakes and holding periods requirements for publicly-held corporations' stockholders to put a proposal for a vote); *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, 983 A.2d 304, (Del. Ch. 2009), afl'd, 981 A.2d 1173 (Del. 2009) (rejecting a challenge to a change of control covenant in a bond indenture permitting the noteholders of the

Thus, facing such uphill battles, one of the few viable avenues left for unaffiliated stockholders to police directors' actions and incentivize them to serve the corporate interest is exercising their constitutional First Amendment rights. Engaging in communication with other stockholders of the company regarding intra-corporate related matters—from management misconduct and outperformance to a mere disagreement with a board's business decision, serves as a vital function for stockholders to raise their concerns in order to push for an amicable engagement or change by gaining support for a collective stockholder action. Therefore, an attempt by directors to deprive stockholders of the right to voice their critique, under the guise of non-pretexual justification, raises the question of whether, and if so to what degree, similar situationally conflicted fiduciary conducts warrant a hard look by courts.

company to redeem their notes at face value if the company underwent a fundamental change of control).

¹⁶ DEL CODE ANN. tit. 8, § 141(d) (expressly permits a certificate of incorporation or bylaw provision that provides for a classified or staggered board).

¹⁷ See generally Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 676 (2007) (“Shareholder franchise does not provide the solid foundation for the legitimacy of directorial power that it is supposed to supply.”); Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control 2* (Nat'l Bureau of Econ. Research, Working Paper No. 8633, 2001), <http://papers.nber.org/papers/w8633.pdf>. (“...even when a rival team would be better at leading the firm, convincing fellow stockholders that this is the case would likely require significant efforts with no guarantee of success. Stockholders would be making their choices under conditions of uncertainty: to vote for the rival team, they must be convinced not only that the incumbents' performance is sub-par, but also that the rival team would likely perform better. Otherwise, stockholders might well choose to stay with the devil they know.”); see also Transcript of Motion to Expedite Ruling, *Flagship Master Fund, LP v. Rent-A-Center, Inc., et al.*, C.A. No. 2017-0165 (Del. Ch. Mar. 10, 2017) (challenge to company's bylaws requiring stockholders' director nominees to be included in the target's proxy statement).

AGAR V. JUDY: THE DIFFICULTIES OF RECONCILING
THE RIGHT TO INTRA-CORPORATE COMMUNICATION WITH
FIDUCIARIES' RIGHT AGAINST DEFAMATION

This long ignored knotty issue of whether managerial actions brought with the goal to muffle stockholders' voice—particularly during an active proxy contest with defeat of plaintiff directors looming, warrant judicial intervention—had not been addressed by the courts, neither in Delaware nor elsewhere, until a recent measured yet important step has been made to establish rules of the road in the case of *Agar v. Judy*.¹⁸ In a first treatment by a Delaware court about when contentious stockholder engagement in the form of a fight letter can give rise to a defamation claim, the Court of Chancery fashioned an approach to balance the competing interests of stockholders' constitutional First Amendment rights of communication and directors' tort law rights against defamation. Although the Court's treatment of this matter of first impression resulted in a largely fact-intensive ruling, as is often the case in defamation cases, it encompasses important ramifications for repeat players in the Chancery Theater, as well as for many observers of corporate governance outside circles of Rodney Square.

The conflict in *Judy* stemmed from a poorly performing company's 2015 stockholders meeting, at which a group of unaffiliated stockholders opposed the reelection of the incumbent directors following many years of corporate functions that had not been carried out and alleged directorial misconducts occurred.¹⁹ In advance of the annual meeting, at which three of the incumbent directors eventually lost their seat, the dissident group signed a letter which they distributed to a large number of the company's stockholders.²⁰

¹⁸ *Judy*, 151 A.3d 456.

¹⁹ *Id.* at 479.

²⁰ *Id.*

The circulated letter included a series of statements that accused the company directors of acting to benefit themselves by engaging in self-dealing, wasteful, and unapproved transactions.²¹ In addition to the allegation of corporate resources misuse, the letter informed its recipients that the incumbents have concealed from the stockholders the existence of court orders entered against the company in lawsuits brought by its stockholders and noteholders,²² as well as that it has

²¹ The series of statements included the following accusations towards the incumbents: (1) “[T]hey were planning to loot [the Company] without any oversight on your part until it was too late.”; (2) “Due to our lawsuits, we have received documents that show in particular [incumbents] have engaged in looting the Company. Since June of 2014, [the incumbent directors] have siphoned over \$7 million in cash and stock to themselves and personal affiliates.”; (3) “Carole Downs is now the leader ... and is in the process of looting the Company along with Barclay Knapp.”; (4) “[the incumbents] siphoned over \$7 million in cash and stock to themselves and personal affiliates.”; (5) “It is in [the incumbent directors’] personal interest to drag this out and siphon your money out at their leisure. [the incumbent board] owe you their fiduciary duty to protect the Company assets but instead they are favoring these other affiliates and themselves.”; and (6) “It is time to act and stop them from taking your money. We must remove them from their positions before it is too late.”

²² The “concealment statements” included the following: (1) “[The incumbent directors are] so afraid of you finding out what they are up to that one of the first things they did when they took over was to take away your right to call for a shareholder meeting by eliminating that provision in the Company Bylaws (They even tried to hide this from us until the Court forced them to send us the amended Bylaws).”; (2) “After an intense battle that lasted into December of 2014, the Company was forced kicking and screaming to settle. This loss shocked them to change their plans and forced them to make payment on all the notes.”; (3) “Have they disclosed to you that the Court has a restraining order prohibiting them from distributing any funds to preferred and common stock holders until the lawsuit in Delaware resolves the complaints?”; (4) “Did they disclose that the Court admonished them that they had to pay the accrued dividends and liquidation preference on preferred stock in liquidation?”; (5) “Did they disclose to you that they were forced by the Court to hold a shareholder meeting on June 22, 2015 (the

breached contractual obligations to preferred stockholders.²³ The letter concluded by urging the stockholders to replace the incumbent board.²⁴ The removed directors then brought a claim for defamation. The dissidents moved to dismiss.

The Court of Chancery granted the dissidents' motion to dismiss in part, holding that corporate directors may be public figures for purposes of electoral-related communications. Thus, exercise of the First Amendment right to free speech on intra-corporate issues by stockholders would not give rise to liability absent a showing—in addition to all other necessary elements of a defamation claim—that the statements made were false and made with actual malice.²⁵

The rationale for holding corporate directors as public figures under the tort and constitutional law standards, the *Judy* Court explained, was two-fold. First, nominees who run for and take corporate office as directors, voluntarily expose themselves to attention and comment on their actions by stockholders, who monitor their performance.²⁶ The second rationale for recognizing fiduciaries

one they didn't want?"; and (6) "Did they disclose to you that the Court ordered [the incumbent directors] to provide books and records?"

²³ *Id.* at 468. ((1) "[The incumbents] were not going to pay what was owed on the notes. They were not going to pay the accrued dividends on preferred stock. They were not going to pay liquidation preference to outstanding preferred stock. They were not going to pay anything on the GX License claims. They reduced stock owned by individuals that had been approved by the Court."; (2) "Thanks to those plaintiffs your notes were paid and not because the Company wanted to, and that is the truth."; (3) "Soon, that \$60 million [in cash the Company received from a transaction] will be down to less than \$5 million and [the incumbent directors are] threatening to renege on their promise to you to liquidate and make a distribution to stockholders.").

²⁴ *Id.* at 467-68.

²⁵ *Id.* at 477.

²⁶ *Id.* at 479 (explaining that the voluntary choice of corporate candidates to thrust themselves in the forefront and endure publicity when seeking to be elected to lead corporations was a key justification in viewing them as a public figure for the electoral-related communications purposes).

as public figures, the Court observed, is that access to corporate funds that directors can deploy to communicate with investors by multiple means, enables them to counter criticism and expose fallacies.²⁷

In considering whether the director-plaintiffs were deemed public figures, the Court found that by seeking reelection after prevailing at a hotly-contested proxy contest in the last elections held in 2013, the director-plaintiffs voluntarily assumed the risk of injury from defamatory falsehood and therefore were deemed public figures.²⁸ Elaborating on its reasoning, the Court noted that the incumbent director's knowledge that the dissident group continuously opposed them, and that both the dissidents and the other stockholders had monitored their actions, served as further evidence that the removed directors exposed themselves to the risk of closer scrutiny.²⁹ The Court then went further and emphasized the importance of the incumbents' greater access to channels of effective communication, namely the ability to utilize internal corporate information to respond to the allegations of misconduct by instructing the Company's employees to develop rebuttals to the dissidents' contentions as well as the board's control of the content of the circulated proxy materials, in supporting the conclusion that the director-plaintiffs were public figures within the community of the Company's stockholders.³⁰

With those overarching considerations in mind, the Court turned to assess whether the statements made in the fight letter were defamatory. Starting its examination by considering the statements of the wrongful wealth transfer, the Court determined that given that the investors knew that the parties were staunch adversaries engaged in a lengthy duel over the control of the Company, the investors would consider those statements as a constitutionally protected

²⁷ *Id.* at 480.

²⁸ *Id.* at 479.

²⁹ *Id.* at 479-80.

³⁰ *Id.* at 480.

expression of opinion, rather than statement of fact.³¹ In further support of its holding, the Court explained that “proxy fight letters are pitches for a cause, and tend towards emphatic language in order to sway shareholders to the dissident's side,” which therefore made it “highly unlikely that the company's stockholders would view the Looting Allegations as alleging criminal conduct.”³² Hence, the Court concluded, the looting statements were constitutionally protected opinion under the First Amendment and therefore not actionable.

Next, the Court turned to assess whether the concealment allegations could give rise to liability as libelous. Finding that the incumbent directors failed to meet their burden of proof and establish that the statements made in connection with judicial orders—which were entered against them in multiple actions—were not substantially true, the Court concluded that the concealment allegations were nonactionable as defamatory.³³

The Court then turned to the removed director's final challenge—the payment allegations that included accusations that the incumbents planned to cause the Company to breach its contractual obligations and prolong distributions to its investors by engaging in a related-party transaction. Failing to proffer any evidence that supported their assertions, the Court held, that at the pleadings stage, it was reasonably conceivable that these statements were known by dissident group to be false or alternatively made with reckless disregard of the truth.³⁴ Therefore, the Court granted the motion to dismiss as to payment allegations.

The Court of Chancery's *Judy* decision is undoubtedly a game changer for stockholders in a couple of respects. First, called to the

³¹ *Id.* at 484-85.

³² *Id.* at 484 (quoting Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations & Business Organizations* § 12.8 (3d ed. 2015)).

³³ *Id.* at 486-87.

³⁴ *Id.*

task of balancing the competing policies of stockholders' constitutional right to free speech and fiduciaries' tort law rights to reputation, the Court acknowledged for the first time the need for protection of the right to communicate with other investors of the company. Presented with this novel and seemingly irreconcilable clash, the Court defined the scope of stockholders' First Amendment rights to free speech in intracorporate contexts by requiring that aggrieved incumbent fiduciaries who bring defamation claims for such communications, bear the evidentiary burden of demonstrating that the statements were false and made with malice. Thus, imposing heightened constitutional pleading requirements for establishing liability for defamation, the Court in *Judy* provided all stockholders, whether of a privately or publicly-owned company, broader protection against wrongful managerial interference with the exercise of their free speech and voting rights.

Second, the *Judy* decision presumably extends beyond proxy contest fight letters to different stockholders engagements, such as activist stockholders' "poison pen" letters.

The Vice-Chancellor's ruling in *Judy*, however, raises corporate law policy concerns. The decision seems to overlook that the incumbents of the Company in *Judy* wrongfully sued, using corporate funds, the proponent stockholders about statements that were mere opinion. Failing to condemn and impose sanctions on fiduciaries for engaging in an impermissible action creates a pervasive incentive for fiduciaries to continue in their attempt to block stockholders from meaningfully and effectively monitor their behavior, further isolating themselves from accountability, as well as exercising their core rights to free speech and voting.

Most problematically, however, is the Court's focus on the director-plaintiffs' challenges to the critique against them in isolation, rather than establishing normative duty to safeguard against managerial interference with stockholders' free speech and voting rights. Put differently, merely balancing the antagonist parties' interests to reputation on the one hand and free speech on the other, without determining whether fiduciary interference with these rights meet equitable standard of conduct of corporate directors, leads to concerns about opportunism, imposition of unnecessary costs on stockholders and overall wealth creation. Alternatively, the Court had not seized the opportunity to determine whether board

interference with stockholders' right of intra-corporate communication should trigger corporate law standard of review.

To illustrate the need of establishing a standard of review under which director liability will be judged in circumstances of potential manipulation of the stockholders franchise, consider the following examples. A publicly-traded company engaged in the production and sale of rare earth minerals has recently completed an initial public offering. Despite the capital raising, the company struggles financially due to underestimation of significant costs necessary to modernize and expand its facilities, as well as a spike in prices of rare earth minerals, which are subject to boom-bust pricing cycles. Shortly after the IPO, certain preferred stockholders who hold registration rights demanded registration of their shares, which they eventually sold in a significant profit. During the same timeframe, the company lagged behind its capital budget. Management also learned that an anticipated loan guarantee would not come through, jeopardizing a joint venture opportunity. The company's preferred stockholders again demanded registration of their shares, which they sold in a profit. At the time of both the private offerings, the company board consisted of eight members, seven of whom either sold stock or were affiliated with the preferred stockholders who sold stock in offerings. A couple of months later, prices of rare earth minerals dropped. Significantly lagging behind its capital budget, the company raised debt through a private note offering as well as capital through stock sales at a deep discount compared to sale prices at which the preferred stockholders sold their shares.

In the lack of standard of conduct and standard of review to check potential abuse of power in situations of directorial actions impinging stockholders' right to speech—such as the filing of the defamation suit—minority stockholders would be discouraged to monitor managerial actions that may be viewed as interested, suboptimal to the corporation, as illustrated by the example above. The absence of a judicial review standard of such unleashed managerial actions, gives rise to the policy concern of disproportionate incentives of boards of directors to take interested actions to wrongfully interfere with the exercise of the constitutional right to speech without being held accountable. That is, the current regime where stockholders can be held liable for libel by mere *after-the-fact* showing that they exercised their First Amendment rights on incomplete information and thus acted with reckless disregard, while fiduciaries are not accountable for acting on the expense of the cestui

que trust that they are supposed to serve, dwarfs stockholders' incentives of real-time management monitoring.

This risk of erecting unreasonable barriers to stockholder monitoring solidifies given that stockholders' communication with other investors of the company is virtually always made with less than perfect information. Despite federal and Delaware corporate law system's effort to drive fuller disclosure of key information like financial projections relevant to transactional votes,³⁵ material conflicts of interest,³⁶ and the process used to reach decisions,³⁷ no

³⁵ See, e.g., *In re Pure Res., Inc., Shareholders Litig.*, 808 A.2d 421, 450 (Del. Ch. 2002) ("When controlling stockholders make tender offers, they have large informational advantages that can only be imperfectly overcome by the special committee process, which almost invariably involves directors who are not involved in the day-to-day management of the subsidiary. The retention of financial advisors by special committees is designed to offset some of this asymmetry, and it would seem to be in full keeping with that goal for the minority stockholders to be given a summary of the core analyses of these advisors in circumstances in which the stockholders must protect themselves in the voting or tender process. That this can be done without great burden is demonstrated by the many transactions in which meaningful summary disclosure of bankers' opinions are made, either by choice or by SEC rule.").

³⁶ See, e.g., *In re El Paso Corp. S'holderLitig.*, 41 A.3d 432, 434 (Del. Ch. 2012) ("The record is filled with debatable negotiating and tactical choices made by El Paso fiduciaries and advisors. Absent a conflict of interest, these debatable choices could be seen as the sort of reasonable . . . ones that must be made in a world of uncertainty. After discovery, however, these choices now must be viewed more skeptically, as the key negotiator on behalf of the Board and a powerfully influential financial advisor each had [undisclosed] financial motives adverse to the best interests of El Paso's stockholders.").

³⁷ See, e.g., *In re Netsmart Techs., Inc. Shareholders Litig.*, 924 A.2d 171, 177, 209 (Del. Ch. 2007), *judgment entered sub nom. In re Netsmart Technologies, Inc. Shareholders Litigation* (Del. Ch. 2007) ("The record, as it currently stands, manifests no reasonable, factual basis for the board's conclusion that strategic buyers in 2006 would not have been interested in Netsmart as it existed at that time. . . . [It seems] important for Netsmart to at least disclose this judicial decision or otherwise provide a fuller, more

other area of the law presents an “information asymmetry” problem as significant as the corporate governance landscape. The reason for the grave asymmetry problem is encompassed in the fact that information is solely within management’s control. Even the statutory mechanism of inspecting corporate books and records does not level the playing field, mainly because stockholders who seek to obtain access to corporate records are required to establish that an alleged wrongdoing, which is the very subject of the investigation sought, occurred and overcome merits defenses without access to the underlying facts.³⁸ Thus, stockholders often fail to satisfy this requirement because the reason the very claims for books and records are based on what a stockholder seeks to investigate.

Another set of situations where subjecting management’s interference with stockholders’ constitutional intracorporate

balanced description of the board’s actions with regard to the possibility of finding a strategic buyer. As the Proxy now stands, its description of that issue leads one to the impression that a more reasoned and thorough decision-making process had been used, and that the process was heavily influenced by earlier searches for a strategic buyer that provided a reliable basis for concluding that no strategic buyer interest existed in 2006.”).

³⁸ The right of stockholders to demand inspection of books and records is by nature conditional, subjected to statutorily, judicial, and corporate-imposed, restrictions that limit stockholders access to intracorporate information. *See* 8 *Del. C.* § 220; *Nw. Indus., Inc. v. B.F. Goodrich Co.*, 260 *A.2d* 428 (*Del.* 1968) (*denying stockholder’s demand for inspection stated as its purpose “to communicate with the other stockholders of your company with reference to a special meeting of the stockholders.”*). Even legal vehicles for obtaining information about the corporation, such as where a stockholder sues to compel inspection if her demand is refused or not answered by initiating a section 220 action, which contemplates summary and expedited proceedings that emphasizes prompt processing and disposition, to investigate purported improper transactions, inquire into management inadequacies, or for communication-related purposes, often defeat stockholder urgent, time sensitive need to address a rising corporate wrongdoing on a real-time basis. *Scott v. Boca Bancorp*, C.A. No. 22649, slip op. at 1 (*Del. Ch.* 1990) (stating that expedited treatment not automatic unless only stock list sought).

communication right to an appropriate standard of review arises in circumstances where directors' decisions are on the specter of suspicious, yet permissible actions.

Take, for example, a saving and loan publicly-held company whose board of directors has recently approved a number of amendments to the bylaws due to media publications that a notorious investment fund firm has considered to increase its stake in the Company due to its recent disappointing performance. The first amendment increased the threshold for nominating candidates to the board from 10% to 30%. The second requiring 80% supermajority voting requirement to amend the bylaws and provisions related to the size of the board. The third reducing the size of the Company's staggered board from seven to five, which results in one seat—rather than three—coming up for election at the current year's annual meeting.

Given the apparent bona fide actions of the board, which was not faced with a proxy contest or an expected proxy contest when it acted, the lack of a standard of review of fiduciary actions that have the effect of hindering the exercise of stockholders' intra-corporate communication rights—such as pretextual defamation claim—effectively forecloses stockholders' remaining oversight tool at hand.

Thus, the increasing importance of real-time monitoring of corporate actions further emphasizes the need of establishing an accountability mechanism against wrongful interference with stockholders' constitutional communication rights. Any efforts by fiduciaries to wrongfully interfere with stockholders' intracorporate right to speech, even where there is no clear conflict of interest between the directors and the stockholders, must bestir deep judicial suspicion to ensure that the legitimacy of the corporate structure itself is not undermined. Or stated bluntly, *Judy* emphasizes the need of formulating doctrinal principles outside the realm of the First Amendment sphere, to provide strong-form protection where director consciously choose to improperly interfere with stockholders' right to free speech and voting.

SEARCHING FOR THE OPTIMAL BALANCE BETWEEN
STOCKHOLDERS' COMMUNICATION RIGHTS AND CORPORATE
LAW PUBLIC POLICY

Stockholders' right to elect directors is in the first instance statutory. Corporate law statutes, in an effort to achieve accountability of corporate fiduciaries, however imprecisely, requires that an annual meeting of stockholders be held for the election of directors.³⁹

Occasionally, boards act in a manner—though not specifically prohibited by the statute nor inherently nefarious—that may have the effect of interfering with or impeding the effective exercise of corporate democracy by stockholders, especially when a contest of control is in the background. Keeping with the traditional vigilance of ensuring the fairness of the process by which directors are elected, courts have approached such directorial interventions that affect the stockholder franchise with a “gimlet eye,”⁴⁰ irrespective of technical compliance with the corporation law statute.⁴¹

³⁹ E.g., DEL CODE ANN. tit. 8, § 211(b)-(c).

⁴⁰ E.g., *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003) (“This Court and the Court of Chancery have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders, especially in an election of directors.”); *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971) (finding that “utiliz[ing] the corporate machinery and the Delaware Law for the purpose of perpetuating [management] in office; and, to that end, for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management” are “inequitable purposes, contrary to established principles of corporate democracy”); *State of Wisconsin Inv. Bd. v. Peerless Sys. Corp.*, 2000 WL 1805376, at *7 (Del. Ch. 2000) (holding that although the primary purpose of an adjournment was to “ensure the passage of” the proposal by “interfering with the shareholder vote,” the board could prove a compelling justification for the adjournment); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 297 (Del. Ch. 2000) (enjoining, under *Blasius*, the board's decision, after learning of a dissident's plan to amend the company's bylaws and declassify the board, to preemptively amend the bylaws to eliminate the

To deal with the complexity of director actions that improperly interfere with a vote touching upon matters of corporate control, the Delaware courts—in a classic manifestation of the concept of separation of powers—have placed the burden of persuasion on

ability of shareholders to remove directors without cause, eliminate shareholders' ability to fill vacancies on the board, and most importantly to require a supermajority shareholder vote to amend the bylaws in the future); *Agranoff v. Miller*, 1999 WL 219650, at *11-12, *18 (Del. Ch. 1999); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988); *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 914 (Del. Ch. 1980) (invalidating board's action setting an annual meeting that made it impossible to comply with an advance notice bylaws requirement after learning about insurgent's intention to wage a proxy fight).

⁴¹ *Schnell*, 285 A.2d 437, 439 (Del. 1971) (holding that "inequitable action does not become permissible simply because it is legally possible"); *Marino v. Patriot Rail Co.*, 131 A.3d 325, 336 (Del. Ch. 2016) ("Post-1967 decisions by the Delaware Supreme Court . . . rendered untenable the strong-form contention that a statutory grant of authority necessarily foreclosed fiduciary review."); see also Adolphe A. Berle, *Corporate Powers As Powers In Trust*, 44 HARV. L. REV. 1049, 1049 (1931) ("[I]n every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a cestui que trust to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary."); *Sample v. Morgan*, 914 A.2d 647, 672 (Del. Ch. 2007) (Strine, V.C.) ("Corporate acts thus must be 'twice-tested' – once by the law and again in equity."); accord *Quadrant Structured Prods. Co. v. Vertin*, 2014 WL 5465535, at *3 (Del. Ch. Oct. 28, 2014) ("Delaware law adheres to the twice-testing principle."), aff'd, 151 A.3d 447 (Del. 2016) (TABLE); *Carsanaro v. Bloodhound Tech., Inc.*, 65 A.3d 618, 641 (Del. Ch. 2013) ("Corporate acts are twice-tested, once for statutory compliance and again in equity."); see also *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 434 (Del. Ch. 2002) (Strine, V.C.) ("Nothing about [the doctrine of independent legal significance] alters the fundamental rule that inequitable actions in technical conformity with statutory law can be restrained by equity.").

boards to justify their actions in order to strictly police inequitable inhibitions of the stockholder franchise.⁴²

⁴² *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 43 (Del. Ch. 2013) (explaining that enhanced scrutiny applies to specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors. Inherent in those situations are subtle structural and situational conflicts that do not rise to a level sufficient to trigger entire fairness review, but also do not comfortably permit expansive judicial deference. In those contexts, “the predicate question of what the board’s true motivation was comes into play,” and “[t]he court must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board.”); *see Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176, 180–82 (Del. 1986) (applying Unocal test to the sale of a corporation in light of concern that the directors rebuffed a premium acquisition offer and agreed to a white knight transaction, because (1) the target CEO felt a “strong personal antipathy” towards the acquirer, and (2) the directors feared potential litigation by noteholders); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (creating enhanced scrutiny to address the “omnipresent specter” that when resisting a hostile takeover, target directors may be influenced by and act to further their own interests or those of incumbent management, “rather than those of the corporation and its shareholders”); *see also In re El Paso Corp. S'holder Litig.*, 41 A.3d 432, 439 (Del. Ch. 2012) (“[T]he potential sale of a corporation has enormous implications for corporate managers and advisors, and a range of human motivations, including but by no means limited to greed, can inspire fiduciaries and their advisors to be less than faithful”); *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1129 (Del. 2003) (extending the rubric of enhanced scrutiny to incorporate the principles that animated Chancellor Allen’s decision in *Blasius* and directed that they be applied “within the . . . enhanced standard of judicial review.”); *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 811 (Del. Ch. 2007); *see also Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992) (holding that enhanced scrutiny applies whenever a board takes unilateral action “touch[ing] upon issues of control”) (quotation marks omitted); *Gilbert v. El Paso Corp.*, 575 A.2d 1131, 1144 (Del. 1990) (holding that a court must apply enhanced scrutiny whenever the board acts “in response to some threat to corporate policy and effectiveness which touches upon issues of control”); *see also* Gregory V. Varallo et al., *From Kahn to Carlton: Recent Developments in Special Committee Practice*, 53

Thus, consistent with the central tradition of Delaware corporate law, a board's conduct that supports an inference of a conscious, self-interested action on part of the fiduciaries to improperly interfere with stockholders' right to intra-corporate communication have sufficient disenfranchising effect to trigger *Mercier v. Inter-Tel*⁴³ and *Pell v. Kill*⁴⁴ enhanced judicial scrutiny.⁴⁵

BUS. LAW. 397, 423 n.121 (1998) (explaining that the two-step Zapata test is "reminiscent of the enhanced scrutiny courts use to examine the actions of directors engaged in a sale of a corporation or other like transactions"); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 851 (2004) (discussing standard and concluding that "*Zapata* is thus quite similar to *Unocal*"); Paramount *Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 (Del. 1993) ("[T]here are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable."); *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 597 (Del. Ch. 2010) ("Avoiding a crude bifurcation of the world into two starkly divergent categories—business judgment rule review reflecting a policy of maximal deference to disinterested board decision-making and entire fairness review reflecting a policy of extreme skepticism toward self-dealing decisions—the Delaware Supreme Court's *Unocal* and *Revlon* decisions adopted a middle ground.").

⁴³ *Id. See Mercier*, 929 A.2d at 818 ("In prior decisions, this court has decided that because board action influencing the election process did not have the effect of precluding or coercing stockholder choice, that action was not taken for the primary purpose of disenfranchising stockholders. Because non-preclusive, non-coercive action did not have the primary purpose of disenfranchisement, the *Blasius* standard did not apply and thus no compelling justification for the board's action had to be shown. That is, the lack of disenfranchising effect provided that the trigger for the test was not pulled.").

⁴⁴ *Judy*, 135 A.3d 764 (Del. Ch. 2016) (enjoining plan to reduce size of board that would maintain certain defendant directors in the majority and would neutralize the threat of a pending proxy contest, explaining that "when facing an electoral contest, incumbent directors are not entitled to determine the outcome for the stockholders. Stockholders elect directors, not the other way around. Even assuming that the Defendant Directors acts for an

By nature, directors cannot be expected to remain neutral with respect to matters of corporate control.⁴⁶ This omnipresent, inherent conflict of interest when a board, even if independent and otherwise disinterested, justifies subjecting fiduciary interference with the stockholders' intracorporate communication rights to a heightened judicial review, even if the board's tactics, however subtle, do not have the effect of outright impairing the franchise. In particular, such robust judicial review requires inquiry into the context—history, timing, and content—of the board's action that interferes with stockholders' right of intracorporate communication.

Invoking an intrusive standard of review to a board's heavy-handed tactic to erect barriers in the path of dissident stockholders' right to speech, especially in the context of a contest for corporate control, is also justified for the reason that the real parties in interest—the minority equity owners—often cannot protect themselves at the ballot box by simply replacing the board. Furthermore, although establishing that a statement was defamatory and made with scienter is a tall order, it is the threat of a retributive

unselfish purpose, they still acted inequitably.”); see also *Aquila, Inc. v. Quanta Servs., Inc.*, 805 A.2d 196, 205 (Del. Ch. 2002) (corporation's creation of an employee benefit trust to hold newly issued stock, thereby measurably diluting the holdings of a significant stockholder engaged in a proxy contest, was “neither preclusive no coercive” and thus would be considered under *Unocal*).

⁴⁵ *Mercier*, 929 A.2d at 810-11 (explaining that enhanced scrutiny review applies to director action that affects stockholder voting requires the board to prove that (1) its motivations were proper and not selfish, (2) it did not preclude stockholders from exercising their right to vote or coerce them into voting a particular way, and (3) the board's actions were reasonable in relation to its legitimate objective. If the fit between means and end is not reasonable, then the board falls short.).

⁴⁶ *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1206 (Del.Ch.1987) (“A candidate for office, whether as an elected official or as a director of a corporation, is likely to prefer to be elected rather than defeated. He therefore has a personal interest in the outcome of the election even if the interest is not financial and he seeks to serve from the best of motives.”).

action motivated by the incumbent directors' self-interest to hinder stockholder intracorporate communication rights by miring the vocal dissident that supports the utility of judicial-intrusive standard of review.

Subjecting a board's action that has the effect of stymieing stockholders' right to speech would thus go a long way to provide a strong medicine against impermissible interference with stockholders franchise.

Employing the enhanced scrutiny test to the director-plaintiffs' defamation suit in *Judy*, as an example, would have likely resulted in findings that the electoral process has been tainted by inequitable behavior of the removed directors. Indeed, the director-plaintiff's action to interfere with the dissident group's First Amendment communication rights with other stockholders of the company was not a blatant and obvious attempt to interfere with the stockholder franchise or otherwise undermined the stockholders' right to act directly, but rather a subtle one. Subtlety, however, does not take conduct beyond the realm of equity. The backdrop of the dysfunctional state of affairs of the company under the incumbent board's management and the animosity between the factions, support the inference that the director-plaintiff's defamation suit was pretextual, designed to thwart the dissident stockholders' opposition and perpetuate them, and was not tailored to adequately justify their wrongful interference with the company stockholders' exercise of their constitutional speech rights.

CONCLUSION: DIRECTOR INTERFERENCE WITH
STOCKHOLDERS' INTRA-CORPORATE COMMUNICATION
RIGHTS MUST REFLECT THE POLICY VALUES EMBODIED IN
THE ENHANCED SCRUTINY STANDARD

The preceding discussion highlights the distortion of incentives that can arise when an appropriate standard of review is not applied in situations of wrongful managerial interference with the right of intra-corporate stockholder communication. In the corporate community, employing the level of behavior that will subject a corporate director to liability is a highly sensitive and important matter. When courts do not carefully inquire into whether legal conduct affecting stockholders' intracorporate communication rights

may nonetheless be situationally inequitable, they affect director behavior in ways that are unintended and undesirable.

Judy illustrates this proposition, leaving open to directors to purposely impinge on the almost sacred right to elect a new board—an area of fundamental importance to stockholders. To align judicial decision-making with the traditional public policy values of fiduciary conduct, courts should reassess this decision, and adopt a strict doctrinal standard to review actions by corporate fiduciaries that affect the right to intra-corporate communication, and as a result stockholders' franchise. That approach would: (1) send a clear message to boards and their advisors that they must be very careful when taking an action that may have the effect of unconstitutionally disenfranchising the electorate in violation of stockholders' First Amendment's right to intra-corporate communication—in other words, applying the enhanced standard of review would leave it open to boards to exercise their broad authority to manage the affairs of the corporation as well as protect their right to reputation, so long as they are prepared to justify, in a situationally specific way, their behavior—; and (2) better balance the competing interests of corporate directors' and officers' tort law right to reputation and stockholders' First Amendment right to communicate with other investors of the corporation.

LEGAL FRAMEWORK AND ECONOMIC CRITIQUE: TRUMP'S TRADE AUTHORITY AND POLICY

A LOOK AT THE LEGALITY, PRACTICALITY, PROBABILITY, AND RATIONALITY OF PRESIDENT TRUMP'S PROPOSED TRADE-RELATED ACTION

*Noah Glazier**

I. INTRODUCTION

President Donald Trump made a wide array of comments regarding trade during his campaign and time as President. These comments' tones range from extremely protectionist and unconventional to more modest and in-line with past administrations. Trump declared most of his more extreme trade-related comments during his time on the campaign trail. For example, Trump claimed he would "rip up" existing trade agreements, label China a "currency manipulator," eliminate or renegotiate the North American Free Trade Agreement (NAFTA),¹ and impose 45 percent and 35 percent tariffs on imports from China and Mexico respectively.² President Trump even suggested an intention to "pull out" of the World Trade Organization (WTO) altogether.³ However, Trump moved away from

* Mr. Glazier would like to give a special thanks to UC Hastings Professor Joel Paul, who provided him with invaluable assistance on this article. He is deeply grateful for Professor Paul's tremendous efforts as both a teacher and a mentor.

¹ See e.g., Nick Corasaniti, Alexander Burns & Binyamin Appelbaum, *Donald Trump Vows to Rip Up Trade Deals and Confront China*, N.Y. TIMES (June 28, 2016), https://www.nytimes.com/2016/06/29/us/politics/donald-trump-trade-speech.html?_r=0.

² See e.g., Paul Wiseman & Joe McDonald, *For Americans, Trump's tariffs on imports could be costly*, CHI. TRIB. (December 1, 2016), <http://www.chicagotribune.com/news/nationworld/ct-donald-trump-tariffs-20161201-story.html>.

³ See e.g., William Mauldin, *Trump Threatens to Pull U.S. Out of World Trade Organization*, WALL ST. J.: WASHINGTON WIRE (June 24, 2016),

these more extreme positions since becoming President. Instead, he has taken a slightly more cautious approach, while still reserving the option to “act [as] aggressively as needed to discourage” trade practices that harm American citizens.⁴ Trump’s trade envoy is finally complete with the confirmation of United States Trade Representative (USTR) Robert Lighthizer, allowing the Administration to pursue “Trump’s strategy for reversing a trade dynamic that he believes hurts the average American worker” at full speed.⁵

The goal of this paper is to assess the legality, practicality, probability, and rationality of the President Trump’s proposed and threatened trade measures. Part II.A of the paper discusses the legal framework surrounding Trump’s authority to engage in unilateral trade actions, including his ability to impose tariff and other non-tariff barriers to trade, such as quotas on imports from foreign countries. This part of the paper will also provide an assessment of the legal challenges, practical constraints, and likelihood of each unilateral trade measure, including an overview of the following: the relevant historical application of certain measures, how other countries or aggrieved parties might respond, and what the Trump administration has already done. Part II.B discusses Trump’s legal capacity to unilaterally withdraw from or terminate NAFTA. Part III.C critiques Trump’s trade policy approach and highlights some of his flawed economic logic.

<https://blogs.wsj.com/washwire/2016/07/24/trump-threatens-to-pull-u-s-out-of-world-trade-organization/>.

⁴ OFFICE OF THE U.S. TRADE REP., EXEC. OFFICE OF THE PRESIDENT, THE PRESIDENT’S 2017 TRADE POLICY AGENDA, (2017), <https://ustr.gov/sites/default/files/files/reports/2017/AnnualReport/Chapter%20I%20-%20The%20President%27s%20Trade%20Policy%20Agenda.pdf> (The President’s 2017 Trade Policy Agenda, quoted above, was written by Robert Lighthizer, the United States Trade Representative).

⁵ Megan Cassella, *It’s deal-making time: Trump’s trade envoy is confirmed*, POLITICO.COM (May 11, 2017), <https://www.politico.com/story/2017/05/11/robert-lighthizer-confirmed-trade-rep-238280>.

II. LEGAL FRAMEWORK AND ECONOMIC CRITIQUE: TRUMP'S TRADE AUTHORITY AND POLICY

A. THE PRESIDENT'S LEGAL AUTHORITY TO IMPOSE UNILATERAL TRADE MEASURES

This section reviews the laws that President Trump may rely on to make his threatened unilateral trade actions a reality. There are over nine statutory sections from various trade-related legislations that could allow the President, often in conjunction with the USTR and other executive agencies, such as the Department of Commerce (DOC) and International Trade Commission (ITC), to impose unilateral trade measures like duties or quotas on imports from foreign countries. The available U.S. laws are divided into two different groups—those that are conventional or more commonly used and those used much less frequently (if at all) in the past.⁶ Given President Trump's approach since taking office, it is more likely that his Administration will utilize the more conventional group of unilateral trade mechanisms, although he will likely use a more aggressive manner than past administrations.⁷ On the other hand, given Trump's unpredictable and unconventional nature, it is also possible that he will utilize some of the more rare legislation, which will likely spark more serious legal and economic concerns.⁸

1. COMMONLY-USED STATUTORY PROVISIONS PERMITTING UNILATERAL TRADE ACTIONS

There are several U.S. trade laws that have been commonly utilized by past presidents to help curb unfair foreign trade practices and to protect American workers, consumers, and producers. The Trump Administration is already pursuing unilateral trade actions under some of these statutory provisions and will likely continue to

⁶ William Clinton, Scott Lincicome, Brian Picone, Richard Eglin, & William Barrett, *Implications of the 2016 US Presidential Election for Trade Policy*, at 6, WHITE & CASE LLP (Sept. 7, 2017), <https://www.jdsupra.com/legalnews/implications-of-the-2016-us-55211/>.

⁷ *Id.* at 6.

⁸ *See id.* at 2-3.

aggressively do so throughout the presidency.⁹ These commonly-used statutory provisions, which primarily involve agency proceedings and investigations, are further categorized into three different forms of measures: (1) Antidumping (AD) and Countervailing Duty (CVD) measures; (2) Section 337 measures; and (3) Section 201 safeguard measures.¹⁰ These measures have been commonly used by Presidents of the past, so their usage will likely cause little legal concern.¹¹ However, such measures are likely to play a crucial role in Trump's trade policy and may be used more aggressively than ever before.¹² Thus, review of these measures is due.

a. AD and CVD Measures

AD (antidumping duties) and CVD (countervailing duties) are unilateral trade actions aimed at leveling the international trade playing field that are commonly used by Presidential administrations.¹³ AD duties protect against countries that are exporting goods at a price that is less than the fair or normal value.¹⁴ CVD provide relief from foreign imports that benefit from government

⁹ See e.g., U.S. DEPARTMENT OF COMMERCE ISSUES AFFIRMATIVE PRELIMINARY ANTIDUMPING DUTY DETERMINATIONS ON BIODIESEL FROM ARGENTINA AND INDONESIA, Oct. 23, 2017 <https://www.commerce.gov/news/press-releases/2017/10/us-department-commerce-issues-affirmative-preliminary-antidumping-duty-1> (for example, from January 20, 2017, through October 23, 2017, the Department of Commerce initiated 73 antidumping and countervailing duty investigations, which represents a 52 percent increase from the previous year.).

¹⁰ See *id.* at 2; see also U.S. INT'L TRADE COMM'N, UNDERSTANDING SAFEGUARD INVESTIGATIONS, https://www.usitc.gov/press_room/us_safeguard.htm (last visited Nov. 18, 2017).

¹¹ CLINTON ET AL., *supra* note 6, at 6.

¹² *Id.*

¹³ *Id.*; see also U.S. INT'L TRADE COMM'N, UNDERSTANDING ANTIDUMPING & COUNTERVAILING DUTY INVESTIGATIONS, USITC Pub. 4540 (June 2015).

¹⁴ ANTIDUMPING AND COUNTERVAILING DUTY HANDBOOK, *supra* note 13, at 10.

subsidies.¹⁵ Title VII of the Tariff Act of 1930 is the authority implementing such duties.¹⁶

President Obama's administration imposed over fifty individual AD and CVD orders on various products and countries in 2016, many of which involved steel imports.¹⁷ As of the end of April 2017, the Trump Administration imposed 16 individual AD and CVD orders on products including "artist canvas, large residential washers, off-the-road tires and stainless steel sheet and strip."¹⁸ For example, the Administration implemented AD duties on Japanese steel imports ranging from 206.43% to 209.46% and on Turkish steel imports ranging from 5.39% to 8.17%.¹⁹ Turkish steel imports were also subject to CVDs of 16.21%.²⁰ Due to the regularity of such measures, it is unlikely that the use of AD and CVD orders by the Trump administration will cause any significant legal concerns because the law behind the implementation of such unilateral trade measures is well established and tested.²¹ As a result, the mechanics behind calculating AD duties and CVDs, which is a very onerous process, are only briefly discussed here.

Two separate government agencies, the DOC and the ITC, are involved in setting and administering AD duties and CVDs.²² The DOC determines whether dumping or actionable subsidizing exists, and if so, determines the respective duties based on the dumping margin or amount of subsidy.²³ The ITC determines whether such dumped or subsidized imports "materially injure, or threaten with

¹⁵ *Id.* at 11.

¹⁶ See 19 U.S.C. §§ 1671-1673i (2012) (on the imposition of countervailing duties and antidumping duties).

¹⁷ Adam Behsudi, *Politico's Morning Trade Brief*, POLITICO.COM (April 24, 2017), <http://www.politico.com/tipsheets/morning-trade/2017/04/eu-trade-chief-comes-calling-219937>.

¹⁸ *Id.*

¹⁹ U.S. DEPT. OF COMMERCE, INT'L TRADE ADMIN. FINDING FACT SHEET (2017), <http://enforcement.trade.gov/download/factsheets/factsheet-multiple-steel-concrete-reinforcing-bar-ad-cvd-051617.pdf>.

²⁰ *Id.*

²¹ CLINTON ET AL., *supra* note 6, at 2.

²² *Id.* at 6.

²³ *Id.*

material injury, an industry in the United States....”²⁴ Material injury is “harm which is not inconsequential, immaterial, or unimportant.”²⁵

It should be noted that the Obama administration implemented a series of significant changes to the DOC’s AD and CVD determination processes, including measures regarding China’s non-market economy (NME) status and its state-owned enterprises.²⁶ These changes have led to an overall increase in AD duties on Chinese imports, specifically where Chinese authorities refused to cooperate with the DOC.²⁷ Despite Trump’s criticisms of Obama-era trade policies, it is likely that his Administration will continue pro-duty actions and potentially utilize or implement other techniques that would broaden the scope and impact of current AD and CVD measures.²⁸ Other techniques include: maintaining China’s NME status, incorporating currency manipulation into AD duty or CVD calculations, utilizing a “self-initiation” process for AD and CVD investigations, and increasing the reliance on and impact of the “anti-circumvention” statute.²⁹

When a country has a non-market economy, normal value cannot be determined by looking at the country’s home market.³⁰ Instead, the normal value is calculated either by a constructed value of a like product based on the cost of factors in a market economy at the same level of development or, if such information is not available, by using the price of a comparable good exported to the U.S. from another market economy at the same level of development.³¹ This process for calculating a non-market economy-based product’s normal value has ultimately led to higher AD duties being imposed on imports from China.³² China joined the World Trade Organization (WTO) in 2001

²⁴ 19 U.S.C. § 1676(a) (1994).

²⁵ 19 U.S.C. § 1677(7)(a) (2016).

²⁶ CLINTON ET AL., *supra* note 6, at 6.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.* at 6-7.

³⁰ See *Technical Information on anti-dumping*, WORLD TRADE ORGANIZATION, https://www.wto.org/english/tratop_e/adp_e/adp_info_e.htm (last visited Nov. 26, 2017).

³¹ 19 U.S.C. § 1677b(c)(1), (c)(2) (2016).

³² See Chad P. Brown, *Should the United States Recognize China as a Market Economy*, at 6, PETERSON INST. INT’L ECON. (Dec. 2016).

and in the process of doing so, it agreed to carry out a series of steps designed to open its markets to global trade to act more like a market economy.³³ In return, China was “led to believe” that other countries, including the U.S., would officially revoke China’s NME status on December 11, 2016.³⁴ However, the Trump Administration has made no efforts to remove China’s NME status and will likely continue to recognize the country as a NME because it allows for higher AD duties, which in turn *ceteris paribus* leads to a decrease in Chinese imports; thus, helping to mitigate the U.S.’s bilateral merchandise account deficit with China.³⁵

Also with regards to China, it is possible that the Trump Administration may direct the DOC to treat deliberate currency (undervaluation) manipulation as an actionable export subsidy or as grounds to modify the constructed value determination mentioned above, which would lead to even higher AD duties.³⁶ However, if this approach were implemented unilaterally, it would likely face a plethora of legal challenges, both internationally and domestically.³⁷ Additionally, as discussed in more detail below,³⁸ China is not deliberately undervaluing its currency at the moment and Trump, for the time being, has completely backed away from his initial threats of labeling China as doing such.³⁹

Another way the Trump administration may attempt to sharpen the teeth of the AD and CVD investigation provisions is by utilizing a self-initiation process whereby Trump would encourage the DOC to instigate such investigations *sua sponte*.⁴⁰ Currently, allegedly injured domestic partners file petitions at the DOC to initiate AD and CVD

³³ *Id.* at 1.

³⁴ *Id.*

³⁵ *Id.* (stating that the reduction in AD duties that would result from recognizing China as a market economy would likely be a modest increase in imports due in part to the CVDs that simultaneously accompany most AD duties on Chinese imports).

³⁶ See CLINTON ET AL., *supra* note 6, at 7.

³⁷ *Id.*

³⁸ See *infra*, Section “Labeling China a Currency Manipulator.”

³⁹ See e.g., Uri Dadush, *Will America Trigger a Global Trade War*, at 2, OCP POLICY CTR. (Feb. 2017).

⁴⁰ See CLINTON ET AL., *supra* note 6, at 6.

investigations; however, the DOC's regulations also technically allow for investigations to be instigated *sua sponte*, or at the direction of the Secretary of Commerce.⁴¹ This allows the current Secretary, Wilbur Ross, to target specific imports from specific countries and subject them to investigations without having to wait for injured parties to file petitions.⁴² Notwithstanding the provision that allows for such self-initiation in the DOC's regulations, the U.S. has not utilized such a process, and doing so will likely be highly controversial.⁴³ In fact, in 2012, the European Union (EU) attempted to self-initiate AD and CVD investigations in a similar fashion against Chinese imports, but ultimately decided otherwise in the face of immense domestic and international opposition.⁴⁴

Lastly, the Trump Administration could take a more aggressive approach to existing AD duty and CVD enforcement by relying more heavily on the anti-circumvention statute.⁴⁵ This statute prohibits the circumvention of existing AD and CVD orders where there is insignificant processing of a good or completion of a good in a third country, or where there is further assembly in the U.S.⁴⁶ A recent case involving the anti-circumvention statute was brought near the end of Obama's presidency by a group of domestic steel producers who argued that China was exporting steel to Vietnam for insignificant processing to circumvent AD and CV duties that exist on certain Chinese steel imports.⁴⁷ A final determination on the matter has yet to be issued, but within 300 days of publication of the initiation decision, the DOC will determine whether China circumvented the existing duty orders.⁴⁸ This time frame may seem long, but it is more expeditious

⁴¹ See 19 C.F.R. § 351.201(a) (2005).

⁴² *Id.*

⁴³ CLINTON ET AL., *supra* note 6, at 6.

⁴⁴ *Id.*

⁴⁵ *Id.* at 7.

⁴⁶ 19 U.S.C. § 1677j (2016); *see also* CLINTON ET AL., *supra* note 6, at 7.

⁴⁷ See e.g., Estelle Tran, *US starts China-related anti-circumvention probes on Vietnamese steel*, S&P GLOBAL (Nov. 2016), <https://www.platts.com/latest-news/metals/houston/us-starts-china-related-anti-circumvention-probes-21010438>.

⁴⁸ Estelle Tran, *Anti-circumvention probes on Vietnamese steel already benefiting US mills*, S&P GLOBAL (Nov. 2016),

than the typical AD duty investigations, which last anywhere from 280-420 days.⁴⁹ Additionally, U.S. steel mills already realized benefits since this initiation, as fearful importers faced with long lead times continue to cancel orders of the steel from Vietnam currently under investigation.⁵⁰ An affirmative determination of circumvention in this case by the DOC will likely signal a more aggressive approach to existing AD and CV duty enforcement.⁵¹ It is likely that the Trump Administration will continue to utilize this anti-circumvention statute, perhaps even more aggressively, to ensure that existing AD and CVD orders are effectively enforced and not subject to regulatory arbitrage by foreign exporters.⁵²

b. Section 337 Measures

Section 337 of the Tariff Act of 1930 prohibits the use of unfair competition methods and is arguably the most powerful, cheap, and expeditious anti-import tool.⁵³ It allows for the broad remedy of excluding imports that benefit from such unfair methods of competition.⁵⁴ Section 337 has three primary uses: to protect intellectual property rights, to thwart anti-competitive activities such as collusion, price fixing, tying, and other forms of predatory pricing, and to promote consumer fraud protection.⁵⁵ Under Section 337, an ITC administrative judge finds a violation has occurred if a foreign country used unfair methods of competition and unfair acts and “the threat or effect of which is to destroy or substantially injure” a U.S. industry or to “restrain or monopolize” U.S. trade and commerce.⁵⁶ The administrative judge then sends his findings to the ITC, which

<http://blogs.platts.com/2016/11/10/anti-circumvention-vietnam-steel-us-mills/>.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ CLINTON ET AL., *supra* note 6, at 7.

⁵² *Id.*

⁵³ *See* 19 U.S.C. § 1337 (2016); *see also* lecture notes from Professor Joel Paul, UC Hastings (April 2017).

⁵⁴ CLINTON ET AL., *supra* note 6, at 9.

⁵⁵ *See* 19 U.S.C. § 1337 (2016); *see also* lecture notes, *supra* note 53.

⁵⁶ 19 U.S.C. § 1337(a)(1)(A) (2016).

takes the findings and makes a recommendation to the President.⁵⁷ So long as the President does not veto the findings and recommendation, they will take effect (i.e., no express presidential approval is needed).⁵⁸ The average length of all Section 337 investigations completed in 2017 was just 10.3 months, rendering Section 337 a powerful and expeditious tool.⁵⁹

However, because of the way this process is designed, President Trump has little to no control over the Section 337 process, especially in the short term.⁶⁰ The entire process is in the hands of the ITC's administrative judges and the agency itself, which is independent and bipartisan.⁶¹ That being said, Trump is likely to take credit for any successful Section 337 actions, such as the potential outcome of a case filed in April 2016 by U.S. Steel against almost all Chinese carbon and alloy steel products.⁶² Trump may also attempt to influence the Section 337 process in the long-run by appointing sympathetic ITC administrative judges and commissioners.⁶³ Additionally, it should be noted that if the ITC does indeed find a violation of Section 337 in the Chinese carbon and steel alloy products case and imposes the broad remedy of excluding such imports, such action will almost certainly be met by opposition from China.⁶⁴ China will likely claim *inter alia* that the action constitutes an impermissible non-tariff barrier to trade in violation of General Agreement on Tariffs and Trade (GATT) Article XI, or that the action otherwise violates the Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement.⁶⁵

⁵⁷ 19 U.S.C. § 1337(j)(1)(b) (2016).

⁵⁸ 19 U.S.C. § 1337(j)(4) (2016).

⁵⁹ UNITED STATES INTERNATIONAL TRADE COMMISSION, SECTION 337 STATISTICS: AVERAGE LENGTH OF INVESTIGATIONS, (Oct. 14, 2017), https://www.usitc.gov/intellectual_property/337_statistics_average_length_investigations.htm

⁶⁰ CLINTON ET AL., *supra* note 6, at 8.

⁶¹ *Id.*

⁶² Certain Carbon and Alloy Steel Products; Institution of Investigation, 81 FR 35381 (June 2, 2016); *see also* CLINTON ET AL., *supra* note 6, at 8 (for a further discussion of recent section 337 cases and their outcomes).

⁶³ *See* CLINTON ET AL., *supra* note 6, at 9.

⁶⁴ *Id.* at 6-7.

⁶⁵ *Id.* at 9.

c. Section 201 Safeguard Measures

Another option available to the Trump Administration is to actively pursue the safeguard investigation measures permitted under Section 201 of the Trade Act of 1974.⁶⁶ While theoretically as potent as Section 337 measures, these safeguard measures have rarely resulted in any type of enforcement action or effective remedy.⁶⁷ Section 201, which is also administered by the ITC, allows for the temporary imposition of higher tariffs based on the finding that a surge or increase in imports is a “substantial cause of serious injury” to a domestic producer of “a like or directly competitive” product.⁶⁸ However, Section 201 investigations are problematic and difficult, particularly with regard to the “substantial cause” prong.⁶⁹ As such, some definitions and explaining are in order.

The requisite increase in imports must be shown by evidence that net imports have increased by at least a certain nominal amount or that they have increased by a certain threshold percentage relative to domestic production.⁷⁰ “Substantial cause” is cause that is important and not less important than any other cause.⁷¹ This is a problematic standard similar to the *Tellabs* pleading standard whereby, e.g., a cause contributing to 33% of the injury along with two other causes each contributing equally will be considered “substantial.”⁷² As it is difficult to compare different inferences of scienter in the *Tellabs* context,⁷³ it is also very difficult to compare different causes of domestic producer injury, particularly because economic causes and factors are often inexorably intertwined and cannot be disaggregated.⁷⁴ The “serious injury” standard means something more serious than

⁶⁶ *Id.* at 8.

⁶⁷ *Id.*

⁶⁸ *Id.* at 8.

⁶⁹ *Id.*

⁷⁰ 19 U.S.C. § 2253(c)(1)(C) (2016).

⁷¹ 19 U.S.C. § 2251 (2016).

⁷² *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

⁷³ *See* Scalia’s dissent in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (discussing the problems with the “at least as compelling as” standard and the difficulties of making determinations re inferences of scienter).

⁷⁴ *See* lecture notes, *supra* note 53.

“material” injury and is thus subject to a higher standard than the injury that must be proven in AD and CVD cases.⁷⁵

Additionally, Section 201 safeguard measures are subject to significant limitations.⁷⁶ Unlike the AD and CVD orders or Section 337 violation remedies, the Section 201 safeguard measures apply to all imports from all countries.⁷⁷ Thus, the safeguard measures could not be used to target individual products (e.g. steel) or countries (e.g. China) and may therefore be seen as less desirable to Trump, who is primarily considered with bilateral merchandise account deficits.⁷⁸ Furthermore, as is the case with Section 337 investigations, Section 201 safeguard measures are implemented and administered by the ITC, an independent and bipartisan agency, which limits Trump’s ability to influence the safeguard process especially in the short-term.⁷⁹

Most Section 201 cases are filed in election years because, in many ways, Section 201 is ultimately a political tool that allows the U.S. government to escape the political pressures imposed by industries seeking protection from a surge of imports.⁸⁰ For example, the petition filed by the U.S. steel industry in the important election year of 2000 was the last Section 201 safeguard imposed on steel.⁸¹ The complaint led to President Bush’s infamous steel tariff, which was imposed in 2002.⁸² However, this tariff was promptly terminated in 2003 after the WTO’s Dispute Settlement Body (DSB) held that the U.S. failed to show that the Section 201 safeguard measures had complied with GATT Article XIX’s escape clause.⁸³

This serves as a salient indication that any usage of Section 201 by the Trump Administration will likely be met by immediate WTO

⁷⁵ CLINTON ET AL., *supra* note 6, at 8.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *See id.*

⁷⁹ *Id.*

⁸⁰ *See* lecture notes from Professor Joel Paul, UC Hastings (April 2017).

⁸¹ CLINTON ET AL., *supra* note 6, at 8.

⁸² Kevin K. Ho, *Trading Rights and Wrongs: The 2002 Bush Steel Tariffs*, 21 BERKELEY J. OF INT’L LAW 825, 832 (2003).

⁸³ *Id.* at 839.

challenges from other countries.⁸⁴ In order to survive such challenges, the U.S. would have to prove to the DSB that, “as a result of unforeseen developments,” there has been such an increase in imports “as to cause or threaten serious injury to domestic producers . . . of like or directly competitive product.”⁸⁵

B. LESS COMMONLY-USED STATUTORY PROVISIONS PERMITTING UNILATERAL TRADE ACTIONS

In contrast to the more commonly-used statutory provisions mentioned above, other less used U.S. laws potentially allow Trump to take broad (and sometimes virtually unfettered) unilateral trade action against foreign imports.⁸⁶ However, because they are infrequently used, these statutory provisions will likely cause a wide range of both legal and economic concerns and will be faced with stark opposition from foreign countries and U.S. industry groups alike.⁸⁷ Additionally, to achieve his trade goals using these statutes, the Trump Administration would likely have to apply a “liberal interpretation of the relevant legal standards,” which would defy past agency practice.⁸⁸ As a result, it is more likely that the Trump administration will opt to utilize the aforementioned more common and conventional statutes.⁸⁹

That being said, the more infrequently-used statutes enumerated below arguably have a higher chance of being utilized under Trump than under any president before, which is exemplified in part by Trump’s decision to instigate two separate Section 232 investigations

⁸⁴ See Binyamin Appelbaum, *Experts Warn of Backlash in Donald Trump’s China Trade Policies*, N.Y. TIMES (May 2, 2016), <https://www.nytimes.com/2016/05/03/us/politics/donald-trump-trade-policy-china.html>; see also CLINTON ET AL., *supra* note 6, at 8.

⁸⁵ General Agreement on Tariffs and Trade, Oct. 30, 1957, 61 Stat. A-11, 55 U.N.T.S. 194, at 36 [hereinafter GATT].

⁸⁶ See Jared R. Silverman, *Multilateral Resolution Over Unilateral Retaliation: Adjudicating the Use of Section 301 Before the WTO*, 17 U. PA. J. INT’L ECON. L. 233, 247-48 (1996) (discussing the impact section 301 has on the President).

⁸⁷ See CLINTON ET AL., *supra* note 6, at 6.

⁸⁸ See *id.*

⁸⁹ *Id.*

in his first one-hundred days as President.⁹⁰ The less commonly-used statutory provisions permitting unilateral trade actions discussed below include: (1) Section 232 national security measures; (2) Section 122 balance-of-payments measures; (3) Section 338 measures; (4) Section 301 measures; and (5) Trading with the Enemy Act (TWEA) and International Emergency Economic Powers Act (EIIPA) measures.⁹¹ This section concludes with a brief discussion of the relative likelihoods of each of these measures.

1. SECTION 232 NATIONAL SECURITY MEASURES

Section 232 of the Trade Expansion Act of 1962 authorizes Secretary of Commerce Wilbur Ross to investigate whether certain classes of imports pose a national security threat to the U.S.⁹² In determining a national security threat, the Secretary and the President consider the “domestic production needed for projected national defense requirements...[and] the importation of goods in terms of their quantities and use.”⁹³ They must also recognize the close relation between national economic welfare and national security, and consider “the impact of foreign competition on the economic welfare of individual domestic industries.”⁹⁴ The DOC is required to instigate Section 232 investigations “upon request of the head of any department or agency, upon application of an interested party”, or sua

⁹⁰ OFFICE OF THE PRESS SEC^Y, PRESIDENTIAL MEMORANDUM FOR THE SECRETARY OF COMMERCE: ALUMINUM IMPORTS AND THREATS TO NATIONAL SECURITY (Apr. 27, 2017), <https://www.whitehouse.gov/the-press-office/2017/04/27/presidential-memorandum-secretary-commerce>; OFFICE OF THE PRESS SEC^Y, PRESIDENTIAL MEMORANDUM FOR THE SECRETARY OF COMMERCE: STEEL IMPORTS AND THREATS TO NATIONAL SECURITY (Apr. 20, 2017), <https://www.whitehouse.gov/the-press-office/2017/04/20/presidential-memorandum-secretary-commerce>; see *infra* Section “Section 232 National Security Measures”.

⁹¹ CLINTON ET AL., *supra* note 6, at 9-13.

⁹² 19 U.S.C. § 1862(b)(1)(A) (2012); *id.* at 10.

⁹³ 19 U.S.C. § 1862(d) (2012).

⁹⁴ *Id.*; see also DEP’T OF COM., FACT SHEET: SECTION 232 INVESTIGATIONS: THE EFFECT OF IMPORTS ON THE NATIONAL SECURITY (2017), <https://www.commerce.gov/news/fact-sheets/2017/04/fact-sheet-section-232-investigations-effect-imports-national-security> [hereinafter *Section 232 Fact Sheet*].

sponte.⁹⁵ Based on a Section 232 report from Secretary Ross, which is prepared within 270 days of initiation, Trump is then authorized to take “actions as the President deems necessary to adjust the imports...so that such imports will not threaten to impair the national security.”⁹⁶ Thus, Section 232 provides President Trump with a tool that is potentially very powerful, as the statute provides no limit on the amount of tariffs or nature of restrictions.⁹⁷

However, utilization of Section 232 in the past has been somewhat rare, especially since the U.S. joined the WTO in 1995.⁹⁸ Since 1980, the DOC has conducted 14 Section 232 investigations, but none of them resulted in the imposition of significant tariffs or other non-tariff barriers to trade.⁹⁹ Since 1995, only two Section 232 probes, one on steel in 2001 and one on crude oil in 1999, resulted in DOC reports declining to recommend that the president take action.¹⁰⁰ However, two notable 1970s Section 232 actions are worth mentioning—those of Presidents Nixon and Ford. Nixon used his authority under Section 232(b) to impose an across-the-board 10 percent surcharge tariff program in 1971.¹⁰¹ Ford, pursuant to his Section 232(b) powers, issued a proclamation in 1975 raising licensing fees on petroleum products and imposing \$1-\$3/barrel fees on oil entering the U.S.¹⁰²

⁹⁵ 19 U.S.C. § 1862(b)(1)(A) (2012).

⁹⁶ *Id.* at (3)(A)(ii)(II).

⁹⁷ *Id.*; see CLINTON ET AL., *supra* note 6, at 10; see also Noland et al., *Assessing Trade Agendas in the US Presidential Campaign*, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, Sept. 2016, at 9.

⁹⁸ See *A National Security Argument on Trade*, STRATFOR ENT., LLC (Apr. 21, 2017, 12:45 PM), <https://www.stratfor.com/node/279276> (stating, “In fact, since the WTO came into force in 1995, the United States has conducted only two Section 232 investigations.”).

⁹⁹ See Bureau of Indus. and Sec., *Section 232 Investigations: The Effect of Imports on the National Security* (2016), <http://www.bis.doc.gov/232>; *Section 232 Fact Sheet* *supra* note 94.

¹⁰⁰ See U.S. Dep’t of Com. Bureau of Export Admin., *The Effect of Imports of Iron Ore and Semi-Finished Steel on the National Security* (2001); U.S. Dep’t of Com. Bureau of Export Admin., *The Effect on the National Security of Imports of Crude Oil and Refined Petroleum Products* (1999).

¹⁰¹ Noland et al., *supra* note 97, at 9-10; see also, CLINTON ET AL., *supra* note 6, at 10.

¹⁰² CLINTON ET AL., *supra* note 6, at 10.

However, after Ford's actions, Congress passed a statute limiting the President's ability to set minimum prices for crude oil absent congressional approval.¹⁰³

So far in his time as President, Trump has directed Secretary Ross to begin two separate Section 232 investigations—one on steel imports and one on aluminum imports, both were initiated in April 2017.¹⁰⁴ “Many have criticized such actions, arguing that they [will] encourage other countries to block U.S. exports on national security grounds.”¹⁰⁵ According to Chad Brown, a senior fellow at the Peterson Institute, “When you go down this path of reverting to the national security exception, it really is the nuclear option in trade law...”¹⁰⁶ Trump's decisions to instigate these probes were made about a week apart in late April, just as he was approaching the 100-day mark of his presidency, perhaps as the result of political and internal pressure to live-up to some of his campaign promises to get tough on trade.¹⁰⁷ Secretary Ross's reports on the matter will not be completed until early 2018 based on the 270 day timeline, so any Section 232(b) action by President Trump will not occur until that time.¹⁰⁸

Trump's use of Section 232 probes will be subject to significant practical and legal constraints, especially if they result in the imposition of tariffs or other non-tariff barriers.¹⁰⁹ The biggest

¹⁰³ See Emergency Petroleum Allocation Act of 1973, Pub. L. No. 94-99, 89 Stat. 481(1975); *id.*

¹⁰⁴ See OFFICE OF THE PRESS SEC'Y, *supra* note 90; see e.g., Doug Palmer & Matthew Nussbaum, *Trump puts aluminum imports in 'national security' crosshairs*, POLITICO (Apr. 26, 2017, 9:25 PM), <http://www.politico.com/story/2017/04/26/trump-aluminum-imports-trade-237665>.

¹⁰⁵ See Doug Palmer, Matthew Nussbaum, *supra* note 104.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Section 232 Fact Sheet supra* note 94; see also, Ana Swanson, *Will 2018 Be the Year of Protectionism? Trump Alone Will Decide*, New York Times (Jan. 3, 2018), <https://www.nytimes.com/2018/01/03/us/politics/2018-trump-protectionism-tariffs.html> (as of January 6, 2018, the reports have not been filed, but the deadlines are soon approaching; the Commerce Department must submit its reports on January 15, 2018 and January 21, 2018 for the steel and aluminum investigations, respectively).

¹⁰⁹ CLINTON ET AL., *supra* note 6, at 2.

practical constraint, as alluded to above, is the risk that such measures will result in retaliatory actions from other countries.¹¹⁰ This risk is especially salient with regard to China, who has demonstrated both the willingness and ability to effectively retaliate in the past (e.g., in response to President Obama's AD duties on Chinese tires).¹¹¹ The perverse economic repercussions that may result serve as significant practical limitations to such action, and will likely deter a mindful Trump Administration from engaging in overly aggressive unilateral Section 232 actions.¹¹²

From a legal standpoint, Trump's Section 232 actions will likely face challenges, both in U.S. courts and at the WTO.¹¹³ Notwithstanding the fact that U.S. courts strongly defer to the executive branch's determinations on national security, it is unclear how such domestic cases may play out in the Section 232 context.¹¹⁴ For example, aggrieved parties bringing claims in U.S. courts might argue that President Trump's unconstrained use of Section 232(b) to impose import restrictions violates the separation of powers principle and, more specifically, the non-delegation doctrine.¹¹⁵ While the non-delegation doctrine has not been explicitly applied by the Supreme Court since 1935, it is still good law.¹¹⁶ In essence, the doctrine states that whenever Congress delegates authority to the executive branch, such delegation is only permissible when Congress provides an accompanying intelligible principle to guide the executive branch on how to exercise such authority.¹¹⁷ Thus, it could be argued that Section 232 gives the President unfettered discretion and fails to

¹¹⁰ *Id.* at 9.

¹¹¹ *Id.* at 11.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 10.

¹¹⁵ See *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 537 (1935); also see *Panama Refining Co. v. Ryan*, 293 U.S. 388, 415 (1935).

¹¹⁶ See *A.L.A. Schechter Poultry Corp.*, 295 U.S. 495, 537; also see, *Panama Refining Co.*, 293 U.S. 388, 420-21.

¹¹⁷ *A.L.A. Schechter Poultry Corp.*, at 530; *Panama Refining Co.*, at 429-30.

provide the requisite intelligible principle; therefore, it unconstitutionally undermines the non-delegation doctrine.¹¹⁸

Additionally, foreign countries targeted by any Section 232(b) actions will almost certainly file complaints with the WTO pursuant to GATT Article XXIII, claiming that their legitimate expectations of trade benefits have been nullified or impaired by the Section 232(b) action.¹¹⁹ However, the U.S. could cite to the national security exception, which allows contracting parties to take “any action which it considers necessary for the protection of its essential security interest...taken in time of war or other emergency in international relations.”¹²⁰ In turn, foreign countries would likely argue that the national security exception does not apply in this context, as there is no sufficiently “essential security interest” or national “emergency” at stake.¹²¹ Taking aluminum as an example, such countries might argue that U.S. national security requirements for aluminum (i.e., the amounts of aluminum required by national defense and homeland security) are entirely supplied by U.S. domestic production, and therefore, imported aluminum simply does not impair U.S. national security.¹²²

They may also argue that international trade in aluminum products strengthens, rather than impairs, the U.S. economy; citing the fact that “the total value of U.S. exports of aluminum semi-finished products”

¹¹⁸ See Tim Meyer, *Trump's threat to withdraw from NAFTA may hit a hurdle: The US Constitution*, The Conversation (Aug. 15, 2017), <http://theconversation.com/trumps-threat-to-withdraw-from-nafta-may-hit-a-hurdle-the-us-constitution-81444>

¹¹⁹ See Noland et al., *supra* note 97, at 10.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² See e.g., *Testimony of the Ministry of Commerce of the People's Republic of China*, U.S. Department of Commerce Section 232 Investigation on the Effect of Imports of Aluminum on U.S. National Security (June 22, 2017) (according to this testimony, the amount of aluminum required by national defense is small, accounting for only 1.7 percent of the U.S. total domestic consumption of aluminum and less than 4 percent of the U.S. total domestic supply of aluminum).

in 2016 alone amounted to \$6.8 billion, “accounting for a \$1.4 billion trade surplus.”¹²³

Moreover, the United States’ attempt to cite the GATT Article XXI national security exception, in this context, will likely face opposition from the WTO itself.¹²⁴ Allowing this exception would both promote “tit-for-tat protectionism” under the subterfuge of “national security” and undercut the entire WTO dispute settlement process.¹²⁵ That being said, the Trump administration emphasized that the U.S. would make its decision concerning the Section 232 aluminum probe case based on the administration’s internal determination; without considering any potential violation of WTO rules.¹²⁶

2. SECTION 122 BALANCE-OF-PAYMENTS MEASURES

Section 122 of the Trade Act of 1974 authorizes the President to combat “large and serious United States balance-of-payments deficits” by imposing temporary import surcharges, quotas, or both.¹²⁷ Such import surcharges cannot exceed fifteen percent, in proportion to the estimated value of the goods concerned.¹²⁸ The surcharge and quota restrictions are limited to last 150 days, absent a congressionally approved extension.¹²⁹ Pursuant to Section 122, the temporary quota restriction can only be exercised if “international trade or monetary agreements to which the United States is a party permit the imposition of quotas as a balance-of-payments measure,” and only to the extent that “the fundamental imbalance cannot be dealt with effectively” by

¹²³ *Id.*

¹²⁴ *See* CLINTON, ET AL., *supra* note 6, at 11.

¹²⁵ *Id.*

¹²⁶ *See* Palmer and Nussbaum, *supra* note 104, (quoting Secretary Ross, “[w]e are going to act based on our view as to what are the proper rules and our view as to who's violating those rules — and the WTO will do what they do.”).

¹²⁷ Trade Act of 1974, 19 U.S.C. Ch. 12 § 12, § 2101, *et seq.*

¹²⁸ *Id.*

¹²⁹ *Id.*

the temporary fifteen percent surcharge, in proportion to the estimated value of the goods concerned.¹³⁰

Section 122 allows the President to impose such temporary restrictions on a non-discriminatory basis or “if the President determines that the purposes of this section will best be served.”¹³¹ Otherwise, the statute permits the President to specifically target countries which the U.S. has a large trade deficit with.¹³² Given President Trump’s overwhelming concern and seemingly exclusive focus on bilateral merchandise trade deficits, if he were to utilize Section 122, President Trump would likely opt for the latter option and target China, Germany, Mexico, and Japan specifically because these countries run the largest bilateral surpluses with the U.S. and are, therefore, his largest concerns.¹³³ While President Trump could take action pursuant to Section 122, absent a finding of a threat to national security, the duration and size of the restrictions would be severely limited by the statutory constraints.

Additionally, as is this case with the less-commonly used statutory measures discussed herein, Section 122 actions would likely spur legal challenges in both the U.S. courts and in a WTO tribunal. Reading the face of the statute and relying on its plain meaning, potential plaintiffs could argue that it would be impossible for the U.S. to have a “large and serious balance-of-payments” deficit given the country’s floating exchange rate regime since current account deficits are offset by capital account surpluses.¹³⁴ In turn, the U.S. would likely cite the historical origins of Section 122 and claim that the term “balance-of-payments deficits” should equate to the modern concept of current account deficits.¹³⁵ Additionally, the U.S. would likely argue that the plaintiffs’ aforementioned line of reasoning would perpetually bar use of Section 122, which is not what Congress intended.

Section 122 actions would also likely encounter challenges from the WTO. Any use of Section 122, to specifically target countries

¹³⁰ *Id.* at § 201(a)(3)(C).

¹³¹ *Id.*

¹³² *Id.* at § 201(d).

¹³³ *See* Dadush, *supra* note 39, at 2.

¹³⁴ *See* Noland et al., *supra* note 97, at 11; *see also*, CLINTON ET AL., *supra* note 6, at 11.

¹³⁵ *See* Noland et al., *supra* note 97, at 11.

which the U.S. has a large trade deficit with, would almost certainly violate GATT Article I's "most-favored nation" provisions.¹³⁶ As a result, targeted countries would likely file GATT Article XXIII "nullification and impairment" complaints. However, the WTO's dispute settlement process would take longer than the 150-day restriction.¹³⁷ As a potential defense to a WTO challenge, the Trump administration may cite GATT Article XII, which, under certain circumstances, permits contracting parties to restrict imports in order to safeguard their balance-of-payments.¹³⁸ However, the U.S. can only properly utilize this defense if the IMF finds that it is experiencing sufficient balance-of-payment difficulties, but countries are rarely found to experience these difficulties.¹³⁹

3. SECTION 338 MEASURES

The "long-forgotten but still intact"¹⁴⁰ Section 338 of the Tariff Act of 1930 provides the President with broad tariff-setting authority by permitting him or her to impose "new or additional duties" of up to fifty percent, in proportion to the estimated value of the goods concerned, on imports from countries that have "discriminated" against U.S. commerce.¹⁴¹ Section 338 authority is triggered when foreign imports are found to (1) impose an "unreasonable charge, exaction, regulation, or limitation" on U.S. goods which is "not equally enforced upon the like articles of every foreign country"; or (2) "[d]iscriminate in fact" against U.S. commerce by placing such commerce "at a disadvantage compared with the commerce of any

¹³⁶ GATT art.1, Oct. 30, 1947, 61 Stat. (5) and (6), 55 U.N.T.S. 196.

¹³⁷ See Noland et al., *supra* note 97, at 11; see also, CLINTON ET AL., *supra* note 6, at 11.

¹³⁸ GATT art.7, *supra* note 85, at 12.

¹³⁹ GATT art. 15, *supra* note 85, at 24-25; see also, Chapter 3 *Quantitative Restrictions*, MINISTRY FOR ECON., TRADE AND INDUS., <http://www.meti.go.jp/english/report/downloadfiles/gCT0003e.pdf>.

¹⁴⁰ See John Veroneau and Catherine Gibson, *The President's Long-Forgotten Power To Raise Tariffs*, LAW 360 (Dec. 14, 2016, 1:53 PM EST), https://www.cov.com/-/media/files/corporate/publications/2016/12/law360_the_presidents_long_for_gotten_power_to_raise_tariffs.pdf.

¹⁴¹ The Tariff Act of 1930, 19 U.S.C. § 1338(b) (1930).

foreign country.”¹⁴² Section 338 also allows the President to completely block certain imports from countries that continue to “discriminate” in the face of the tariffs; up to fifty percent, in proportion to the estimated value of the goods concerned.¹⁴³ Section 338 investigations may be instigated as deemed necessary or via private party petitions to the ITC.¹⁴⁴

Despite the theoretically immense tariff authority that Section 338 provides the President, its lack of use, coupled with substantial pragmatic and legal constraints, render it unlikely to be used as a tool for trade. Section 338 has never been used to impose duties on foreign imports. In fact, no public record relating to Section 338 was uncovered since a telegram from then-Secretary of State Dean Acheson mentioned it in 1949.¹⁴⁵ As a result, there are currently no regulations regarding Section 338 presidential proclamations.¹⁴⁶ The statutory provision appears functionally “defunct,” as it is “overshadowed by more recent enactments,” particularly Section 301 of the Trade Act of 1974.¹⁴⁷ Even if President Trump utilized Section 338, despite the fact that it is functionally defunct and forgotten, such use would likely be met with immense pushback in American courts. Injured parties would likely, among other things, make non-delegation doctrinal arguments such as those discussed in the Section 232 context above.¹⁴⁸ The injured parties may also argue that the Uruguay Rounds Agreements Act, which formally adopts the GATT, supersedes Section 1338 and, therefore, renders it void.¹⁴⁹

Additionally, WTO member states’ MFN obligations complicate Section 1338’s requirements.¹⁵⁰ As mentioned above, Section 1338 requires a finding of intercountry trade-related discrimination that

¹⁴² 19 U.S.C. § 1338(a) (1930); *see also*, Veroneau and Gibson, *supra* note 140, at 1; *see also*, CLINTON ET AL., *supra* note 6, at 9.

¹⁴³ 19 U.S.C. § 1338(b) (1930).

¹⁴⁴ *See* Veroneau and Gibson, *supra* note 140, at 1.

¹⁴⁵ *Id.* at 2.

¹⁴⁶ *See* CLINTON ET AL., *supra* note 6, at 9.

¹⁴⁷ *Id.*

¹⁴⁸ *See* CLINTON ET AL., *supra* note 6, at 9.

¹⁴⁹ *See* Uruguay Rounds Agreement Act, Apr. 15, 1994, 33 I.L.M 1143.

¹⁵⁰ *See* CLINTON ET AL., *supra* note 6, at 9.

results in an impact disparately effecting the U.S.¹⁵¹ GATT Article I obliges countries to treat each other on an MFN basis.¹⁵² Therefore, trade-related discrimination is difficult to prove whenever the target country is a WTO member.¹⁵³ In fact, the principal idea and goal behind the GATT is twofold; countries both promote non-discrimination and facilitate comparative advantage by preventing purchasing decisions based on a good's national origin.¹⁵⁴ Thus, it seems that GATT currently serves the primary purpose of this antiquated statutory provision—to thwart discriminatory foreign trade practices (and Section 301 of the Trade Act of 1974, discussed in the sub-section below).

Another limitation of the statute stems from the fact that Section 1338 authorizes the ITC, and not the President or any other agency, to determine whether the requisite “discrimination” occurred.¹⁵⁵ Therefore, any unilateral actions by the President would arguably only be permissible only after such a determination by the ITC (which is an independent and bipartisan agency). Section 1338 is, in a way, similarly limited to the Sections 1337 and 2132 measures, as discussed earlier, which are also subject to ITC involvement.¹⁵⁶ Finally, any Section 1338 actions will be met by immediate WTO challenges. Targeted countries could claim, among other things, that the U.S. violated GATT Article II by failing to bind itself to its tariff concessions.¹⁵⁷ This Article II argument is available to targeted countries anytime the U.S. unilaterally raises tariffs.¹⁵⁸ Absent some permissible exception, a WTO panel will likely hold adversely to the U.S.

¹⁵¹ See 19 U.S.C. § 1338(a)(2).

¹⁵² GATT art. 1, *supra* note 85.

¹⁵³ See Clinton et al., *supra* note 6, at 9.

¹⁵⁴ See generally GATT art. 1, *supra* note 85 (explaining that the treaty seeks mutually advantageous agreements, which reduce barriers to trade).

¹⁵⁵ 19 U.S.C. § 1338(g); see also CLINTON ET AL., *supra* note 6, at 10.

¹⁵⁶ 19 U.S.C. § 1338 (2016).

¹⁵⁷ See GATT, art. 2, *supra* note 85.

¹⁵⁸ *Id.*

4. SECTION 301 MEASURES

Section 301 of the Trade Act of 1974 authorizes the United States Trade Representative (hereinafter USTR), at the direction of the President, to respond to unfair trade practices by taking a wide variety of retaliatory actions, including increasing tariffs or other import restrictions.¹⁵⁹ Despite Section 301's location among less-commonly cited statutes, the Trump administration referenced the statute in the 2017 National Trade Policy Agenda.¹⁶⁰ Section 301(2411) prescribes both mandatory and discretionary USTR action.¹⁶¹ Section 301(a) involves "mandatory action" which the USTR must take when a state violates a U.S. trade agreement.¹⁶² Conversely, Section 301(b) involves "discretionary action" which the USTR may take if it is determined that a foreign country's trade actions are "unreasonable or discriminatory" and "burden or restrict" U.S. commerce.¹⁶³

The statute defines "unreasonable" and "discriminatory" broadly.¹⁶⁴ State actions can be considered "unreasonable" even if they are not "in violation of, or inconsistent with, the international legal rights of the United States," but are "otherwise unfair and inequitable."¹⁶⁵ State actions are considered "discriminatory" if they "...den[y] national or most-favored-nation treatment to United States goods, services, or investment."¹⁶⁶ If the USTR finds such "unreasonable or discriminatory" conduct, Section 301(b) authorizes the USTR, subject to the direction of the President, to "take all appropriate and feasible action . . . to obtain the elimination of" such conduct.¹⁶⁷ Thus, Section 301 gives the President, through the USTR, broad authority to retaliate against unfair foreign trade practices (e.g., market access restrictions or other U.S. export obstacles) by imposing

¹⁵⁹ 19 U.S.C. § 301 (2016); 19 U.S.C. §§2411-2420 (2016).

¹⁶⁰ See The President's 2017 Trade Policy Agenda, *supra* note 4, at 3-4.

¹⁶¹ 19 U.S.C. § 301 (2016).

¹⁶² 19 U.S.C. § 2411(a) (2016).

¹⁶³ 19 U.S.C. § 2411(b) (2016).

¹⁶⁴ See 19 U.S.C. § 2411 (2016).

¹⁶⁵ 19 U.S.C. § 2411(d)(3)(A) (2016).

¹⁶⁶ 19 U.S.C. § 2411(d)(5) (2016).

¹⁶⁷ 19 U.S.C. § 2411(b) (2016).

a wide range of retaliatory actions, including tariff increases or quotas.¹⁶⁸

The retaliatory actions, that Section 301(c) authorizes, include the ability to: withdraw or suspend the benefits of certain trade agreement concessions; impose duties or other import restrictions for as long as the USTR determines appropriate; withdraw, limit, or suspend preferential duty treatment; and enter into binding agreements that obligate offending foreign countries to eliminate or phase out their unfair foreign trade practices.¹⁶⁹ These authorized actions may be taken on either a nondiscriminatory basis or solely against targeted foreign countries based on their unfair practices.¹⁷⁰ Section 301 investigations may be instigated by the USTR in response to private party petitions or, “after consulting with the appropriate private sector advisory committees,” the USTR can initiate investigations by its own volition.¹⁷¹ As a result, Section 301 has historically served as an effective way for private parties, who have no right of action under the WTO’s Dispute Settlement Understanding, to petition the U.S. government to take action. These petitions have resulted in WTO hearings instead of *per se* retaliation.¹⁷²

While Section 301 potentially provides the USTR and the President with broad authority to respond to unfair trade practices, its historical usage and success rate suggest that the tool may be less powerful than it seems.¹⁷³ Historically, the U.S. has been more successful using multilateral means to get trade concessions than using Section 301 as a retaliatory tool.¹⁷⁴ Based on a study comparing a total of 189 trade actions between 1975 and 2000, the U.S. was thirty-four

¹⁶⁸ 19 U.S.C. §§ 2411-2420; *see also* CLINTON ET AL., *supra* note 6, at 12.

¹⁶⁹ 19 U.S.C. § 2411(c).

¹⁷⁰ *See* 19 U.S.C. § 2411(c)(3)(A).

¹⁷¹ *See* CLINTON ET AL., *supra* note 6, at 12.

¹⁷² *See* lecture notes, *supra* note 53 (noting that the establishment of the WTO, Section 301 has not produced any unilateral sanctions).

¹⁷³ *See* 19 U.S.C. § 2411(a).

¹⁷⁴ *See* Krzysztof J. Pelc, “Will Trump’s unilateral trade approach work? History says no” WASHINGTON POST (Mar. 7, 2017), https://www.washingtonpost.com/news/monkey-cage/wp/2017/03/07/will-trumps-unilateral-trade-approach-work-history-says-no/?utm_term=.34e5881b7ca0.

percent less likely to secure targeted country concessions when it utilized the unilateral Section 301 route over multilateral channels.¹⁷⁵ This is primarily because targeted countries, particularly Japan, viewed resisting unilateralism as beneficial in the long-run.¹⁷⁶ Japan, and other countries, feared that conceding to such retaliation would incentivize the U.S., and perhaps other well-established, developed nations, to impose similar threats and unilateral coercion in the future.¹⁷⁷ On the other hand, when countries concede to legitimate multilateral challenges, it merely shows that the countries are “good global citizens” who may hope to achieve similarly beneficial concessions through the same legitimate multilateral means in the future.¹⁷⁸ Thus, Section 301, despite providing a facially potent threat of retaliation, may prove to be less effective than it seems.

Additionally, Section 301’s practical and legal constraints make its utilization less likely and effective, even if it were utilized. The U.S. agreed, in the Statement of Administrative Action accompanying the Uruguay Agreements Act, not to unilaterally invoke Section 301 prior to an affirmative WTO determination.¹⁷⁹ Therefore, the U.S. is precluded from imposing Section 301 actions without first filing a complaint with the WTO and receiving a favorable, merit-based determination from the WTO’s panel or Appellate Body; a time-consuming process. However, such a restriction only covers Section 301 actions taken in connection with claims covered by existing WTO agreements, and as a result the USTR could initiate Section 301 against “unreasonable or discriminatory” practices that are not covered by WTO agreements.¹⁸⁰ That being said, this “exception” is rather weak

¹⁷⁵ See Krzysztof J. Pelc, *Constraining Coercion? Legitimacy and Its Role in U.S. Trade Policy, 1975 – 2000*, 64 INT’L ORG. (Jan. 1, 2010), <https://www.cambridge.org/core/journals/international-organization/article/constraining-coercion-legitimacy-and-its-role-in-us-trade-policy-19752000/28776DB90B9BD03EA6728E723157CF6E>.

¹⁷⁶ See generally, *id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ H.R. 5110, 103rd Cong. (1994); see also CLINTON ET AL., *supra* note 6, at 13; Noland et al., *supra* note 97, at 11.

¹⁸⁰ H.R. 5110, 103rd Cong. (1994); see also CLINTON ET AL., *supra* note 6, at 13.

in practice as the USTR has been disinclined to challenge any such practices that are not covered by WTO agreements.¹⁸¹

If President Trump and USTR Lighthizer were to unilaterally impose Section 301 actions, either by alleging that the targeted discriminatory practice was outside WTO agreements or by ignoring the WTO entirely, such actions would be subject to immediate legal challenge.¹⁸² For example, as discussed above vis- à-vis some of the aforementioned statutory provisions, targeted countries would bring GATT Article XXIII nullification and impairment claims to the WTO.¹⁸³ In a 1999 case, the EU filed a WTO complaint against the U.S. for its use of Section 301. The WTO determined that the U.S. had violated its WTO commitments by failing to pursue WTO actions instead of engaging in Section 301 unilateralism.¹⁸⁴ This case serves as important precedent and foreshadows the fact that the Trump administration will likely lose any WTO challenges to its unilateral use of Section 301, especially if the targeted action is covered by WTO agreements (which it almost certainly would be, given the breadth of contracting parties' WTO commitments).¹⁸⁵

Aside from these legal hurdles and procedural limitations, a salient practical constraint on Section 301 is the risk of retaliatory action by targeted countries in lieu of legal challenges, and the deleterious economic consequences that would ensue. Section 301 actions may indeed spur a tit-for-tat retaliatory trade war as seen in the 1930s,¹⁸⁶ as targeted countries decide to unilaterally retaliate back against the U.S. using the same arguments the Trump administration had offered toward WTO applicability.¹⁸⁷ This could potentially stimulate a dangerous self-perpetuating cycle that could plausibly

¹⁸¹ See CLINTON ET AL., *supra* note 6, at 13.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ See DS 152, *United States — Sections 301–310 of the Trade Act 1974*, WTO (1999), https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds152_e.htm; see also, CLINTON ET AL., *supra* note 6, at 13.

¹⁸⁵ *Id.*

¹⁸⁶ See e.g., Enda Curran, *Trump Rhetoric Raises Specter of 1930s-Style Trade War*, BLOOMBERG (January 6, 2017), <https://www.bloomberg.com/news/articles/2017-01-06/trump-rhetoric-raises-specter-of-1930s-style-trade-war-with-asia>.

¹⁸⁷ See CLINTON ET AL., *supra* note 6, at 13.

cripple the global economy.¹⁸⁸ While the Trump administration purportedly remains indifferent to adverse WTO rulings, it is certainly sensitive to retaliation, especially targeted at politically important goods such as Florida oranges.¹⁸⁹

5. TWEA AND IEEPA MEASURES¹⁹⁰

The Trading with the Enemy Act of 1917 (TWEA), enacted as the U.S. was entering World War I, delegates expansive authority to the President, allowing him to freeze and seize foreign assets, and “regulate” all forms of international commerce during times of war.¹⁹¹ A significant limit on President Trump’s use of the TWEA is the “during the time of war” requirement.¹⁹² While President Roosevelt was able to successfully invoke Section 5(b) of the TWEA during the heart of the Great Depression to declare a national emergency and order a bank holiday,¹⁹³ the scope of the statute has since been more limited by Congress. In 1976, Congress amended the TWEA to limit its application more directly to times of war.¹⁹⁴ Another significant constraint is that the TWEA does not specifically authorize the President to increase tariffs. Instead, it vaguely permits him to “regulate” foreign commerce.¹⁹⁵ Thus, invoking the TWEA to increase tariffs would generate a plethora of legal challenges.¹⁹⁶ These challenges would likely hinge in part on what “regulate” entails in this context and in part on an interpretation of whether Congress intended the TWEA to be used only during times of congressionally declared

¹⁸⁸ See e.g., Curran, *supra* note 186.

¹⁸⁹ *Id.*

¹⁹⁰ For a compressive review of both measures, see Chapter 5: *Authorities Relating to Political or Economic Security*; Committee on Ways and Means (2010 Edition), 251-266, available at: <https://www.gpo.gov/fdsys/pkg/CPRT-111WPRT63130/pdf/CPRT-111WPRT63130.pdf>.

¹⁹¹ Trading with the Enemy Act of 1917 §§ 5(a)-(b), as amend. (1976); see also, Noland et al., *supra* note 97, at 11-13; see also, CLINTON ET AL., *supra* note 6, at 14.

¹⁹² Chapter 5, *supra* note 190, at 251.

¹⁹³ See Noland et al., *supra* note 97, at 12.

¹⁹⁴ See CLINTON ET AL., *supra* note 6, at 14.

¹⁹⁵ Trading with the Enemy Act of 1917 § 5(b), as amend. (1976).

¹⁹⁶ See CLINTON ET AL., *supra* note 6, at 14.

war (as opposed to unauthorized military action, e.g., the ongoing 'war' on terrorism).¹⁹⁷

The International Emergency Economic Powers Act of 1977 (IEEPA), which further limits the applicability of the TWEA, similarly authorizes the President to freeze and seize foreign assets and "regulate" international commerce.¹⁹⁸ However, unlike the TWEA, the IEEPA empowers the President to "regulate" accordingly in order to respond to "unusual or extraordinary [international] threat[s]" originating outside the U.S. and does not have a "during the time of war" requirement.¹⁹⁹ Importantly, President Trump may only invoke his IEEPA authority if a national emergency has been declared under the National Emergencies Act.²⁰⁰ Therefore, in the IEEPA context, President Trump could *not* declare an actionable national emergency *sua sponte*, which imposes a significant constraint on its usage. Additionally, while the IEEPA does not require consent from Congress, the act mandates that the President consult with Congress and provide periodic reports explaining and justifying his actions.²⁰¹ As a result, if President Trump invokes his IEEPA powers to engage in actions adverse to politically important constituents, Congress will likely attempt to pass limiting legislation, which would require two-thirds of both houses to survive Trump's veto.

Nevertheless, President Trump's IEEPA powers remain extensive. Historically, the IEEPA has been invoked by Presidents to impose other export controls such as sanctions and embargoes.²⁰² Since its inception, it has been utilized by past Presidents as a powerful tool at least sixteen times.²⁰³ For example, during the Iranian Hostage Crisis, President Carter called upon his IEEPA powers in Executive Order 12170 to freeze about \$8 billion of Iranian government assets

¹⁹⁷ *Id.*

¹⁹⁸ The International Emergency Economic Powers Act of 1977; *see also*, Noland et al., *supra* note 97, at 11-13; *see also*, CLINTON ET AL., *supra* note 6, at 14.

¹⁹⁹ *Id.*

²⁰⁰ *See* Chapter 5, *supra* note 190, at 251.

²⁰¹ *Id.* at 252.

²⁰² *Id.* at 252-63.

²⁰³ *Id.*

held in the U.S.²⁰⁴ The IEEPA was also used in 1985 by President Reagan to block all exports and imports to and from Nicaragua in response to its “aggressive activities in Central America.”²⁰⁵ In 1997, President Clinton used his IEEPA authority to block Sudan government property and prohibit certain transactions due in part to Sudan’s support for international terrorism.²⁰⁶ Importantly, the President’s IEEPA authority was further enhanced in 2001 by Section 106 of the USA Patriot Act, which permits the blocking of assets during the “pendency of an investigation.”²⁰⁷ That being said, IEEPA has never been used specifically to combat trade deficits.²⁰⁸

Given its scope, applicability, and historical usage, President Trump could likely use the IEEPA provisions to prohibit trade with foreign nations actively involved in terrorism.²⁰⁹ In fact, Presidents Clinton, Bush, and Obama all used the IEEPA for that very purpose.²¹⁰ However, President Trump’s usage of the IEEPA to target and stunt imports from China or Mexico on economic grounds, for example, would require a very liberal interpretation of the statute.²¹¹ Additionally, use of either the TWEA or IEEPA will probably be met by legal challenges filed at the WTO by targeted countries.²¹² Because these statutory provisions involve national security concerns, the U.S. would likely cite the GATT Article XXI national security exception in response to any nullification and impairment WTO challenges à la Section 232.²¹³ However, depending on the circumstances of the national emergency, the WTO may be reluctant to recognize such an exception in this context due to the same institutional concerns discussed vis-à-vis Section 232 above.²¹⁴ Furthermore, as is this case with utilization of any of the aforementioned unilateral trade action

²⁰⁴ *Id.* at 254.

²⁰⁵ *Id.* at 255-56.

²⁰⁶ *Id.* at 261.

²⁰⁷ *Id.* at 251-52.

²⁰⁸ *Id.*

²⁰⁹ *See id.*

²¹⁰ *See id.* at 241, 254.

²¹¹ *See* CLINTON ET AL., *supra* note 6, at 14.

²¹² *See id.* at 14.

²¹³ *See id.*

²¹⁴ *See* Trade Expansion Act of 1962, Pub. L. No. 87-794, 76 Stat. 232; *see also* CLINTON ET AL., *supra* note 6, at 14.

vehicles, the risk of retaliation and subsequent consequences serves as a significant practical constraint on such measures.²¹⁵

6. RELATIVE LIKELIHOOD OF THE LESS-COMMONLY USED TRADE LAWS

Given the legal and practical constraints and framework analysis discussed above, the aforementioned less commonly used statutory provisions have the following relative likelihood of use by the Trump administration: Section 232 ≥ Section 301 > IEEPA > Section 122 > TWEA > Section 338.²¹⁶ As previously discussed, the Trump administration has already initiated two Section 232 probes, one on steel and one on aluminum.²¹⁷ Additionally, after explicitly referencing Section 301 in the President's March 2017 Trade Policy Agenda, which refers to Section 301 as "a powerful lever to encourage foreign countries to adopt more market-friendly policies,"²¹⁸ the Trump administration officially instigated a Section 301 investigation of China in August 2017.²¹⁹ President Trump or his administration have not yet meaningfully mentioned the other less common measures and laws.

C. OTHER THREATENED TRADE-RELATED ACTION

In addition to threatening other countries with duties and other import restrictions, Trump has repeatedly claimed, including in his *Contract with the American Voter*, that he would "direct the Treasury Secretary to label China a currency manipulator" and that President Trump would impose appropriate countervailing duties to combat such

²¹⁵ See CLINTON, ET. AL, *supra* note 6, at 14.

²¹⁶ With Section 232 being the most likely and Section 338 the least likely.

²¹⁷ See Trade Expansion Act of 1962, Pub. L. No. 87-794, 76 Stat. 232.

²¹⁸ THE PRESIDENT'S 2017 TRADE POLICY AGENDA, *supra* note 4, at 4.

²¹⁹ See Robert Lighthizer, *USTR Announces Initiation of Section 301 Investigation of China* (Aug. 2017), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/august/ustr-announces-initiation-section>.

practice.²²⁰ Since his time as President, Trump has completely reversed himself on this position.²²¹ Nevertheless, the U.S. Treasury's currency manipulation criteria and reporting processes are discussed below. These criteria and report determination mechanisms remain relevant issues due to President Trump's high propensity to flip-flop on important issues.²²²

1. LABELING CHINA A CURRENCY MANIPULATOR

Two different U.S. laws, Section 3004 of the Omnibus Trade and Competitiveness Act of 1988,²²³ and Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015,²²⁴ direct Secretary of the Treasury Steven Mnuchin to periodically analyze the macroeconomic and exchange rate policies of major U.S. trading partners. Section 3004 mandates annual reporting, and Section 701 mandates biannual reporting.²²⁵ The goal of the reports is to determine whether countries are deliberating to manipulate their currencies "for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."²²⁶

Section 701 provides Secretary Mnuchin with three criterion for identifying currency manipulation by considering whether countries have: (1) a bilateral merchandise trade surplus with the U.S. exceeding \$20 billion; (2) a net current account "surplus in excess of 3% of

²²⁰ Donald J. Trump, "Contract with the American Voter," available at: https://assets.donaldjtrump.com/CONTRACT_FOR_THE_VOTER.pdf; see, e.g., Corasaniti, et. al., *supra* note 1; see also, CLINTON ET AL., *supra* note 6, at 15 ("Mr. Trump's campaign stated that "on day one of the Trump administration the US Treasury Department will designate China as a currency manipulator", and that "this will begin a process that imposes appropriate countervailing duties" on Chinese products.").

²²¹ See, e.g., Matthew Nussbaum, *Trump shifting positions at breakneck pace*, POLITICO, Apr. 12, 2017, <http://www.politico.com/story/2017/04/donald-trump-shifts-positions-nato-health-care-china-237175>.

²²² See, e.g., *id.*

²²³ 22 U.S.C. § 5305 (2016).

²²⁴ 19 U.S.C. § 4421 (Supp. 2017).

²²⁵ 22 U.S.C. § 5305(a); 19 U.S.C. § 4421(a)(1) (2016).

²²⁶ 22 U.S.C. § 5304(b) (2016).

GDP”); and (3) systematically intervened to depress their currencies.²²⁷ While China, running by far the greatest merchandise trade surplus with the U.S. of approximately \$356 billion in 2015, certainly satisfies the first criterion, it *fails* to satisfy the other two criterion.²²⁸ China’s net current account surplus is approximately in excess of only 2.4% of its GDP, thus failing to meet the Treasury’s 3% benchmark.²²⁹ Additionally, regarding the third criterion, China is not systemically intervening to depress its currency at the moment.²³⁰ In fact, China recently has been selling U.S. treasury bonds at a record pace in an effort to prop up the yuan’s value.²³¹ Currently, just two countries, Taiwan and Switzerland, are actively intervening to depress their currencies; however, they both fail to meet the \$20 billion bilateral goods deficit benchmark.²³²

Even if China were to satisfy the three criteria or Secretary Mnuchin otherwise labeled the country a currency manipulator, neither Section 3004 nor Section 701 authorize President Trump to impose countervailing duties, or any other import restrictions, as a response.²³³ Instead, Section 701 merely directs President Trump, through Secretary Mnuchin, to commence “enhanced bilateral engagement[s]” with any offending countries to “urge implementation of policies to address the causes of the undervaluation of its currency.”²³⁴ Under Section 701(c)(1), the President is entitled to engage in limited forms of remedial action if such offending countries fail to adopt appropriate corrective policies within one year of the

²²⁷ Dadush, *supra* note 39, at 2; *see also* 19 U.S.C. § 4421(a)(2)(A)(ii)(I-III) (2016).

²²⁸ *See* Dadush, *supra* note 39, at 2.

²²⁹ *Id.*

²³⁰ *See generally, id.* (introducing China’s satisfaction of the elements of currency manipulation).

²³¹ *See, e.g.,* Evelyn Cheng, *China is working hard to support its currency — it sold US government bonds for six straight months*, CNBC (Jan. 2017), <https://www.cnbc.com/2017/01/19/china-is-working-hard-to-support-its-currency--it-sold-us-government-bonds-for-six-straight-months.html>.

²³² *See* Dadush, *supra* note 39, at 2.

²³³ *See* 22 U.S.C. § 5304(b) (2016); *see also* 19 U.S.C. § 4421(c)(1)(A)-(D) (2016); *see also* CLINTON ET AL., *supra* note 6, at 14.

²³⁴ 19 U.S.C. § 4421(b)(1) (2016).

commencement of the bilateral engagements.²³⁵ However, none of these remedial actions permit President Trump to increase tariffs or impose any other non-tariff barriers to trade.²³⁶ As a result, even if the Trump Administration were to label China a currency manipulator, it would not be able to increase duties or otherwise restrict Chinese imports as a response.²³⁷ To do so, President Trump would have to invoke one of the aforementioned U.S. laws permitting unilateral trade action.²³⁸

2. PRESIDENT'S LEGAL AUTHORITY TO TERMINATE NAFTA

President Trump has repeatedly publicly censured NAFTA calling it the “worst trade deal in the history of the world” and threatening to “tear it up.”²³⁹ Notwithstanding his purported dislike for the free trade agreement, President Trump has since announced that he will *not* be terminating the agreement but instead renegotiating it.²⁴⁰ The Trump Administration formally began this renegotiation process on May 18, 2017, when it sent a letter to Congress stating its intentions to do so.²⁴¹ Despite this formal indication of intent to renegotiate, the discussion here focuses on whether President Trump has the authority to unilaterally withdraw from or terminate NAFTA.²⁴²

²³⁵ 19 U.S.C. § 4421(c)(1) (2016).

²³⁶ For a list of permissible remedial actions under this section, *see* 19 U.S.C. §§ 4421(c)(1)(A)-(D) (2016).

²³⁷ *See id.*

²³⁸ *See* Trade Act of 1974 § 201.

²³⁹ For a list of all the negative statements Trump has said about NAFTA, *see generally* Meera Jagannathan, “*Here are all the terrible things President Trump has said about NAFTA — before deciding to stick with it,*” NY DAILY NEWS (Apr. 27, 2017), <http://www.nydailynews.com/news/politics/terrible-president-trump-nafta-article-1.3107104>.

²⁴⁰ *See, e.g., id.*

²⁴¹ *See* USTR Lighthizer’s letter of intent to Congress, <https://ustr.gov/sites/default/files/files/Press/Releases/NAFTA%20Notification.pdf>.

²⁴² For a compressive discussion of the NAFTA termination process, *see* Jon R. Johnson, *The Art of Breaking the Deal: What President Trump Can and Can’t Do About NAFTA*, C. D. Howe Institute (Jan. 2017),

a. Terminating NAFTA

Although it no longer seems as relevant, President Trump's ability to unilaterally terminate NAFTA is briefly reviewed first. NAFTA Article 2205 provides that a Party (i.e. the U.S., Canada, or Mexico) may withdraw from the agreement six months after providing sufficient notice.²⁴³ However, merely giving such notice does not give effect to such a withdrawal. Instead, such a withdrawal can be effectuated only if Congress concurs, since "the President and Congress have joint authority over trade agreements."²⁴⁴

U.S. trade agreements such as NAFTA are: (1) negotiated by the USTR, (2) signed and approved by the President through his foreign affairs power, and importantly (3) approved and implemented by Congress through congressionally enacted legislation.²⁴⁵ Congress's involvement is constitutionally imperative, since trade agreements like NAFTA directly affect U.S. commerce, the regulation of which is expressly delegated to Congress in Article I's Commerce Clause.²⁴⁶ Thus, withdrawal from NAFTA can only have effect if Congress contemporaneously repeals its implementing legislation, which is codified in the North American Free Trade Agreement Implementation Act.²⁴⁷ Therefore, President Trump could *not* unilaterally withdraw from NAFTA.

Some legal experts have argued that President Trump has the authority to unilaterally withdraw from NAFTA pursuant to the "termination and withdrawal authority" described in Section 125 of the Trade Act of 1974.²⁴⁸ However, this argument is misguided and

https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/Commentary_464.pdf.

²⁴³ See North American Free Trade Agreement art. 2205, Dec. 6, 1983.

²⁴⁴ Johnson, *supra* note 242, at 1.

²⁴⁵ See *id.* at 4.

²⁴⁶ See *id.*

²⁴⁷ See *id.*

²⁴⁸ See, e.g., Warren H. Maruyama & Robert D. Kyle, *President Trump Will Have Broad Presidential Authority to Terminate Trade Agreements and Impose Punitive Duties on U.S. Trading Partners*, HOGAN LOVELLS (Nov. 2016), <https://www.hoganlovells.com/en/publications/the-next-president-will-have-broad-authority-to-terminate-free-trade-agreements-and-impose-punitive-duties-on-foreign-countries>.

incorrect. Section 125(a) states that every trade agreement entered into by the U.S. must contain a provision allowing the U.S. to withdraw after giving appropriate notice.²⁴⁹ However, this sub-section is silent regarding the President's authority to unilaterally withdraw from trade agreements.²⁵⁰ Section 125(b) reads "[t]he President may at any time terminate, in whole or in part, any *proclamation* made under this chapter" (*emphasis added*).²⁵¹ Thus, pursuant to Section 125(b), President Trump may have the authority to unilaterally withdraw from certain NAFTA-related proclamations, but not from NAFTA as a whole.

Importantly, a number of NAFTA provisions were implemented through presidential proclamation rather than explicit enumeration in the North American Free Trade Agreement Implementation Act (Implementation Act).²⁵² For example, Section 201(a)(1)(A) of the Implementation Act enables the President to proclaim "modifications or continuation of any dut[ies]"²⁵³ and Section 202(q) permits the President to proclaim certain matters respecting rules of origin.²⁵⁴ Pursuant to, *inter alia*, the various sections of the Implementation Act authorizing NAFTA-related presidential proclamations, "President Clinton gave effect to various NAFTA provisions by issuing Proclamation 6641 on December 15, 1993," including a number of duty-related provisions.²⁵⁵

President Trump, invoking Section 125(b) of The Trade Act of 1974, *may* be able to unilaterally terminate Proclamation 6641 in part or in whole.²⁵⁶ However, it is unlikely that the President has such authority, particularly regarding a termination in whole. Proclamation 6641 was invoked in part pursuant to the Implementation Act, which

²⁴⁹ See 19 U.S.C. § 2135(a) (2016).

²⁵⁰ See *id.*

²⁵¹ *Id.* § 2135(b).

²⁵² See, e.g., Johnson, *supra* note 242, at 5-6.

²⁵³ 19 U.S.C. § 3331(a)(1)(A) (2016).

²⁵⁴ 19 U.S.C. § 3332(q) (2016); see also Johnson, *supra* note 242, at 5.

²⁵⁵ Johnson, *supra* note 242, at 6; see also Proclamation No. 6641, 58

Fed. Reg. 66867, 2596 (Dec. 15, 1993).

²⁵⁶ See 19 U.S.C. § 2135(b) (2016).

specially provides for NAFTA-related tariff treatment.²⁵⁷ Notably, Section 125(b) only allows the President to unilaterally terminate “any proclamation made under *this* chapter”; thus, Section 125(b) only allows the President to terminate proclamations made pursuant to Title 19, Chapter 12 of the U.S. Code.²⁵⁸ Therefore, Section 125(b) does not apply to the Implementation Act, which is found in 19 U.S.C. 21.²⁵⁹ As a result, Section 125(b) cannot be used to terminate any parts of Proclamation 6641 made pursuant to the Implementation Act, an Act found in 19 U.S.C., Chapter 21 and *not* Chapter 12.

Furthermore, Proclamation 6641 was made pursuant to a number of different U.S. Acts in addition to the Implementation Act, including Sections 201 and 203 of the Automotive Products Trade Act of 1965 (19 U.S.C. 8) and Sections 1102(a) and 1204 of the Omnibus Trade and Competitiveness Act of 1988 (19 U.S.C. 18).²⁶⁰ As discussed above, Section 125(b) does not apply to either of these Acts because they are enumerated outside 19 U.S.C. 12.²⁶¹ Therefore, Section 125(b) cannot be used to terminate the parts of Proclamation 6641 that were made pursuant to Acts found in 19 U.S.C. Chapters 21, 18, and 8, and *not* in Chapter 12.

Conceivably, President Trump could invoke Section 125(b) to terminate the parts of Proclamation 6641 that were made pursuant to Sections 504 and 604 of The Trade Act of 1974, which are found in 19 U.S.C. 2464(c) and 2483.²⁶² However, this would be highly impractical as it would frustrate the administration of NAFTA, anger Canada and Mexico, and “provoke a major confrontation with Congress.”²⁶³ Additionally, such in part termination of Proclamation

²⁵⁷ See Proclamation No. 6641, 58 Fed. Reg. 66867, 2596, 2596-98 (Dec. 15, 1993); see also Johnson, *supra* note 242, at 6.

²⁵⁸ 19 U.S.C. § 2135(b) (2016) (emphasis added).

²⁵⁹ See, e.g., Johnson, *supra* note 242, at 6.

²⁶⁰ See Proclamation No. 6641, 58 Fed. Reg. 66867, 2596, 2598 (Dec. 15, 1993); see also Johnson, *supra* note 242, at 6.

²⁶¹ See 19 U.S.C. § 2135(b) (2016).

²⁶² See Proclamation No. 6641, 58 Fed. Reg. 66867, 2596, 2598 (Dec. 15, 1993); see also 19 U.S.C. § 2464(c) (2016); see also 19 U.S.C. § 2483 (2016).

²⁶³ Johnson, *supra* note 242, at 6.

6641 would ultimately have an insignificant effect on NAFTA as a whole, especially regarding NAFTA-related tariff treatment.

3. CRITIQUE OF TRUMP'S TRADE POLICY APPROACH AND FLAWED TRADE-ECONOMICS LOGIC

President Trump's trade rhetoric, which has been largely aimed at instigating a resurgence of protectionist policies, is motivated primarily by his exclusive focus on the bilateral merchandise account trade deficits that the U.S. runs with other countries.²⁶⁴ This exclusive focus makes little sense in an integrated globalized economy, putting the rationality of President Trump's trade policy approach into question. Additionally, President Trump's trade-economics logic is simply flawed, as he fails to take into account (1) the negative consequences that increased trade barriers can have on American companies that operate as part of international production chains and (2) the portion of foreign country exports consisting of American made component parts.²⁶⁵

President Trump erroneously sees bilateral merchandise account deficits as the result of unfair foreign trade practices and not the result of systemic economic forces.²⁶⁶ According to Trump, these deficits are the primary cause of U.S. manufacturing job loss and economic disadvantage.²⁶⁷ As such, Trump also believes that reversing these trade deficits will re-open abandoned or transformed U.S. manufacturing facilities and create a substantial volume of jobs.²⁶⁸ In reality, trade deficits merely reflect a low savings rate relative to consumption and investment rates, and are a function of these rates more than of trade policy.²⁶⁹ Additionally, reversing trade deficits will likely have little to no effect on manufacturing-sector employment rates due to automation.²⁷⁰ Furthermore, despite what President

²⁶⁴ See Dadush, *supra* note 39, at 5.

²⁶⁵ See *id.* at 5-7.

²⁶⁶ See *id.* at 2.

²⁶⁷ E.g., Don Lee, *Why Trump's Obsession with Trade Deficits is Misguided*, L.A. TIMES, May 2, 2017, <http://www.latimes.com/business/la-fi-trade-deficit-trump-obsession-20170502-htlm1story.html>.

²⁶⁸ *Id.*

²⁶⁹ *Id.*

²⁷⁰ *Id.*

Trump has suggested, international trade is not a “zero-sum affair,” and “expanded trade has historically tended to support economic growth.”²⁷¹

The Trump administration should be focused more on the size and sustainability of global (i.e., not bilateral) current account balances, which depend more on domestic spending than on trade policies.²⁷² Nevertheless, the administration remains fixed on bilateral merchandise account deficits.²⁷³ As a result, it appears President Trump is primarily concerned with the trade practices of four countries in particular—China, Germany, Japan, and Mexico—because of the large goods account surpluses they run with the U.S. (see Figure 1 below).²⁷⁴ However, as previously discussed, bilateral goods deficits are only one of the important factors used by the Department of the Treasury to identify unfair foreign trade practices. Neither China nor Mexico have global current account surpluses in excess of 3 percent of their GDPs. Additionally, none of these four countries is actively intervening to decrease the value of its currency.²⁷⁵

Based on his trade-related discourse, it appears President Trump’s chief concern is to bring jobs, especially manufacturing jobs, back to the U.S. However, the U.S. economy is near full employment as the current unemployment rate has dropped to 4.4 percent, a 10-year low.²⁷⁶ Furthermore, President Trump’s proposed tax cuts and increases to infrastructure spending will increase domestic spending and demand for goods further exacerbating the current account deficit issue.²⁷⁷ Regardless, the U.S.’s global current account deficit is only at 2.5% of GDP and is no longer as big of a concern as it once was (in

²⁷¹ E.g., Peter S. Goodman, *Behind Trump’s Trade Deficit Obsession: Deficient Analysis*, N. Y. TIMES, Apr. 5, 2017, https://www.nytimes.com/2017/04/05/business/trump-xi-trade-deficit-china.html?_r=0.

²⁷² See Dadush, *supra* note 39, at 2.

²⁷³ See *id.*

²⁷⁴ See *id.*; see also, Lee, *supra* note 267 (explaining that trade deficits should not be the only benchmark for economic health).

²⁷⁵ See Dadush, *supra* note 39, at 2.

²⁷⁶ BUREAU OF LABOR STATISTICS, LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY (2017) <https://data.bls.gov/timeseries/LNS14000000>.

²⁷⁷ See Dadush, *supra* note 39, at 3.

2006, e.g., the U.S.'s current account deficit was at almost 6% of its GDP).²⁷⁸ In the short-term, such a deficit is likely sustainable due “in part to shale oil and gas.”²⁷⁹ In the long-run, President Trump’s plan to bring jobs back to America also “makes little sense.”²⁸⁰ Many economists believe that advances in information and communication technology and automation—and *not* trade practices abroad—are the main “source of job dislocation.”²⁸¹ In fact, some have argued that as much as 88% of U.S. manufacturing job losses between 2000 and 2010 were the result of advances in technology.²⁸² These technological advances allow manufacturing companies to produce more output with less people (see Figure 2).²⁸³ Thus, Trump’s goal to bring jobs back to America by targeting and deterring other countries’ “unfair” trade practices through unilateral trade action is based on irrational assumptions and will likely prove futile.

Additionally, President Trump fails to properly consider the negative consequences that will affect U.S. companies as a result of his decision to increase trade barriers via unilateral action. What Trump fails to see (or chooses to ignore) is that increasing tariffs or other non-tariff barriers to trade on foreign imports functionally represents a tax on U.S. exports and production, as about 50% “of U.S. imports consist of raw materials, parts, and components.”²⁸⁴ This is a particularly salient issue for companies like Boeing, whose supply chains are extremely globally integrated (see Figure 3 below).²⁸⁵ Moreover, a significant portion of foreign countries’ exports is often made up of raw materials, parts, and components originating in the

²⁷⁸ *Id.*; *Current Account Balance (% of GDP)*, The World Bank: Data, <https://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS?end=2016&locations=US&start=1970&view=chart>, (last visited Nov. 27, 2017).

²⁷⁹ See Dadush, *supra* note 39, at 3.

²⁸⁰ *Id.*

²⁸¹ *E.g., id.*; see also, Lee, *supra* note 267.

²⁸² See e.g., Michael J. Hicks and Srikant Devaraj, *The Myth and Reality of Manufacturing in America*, BALL S.U. (2017), <http://conexus.cberdata.org/files/MfgReality.pdf>.

²⁸³ Ben Casselman, *Manufacturing Jobs Are Never Coming Back*, FIVE THIRTY-EIGHT (Mar. 18, 2016), <https://fivethirtyeight.com/features/manufacturing-jobs-are-never-coming-back/>.

²⁸⁴ Dadush, *supra* note 39, at 2-3.

²⁸⁵ *Id.*

United States.²⁸⁶ For example, it is estimated that about 40% of the value of goods imported from Mexico is made in the U.S. (i.e., that 40 percent of imports from Mexico consist of parts and components produced by American companies in the U.S.).²⁸⁷ Similarly, various studies have shown that China's bilateral merchandise account surplus with the U.S. is overstated by as much as 50% due to the significant portion of China's exports that consist of assembled products produced from component parts originally made in the U.S. and imported by China.²⁸⁸ As a result of these economic realities, it is clear that President Trump's trade-economics logic is simply flawed.

²⁸⁶ *See id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

Figure 1

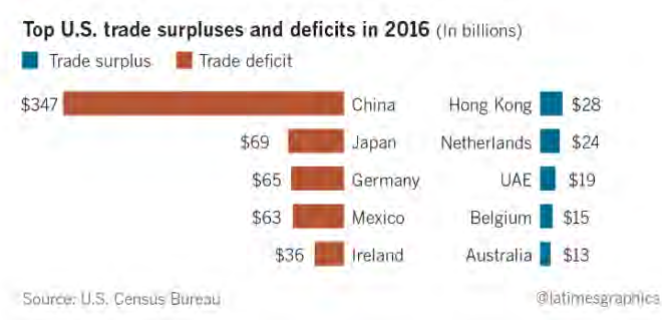


Figure 2

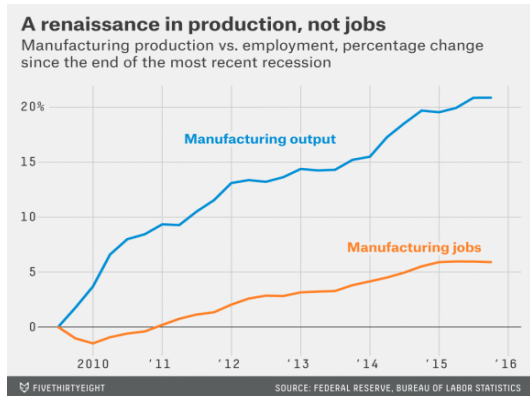
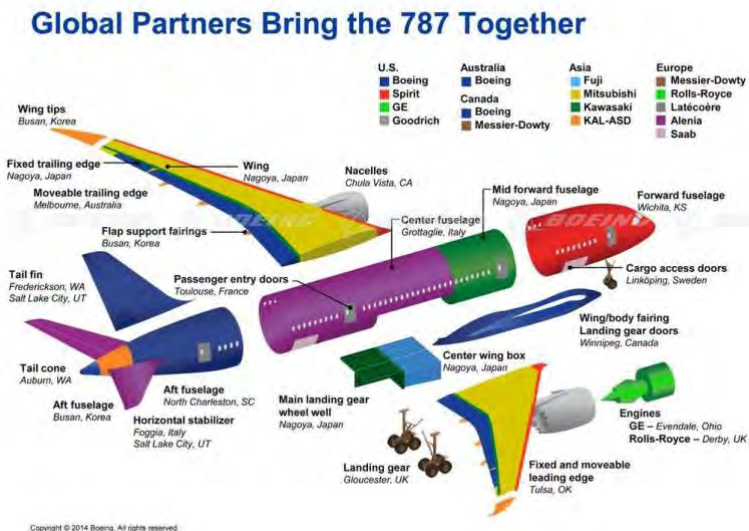


Figure 3



REFORMS OF CORPORATE GOVERNANCE:
COMPETING MODELS AND EMERGING TRENDS IN THE
UNITED KINGDOM AND THE EUROPEAN UNION

*Akio Otsuka**

I. INTRODUCTION

Large public corporations are hierarchical organizations. The Board of Directors is generally at the apex of the hierarchy. Most formal legal authority within the corporation is vested in the Board, although the Board delegates much of its authority to executive officers, who in turn delegate much to middle-level managers, and so on down.

The predominant academic view of corporate law today rests on the principal-agent paradigm. Most corporate law scholarship has continued to analyze corporate law in terms of agency relationships, as based upon the classic Berle-Means-type separation of ownership and control under a dispersed ownership structure. Corporate law places a great deal of authority in the Board. However, the reality is that the CEO wields primacy. The CEO dominated corporate governance system aided in igniting the current economic crisis, wherein many CEOs encouraged corporate practices aimed at short-term share price maximization and ignored long-term risks.

Corporate law has mechanisms to hold boards accountable for gross misuse of their authority. However, those mechanisms are quite limited due to the shareholders' collective action. Corporate law must balance authority against accountability, but most of the time, in the United States, corporate law strikes that balance in favor of authority. Many corporate law scholars have argued for corporate law reforms that give more strength to legal accountability mechanisms, such as shareholder voting, shareholder bylaws, or derivative suits. One of the essential normative questions in

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corporate law is how the market should balance authority against accountability.

Berle and Means are still correct. The status quo in a modern public corporation is not traditional shareholder primacy, team production, or director primacy. Rather, it is CEO domination. If boards, prior to the financial crisis, had successfully monitored serious events, such as the recent financial crisis, by relying on independent information, they might have been able to challenge their CEOs and executive officers to increase the long-term well-being and value of their corporations. The interests of not only shareholders but also other corporate constituencies and that of the public would be far better served with shareholder primacy. Corporate governance reform must focus primarily on promoting the long-term well-being of the corporation, balancing constituencies' interests, and ensuring accountability. There are various approaches to achieving such goals.

This paper considers the implications of the enlightened shareholder value model and other reforms made in the United Kingdom (U.K.) and the European Union (E.U.), and proposes corporate law reforms that give more strength to accountability mechanisms. Part II describes and analyzes two views of the corporation: the agency model and the team production model. It explains why the team production model offers a false account of current reality, and then moves to the director primacy model. Part III discusses the functions of a public corporation. Independent monitoring boards currently cannot discover any serious problems with the business decisions of executive officers because independent directors inevitably rely heavily on corporate officers for information used in monitoring tasks. This also holds true for the director primacy model and the team production model. Part IV proposes a corporate governance reform that is embodied in the enlightened shareholders value model, which was a part of the 2006 U.K. Companies Act and other reforms made in the United Kingdom and the E.U.; this suggests that the Board should promote the long-term well-being of the corporation, balancing constituencies' interests and ensuring accountability.

II. BACKGROUND: TWO VIEWS OF THE CORPORATION

The current discussion related to policy issues on corporate law is based on the economic theory of the firm. Depending upon how

we analyze such theories, there are two primary perspectives: the agency model and the team production model. Whereas the former emphasizes the principal-agent relationship between shareholders and managers, the latter brings other non-shareholder constituencies into consideration. These models are analyzed in a descriptive and normative light.

A. AGENCY THEORY

The agency view dominates most corporate law scholarship today. In 1932, Adolf Berle and Gardiner Means were the first to empirically identify the strong separation of ownership between shareholders and managers' control in large U.S. corporations.¹ They argued that most public corporations are not operated in the interests of their owners, the shareholders, but in the interests of their agents, the managers.² Around the 1970s, legal scholars developed the theory of the firm, based on the economic theories of Ronald Coase and other forerunners, which focused primarily on efficiency and the firm's role as a device for minimizing transaction costs within production processes.³ According to the "nexus of contracts model," which is now the dominant corporate law theory, a firm is made up of various explicit and implicit contracts among a firm's constituencies. In other words, the firm is a complex "aggregate of various inputs acting together to produce goods or services."⁴ While Michael Jensen and William Meckling emphasized the nature of the firm as a nexus of contracts⁵—a center of coordination of productive factors consisting of explicit and implicit contracts—,⁶ the nature of

¹ See Adolf A. Berle & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

² See *id.* at 124.

³ *Coase's Theory of the Firm*, *THE ECONOMIST*, July 27, 2017, <https://www.economist.com/news/economics-brief/21725542-if-markets-are-so-good-directing-resources-why-do-companies-exist-first-our>.

⁴ Stephen M. Bainbridge, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 28 (2008).

⁵ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976).

⁶ *E.g.*, Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 12 (1991). See generally Armen A. Alchain & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972).

the firm as a legal entity is not explained under the terms of the theory. The nexus at the center of Jensen and Meckling's firm is a mere legal fiction; it is "not an individual" and has no real independent existence.⁷ Jensen and Meckling then focused on agency costs, which the upper-level managers created (who are charged with doing as the principal's request).⁸ The agency costs represent conflicts of interest between shareholders, which consist of monitoring costs, bonding costs, and residual losses that contractual mechanisms cannot entirely eliminate.⁹ The nexus of contracts theory has been influential in shaping corporate law theory over the past three decades.¹⁰

This theory is not truly a theory of the firm at all because it "says nothing about why firms exist or what kind of activity is undertaken by a certain firm."¹¹ Rather, it is only a theory of agency costs within certain types of firms, including corporations.¹² If a corporation is really no more than a nexus of contracts under the theory, there should be no need for corporations or corporate law. If the notion of corporations is not necessary, there is no need for the law to create and support them. Thus, the nexus of contracts theory has been argued outside of the theory of the firm and as a descriptive model for corporate law scholars.

However, the nexus of contracts theory argues that corporate law represents several default contracts that permit the involved parties to opt out of these relations through agreement.¹³ Consequently, its proponents assert that corporate law should be mostly non-mandatory to provide private parties with the opportunity to spontaneously order

⁷ Jensen & Meckling, *supra* note 5, at 311; Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 485 (2001) ("[T]he firm is not a thing, but rather a nexus or web of explicit and implicit contracts.").

⁸ See Jensen & Meckling, *supra* note 5, at 311.

⁹ *Id.* at 310-11.

¹⁰ See, e.g., Easterbrook & Fischel, *supra* note 6, at 1-39 (discussing the corporate contract); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318-27 (1993) (discussing the importance and impact of the nexus-of-contracts theory).

¹¹ Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727, 731-32 (2004).

¹² See Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1763-65 (1989).

¹³ Ulen, *supra* note 10, at 322.

their affairs as they deem appropriate.¹⁴ Thus, the proponents of the nexus of contracts theory have emphasized the non-mandatory nature of corporate law, and they have counseled against changes to the status quo based on the contractual nature of that status quo.¹⁵

Leading contractarians also adopt the traditional “shareholder primacy” argument that shareholders, as the firm’s residual claimants, are assumed to act as the ultimate principals in agency contracts that hire the firm’s productive resources, thereby establishing the nexus that makes up the firm.¹⁶ Directors and officers are treated under such contracts as contractual agents of the shareholders, with fiduciary obligations to maximize shareholder wealth.¹⁷ Thus, according to the nexus of contracts theory, shareholders retain a privileged position among the various contracting parties that constitute the firm, while the interests of non-shareholder constituencies remain subordinated.¹⁸ However, it is generally acknowledged that shareholder wealth maximization is itself only a norm of corporate behavior, rather than a legal rule.¹⁹ Indeed, neither case law nor corporate statutes impose on directors and officers an obligation to maximize shareholder wealth.²⁰ Even in Delaware, whose corporate code is less amenable to stakeholder interests than many other state corporate statutes, management’s decision-making is not required to maximize shareholder wealth, nor are shareholders’ interests the only ones that justify management’s decisions.²¹ Moreover, the Delaware courts have held that directors and officers have a fiduciary duty to act in the best interests of the corporation,

¹⁴ *Id.* at 324.

¹⁵ *Id.* at 322–23 (discussing the overall impact of the theory).

¹⁶ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 N.W.UNIV. L. REV. 547, 547-48 (2003).

¹⁷ *Id.* at 548.

¹⁸ *Id.*

¹⁹ Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 650 (2006) (“Commentators widely recognize that shareholder primacy functions more as a norm than an enforceable legal rule.”).

²⁰ See *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986); *Contra, Paramount Commc’n., Inc. v. Time, Inc.*, 571 A.2d 1140, 1145, 1155 (Del. 1990).

²¹ See Fisch, *supra* note 19, at 652 (observing that Delaware’s corporate statute is silent both with respect to the standard by which board decisions are evaluated and with respect to the stakeholders, whose interests may legitimately be taken into account).

and not only in the interests of the shareholders.²² The courts also state that fiduciary duties are owed to “the corporation and its stockholders.”²³ Consequently, courts will not second-guess directors’ business judgment that is based on concerns about employees, communities, and other non-shareholder constituencies without finding a clear breach of fiduciary duty.

The nexus of contracts theory has attracted considerable critique, wherein it is premised on the assumption of the “Coasean World” of an ideal market comprised of perfectly rational economic decision-makers.²⁴ Moreover, as stated above, a necessity for corporations or corporate law is uncertain under the theory, because the theory is only a theory of agency costs and a corporation is no more than a nexus of contracts. Certainly, the fundamental corporate governance structures and mechanisms that Berle-Means-type corporations in the United States adopted are conceived as static and uniform. However, the corporate governance structures in public corporations vary, and thereby, there is no ideal stock market as well.

B. TEAM PRODUCTION THEORY

Generally, under state corporate statutes, shareholders alone enjoy voting rights, information rights, and the right to bring derivative suits. In a series of articles, Margaret Blair and Lynn Stout have developed a team production theory of corporate law wherein they argue that the Board’s role is not to solely act for the shareholders’ interests; rather, its role is to act as a mediating hierarch, balancing the interests of the various corporate constituencies.²⁵

²² See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000)).

²³ *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996); see also, *Loft, Inc. v. Guth*, 2 A.2d 225, 238 (Del. Ch. 1938) (*aff’d sub nom. Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)).

²⁴ See Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 796 (2006).

²⁵ See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276–87 (1999).

1. DESCRIPTION OF THE THEORY

Like the nexus of contracts theory, the team production model views the firm as a series of relationships between various constituencies.²⁶ While arguing that the Board of Directors serves as the ultimate authority in assigning responsibilities, mediating disputes, and distributing profits, Blair and Stout do not claim that the goal of the corporation should be shareholder wealth maximization.²⁷ Instead, the corporation is made up of all constituencies who are responsible for the business of the enterprise, and the directors have a responsibility to all of these constituencies in the corporate enterprise.²⁸ Blair and Stout argue that “the way in which corporate law actually works in practice is consistent with the notion that directors are independent hierarchs whose fiduciary...[duties] run [chiefly] to the corporate entity itself and only instrumentally to all of its” constituencies.²⁹ Thus, directors are not mere agents because “they are not subject to direct control or supervision by anyone,” including the shareholders, while also a unique form of fiduciary who most closely resemble trustees.³⁰

Crucially, control over the firm’s assets is not actually given to shareholders but to the legal entity of the firm itself.³¹ Team members submit to the hierarchy and the ownership on their own, as this is beneficial for them.³² Blair and Stout argue that shareholders are not the only residual risk bearers within a corporation.³³ Additionally, other corporate constituencies who are also the residual risk-bearers frequently make firm-specific investments—for example, employees specialize their human capital.³⁴ Such investments are obviously essential for the creation of value in the firm. Therefore, it

²⁶ *Id.* at 254 (asserting the team production approach is “consistent with the ‘nexus of contracts’ approach”).

²⁷ *Id.* at 251.

²⁸ *See id.* at 253.

²⁹ *Id.* at 289.

³⁰ *Id.* at 290-91.

³¹ *Id.* at 274 n.57.

³² *Id.* at 274.

³³ Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L.Q. 403, 418 (2001).

³⁴ *See id.* at 418. (“Creditors, managers, employees—even suppliers, customers, and communities—also make firm-specific investments that tie their economic fortunes to the firm’s fate”).

seems appropriate and necessary for team members who make firm-specific investments to delegate exclusive authority to the Board of Directors as a mediating hierarch to organize the firm's inputs, distribute its outputs, and resolve interest conflicts among the team members.³⁵ In a more descriptive manner, each team member charges the Board of Directors with (1) mediating among the conflicting interests of all the constituencies and (2) protecting all constituencies' return on their respective investments from post-investment opportunistic behavior by other constituencies.³⁶ The Board of Directors is not a team member and must be independent of any of the team members,³⁷ which implies that the Board has no expectation of sharing in the value that the team created. Given the firm-specific investments the team members made, the Board serves similarly to a trustee³⁸ ("trusted mediator"³⁹) or fiduciary⁴⁰ for the entire firm, but it remains insulated from any direct team member control. As "mediating hierarchs" standing among all constituencies, including shareholders, directors are to assume the task of balancing conflicting interests and, if necessary, rearranging production factors.⁴¹ Thus, Blair and Stout interpret the Board's duty to serve the interests of the corporation not as shareholder interest, but as the aggregate welfare function.⁴²

2. PRECURSOR OF THE THEORY

Blair and Stout's team production model is deeply dependent upon the works of Alchian and Demsetz, and Rajan and Zingales for a new school of corporate law and economics based on the theory of the firm.⁴³ Blair and Stout discuss the principal-agent and property rights approaches and draw comprehensively on the work of Alchian

³⁵ *Id.* at 421.

³⁶ *See id.* (Because the team members cede control over "team specific inputs and surplus that results from team production," to the Board of Directors, the team members charge and entrust the Board of Directors with these duties).

³⁷ *Id.* ("It is essential that the hierarch remains free from the command and control of any of the team members").

³⁸ Blair & Stout, *supra* note 25, at 291.

³⁹ Blair & Stout, *supra* note 33, at 408.

⁴⁰ Blair & Stout, *supra* note 25, at 291.

⁴¹ Blair & Stout, *supra* note 33, at 421.

⁴² Blair & Stout, *supra* note 25, at 288-89.

⁴³ *See id.* at 265-69

and Demsetz in conceptualizing the firm as a method for coordinating production.⁴⁴ Then, they move on to consider the work of Holmstrom,⁴⁵ Tirole,⁴⁶ and Rajan and Zingales⁴⁷ in developing their own team production model.

“With team production it is difficult, solely by observing total output, either to define or determine each member’s contribution to this output of the cooperating inputs.”⁴⁸ In accordance with Alchian and Demsetz, for team production to be successful, several contributors must put forth investments of resources, in certain circumstances, in which the team’s created value is observable.⁴⁹ However, it is difficult to define the contribution of each to this value.⁵⁰ A difficulty arises in designing payment schemes as to how to counteract the incentives of the team members to shirk since the rewarding is not made on the basis of actual individual contributions.⁵¹ Alchian and Demsetz argue that monitoring and sanctioning generally counteract shirking incentives within team production.⁵² Individuals have an incentive to free ride on the contributions of others, which is disadvantageous for the whole team.⁵³ The monitor would be entitled to retain all of the team’s produced value, after compensating the other team members for their contributions with fixed rewards, which input markets determine.⁵⁴ The residual claimant provides the monitor with appropriate incentives to assemble a productive team and pay close attention to the other team members’ contributions.⁵⁵ Alchian and Demsetz maintain that one of the essential characteristics of firms is that they solve the problem of shirking through the introduction of a centralized contractual agent, that is, an owner-manager or a manager

⁴⁴ *Id.* at 265-66.

⁴⁵ Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982).

⁴⁶ Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations*, 2 J. L. ECON. & ORG. 181 (1986).

⁴⁷ Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q. J. ECON. 387 (1998).

⁴⁸ Alchian & Demsetz, *supra* note 6, at 779.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 779-81.

⁵² *Id.* at 781-83.

⁵³ *Id.* at 779-81.

⁵⁴ *Id.* at 781-83.

⁵⁵ *Id.* at 779-81.

who is equipped with the capability of monitoring and the right to sanction the behavior of all team members.⁵⁶

One difficulty with Alchian and Demsetz's model is that shareholders in a large public corporation do not, in fact, play such an active role as the monitor and residual claimant that the model predicts. Another problem with the model is that it does not consider the problems associated with firm-specific investments.⁵⁷ As Blair and Stout argue, the public corporation is not a "nexus of contracts," but a "nexus of firm-specific investments," wherein "several different groups contribute unique and essential resources to the" firm, and each group finds "it difficult to protect its contribution through explicit contracts."⁵⁸ Further, the firm-specific investments, once made, become well sunk in the firm.⁵⁹ These investments reduce the team members' mobility⁶⁰ and therefore expose the contributors "to opportunistic exploitation by other team members."⁶¹

Assuming that the firm is made up of firm-specific investments, Rajan and Zingales developed a theory of the firm based on the property rights approach in terms of power and access to resources.⁶² They further discuss the risks of underinvestment associated with firm-specific investments: any party not in control of firm-specific investments has an incentive to under invest thereby avoiding a controlling party, while firm-specific investments may make it less lucrative to sell the property rights to a third party.⁶³

3. CRITIQUE

Blair and Stout developed their team production model to serve both positive and normative purposes.⁶⁴ They contend that the team

⁵⁶ *Id.*

⁵⁷ Blair & Stout, *supra* note 25, at 275; *see also, e.g.*, Rajan & Zingales, *supra* note 47; Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J. L. & ECON. 453 (1993).

⁵⁸ Blair & Stout, *supra* note 25, at 275.

⁵⁹ *Id.* at 276. *See infra* text accompanying notes 64-69.

⁶⁰ *Id.* at 277-79 (observing participants having made firm-specific investments as "'stuck' in the firm").

⁶¹ *Id.* at 276.

⁶² Rajan & Zingales, *supra* note 47.

⁶³ *Id.* at 406-11 (relaxing the assumption that the value of an asset for other uses increases at least somewhat with specific investments).

⁶⁴ Blair & Stout, *supra* note 25, at 288-289.

production model better reflects the law's approach to the corporation as directors left alone to manage the corporate affairs.⁶⁵ According to Blair and Stout, however, the team production model requires the Board of Directors to serve all constituencies, rather than the shareholders alone.⁶⁶ They also argue that the model is a better positivist approach—in that a board balances interests among various constituencies in practice—as well as a better normative approach.⁶⁷ In fact, U.S. corporate law gives directors remarkable discretion to sacrifice shareholders' interests in favor of management, employees, and other non-shareholder constituencies.⁶⁸ Further, statutes in over half the states expressly allow boards to weigh non-shareholder interests for takeover threats.⁶⁹ Directors have broad discretion to adopt takeover defenses, which allows them to promote other constituencies' interests over short-term shareholder wealth maximization.⁷⁰ The team production model offers incentives for all team members and describes the fundamental contracting problem that corporate law attempts to resolve.⁷¹ However, the team production theory attracted considerable criticism directed at its descriptive and normative claims.⁷²

In terms of the descriptive claim, criticism of the team production theory indicates that boards of directors are not in fact independent; in reality, management often dominates them even in

⁶⁵ *Id.* at 287-319.

⁶⁶ *Id.* at 288.

⁶⁷ *Id.* at 290-92.

⁶⁸ *Id.* at 327-28 n.208.

⁶⁹ *See id.* at 303-04 n.144 (stating that twenty-eight states allow directors to consider non-shareholder interests); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 n.1, 587 n.33 (1992) (listing the statutes).

⁷⁰ *See* Fisch, *supra* note 19, at 651.

⁷¹ Blair & Stout, *supra* note 25, at 327-28.

⁷² *See, e.g.*, John C. Coates, IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002); David Millon, *New Game Plan or Business as Usual - A critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000). Blair & Stout's theory has also attracted proponents: *see, e.g.*, Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667 (2002).

corporations with a majority of non-management directors.⁷³ Moreover, critics claim that Blair and Stout overlook the impact of the stock market.⁷⁴ Boards cannot ignore the impact due to fluctuation in the stock prices.⁷⁵ The theory depends upon the Board's independence and neutrality with respect to potentially conflicting interests between shareholders and non-shareholder constituencies.⁷⁶ Blair and Stout assert that corporate law reflects their argument that it vests the directors with the exclusive power to manage the corporation and insulates them from shareholder interference or any other team member.⁷⁷ The greater concern is whether boards actually function as the team production model says they should; in reality, a strong preference for short-term share price maximization binds directors because this is what most institutional shareholders want.⁷⁸ Thus, the problem with the team production model is that boards are not in fact independent at all and do not have board discretion, and directors do not and cannot behave the way the theory says they should.⁷⁹

Under U.S. corporate law, however, shareholders alone enjoy voting rights, information rights, and the right to bring derivative suits.⁸⁰ Blair and Stout argue that, although shareholders alone have the right to elect directors, this does not impair the Board's independence because the very large number of shareholders means that voting in most public corporations is a "meaningless rite."⁸¹ The argument is not persuasive in terms of a normative claim, although the reality is such as they argue. Furthermore, it is doubtful that the team production model provides the Board with any incentive to

⁷³ Coates, *supra* note 72 at 845-47.

⁷⁴ *Id.* at 849.

⁷⁵ See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (arguing that boards and managers have an incentive to maximize the stock price, independently of any legal duty to do so, because a depressed stock price makes the corporation a potential takeover target and thereby jeopardizes the incumbent directors' and managers' positions).

⁷⁶ See generally Blair & Stout, *supra* note 33, at 416-18 (detailing the relationship between shareholders and non-shareholders).

⁷⁷ *Id.* at 423-24.

⁷⁸ *Id.* at 428-30.

⁷⁹ David Millon, *Team Production Theory: A Critical Appreciation*, 62 UCLA L. REV. DISC. 79, 80-81 (2014).

⁸⁰ Blair & Stout, *supra* note 33, at 409 n.10.

⁸¹ *Id.* at 434.

perform its duties conscientiously.⁸² Therefore, from the normative aspect, Blair and Stout's argument is controversial.

C. TENTATIVE CONCLUSION—DIRECTOR PRIMACY

From the normative and positive aspects, the nexus of contracts model is slightly ahead of the team production model. However, in terms of the discretionary powers of the Board of Directors, the director primacy model is somewhat further ahead. Proponents of the director primacy model claim that boards must be mostly free of shareholder interference to serve shareholder interests.⁸³

Stephen Bainbridge draws upon the theory of the firm (in contrast to the team production theory but in accordance with the nexus of contracts theory), arguing that shareholders alone, as opposed to other stakeholders, are the appropriate beneficiaries of director fiduciary duties.⁸⁴ According to the director primacy model, directors are ultimately responsible for shareholder wealth maximization, rather than promoting stakeholder interests,⁸⁵ and the interests of shareholders should prevail over those of any other constituencies.⁸⁶ Additionally, directors (rather than managers, shareholders, and stakeholders) are completely responsible for control over the corporation.⁸⁷ Bainbridge recognizes that directors are in the role of "Platonic guardians," that is, a form of trustee similar to the philosopher kings in Plato's *Republic*.⁸⁸ Under the director primacy theory, the focus is not on a firm's nature as a nexus of contracts; rather, Bainbridge argues that the firm has a nexus of its contracts which is a board of directors well-equipped with the ultimate "power of fiat."⁸⁹ He argues that the powers of the Board of Directors are original and undelegated, and that neither shareholders

⁸² Meese, *supra* note 72, at 1665-66.

⁸³ See Kostant, *supra* note 72, at 693-94.

⁸⁴ Bainbridge, *supra* note 7, at 550.

⁸⁵ *Id.* at 572.

⁸⁶ *Id.* at 577-85.

⁸⁷ *Id.* at 550.

⁸⁸ *Id.* at 550-51, 560; see also Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 8 & n.28 (2002) (referring to the Board again as a "sui generis body").

⁸⁹ *E.g.*, Bainbridge, *supra* note 16, at 554-60.

nor courts should weaken the Board's decision-making authority.⁹⁰ The Board negotiates with and hires the various factors of production or "capital."⁹¹ Thus, the Board of Directors, not shareholders, is—and should be—in control of the corporation, exercising almost unconstrained authority to ensure corporate decision-making efficiency.

Bainbridge argues that there is a core tension between the Board's authority and the responsible exercise of such authority; shareholder voting rights are one of the mechanisms that hold directors accountable.⁹² An increase in shareholders' right to review board decisions might weaken the core of corporate governance and shifting the power of decision-making to shareholders is undesirable in itself in accordance with director primacy.⁹³ As a positive matter, Bainbridge contends that the director-centered model of the firm matches both modern corporate practice and the structure of most state laws (particularly Delaware, the dominant model).⁹⁴ As noted above, however, director primacy might also face difficulties because of CEO domination and performance of some functions required under corporate governance. Part III addresses such functions and the reality in which the shift of authority to the independent board has weakened boards. Thus, CEOs find themselves in an extremely powerful position.

III. MONITORING AND MANAGEMENT FUNCTIONS

This part first addresses the functions that corporate law asserts a board of directors should perform and then argues that a board of directors, in a large public corporation, is ineffective for performing such functions. Boards of public corporations primarily have two areas: monitoring the activities of the corporate executives and managing the corporation's business affairs.⁹⁵ The Board's

⁹⁰ Bainbridge, *supra* note 4, at 11-12 (stating shareholder wealth maximization is the law in the United States).

⁹¹ Bainbridge, *supra* note 16, at 560.

⁹² *Id.* at 555-60.

⁹³ *Id.* at 557-59.

⁹⁴ *Id.* at 568-74; *see also* Bainbridge, *supra* note 4, at 105-53 (providing an extensive discussion of director primacy's role within the law).

⁹⁵ Compare, Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 790-805 (2011) (discussing the dual monitoring and management functions of the modern board), *with* STEPHEN M.

management responsibilities essentially involve making the final decision on major issues, such as issuing dividends, pursuing mergers and acquisitions, and the like.⁹⁶ In contrast, the Board's monitoring responsibilities primarily involve appointing the CEO and evaluating the management team.⁹⁷ A public corporation's Board of Directors has various degrees of autonomy and control in relation to the corporation's CEO.⁹⁸

Modern corporate law includes the notion of a "monitoring" board, which usually requires the Board to have independent directors. "Independent" directors are assumed to have little or no personal or financial relationship with the firm.⁹⁹ Part-time, or independent directors, are arguably never equipped to make corporate policy or manage the corporate business.¹⁰⁰ Will they be ill-equipped in the context of monitoring? Melvin Eisenberg challenged the insider-dominated boards of the day and argued that the modern board should serve as an independent monitor that works to protect shareholder interests.¹⁰¹ Eisenberg asserted that there is one function that the Board can perform better than any other corporate group: "Selecting, monitoring[,], and removing the members of the chief executive's office."¹⁰² Through the notion of the monitoring board, Eisenberg tried to change the reality so that it was not the Board, but the executives who actually managed the

BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 49–50, 61 (2012) (indicating that the literature identifies three functions for the public board: (1) monitoring and disciplining management, (2) providing advice and guidance to managers, and (3) providing a network of useful political and business contacts.).

⁹⁶ Alces, *supra* note 95, at 798.

⁹⁷ See Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 269–71 (1997).

⁹⁸ Bainbridge, *supra* note 16, at 559–60 (from a legal perspective, any control a CEO has is delegated from the Board to the CEO – the Board ultimately retains control.). See also DEL. CODE ANN. tit. 8, § 141(a) (2013).

⁹⁹ Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L. J. 315, 322–23 (2005).

¹⁰⁰ Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 387 (1975).

¹⁰¹ See Melvin Aron Eisenberg, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976).

¹⁰² *Id.* at 170.

corporation.¹⁰³ By the end of the 1970s, the ideal board became a monitoring board rather than a merely nominal body.¹⁰⁴ If a board is free of conflicts of interests—that is, free of ties to the CEO—then it is ideal for the Board to monitor the CEO’s performance. Thus, Eisenberg’s innovative notion of the independent monitoring board now dominates corporate governance.¹⁰⁵

Therefore, the independent board monitors executive officers, including CEOs, to ensure that they run the corporation for the benefit of the shareholders.¹⁰⁶ Indeed, increasing Board independence has been the key to corporate governance reform for the past three decades. In designing a monitoring board for a public corporation, federal and state laws, as well as public listing rules, have required that only “independent” board members be allowed to perform certain functions. After the Enron and WorldCom scandals, the Sarbanes-Oxley Act of 2002 effectively required an independent audit committee.¹⁰⁷ Furthermore, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 stipulated that public corporations must have independent audit and compensation committees.¹⁰⁸ The rules of the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and the National Association of Securities Dealers Automated Quotations (NASDAQ) influenced most large public corporations to have a majority of independent directors on the full board and on several oversight committees.¹⁰⁹ However, these reforms have not improved

¹⁰³ *Id.* at 140.

¹⁰⁴ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1518 (2007).

¹⁰⁵ See also Bainbridge, *supra* note 4, at 53.

¹⁰⁶ Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 17 (2004) (describing the ALI’s Corporate Governance Project).

¹⁰⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7201).

¹⁰⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (codified at 15 U.S.C. § 78j-3).

¹⁰⁹ See Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 282-88 (2006) (describing the NYSE requirements).

board performance, which some commentators have pointed out.¹¹⁰ Thus, in terms of the efficacy of corporate governance, repeated regulatory efforts to increase board independence have unfortunately proved futile or even counterproductive.

First, the independent monitoring board has been criticized for being ineffective at performing even the most basic monitoring function.¹¹¹ Directors inevitably rely heavily on executive officers for the information they use in monitoring tasks.¹¹² Moreover, directors from outside the corporation or the industry only have limited channels to obtain the corporation's or the industry's inside information, and therefore have to depend heavily on executive officers for information about the corporation and the industry. Furthermore, they have limited time, expertise, and attention to devote to conducting the corporation's business affairs. Ironically, the shift to the independent board has weakened boards and, moreover, placed the CEO in an extremely powerful position in a corporation.

Directors are at a disadvantage in monitoring executive officers, because they cannot avoid relying heavily on those officers for the information they use to monitor themselves. This problem with the monitoring structure became apparent particularly during the recent financial crisis.¹¹³ Independent monitoring boards could not discover any serious problems with the business decisions that executive officers were making and, thus, could not prevent the collapse of

¹¹⁰ See, e.g., Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002); Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm* 34–43 (Columbia Law & Econ., Working Paper No. 301, 2006) (showing several studies have found no correlation between corporate performance and board “independence” as defined by regulations). See, e.g., Catherine M. Daily & Dan R. Dalton, *Board of Directors Leadership and Structure: Control and Performance Implications*, 17 ENTREPRENEURSHIP: THEORY AND PRACTICE 65, 75 (1993) (indicating some studies find a positive impact from increased board independence.). See, e.g., April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 300–01 (1998) (other studies find a negative impact from increased board independence.).

¹¹¹ Fisch, *supra* note 97, at 268–70.

¹¹² Alces, *supra* note 95, at 795.

¹¹³ See generally Lisa Fairfax, *Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692 (2011).

financial firms. As Lawrence Mitchell pointed out, the CEO can easily manipulate or suppress the information provided to the Board because the position is typically the sole, or nearly sole, source of information for the Board.¹¹⁴ Thus, most boards are rather passive, because CEOs dominate the Board and employ their power in their own interests.¹¹⁵ If the Board remains passive, there is no one who actively questions and challenges the CEO's or management's decisions. If boards had successfully monitored serious events, such as the recent financial crisis, and relied on their independent information, they might have been able to challenge the CEOs and management on the long-term wisdom of these decisions. It is difficult to provide independent directors with strong incentives to monitor executive officers more carefully.¹¹⁶

In terms of management function, most boards of modern public corporations are now composed of mostly independent directors; however, it has been general practice for the CEO to serve as the chairman of the Board of Directors.¹¹⁷ That means the CEO sets the Board's agenda and calls board meetings. In most instances, the work of inside directors is most important to the Board's management function, because they know more about the day-to-day business of the firm as well as its relationship with the various corporate constituencies. As noted above, the Board must rely heavily on inside directors for information and judgment, and the Board's independence may, paradoxically, obstruct its ability to make independent business decisions. Independent directors are ill-equipped to second-guess the decisions of the CEO and the

¹¹⁴ Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOKLYN. L. REV. 1313, 1350 (2005).

¹¹⁵ Charles M. Elson, *Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127 (1996). See generally Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 898–903, 913–17 (1996) (cataloging the many ways in which CEOs dominate outside directors).

¹¹⁶ Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991).

¹¹⁷ See Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 351 (2000).

management team.¹¹⁸ Further, outside directors may avoid asking complex questions and presenting strategic alternatives.¹¹⁹ Thus, the independent board is not well-equipped to make final decisions and must rely heavily on the information and judgment of others who are more involved in the everyday business of the corporation.

Therefore, it is not assumed to be the outside board members but the executive officers who work most directly and closely with various constituencies and perform the mediation function in the firm. Contrary to the claims of the team production model, boards of most public corporations do not serve as independent mediators of conflicting interests between shareholders and other stakeholders. The Board does not and cannot perform a meaningfully independent role in significant decision-making. Senior officers, through the interaction of corporate constituencies with the firm's managers, largely decide the day-to-day business of the corporation. Even if a corporation moves to the adoption of supermajority independent boards, the CEO, paradoxically, continues to be the significant decision-maker in the modern public corporation. Corporate governance theory generally ignores this reality, at least for public corporations.

The team production model assumes that directors actively and continuously mediate among the various interests of shareholder, labor, management, community, and any other stakeholders. As some commentators point out, mediating among corporate constituencies "requires a solid operational knowledge of the rights each party has" in relation to the corporation and of the corporation's corresponding obligations.¹²⁰ However, the modern part-time board member simply is not expected to take such an active role in management. While in the real world, senior officers know much more about such a role than the Board does and often negotiate the firm's contracts on its behalf, the Board must rely heavily on senior officers for independent monitoring to adjust and mediate the

¹¹⁸ Gilson & Kraakman, *supra* note 116, at 889 (observing that outside directors rarely exercise their judgment today, not only because they lack the time and the incentives to do so but also "because board meetings are dominated by a management ethos of forced collegiality and agreement").

¹¹⁹ *Id.*

¹²⁰ Alces, *supra* note 95, at 801.

different claims of different constituencies.¹²¹ In sum, independent directors are ill-equipped to serve as mediators of diverse and conflicting corporate constituency interests. Thus, the mediator of such constituency interests, if any, is not the Board but the CEO, even if the Board is assumed to mediate between corporate constituencies under the team production theory. Therefore, it may be unconvincing to argue that the Board is in a particularly good position to perform the mediation function. Hence, the team production model might not signify the reality in the firm.¹²² Additionally, in the real world, director primacy might also face the same difficulties for the same reason of CEO domination.¹²³

IV. A PROPOSAL FOR CORPORATE GOVERNANCE REFORMS: ENLIGHTENED SHAREHOLDER VALUE MODEL

One of the key tensions within any system of corporate governance is the necessary trade-off between authority and accountability.¹²⁴ In that case, the underlying issue in corporate governance is the need for balance between the authority granted to directors and accountability for the directors' actions which shareholders seek.¹²⁵ Bainbridge also argues that there is an inherent "tension between authority and accountability" under the director primacy model, such that when shareholders provide capital to a

¹²¹ See, e.g., Anne Tucket Nees, *Who's the Boss? Unmasking Oversight Liability within the Corporate Puzzle*, 35 DEL. J. CORP. L. 199, 251 (2010).

¹²² Additionally, as noted in Part III, the team production theory opposes the structure of modern U.S. corporate law in which shareholders alone enjoy the right of electing directors and the corporate objective of shareholder wealth maximization.

¹²³ See Bainbridge, *supra* note 16, at 567, 569 (regarding the Board as both the ultimate monitor and a body that exercises fiat in the corporation).

¹²⁴ E.g., Stephen Bainbridge, *Bruner on Director Primacy and Other Pure Theories of Corporate Governance*, [businessassociationsblog.com](http://www.businessassociationsblog.com/) (Sept. 4, 2007), <http://www.businessassociationsblog.com/lawandbusiness/comments/brunerondirectorprimacyandotherpuretheoriesofcorporategovernance/> (stating that corporate governance reflects the balancing of "two competing values" – "authority and accountability," which are "ultimately irreconcilable").

¹²⁵ See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 122-23 (10th ed. 2007).

corporation they implicitly contract for the directors to pursue shareholder wealth maximization.¹²⁶ Thus, we first have to discuss whether the governance structure ensures that the accountability will be appropriate for the Board's authority.

Another factor to consider is that the economic crisis exposed substantial issues which stemmed from the connection of CEO compensation incentives with short-term gains. This problem has become more serious due to the passivity of modern public boards, which simply obey the CEO's decisions and accept the information he/she provides. The corporate governance structure must be reformed to read just such an incentive structure in favor of the long-term well-being of the corporation. George Dent argues that shareholder rights must be expanded to achieve the goal of addressing the issue of CEO domination.¹²⁷ However, transferring power from CEOs to shareholders will not necessarily solve this problem. Proposals to increase shareholder power are criticized for being ineffective and inadequate partly because shareholders are at an informational disadvantage and partly because they tend to be indifferent to their voting power and to another kind of shareholder power, such as derivative suits and information rights.¹²⁸ If the goal of corporate governance reform is to increase the long-term well-being and value of the corporation, some shareholders may have a short-term bias that prevents CEOs from effectively achieving this long-term goal.

As noted above, independent mediators of conflicting interests in most public corporations are not a board of directors but CEOs. In a normative light, the Board should still serve as both a monitor for mediating constituencies' interests in relation to the CEO and as a manager that makes a final decision on fundamental corporate issues through considering such constituencies' interests. The team production theory has provided the perspective that the Board of Directors should assume the role of a mediating hierarch among all

¹²⁶ Bainbridge *supra* note 16, at, 605, 573 (arguing the key to corporate governance lies in maintaining the proper balance of authority and accountability).

¹²⁷ See, George W. Dent, *Academics in Wonderland: The Team Production and Director Primacy and Models of Corporate Governance*, 44 *HOUS. L. REV.* 1213, 1273 (2008).

¹²⁸ See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 *MICH. L. REV.* 520 (1990) (this is often referred to as a collective action problem).

constituencies, including shareholders. Thus, this theory presents a substantial opportunity for balancing constituencies' interests under corporate governance. Incidentally, the director primacy model is concerned with the allocation of power within the firm, but has little to say about how that power is to be used other than requiring that it be used to maximize shareholder wealth.¹²⁹

I propose that any corporate governance reform must focus primarily on promoting the long-term well-being of the corporation, balancing constituencies' interests, and ensuring accountability (or transparency). In light of this goal, I will examine a proposal for corporate governance reforms, that is, the "enlightened shareholder value" (ESV) approach and the director's reporting, which are currently accepted in the United Kingdom.

A. *THE U.K. COMPANIES ACT 2006*

The U.K. Companies Act 2006 (the Act) attempts to reconcile shareholders' primacy with companies and with other long-term and stakeholder concerns.¹³⁰ This legal duty requires directors to promote the long-term success of the corporation for the benefit of the shareholders as a whole, but in doing so, directors must consider the list of stakeholder interests described in section 172(1) of the Act.¹³¹ This is referred to as the ESV approach¹³² of corporate governance, which merges elements of the shareholder primacy and stakeholder models. The Company Law Review (CLR), which

¹²⁹ See Bainbridge, *supra* note 16, at 792 (contrasting Blair & Stout, Bainbridge states he did not approach the Board of Directors from a perspective framed by the question "what does the Board do?" in developing the director primacy model.).

¹³⁰ See also Paul L. Davies, *Enlightened Shareholder Value and the New Responsibilities of Directors* (Oct. 4, 2005), http://law.unimelb.edu.au/_data/assets/pdf_file/0014/1710014/94-Enlightened_Shareholder_Value_and_the_New_Responsibilities_of_Directors1.pdf (arguing the ESV approach is not very different from a shareholder approach).

¹³¹ See COMPANIES ACT 2006, c. 46, § 712 (U.K.).

¹³² *Id.*; Daniel Attenborough, *The Company Law Reform Bill: An Analysis of Directors' Duties and the Objective of the Company*, 27 COMPANY LAW 162, 165 (2006).

worked on the Act, accepted the concept of the ESV as a fundamental principle in corporate governance.¹³³

1. DIRECTORS' FIDUCIARY DUTY

The core of the ESV principle is embodied in section 172 of the Act, which defines the fiduciary duties of directors:

“(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers, and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.”¹³⁴

The “enlightened shareholder” is the yardstick for a hypothetical shareholder who is interested in the long-term well-being and performance of the corporation and its social and environmental impact.¹³⁵ Under this ESV approach, directors, who are ultimately required to promote shareholder interests, must consider the factors that affect the company's relationships and performance. The fundamental elements of the ESV model are: (1) an explicit focus on long-term shareholder value as the goal of the corporation and (2) a requirement that directors consider the impact of their decisions on extended stakeholder constituencies' interests that are referred to in section 172 to promote the success of the corporation, however, on

¹³³ See Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's "Enlightened Shareholder Value Approach,"* 29 SYDNEY L. REV. 577, 579 (2007).

¹³⁴ *Id.* at 591.

¹³⁵ See Andrew Keay, *Moving towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado about Little,* 22 EUR. BUS. L. REV. 1, 40 (2011).

the premise that no change in the corporate decision-maker (i.e., the Board) and no transfer of shareholders' voting rights to other stakeholders is made at all.¹³⁶ In terms of the last premise, under the Act, directors remain directly accountable only to shareholders, and the Board is maintained as the decision-making authority of the corporation.¹³⁷ Thus, the Act defines shareholders as the sole corporate constituency entitled to elect directors, bring derivative suits, and authorize interested transactions.

The CLR took the view that directors' duties should be formulated in terms of the notion that shareholder value depends upon directors' successful management through their consideration of the corporation's relationships with other constituencies.¹³⁸ Hence, although section 172 of the Act, which includes the ESV approach, initially defines the scope of directors' duties, it also indicates what shareholders' interests should be and how they should be addressed.¹³⁹ "Under this approach, directors must primarily focus on promoting the best interests of shareholders"; however, they must also consider the interests of other key constituencies as long as such consideration promotes the success of the corporation for the benefits of its shareholders.¹⁴⁰ A major concern here was whether to uphold the notion of the shareholder primacy approach or whether a "pluralist approach" to corporate governance should be substituted for this approach.¹⁴¹ Contrary to the claims of the ESV approach, the "pluralist approach" proposes that directors should consider all relevant constituencies' interests equally, which include those of shareholders, and that directors should give primacy to non-shareholder constituencies, even sacrificing shareholders' interests in

¹³⁶ See Virginia Harper Ho, "Enlightened Shareholder Value": *Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 IOWA J. CORP. L. 59, 79 (2010).

¹³⁷ See generally COMPANIES ACT 2006, *supra* note 131.

¹³⁸ See Keay, *supra* note 133, at 579.

¹³⁹ See Andrew Keay, *Enlightened Shareholder Value, The Reform of the Duties of Corporation Directors and the Corporate Objective*, LLOYD'S MAR. COM.L. Q. 335, 339 (2006); see also Keay *supra* note 135, at 2, 18.

¹⁴⁰ See John Lowry, *The Duty of Loyalty of Company Directors: Bridging the Accountability Gap through Efficient Disclosure*, 68 CAMBRIDGE L. J. 607, 616 (2009).

¹⁴¹ See Gavin Kelly & John Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach*, THE POL. ECON. OF THE COMPANY (CLR did not use the term "stakeholder," but rather the term "pluralist" throughout).

case of a conflict in interests between shareholders and non-shareholders.¹⁴² Although the CLR recognized the merits of the stakeholder approach, it did not recommend its adoption and finally chose a modified model, which is the ESV model.

2. NARRATIVE REPORTING

The U.K. has expanded the scope of the directors' narrative reporting requirement through the directors' business review. In section 417(2) of the Act, the statutory objective of the business review is declared, which holds that directors, not the corporation, are required to compile a business review to inform shareholders of the corporation and help them assess and evaluate how the directors have performed their duty under section 172.¹⁴³ Thus, the Act requires directors in public corporations to recognize and report on the non-exhaustive list of factors specified in section 172(1) as part of the comprehensive disclosures to investors.¹⁴⁴ The business review must include "a fair review of the company's business, and a description of the principal risks and uncertainties facing the company."¹⁴⁵ Further, it must be "a balanced and comprehensive analysis" of the corporation's financial performance as well as the main trends and factors likely to affect the future development and performance of the listed corporation's business.¹⁴⁶ Specifically, the business review for a listed corporation must include information about the corporation's environmental impact, employees, social and community issues, and essential contractual arrangements.¹⁴⁷ The analysis in the business review must be based on both financial and non-financial key performance indicators (KPIs).¹⁴⁸ The narrative reporting in the directors' business review in the United Kingdom possibly goes further than the narrative reporting system in the United States, which is more focused on financial performance. The tendency toward expanded directors' narrative reporting has been

¹⁴² *Id.*

¹⁴³ *See* COMPANIES ACT 2006, c. 46, § 417(2) (U.K.).

¹⁴⁴ *Id.* at § 417 (however, companies subject to the small companies' regime are exempted from the business review requirement).

¹⁴⁵ *Id.* at § 417(3)(a)-(b).

¹⁴⁶ *Id.* at § 417(4)-(5).

¹⁴⁷ *Id.* at § 417(5) (if the business review does not include the relevant information, it must include a statement detailing which kind of information is not contained therein.).

¹⁴⁸ *Id.* at § 417(6).

increasing, and the U.K. government in early 2012 proposed a revision of the directors' business review in section 417 of the Act. The directors' business review is now replaced with a "strategic report," which is the new narrative reporting requirement.¹⁴⁹

Thus, in August 2013, the Companies Reform Regulations 2013 amended the Act which implements the strategic report and the directors' report (instead of the annual directors' statement) to replace the directors' business review in the now superseded section 417 of the Act.¹⁵⁰ All U.K. corporations, except those that are "small," are required to produce a strategic report, as well as a directors' report, within their annual report. The strategic report is to cover the same material as the old business review, such as, in the case of listed corporations, principal risks and uncertainties, and KPIs. The new strategic report, in relation to strategy and business model, the gender of the directors, senior managers, employees of the corporation, and human rights issues and policies, requires listed corporations to provide additional disclosures.¹⁵¹

As seen from sections 172, 417, and 414A-D of the Act, the U.K. corporate law reforms require boards to justify their decisions in terms of long-term shareholder value and stakeholder interests, and to disclose risks impacting stakeholders.¹⁵² By doing so, the U.K. has made management at least indirectly accountable to stakeholders. The factors listed in section 172(1) and the strategic report and directors' report, which requests compliance with such sections, will allow directors to defend any bona fide business decision aimed at promoting the success of the corporation.¹⁵³ However, section 463 of the Act causes a director to be liable for compensating the

¹⁴⁹ See COMPANIES ACT 2006, c. 46, § 414A (U.K.) (In August 2013, the Companies Reform Regulations 2013 amended the Companies Act 2006, which implements the Strategic Report and the Directors' Report (instead of the Annual Directors' Statement) to replace the directors' business review in the now superseded section 417 of the Act.); see § 414C(2)(4) (the Strategic Report now incorporates the former requirements of the superseded directors' business review in section 417 of the Act, as well as a description of the company's strategy, business model, and gender diversity on the Board.).

¹⁵⁰ COMPANIES ACT 2006, *supra* note 149, at § 414A.

¹⁵¹ *Id.* at § 414C(8).

¹⁵² *Id.* at §§ 172, 417, 414(A)-(D).

¹⁵³ *Id.* at § 172(1); COMPANIES ACT 2006 (STRATEGIC REPORTS AND DIRECTOR'S REPORT) REGULATIONS 2013 S.I. 2008/393, (§ 414C(1)) (U.K.).

corporation for any of its own losses if the director knowingly makes an untrue statement or dishonest omission in a director's report, statement, or summary financial statements.¹⁵⁴ In sum, the U.K. approach aims to enhance directors' accountability through compliance with such sections and to simultaneously push corporations in the direction of greater social responsibility.¹⁵⁵

V. OTHER PROGRESS

In 2010 the Financial Reporting Council (FRC) published The U.K. Corporate Governance Code (the "Code," as updated in 2014), which sets out standards of good practice for listed corporations on board composition and on development, remuneration, shareholder relations, accountability, and audit.¹⁵⁶ Additionally, in 2011 the FRC published the "FRC Guidance on Board Effectiveness".¹⁵⁷ The guidance is intended to assist companies in applying the principles of the Code, which relates primarily to Sections A and B that deal with the leadership and effectiveness of the Board, per Listing Rule 9.8.6.¹⁵⁸ In the case of a listed company, its annual financial report must include (1) a statement of how the listed company has applied the Main Principles set out in the Code in a manner that would enable shareholders to evaluate the application of the principles, and (2) a statement as to whether the listed company has complied with all relevant provisions set out in the Code or has not complied with all relevant provisions set out in the Code.¹⁵⁹ If the company has not complied with all relevant provisions, it must include a statement setting out those provisions with which it has not complied and the

¹⁵⁴ See COMPANIES ACT 2006, c. 46, § 463, (U.K.).

¹⁵⁵ See Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L. J. 493, 500 (2005).

¹⁵⁶ See FINANCIAL REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE (2014),

¹⁵⁷ See FINANCIAL REPORTING COUNCIL, GUIDANCE ON BOARD EFFECTIVENESS (2011).

¹⁵⁸ See FINANCIAL CONDUCT AUTHORITY, LISTING RULE 9.8.4 (May 16, 2014) <https://www.handbook.fca.org.uk/handbook/LR/9/8.html>

¹⁵⁹ See FINANCIAL REPORTING COUNCIL, *supra* note 157, at 9.8.6 (5) and (6).

company's reasons for non-compliance.¹⁶⁰ This means the Listing Rules apply the so-called "comply or explain" rule.

VI. E.U. CORPORATE REFORM

In addition to the U.K. movement, there is E.U. corporate reform. The Council of the European Commission adopted Directive 2013/34/EU on large companies' disclosure of non-financial information.¹⁶¹ If a company is large (i.e., listed and non-listed, but having more than 250 employees), the Board must prepare a management report containing the analysis including both financial and non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.¹⁶²

According to E.U. Directive 2014/95/EU, which amended the said Accounting Directive, the Board must disclose information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.¹⁶³ Moreover, large listed companies shall also disclose information regarding the diversity of the Board.¹⁶⁴ The required disclosure must also include a description of the company's pursued policy related to the above-mentioned matters, the results of these policies, and the risks related to these matters, and how the company manages those risks.¹⁶⁵ The objective of the Directive "is to increase E.U. companies' transparency and performance on environmental and social matters, and therefore, to contribute effectively to long-term economic growth

¹⁶⁰ FINANCIAL REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE, *supra* note 156.

¹⁶¹ Council Directive 182/19, art. 19, 2013 O.J. (L182/19) (EC).

¹⁶² *Id.*

¹⁶³ Directive 2014/95, of the European Parliament and of the Council of 22 October 2014 as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. (L 330/1). 19(a); *see* European Commission Memoranda MEMO/14/301, Disclosure of Non-financial and Diversity Information by Large Companies and Groups – Frequently Asked Questions (April 15, 2014).

¹⁶⁴ *See* Article 20 (g) of Directive 2014/95/EU.

¹⁶⁵ *See* European Commission Memoranda, *supra* note 163. *See also* Article 29a of Directive 2014/95/EU.

and employment.”¹⁶⁶ More transparency will help companies better manage the opportunities and non-financial risks.¹⁶⁷ These directives are aimed at complementing the narrative reporting regulations in the United Kingdom.¹⁶⁸ “Through complying with the narrative reporting regulations, as mentioned above, U.K. listed companies will be disclosing specific information on the companies’ strategy, business model, human rights and gender diversity in their strategic report, and providing information on greenhouse gas emissions in their directors’ report.”¹⁶⁹

Expansion of the disclosure of financial and non-financial information and the narrative reporting system that has been adopted in the United Kingdom and the E.U. are helping increase the accountability and transparency of the decision-making process in terms of considering multi-stakeholder interests. The recent progress in this regard should be positively evaluated in terms of corporate governance.

*A. APPLICABILITY OF THE ESV APPROACH TO
U.S. CORPORATE LAW*

Is it acceptable under U.S. corporate law that directors are able to or must consider the interests of other constituencies besides shareholders? Is such consideration in conflict with the notion of shareholder wealth maximization?

Under Delaware law, the fiduciary duty of loyalty requires directors to act in the best interests of the corporation and its shareholders,¹⁷⁰ and most states have the same or almost the same statutes. However, under U.S. corporate law, directors should also consider the interests of other corporate constituencies to the extent that those interests meet the best interests of the shareholders. Thus, the above description is like the ESV approach used in the United

¹⁶⁶ See European Commission Memoranda, *supra* note 163.

¹⁶⁷ *Id.*

¹⁶⁸ International Accounting Standards Board, *Regulations implementing EU Non-Financial Reporting Directive* published (Sept. 16, 2017, 11:09AM), <https://www.iasplus.com/en-gb/news/2016/12/regulations-implementing-eu-non-financial-reporting-directive-published>.

¹⁶⁹ *Id.*

¹⁷⁰ *ATR-Kim Eng. Fin. Corp. v. Araneta*, No. CIV.A. 489-N, 2006 WL 3783520, at 16 (Del Ch. Dec. 21, 2006) (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1983)).

Kingdom. Einer Elhauge's argument will serve as a useful framework for addressing the above questions.

Elhauge argues that managers have, and should have, discretion under corporate law to sacrifice profits in the public interest,¹⁷¹ essentially, the interests of non-shareholders.¹⁷² Elhauge observes that "the law has never barred corporations from sacrificing corporate profits to further public interest goals that are not required by law,"¹⁷³ and that the existence of managerial discretion to sacrifice profits in the public interest is rather socially desirable.¹⁷⁴ Additionally, this would be true even if the objective of corporate law were shareholders' profits maximization because it inevitably entails the business judgment rule. According to Elhauge, the business judgment rule in effect leaves managers with latent discretion to sacrifice profits in the public interest, which discretion Elhauge argues is socially desirable.¹⁷⁵ Thus, the business judgment rule protects most managerial decisions that involve potential shareholder-stakeholder conflicts of interest.¹⁷⁶ In support of his argument, Elhauge points to the so-called constituency statutes that many states enacted which authorize managers explicitly to consider the interests of non-shareholder constituencies and the American Law Institute's Principles of Corporate Governance, which authorize boards of directors to devote a reasonable amount of resources to "public welfare, humanitarian, educational, and philanthropic purposes," even if the conduct either yields no economic return or

¹⁷¹ Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 739 (2005). See, e.g., LAWRENCE E. MITCHELL, *CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT* (2001); Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999); Ian B. Lee, *Is There a Cure for Corporate "Psychopathy"?* 42 AM. BUS. L. J. 65(2005); *Shlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (leading case on profit-sacrificing decisions).

¹⁷² Elhauge, *supra* note 171, at 744.

¹⁷³ *Id.* at 763.

¹⁷⁴ *Id.* at 738-40.

¹⁷⁵ *Id.*

¹⁷⁶ See *id.* at 775; see also Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 VA. L. & BUS. REV. 177, 181 (2008).

entails a net economic loss.¹⁷⁷ Further, Elhauge refers to Delaware case law on takeovers, particularly *Unocal Corp v. Mesa Petroleum Co.*,¹⁷⁸ which he observes confirmed explicitly that shareholders' interests are not a controlling factor.¹⁷⁹ According to Elhauge, "under the business judgment rule, courts are extraordinarily willing to sustain managers' decisions that apparently sacrifice profits (at least in the short run) on the grounds that they may conceivably maximize profits (at least in the long run)."¹⁸⁰ More or less any decision to sacrifice profits has a conceivable link to long-term profits; therefore, this suffices to give managers substantial de facto discretion to sacrifice profits in the public interest.¹⁸¹ Elhauge further argues that when managers sacrifice profits in the public interest, they are often maximizing the shareholders' welfare.¹⁸² Consequently, he suggests that maximizing shareholder welfare is not the same thing as maximizing shareholder profits.¹⁸³

The United States and the United Kingdom have the same structure of dispersed share ownership and well-developed securities markets and depend upon a similar stock market for corporate control. Moreover, in both countries, stock ownership has become increasingly concentrated in institutions such as mutual funds or pension funds. Indeed, there are many reasons why such a stakeholder-oriented regulatory shift is unlikely. Per some commentators, key differences between the dominant institutional investors in the United Kingdom (i.e., pension funds) and the United States (i.e., mutual funds), as well as the two countries' regulatory environments, make stakeholder-oriented corporate reform less likely in the United States.¹⁸⁴ However, I do not believe these differences are crucial to introducing the ESV approach to the United States.

Moreover, the regulatory framework for the exercise of shareholders' corporate governance role in the United Kingdom is

¹⁷⁷ Elhauge, *supra* note 171, at 763–66 (citing 1 Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations § 2.01(b)(3) (1992)).

¹⁷⁸ *Id.* at 764–65 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 770–71.

¹⁸¹ *Id.*

¹⁸² *Id.* at 785.

¹⁸³ *Id.* at 783.

¹⁸⁴ Ho, *supra* note 136, at 79–80.

much more empowering as compared to the United States.¹⁸⁵ The enhanced narrative reporting regime proposed in the United Kingdom has the objective of making a significant impact on the exercise of shareholders' corporate governance role in monitoring, scrutiny, and engagement. However, I am not suggesting that we should enhance shareholders' role in corporate governance by achieving the narrative reporting regime and finally moving on to shareholder primacy. Structural issues such as short-termism and the reliance on capital market gains, rather than long-term corporate value, caused the shareholders' failure of engagement. Many institutional shareholders delegate investment management to asset managers, and their short-termism relationships with asset managers contribute to the short-term prospects of investment management. I, rather, contend that the narrative reporting regime would ensure accountability for directors' actions, particularly, the market's monitoring function and market discipline, which would ultimately improve corporate governance. Moreover, such narrative reporting would enhance the communication between the Board and the CEO, and the corporation and all stakeholders thereby helping solve the asymmetric information problem.

There might be criticisms to my argument explained above, which has focused on structural issues such as directors' short-termism, which caused the recent financial crisis. First, there might be skepticism that narrative reporting is useful in avoiding such a crisis. One commentator argues that the enhancement of corporate disclosure in narrative reporting would not likely have any significant impact on investor behavior, in terms of shareholder engagement, because investors probably use such disclosure not for engagement (especially institutional shareholders) but for trading decisions.¹⁸⁶ However, assuming that we cannot completely change CEO domination and asymmetric information, the capital market must change in terms of socially responsible investment, and the enhancement of the norm of the ESV and the disclosure supporting such norm would surely lead to improvement in the accountability

¹⁸⁵ CHRISTOPHER M. BRUNER, *CORPORATE GOVERNANCE IN THE COMMON-LAW WORLD: THE POLITICAL FOUNDATIONS OF SHAREHOLDER POWER* 36–37 (2013).

¹⁸⁶ See Iris H-Y Chiu, *Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK*, 38 *DEL. J. CORP. L.* 983, 1009–1011 (2014) (arguing that narrative reporting may be criticized as being too subjective and qualitative).

and sustainable growth of corporations, which would in turn lead to shareholder engagement. As noted above, I support the director primacy model wherein the Board is in control of the corporation. Hence, exercising almost unconstrained authority to ensure corporate decision-making efficiency. Second, there might a question whether the ESV approach and narrative reporting infringe on the Board's traditional role as a central decision-maker with the ultimate "power of fiat," which corporate law affords the Board, because the Board's discretion might be constrained to some extent to perform fiduciary duty in terms of the ESV approach and disclosure of nonfinancial information. However, the said framework would be intended not to empower shareholders or enhance shareholder activism, but to ensure the accountability of the directors, who have broad discretion. Under the ESV model, directors still have broad discretion regarding which interests of constituencies they consider and how they consider such interests.

To avoid a future financial crisis corporate governance reform must focus primarily on promoting the long-term well-being of the corporation, balancing constituencies' interests, and ensuring accountability and transparency. For these purposes, I argue that a combination of the ESV approach and the narrative reporting system as used in United Kingdom¹⁸⁷ would be a more effective approach to address this problem. In terms of the norm, however, we should retain the director primacy model rather than the team production model, as we have to deal with the reality that boards depend heavily upon CEOs for corporate information, although they must perform a monitoring function. There are difficulties in overcoming such a dilemma between director primacy and CEO domination. In sum, it is incorrect to assume that only a board that is made up of independent or outside directors can monitor well because the way in which the monitoring function works within a corporation is different for each corporation.¹⁸⁸ Globalization trends related to communication between corporation and stakeholders, including investors, will no doubt increase "transparency."¹⁸⁹ Based on the idea that transparency will lead to sound management and

¹⁸⁷ *Id.*

¹⁸⁸ See Gordon, *supra* note 104, at 1505–09.

¹⁸⁹ See, e.g., David Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities, 10 (2009) (explaining that the UK government has proposed corporate transparency reforms in order to support shareholders' stewardship role).

performance improvement, the E.U. believes that requiring the disclosure of non-financial information will lead to long-term corporate value. Such a notion and system are sufficiently applicable to the U.S. model of corporate governance.

VII. CONCLUSION

The current environment where corporations and the global economy operate presents an important opportunity for reform.¹⁹⁰ It is in society's best interest to focus corporate governance reform on enhancing the long-term health and value of the corporation. The director primacy model struggles with the Board's practical capacity to deviate from shareholder interests and the shareholders' capacity for autonomous action. The team production model is criticized for shareholders' capacity to discipline the Board through autonomous action.¹⁹¹ There is no single overriding theory, and strict adherence to any pure theory would not prove helpful. In fact, "the social and economic roles of the public corporations are so diverse and far-reaching that we cannot expect any single concept to serve us well in all contexts."¹⁹²

From the perspective of corporate reform, we must ensure that the functions that public corporations are expected to perform under corporate governance will work well as such. I have pointed out above that the shift to the independent board, which has weakened the Board as a monitoring body, has caused a problem. However, my proposal of promoting the long-term well-being of the corporation, balancing constituencies' interests, and ensuring accountability and

¹⁹⁰ See e.g., Bruce E. Aronson, Japanese Corporate Governance Reform: A Comparative Perspective, 11 *Hastings Bus. L. J.* 85 (2015). In 2014, the Japanese Diet passed a bill amending the corporate law. According to the amended corporate law, no outside directors are mandatory in a corporation with a board of corporate auditors, which is adopted in a vast majority of listed corporations. If the corporation lacks outside directors, the directors in such a corporation must explain in a shareholders' meeting why it is reasonable for the corporation to have no outside directors at all. This is often explained such that Japanese corporate law follows the UK style of the "comply or explain" principle. Such an explanation provision is set forth not in corporate law but in the listing regulation.

¹⁹¹ Christopher M. Bruner, *Corporate Governance Theory and Review of Board Decisions*, 62 *UCLA L. REV. DISC.* 87, 89 (2014).

¹⁹² *Id.*

transparency seems to be still ineffective for addressing this problem. We must keep in mind that the Board should not perform the monitoring function on its own. The stock market, gatekeepers,¹⁹³ and social norms must supplement corporate governance,¹⁹⁴ and boards must perform it. The narrative reporting that is currently expanding in the United Kingdom and the E.U. might help enhance the monitoring function that the stock market can perform. If a third-party organization were to value such directors' narrative reporting, which I would recommend, then such a new gatekeeper would work for corporate governance. Role allocation is necessary for ensuring the monitoring function for a corporation.

¹⁹³ See generally JOHN C. COFFEE, GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE (2006) ("all boards of directors are prisoners of their gatekeepers.").

¹⁹⁴ See Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1253-1292 (1999) (discussing the role of social norms in several key areas of corporate law, including fiduciary duties, corporate governance, and takeovers). See also Robert Cooter & Melvin A. Eisenberg, *Fairness, Character, and Efficiency in Firms*, 149 U. PA. L. REV. 1717, 1721 (2001) (arguing that firm-specific fairness norms promote efficiency).

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