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Message from the Chair

By James F. Horan

The Committee on Attorneys in Public Service (CAPS) exists to bring together government and public service lawyers to further our common interests and the public welfare. The NYSBA Annual Meeting in New York City each January provides CAPS with the forum to advance our mission and purposes through our full day educational program (Program) and through the CAPS Awards Reception.

> *"In an effort to encourage more young attorneys to pursue careers in public service, NYSBA launched . . . SLAPI to help in paying the educational debt for law school graduates who practice public service law."*

Our Mission Statement defines one of our purposes as providing continuing legal education and resources related to the practice of public service attorneys and enhancing the relevance of all NYSBA-sponsored activities and services for public service attorneys. Once again, CAPS provided continuing legal education with Professors Susan Herman, from Brooklyn Law School, and Erwin Chemerinsky, from the University of Southern California, providing the focus for the Program. In the morning, Professors Herman and Chemerinsky presented their annual summary on the past term's decisions from the United States Supreme Court. In the afternoon, the professors participated in a panel discussion, on Civil Liberties and the War on Terrorism, with Assistant Queens County District Attorney Linda Cantoni and Justice Department Attorney Benton Campbell. The Program drew the largest audience ever to attend our Annual Meeting Program and that audience heaped high praise on the Program and its participants. High praise also goes to CAPS Member Marjorie McCoy for her work in putting together the Program.

The Mission Statement also provides that CAPS should advocate for public service attorneys in our quest for excellence, fairness and justice in the performance of our duties. Through our prior Chair Hank Greenburg, CAPS has identified the problem of trying to attract young attorneys to lower-paying public service jobs, especially at a time when recent law school graduates face overwhelming student loan debts. The CAPS Reception at the Annual Meeting marked the public announcement of the winners of the first five awards under the new NYSBA Student Loan Assistance Program

In an effort to encourage more young attorneys to pursue careers in public service, NYSBA launched Student Loan Assistance for the Public Interest (SLAPI) to help in paying the educational debt for law school graduates who practice public service law. In the initial SLAPI awards, the New York Bar Foundation presented $25,000 to five recent law graduates entering public service. At the CAPS reception, Glen Bruening, a CAPS Member and the SLAPI Chair, announced the first awards. The recipients, several of whom were able to attend the CAPS Reception, were:

- Corinne Lundstrum of My Sister's Place, a not-for-profit agency dedicated to ending domestic violence;
- Sara Lynne Thrasher of Southern Tier Legal Services;
- Mary Lynne Frey of the Bronx Legal Aid Society;
- Holly Graham of the Legal Aid Society, Juvenile Rights Division in Manhattan; and
- Christopher Nelson of the Administration for Children Services.

The Mission Statement also calls on CAPS to promote the highest standards of professional conduct and competence, fairness, social justice, diligence and civility. To advance that purpose, CAPS presents the Annual Award for Excellence in Public Service to recognize excellence by a member or members of the legal profession in the commitment to and performance of public service.

This year, CAPS presented the Award to Jeffrey D. Friedlander and Leonard Koerner, who have combined for almost seventy years in public service at the New York City Department of Law. In nominating the eventual award winners, New York City Corporation Counsel Michael A. Cardozo stated that Mr. Friedlander and Mr. Koerner typify the best in the legal profession and represent hundreds of Assistant Corporation Counsels who serve the state's largest municipality in facing extraordinary and unique fiscal and legal challenges.

Mr. Friedlander serves as First Assistant City Corporation Counsel and has played a significant role in expanding New York City's Landmarks Preservation Law, establishing anti-apartheid legislation and divestiture, drafting the Gay Rights Bill and the Watershed Protection Agreement and establishing the New York City Campaign Finance Law and the Civilian Complaint Review Board. In addition, Mr. Friedlander writes a bi-monthly Municipal Law column for the *New York Law Journal*, serves on several bar committees and volunteers for a number of community and charitable organizations.

Mr. Koerner leads the Law Department's Appeals Division and oversees the Law Department's Administrative Law and General Litigation Divisions. Mr. Koerner has established himself as one of the state's leading appellate attorneys, handling a number of the city's seminal cases and arguing before the United States Supreme Court, the Second Circuit, the First and Second Departments of the Appellate Division, and sixty times before the New York Court of Appeals.

At the Reception, the two recipients and Mr. Cardozo spoke eloquently about the challenges and rewards in public service. Mr. Friedlander also emphasized the need to continue to attract young attorneys into public service and to deal with student loan debt problem.

With the Annual Meeting now behind us, CAPS turns to planning to the matters which we will address this year. We would welcome your comments and suggestions to aid us in continuing to promote our mission.

Hon. James F. Horan, Chair of the NYSBA Committee on Attorneys in Public Service, serves as an Administrative Law Judge with the New York State Department of Health. He is the Immediate Past President of the New York State Administrative Law Judges Association.

Editor's Foreword

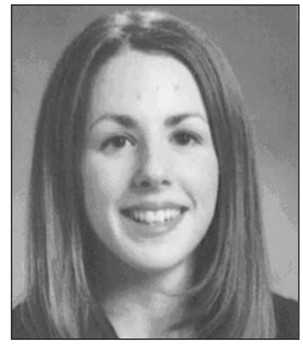
By Vincent Martin Bonventre

Enron, WorldCom, Arthur Andersen, Adelphia, Tyco, savings and loans, etc., etc., etc. A virtual "scandal-a-thon" of fraud, greed and other corporate corruption has left Americans understandably aghast about the apparent state of big business ethics and bewildered at the conspicuous inadequacy of protective oversight and enforcement by government.

Faced with allegations of misconduct, business and its executives turn to their corporate lawyers and white collar defense counsel. Shareholders, employees, and others directly injured retain plaintiffs' lawyers who specialize in obtaining compensation from corporate and financial abusers. Consumers and concerned citizens generally, however—looking to hold those responsible accountable and to restore trust and ethics to the marketplace—naturally turn to government and, especially, to government lawyers whose only client is the public interest.

It is quite appropriate, then, as well as timely, to devote this issue of the *Government, Law and Policy Journal* to the theme of corporate accountability. The diverse collection of topics and authors herein assures an issue that is not only illuminating and provocative, but also of critical importance and relevance to all who work in the public's trust.

In the issue's first article, Edward Mierzwinski, the Consumer Program Director of U.S. PIRG, decries the federal government's interference with the ability of states and localities to adopt their own consumer-protective regulations. Powerful special interests—such as the banking and insurance lobbies—have succeeded in persuading both Congress and the White House to preclude state and local governments from enacting tougher business standards. New York Attorney General Eliot Spitzer, whose office was last year's recipient of the CAPS Award for Excellence in Public Service, registers a similar complaint in his latest contribution to this *Journal*. A dubious "New Federalism," whose partisans have promoted as necessary to free the states from an overbearing federal government, is now giving way—at the insistence of the same partisans—to a policy of federal intervention. The purpose and effect is to disempower states from enforcing consumer protections against corporate violators.



Deborah Platt Majoras, presently at Jones Day following service in the Antitrust Division of the U.S. Justice Department, addresses the related implications of multi-layered business regulations. Even among those committed to aggressive antitrust enforcement, federal and state officials typically view the wisdom of having a dual system of laws and prosecution from very different perspectives. Not surprisingly, the view from the federal vantage point is usually that states should stay clear of matters of natural and global concern. Equally unsurprising is the perspective of state officials. Two contributors, J. Stephen Casscles, Counsel to a leading member of the New York State Senate, and Mark L. Gardner, a former deputy superintendent of the state's Insurance Department, both see the role of states as crucial to corporate accountability. Casscles notes that states such as New York have sought to fill the federal regulatory and enforcement void which has been made all-too-undeniable by the large-scale corporate scandals of the last few years. Gardner argues that perhaps the greatest scandal of all—the collapse of Adelphia Communications—would likely never have occurred if it were regulated the way New York regulates insurers doing business in the state.

"Consumers and concerned citizens . . . naturally turn to government and, especially, to government lawyers whose only client is the public interest."

The final offerings in this issue—final as a matter of editorial organization logic, but surely not as a matter of substance and significance—are from three eminent contributors sharing their own special insights. Stuart C. Gilman, President of the Ethics Resource Center in Washington, D.C., argues that ethical minimalism is to blame for the current crisis in corporate scandal and the resultant loss in public confidence in our institutions. Business in America must be encouraged by the requisite laws and enforcement to strive for the highest standards. John R. Boatright, the Executive Director of the Society for Business Ethics and Professor in the Graduate School of Business at Chicago's Loyola University, questions whether increasing responsibility on individual executives is the best way to reform corporate behavior. He warns that overemphasizing individual rather than organizational accountability can be both unfair and ineffective in complex business environments. Steven C. Krane, formerly President of the New York State Bar Association and currently of Proskauer Rose, addresses the vexatious tensions between professional confidentiality and personal conscience in the face of egregious corporate-client misconduct. There are no easy, comfortable answers; even as "officers of the court," private attorneys ought not to be converted into public snitches on their clients.

My work as Editor-in-Chief of the *GLP Journal* is made immeasurably easier and more gratifying by the assistance of the student editors from Albany Law School. They do the technical editing and sub-editing, and they add an extra set of sharp minds and eyes to the entire editorial process—from identifying possible contributors and soliciting articles to proofreading and overall organization of the journal. They are a bright, enthusiastic and conscientious group, and it is particularly rewarding to work with them.

As always, the *GLP Journal* and I will miss the graduating seniors and, especially, Ilana Eck, this academic year's Executive Editor. She has supervised the student editorial process for this issue and the preceding one. Exceptional is a word that comes readily to mind to describe Ilana, her work, and the joy of working with her.

Also, The Board of Editors, Chairman James Horan, my colleague Patricia Salkin who is Director of the law school's Government Law Center, Pat Wood of membership at the Bar Association and Lyn Curtis of the Association's publications staff—they all make this enterprise such a pleasant and, I believe, high-quality and extremely valuable one.

Of course, any errors or shortcomings are my responsibility. Any comments, negative or otherwise, are welcomed and may be addressed to me.

Vincent Martin Bonventre, J.D., Ph.D., is the Editor-in-Chief of the *GLP Journal* and Professor of Law at Albany Law School. He is also the Editor of the annual *State Constitutional Commentary* and the Director of the Center for Judicial Process.

Ilana A. Eck, the Executive Editor of the *GLP Journal*, is a member of the Albany Law School class of 2004 and an Associate Editor of the *Albany Law Review*.

Preemption of State Consumer Laws: Federal Interference Is a Market Failure

By Edmund Mierzwinski

In January 2001, President-elect George W. Bush told a gathering of governors, "While I believe there's a role for the federal government, it's not to impose its will on states and local communities." But on a growing number of issues, powerful special interests are persuading Congress and the White House to do just that. When it comes to consumer protection and the environment, they're imposing federal law while wiping out the states' ability to pass stronger standards.

"Congress and the executive branch, backed by the courts, have failed to learn what may be the most important lesson of the federalist system: competition for public policy ideas fosters accountability."

In December, the President signed the Fair and Accurate Credit Transactions (FACT) Act,[1] a major law derived from numerous recent state privacy, credit reporting, and identity theft initiatives. Its price, however, was unacceptable: Congress permanently restricted states from enacting most future laws in the area. Then, in January, a previously obscure federal banking regulator—the little-noticed Office of the Comptroller of the Currency (OCC)—eliminated application of all state consumer protection and predatory lending laws, as well as state enforcement authority, over national banks, even when no federal law protected consumers at all.

Congress and the executive branch, backed by the courts, have failed to learn what may be the most important lesson of the federalist system: competition for public policy ideas fosters accountability. A marketplace of public policy ideas is no different than a marketplace of consumer products—when you have only one seller, you have a monopoly. A monopoly of ideas is a market failure that leads to bad public policy.[2]

Congress rarely acts to protect consumers unless the states act first, unless there is a scandal. Even the epic Enron scandal didn't guarantee passage of a corporate reform law in 2002. Without the follow-on WorldCom scandal, the accountants and Wall Street would have blocked significant reforms.[3] We cannot wait for more scandals; we need to ensure that the states remain as sellers in the marketplace of ideas. And, of course, the states, led by New York Attorney General Eliot Spitzer and Massachusetts Secretary of State William Galvin, have also shown the U.S. Securities and Exchange Commission (SEC) the way when it comes to fighting investment and mutual fund scandals.

I. The OCC Takes the Field, Wants No Team Against It

It's easiest to win when you have no opponents. In January 2004 the Treasury Department's OCC[4] issued two related and sweeping rules, one preempting nearly all consumer laws and the other restricting nearly all enforcement powers of states. The OCC asserted it had authority to take the field over virtually all matters pertaining to national banks, even when no federal law protected consumers from unfair or predatory financial practices.

In its new "preemption rule,"[5] the OCC re-wrote and weakened the applicable Supreme Court preemption test from the 1996 *Barnett* decision.[6] In its "visitorial powers rule,"[7] OCC rolled back long-standing authority of state attorneys general and other officials to investigate or enforce violations by national banks. OCC also boldly asserted that these new limits extended even to actions against a national bank's state-licensed operating subsidiaries.

The issuance of the OCC rules has sparked a bipartisan storm of protest from state legislatures,[8] state financial regulators,[9] and state attorneys general, who criticized the OCC's characterization that the "National Bank Act 'protect[s] national banks from potential state hostility.'"[10]

Even the normally complacent House Financial Services Committee has weighed in. In addition to holding OCC oversight hearings, it has passed a bipartisan budget resolution on a vote of 34-28, stating that the OCC action "may represent an unprecedented expansion of Federal preemption authority" and "comes without congressional authorization, and without a corresponding increase in budget resources for the agency." The committee also pointed out that without a budget increase, the OCC cannot really expect its modest staff of forty consumer-complaint specialists to both continue their own work and also take over much of the work of an estimated 700 state consumer enforcers and examiners. "In the area of abusive mortgage lending practices alone, state bank supervisory agencies initiated 20,332 investigations in 2003 in response to consumer complaints, which resulted in 4,035 enforcement actions."[11]

Throughout the 1990s, financial deregulation had resulted in skyrocketing bank fees as well as the imposition of new fees. The growth of risk-based pricing in mortgage lending triggered a rapid growth in predatory lending practices. In the absence of federal action to prevent abuses, and based on clear anti-preemptive language in the Truth In Lending Act, Electronic Funds Transfer Act, and other laws,[12] states and sometimes cities enacted laws that required banks to offer low-cost checking accounts (New Jersey and New York); banned certain fees, including fees for non-customers to cash checks drawn on the bank itself (Texas) or surcharges imposed by owners of ATMs on non-customers (Iowa and Connecticut by administrative order, the cities of Santa Monica and San Francisco, California, by local ordinance); required additional credit card disclosures (California); and restricted predatory lending.[13] A series of unfortunate court decisions[14] that paid too much deference to the OCC held that the National Bank Act preempted some of these actions; the OCC issued preemption determinations overruling others. These victories buoyed the agency to take its January actions, essentially "taking the field" over all matters regarding both national banks and their operating subsidiaries.

Unless overturned,[15] the OCC's power play will also have a chilling effect on state regulatory and legislative actions aimed at state-chartered institutions. No rational state would impose stricter rules or take strong enforcement actions against its regulated entities if its actions would place them at a competitive disadvantage to federally regulated entities.

II. State Laboratories Provide Innovate Ideas to Protect Privacy, Fix Credit Report Errors, and Develop Cures for Identity Theft

Since the mid-1990s, the crime of identity theft had been growing. Identity theft occurs for the same reason that mistakes in credit reports do: sloppy bank, department store, and credit bureau practices. Yet major 1996 amendments to the Fair Credit Reporting Act (FCRA) had no provisions for identity theft. While that year Congress did finally complete a seven-year effort to clear up credit bureau errors, the last four years of that fight had largely been a back-room fight over the scope of proposed preemption, not a public debate over substance.[16] As enacted in 1970, only inconsistent state laws were preempted. The 1996 revision included a provision specifically preempting the states in some, but not all, areas. But, Congress set the preemption to expire on January 1, 2004, unless it acted affirmatively to renew. The expiration of preemption, not the rise of identity theft, was the spark that kindled the FACT Act's passage.

Despite the growing threat of identity theft, until 2003 Congress had done virtually nothing to prevent identity theft or make it easier for its victims to clean up. In 1998, it did follow the lead of several states and enacted legislation criminalizing financial identity theft. The 1998 law also, importantly, required the Federal Trade Commission (FTC) to establish a consumer clearinghouse and increase its surveillance of the crime.[17] Yet, the threat of increased jail time did little to deter growth of the crime, which involves no physical risk and little criminal skill.

As early as 1996, however, the FTC had held a workshop to discuss identity theft solutions.[18] The problems only grew while Congress dawdled. In September 2003, the FTC released a study that revealed to the nation what advocates, and the credit bureaus and credit card companies, had known all along. The cost to consumers and the nation was staggering. Over twenty-seven million Americans, or one in eight of all adults, had been victims in the past five years and the estimated cost to consumers and the economy was over fifty billion dollars.[19]

A. States Take the Lead

So, while they waited for Congress to enact the 1996 accuracy amendments and then in areas where the 1996 amendments were deficient, the states took the lead first to improve the accuracy of credit reports and then to fight identity theft. Vermont (1992) and California (1994) adopted omnibus credit reporting and privacy reforms before Congress acted in 1996.

Ultimately, prior to the 2003 enactment of the FACT Act, seven states granted consumers the right to obtain free annual credit reports. Two states gave consumers the right to obtain business records from firms where the thief had used their identity. Others enacted laws to truncate the number of digits of an account number that could appear on a receipt. California, which has enacted an estimated thirty separate identity theft and credit reporting laws, required creditors to increase the standard for matching the identity of a credit applicant to a credit report.[20]

California in 2000,[21] following a joint campaign by consumer groups, realtors, and an upstart Internet bank

E-Loan, became the first state to prohibit contractual restrictions on showing consumers their credit scores, ending a decade of stalling by Congress and the FTC.[22] This reform didn't *merely* give consumers rights; it changed the industry's business model. Now, the sale of credit scores to consumers is a profit center for the company and its competitors.

Contrary to the specious balkanization theories[23] expounded by supporters of preemption, the development of these credit reporting and identity theft reforms by the states throughout the 1990s demonstrates that states don't generally enact or consider fifty different conflicting laws—instead one state acts and then other states consider similar or identical provisions, if that state law is good enough to export.

B. State Financial Privacy Laws, GLB, and FCRA

The states also acted throughout this period to preserve financial privacy. Unlike European countries, which had largely adopted overarching privacy laws applying to all transactions, U.S. privacy law had been enacted sector-by-sector. Not surprisingly, the two most important sectors—health privacy and financial privacy—were the last to gain privacy rights.

Enactment of the 1999 Gramm-Leach-Bliley Financial Services Modernization Act (GLB) repealed portions of the 1933 Glass-Steagall Act and allowed mergers between banks, brokerages and insurance firms. But GLB's debates occurred against a backdrop of well-publicized privacy invasions, so Congress included a modest privacy provision in the final bill.

GLB required firms to safeguard or secure customer information and to provide customers annual notices of information-sharing policies. Advocates argued that "notice was not enough" to protect privacy.[24] So, the final law also gave consumers a limited right to opt out of sharing with unaffiliated third-party firms, but allowed unfettered sharing of detailed "transactions or experiences" information among corporate affiliates, and among third parties with certain marketing relationships, regardless of a consumer's privacy preference.

Then, during conference consideration of the bill, Senator Paul Sarbanes (D-Md.) added an amendment allowing states to enact stronger financial privacy laws.[25]

Following enactment of the Sarbanes amendment, dozens of states sought in their 2000 and 2001 legislative sessions to protect financial privacy and limit information-sharing among affiliates and third parties.[26] California State Senator Jackie Speier pushed the hardest. Various versions of her bill passed the state Senate several times between 2000 and 2002 but industry lobbyists were able to defeat it in the state Assembly.

Advocates tried two mechanisms to bypass the Assembly logjam. First, several local jurisdictions, led by San Mateo County and Daly City, passed local ordinances protecting financial privacy. Second, with financial backing from Chris Larsen, founder of E-Loan Bank, advocates collected over 600,000 voter signatures, enough to qualify an even stronger ballot initiative and referendum. The ballot question would have provided for express consent, or an opt-in, before any sharing between either affiliates or third parties. On the deadline for filing the signatures to qualify the ballot question, the industry agreed to a legislative compromise.

As enacted and signed in August 2003, California's SB 1 provides for an opt-out for sharing of information among affiliates and some third parties, with some affiliated company exceptions. GLB provides only notice in these circumstances. In other third-party sharing circumstances, SB 1 requires an opt-in.[27] GLB provides only an opt-out. During consideration of the federal FACT Act, an additional provision was added. Consumers cannot block the sharing of their information with affiliates, but they can block the use of that information for marketing, subject to numerous exceptions.

Throughout the debate over the Speier bills, industry had argued that the so-called FCRA savings clause of GLB limited the effect of the Sarbanes amendment so that state financial privacy laws could not be enacted affecting affiliate sharing. In July 2003, a U.S. district court judge agreed with this view as it applied to the California local ordinances.[28] Consumer advocates and state attorneys general disagree with the court's interpretation, believing that the purpose of the FCRA savings clause was to preserve only the "operation" of the FCRA, not preserve its exceptions from coverage. Until *Daly City* is appealed, we won't know which interpretation is correct.[29]

C. Nearly All FACT Act's Good Features Derived from States

While FACT Act's engine was the industry drive to renew permanent preemption of state law, the train included numerous cars of state-produced legislative ideas. Arguably, only one significant provision of the new law—its concept of "risk-based pricing disclosures"—had not been previously developed in state public policy laboratories.[30] Much of the rest of the bill had been stalled in the House Financial Services Committee since 2000 with no action. In 2002, the Senate had passed a bill including other parts of the reforms, but only because industry opponents knew it had no chance to become law.[31]

D. Industry's FACT Act Preemption Campaign

To win on preemption, the industry mounted a multi-million dollar campaign featuring massive campaign donations and lobbying expenditures as well as an unprecedented radio, magazine, newspaper, and subway ad campaign. It gained the support of Federal Reserve Chairman Alan Greenspan and Treasury Secretary John T. Snow.[32] Yet, every major consumer group and nearly every state attorney general opposed the final version of the law[33] because of the permanent limits it imposed on some state activities.

Fortunately, while the FACT Act extends the 1996 preemption in certain areas and expands them in some ways, the expansion of preemption is tempered in the area of identity theft, where the FTC and others admitted that Congress might not have all the answers. For example, the act only limits states from enacting new identity theft laws when their laws would affect "conduct required under specific provisions" of the new federal law.[34]

E. Congress Made a Second Mistake: It Preempted Permanently

Congress actually made two mistakes in consideration of the FACT Act. First, it extended preemption. Second, it extended that preemption permanently. The 1996 imposition of temporary preemption forced Congress and the industry back to the table in 2003 for an unprecedented series of hearings. Those hearings featured 109 witnesses on both credit reporting accuracy and identity theft related issues.

During floor consideration of the House bill, a moderate to conservative senior Democrat, Rep. Paul Kanjorski (D-Pa), argued unsuccessfully for extending the preemption only for another nine years with another sunset provision. Kanjorski said his amendment would allow Congress to "trust but verify," as President Reagan did with the Soviet Union.[35]

III. Preemption and States' Rights

The detailed examples of the negative effect of administrative and congressional preemption above are illustrative. Many more exist.[36] States and even local jurisdictions have long been the laboratories for innovative public policy, particularly in the realm of environmental and consumer protection. The federal Clean Air Act grew out of a growing state and municipal movement to enact air pollution control measures. The national organic labeling law, enacted in October 2002, was passed only after several states, including Oregon, Washington, Texas, Idaho, California, and Colorado, passed their own laws. In 1982, Arizona enacted the first "Motor Voter" law to allow citizens to register to vote when applying for or renewing drivers' licenses; Colorado placed the issue on the ballot, passing its Motor Voter law in 1984. National legislation followed suit in 1993. The 1988 federal law limiting abusive bank policies on deposited check holding was adapted from previously enacted laws in Massachusetts and other states. Cities and counties have long led the smoke-free indoor air movement, prompting states to begin acting, while Congress has proven itself virtually incapable of adequately regulating the tobacco industry. A recent and highly successful FTC program—the National Do Not Call Registry to which 58 million consumers have added their names in one year—had already been enacted in forty states.[37]

Recently, one of the last holdouts against federal regulation, the insurance industry, has launched a campaign to preempt stronger state insurance regulations and establish an "optional" federal chartering system that would allow companies to export home-state regulations to any state where they do business, creating yet another race to the bottom.[38]

While Congress rarely learns from its mistakes, perhaps the OCC's actions, however wrong, will continue to focus sunlight on the growing threat that preemption poses to the development of good consumer protection policy. Perhaps that sunlight, said by Brandeis "to be the best of disinfectants,"[39] will cure the preemption "disease" sweeping Washington.

Efficient federal public policy is one that is balanced at the point where even though the states have the authority to act, they feel no need to do so. Since we cannot guarantee that we are ever at that optimum, setting federal law as a floor of protection as the default—without also preempting the states—allows us to retain the safety net of competition to guarantee the best public policy.

Endnotes

1. *See* Fair and Accurate Credit Transactions Act of 2003, Pub. L. 108-159, 117 Stat. 1952. The amended text of the Fair Credit Reporting Act, 15 U.S.C. §§ 1681–1681x (2004), is *available at* http://www.ftc.gov/os/statutes/031224fcra.pdf (last visited Apr. 5, 2004). For a detailed discussion of the act's provisions, prepared by a consortium of consumer groups, see U.S. Public Interest Research Group et al., *2003 Changes to the Fair Credit Reporting Act: Important Steps Forward at a High Cost* (Jan. 7, 2004), *available at* http://www.pirg.org/consumer/pdfs/fcrafinalsumm.pdf (last visited Apr. 5, 2004).

2. As Roderick Hills has articulated:

> The value of federalism, if any, will result from the often competitive interaction of the levels of government. In particular . . . the presumption against preemption makes sense not because states are necessarily good regulators of conduct within their borders but rather because state regulation makes Congress a more honest, more democratically accountable regulator of conduct throughout the nation. To reverse the usual formula, national

values are well-protected by the states' political process.

Roderick M. Hills, Jr., *Against Preemption: How Federalism Can Improve the National Legislative Process*, John M. Olin Center for Law & Economics, University of Michigan Law School, *available at* http://www.law.umich.edu/CentersAndPrograms/olin/abstracts/03-007.htm (last visited Apr. 5, 2004).

3. When the WorldCom scandal broke, it forced President Bush to give a speech on corporate accountability at the New York Stock Exchange. The corporate scandal-a-thon gave Senator Paul Sarbanes (D-Md.), then chairman of the Senate Banking Committee, enough bipartisan support to move a strong reform bill through the Senate floor on a series of unanimous floor votes—with only strengthening amendments added, including a broad corporate crime provision authored by Pat Leahy (D-Vt.)—and prevented industry from pursuing a strategy of weakening the bill in favor of the much weaker House bill in conference committee. *See* Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

4. OCC regulates all nationally chartered banks; its companion, the Office of Thrift Supervision (OTS), regulates nationally chartered thrifts and savings-and-loans.

5. *See* OCC Preemption Rule, 69 Fed. Reg. 1904 (Jan. 13, 2004); *see also Congressional Review of OCC Preemption: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Financial Services*, 108th Cong. (2004) (statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency).

6. Professor Arthur Wilmarth recently summarized for the California legislature the Supreme Court jurisprudence supporting applicability of states laws to national banks, when not in conflict with federal laws, from the beginnings of the National Bank Act in the 1860s:

> In Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 33 (1996), the Supreme Court held that a state may not "forbid, or impair significantly, the exercise of a power that Congress explicitly granted" to national banks. However, immediately after that statement, the Court added that "[t]o say this is not to deprive States of the power to regulate national banks, where . . . doing so does not prevent or significantly interfere with the national bank's exercise of its powers." Id. at 33-34. . . . The Supreme Court has also affirmed that states have a legitimate role in regulating financial services generally, because "banking and related financial activities are of profound local concern."

Joint Hearing Before the S. Comm. on Banking, Commerce and International Trade and the Assemb. Banking and Finance Comm., 2001-2002 Leg. Sess. (Cal. 2002) (statement of Professor Arthur E. Wilmarth, Jr., George Washington University Law School) (footnotes omitted), *available at* http://www.corp.ca.gov/pressrel/03/fmf/itnfmf052103Wilmarth.htm (last visited Apr. 5, 2004).

7. *See* OCC Visitorial Powers Rule, 69 Fed. Reg. 1895 (Jan. 13, 2004).

8. *See* Letter from the National Conference of State Legislatures to the Honorable John D. Hawke, Jr., Comptroller of the Currency (Oct. 6, 2003), *available at* http://www.ncsl.org/standcomm/scfin/occ031006.htm (last visited Apr. 5, 2004).

9. "These regulations are not minor or incremental changes. Their scope is nearly unlimited, and their implications are potentially enormous. These regulations exceed the OCC's statutory authority and disregard Congressional intent." *Congressional Review of OCC Preemption: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Financial Services*, 108th Cong. (2004) (written statement of Diana Taylor, Superintendent, State of New York Banking Department), *available at* http://www.banking.state.ny.us/sp040128.htm (last visited Apr. 5, 2004). Taylor was appointed by Republican Governor George Pataki.

10. "The OCC declares in the Federal Register comment that the National Bank Act 'protect[s] national banks from potential state hostility. . . .' When we as Attorneys General enforce the laws on behalf of the residents of our States, we do not undermine banks but rather protect both consumers and business competitors from those that engage in deceptive acts and practices and unfair competition." National Association of Attorneys General, *Forty-Seven Attorneys General and the District of Columbia Corporation Counsel Submits Comments Objecting to the OCC's Reinterpretation of its Visitorial Powers* 2 (Apr. 8, 2003), *available at* http://www.naag.org/issues/pdf/20030408-comments-occ.pdf (last visited Apr. 5, 2004).

11. *See Comm. on Fin. Serv., 108th Cong., Views and Estimates of the Committee on Financial Services on Matters to be Set Forth in the Concurrent Resolution on the Budget for Fiscal Year 2005*, at 15–16 (Comm. Print 2004).

12. The state law savings clause of the Electronic Funds Transfer Act is illustrative of many consumer banking laws (although see discussion *infra* regarding Fair Credit Reporting Act): "This subchapter does not annul, alter, or affect the laws of any State relating to electronic fund transfers, except to the extent that those laws are inconsistent with the provisions of this subchapter, and then only to the extent of the inconsistency. A State law is not inconsistent with this subchapter if the protection such law affords any consumer is greater than the protection afforded by this subchapter." 15 U.S.C. § 1693q (2004).

13. The congressional response to predatory mortgage lending, the 1994 Home Ownership and Equity Protection Act (HOEPA), is non-preemptive. 15 U.S.C. § 1640(e). In 2001, North Carolina was the first state to enact a comprehensive predatory lending law. Others followed, including California, Georgia, Illinois, Massachusetts, New Jersey, New Mexico, New York, and South Carolina. When the secondary market raised concerns about the tough assignee liability provisions in Georgia's and New Jersey's laws, those states acted quickly to modify their laws. For a discussion of predatory lending issues and the states, see *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Joint Hearing Before the House Subcommittees on Financial Institutions and Consumer Credit and Housing and Community Opportunity*, 108th Cong. (2003) (statement of George Brown, Senior Vice President, Self Help, Spokesperson, Coalition for Responsible Lending), *available at* http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=267 (last visited Apr. 5, 2004).

14. See, for example, on ATM surcharges, *Bank of America vs. City and County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), *cert. denied*, 123 S. Ct. 2220 (2003), in which the Ninth Circuit upheld a district court decision invalidating local ATM surcharge bans. See *Wells Fargo Bank of Texas NA v. James*, 321 F.3d 488 (5th Cir. 2003), in which the Fifth Circuit preempted a Texas law requiring banks to cash checks for non-customers at "par value" or without fees. In both of these cases, OCC filed as an *amicus* on the side of the national banks.

15. Unfortunately, as Wilmarth, *supra* note 6, points out:

> I believe that the OCC's recent preemption efforts, including those proposed in OCC Dockets 03-02 and 03-04, far exceed the lawful boundaries of the OCC's authority under federal banking statutes and the U.S. Constitution. However, recent federal court decisions have not required the OCC to observe the limits established by Congress and the Constitution. I therefore encourage state officials

in California and elsewhere to redouble their efforts to persuade Congress that it must pass new legislation to clarify the limits on the OCC's power to preempt state law.

16. The Fair Credit Reporting Act, 15 U.S.C. §§ 1681 *et seq.*, was enacted in 1970. Congress began efforts to address its deficiencies in 1989 and bills similar to the 1996 final law were considered on the House floor as early as 1992. Major amendments were finally enacted in 1996. *See* Consumer Credit Reporting Reform Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009, 3009-426–3009-454; *see also* discussion *infra* of the battle over the 2003 amendments resulting in passage of the Fair and Accurate Credit Transactions Act.

17. Identity Theft and Assumption Deterrence Act of 1998, Pub. L. No. 105-318, 112 Stat. 3007. At least forty-eight states have also criminalized identity theft.

18. *See* Official Transcript, Consumer Identity Fraud Workshop, Federal Trade Commission (Aug. 20, 1996), *available at* http://www.ftc.gov/opp/cf082096.pdf (last visited Apr. 5, 2004).

19. Press Release, Federal Trade Commission, FTC Releases Survey of Identity Theft in U.S. 27.3 Million Victims in Past 5 Years, Billions in Losses for Businesses and Consumers (Sept. 3, 2003), *available at* http://www.ftc.gov/opa/2003/09/idtheft.htm (last visited Apr. 5, 2004). The U.S. General Accounting Office (GAO) has released several reports on identity theft. Its first major report, released in 1998, helped document that identity theft was not an anecdotal problem. *See* U.S. Gen. Accounting Office, No. GAO/GGD-98-100BR, Identity Fraud: Information on Prevalence, Cost, and Internet Impact is Limited (1998), *available at* http://www.gao.gov/archive/1998/gg98100b.pdf (last visited Apr. 5, 2004).

20. *See* Privacy Rights Clearinghouse & Consumers Union, West Coast Regional Office, California Identity Theft Laws, *at* http://www.privacyrights.org/ar/ITLawsCA.htm (providing a compilation of identity theft laws in California) (last visited Apr. 5, 2004).

21. *See* 2000 Cal. Legis. Serv. 978 (West). This session law, authored by State Senator Liz Figueroa, was "An act to amend Sections 1785.10, 1785.15, and 1785.16 of, and to add Sections 1785.15.1, 1785.15.2, and 1785.20.2 to, the Civil Code, relating to consumer credit."

22. Throughout the 1990s, the industry had fought a holding action against disclosing credit scores, aided by flip-flopping by the FTC, which in 1992 had proposed that scores be disclosed as part of reports but then reneged. Industry arguments ranged from the disingenuous, "Credit scores change all the time," to the disgraceful, "Consumers won't understand them." *See Hearing on H.R. 2856 Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Banking and Financial Services*, 106th Cong. (2000) (statements of Edmund Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group and Chris Larsen, Chief Executive Officer, E-Loan, Inc.), *available at*. http://financialservices.house.gov/banking/92100toc.htm (last visited Apr. 5, 2004).

23. *See* Partnership to Protect Consumer Credit, Research/Resources (establishing a link to studies performed by the industry-funded coalition), *at* http://www.protectconsumercredit.org/ (last visited Apr. 6, 2004). *But cf.* Elizabeth Warren, *The Market for Data: The Changing Role of Social Sciences in Shaping the Law*, 2002 Wis. L. Rev. 1 (providing a critical view of industry-funded "academic" studies), *available at* http://ssrn.com/abstract=332162 (last visited Apr. 6, 2004).

24. The GLB privacy notices have been widely belittled by consumers, the media, and even by many of the Washington lawyers who presumably wrote them. A "readability" expert commissioned by the Privacy Rights Clearinghouse found that the notices required a graduate school education to understand. Of course, another problem with the notices is that even if you could understand them, they essentially provide a right without a remedy, since your right to opt out is very limited. Recently, the financial agencies proposed simplifying the notices. *See* Interagency Proposal to Consider Alternative Forms of Privacy Notices Under the Gramm-Leach-Bliley (GLB) Act, 68 Fed. Reg. 75164 (Dec. 30, 2003), *available at* http://www.ftc.gov/os/2003/12/031223anprfinalglbnotices.pdf (last visited Apr. 6, 2004). For a summary of consumer group positions on the proposal, see Privacy Rights Clearinghouse et al., Federal Agencies' Joint Request for Comment: Alternative Forms of Privacy Notices (Mar. 26, 2004), *available at* http://www.privacyrights.org/ar/ftc-noticeANPR.htm (last visited Apr. 6, 2004).

25. 15 U.S.C. § 6807(b).

26. Most other states were unsuccessful in enacting financial privacy laws regarding bank information sharing. By citizen referendum in 2002, however, North Dakota overturned a bank-sponsored 2001 law weakening its "no-sharing" law for certain third-party sharing. *See Financial Privacy and Consumer Protection, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of James M. Kasper, Representative, North Dakota House of Representatives), *available at* http://banking.senate.gov/02_09hrg/091902/kasper.htm (last visited Apr. 6, 2004). Because insurance is still regulated by the states, GLB required states to enact companion regulations. At least thirty-five states have enacted opt-in rules for health information. Vermont and New Mexico have enacted opt-in laws for all information held by insurance companies. For discussion of this and additional rationales against preemption of state affiliate sharing laws, see *Affiliate Sharing Practices and their Relationship with the Fair Credit Reporting Act, Hearing Before the S. Banking Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2003) (statement of Julie Brill, Assistant Attorney General, State of Vermont), *available at* http://banking.senate.gov/_files/brill.pdf (last visited Apr. 6, 2004).

27. For a chronology and timeline of the California and federal efforts, see Privacy Rights Clearinghouse *at* http://www.privacyrights.org/califfinpriv.htm (last visited Apr. 6, 2004).

28. The third-party opt-in was not overturned by the court, only the affiliate sharing provision. San Mateo Supervisor Mike Nevin led this fight and maintains a web page archiving the history of the debate, including links to the District Court of the United States for the Northern District of California decision in *Bank of America vs. Daly City*, 279 F. Supp. 2d 1118 (N.D. Cal. 2003). *See* Supervisor Mike Nevin, County of San Mateo, *Financial Privacy Information Ordinance*, *at* http://www.co.sanmateo.ca.us/smc/department/home/0,,1864_4318241_4513009,00.html (last visited Apr. 6, 2004). "During the long debate by the state legislature over adopting California financial privacy legislation, the Association of Bay Area Governments (ABAG) took the position of strongly supporting efforts by Bay Area local governments to ensure consumer financial privacy." *See* Ass'n of Bay Area Gov'ts Online, *at* http://www.abag.ca.gov/privacy/index.html (last visited Apr. 6, 2004).

29. For a discussion of why consumer advocates believe that the *Daly City* court decision is wrong, see *Affiliate Sharing Practices and their Relationship to the Fair Credit Reporting Act: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2003) (statements of Edmund Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group; Julie Brill, Assistant Attorney General, State of Vermont; and Joel R. Reidenberg, Professor of Law and Director of the Graduate Program, Fordham University), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=46 (last visited Apr. 6, 2004).

30. The Federal Trade Commission deserves credit for helping to convince Congress to enact one *de novo* reform. Section 615 of the FCRA had generally provided that any "adverse action" based on a credit report triggered an "adverse action notice," which described a consumer's rights. One exception to the adverse action notice requirement had been when a consumer accepts a "counter-offer," which is a prevalent outcome with the growing use of risk-based pricing. The exception is based on the FCRA's cross-reference to the Equal Credit Opportunity Act (ECOA). Section 311 of FACTA requires development of a risk-based pricing notice.

31. *See* Identity Theft Prevention Act of 2000, H.R. 4311, 106th Cong. (2000); Identity Theft Prevention Act of 2001, H.R. 3053, 107th Cong. (2001). Both of these bills were introduced by Rep. Darlene Hooley of Oregon. The Hooley bills included the following FACT Act reforms: free credit reports, fraud alerts, address change verification, and credit card number truncation. *See also* Restore Your Identity Act of 2001, S. 1742, 107th Cong. (2001). This bill was introduced by Sen. Maria Cantwell of Washington. Industry supporters allowed this bill to pass the full Senate only when they saw it had no hopes in the House. It gave identity theft victims the following rights included in the FACT Act: the right to obtain business records and to block fraudulent trade lines. It also partially restored a longer statute of limitations for bringing lawsuits against credit bureaus. A stronger version of this provision reversing the Supreme Court's ruling in *TRW, Inc. v. Andrews*, 534 U.S. 19 (2001), was included in the FACT Act Section 156.

32. The author of this article, one of the lead consumer negotiators on the FCRA bill, requested a meeting with the United States Treasury's point man on FCRA, Assistant Secretary Wayne Abernathy, and was referred instead to staff. The Electronic Privacy Information Center (EPIC) has compiled a series of documents based on an FOIA request (examples of which may be found on EPIC's website *at* http://www.epic.org/privacy/preemption/treasfcrafoia.pdf) to the Treasury that EPIC says allege that the department biased its decision-making on preemption and met with many more industry representatives than consumer representatives. *See* Electronic Privacy Information Center, *FOIA Doc's Show Bias Towards Preemption at Treasury* (Jan. 28, 2004), *at* http://www.epic.org/privacy/preemption/ (last visited Apr. 6, 2004). Conversely, consumer groups enjoyed good, regular communication with staff of the FTC, an independent agency.

33. While the National Conference of State Legislatures is against OCC preemption, *see supra* note 4, consumer advocates were disappointed that it supported continued FCRA preemption in a resolution adopted in 2003. "However, NCSL acknowledges the benefit of a uniform national credit reporting system to the nation's economy. Therefore, NCSL does not oppose the reauthorization of the seven limited areas that were subject to federal preemption by the 1996 Amendments of the Fair Credit Reporting Act of 1970 (FCRA)." *See* National Conference of State Legislatures, Financial Information Policy, *available at* http://www.ncsl.org/statefed/Financialsc.htm#FinancialInformationPrivacy (last visited Apr. 6, 2004).

34. For a detailed analysis, see Gail Hillebrand, Consumers Union, *After the FACT Act: What The States Can Still Do To Prevent Identity Theft* (2004), *available at* http://www.consumersunion.org/pdf/FACT-0104.pdf (last visited Apr. 6, 2004).

35. *See* Cong. Rec. H8158 (daily ed. Sept. 10, 2003). The Kanjorski amendment No. 391 to HR 2622 failed 112-310.

36. This section is derived from Alison Cassady, U.S. PIRG Education Fund, The Politics of Preemption: The Role of State and Federal Government in Environmental and Consumer Protection Under the Bush Administration (2003), *available at* http://uspirg.org/reports/politicsofpreemption.pdf (last visited Apr. 6, 2004).

37. *See* Direct Marketing Association, State Do Not Call List Laws—March 2004 (maintaining a website linking to forty state laws as of March 2004), *at* http://www.the-dma.org/government/donotcalllists.shtml (last visited Apr. 6, 2004).

38. *See Working with State Regulators to Increase Insurance Choices for Consumers: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the House Comm. on Financial Services*, 108th Cong. (2004) (statement of J. Robert Hunter, Director of Insurance, Consumer Federation of America), *available at* http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=288 (last visited Apr. 6, 2004).

> "Intransigent" state legislatures would be cut out of the process, because Chairman Oxley has stated that "we can't rely on all 50 state legislatures to adopt exact uniform compliance." State Insurance Commissioners would become mere federal functionaries in preempted areas, acting as tools to carry out federal edicts. Chairman Oxley would take this preemptive approach despite his praise for the states as "laboratories for reform" and as "more responsive to the local marketplace as well as to local consumers."

Id.

39. "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." Louis Brandeis, Other People's Money and How the Bankers Use It 92 (1971). Brandeis, of course, even more famously praised our federal system, since it allowed states to act as laboratories and "try novel social and economic experiments without risk to the rest of the country." *See New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

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Federal Efforts to Curtail State Protection of Consumer Interests[1]

By Eliot Spitzer

When I was in law school in 1984, President Reagan and his ideological counterparts were promoting a new legal jurisprudence that was rooted in a belief that too much power was concentrated in Washington. This new legal theory—commonly referred to as the "New Federalism"—envisioned a fundamental restructuring of the centralized federal power that had defined our government since the days of Franklin Delano Roosevelt. The New Federalism was formulated to support the administration's decision to step aside from many of the critical functions that the federal government had long performed and to allow the states to step in and assume the regulatory role.

Until the 1980s, federal agencies such as the Environmental Protection Agency, the Securities and Exchange Commission and the Federal Trade Commission had the primary role in enforcing laws and regulations designed to protect the environment, investors and consumers. President Reagan argued that too much power was wielded by Washington regulators who did not understand the businesses they were regulating or the problems confronting the citizens they were supposed to protect.

As a law student, I was dubious of the New Federalism. I didn't think that it made sense for the federal government to say to New York: "You enforce the securities laws. You enforce the antitrust laws. You enforce the civil rights laws. We are not going to do it." I believed that regulatory uniformity was important, that in our nationally integrated economy, there should be one set of rules enforced by one centralized authority, not by fifty separate states.

Despite my apprehension, the New Federalism prevailed. President Reagan was elected twice, and was able to appoint judges who shared his views to the Supreme Court and throughout the federal courts. And both Bush presidencies have also promoted the New Federalism, devolving increasing regulatory authority to the states.

The current President Bush was so devoted to the New Federalism that at a meeting with the National Governors Association he announced the creation of an interagency working group on federalism and promised an executive order by the end of August 2001 that would "require the departments and agencies to respect the rights of our states and territories."

But as of today, neither the executive order nor the respect for state's rights has materialized. In fact, the Administration has been singularly aggressive in its attempt to prevent the states from filling the regulatory void left by the federal government's withdrawal from aggressive enforcement. To put it bluntly, the Administration abandons its devotion to the New Federalism as soon as the states step in to enforce the laws that the Administration would prefer remain dormant. When the EPA decided not to pursue Midwest power plants creating acid rain that polluted the Northeast, the states stepped in. The states sued the power plants and won. But the Administration tried to change the rules of the game by having the EPA "reinterpret" regulations and threatening to sit on already filed lawsuits that would have brought even more environmental benefits to the nation as a whole. When the Securities and Exchange Commission was lax in policing Wall Street's violations of the law, we sued and invited federal regulators to join us, but the SEC's first reaction was to try to push us aside and some in Congress repeatedly attempted to foreclose further state action.

"[T]he [Bush] Administration abandons its devotion to the New Federalism as soon as the states step in to enforce the laws that the Administration would prefer remain dormant."

There are other instances of the Administration both neglecting enforcement and attempting to prevent the states from filling the void. Working though the Office of the Comptroller of the Currency, the Administration has actively worked to preempt state efforts to defend citizens who have been victimized by predatory lending and other banking abuses.

Access to credit is one of the most important issues facing consumers today; securing a loan is essential to realizing the "American Dream" of home ownership, and the use of credit to finance everyday living is more common today than ever before. Despite the fact that the median income in many minority neighborhoods is well above that of the national average, financial institutions have little or no presence in many of these communities. African-Americans at all income levels are three times more likely to be denied loans from a conventional bank than their white counterparts. Black and Latino borrowers are six times more likely to rely on sub-prime lending institutions for financing. Many of the major banking corporations disregard laws that require them to offer basic services to residents of low-income neighborhoods. As a result of this limited access to capital, low-income and minority groups are particularly vulnerable to predatory lending.

The states identified the problems caused by predatory lending several years ago, and they took immediate action. In 1999, The New York Office of the Attorney General, Civil Rights Bureau, sued Delta Funding Corporation for engaging in a variety of illegal practices that defrauded mostly minority borrowers.[2] These practices included misrepresenting the terms of loans, making loans without regard to the consumer's ability to repay, paying illegal kickbacks under the guise of yield spread premiums, and violating New York's Civil Rights Law and the Federal Equal Credit Opportunity Act.[3] There are two prime examples of actual consumers victimized by Delta's predatory practices. In one case, a homeowner with a $75,000 mortgage was pressured into replacing that mortgage with a new $90,000 loan. The borrower did not receive any of the new funds—all of the additional $15,000 went to cover fees charged by Delta and its broker. However, as a result of the larger loan amount, the borrower's monthly payments increased more than $200 per month.

In another case, a homeowner with a $90,000 mortgage was pressured into replacing it with a new $115,000 loan. Only $7,000 of the additional $25,000 went to the homeowner, but her monthly payments increased by more than $300 per month. In other words, this consumer wound up paying an extra $300 per month for 30 years in return for a lump-sum payment of just $7,000—an effective interest rate of over 50% annually. Not surprisingly, six months later, this homeowner was in default on her new mortgage.

After the Office of the Attorney General sued, Delta agreed to pay $6 million to consumers and to alter the way it does business. Last year, a multistate group consisting of attorneys general and bank regulators from all fifty states and the District of Columbia entered into an historic settlement with Household International, the parent company of Household Finance Corporation and Beneficial Finance Corporation.[4] The settlement required Household to pay almost $500 million to consumers to resolve allegations that Household duped consumers into refinancing existing debts with high-cost mortgage loans by misrepresenting the loan terms or failing to disclose material information to consumers. The agreement also required Household to change the way it does business, requiring, among other provisions, disclosure to consumers and banning exorbitant fees.

Because predatory lending is such a widespread and serious problem, New York and other states, including North Carolina and Georgia, enacted laws aimed at curbing such practices. What do you think the response of the banks was to these predatory lending laws? If you said: "They recognized that predatory lending is a serious problem, and they agreed to comply with the law and implement practices to ensure that they did not violate it," you would be wrong. If you said: "They ran to Congress and federal regulators to get these predatory lending laws preempted," you are right.

The regulatory agency they ran to was the Office of the Comptroller of the Currency (OCC). The OCC was established in 1863 as a bureau of the U.S. Department of the Treasury. Its primary function is to issue charters to qualified banks and to supervise the banking operations of federally chartered banks to ensure their safety and soundness. To achieve this goal, the OCC has a staff of examiners who review the banks' books and records. Indeed, the National Bank Act gives the OCC exclusive power, known as "visitorial power," to conduct such examinations.[5]

Unlike most federal agencies, the OCC is funded directly by the entities that it oversees. In other words, the banks being examined pay for the examinations conducted by the OCC. In fact, these payments, along with other fees paid by the banks, comprise OCC's entire operating budget. The larger the bank, the larger the fee it pays to the OCC. Not surprisingly, when the banks ran to the OCC for protection from state predatory lending laws, they found a regulator that already was embarked on a mission to preempt nearly all state consumer protection laws and provide immunity from state attorneys general for the banks they regulate.

Although the OCC has exclusive "visitorial powers" over national banks, for 140 years national banks have been subject to the laws of the states in which they operate. During that time, state officials have routinely enforced their consumer protection laws against violations by national banks without interference from the OCC.

The courts have affirmed the states' authority to enforce their laws against national banks, as long as those laws do not substantially interfere with any federal law. Indeed, over 100 years ago, in *National Bank v. Commonwealth*,[6] the United States Supreme Court unequivocally acknowledged that national banks are subject to state regulation:

> [Federal banks] are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. It is only when the State law incapacitates the banks from discharging their duties to the government that it becomes unconstitutional.[7]

More recently, in *Barnett Bank of Marion County, N.A. v. Nelson*,[8] the Supreme Court affirmed the states' role in regulating national banks:

> [I]n defining the pre-emptive scope of statutes and regulations granting a power to national banks, [the Supreme Court's] cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers.[9]

This interpretation is consistent with congressional intent. In 1994, when it enacted the Riegle-Neal Interstate Branching and Bank Efficiency Act,[10] Congress noted that states have a legitimate interest in the conduct of banks operating in their state, regardless of whether the bank is national; states have a strong interest in protecting the rights of their citizens and businesses.[11]

Despite this precedent, in recent years the OCC has promoted a radical, self-serving and legally unsupportable interpretation of its "visitorial powers" and the preemptive effects of the National Bank Act. This began a few years ago in an effort to entice state-chartered banks to seek a federal charter by offering them "protection" from state oversight and enforcement. The interpretation has both the intent and effect of stripping away almost all state-law remedies for consumers who are dealt with unfairly by national banks. The OCC has concluded it has sole jurisdiction over national banks because the National Bank Act preempts nearly all state laws that affect the way a national bank, or its subsidiary, does business.

The OCC's anti-consumer agenda took an even more radical turn in November 2002, when it issued a three-page advisory letter to all its banks.[12] The letter set forth the OCC's self-serving and incorrect interpretation of the extent to which the National Bank Act preempts the application of state laws and limits state enforcement. It also directed the banks to consult immediately with the OCC if state officials contacted them or sought any information as part of a law enforcement investigation.[13]

During the past year, the OCC issued two proposed regulations intended to codify its new interpretation of the National Bank Act.[14] The effect of these proposals would be to exempt national banks from nearly all state consumer protection laws and to prevent state officials from enforcing state laws against national banks.

The OCC's proposed regulations brought an immediate and bipartisan public outcry. All fifty state attorneys general and all fifty state banking superintendents submitted comments in opposition to the proposed rules. Numerous consumer groups also voiced their strong opposition, as did the American Association of Retired Persons. The comments pointed out that the OCC's new interpretation of the National Bank Act was inconsistent with existing law and bad public policy.

Members of Congress also voiced their opposition to the OCC's proposed rules. New York Congresswoman Sue Kelly, a Republican who chairs the House Financial Services Subcommittee on oversight and investigations, was deeply troubled by the OCC's intention to promulgate rules that would nullify state consumer lending laws and take away the states' right to examine and take enforcement action against national banks and their subsidiaries.[15] Congresswoman Kelly therefore asked that the OCC hold off finalizing its proposed rules until her committee had an opportunity to hold hearings on the issue.[16]

To be clear, those of us who oppose the OCC proposals recognize that the OCC has primary regulatory authority over national banks. We also recognize that state laws that substantially interfere with federal law are preempted. What we object to, and what we are challenging in court, is the OCC's attempt to take these unremarkable and uncontested propositions and twist them in an improper and unsupportable attempt to usurp a state's ability to enforce its own laws. Not surprisingly, the banking industry supported the proposed rules. In January 2004, the OCC finalized and adopted the rules and specifically targeted predatory lending laws for preemption.[17] In fact, even before it finalized its general preemption regulations, the OCC declared that national banks and their operating subsidiaries did not have to comply with Georgia's predatory lending law.[18]

The OCC argues that preemption is necessary because it is difficult for banks to understand and comply with a patchwork of differing state laws and regulations. However, this argument in support of uniformity has been around for a long time, and has not led to the "field preemption" of banking law. In fact, in 1994, when Congress passed the Riegle-Neal Interstate Branching and Bank Efficiency Act in direct response to the need for greater uniformity and flexibility, it would not expand preemption to the extent now sought by the OCC.

What does all this mean for the real-world consumer? If these rules are allowed to stand, state legislatures and officials will be powerless to protect their citizens from even the most egregious conduct engaged in by a federally charted bank or its subsidiary. It would mean that states are powerless to protect their citizens from predatory lending engaged in by national banks or their subsidiaries – practices that cause substantial injury to some of the states' most vulnerable citizens, including low-income, elderly and minority homeowners.

The OCC contends that national banks are not currently engaging in predatory lending. However, even the OCC acknowledges that national banks have engaged in such practices. Frankly, it's difficult to understand the banks' opposition to state predatory lending laws, as even those laws merely prohibit a practice that never occurs. Moreover, by promoting the federal charter as a means of evading state laws and enforcement, the OCC is promoting a "race to the bottom" that inevitably will attract those who wish to engage in the type of lending which leads to predatory practices.

If left standing, the OCC's rules will also prevent state officials from protecting their citizens in the most routine banking matters. Let me give you the most recent example of a case where my office and the OCC were at odds. And while the bank's conduct sounds like it could only exist in a law school hypothetical, I give you my word that this is all true.

A few weeks ago the Albany Office of the Attorney General was contacted by a local attorney who was unable to resolve a dispute her client had with his mortgage bank. In 1974, her client had taken out a 25-year mortgage for $27,000 from a local state bank. Her client had arranged for the bank to receive monthly payments through automatic deductions from his checking account. Over the years, the loan was sold a number of times and eventually acquired by a subsidiary of a national bank. Although the final payment due on the mortgage loan was made in October 1999, the consumer did not realize that the loan had been paid off, and the bank continued to take monthly payments from his account for almost four years before the consumer eventually had the payments stopped. By that time, the consumer had been overcharged more than $9,000. Despite these overpayments, the bank notified the consumer that due to an error attributable to the original lender, his monthly payments had been $16 too low. The bank therefore advised the consumer that it had unilaterally extending the maturity date by 11 years—to 2010, requiring him to pay an additional $25,000.

The consumer's attorney contacted the Office of the Attorney General after she had made several efforts to resolve this matter with the bank and the bank responded by demanding additional payments and threatening to take away the consumer's home. After receiving evidence of the bank's illegal actions, the Office of the Attorney General sent a letter requesting that it discharge its mortgage lien on the consumer's home and refund the payments it had taken since the mortgage was paid off in October 1999. The bank ignored our letter, and a follow-up phone call was made to the bank's general counsel. The general counsel responded by leaving a voice mail message saying that the bank did not have to deal with the attorney general's office because the OCC had sole regulatory authority. The Office of the Attorney General responded by filing a lawsuit to restrain the bank from foreclosing on the consumer's home. After the lawsuit was filed, and presumably as a result of the embarrassment it caused the bank and the OCC, the mortgage lien was discharged and the overpayments were refunded. However, the Office of the Attorney General is still pursuing this case to impose penalties on the bank for its egregious conduct and to obtain a ruling that the bank is not exempt from state laws. The OCC has not yet announced whether it will intervene to try and stop the action.

This incident is representative of many others that rebut the OCC's contention that it is capable of protecting consumers without assistance from the states. Consumers need more protection, not less; we should have more cops on the beat, not fewer. There are several congressional committees that are reviewing the OCC's new regulations, and I am hopeful that they will take action and repeal them.

Absent legislative action, the outcome of the state's dispute with the OCC will turn on legal interpretations. That is as it must be, and I am confident that the law is on the states' side. We have the right—indeed, the obligation—and the responsibility to enforce violations of state consumer laws against national banks doing business within our jurisdiction.

But we must not permit that legal debate to obscure what is really happening around us. We must not lose sight of the fact that the OCC's actions are consistent with this Administration's attempt to simultaneously withdraw from enforcing laws that protect average citizens and yet, to claim that it has the sole authority to enforce those laws.

The use of economic power to victimize people, and sometimes entire communities, particularly communities of color, is a form of discrimination that has yet to be fully addressed. Economic discrimination represents a challenging frontier in the civil rights landscape. Some of this conduct may be technically legal—in which case we must advocate for more stringent laws. But much of it is already illegal, and we must be more, not less, vigilant in enforcing these laws.

I invite the federal government to join the Office of the Attorney General's efforts to protect New Yorkers from predatory lenders. But we will not be passive if the Administration chooses not to enforce these laws, as it has chosen not to enforce so many laws that protect consumers against special interests. And we will not permit the Administration to argue that the states are prohibited from enforcing consumer protection laws that Washington has chosen to abandon.

Logically speaking, New Federalists should be in favor of state enforcement of consumer protection laws such as the predatory lending statutes. Unfortunately, as I've discussed today, the New Federalists are not true federalists. When confronted with a choice between special interests on one side and state protection of consumer interests on the other side, the Administration chooses special interests every time.

Despite the longest period of economic prosperity in history, economic injustice still thrives. Law enforcement isn't the remedy for all of the inequalities that we see in housing, employment and education. But it is an important part of the solution, offering vital civil rights protection to some of society's most vulnerable citizens. People who are poor, elderly or minorities should not be victimized by predatory banking practices that leave them homeless and hopeless.

I believe that standing up for people in this sort of situation should be one of the federal government's primary roles. Right now, they are not assuming their role, and that is too bad. But if the federal government won't take action, we at the state level will.

Endnotes

1. This article is adapted from a speech delivered at Georgetown University, Feb. 24, 2003.
2. Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer Announces Landmark, $6 Million Settlement with Long Island Mortgage Company (June 29, 1999), *available at* http://www.oag.state.ny.us/press/1999/jun/jun23a_99.html.
3. *Id.*
4. Press Release, State of New York Banking Department, Governor Pataki, Attorney General Spitzer Announces $484 Million Agreement with Household International, Inc. (Oct. 11, 2002), *available at* http://www.banking.state.ny.us/ra021011.htm.
5. 12 U.S.C. § 21 *et seq.* (2003).
6. 76 U.S. 353, 362 (1869).
7. *Id.* at 362.
8. 517 U.S. 25 (1996).
9. *Id.* at 33.
10. Pub. L. 103-328, 108 Stat. 2338 (Sept. 29, 1994).
11. *Id.*
12. OCC Advisory Letter, Questions Concerning Applicability and Enforcement of State Laws (Nov. 25, 2002), *available at* http://www.occ.treas.gov/ftp/advisory/2002-9.txt.
13. *Id*. (stating that "[n]ational banks should contact the OCC if they are contacted by a state official seeking information from the bank that may constitute an attempt to exercise visitation or enforcement power over the bank").
14. *See* 69 Fed. Reg. 1895 (Jan 13, 2004) (describing two proposed changes to section 7.4000 which would ensure OCC's control over national bank activities).
15. *See id.* for a discussion of the impact of OCC's rules.
16. Press Release, Congresswoman Sue Kelly, New York's 19th District, Chairwoman Kelly Holds Hearing on OCC Preemption Rules, *available at* http://suekelly.house.gov/News.asp?ARTICLE3316=3661&PG3316=2.
17. *Id*. (reporting that Kelly urged OCC to delay finalizing the preemption rules until Congress could hold hearings to review the agency's proposal).
18. Press Release, Office of New York State Attorney General Eliot Spitzer, New York Officials, CAACP Call On The OCC to Reverse Its Position on Federal Preemption of State Predatory Lending Laws; Officials Vowed to Pursue Legal Action (Dec. 10, 2003), *available at* http://www.oag.state.ny.us/press/2003/dec/dec10a_03.html.

Eliot Spitzer is the Attorney General of New York State. His entire office was presented with the Award for Excellence in Public Service last year by the Committee on Attorneys in Public Service.

Antitrust Compliance in a Federal/State Environment

By Deborah Platt Majoras

During my recent tenure as Principal Deputy Assistant Attorney General in the Department of Justice Antitrust Division (DOJ), I gave a presentation to a group of in-house lawyers regarding the globalization of vigorous antitrust enforcement. Much to my dismay, at the conclusion of my remarks, one general counsel remarked that he had thought that antitrust enforcement was virtually dead, and that his firm had been focused on compliance with the new Sarbanes-Oxley legislation and related corporate fraud issues, apparently to the exclusion of antitrust compliance. Needless to say, I reminded him of the perils of ignoring antitrust enforcement, including record-breaking fines and prison sentences for executives. Indeed, in just the United States alone, a firm may encounter multiple enforcers, including two or more federal agencies,[1] fifty-six states or territories, and an almost infinite number of private attorneys general.

The multiplicity of enforcers has prompted significant debate among the private bar, the business community, and the enforcers themselves: Does our multi-layered system for enforcing the antitrust laws strike the appropriate balance between deterring, terminating, and punishing anticompetitive conduct and avoiding chilling aggressive competitive behavior that benefits U.S. consumers? Within the context of the broader debate, the balance and the tension between federal and state enforcement of the antitrust laws, particularly in light of an increasingly global economy, is often highlighted. Some argue that states should stay out of matters of national or global concern, while others argue that states make a strong contribution to all antitrust enforcement, even on a national or global basis. Not surprisingly, where one sits affects where one stands on the issue, as private practitioners and former federal officials often publicly adopt the former view, and former state officials generally support the latter.

Regardless of where one falls on the spectrum of debate, the fact remains that our system today includes aggressive antitrust enforcement by both federal and state enforcers. After all, those who lobby for enforcement action may not so limit themselves. While most firms and their lawyers today are well aware of the enforcement mandates of the DOJ and the FTC, they should also be aware that Congress has explicitly provided a role for the states in federal antitrust enforcement, albeit a different role than that afforded to the federal agencies. Under the federal antitrust laws, states are treated as private litigants rather than sovereign enforcers.[2] As a result, states must make a sufficient showing of injury before securing injunctive relief. This distinction, however, may have little practical impact for firms. Significantly, the United States Supreme Court has stated that the states may pursue remedies outside of any being sought by the federal government.[3] Further, most states have their own antitrust laws—generally modeled after federal law—that they enforce in their sovereign capacity, and those laws are not preempted even if they impose liability beyond what federal law provides.[4]

"Within the context of the broader debate, the balance and the tension between federal and state enforcement of the antitrust laws, particularly in light of an increasingly global economy, is often highlighted."

Without question, the federal-state enforcement dichotomy creates serious challenges for firms endeavoring to keep their business conduct within lawful boundaries. Having multiple enforcers of the same laws may create the sort of uncertainty that makes business planning difficult. Fortunately, recognizing that pure duplication of effort may waste scarce resources and the potential for enforcement divergence may create uncertainty that chills lawful conduct, government enforcers have cooperated with one another in an effort to avoid these negative consequences. The state attorneys general coordinate multistate antitrust actions through the National Association of Attorneys General (NAAG) Multistate Task Force.[5] Both the DOJ and the FTC work together with NAAG on multiple matters.[6] Perhaps contrary to popular belief—instances of divergence get more ink—these coordination efforts have largely succeeded in minimizing inconsistent enforcement efforts. However, no firm should presume complete harmony when it evaluates the enforcement landscape because there have been differences in enforcement approach.

Perhaps no case highlights this point better than the *Microsoft* case. Federal enforcers and one group of states had distinct differences in their enforcement approach on how to remedy Microsoft's unlawful actions compared to another group of states. Although this divergence is rare, it is noteworthy in this instance given the significance of the case and the harmonious course it had previously followed. This case also provided the opportunity to air out the legal aspects of federal-state enforcement. Given the strong passions reflected on all sides of the issue, this exercise was probably healthy.

Since their filing in 1998, the courts had treated the United States' and the states' respective suits against Microsoft as virtually indistinguishable.[7] Accordingly, the cases had been consolidated for all purposes, tried together, decided together, appealed together, and remanded together.[8] After the Court of Appeals sustained only portions of one claim against Microsoft and remanded the cases, the District Court ordered all parties to engage in settlement negotiations "seven days a week and around the clock" for five weeks, and ultimately appointed a professional mediator to assist.[9] Following the Court's order, representatives from the DOJ and primarily from the states of New York, Ohio, and Wisconsin negotiated intensely with Microsoft for more than a month.

At the end of the five weeks, on November 2, 2001, the United States and nine states, including New York, Ohio, and Wisconsin, had agreed to a settlement with Microsoft.[10] After taking a few days to consider it, nine other states and the District of Columbia declined to join. Thus, notwithstanding intense cooperative efforts, the enforcers split ten-to-ten. The DOJ and nine states proceeded with the settlement, while the other states proceeded to remedies litigation.

Microsoft, however, argued that the states could not lawfully proceed. In a motion to dismiss the non-settling states' demand for additional equitable relief, Microsoft claimed that as a matter of constitutional and antitrust law, the states had no role in remedying nationwide conduct in a case that the federal government had litigated and settled.[11] According to Microsoft, to establish *parens patriae* standing under federal antitrust law, the states must have been seeking to remedy some state-specific injury, rather than just seeking to substitute their judgment for that of the United States. Not surprisingly, the states, even including those that had settled, disagreed vehemently with Microsoft's position, arguing—with some variation in multiple briefs—that state antitrust enforcement is the work of independent sovereigns standing on an equal footing with the United States.[12] In their collective view, the fact that the case involved conduct of importance to the nation as a whole and as to which the United States had settled was irrelevant under the law.

At the District Court's request the United States filed an *amicus* brief, agreeing with the states that dismissal was not required as a matter of law, without entirely supporting the states' reasoning.[13] In the brief, the DOJ made the point that the United States is the sole enforcer of the federal antitrust laws on behalf of the American public. While states have the authority to seek injunctive relief under federal law, they do so as private parties, not as sovereign law enforcers. The effective difference is that the United States may seek and secure injunctions to restrain violations without a showing of injury, while the states, like other private parties, must demonstrate a requisite injury to its citizens—a distinction that Congress expressly created and preserved. While reminding the Court of the states' standing requirement, the DOJ nonetheless disagreed with Microsoft's legal position that a state cannot have standing to remedy injury to its citizens if the same injury was also felt in other states.

The United States did not, however, believe that its settlement was irrelevant to the Court's exercise of its equitable discretion in considering the non-settling states' remedial proposals. In its brief, the DOJ took the position that the Court should take into account the United States' enforcement judgment in entering into its settlement and, if approved, how that would bear on the non-settling states' requisite threatened loss or damage; whether a small group of states were the parties best situated to obtain relief of such broad reach and implication; and whether the states were using their *parens patriae* authority improperly to act on behalf of the private interests of certain firms, an allegation that Microsoft had lodged.

The District Court denied Microsoft's motion to dismiss, largely on the basis that the Court of Appeals had explicitly or implicitly confirmed the states' standing.[14] At the same time, the Court stated that the United States' policy arguments might inform the Court in devising a remedy for the states.[15] In the end, the settlement not only informed the Court's equitable discretion, but it greatly shaped it. Not only did the Court find that the settlement reached by the United States and nine states was in the public interest, after a remedies trial, it went on to adopt the settlement decree with some minor changes, as the remedy for the remaining states.[16] In rejecting the non-settling states' remedial proposals, the Court found that they had shown "little respect for the parameters of liability that were so precisely delineated by the appellate court" and had presented "little, if any" legitimate legal or economic justification for their proposed remedies.[17]

This was not the end. The state of Massachusetts appealed the Court's remedy decision. Together with an appeal by two trade organizations of the DOJ's settlement, the case was argued to the United States Court of Appeals for the District of Columbia Circuit on November 4, 2003, and a decision is expected any day.

In almost all respects, *Microsoft* is an extraordinary case. However, there are other examples of respective states adopting different courses, or of the federal government and one or more state attorneys general diverging in antitrust enforcement approach. For example, on

June 18, 2003, less than two weeks after Oracle Corporation announced its hostile takeover bid for PeopleSoft, the state of Connecticut unilaterally filed a complaint seeking to block the takeover.[18] Eventually, the United States and seven other states also filed a complaint, but they did not file until February 26, 2004, following an eight-month investigation.[19] As a result, Oracle is simultaneously defending separate antitrust lawsuits in San Francisco and Connecticut courts.

In another recent merger matter, the DOJ entered into a settlement with Alcan Inc. in connection with its bid for Pechiney S.A.[20] Under the terms of the consent decree, to preserve competition in the market for brazing sheet, Alcan is obligated to divest Pechiney's plant in Ravenswood, West Virginia. However, the state of West Virginia does not want Alcan to divest the plant in its state because it is concerned that new owners will not operate it sufficiently, causing it to fail and eliminate jobs. The state has therefore moved to intervene in the DOJ's Tunney Act proceeding so that it can oppose the DOJ's settlement.

Furthermore, enforcers do not always agree on matters of policy. In a recent Section 2 case decided by the Supreme Court,[21] the United States, through an *amicus* brief signed by both the DOJ and the FTC, was ultimately successful in urging the Supreme Court to dismiss the case against Verizon Communications. Some states, led by Virginia, also filed a brief urging dismissal. Several others, however, led by New York, filed a joint *amicus* brief in support of the Law Offices of Curtis Trinko.

As previously stated, divergence is not the norm, as antitrust enforcers regularly cooperate in investigations that generally produce common or complementary results. Nonetheless, the potential for differences in enforcement approach is strong enough that firms cannot ignore it. When evaluating the potential for antitrust attention, firms' legal counsel should consider the possibility that a state or states, in addition to a federal agency, might be interested in investigating the merger or conduct. Relevant factors to assess may include whether a particular state has been recently active in antitrust enforcement (e.g., New York); whether a state or states have been particularly interested in the relevant industry (e.g., pharmaceuticals); whether the matter involves products of strong interest to consumers in the state (e.g., the DirecTv/Echostar merger); whether the matter involves assets and/or jobs in the state (e.g., the Alcan/Pechiney transaction); and whether complaining parties are found in a particular state (e.g., Microsoft's competitors in California).

Endnotes

1. The DOJ and the Federal Trade Commission (FTC) share federal enforcement of the U.S. antitrust laws. In addition, several federal agencies also consider competition issues—for example, the Federal Communications Commission—in the sectors that they regulate.
2. 15 U.S.C. § 26.
3. *See California v. Am. Stores Co.*, 495 U.S. 271 (1990).
4. *California v. ARC Am. Corp.*, 490 U.S. 93, 105 (1989).
5. *See generally* http://www.naag.org/issues/issue-antitrust.php (last visited Apr. 5, 2004).
6. Protocol For Coordination In Merger Investigations Between The Federal Enforcement Agencies And State Attorneys General, *available at* http://www.usdoj.gov/atr/public/guidelines/1773.htm (last visited Apr. 5, 2004).
7. *United States v. Microsoft Corp.*, Civil Action No. 98-1232 (D.D.C. filed May 18, 1998); *State of New York, et al. v. Microsoft Corp.*, Civil Action No. 98-1233 (D.D.C. filed May 18, 1998).
8. *See United States v. Microsoft Corp.*, 84 F. Supp. 2d 9 (D.D.C. 1999); *United States v. Microsoft Corp.*, 87 F. Supp. 2d 30 (D.D.C. 2000); *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).
9. Order, *United States v. Microsoft Corp.*, Civil Action No. 98-1232, 2001 U.S. Dist. LEXIS 24272 at *8–9 (D.D.C. Sept. 28, 2001).
10. *United States v. Microsoft Corp.*, Civil Action No. 98-1232, 2002 U.S. Dist. LEXIS 22861 (D.D.C. Nov. 12, 2002).
11. Motion for Dismissal of the Non-Settling States' Demand for Equitable Relief (and Memorandum in Support), *New York v. Microsoft Corp.* (filed Feb. 26, 2002).
12. Plaintiff Litigating States' Response to Microsoft's "Motion for Dismissal of the Non-Settling States" Demand for Equitable Relief, *New York v. Microsoft Corp.*, at 12–15 (filed Mar. 15, 2002); Memorandum of Plaintiff State of New York as Amicus Curiae in Opposition to the Motion of Defendant Microsoft Corporation for Dismissal of the Litigating States' Demand for Equitable Relief, *New York v. Microsoft Corp.*, at 9–14 (filed Mar. 15, 2002); Memorandum of 24 States as Amicus Curiae in Support of the Commonwealth of Massachusetts, the District of Columbia, and the States of California, Connecticut, Iowa, Florida, Kansas, Minnesota, Utah, and West Virginia, *New York v. Microsoft Corp.*, at 8–11 (filed Mar. 15, 2002).
13. Order, *New York, v. Microsoft Corp.* (Mar. 25, 2002). Memorandum Amicus Curiae of the United States of America Regarding Microsoft Corporation's Motion for Dismissal of the Non-Settling States' Demand for Equitable Relief, *New York. v. Microsoft Corp.* (filed Apr. 15, 2002).
14. *New York. v. Microsoft Corp.*, 209 F. Supp. 2d 132 (D.D.C. 2002).
15. *Id*. at 155 n.28.
16. *New York v. Microsoft Corp.*, 224 F. Supp. 2d 76 (D.D.C. 2002).
17. *Id.* at 192.
18. *Connecticut v. Oracle Corp.*, C.A. No. 1:03-1072 (D. Conn., June 18, 2003).
19. *United States v. Oracle Corp.*, Case No. C 04 0807 (N.D. Cal., filed Feb. 26, 2004). Along with New York, the other states are Texas, Hawaii, Maryland, Massachusetts, Minnesota, and North Dakota.
20. *United States v. Alcan Inc.*, Case No. 1:030CV02012 (D.D.C. proposed final judgment, filed Sept. 29, 2003).
21. *Verizon Comm. Inc., v. Curtis Trinko, LLP*, 2004 WL 51011 (Jan. 13, 2004).

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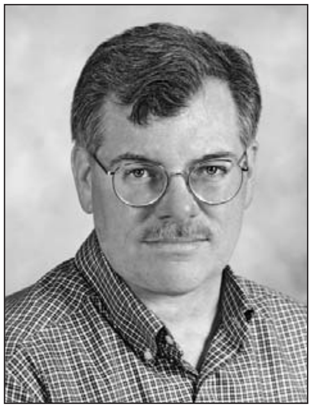
Corporate Standards and Financial Regulations: State or Federal Function?

By J. Stephen Casscles



For the past three years, large-scale accounting, corporate governance and insider-trading scandals have come to the attention of investors and the general public. These scandals highlight the systemic deficiencies that exist in the regulation of this nation's stock exchanges, corporate boardrooms, and financial services industry. These scandals also suggest that the federal government, the primary regulator of these critical economic entities, was not the most diligent regulator. The federal government should have known that large numbers of conflict of interest-laden activities were driving illicit profits to investment banks, accounting firms, and corporate officers. These illicit profits were often squeezed from small investors and state and local government employee pension plans.

This article explores the reciprocal relationship that exists between federal and state regulators who supervise the activities that occur in our corporate boardrooms, stock exchanges, and in the financial services industry. Further, it will suggest a state/federal regulatory balance that would properly and cost-effectively supervise corporate governance and securities trading activities.

By the laws it enacts, the New York State legislature has vested the Governor, Attorney General, and State Comptroller with many regulatory powers and responsibilities. These responsibilities include protecting our citizens from scam securities schemes, acts of corporate malfeasance, and misrepresentations made to defraud New Yorkers of their rightfully earned savings and retirement plan assets.

Federal Legacy: Large-Scale Corporate Scandals

The Securities and Exchange Commission (SEC) together with the U.S. Treasury Department are the primary regulators of this nation's stock exchanges and financial service industry. It is the federal government's statutory responsibility to ensure that accurate corporate financial disclosure statements are prepared and made available to the public so that investors can make informed decisions regarding stocks and securities purchases. The federal government also has supervisory power over auditors, attorneys, and other financial analysts responsible for preparing financial disclosure statements. The SEC's regulatory charge is to protect all investors from fraudulent, insider-trading, or other conflict of interest activities which can hinder the optimal operation of a free marketplace. The SEC is responsible for placing both small and large investors on a level playing field and ensuring the proper function of a fair securities market.

Unfortunately, due to the SEC's inability to properly regulate the market over the past five years, the amount of money lost by both small and institutional investors has been staggering. For example, due to corporate board-directed accounting shenanigans, 11,000 Enron employees needlessly lost nearly $600 million in their retirement plans in less than one year. WorldCom's accountants had hidden anywhere from $7 to $11 billion in expenses in order to show higher profits. WorldCom's stock imploded in value from $16 per share to 83 cents per share within one year. The total loss to investors not privy to insider information was approximately $45 billion. The New York State Public Employees Retirement Fund alone lost hundreds of millions of dollars due to the decline of WorldCom stock.

Washington's inability to properly regulate corporate activities in a timely manner is also evidenced by the long list of other corporations that have been accused of utilizing improper accounting practices, insider trading, or other fraudulent acts. The list includes some of America's largest corporations: Rite Aid, Adelphia, ImClone, Xerox, WorldCom, Tyco, Dynergy, Cendant, W.R. Grace, Sunbeam, Lucent, and Oxford Health Plans.

Certain accounting firms helped to push Enron and WorldCom off the financial cliff. Accounting firms, such as Arthur Andersen, are supervised by the SEC and by their own professional board, the Financial Accounting Standards Board, which is based in Washington. Their now well-documented conflicts of interest led them to turn a blind eye to the activities occurring at Enron, WorldCom, and other corporate giants.

The duty of an accounting firm is to accurately evaluate a public corporation's business assets and liabilities, and to render an objective opinion of the accuracy and propriety of the accounting methods used in the financial statements prepared by the audited company's own in-house accountants. However, some accounting firms received consulting fees from clients that were four times the amount of money they were paid for their auditing services. Some accounting firms helped corporations to develop suspect business plans. These plans fraudulently put their client's books in the best light possible in an attempt to attract new investors or retain old ones.

On Wall Street, many prominent investment and brokerage houses may have also engaged in conflict of interest activities. It seems that these firms allowed their stock analysts to benefit financially for publicly praising certain risky securities. Further, these brokerage firms allowed their analysts to inappropriately promote stocks of companies whose investment banking business the firm was trying to secure. The litany of fraudulent acts committed by Wall Street during the roaring 1990s begs the question: What was Washington doing to protect the public interest?

Did the federal government know the scope of the fraudulent activities that were occurring on Wall Street and in corporate boardrooms? If so, was it incapable of acting? Or, was it a blind regulator that was not aware of questionable practices? Either way, the federal government should be much more vigilant in supervising the operation of the stock exchanges, the activities that occur in corporate board rooms, and in the financial services industry as a whole.

States Proceed, Washington Follows

The magnitude of the corporate fraud and financial scandals was exposed, not because of diligent federal regulatory oversight, but rather because corporations began to implode from their own financial mismanagement. Only after giant bankruptcies began to pile up did the federal government, under public pressure, begin to act. Another impetus to federal action was quick and effective action taken by the states. New York, California, North Carolina and other states acted to protect their own investors' interests.

Congress enacted the Sarbanes-Oxley Act[1] in part to end some of the more egregious conflict of interest relationships that existed between accountants and corporate officers. It created, under the umbrella of the SEC, a new Public Accounting Oversight Board to oversee public auditors. Unfortunately, there now seems to be some concern that this new board may be overly sympathetic to the concerns of the accounting and financial services industry and not concerned enough about the interests of the investing public.

Over the past three years, states such as New York have filled, to the extent that they could, the regulatory void left by the federal government. For example, in the spring of 2002 the New York State Attorney General settled a lawsuit with Merrill Lynch for violation of New York's Martin Act.[2] This broad state law bars fraud in the sale or offering of securities. Over forty other states have similar "blue sky" laws on the books. These laws give states a useful tool to help protect their citizens from the fraudulent sale of securities.

In the Merrill Lynch settlement, the firm agreed to pay $100 million in penalties to New York, other states, and the North American Securities Administrators Association (NASAA), an umbrella organization for state securities regulators. The settlement also provided that analysts' pay must be separated from the firm's investment banking business, established a new committee to oversee the objectivity of stock picks recommended for sale to investors, and decreed that a system would be created to monitor e-mail between investment bankers and stock analysts.

To follow up the Merrill Lynch settlement, in December 2002 New York, along with 49 other states and the SEC, entered into another settlement with other major Wall Street firms. This group of financial services firms included Goldman Sachs, Morgan Stanley, Citigroup's Salomon Smith Barney, Lehman Brothers, and Bear Stearns. New York and the other states' enforcement agencies uncovered similar fraudulent activities, more violations of the Martin Act and violations of the "blue sky" laws of other states. In the settlement, these Wall Street firms agreed to pay substantial fines, finance independent research for investors, and establish a nationwide investor education program.

In its continuing effort to protect investors, the state of New York, under state law, sued telecommunications corporate officers for allegedly taking millions in profits from initial public offerings (IPO) of stocks without disclosing potential conflicts of interest. Top telecommunications firms such as Qwest Communications International, WorldCom, Metromedia Fiber Network, and McLeod USA have been accused of steering business to Salomon Smith Barney in exchange for officers receiving access to bargain-basement-priced IPO shares. Once the IPO shares increased in value from either staged or hyped-up trading or other market forces, the shares were sold by these officers for millions of dollars in profits.

Another example of non-federal action can be found in a joint statement issued in 2002 by the New York State Comptroller and the Treasurers from the states of California and North Carolina. The managers of these three state retirement funds have clout on Wall Street because they oversee assets worth more than $400 billion and are viewed as leaders by the managers of other state employee pension funds. The joint statement requires all external money managers hired by these three state employee pension funds to independently scrutinize the accounting practices and governance structures of a company prior to purchasing its stock. In addition, money managers will not only be required to minimize and disclose their conflicts of interest, but they will also be required to make trades through brokerage firms that comply with the standards laid out in the Merrill Lynch settlement. Firms that do not adhere to the standards will be prohibited from managing state pension funds.

Appropriate Level of Government

Federalism

Our country has a large geographical size, a diverse population, and a multifaceted economy. Federalism, as embodied in the United States Constitution, uniquely satisfies the economic, political and social needs of America. Unfortunately, to some, "states' rights" and the tenet that states retain certain powers to help protect its citizens has a negative connotation. One reason for this, and justifiably so, is that the defenders of slavery and segregation based their justification for such abhorrent policies on "states' rights" arguments. On the other hand, at the turn of the last century, to protect its citizens' general economic and social welfare, progressive states also cited "states' rights" as their legal and moral authority to curb abusive practices being exercised by entrenched corporate giants. As one example, after the Civil War, the U.S. government, particularly the federal courts, paved the way for big-business trusts. However, after numerous scandals were uncovered in the late 19th Century by journalists, muckrakers, and some good government groups, it was the states that initiated regulations to protect the citizenry from the excesses of corporate greed and control of the economy.

Embodied in the principle of federalism is the enduring tension between those who favor central control and power from Washington and those who favor more state and local control to provide for their own well-being. The dual claims and reciprocal roles of the federal and state governments have contributed to this tension. The specifics of each economic, political and social battle has forced politicians and historians to reassess the nature and benefit to the public of each shift in the balance of power between the federal and state governments. In the end, this tension helps promote the enactment of public policies that appropriately balance these two just claims and should be left unresolved.

State Role

The states have filled a regulatory void that was left by Washington, and have pointed the federal government in the right direction to correct its deficient regulatory practices. Wall Street should not, however, be regulated primarily by the states because a single set of prudent and uniform accounting and corporate governance standards should control all corporate disclosure statements and transactions.

Having one set of uniform accounting standards promulgated by one nationwide regulator is essential so all investors can accurately compare the books of different companies by the same standard. In fact, the National Association of Insurance Commissioners (NAIC) and the International Accounting Standards Board (IASB) are now drafting a new set of accounting rules that could be applicable to all national and international insurers.

The world is getting smaller and more interconnected. Therefore, advocating that the states, individually, should develop and enforce potentially widely differing accounting and corporate governance standards would be harmful for investors and for the integrity of our financial and monetary system. It is encouraging that the SEC, the New York Stock Exchange (NYSE), and the National Association of Securities Dealers (NASD) are now working with the state of New York and the North American Securities Administrators Association (NASAA) in a coordinated fashion to properly regulate this nation's stock exchanges and financial services industry.

With all that said, it is still very important to retain a vibrant state-based regulatory apparatus to monitor corporate governance issues, securities trading activities and the provision of financial services. The recent state regulatory actions taken to curb abuses in our nation's stock exchanges and in corporate boardrooms vividly demonstrate the strengths of our existing federalist system. There was one dominant regulator, based in Washington, which was either unwilling or unable to properly regulate the stock exchanges and the financial services industry. Luckily, the states possessed limited ancillary powers to regulate these markets, and when Washington failed to act to protect its citizens, the states stepped in to correct the many abuses that were occurring. Installing more than one regulator, while duplicative, may provide some advantages to the public. Having more than one level of government looking over the shoulders of corporate boardrooms, stock transactions, and the financial services industry in a coordinated manner can help to ensure that investors are better protected from fraudulent activities.

While the financial services industry and national stock exchanges may not like it, having multiple regulatory authorities review financial transactions in a coordinated manner can enhance protections provided to the general public and the investment community. The presence of more than one regulator can minimize the risk of failure and total potential losses from inept regulation. In contrast, placing one federal regulator in control of all regulatory and supervisory functions, and removing the state's ancillary regulatory powers, may only increase the risk of failure and the size of potential financial losses.

In stating the benefits provided by a multiple regulatory agency review conducted in a coordinated manner, it is important to note that any successful regulatory system must also minimize administrative costs to the regulated industry. For the benefit of the consumer, minimizing the administrative costs of transactions so the rate of return on investment will be maximized is essential.

State/Federal Regulatory Mix

The current regulatory mix of governmental agencies monitoring the financial services industry is appropriately balanced. For financial services, it is appropriate to have a dominant Washington-based regulator with limited ancillary powers being possessed by state governments to be exercised only when needed to protect its citizens.

As we saw with the savings and loan crisis in the mid-1980s as well as the current financial scandals, our federalist tradition demonstrates that there is an inherent danger in designating a single national regulator to police all economic activities. If the sole federal regulator makes a mistake, misinterprets or misses an important industry trend, then there is no safety net to protect the public from such agency's failings. It is only after scores of billions of dollars in investor-owned assets have been lost or stolen and insolvencies ensue in several major corporations or in an entire segment of our economy that action is taken. Empowering only one regulatory agency for a diverse and massive industry, such as financial services, overly concentrates the regulatory supervisory decision-making processes and heightens the risks posed to consumers and financial institutions.

There is a movement in the U.S. Congress to curtail the states' authority to possess even ancillary powers to regulate the financial services industry or to retain effective powers to supervise activities that occur in our nation's corporate boardrooms. State legislators and other elected state officials should consider stressing to members of Congress the importance of maintaining the current regulatory status quo. However, state legislators and other state regulators should also convey to Congress that they understand that, to be effective, these regulatory powers need to consist of a uniform set of standards that are enforced in a coordinated manner. Regulated parties can then clearly predict what is expected of them as they operate in different parts of the country and the world.

Once a uniform set of standards has been established by a nationwide regulator, with input provided by the states, the states should be less inclined to promulgate standards that deviate from those established standards. However, state regulators should remain vigilant in enforcing established uniform standards of conduct to protect their own citizens from corporate malfeasance or misrepresentation.

There is another area of regulation with which the states should be concerned. The states should, in a coordinated fashion, ensure that smaller corporations that operate within their borders and which are not publicly traded also abide by a relatively uniform set of prudent accounting and corporate governance standards. While many smaller corporations are not publicly traded and hence are not subject to SEC or Treasury Department regulatory guidelines and disclosure requirements, the states have an obligation to promulgate adequate rules to regulate corporate governance and accounting practices and ensure these corporations follow them.

The states, in a coordinated fashion and in consultation with local state professional associations, should develop a comprehensive set of standards to govern the operation of these small corporations throughout the nation. These standards may need to be altered slightly in different parts of the country to accommodate local practices and history. However, uniformity in regulation should assist state regulators in supervising the operation of smaller private business enterprises within their borders. Further, it should help states to compare notes with other state regulators on how best to enforce these standards since their regulatory standards would be similar.

Conclusion

As past history clearly demonstrates, the large geographic area, demographic size, and economic diversity of this country require retention of the current mix of state and federal regulators. This mix simultaneously promotes uniformity in standards while leaving room for variation based on the local needs of each state. State legislators may wish to convey this message to Congress so the federal government does not impose a one size-fits-all regulatory scheme on all of the states.

Endnotes

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).
2. N.Y. Gen. Bus. Law §§ 352–53 (Consol. 1921).

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Adelphia Communications: Were It a New York Company, Might It Still Be in Business?

By Mark L. Gardner

In the midst of all the current hullabaloo and hand-wringing by the media about the many corporate scandals currently erupting across America, one giant scandal has largely escaped the public's unblinking eye. Paradoxically, this corporate scandal may be the biggest, and possibly most interesting of them all. Yes, even bigger than Enron, WorldCom and the foreign newcomer to the group, Parmalat. The name of the company? Adelphia Communications. Its business? Cable television. Its sin? Besides a breathtaking drop in share price, to "co-borrow" money with its founders, the Rigas family.

> *"[T]he number and size of the 'co-borrowings,' the composition of the Board of Directors that approved them and the purposes for which the funds were used all should have alarmed federal regulators. But that didn't happen."*

This "co-borrowing" consisted of the company and several individuals together borrowing enormous sums of money from banks. A "co-borrowing" is essentially a joint loan taken out by the corporation and individuals. This "co-borrowing" may sound vaguely similar, like the loans made to Dennis Kozlowski at Tyco. It is similar insofar as a person received large amounts of cash to which he may not have been entitled. But the "co-borrowed" amounts that certain members of the Rigas family are alleged to have taken for their own purposes are astounding—$2.3 billion.[1]

However, it is not merely the "co-borrowing" concept and the sheer magnitude of the dollars involved that sets Adelphia apart from its scandal-ridden brethren. There are several peculiar differences that distinguish the Adelphia scandal from the other corporate scandals of the new millennium. For instance, the primary purpose to which the "co-borrowed" funds was applied by Rigas family members—buying shares of Adelphia stock—did not appear on the surface to be outrageous. Unlike most major corporations, Adelphia's corporate headquarters were not located in a major metropolitan U.S. city. Unlike the random collection of individuals that managed the other scandal-ridden companies, Adelphia was founded and managed by the members of a tightly knit family.

As a former insurance regulator, I was intrigued by another difference. It is interesting that Adelphia Communications collapsed as a result of one seemingly simple trick—the "co-borrowings"—that was replayed over and over again. One would think that a regulatory body would have discovered this unusual financial shenanigan. I wondered if the same collapse would have ensued if the directors or officers of an insurance company had engaged in the same type of self-dealing. Perhaps if Adelphia Communications were an insurance company, a state insurance department would have discovered the "co-borrowings" earlier, and saved the company.

To me, the number and size of the "co-borrowings," the composition of the Board of Directors that approved them and the purposes for which the funds were used all should have alarmed federal regulators. But that didn't happen. Setting aside the question of whether the SEC should have detected the latter activities earlier, perhaps if the primary regulator overseeing Adelphia was an insurance department and had a different set of statutory and regulatory tools at its disposal, the final outcome of Adelphia Communications' self-dealing problems would have ended differently.

Had Adelphia been a property/casualty insurer domiciled in New York State, would it have ultimately survived its own misfeasance? This article will analyze whether the "co-borrowings" made for the benefit of Adelphia's owners, and the manner in which they were executed, would have been barred under New York's insurance laws and regulations, and subject to the supervision of the New York State Insurance Department (NYSID). Specifically, this article will focus upon four actions taken by Adelphia's management in connection with the "co-borrowings," correlate those actions to New York's statutory and regulatory insurance provisions and probe whether these four actions would have been barred or blocked by such provisions.

To answer the question of whether Adelphia would have survived under New York's insurance regulatory system, let us first review the demise of Adelphia Communications. In doing so, you will not only see the particular corporate transactions that contributed to the collapse of the company, but also witness the self-destruction of a proud American family against the backdrop of financial scandal.

The Rise and Fall of Adelphia Communications

Adelphia Communications was, more than anything else, a family-run company. Unlike the giant, ruddy-faced corporations founded by well-educated scions and headquartered in major American cities, Adelphia was founded by the son of Greek immigrants and based in Coudersport, Pennsylvania. The population of Coudersport is 2,600, and the nearest major city is Buffalo, New York. The founder of Adelphia, John Rigas, moved there when he was 28 years old. At nearly 80 years of age, John Rigas stills lives there, and has become somewhat of a local legend to the residents of the small town.[2]

As this article is being written, John Rigas is on trial in U.S. District Court in Manhattan, probably wishing that he was still in Coudersport. The SEC has filed criminal and civil complaints against him, several of his sons and other corporate officers. In its civil complaint, the SEC characterized the Adelphia story as "one of the most extensive financial frauds ever to take place at a public company."[3] That is certainly a bold statement by the SEC, and particularly so when made in the aftermath of the collapse of Enron and the like. With his company bankrupt, and two of his three sons also named in the federal government's criminal indictment, John Rigas must rue the day that the first "co-borrowing" was structured.

That day was back in 1996. The first "co-borrowing loan," like the others to follow, was essentially a loan from which either select members of the Rigas family, or Adelphia itself, could draw money. The first loan was for $200 million, it was approved by the Board of Directors, and the loan agreement specifically said that the Rigases could borrow money to buy stock.[4] And they did.

While the Rigases drew money from the loan, Adelphia was rapidly growing. In 1999, the company was providing service to over 5 million cable subscribers. It moved up to sixth place in the listing of the top ten largest cable TV systems in the U.S. Adelphia was moving into new states, and growing in size at a rapid rate.

However, as it grew, so did the company's debt. By 1999, Adelphia's total debt had grown to $9.7 billion, and the debt-to-cash-flow ratio was almost nine to one. In the cable TV industry, a normal ratio was five or six to one. But perhaps this esoteric financial analysis ratio may have been overlooked by analysts and investors as a result of Adelphia's rising stock price. The price of a share of the company's stock more than doubled in 1998, and then doubled again in 1999. In May of 1999, the price of a share stood at $86.[5]

As the company prospered, more "co-borrowings" were authorized by the Board of Directors. The amounts were truly astronomical. In the years 1999, 2000 and 2001, a consortium of banks loaned $5.6 billion to Adelphia. However, since the money was "co-borrowed," the money was also effectively loaned to some in the Rigas family. Beginning in 1998, the Rigas family eventually purchased $1.8 billion in shares of Adelphia stock and other securities.[6] Some said that the stock was purchased for purposes of retaining control of the company. Whatever the reason for purchasing, the "co-borrowings" were the source of the money.

By the end of 2001, the Rigas family had borrowed $2.3 billion under the "co-borrowings."[7] However, the funds co-borrowed by the Rigases were never disclosed to the public in Adelphia's financial statements. The SEC's Civil Complaint overflows with allegations of instances in which money supposedly borrowed by the Rigases from Adelphia was omitted from financial statements. Because the overall co-borrowed amounts were so enormous, perhaps the smaller amounts taken by the Rigases escaped the attention of the public and federal regulators.

To a financial analyst, a stockbroker or an impartial observer, these enormous loans should have generated intense interest, if not suspicion. However, the "co-borrowings" may not have generated any suspicion because they were approved by the Board of Directors. Maybe they would have generated suspicion if someone had examined the composition of the Board of Directors. The majority of the Board was comprised of Rigas family members.[8] Of the outside directors, some were close friends or cronies of the Rigas family. In addition, the Audit Committee of the Board was, at certain crucial junctures, comprised of just two people. One of John Rigas' sons, Tim, and one of John Rigas' friends were the sole members of the Audit Committee.[9] When the Audit Committee and the Board of Directors approved the "co-borrowings," it may not have been a textbook example of model corporate governance practices.

The composition of the Board may also explain why it failed to examine the purposes for which the "co-borrowed" funds were being used by the Rigas family. Not only was the family buying up a burgeoning number of shares, but it was also using the funds for a surprising set of reasons. Large amounts of cash were disbursed by the family for purposes completely unrelated to Adelphia's business. For example, approximately $150 million was lent to the Buffalo Sabres, a professional hockey team owned by John Rigas. Forty-five million dollars was loaned to John Rigas for private business purposes. Three million dollars was allocated to a film that was produced by John Rigas' daughter. Interestingly, when the price of Adelphia stock began to plummet, the Rigas family appropriated $170 million more to pay off margin calls on their vast holdings of Adelphia stock. Clearly one could conclude, as did the SEC and the Justice Department, that a lot of the money was being used for personal purposes.

The Four Actions that Contributed to the Collapse of Adelphia

The foregoing limited history of certain financial transactions and related corporate decisions made by Adelphia between the late 1990s and its bankruptcy in June 2002 reveals four distinct actions that, if discovered, should have been troublesome to regulators. These actions ultimately caused great harm to Adelphia's stockholders when they became publicized and Adelphia's per share stock price plummeted:

1. Billions of dollars were jointly "co-borrowed," on numerous occasions, by Adelphia and the family that founded Adelphia;
2. Significant amounts of the "co-borrowings" were spent by the Rigas family on purposes both personal in nature and completely unrelated to the interests of Adelphia;
3. The "co-borrowings" were approved by the Board of Directors;
4. The Board of Directors was structured to hold a majority of Rigas family members.

Would Adelphia Have Survived as a Property/Casualty Insurer Domiciled in New York?

The central question of this article is whether the collapse, and ultimate bankruptcy, of Adelphia could have been averted had these four actions been quickly identified, investigated and acted upon by insurance regulators. Specifically, would Adelphia, had it been a property/casualty insurer domiciled in New York State, survive its own misfeasance due to regulatory intervention by the NYSID under New York's insurance regulatory system?

For purposes of this analysis, let us cast Adelphia Communications as a top-twenty property/casualty insurer that has been in business for seventy-five years. Adelphia P&C, as it will be called, is a company that is publicly traded on the New York Stock Exchange. It is not a household name, like Allstate or State Farm, but it is also not an obscure, upstate New York mutual insurance company. It primarily writes commercial coverages, like commercial general liability, property and excess casualty policies, but also has niche writings in the directors-and-officers liability product line. Annual gross written premiums written during the late 1990s increased from $1.2 billion to $1.4 billion in 2000.

Like most other major property/casualty insurers, Adelphia P&C is part of a holding company system. Its parent, Adelphia Holdings, is also domiciled in New York State. Both companies maintain corporate headquarters in Buffalo. Adelphia P&C maintains a thirteen-member board of directors, and the board meets regularly. Adelphia Holdings' board of directors consists of the same thirteen members who are on Adelphia P&C's board.

Adelphia P&C has been profitable for years, and is not on any regulatory entity's "radar screen" due to questions about its financial health. Its net income has risen every year during the period of 1998-2002. (The latter is the same period on which the SEC focused its attention when it became aware of the improprieties at Adelphia). Policyholder surplus is more than adequate, as evidenced by the company writing at a conservative premium-to-surplus ratio of one-to-one.

Two Ancillary Questions: Timing of Discovery and Regulatory Powers

The central question of this article hinges on two other questions. First, would any of the four actions have been timely *discovered* under New York's insurance regulatory system, or would the discovery have been made as late as that made by federal regulators? Second, if any of these four actions had been timely discovered under New York's insurance regulatory system, are there adequate regulatory mechanisms under that system to address the action(s) and preserve Adelphia?

Clearly, if none of the four actions had been discovered in a timely fashion by the NYSID, the second ancillary question is moot. Without early discovery, and accompanying early intervention by the NYSID, the existence of adequate regulatory mechanisms becomes meaningless. Accordingly, absent early discovery of any of the four actions, it is highly unlikely that there would be any difference in Adelphia's fate.

Would Any of the Four Actions Have Been Timely Discovered Under New York's Insurance Regulatory System, or Would the Discovery Thereof Be as Late as that Made by Federal Regulators?

Of the four actions taken by Adelphia's management, perhaps the one most likely to be discovered was the "co-borrowings." The reason for this is that they occurred over a period of years, they were for extraordinary amounts of money and they demonstrated a glaring abuse of corporate governance process. Thus, the answer to the discovery question may hinge on whether the most egregious of the four actions—the "co-borrowings" by Adelphia and the Rigas family—would have been discovered by the NYSID. If the "co-borrowings" were brought to the attention of the NYSID by employees of Adelphia P&C, or by another entity, the other three actions would undoubtedly have been quickly identified by the NYSID as supplemental to the "co-borrowings."

In the New York Insurance Law, there are three sets of "special regulatory tools" that empower the NYSID to closely scrutinize the practices and financial health of property/casualty insurers. For example, insurers must file detailed financial statements on a quarterly and annual basis with the NYSID.[10] This filing requirement enables the NYSID to frequently study the financial condition of an insurer.

In addition to requiring detailed financial reports, the NYSID is also authorized by statute to conduct financial examinations and market conduct examinations of insurers.[11] These examinations give the NYSID ample opportunity to ferret out anomalies and abnormalities in, respectively, an insurer's financial condition and an insurer's pricing practices.

The third set of "special regulatory tools" relates to an insurer's relationship with its parent and its affiliates. The NYSID requires members of an insurance holding company system to report certain changes in the relationships between the entities within the system.[12] Those changes, including a change in who controls the insurer(s), must be reported to the NYSID within certain time frames. This rigorous reporting requirement provides the NYSID with another opportunity to detect problematic activities.

There is yet another fertile area that gives the NYSID opportunities to learn of, probe and investigate questionable activities. In the insurance industry, as in most other commercial markets, there is intense competition and jockeying for market share. Often this competition results in failed deals, resentment and ill will between insurers. This competition sometimes results in the same antagonism and negativity on the parts of employees, vendors and insurance producers. Not infrequently, this negativity results in a disgruntled entity notifying the NYSID of an unlawful action taken by an insurer.

In my opinion, the three sets of "special regulatory tools" at the disposition of the NYSID, coupled with the competitive environment that gives rise to often malicious disclosure of a competitor's actions, may well have led to a discovery of the "co-borrowings" by the NYSID. For purposes of this article, let us assume that six months after the first major "co-borrowing" was made by Adelphia P&C in 1996 for $200 million, the CEO of a rival insurer quietly notified the NYSID of this transaction.

If Any of the Four Actions Were Discovered Under New York's Insurance Regulatory System, Are There Provisions to Adequately Regulate Such Actions?

The following analysis addresses the above question by identifying each respective action, referencing the most applicable statutory and regulatory provisions in New York's insurance laws and regulations and indicating whether each respective action would have been barred under such provisions.

The purpose of this analysis is to determine whether provisions exist under New York State's insurance code and regulations to block Adelphia P&C's senior management from taking these four actions. These laws and regulations shall collectively be referred to as New York's Insurance Laws (NYIL). Accordingly, completely excluded from this analysis are all federal statutes and rules, including but not limited to the Sarbanes-Oxley Act, all federal securities laws and regulations and all federal case law. Also excluded from this analysis are all "non-insurance" state statutes and regulations, including but not limited to New York's Business Corporation Law, all New York securities laws and regulations, and all New York case law. This analysis is strictly and exclusively limited to New York's statutory and regulatory provisions that govern the regulation of insurance.

1. Billions of Dollars Were Jointly "Co-Borrowed," on Numerous Occasions, by Adelphia P&C and the Rigas Family

In the NYIL, there are at least three provisions that would apply to the joint borrowing of funds by an insurer and individuals. However, it is important to note at the outset that, generally speaking, insurers themselves normally do not directly borrow money. With the exception of "surplus notes," which are essentially loans made to increase an insurer's total cash on hand to pay claims, insurance companies rarely borrow money directly. The reason for this, according to some financial experts, is that banks are reluctant to loan large amounts of money to insurers due to their unpredictable earnings. Generally speaking, it is the insurer's parent, or holding company, that will borrow from a bank, based on the underlying strength of the insurer.

Nevertheless, if an insurer were to directly borrow money, and Adelphia P&C were to have engaged in a "co-borrowing," then that transaction is governed by a section of NYIL.[13] Under Section 1307, a loan to an insurer shall be "repaid only out of free and divisible surplus *of such insurer* with the approval of the superintendent whenever, in his judgment, the financial condition of such insurer warrants."[14] Under this section, if funds were "co-borrowed" by an insurer and natural persons, an individual could not repay the funds. Hence, the joint liability structure of the "co-borrowing" would be invalid.

More importantly, the section also states that an insurer can consummate no loan, "unless such agreement is in writing and shall have been approved by the Superintendent as not unfair, misleading or contrary to law."[15] If Adelphia P&C behaved like Adelphia Communications with respect to corporate governance, it is unlikely that Adelphia P&C would have filed the loan with the Superintendent for approval. When discovered by regulators, the loan would have been adjudged "unfair" to Adelphia P&C because the members of the Rigas family could take essentially as much of the "co-borrowed" money as they wanted. Under Section 1307, it is clear that the first and all subsequent "co-borrowings" would not be permitted.

Section 1505 also applies to the "co-borrowings." This section provides for the regulation of transactions by insurers within a holding company system. Specifically, Section 1505 requires that, "transactions within a holding company system to which a controlled insurer is a party . . . be fair and equitable."[16] If it were established that the loan taken out by Adelphia P&C was a transaction within a holding company system because the proceeds of the loan were immediately funneled or ultimately dividended to Adelphia Holdings (or vice versa), then it would be difficult for Adelphia to claim that the loan was a "fair and equitable" transaction. The reason for this is that huge sums of money never reached Adelphia Holdings, because they were diverted by the directors and officers of Adelphia P&C to themselves.

Section 1505 also requires that "payments received shall be allocated to the insurer on an equitable basis. . . ." [17] This requirement was clearly breached by the loan payments never fully reaching Adelphia P&C on numerous occasions. Finally, Section 1505 requires "[t]he books, accounts and records of each party to all transactions [to] be [] maintained . . . clearly and accurately. . . ."[18] This subsection was undoubtedly violated when, as pointed out explicitly in the SEC's complaint, "[u]nder GAAP, Adelphia should have included on its consolidated balance sheet *all* of the amounts outstanding under the Co-Borrowing Credit Facilities."[19]

Section 1506 is also applicable. This section describes how, when certain circumstances arise that will adversely affect an insurer, the overall article is violated. For example, when a corporate parent (Adelphia Holdings) or any of its *officers or directors* has demonstrated untrustworthiness, there may be a violation of this article. Since the directors of Adelphia Holdings are the same as those on the Board of Directors of Adelphia P&C, a finding of "untrustworthiness" could probably be established for the individuals on the Adelphia Holdings Board. This "untrustworthiness" would, of course, be the taking of the funds that were co-borrowed with little or no hope of repayment possible.

However, for a violation of the article to be established, the section requires the Superintendent to conduct a hearing.[20] If the Superintendent determines from the hearing that "untrustworthiness" did result from the transaction, he may issue an order to direct the violators to "take appropriate action to cure such violation."[21] If the Superintendent did find untrustworthiness on the part of the directors, then the Superintendent would probably issue an order compelling Adelphia P&C to modify or rescind the first "co-borrowing," and prohibiting it from borrowing additional funds under a joint arrangement.

In view of the foregoing, the above-described action would be prohibited under the NYIL, and the NYSID had the enforcement tools to ensure that the law would be followed.

2. Significant Amounts of the "Co-Borrowings" Were Spent by the Rigas Family on Purposes Both Personal in Nature and Completely Unrelated to the Interests of Adelphia

According to the SEC's complaint, on numerous occasions members of the Rigas family spent substantial parts of the "co-borrowings" on personal expenditures. As previously noted in this article, funds were spent on a professional hockey team, production of a film and payment of margin calls. But there was more.

In February 2000, the Rigases orchestrated the purchase of timber rights on Pennsylvania land for over $26 million.[22] This purchase was made with co-borrowed funds. At about the same time, the Rigases applied approximately $12.8 million of co-borrowed funds to build a golf club and golf course on property owned, directly or indirectly, by the Rigases.[23]

Clearly tens of millions of dollars of co-borrowed funds were used for personal purposes. It would be difficult, if not impossible, for the Rigases to argue that these expenditures would have benefited Adelphia P&C in any meaningful fashion. Perhaps as a result of that obstacle, the Rigases have offered the defense that they merely borrowed the funds in question from Adelphia. This argument has been made even though the SEC has alleged that the Rigases deliberately concealed the diversion of co-borrowed funds.[24] Regardless, let us assume for purposes of this article that the family would offer this same defense for Adelphia P&C.

As you may recall, all of the members of the Rigas family under investigation were either directors, officers, or both, of Adelphia Communications. Accordingly, they now are all directors and officers of Adelphia P&C. If the Rigases asserted the defense that they were merely borrowing money from Adelphia P&C, their respective duties and fiduciary responsibilities under applicable director and officer laws would immediately come into question. However, as noted previously, such statutes and corresponding case laws are excluded from this analysis.

Nevertheless, under NYIL, the Rigases' defense fails immediately. In fact, one of the worst arguments that they could make would be to say that they were borrowing the money from Adelphia P&C. The reason for this is that Section 1411 applies directly to the Rigases' defense. It strictly prohibits an insurer from making any loan, either directly or through a subsidiary, to a director or officer.[25] Since the Rigases are directors and officers of Adelphia P&C, they would be prohibited from receiving the proceeds of a loan made to them by Adelphia P&C, and hence from using the funds for any purpose, much less for a personal purpose. Section 1411 also prohibits the making of an "advance" to a director or officer for future services to be performed beyond one year after the making of the advance.[26] These two provisions would seem to present formidable obstacles to the Rigases' claim that they borrowed the moneys from Adelphia P&C.

Section 1411 is one of the many sections in Article 14 that restrict *investments* that can be made by insurance companies doing business in New York. Another section, 1407, imposes another restriction on investments that can be made by insurers. When Adelphia P&C supposedly loaned money to the members of the Rigas family, the company effectively made an investment. Since an investment had been made by an insurer, Section 1407(c) would apply to the transaction. This section states that an insurer's investments are subject to "the other requirements of law (statutory and otherwise) that affect the standards of care of directors and officers of corporations."[27] Additionally, Section 1407 requires that "the insurer's directors and officers shall perform their duties in good faith and with that degree of care that an ordinarily prudent individual in a like position would use under similar circumstances."[28] It would be difficult for Adelphia P&C to defend the loan as a permissible investment when the standards of care applicable to directors and officers would likely forbid self-dealing and the making of such a loan.

Finally, a section previously cited in this article is applicable to the personal use of the co-borrowed funds. Section 1506(C)(1), relating to the untrustworthiness of directors and officers, was likely violated by the directors and officers spending the co-borrowed funds on personal expenditures. The application of this section would be triggered again if the directors (or officers) of the parent company, Adelphia Holdings, are alleged to have been untrustworthy due to the use of corporate funds for personal purposes. Although this section only applies to the directors of the parent company, since the directors on Adelphia Holdings' Board are the same individuals on the Board of Adelphia P&C, the result is the same.

In view of the foregoing, the "co-borrowings" spent by the Rigases on purposes both personal and unrelated to the interests of Adelphia would be prohibited under the NYIL.

3. The "Co-Borrowings" Were Approved by the Board of Directors

The above-described action is clearly one that would be covered by New York's Business Corporation Law (BCL), and relevant case law. The question of whether the approval of the "co-borrowings" by the Board constituted a breach of fiduciary duty, or a violation of the Business Judgment Rule, would be decided by applying the principles found in the BCL and its corresponding case law. Interestingly, a section in the NYIL applicable to *life* insurers reinforces the applicability of the BCL to Boards of Directors of insurance companies. Section 1202 states that a director of a life insurer shall perform his duties as a director in accordance with section 717 of the BCL.[29]

In addition, there is another section in the NYIL that essentially states that all other New York laws apply to insurance companies, unless specifically superseded by the NYIL.[30] This section effectively brings in the applicable sections of the BCL and other chapters that apply to this situation. For example, BCL section 714 specifically addresses the question of whether a loan to a director may be approved by a Board, and this section would apply to the decision made by the Board of Adelphia P&C.

Ironically, there is one provision of the NYIL that ultimately applies to the approval of the co-borrowings by the Board of Adelphia P&C. After the co-borrowings were discovered and investigated, Section 1216 would probably apply to Adelphia P&C. Specifically, if shareholder lawsuits were brought against Adelphia P&C and its directors, or if Adelphia P&C itself brought actions against its directors, and thereafter the directors sought indemnification under the BCL, then Section 1216 would apply. In short, Adelphia P&C would not be able to pay indemnification to the directors or officers unless a notice was first filed with the Superintendent, thirty days in advance, that specified "the payees, the amounts, the manner in which such payment is authorized, and the nature and status . . . of the litigation or threatened litigation."[31]

In view of the absence of applicable NYIL provisions, the above-described action would not be directly regulated or prohibited by the NYIL.

4. The Board of Directors Was Structured to Hold a Majority of Rigas Family Members

As with the approval of the "co-borrowings" by the Board of Directors, this action is clearly one that would be covered by the BCL and relevant case law. The question of whether the stacking of the Board constituted a breach of fiduciary duty by management would be answered by examining the BCL and its corresponding case law.

If Adelphia P&C were a domestic *life* insurer, then a provision of the NYIL would apply. Under Section 1202, not less than one-third of the Board of Directors must be persons who are not officers or employees of the company.[32] However, there is no corresponding requirement for a property/casualty insurer.

In view of the absence of applicable NYIL provisions, the above-described action would not be directly regulated or prohibited by the NYIL.

Conclusion

In conclusion, Adelphia P&C might have survived if it had been operating as an insurer and regulated as such under New York law. There are adequate regulatory mechanisms in the NYIL that could have been invoked by the NYSID for the protection of Adelphia P&C and its policyholders. Assuming, *arguendo*, that the NYSID timely discovered one of the early "co-borrowings," and that the NYISD had acted quickly, regulatory action probably could have been taken to prevent future "co-borrowings." Assuming further that preemptive regulatory action by the NYSID could have prevented additional "co-borrowings," and led to a change in Adelphia's management, Adelphia might have escaped one of the more remarkable examples of management misfeasance in American history.

Endnotes

1. Roger Lowenstein, *The Company They Kept*, N.Y. Times, Feb. 1, 2004, sec. 6, at 27.
2. *Id*. at 28.
3. Complaint, *Securities and Exchange Commission v. Adelphia Communications Corp*., 02 Civ. 5776 (KW) (S.D.N.Y.), ¶ 1 (hereinafter "SEC Complaint").
4. Lowenstein, *supra* note 1.
5. *Id*. at 31.
6. *Id*. at 32.
7. *Id*.
8. *Id* at 31.
9. *Id*. at 32.
10. N.Y. Ins. Law § 307 (Consol. 2004).
11. *Id*. § 307.
12. *Id*. § 1505.
13. *Id*. § 1307.
14. *Id*. § 1307(b) (emphasis added).
15. *Id*. § 1307(d).
16. *Id*. § 1505(a)(1).
17. *Id*. § 1505(a)(3).
18. *Id*. § 1505(b).
19. SEC Complaint, ¶ 31 (emphasis added).
20. N.Y. Ins. Law § 1506(c)(2) (Consol. 2004).
21. *Id*.
22. SEC Complaint, ¶ 114(b) at 28.
23. *Id*. at ¶114(c) at 28.
24. *Id*. at ¶¶ 1–2.
25. N.Y. Ins. Law § 1411(f)(1) (Consol. 2004).
26. *Id*. § 1411(f)(2).
27. *Id*. § 1407(c).
28. *Id*.
29. *Id*. § 1202(c).
30. *Id*. § 301.
31. *Id*. § 1216.
32. *Id*. § 1202(b)(1).

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Sentencing Guidelines: An Incentive for Organizational Ethics[1]

By Stuart C. Gilman

It is quite true that where a person stands on any given issue depends on where he or she sits. The role of the Ethics Resource Center (ERC) in today's society has evolved, and its current role in shaping the values of modern business ethics affords it a unique perspective to evaluate Federal Sentencing Guidelines for Organizations.

The ERC is one of the oldest nonprofits in the United States addressing the issue of ethics. Founded in 1922 as American Viewpoint, what is now the Ethics Resource Center began as an educational corporation. The ERC was dedicated to helping immigrants become productive members of American society by teaching them about the values of our country.[2] In the 1970s, with the upswing of concern for the ethical practices of business organizations, the Center's focus shifted to organizational ethics in business, government and non-profit entities.[3]

As the Center's role changed, the first U.S. Code of Ethics for Government Service was drafted, published and distributed by the ERC in 1980.[4] In 1985, the ERC provided consulting services to General Dynamics and formation of the first comprehensive organizational ethics office in the United States resulted. The same year, advice to the President's Blue Ribbon Commission on Defense Management led to the formation of the Defense Industry Initiative (DII). The ERC served that body as its first independent reporting agency.[5] Much of what the ERC helped create in concert with General Dynamics and in the DII was instrumental in formulating the model of "an effective program to prevent and detect violations" as later defined in U.S. Federal Sentencing Guidelines for Organizations (FSGO).[6]

Since then, the ERC has engaged in extensive applied research through its advisory services to organizations, analytical research through such efforts as our National Business Ethics Surveys and projects undertaken by our Fellows Program. The ERC has examined many issues of concern to today's businesses, including the role of leadership in the implementation of ethics programs, the sources of pressure to commit misconduct faced by employees, and the impact of an ethics program on the creation of an organizational culture.

This article will address and consider the ERC's position on three issues concerning proposed changes to Chapter Eight of the FSGO, specifically:

- Role of the leader in establishing and maintaining an ethical culture within an organization—including the positioning of the ethics office and ethics officer;
- Role of the Board of Directors in providing oversight and establishment of an ethical culture; and
- Creation of an ethical culture within an organization, and the extent to which the culture of an organization can be regulated by the FSGO.

"An executive can comply with Sarbanes-Oxley and attest to his or her organization's integrity only to the extent that he or she has set the tone for organizational integrity at the top."

The Leader's Role Within an Organization

Much of the recent conversation regarding organizational leadership has centered on business scandals and the most appropriate way to avoid similar scandals in the future. Such a response is most evident in the Sarbanes-Oxley Act of 2002.[7] This legislation requires executive leadership to attest to the integrity of their organizations' financial reporting and overall operations. Consequently, there is a presumption of an effective system of monitoring and oversight of business conduct of the organization (as prescribed in Chapter Eight of the FSGO's reference to effective programs to prevent and detect violations).[8] Attesting to fiscal integrity is only possible if monitoring and oversight are integrated into the systems and practices at all levels of the organization—including formal systems, informal operating norms and the culture as understood by all employees.

This requires leadership. An executive can comply with Sarbanes-Oxley and attest to his or her organization's integrity only to the extent that he or she has set the tone for organizational integrity at the top.

One of the most important ways this can be accomplished by a leader is by serving as a role model. A leader's behavior has the ability to shape employees' perceptions of what constitutes acceptable ethical behavior, as well as employees' personal views of the leader. In other words, leadership translates from the "top down"; the conduct of the superiors influences the actions of the subordinates.

If ethical behavior is to be integrated throughout an entire organization, no matter the size, those who are seen as leaders must proactively encourage ethical behavior and facilitate (legitimize) ethical dialogue. When they do, their actions help shape and maintain an ethical culture.

Recent research from the ERC Fellows Program[9] supports the notion that being perceived as an ethical role model requires more than simply being an ethical person. Leaders must make visible the ethical challenges they face and the ethical standards they apply to any given situation. To illustrate, consider downsizing. Most CEOs freely describe the ethical challenges of downsizing in private conversations. Off the record, most executives will openly discuss the struggles, the dilemmas and the ethical reasoning that led to their decisions. But these same leaders, when making public statements about downsizing, never mention ethics. Their decisions are often supported with statements about operating efficiencies, streamlining, increased productivity and cost controls—messages designed to impress stock analysts. Employees and other stakeholders naturally assume that these CEOs never considered the ethics of their choices. Ethical leaders can fail in the role of being an ethical role model—simply by failing to make the ethical issues explicit.[10]

This brings us to the question of who is a leader in an organization. While it is clear that high-level personnel such as the CEO, CFO, members of the Audit Committee of the Board, and other highly visible personnel are key leaders within an organization, it may be less intuitively apparent how much the behavior of employees down the "chain of command" affects the ethical culture, because they, too, are leaders. The key is not the "title" of the executive, but the role of the individual. Leaders must be understood in terms of their impact on other individuals—senior leadership must be understood in terms of their impact on supervisors, who in turn impact employees. According to an Office of Government Ethics survey conducted in 2000:

> [S]upervisory attention to ethics has strong relationships with program outcomes. Simply put, when employees believe that their direct supervisors are genuinely concerned with maintaining an ethical environment and supporting ethical performance, their positive perceptions of the organizational culture and other employees' behavior also increases. Second, an unanticipated finding of the study is that supervisors . . . tend to have a more positive perception of cultural factors and outcomes than do non-supervisors.[11]

Thus, while leadership changes culture, an employee's immediate supervisor most directly impacts individual employee behavior.

ERC Fellows Program research[12] provides supporting evidence that an immediate supervisor and peers exercise the most influence over perceptions of the standards for ethical business conduct in organizations. While lower-level employees might not be recognized as "formal" leaders in the organizational hierarchy, it is clear that people at all levels of organizations can serve as "opinion leaders."

Despite widespread leadership within an organization, the CEO is the leader with the most impact over the entire culture of the organization. It cannot be safely concluded that any one individual can effectively discern the needs of the entire organization when it comes to setting ethical standards, and thus, there is reason to be concerned about the observed reality that ethics office staffs and ethics officers themselves seem to be "migrating" further down into the organizational hierarchy. In short, ethics officers in many companies are becoming increasingly removed from the CEO and the ethics committee of the Board. Ethics officers provide a critical linkage between senior executives' cultural values and supervisors' direction of behavior. Good ethics officers serve as a transmission link between supervisors and managers. If they are buried in the organization, ethics officers will become ineffective as advisors to and communicators for senior executives. Because of this, ethics officers are playing less of a role in communicating the values of the organizational culture to supervisors, who in fact have the greatest impact on the behavior of employees.

One reason for this migration downward of the ethics officer is the failure of the current language of Chapter Eight to specify to whom the ethics officer should report.[13] Although the guidelines state that there should be high-level personnel responsible for an effective program, the ERC believes this language is too vague; the ethics officer must have direct and unfettered access to the highest authorities within an organization, including the CEO, COO, CFO and appropriate members and/or committees of the Board.

One way to characterize this level of access is to see the ethics officer as a direct report to both the CEO and the Board. In contrast, when ethics officers are several levels away from the CEO/CFO/Audit Committee, it becomes very difficult for them to impact an ethical culture or contribute substantively to the ethical integrity of an organization.

The Board's Role

The Board of Directors has a role in the direction of the leadership and integrity of an organization. The current business landscape makes it vital that Boards take an active role in shaping the ethical culture of the organizations they oversee. The Board of Directors sets the tone for the company as a whole. Since the Board is ultimately accountable for the consequences of an organization's actions, it has the responsibility of holding the CEO and other high-level employees liable for their decisions and actions. To exercise this responsibility effectively, the Board must be actively involved in ensuring ethics and compliance are addressed. The Board must oversee the design of the ethics program itself, but also accept accountability for its eventual success.

At a minimum, the Board needs to determine the scope of the ethics program in several areas. In particular, the Board should have a role in determining:

1. The form and content of the information provided to the ethics officer. Examples include: help line activity numbers, patterns in issues raised, disciplinary actions taken, actions to protect those reporting observed misconduct, training activity, internal assessments of employee perceptions of ethics program effectiveness, general employee attitudes, and evidence of adherence to or violations of the organization's compliance and ethics standards.
2. The focus of the ethics and compliance efforts, whether strictly compliance-based, more broadly values-based or reaching beyond the corporate boundaries to address broader social issues.
3. The role and organizational positioning of the Ethics Officer. The ERC believes it is essential for Boards to recognize the urgency of expanding compliance programs (and simultaneously ethics officer roles) beyond satisfying legal and regulatory minimums.

The ERC also believes FSGO should encourage Boards to go past simple benchmarking of current industry standards and compliance with current law and regulation. As the ultimate custodians of corporate ethics, Boards are responsible for meeting their fiduciary obligations to employees, shareholders, and ultimately society as a whole. In this way the FSGO will be empowering the judiciary to address society's demands that organizations meet the ethical standards of honesty, integrity, fairness and transparency—traits evidently absent based on our recent experience.

Since a Board of Directors has ultimate authority over the scope of ethics programs within an organization, it naturally has jurisdiction over the search and selection criteria for CEOs. In order to ensure that the ethical goals of their organization are met, the Board is obliged to establish objectives for the ethical conduct of CEOs. Ideally, the Board would articulate selection criteria that reflect characteristics that allow the organization to fulfill its ethical obligations.

Furthermore, the Board must design a performance review and compensation system for the CEO and other high-level personnel to ensure that the ethical culture of the organization is maintained. One example of such a system can be found in Royal Dutch Shell. In this company, 168 country chairpersons are required to submit a detailed annual accounting of such issues as: the ethical challenges they have addressed; steps they have taken to prepare staff to address those challenges; the impact of ethics and compliance on joint ventures, local economies and local politics; how they have measured their ethics and compliance success/progress; specific measurable goals they would set for the coming year and more. These accounts must be submitted in a standardized format provided by Shell's International Directorate—an arm of the Committee of Managing Directors. All these letters are then gathered, summarized and analyzed for the Committee of Managing Directors.

To further lend legitimacy to the process, each country chair has a face-to-face meeting with his/her managing director to discuss the letter and amend the future plans. This meeting has direct feedback into the compensation decisions for that year. As the Shell example suggests, in essence, the Board's role in the framing of the ethical culture in a company gives it tremendous authority over the course of development for all of its employees.

A major challenge every Board of Directors faces is the potential for conflicts of interest among high-level personnel and the Board. Conflicts may appear in decisions such as the selection of future Board members, executive selections, evaluations, compensation, and when to recuse oneself from the decision-making process. Some measures, however, minimize the opportunity for such conflicts.

To reduce the potential for conflicts, the ERC recommends the involvement of a truly independent third party. At minimum, each Board should regularly subject itself to an independent review of its major actions and decisions. That review should concentrate on the Board's oversight of the executive management team and its own freedom from conflicts of interest. Without such a platform of integrity coming from the highest level, the future of the organization will always be uncertain.

Ethical Culture

All of these actions ultimately result in the creation of an organization's ethical culture. The ERC believes that Chapter Eight of the Sentencing Guidelines should encourage organizations to foster ethical cultures and ensure focus on the intent of legal and regulatory requirements as opposed to mere technical compliance that can potentially circumvent the intent or spirit of the law or regulation. The ERC believes the FSGO should require organizations to make systemic and sustained efforts to create a culture that fosters ethical business practices and ethical employee behavior. Those behaviors are, in part, based on perceived organizational expectations and observation of those actions that are modeled, punished, or rewarded. Frequently, behavior modeled, rewarded, or punished influences beliefs of what is truly valued by an organization. These beliefs set a standard of ethical business conduct and becomes the presumptive choice of most employees.

The organization's efforts to create an ethical business culture should be observable, measurable and open to audit. There should be a demonstrated alignment of the organization's mission, goals, values, code of conduct, policies, compliance activities and performance management with integrity and transparency of those systems and processes as a foundational element.

A thorough independent, third-party assessment of senior management's actions (including the Board of Directors') regarding exceptions to policy, preferential treatment of employees, selection/promotion practices and disciplinary employee actions should be a regular element of the organization's governance systems. This assessment will reveal the degrees of consistency with legal requirements, stated organizational values and ethical business practice.

A natural question arises from this observation. How can guidelines effectively mandate ethical cultures? A first step is to regularly assess the effectiveness of the organization's leadership—at all levels—in applying the stated organizational values in strategic and tactical decisions and actions. Organizations should be able to identify the steps taken to ensure employee behavior is consistent with the values and codes of that organization. Outcomes can be evaluated including those evidenced in hiring practices, previous audits, violations of policy, recruiting and marketing practices, rewards and disciplinary actions. Initial assessments evaluate the current ethical performance as well as provide baseline data for defining future objectives and assessing future progress.

For many organizations, an essential element of an effective ethics and compliance program is the creation of systems to encourage employees to report observed misconduct and to appropriately raise and voice ethics concerns. It is well-documented that employees are often unwilling to take such actions. Research on whistle-blowing suggests that the top two reasons employees fail to raise ethics concerns or report misconduct are: (1) a belief that nothing will be done and (2) fear of retaliation.[14] These reasons have as much to do with organizational culture as with formal mechanisms such as anonymous reporting lines. A greater emphasis on ethical culture may help to encourage reporting by ensuring that such reports are valued, acted upon and result in appropriate responses. That includes positive consequences for the employee making the report.

Another key to understanding the concept of an ethical work culture is to consider social interaction. Humans derive at least some norms of conduct from peers, leaders, and environment. As strong as the moral compasses of individual employees may be, ethical dilemmas and uncertainties in the workplace will, at some point, lead them to seek confirmation of their views with others in the work environment. As a result, it is not uncommon for employees to align their actions to the beliefs and expectations of the organization and their peers.[15] If organizations impact employees' moral development, an obligation arises to help employees refine their ability to recognize the ethical components of the situation they are dealing with. Leaders must show employees how to apply ethical reasoning to the challenges faced on a day-to-day basis.

A commitment to intentional, positive moral development is more than just good public relations. When organizations effectively communicate why they want their employees "to do the right thing" it becomes easier for employees to conceptualize and put those values and expectations into action.

In addition, when employee evaluations include more than merely checking a box on ethics and compliance (e.g., checking that there were no reportable violations), there is increased positive reinforcement that is essential in developing an ethical culture. The ERC believes that moral development does not stop as the child leaves the household, or the student leaves college, but rather continues for life. This makes it imperative that organizations take a direct hand in the moral development of their employees so that the positive, ethical values of that organization will be reflected in the actions and decisions of their employees.

Summary

In summary, the ERC believes that legal compliance is a minimum standard. The FSGO should encourage organizations to reach higher, evolving toward the highest standards, not seeking the minimum tolerated by society. This country is experiencing a crisis of trust and confidence. In part that crisis can be attributed to the belief that many hold regarding the value of the ethical minimum—skating on the fine line of legal defensibility and turning one's back on higher ethical principles. Public confidence in our institutions is too dear a price to pay for ethical minimalism. The bar must be raised, and the above suggestions and recommendations are the starting point.

Endnotes

1. This article is adapted from testimony originally presented to the Advisory Group on Federal Sentencing Guidelines for Organizations on behalf of the Ethics Resource Center, Nov. 18, 2002.
2. *See* http://www.ethics.org/resources/article_detail.cfm?ID=834.
3. *Id*.
4. Code of Ethics for Government Service, Pub. L. No. 96-303, 94 Stat. 855 (1980) (codified at 4 U.S.C. § 7301).
5. *See* http://www.ethics.org/resources/article_detail.cfm?ID=765; http://www.ethics.org/history.html.
6. *See* http://www.ussc.gov/2002guid/TABCON02.htm.
7. *See e.g.*, Jonathan A. Treadway, *Problems With Potential Application of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Small, Non-Public Banking Organizations*, 8 N.C. Banking Inst. 165, 165 (2004) ("The Sarbanes-Oxley Act of 2002 was passed by Congress as a response to a rash of corporate scandals involving companies such as Enron, WorldCom, and Global Crossing."); Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 St. John's L. Rev. 671, 671 (2002).
8. *See* http://www.ussc.gov/2002guid/8c2_5.htm (at § 8C2.5(f)); *see also* http://www.ussc.gov/2002guid/8c4_10.htm.
9. L.K. Trevino et al., *Moral Person and Moral Manager: How Executives Develop a Reputation for Ethical Leadership*, California Management Review (2000).
10. Frank J. Navran, Truth & Trust: The First Two Victims of Downsizing (Athabasca Univ. Press 1995).
11. U.S. Office of Government Ethics, Executive Branch Employee Ethics Survey, 2000 (final report), at 53.
12. *See* http://www.ethics.org/fellows/aboutefp.html.
13. *See* http://www.ussc.gov/2002guid/CHAP8.htm.
14. David Uchida, Coszalter v. City of Salem*: Just Whistle While You Work—Expanding First Amendment Protection for the Whistle-blowing Employees*, 37 LOY. L.A. L. REV. 169 (2003).
15. For long-standing arguments in this area, see Robert Merton, Social comparison Processes (Zey-Ferrell & Ferrell, 1982) (1968).

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Individual Responsibility and the Sarbanes-Oxley Act[1]

By John R. Boatright

In *The Devil's Dictionary*, Ambrose Bierce defines a corporation as "[a]n ingenious device for obtaining individual profit without individual responsibility."[2] This famous quip has special relevance in the aftermath of the scandals at Enron, WorldCom, Tyco, and other companies. Many people are angry that executives like Kenneth Lay, Bernie Ebbers, and Dennis Kozlowski could inflict such great losses on investors and employees without suffering greater personal consequences. The legal process has not yet run its course, and perhaps in the end justice will be done. In the meantime, Congress has produced the Sarbanes-Oxley Act, which, among other things, places greater stress on the personal responsibility of top executives to prevent corporate scandals. In introducing this legislation, President George W. Bush intended to help usher in a "new ethic of personal responsibility in the business community."[3]

An emphasis on individual responsibility is reflected in four provisions of the Sarbanes-Oxley Act (SOX). Sections 302 and 404 require that the top officers certify the accuracy of certain reports and the effectiveness of internal control systems. Section 304 mandates the return of incentive compensation in the event of a restatement. And Title IX, known as the White-Collar Penalty Enhancement Act, greatly increases the fines and sentences for fraud and other misconduct.

Many observers dismiss these provisions as efforts by Congress to express outrage and impress the public with a show of toughness, without actually altering existing legal duties. My concern is not with the impact of SOX on the individual responsibility of executives, but with whether attempting to place more responsibility on individual executives, assuming it can be done, is a good idea. What, you may ask? Do we want executives to be irresponsible? That's not the question. Rather, the question is, in our efforts to reform corporate America and prevent more Enrons, should the major thrust of regulation be on individuals or corporations?

This question is addressed by the large amount of legal literature acknowledging the choice between individual and enterprise liability. At one time, the law recognized only the former on the grounds that only individuals could provide the necessary elements of *actus reus* (the "guilty act") and *mens rea* (the "guilty mind"). Considerable theoretical work was required to develop a coherent doctrine of enterprise liability. However, once accepted, this doctrine quickly dominated approaches to corporate regulation, as evidenced, for example, by the federal sentencing guidelines for organizations. The law and economics movement, with its Chicago school theory of optimal fines, also strongly favors punishment directed at corporations.

The issue of enterprise versus individual liability is relevant only to wrongdoing that occurs in the ordinary course of business, where individuals act within the scope of their authority. We are not speaking here of crimes committed by top officers for their own benefit. For example, Jeffrey Skilling is charged with 35 counts of fraud, conspiracy, and insider trading. Many of his actions may well turn out to have been criminal—for which he should bear the consequences—but in many cases he no doubt depended on recommendations and opinions of subordinates and the company's accountants and lawyers, and believed that what he did was proper business conduct. His lawyer remarked, "If a COO can't rely on the dozens of experts who review and recommend transactions, then no COO should go to work tomorrow, because they may find themselves indicted."[4] We should be careful not to hold individuals criminally liable for conduct that is difficult to distinguish from standard business practice, even if it results in a corporate disaster like Enron.

Corporate misconduct is generally not committed solely for personal gain. Typically, one engages in corporate misconduct to advance one's interest in the organization and to benefit the organization in the pursuit of legitimate business goals. Consequently, the main objective of the law should be to deter undesirable conduct rather than to mete out punishment based on desert. The choice of means is an empirical matter: Which has greater deterrent effect, individual or enterprise liability? In the absence of hard evidence, we can turn to theory for answers. Two theories suggest themselves: agency theory, including transaction cost economics,[5] and behavioral law and economics.[6]

Agency theory analyzes corporate misconduct as a conflict of interest that arises in a firm with a separation of ownership and control. If owners and managers are the same people, then there is no distinction between individual and enterprise liability. With the separation of ownership and control, the possibility arises that managers could engage in misconduct primarily for their own benefit. Even so, according to agency theory, managers should be highly risk-averse because they hold an undiversified investment in the firm. Misconduct should be rare because managers would incur considerable risk for benefits that flow disproportionately to the shareholders. An exception occurs when a company faces insolvency and an accompanying threat of job loss for everyone. Then we should expect to see desperate efforts to save the firm.

The question of whether to hold individuals or corporations responsible is addressed by the Coase theorem, which holds that if transaction costs are negligible, then it will not matter how liability is allocated.[7] Absent transaction costs, managers and shareholders would contract so as to reach an optimal allocation of liability. In this case, however, transaction costs are significant, and so the initial allocation of liability is important in achieving efficiency. Agency theory provides the following arguments for placing responsibility primarily on corporations rather than individuals:

1. Corporations are in a better position than the state to monitor employee behavior, and they can impose stronger penalties with greater certainty. One reason for this is the "deterrence trap," which occurs because the optimal fine is apt to outstrip the ability of individuals to pay, thereby reducing its deterrent value. Holding corporations responsible, rather than individuals, thus provides a more effective deterrent at a lower cost.

2. Responsibility brings with it some risk of the penalties for misconduct. Generally, highly diversified shareholders are less risk-averse than managers, and consequently shareholders can bear the risk of responsibility with less cost. Placing responsibility on individuals is thus an inefficient allocation of risk that reduces profitability and raises the cost of capital. Risk-bearing in this, as in other matters, is the role for shareholders in a corporation.

3. If managers were to bear great risk from individual responsibility, then they would use corporate assets to protect themselves. The result would be not only a misuse of corporate assets but also the avoidance of risky projects and, overall, corporations would not operate at the level of risk that shareholders prefer. Ironically, one effect of SOX is that it imposes on corporations the kind of control that agency theory suggests managers, if allowed, would put in place to protect themselves.

4. The more that responsibility is shifted to individuals, the less incentive shareholders have to select and monitor managers' activities and to invest in internal controls. This phenomenon has been labeled by William Laufer as "the paradox of compliance." He writes, "The purchase of compliance sufficient to shift the risk of liability and loss, in certain firms, has the effect of decreasing levels of care . . . This acceptance, coupled with the constant pressure on middle management to produce results, has led to increased deviance throughout the corporate hierarachy."[8] In short, more emphasis on compliance, paradoxically, creates greater deviance.

Agency theory assumes that individuals behave rationally in the sense of neo-classical economics, yet experience tells us otherwise. Research in social psychology with respect to decision-making foremost asserts that people are vulnerable to many cognitive biases that distort their decision-making abilities and produce unintended, unethical and illegal conduct.[9] Second, such research also points out that people make decisions on the basis of heuristic devices, or rules of thumb, which may work well in many cases but can lead to systematic errors. Third, managers may not be risk-averse—as agency theory holds—rather, they may actually be risk-seekers. These factors all suggest that predictions about the effectiveness of sanctions to deter managers under more realistic assumptions about rationality may differ markedly from those derived from a neo-classical economics, rational-actor model.

With this social psychology research in mind, we can understand how decent, conscientious executives of reputable companies come to engage in misconduct. Donald C. Langevoort describes a hypothetical, yet typical, scenario of how fraud occurs:

> The firm was successful, and no doubt had a good deal of aggregate self-esteem; the adverse bits of information were slow in coming and inconsistent with well-established schemas; and there was a heavy commitment to the success of the projects. It is perfectly plausible that, especially in the first small steps toward committing to the project . . . individual managers were particularly optimistic. In the early stages of the project, this optimistic schema was resistant to the first (still ambiguous) bits of potentially disconfirming information. By the time their seriousness started to become clearer, there was a high degree of commitment to strengthen the prevailing beliefs. . . . Moreover, by that time the managers were committed to their publicly expressed optimism, from which they could not easily step away, even as the signs of trouble became palpable. Only at that late stage was there a truly deliberate form of dissembling.[10]

If this is an accurate analysis of typical corporate wrongdoing, what can be done to deter managers from misconduct? The remedy, insofar as there is one, is for business organizations to develop decision-making processes that compensate for the distorting effects of biases and heuristics, thus producing sound decisions. Steps might include systematic information gathering, multiple lines of communication, and the involvement of people with diverse perspectives. Changes might also be needed in the corporate culture and belief system. These kinds of reforms, which involve organizational processes, are best brought about by sanctions applied to the corporation. Only the threat of loss to the shareholder provides a sufficient inducement for the corporation to undertake the necessary measures.[11]

Although cognitive biases can produce flawed decision-making, at times these very biases are a valued characteristic of successful business leaders. We expect executives to be optimistic, highly confident risk takers, and these features are often responsible for their success. Leaders with these characteristics can also inspire others and help a team recover after serious setbacks. Certain kinds of competitive environments may invite, and even demand, executives who fit the profile for the Machiavellian or the narcissistic personality type.

In a *Harvard Business Review* article, Michael Maccoby claims that in an age of innovation, narcissistic leaders like George Soros and Jack Welch are essential. He writes, "They are gifted and creative strategists who see the big picture and find meaning in the risky challenge of changing the world . . . . Indeed, one reason we look to productive narcissists in times of great transition is that they have the audacity to push through the massive transformations that society periodically undertakes."[12]

Sanctions on individuals, no matter how strong, are unlikely to deter the hard-core narcissist or even the optimistic, confident personality type. At best, they could discourage such persons from assuming corporate leadership roles. Although sanctions on corporations might give shareholders pause about hiring such persons, the loss to the economy would probably exceed the benefit. In any event, the main conclusion to be drawn from behavioral theory is similar to that of agency theory: In order to deter wrongdoing, primary responsibility should be placed on corporations. Not only is too much emphasis on individual responsibility likely to be unproductive as a deterrent, but it is also apt to deprive society of the strongest possible corporate leadership.

Individual responsibility is deeply embedded in our idea of morality, so it is natural that we respond to the recent scandals with the Sarbanes-Oxley Act, which places additional responsibility on individuals to prevent corporate misconduct. Certainly, no one will deny the commonsense conclusion of John Coffee, who asserts that in regulating American business, "a dual focus on the firm and the individual is necessary." "Neither," he says, "can be safely ignored."[13] Nevertheless, we need to be careful what we wish for. A "get tough on executives" message feels good. However, too much emphasis on individual responsibility can be unfair to decent people in business who have to struggle under tremendous pressures. It can also be an ineffective means of regulating business behavior in a very complex organizational environment.

Endnotes

1. This article is adapted from Individual Responsibility in the American Corporate System: Does Sarbanes-Oxley Strike the Right Balance?, presented at a conference entitled Ethics in the Financial Services after Sarbanes-Oxley, which took place at the Carlson School of Management, University of Minnesota, April 15–17, 2004.
2. Ambrose Gwinnett Bierce, The Devil's Dictionary, *available at* http://www.alcyone.com/max/lit/devils/c.html.
3. Press Release, President Bush, President Announces Tough New Enforcement Initiatives for Reform (July 9, 2002), *at* http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html.
4. Mary Flood, *Task Force Preparing Indictment for Skilling*, Hous. Chron., Feb. 13, 2004, at A1.
5. Agency theory and transaction cost economics are fundamental tools in financial economics. *See* Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975); Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (1985); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).
6. Behavioral law and economics is based primarily on the work by Amos Tversky and Daniel Kahneman. *See* Christine Jolls, et al., *A Behavioral Approach to Law and Economics*, 50 Stan. L. Rev. 1471 (1998). This article is also published in Behavioral Law and Economics 13 (Cass R. Sunstein, et al. eds., 2000).
7. Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).
8. William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance,* 52 Vand. L. Rev. 1343, 1415 (1999).
9. For a summary, see David M. Messick & Max Bazerman, *Ethical Leadership and the Psychology of Decision Making,* 37 Sloan Mgmt. Rev. 9 (1996).
10. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors*, 146 U. Pa. L. Rev. 101, 147 (1997).
11. *See* Lynne L. Dallas, *Proposals for Reform of Corporate Boards and Directors: The Dual Board and Board Ombudsperson*, 54 Wash. & Lee L. Rev. 91, 120 (1997) ("Shareholder representatives are enabled to monitor managers because of the corporation's dependence on shareholder democracy for the legitimacy of its governance structure.").
12. Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, the Inevitable Cons*, Harv. Bus. Rev., Jan.-Feb. 2000, at 70.
13. John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 Mich. L. Rev. 386, 410 (1981).

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Don't Tell Anyone (Our Confidentiality Rules Are Changing)

By Steven C. Krane

Being a lawyer isn't always easy. Sometimes, through no fault of our own, our professional obligations put us in difficult situations. It may be because a client did something, or failed to do something. Or it could be because a client told us something we wish we hadn't heard. Ethical and moral quandaries can be thrust upon us through events beyond our control.

We owe a broad range of professional responsibilities to our clients. Foremost among these is the duty of confidentiality, a core value of the profession that is intrinsic to the attorney-client relationship. We can assure our clients that they can tell us anything and everything because we will carry their secrets with us to the grave. Our clients can be completely candid with us. They can rely on the stability of their relationship with us. This construct sets us apart from other professions, enabling us to provide our clients with dispassionate legal advice based on the fullest possible understanding of the facts.

Sometimes lawyers wish they didn't have to maintain complete silence. Sometimes professional obligations put lawyers in distasteful positions. They are obligations nonetheless, and simply part of the territory that one enters when taking the oath as an attorney and counselor at law. And so it has long been for lawyers whose clients tell them that people are about to get hurt, or that people have been hurt in the past and that more people may well be hurt in the future. Unsettling as it sometimes may be to keep that information in confidence, it is the price we pay for the ability to give our clients the full benefit of the attorney-client privilege and the ethical duty of confidentiality.

However, once a decade or so, some unfortunate event sparks the renewal of an ever-smoldering movement toward diluting our fundamental confidentiality obligation to our clients. In the 1970s, the National Student Marketing and Watergate scandals, in both of which lawyers played prominent roles, provoked the American Bar Association on a course that scuttled the then-new Model Code of Professional Responsibility and replaced it with a more austere set of ethical precepts, the Model Rules of Professional Conduct. The Model Rules focused more attention on the discomfort often felt by lawyers when they learn that their clients have committed, or plan to commit, some wrongful act. The confidentiality rule survived the 1970s, only to be assaulted once again in the 1980s after the OPM Leasing scandal raised questions regarding the lawyers for the offending enterprise. Another effort to scuttle confidentiality was prompted by the savings and loan crisis of the 1990s. Lawyers were there, too. And now, Enron, WorldCom and other recent financial debacles have again thrown the organized bar into a full-blown debate over the inviolability of our ethical obligation to keep our mouths shut.

"Where were the lawyers?" "Why didn't the lawyers speak up?" In editorial pages, in congressional hearings, on late-night talk shows, these questions were repeatedly raised. How could lawyers have remained silent in the face of such reprehensible acts by their clients? Without considering the damage that would be caused to the attorney-client relationship, or the implications of any relaxation of this critical underpinning of our government by the rule of law, the cry was raised for a change to "allow" lawyers to reveal their client's secrets if they felt like it. The Sarbanes-Oxley Act of 2002[1] opened the door to this diminution in client protection, followed by an overly aggressive set of proposed regulations issued by the Securities and Exchange Commission, ostensibly pursuant to the directives enacted by Congress. Still under consideration by the SEC at this moment is a rule that would require, not just permit, lawyers representing public companies to make affirmative disclosure to governmental authorities of violations of law by their clients.[2] The lawyer would effectively be converted from trusted confidant to government watchdog, or perhaps as more accurately described, cast in the role of rat.

Swept up in this frenzy, in 2002 and 2003 the American Bar Association House of Delegates added two new exceptions to the key confidentiality provision, Rule 1.6, of the Model Rules of Professional Conduct. One exception, in the words of the ABA Commentary, "recognizes the overriding value of life and physical integrity and permits disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm."[3] This exception would permit disclosure of otherwise confidential information to prevent any serious injury—criminal or not. For example, the information may be the client's knowledge of a natural force that will cause loss of life or a threat to life made by a third person. In another, more far-reaching amendment, the ABA House of Delegates added exceptions to permit a lawyer to disclose confidential information to "prevent, mitigate or rectify" a client's crime or fraud that is "reasonably certain" to result in, or has resulted in, "substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services."[4]

These were the same suggestions that had been advocated in prior decades. Only now the cadre of legal ethicists who have been pressing this agenda were able to point to its incorporation in Section 66 of the American Law Institute's "Restatement of the Law Governing Lawyers," released in 2000. The Restatement commentary castigated lawyers who defend manufacturers of defective products, or who represent industries that send toxic substances into our water or air. They vilified personal injury lawyers who declined to disclose information suggesting a pattern of failures of Firestone tires because it could have prejudiced their clients' cases, terming their behavior "outrageous."[5]

Of course, whatever the American Bar Association or American Law Institute may say about lawyer ethics, their statements lack one essential element: the force of law. It is up to the individual states to decide whether to relax the confidentiality rules for lawyers subject to their disciplinary jurisdiction. The New York State Bar Association's Committee on Standards of Attorney Conduct (COSAC) is now considering whether to recommend the adoption of the Model Rules of Professional Conduct in New York, which is one of only five states (along with Oregon, Ohio, Nebraska, and Iowa) to adhere to the Model Code format. As part of that process, COSAC will consider the ABA's recent amendments to confidentiality.

New York's rules of ethics, specifically Disciplinary Rule 4-101(C)(3), currently provide that if a client states an intent to commit a crime—any crime—the lawyer *may* reveal information necessary to prevent its commission. Ethical Consideration 4-7 of the New York Code cautions lawyers considering the exercise of this right to take into account:

> [S]uch factors as the seriousness of the potential injury to others if the prospective crime is committed, the likelihood that it will be committed and its imminence, the apparent absence of any other feasible way in which the potential injury can be prevented, the extent to which the client may have attempted to involve the lawyer in the prospective crime, the circumstances under which the lawyer acquired the information of the client's intent, and any other possibly aggravating or extenuating circumstances.[6]

In other words, whatever may be said about the overinclusiveness or underinclusiveness of the current New York rule, we already allow lawyers to bring their personal conscience and morality to bear in deciding whether to breach confidentiality and attempt to prevent criminal activity by a client. The starkest example is the client who brandishes a gun at her lawyer's office, declares her intention to shoot her husband that day, and rushes off to find him. In such an extreme case, the lawyer is not precluded from calling the police (but is not required to do so, either).

To be sure, lawyers who receive confidential information from their clients are in uncomfortable situations. Under present New York rules, however, unless client activity is prospective and criminal, the answer is clear: Lawyers must preserve the confidentiality of what they know. Were we to allow disclosures of client confidences in these circumstances, telling lawyers that they *may* disclose, how long will it be before a court reviewing lawyer conduct in the stark light of hindsight concludes that the lawyer *should have* disclosed?

We accept almost without thinking that the most reprehensible of our society, no matter how unpopular, are entitled to the benefit of effective legal services. The mass murderer, the child molester and the racist hatemonger are all entitled to legal representation. So are those who generate toxic waste or injurious products, or who have published false or misleading financial statements. As a profession, we have always put the interests of our clients first, except in the most extreme of circumstances. We exist as a profession chiefly to serve those clients, and to provide them with legal counsel and representation. Secondarily, we are "officers of the court," a lofty concept that nonetheless does not convert us into private attorneys general or public snitches.

The result isn't always pretty. We cannot always feel all warm and fuzzy inside about what we do. Nevertheless, we should not walk away from our professional obligations because they sometimes are difficult to bear, even in the face of the latest headline-grabbing scandal.

Endnotes

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).
2. Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), *at* http://www.sec.gov/news/press/2002-158.htmn (last modified Nov. 6, 2002).
3. Model Rules of Prof'l Conduct R. 1.6 cmt. n.6 (2002) (discussing disclosure adverse to client under rule 1.6(b)(1)).
4. Model Rules of Prof'l Conduct R. 1.6 (b)(2), (3) (2003).
5. *See* Restatement (Third) of Law Governing Lawyers § 66 (2000); Proceedings of the American Law Institute's 1997 Annual Meeting: The author participated in the proceedings.
6. N.Y. State Bar Ass'n Lawyer's Code of Prof'l Responsibility EC 4–7 (1970) (amended 2002).

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GLC Endnote


Patricia E. Salkin


Rose Mary K. Bailly

The very first issue of the *Government, Law and Policy Journal* focused on the challenging subject of government ethics at the state and local levels. At the time, no one might have imagined how society would shortly be impacted by corporate ethics scandals that rocked the stock market and affected the lives of so many citizens. Jobs, retirement savings and retirement income, and everyday investing were suddenly exposed as vulnerable, as news hit of the Enron scandal, the WorldCom crisis, the Adelphia Communications fraud and the Martha Stewart investigation. No longer was the ethics spotlight on government actors. In fact, now it is the government's lawyers who have been called upon to develop new legal and regulatory frameworks to protect and preserve the integrity of the stock market and the integrity of our economy.

Many people are aware that, at the federal level, it is the Securities and Exchange Commission (SEC) that is charged with regulating the nation's stock exchanges and financial markets. Recent corporate behaviors, however, pointed to grave shortcomings in the law and its enforcement. This led to the adoption of the Sarbanes-Oxley Act which, among other things, placed significant responsibilities on corporations and established a new Public Accounting Oversight Board to oversee public auditors. Issues including the applicability of sentencing guidelines for organizations, attorney-client confidentiality in the corporate environment, antitrust regulation and consumer protection—all discussed in this issue—just begin to scratch the surface of the challenges that have recently confronted government lawyers.

Surprising, perhaps, has been the role that states have assumed in the effort to address corporate ethics scandals. New York's Attorney General, Eliot Spitzer, attracted the national spotlight when he settled an unprecedented lawsuit with Merrill Lynch for violating the state's securities law fraud. This action led the way for a wave of settlements between states and other financial services firms across the country. New York, more than any other state, has a special interest in the efficiency and integrity of the world financial services market headquartered in New York City.

One of the many lessons learned from these scandals is that the public demands and is entitled to impeccable ethical conduct not just from public officials, but from corporate America, where the people invest their savings and bank on their jobs and retirement. Just as government has to regulate ethical conduct in the public sector, a new legal and regulatory regime continues to develop to avoid the incomprehensible corporate scandals that erupted at the turn of the new century. The outstanding articles printed in this issue represent a starting point to more fully understand the appropriate role of governments in ensuring corporate responsibility in America and highlight the challenges and creativity of government lawyers in this ongoing effort.

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Director, Government Law Center
Associate Dean and Professor of Government Law
Albany Law School

Rose Mary K. Bailly
Associate Editor, *GLP Journal*
Special Counsel, Government Law Center

The Committee on Attorneys in Public Service

ANNUAL MEETING AND RECEPTION

Tuesday, January 27
New York Marriott Marquis

Professor Erwin Chemerinsky

Brooklyn Law Professor
Susan Herman

Benton Campbell

Linda Cantoni

The Committee on Attorneys in Public Service sponsored two educational programs and its annual Award for Excellence in Public Service Reception during NYSBA's 2004 Annual Meeting. The events took place on Tuesday, January 27th.

The morning educational program, "Supreme Court and American Society: The Dialogue Continues," featured nationally known Supreme Court experts Professor Erwin Chemerinsky from the University of Southern California Law School and Professor Susan Herman from Brooklyn Law School.

The afternoon program topic was "A Critical Balance: Safeguarding Civil Liberties While Countering Terrorism." Featured panelists included Professor Susan Herman; Linda Cantoni, Counsel to Investigations Division, Queens County District Attorney's Office; and Benton Campbell, Assistant U.S. Attorney (former Anti-terrorism Task Force Coordinator, E.D.N.Y., and Enron prosecutor).

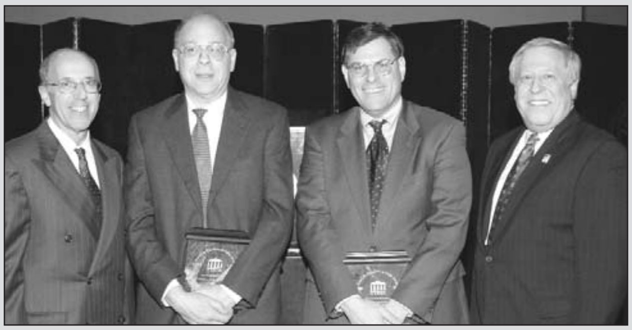
The Annual Award for Excellence in Public Service was awarded to two attorneys in the New York City Law Department, Jeffrey Friedlander and Leonard Koerner. The Honorable Michael Cardozo, New York City Corporation Counsel, nominated Mr. Friedlander and Mr. Koerner for the award.

The Student Loan Assistance for Public Interest (SLAPI) announced the awarding of grants to its first scholarship winners, made possible by a $25,000 grant from The New York Bar Foundation. Two winners, Mary Lynne Frey and Holly Graham of the Bronx Legal Aid Society, Juvenile Rights Division, were present at the CAPS event where the announcement was made. SLAPI is chaired by Glen Bruening and The New York Bar Foundation is led by its President Robert Haig.

CAPS member Tyrone Butler, Kay Murray and past CAPS Chair Barbara Smith.

CAPS Chair James Horan and Carl Copps.

NYSBA Executive Director Patricia Bucklin with Executive Committee member Sharon Stern Gerstman and the Honorable Evelyn Frazee, Supreme Court, Rochester.



The Honorable Michael Cardozo, Corporation Counsel, New York with CAPS Award for Excellence in Public Service winners Leonard Koerner and Jeffrey Friedlander and NYSBA President A. Thomas Levin.

Jeff Friedlander and colleagues.

Peter Loomis; CAPS Chair James Horan; Marc Zyleberg; Alan Rachlin; and Patricia Wood, NYSBA Senior Director, Membership Services.

Student Loan Assistance for Public Interest Committee Chair Glenn Bruening; Cindy Feathers, NYSBA Director of Pro Bono Affairs; SLAPI scholarship winners Mary Lynne Frey and Holly Graham of the Bronx Legal Aid Society; and The New York Bar Foundation President Robert Haig.

NYSBA President A. Thomas Levin; Dr. Harold L. Burstyn; and Miriam M. (Mimi) Netter.

NYSBA Executive Director Patricia Bucklin with past NYSBA President M. Catherine Richardson; Executive Committee member Claire Gutekunst; and Patricia Wood, NYSBA Senior Director, Membership Services.

NYSBA PUBLICATIONS OF INTEREST FOR GOVERNMENT ATTORNEYS

***Legal Careers in New York State Government,* Eighth Edition**
Legal Careers in New York Government was compiled to assist law students and lawyers who are considering careers and/or work experience in public service with the State of New York. The Eighth Edition expands the text to include comprehensive information on employment opportunities with the government in New York State.

***Public Sector Labor and Employment Law*, Second Edition**
This landmark text is the leading reference on public sector labor and employment law in New York State. All practitioners will benefit from the comprehensive coverage of this book, whether they represent employees, unions or management. Practitioners new to the field, as well as the non-attorney, will benefit from the book's clear, well-organized coverage of what can be a very complex area of law.

Ethics in Government, The Public Trust: A Two-Way Street
This book is the first-ever compilation of information on state and local government ethics in one comprehensive volume. Assembled as a collection of chapters written by the government lawyers who work daily on legal and policy issues regarding ethical conduct and integrity in government, this book provides a one-stop-shopping introduction to ethics in state and local government.

Preparing For and Trying the Civil Lawsuit
In *Preparing For and Trying the Civil Lawsuit*, 20 of New York State's leading trial practitioners reveal the techniques and tactics they have found most effective when trying a civil lawsuit. The numerous practice tips will provide excellent background for representing your client, whenever your case goes to trial.

Federal Civil Practice
Federal Civil Practice is an invaluable guide for new or inexperienced federal court practitioners, who may find the multi-volume treatises on this topic inaccessible as sources of information for quick reference. The more experienced practitioner will benefit from the practical advice and strategies discussed by some of the leading federal court practitioners in New York State.

***Evidentiary Privileges (Grand Jury, Criminal and Civil Trials)*, Fourth Edition**
This book expands and updates the coverage of the extremely well-received *Grand Jury in New York*. It covers the evidentiary, constitutional and purported privileges which may be asserted at the grand jury and at trial. Also examined are the duties and rights derived from constitutional, statutory and case law.

***New York Municipal Formbook*, Second Edition**
The Municipal Formbook contains over 800 forms, edited for use by town, village and city attorneys and officials, including many documents prepared for unusual situations, which will alleviate the need to "reinvent the wheel" when similar situations present themselves.

***Antitrust Law in New York State*, Second Edition**
This is the only publication devoted exclusively to questions of practice and procedure arising under the Donnelly Act, the New York State antitrust law. *Antitrust Law* was written by leading antitrust law practitioners, and includes invaluable, authoritative articles from a variety of sources, settlement agreements and sample jury instructions.

Criminal Law and Practice

Criminal Law and Practice is a practical guide for attorneys representing clients charged with violations, misdemeanors or felonies. This monograph focuses on the types of offenses and crimes that the general practitioner is most likely to encounter. The practice guides are useful for the specialist and nonspecialist alike.

***New York Criminal Practice*, Second Edition**

This publication expands, updates and revises the extremely popular *New York Criminal Practice Handbook*. It covers all aspects of the criminal case, from the initial identification and questioning by law enforcement officials through the trial and appeals. Numerous practice tips are provided, as well as sample lines of questioning and advice on plea bargaining and jury selection.

***The Practice of Criminal Law under the CPLR and Related Civil Procedure Statutes*, Third Edition**

This book pulls together in an orderly, logical way the rules and provisions of law concerning jurisdiction, evidence, motion practice, contempt proceedings and article 78 and habeas corpus applications, none of which is covered in the CPL or the Penal Law. Additionally, some rules that have evolved through judicial precedent—for example, the parent-child privilege and other common law privileges—are included and discussed. The Third Edition features greatly expanded discussions of case law and the relevant statutes.

Environmental Crimes

Federal, state and local prosecutors have specialized units that focus on the prosecution of environmental crimes. As a result, corporations, and those who run them, are often at risk of criminal prosecution for a galaxy of environmental offenses, many of which, years ago, went largely unnoticed or were handled by warnings or civil penalties. The authors have incorporated into this publication a wealth of prosecutorial and defense experience at the federal, state and local levels to assist practitioners in this important area.

***School Law*, 29th Edition**

The 29th edition of School Law has undergone significant change, including an updated chapter on charter schools. A few of the changes covered include implementation of the "No Child Left Behind Act," school district reporting responsibilities, the appointment of special education impartial hearing officers, and teacher certification. Especially helpful are the summary of legal developments and the comprehensive index

***Representing People with Disabilities*, Third Edition**

Newly organized and completely updated, *Representing People with Disabilities*, Third Edition, is a comprehensive reference which covers the myriad legal concerns of people with disabilities—including an in-depth examination of the Americans with Disabilities Act. This invaluable resource has been expanded to include two new chapters.

For the complete NYSBA publications catalog and order information, go to www.nysba.org/pubs or call 800-582-2452.

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