ACKNOWLEDGEMENTS

The Spring semester has brought us many joys. First and foremost, we celebrate that in the latest edition of the Washington & Lee University's Law Journal Rankings, released in March, the Journal finished 34th among the 58 specialized, student-edited, online-only legal periodicals. These rankings, the best regarded in the legal community, are based on the number of citations made to each legal periodical in existence since 2006. Considering that we have been around for only five of the eight years these rankings cover, standing in the 41st percentile of our category truly is a remarkable accomplishment. It attests the quality of our content and the devotion of our editors. For that we thank our the tenacity of predecessors, the proficiency of our authors, and the loyalty of readers.

Also, on April 21st, we held the forum titled *Tax Reform: A Critical Approach*, with panelists Kermit Lucena-Zabala, CPA, President of the Puerto Rico Society of Certified Public Accountants, Juan Méndez-Torres, CPA, Esq., former Secretary of the Treasury, Jorge San Miguel, Esq., former advisor to the Governor of Puerto Rico on energy matters, and José Sosa-Lloréns, Esq., Chair of the Corporate Department of Fiddler, González & Rodríguez, P.S.C. Their insight about the executive bill implementing the first Value-Added Tax in U.S. soil was welcomed by an audience of members of the UPR-Law community and by the general public as well. Thanks to our distinguished panelists and to Deans Neptune and Garay, to Mrs. Lacot and to Mrs. Amarilys Ortiz, Director of at UPR-Law's Outreach, for their outright support with this event.

The tax forum was the perfect occasion to launch our new website: www.uprblj.org. Keeping the contents of our former webpage, while adding new functionalities, our issues and related content will be featured here from now on. We thank our editors, José Fuentes, Israel Ramírez, and Katherine Ruiz, for their collaboration with Miss Naydeen de León, M. Arch., in the completion of this project. And, fully aware of social media's reach, we started to increase our presence in key platforms. So, to keep track of recent developments in business law, please follow us on Facebook (www.facebook.com/UPRBLJ), Twitter (www.twitter.com/UPRBusLJ), and YouTube (www.youtube.com/user/UPRBLJ).

We also strengthened our professional network this semester. In late April, we visited Deloitte Tax LLP, where the Managing Partner of the firm, Francisco ("Paco") Castillo, CPA, Esq., and the Editor-in-Chief of our

Second Volume, Felipe Rodríguez Lafontaine, CPA, Esq., Tax Manager of the firm, greeted us. After a neat presentation about the work of CPAs and attorneys at , we talked about employment prospects in the tax and consulting sectors, highlighting the competitive advantage editorial experience confers to aspiring professionals. We appreciate the time Paco, Felipe and the great people at Deloitte invested on us, aiming to build up our relationship. May this be the first of many professional partnerships to come.

Then in early May, we offered CLE seminar titled: *Jurisdictional Issues over Internet Commercial Disputes*, in conjunction with UPR-Law's Trust. Attys. Jennifer García, Chair of Ferraiuoli LLC's Litigation Department, and Elizabeth Villagrasa, Associate of the same Department, contrasted the pros and cons of litigating controversies arising from transactions made via internet in federal and state courts. Both speakers and attendants enjoyed the experience, where issues of interest to local practitioners were addressed, specially those concerning the handling of cases that turn more common every day, to clients of all kinds. Hoping that their effort culminate in an article publishable in the Journal, we thank Attys. García and Villagrasa for their utter collaboration and support.

SUBJECTIVE FALSITY UNDER SECTION 11 OF THE SECURITIES ACT: PROTECTING STATEMENTS OF OPINION

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I. INTRODUCTION

On May 23, 2013, the Sixth Circuit's decision in *Omnicare*[1] created a circuit split with both the Second[2] and Ninth[3] Circuits when it held that a plaintiff bringing a claim under section 11 of the Securities Act of 1933 ("Securities Act") is not required to plead knowledge of falsity, known as "subjective falsity," regarding a false statement of opinion contained in a registration statement filed with the Securities and Exchange Commission ("SEC") in order to state a claim.[4] The decision caused uproar in the securities law community, particularly due to its potential detrimental effects on industries that are already highly regulated.[5] The Sixth Circuit distinguished section 11 claims from those brought under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and SEC Rule 10b-5,[6] which require a showing of scienter, and held that claims involving alleged false or misleading opinions brought under section 11 are subject to a strict liability standard and do not require a plaintiff to plead knowledge of falsity. This Article argues that a better approach is to require a section 11 plaintiff

[1] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 719 F.3d 498 (6th Cir. 2013), *reh'g & reh'g en banc denied* (July 23, 2013), *petition for cert. filed sub nom.*, Omnicare, Inc. v. The Laborers Dist. Council, 2013 WL 5532735 (U.S. Oct. 4, 2013) (No. 13-435).

[2] *See* Fait v. Regions Fin. Corp., 655 F.3d 105, 113 (2nd Cir. 2011) (affirming the district court's decision to dismiss a section 11 claim for failing to "plausibly allege subjective falsity").

[3] *See* Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009) (requiring section 11 complaints to "allege... with particularity that the statements were both objectively and subjectively false or misleading").

[4] *See Omnicare*, 719 F.3d at 505-07.

[5] *See* Chip Phinney, Megan Gates, Kevin McGinty, & Michael Connolly, *Federal Court Rules That Issuers Face Strict Liability for Erroneous Statements About Legal Compliance in Registration Statements, Even if They Did Not Know the Statements Were False*, MINTZ LEVIN (June 11, 2013), http://www.mintz.com/newsletter/2013/Advisories/3134-0613-NAT-LIT/3134-0613-NAT-LIT.pdf (last visited Oct. 18, 2013).

[6] 17 C.F.R. § 240.10b-5 (2013).

to plead both objective and subject falsity for statements of opinion made in a registration statement because such an approach would help prevent the detrimental effects of the *Omnicare* decision, including increased litigation costs, decreased shareholder value, and deterrence of expert opinions, on defendants in highly-regulated industries such as healthcare and finance.

Omnicare, Inc. ("Omnicare"), headquartered in Cincinnati, Ohio, is a Fortune 500 healthcare company that directly and through its subsidiaries provides pharmaceutical services to long term care facilities and to other customers, specializing in senior care and serving other "targeted populations."[7] Omnicare, a leading independent provider of pharmacy services to long-term care institutions such as nursing homes, retirement centers and other institutional health care facilities, serves as a market-leader in professional pharmacy-related consulting and data management services for skilled nursing, assisted living and other chronic care institutions.[8] Moreover, Omnicare boasts unparalleled clinical knowledge of the geriatric market, describes their technology capabilities as among the industry's most innovative, and commercializes services for the "bio-pharmaceutical industry and end-of-life disease management."[9] Omnicare purchases and repackages prescription and non-prescription medication, dispenses medication, provides "computerized medical recordkeeping and third-party billing" for patients in long-term care facilities, and maintains a pharmacist consulting services business, which includes drug therapy evaluations for patients and monitoring drug administration in nursing homes.[10] In addition, Omnicare offers infusion therapy and distribution of medical supplies to nursing home facility clients.[11] Omnicare provides services to over 167,000 residents in almost 1,900 nursing homes and other long-term care facilities.[12]

In February of 2006, two shareholder pension funds filed a class-action suit against Omnicare in the United States District Court for the Eastern District of Kentucky, alleging violations of section 10(b) and section 20(a) of the Securities Exchange Act of 1934 ("Exchange Act").[13] In this case, plaintiffs argued that Omnicare engaged in "a fraudulent scheme that artificially inflated Omnicare's stock price by misrepresenting the company's financial results and business practices."[14] The court consolidated this matter with an almost identical case against Omnicare and named Laborers District Council Construction

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[7] *About Us*, OMNICARE, INC., http://www.omnicare.com/about-us.aspx (last visited Jan. 6, 2014).
[8] *Corporate Profile*, OMNICARE, INC., http://ir.omnicare.com/phoenix_zhtml?c=65516&p=irol-irhome (last visited Jan. 6, 2014).
[9] *Id.*
[10] Omnicare, Inc., Registration Statement (Form S-3) (May 5, 1995).
[11] *Id.*
[12] *Id.*
[13] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 527 F. Supp. 2d 698, 700-01 (E.D. Ky. 2009).
[14] *Id.* at 701.

Industry Pension Fund as the lead plaintiff.[15] Thereafter, plaintiffs filed their Consolidated Amended Complaint, and a week later, Omnicare disclosed that its profits fell 51% in the second quarter of 2006 after losing $18.3 million in UnitedHealthGroup ("UHG") contracts.[16]

In October 2006, plaintiffs amended the complaint to add the section 11 claims against Omnicare alleging that false statements or omissions were made in its registration statement filed on November 23, 2005 (hereinafter the "Registration Statement").[17] The false and misleading statements or omissions claims consisted of the following: (1) false representation regarding its adherence to applicable federal and state laws and regulations related to its unused-drugs practices; (2) issuing financial statements in 2005 and 2006 based on practices that failed to comply with Generally Accepted Accounting Principles ("GAAP")[18]; (3) failing to disclose in a timely manner the contract dispute with UHG; and (4) making false and misleading statements regarding a transition to the Medicare Part D program.[19]

Plaintiffs alleged a host of fraud claims, including improper revenue recognition, overvaluation of receivables and inventory, failure to properly reserve for state and federal investigations, failure to comply with state and federal laws, omission in substantial changes in revenue stream for failing to inform investors about the UHG contract reformation, and insider trading.[20] Essentially, plaintiffs alleged that Omnicare artificially inflated Omnicare's stock price by misrepresenting the company's financial status at the expense of the investors.[21] On October 17, 2007, the District Court held that, "[v]iewed in their totality, plaintiffs' allegations do not give rise to a cogent inference that defendants had an intent to deceive, manipulate, or defraud investors" and dismissed the complaint."[22]

On appeal in October of 2009, the Sixth Circuit held that loss causation is not an element of a section 11 claim, but rather an affirmative defense, and remanded this claim back to the District Court to determine whether the

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[15] *Id.*

[16] *Id.*

[17] *See id.* at 701-02; *See also* Omnicare, Inc., Registration Statement (Form S-3/A) (Nov. 23, 2005).

[18] *See Facts About FASB*, FIN. ACCOUNTING STANDARDS BD., http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176154526495 (last visited Jan. 6, 2014) (citing Financial Reporting Release No. 1, Section 101; April 2003 Policy Statement) (Although the SEC has authority to establish accounting and reporting standards under the Exchange Act, historically, the SEC has relied on the private sector for these principles. Since 1973, the private organization overseeing the task has been the Financial Accounting Standards Boards (FASB), and the SEC has officially recognized these principals as authoritative).

[19] *Omnicare*, 527 F. Supp. 2d at 702.

[20] First Amended Complaint at *4, *Omnicare*, 527 F. Supp. 2d 698 (E.D. Ky. 2009) (No. 2:06-cv-00026-WOB).

[21] *Id.* at 110.

[22] *Omnicare*, 527 F. Supp. 2d at 712 (internal citation omitted).

heighted pleading standards of Rule 9(b) had been met.[23] On remand, the District Court granted Omnicare's renewed motion to dismiss for failure to plead with particularity under Rule 9(b), but granted plaintiffs' motion to file a second amended complaint. Citing *Morse v. McWhorter*,[24] the court noted that leave to amend is appropriate in the context of securities litigation where the complaint does not allege fraud with particularity.[25] The court highlighted the fact that, although the claim had previously been dismissed, leave to amend was warranted because information became available to plaintiffs after the dismissal and close review of the proposed second amended complaint showed that plaintiffs "arguably crafted a viable complaint."[26]

Pursuant to Omnicare's offering of 12.8 million shares of common stock to the public in December of 2005, the company incorporated certain previously filed documents with the SEC from August and November into a registration statement and prospectus.[27] According to the Third Amended Complaint ("TAC"), Omnicare was engaged in several illegal activities including kickback arrangements with pharmaceutical companies and submitting false claims to Medicare and Medicaid.[28]

In February of 2012, after plaintiffs realleged section 11 claims based on newly discovered information,[29] the District Court dismissed the TAC after determining that the plaintiffs failed to adequately plead knowledge of wrongdoing.[30] In addition, the court determined that the plaintiffs failed to satisfy the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure ("Rule 9(b)") when alleging Omnicare's statements and omissions regarding GAAP upon determining the statements sound in fraud.[31] The court also rejected plaintiffs' claims regarding legal compliance after determining that statements regarding legal compliance were considered "soft

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[23] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 583 F.3d 935, 947-48 (6th Cir. 2009).

[24] 290 F.3d 795 (6th Cir. 2002).

[25] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., No. 2006-26 (WOB), 2011 WL 2786301, at 2 (E.D. Ky. July 14, 2011) (quoting *Morse*, 290 F.3d at 799-800).

[26] *Omnicare*, 2011 WL 2786301, at 2-3.

[27] Third Amended Complaint, Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund. v. Omnicare, Inc., No. 2006-26 (WOB), 2012 WL 462551, at 1 (E.D. Ky. 2012). Pursuant to section 5(c) of the Securities Act, a prospectus may not be offered for the sale of securities, required to be registered, prior to the filing of a registration statement. *See* 15 U.S.C. § 77e (2012).

[28] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund. v. Omnicare, Inc., 719 F.3d 498, 501 (6th Cir. 2013).

[29] *See* Third Amended Complaint, *supra* note 27, at 2.

[30] *Omnicare*, 2012 WL 462551, at 3-5.

[31] *Id. See also* Rombach v. Chang, 355 F.3d 164, 170 (2nd Cir. 2004) (citing Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3rd Cir.1992)) (discussing several circuits' position that Rule 9(b) applies to section 11 claims that sound in fraud).

information" that is generally not actionable, while also rejecting argument that Omnicare had a duty to disclose these alleged illegal activities.[32]

In May of 2013, the Sixth Circuit reversed the District Court's holding with respect to the legal compliance claims and held that section 11 is a strict liability provision for which knowledge of falsity is not required.[33] The court agreed with the District Court to the extent that section 11 claims do not require pleading scienter,[34] but declined to extend the Second and Ninth Circuits' application of *Virginia Bankshares* to a claim pursuant to a different section than14(a) of the Exchange Act.[35]

Both *Fait* and *Rubke* relied on *Virginia Bankshares*' application of strict liability to section 14(a), a non-strict liability statute, in supporting their respective requirements of subjective falsity. In the *Omnicare* opinion, Judge Cole determined that "the Court could not have intended that musings regarding the [section 14(a) non-strict liability] requirement would later be applied to an unrelated statute."[36]

Part I of this Article discusses the background of the recent circuit court opinions involving section 11 as well as their reliance on or distinguishing of *Virginia Bankshares* to support or refute subjective falsity determinations. Part II describes the Sixth Circuit's explicit departure from the Second and Ninth Circuit's subjective falsity requirement for statements of opinion under section 11 and the key securities fraud provisions cited in the respective courts' opinions. Part III analyzes section 11's requirements and similar provisions commonly pled alongside section 11 claims. Part IV discusses strict liability's detrimental effect on highly-regulated industries such as healthcare and banking. Part V proposes an objective-and-subjective-falsity solution to the strict liability holding of *Omnicare* and considers the likelihood of this solution's success.

II. BACKGROUND

A. The Securities Act of 1933 and Section 11

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[32] *Omnicare*, 2012 WL 462551.

[33] *Omnicare*, 719 F.3d at 507-11.

[34] *See also* David I. Michaels, *No Fraud? No Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933*, 26 ANN. REV. BANKING & FIN. L. 345, 364 (2007) (discussing the fact that section 11 plaintiffs are not required to plead scienter because it is only listed in the "due diligence" defenses of section 11).

[35] *Omnicare*, 719 F.3d at 506. Section 14(a) of the Exchange Act states that "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any [non-exempt] security ... registered pursuant to section 12 of [the Exchange Act] ...." 15 U.S.C. § 78n(a) (2012).

[36] *Omnicare*, 719 F.3d at 507.

Part I.A.1 begins with a brief discussion of the history of the Securities Act, which has been written about extensively, but several of the same issues highlighted in the legislative debate regarding certain provisions in the Securities Act are still germane topics today and are relevant to this argument. Part I.A.1 also briefly discusses the history of section 11. Part I.A.2 investigates the purpose and scope of section 11.

1. History of the Securities Act of 1933 and Section 11

After the Great Stock Market Crash of 1929 and the ensuing Great Depression, Congress established the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively, the "Securities Acts"), among other less prominent statutes, in an effort to prevent a future collapse of the U.S. economy through federal regulation of securities markets.[37] Despite the fact that state "blue sky laws" had been in existence since as early as 1911, the statutes had "limited jurisdictional reach, contained many special interest exemptions, and were enforced by states, which had limited resources."[38] Thus, with the creation of both the Securities Act and the Exchange Act, regulating the primary and secondary markets, respectively, Congress created the first major overhaul of the United States securities markets in our nation's history[39] with the goal of "protect[ing] the investing public and honest business" through a policy of "informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation."[40]

From the beginning of the Acts' respective enactments, competing views came to the forefront over whether securities regulation should be regulated under strict provisions such as the original 1933 bills[41] or a more self-

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[37] *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) ("The act naturally had its beginnings in the high financing of the Twenties that was followed by the market crash of 1929 ...even before [FDR became President], a spectacularly illuminating investigation of the nature of [securities] financing was being undertaken by the Senate Banking and Currency Committee under the direction of its able counsel, Ferdinand D. Pecora."). Pecora later became one of the original members of the SEC. *See* LOUIS LOSS, JOEL SELIGMAN, & TROY PAREDES, 1 SECURITIES REGULATION 257 (4th ed. 2013).

[38] *See* LOSS ET AL., *supra* note 37, at 50-54 ("[C]redit for the first comprehensive [securities] licensing system properly goes to Kansas for its statute in 1911 ... it is there, apparently, that the term *blue sky law* first came into general use to describe legislation aimed at promoters who 'would sell building lots in the blue sky in fee simple.'" *Id.* at 53 (quoting Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37 (1916)).

[39] *See* WILLARD E. ATKINS, GEORGE W. EDWARDS & HAROLD G. MOULTON, THE REGULATION OF THE SECURITY MARKETS 56-57, *in* WALL STREET AND THE SECURITY MARKETS (Vincent P. Carosso & Robert Sobel, eds. 1975).

[40] *Id.* (quoting *Regulation of Securities*, S. Rept. 47, 73 Cong. 1 sess., p. 1.).

[41] *See* S. 875 & H.R. 4314, 73d Cong., 1st Sess. §§ 6(c), (e)-(f) (1933) (providing for revocation of registration of securities upon a finding by administration that "the enterprise or business of the

regulatory "disclosure policy" similar to the British Companies Act of 1900.[42] After the Securities Act became effective in May 1933, it became the subject of skepticism from scholars for falling short of accomplishing its purposes.[43] They believed that the Securities Act was inadequate because either the individuals needing investment guidance lacked the proper training or intelligence to comprehend and find useful the information in a registration statement or individuals were too concerned with gaining a profit based on speculation to even consider the disclosed data prior to investing.[44] While drafting the bill that became the Securities Act, drafters considered "all the postwar bills, the English Companies Act, the New York Martin Act, the old Uniform Sale of Securities Act, and some of the new Continental legislation."[45] President Roosevelt chose the disclosure philosophy and this philosophy is "firmly entrenched" in the Securities Act.[46] However, following enactment of the Acts, controversy over federal mandatory corporate disclosure continued, particularly regarding the Securities Act's civil liability provisions.[47] Critics, although conceding the need for a mandatory disclosure system, took issue with the severity of certain provisions of the Securities Act, which they believed "impeded capital formation."[48]

According to the SEC, the Securities Act of 1933 has two basic objectives: (1) "[T]o require that investors receive financial and other significant information concerning securities being offered for public sale"; and (2) "[T]o prohibit deceit, misrepresentations, and other fraud in the sale of securities."[49] Further, the SEC states that it accomplishes these primary goals by requiring companies to

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issuer … or the security is not based upon sound principles, and that the revocation is in the interest of the public welfare" or that the issuer is otherwise dishonest, in unsound condition, or insolvent.).

[42] *See* Huston Thompson, *Regulation of the Sale of Securities in Interstate Commerce*, 9 ABA J. 157, 157-58 (1923) ("In drafting this Act, the Board of Trade and others who were responsible for the legislation sought to frame a bill which would interfere as little as possible with legitimate business, and at the same time tend to exclude those who were seeking to secure unfairly the money of the investing public."). *See also* LOSS ET AL., *supra* note 37 (discussing Justice Louis D. Brandeis' influence on the disclosure philosophy of securities regulation, and his strong advocacy for publicity as a remedy for industry abuse of securities while also recognizing Brandeis' position that the law should not attempt to prevent investors from making bad bargains); L. Brandeis, *Other People's Money* (1914).

[43] *See* LOSS ET AL., *supra* note 37, at 262 (citing William O. Douglas, *Protecting the Investor*, 23 Yale Rev. (N.S.) 521 (1934)).

[44] *See id.*

[45] *Id.* at 268 (citing U.S. DEPT. OF COMMERCE, *A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act*, Hearings before House Comm. on Interstate & Foreign Commerce, H.R. 4314, 73d Cong., 1st Sess. 100-10 (1933).

[46] *Id.* at 266.

[47] *See id.* at 269 (citing J. SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 77-81 (3d ed. 2003)).

[48] LOSS ET AL., *supra* note 37 at 269.

[49] *Registration Under the Securities Act of 1933*, SEC, http://www.sec.gov/answers/regis33.htm (last visited Jan. 6, 2014).

disclose important financial information through the registration of securities, which enables investors to be informed before making the decision to invest in the securities.[50] The Senate Report on the Securities Act describes the purpose of the bill as protecting the investing public and honest business by informing investors of the "facts concerning the securities to be offered for sale in interstate commerce and providing protection against fraud and misrepresentation."[51]

Moreover, all securities offered in the United States must be registered with the SEC or must qualify for an exemption[52] from the registration requirements.[53] Pursuant to the Securities Act, the registration statement must contain specific and detailed information with "great particularity."[54] In addition, it must be signed by the specified officers and by a majority of the board of directors.[55] Under section 2(8) of the Securities Act, the term "registration statement" includes any amendment and any report, document, or memorandum accompanying the registration statement or incorporated within the registration statement by reference.[56] In order to pursue the Security Act's goal of providing adequate disclosure of necessary information on the registration statement to enable investors to reach informed decisions, legislators desired to protect against statements or omissions that may not otherwise be viewed as fraudulent or deceitful, but may still mislead, and thus, drafted section 11, which was "the source of the greatest criticism of the Securities Act as originally enacted."[57]

As enacted in 1933, the original section 11 provided a greater burden on participants in the filing of registration statements.[58] After intense criticism over the risk that the original section 11 imposed on persons associated with the filing of the registration statement, "insistent demand" led to amendment of section 11

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[50] *Id.*

[51] MARC I. STEINBERG, CONTEMPORARY ISSUES IN SECURITIES REGULATION 7 n.19 (1988) (quoting S. REP. NO. 47, 73RD CONG., 1ST SESS. 1 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 17.1 (J. Ellenberger & E. Mahar eds. 1973)).

[52] Exemptions from registration of securities include non-public offerings under § 4(2); SEC-specified dollar amount thresholds under 3(b) and Regulations A and D; intrastate offerings under § 3(a)(11); certain foreign transactions under Regulation S; the safe harbor exemption for secondary transactions under SEC Rule 144 and 144A; and the section 4 ½ exemption for downstream sales. *See* 15 U.S.C. § 77d (2012); 15 U.S.C. § 77s(c)(3)(C) (2012).

[53] *Registration Under the Securities Act of 1933*, *supra* note 49.

[54] CHARLES H. MEYER, THE SECURITIES EXCHANGE ACT OF 1934, at 157 (Francis Emory Fitch, Inc. ed. 1994) (1934).

[55] *Id.*

[56] *See* Securities Act § 2(8), codified at 15 U.S.C. § 77(b)(a)(8) (2012). *See also* Securities Act § 6, codified at 15 U.S.C. § 77f (2012) (describing the requirements for registration of securities).

[57] MEYER, *supra* note 54, at 197.

[58] *See, e.g.*, William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 567 n.128 (2006) (citing LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 11-C-2-d-i-B (3d ed. 2004) (discussing that the original section 11 enacted in 1933 required a fiduciary duty of experts, but the provision was changed in 1934)).

in 1934.[59] One of the disastrous effects of the original section 11, as enacted in 1933, was that new financing basically came to a halt, which turned out to be an unintended consequence that could have led to an even longer depression had it not been "radically amended" the following year.[60]

2. Purpose and Scope of Section 11

Section 11 provides a right of action for any person acquiring a security offered in conjunction with a registration statement containing an untrue statement or omitting information necessary to make the disclosures not misleading.[61] This statute protects investors by enabling them to bring a private right of action against specific parties involved in the filed registration statement, including all signers,[62] directors or partners,[63] future directors or partners explicitly named,[64] accountants, engineers, appraisers, auditors, or other individuals for statements made in their professional capacity, or any person who has assisted in the preparation of or has certified the registration statement itself, or has prepared or certified a report or valuation used in connection with the registration statement,[65] and every underwriter of the security.[66] Therefore, the purpose of Section 11 is to "assure compliance with the disclosure provisions of the [Securities] Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering."[67]

a. Forum and Statute of Limitations

Several statutes and common law provisions place limits on section 11 claims. While individuals bringing section 11 claims may bring suit in either state or federal court, class actions that include more than fifty plaintiffs must be filed in federal court.[68] Additionally, section 11 plaintiffs have the advantage of bringing suit in either law or equity, effectively enabling them to prevent a defendant from a jury trial.[69]

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[59] MEYER, *supra* note 54, at 197-98.
[60] *Id.*
[61] *See* 15 U.S.C. §77k(a) (2012).
[62] *See id.* §77k(a)(1).
[63] *See id.* §77k(a)(2).
[64] *See id.* §77k(a)(3) (These future directors or partners must have consented to be named in the registration statement in order to be liable).
[65] *See id.* §77k(a)(4).
[66] *See id.* §77k(a)(5).
[67] In re WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 491 (S.D.N.Y. 2005) (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983)).
[68] *See* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, 2 LAW SEC. REG. § 7.3[2][B] (2013); Private Securities Litigation Reform Act of 1995 (PSLRA) Pub.L. 104–67, 109 Stat. 737 (1995).
[69] HAZEN, *supra* note 68.

The statute of limitations for section 11 claims, included under section 13 of the Securities Act, provides a one-year "constructive-discovery rule" and a maximum allowable limitations period of three years following the offer of securities.[70]

b. What Gives Rise to a Section 11 Claim?

The misstatements or omissions on a registration statement for which a plaintiff may bring suit pursuant to section 11 include (i) "an untrue statement of material fact," contained in the registration statement; (ii) omission of a material fact "required to be stated therein"; or (iii) omission of a material fact "necessary to make the statements therein not misleading."[71] Because section 11 does not expressly provide for liability for statements of opinion made in a registration statement, it is important to analyze interpretations of other elements of a section 11 claim.[72]

c. Materiality Requirement

While section 11 provides for liability upon a determination of an untrue statement of material fact or an omission of a required statement of material fact in the registration statement, it also allows for liability for an omission that makes the registration statement materially misleading.[73] Whether or not a registration statement is materially misleading does not depend on an evaluation of separate statements contained within a registration statement, but rather, whether "representations, taken together and in context, would have misled a reasonable investor about the nature of the securities."[74] Thus, a group of individual claims which may be true, but when evaluated as a whole appear to be misleading, would subject a director, officer, or other section 11 defendant to potential liability.[75]

The requirement of materiality in the registration statement context has given rise to intense debate[76] because the applicable SEC rule requires a judicial analysis of the facts and opinions in order to interpret which "have an important bearing upon the nature or condition of the issuing corporation or its business."[77]

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[70] Merck & Co., Inc. v. Reynolds, 559 U.S. 633, 656 (2010); *accord* 15 U.S.C. § 77m (requiring a plaintiff to bring a claim within one year of "discovery of [an] untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence," but in no case more than three years following a "bona fide offer[ing]" of the security to the public.").

[71] 15 U.S.C. § 77k (2012).

[72] *See Id.*

[73] *Id.* § 77k(a).

[74] DeMaria v. Andersen, 318 F.3d 170, 180 (2nd Cir.2003) (citation omitted).

[75] *See* McMahan & Co. v. Wherehouse Entm't, Inc., 900 F.2d 576, 579 (2nd Cir. 1990).

[76] *See, e.g.*, *In re* Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 358–59 (2nd Cir.2010) (discussing liability for misleading statements contained in a registration statement).

[77] Escott v. BarChris Const. Corp., 283 F. Supp. 643, 681 (S.D.N.Y. 1968).

The SEC rule regarding materiality in the registration statement context limits liability to misstatements or omissions *that an average prudent investor* should be informed of before buying the security.[78] However, in the context of items contained in or omitted from financial reports, materiality is taken into account in light of surrounding circumstances, including the magnitude of the misstatement or omission being "such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."[79] Similarly, a misstatement or omission is material if there exists "a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available."[80]

Materiality is a mixed question of law and fact.[81] While material *facts* "include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities,"[82] material *opinions* include statements of legal compliance,[83] accountant and auditor opinions, including Generally Accepted Auditing Standards ("GAAS") and GAAP, [84] SFAS 107, and credit risk in commercial real estate holdings,[85] Repo 105 accounting maneuvers,[86] risk limits, stress tests, and Value-at-Risk opinions.[87] Although not expressly identified as actionable under section 11, courts and commentators have considered statements of opinion as actionable under the federal securities laws because they contain "implicit factual representations."[88]

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[78] 17 C.F.R. § 230.405 (2013).

[79] SEC STAFF ACCOUNTING BULLETIN: NO. 99 – MATERIALITY (citing FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information ("Concepts Statement No. 2"), 132 (1980)); *see also* Concepts Statement No. 2, Glossary of Terms – Materiality (defining materiality).

[80] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (citations omitted).

[81] *In re* Metro. Sec. Litig., 532 F. Supp. 2d 1260, 1290 (E.D. Wash. 2007) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

[82] Kronfeld v. Trans World Airlines, Inc., 832 F.2d 726, 732 (2nd Cir. 1987) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2nd Cir.1968) (en banc), *cert. denied sub nom.*, Kline v. SEC, 394 U.S. 976 (1969)).

[83] *See* Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 719 F.3d 498 (6th Cir. 2013).

[84] *See In re* Lehman Bros. Sec. & ERISA Litig., 903 F. Supp. 2d 152, 182 (S.D.N.Y. 2012); *In re Metro.*, 532 F. Supp. 2d at 1290.

[85] *See In re Metro.*, 532 F. Supp. 2d at 1290.

[86] *See In re Lehman Bros.*, 903 F. Supp. 2d at 178.

[87] *See Id.* at 179.

[88] Wendy Gerwick Couture, *Opinions Actionable as Securities Fraud*, 73 LA. L. REV. 381, 386 (2013) (citing *In re* Nat'l Century Fin. Enters., Inc., Inv. Litig., 580 F. Supp. 2d 630, 639 (S.D. Ohio 2008); Mayer v. Mylod, 988 F.2d 635, 638 (6th Cir. 1993); *In re* Credit Suisse First Bos. Corp., 431 F.3d 36, 47 (1st Cir. 2005); Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1095 (1991).(Professor Couture

B. Section 11 Plaintiffs, Defendants, and Pleading Requirements

Part I.B.1 discusses section 11 plaintiffs, the tracing requirement, and reliance on false or misleading statements made in registration statements filed with the SEC. Part I.B.2 explores section 11 defendants and defenses available under section 11. Part I.B.3 identifies section 11 pleading requirements and the debate surrounding these requirements while Part I.B.4 discusses the strict liability and negligence standards of section 11.

1. Section 11 Plaintiffs, the Tracing Requirement, and Reliance

In order to bring a private right of action under section 11, a plaintiff must not only have purchased the registered security, but also must be able to "trace" the security to the offering for which the false or misleading registration statement was filed if the purchase did not occur at the time of or shortly after the offering.[89] If a security is purchased pursuant to an offering that occurred prior to the filing of a false or misleading registration statement, section 11 provides no relief since "the pre-registration purchaser falls outside the scope of Section 11."[90] Thus, under section 11, plaintiffs who bought securities subject to a false or misleading registration statement may bring suit if they "purchased at the time of the initial public offering, or if they are 'aftermarket purchasers who can trace their shares to an allegedly misleading registration statement.'"[91]

A presumption of reliance exists for false or misleading registration statements during the first twelve months following the day the registration statement came into effect, but after that time period, a purchaser must prove that he or she relied on the false or misleading registration statement to satisfy a section 11 claim.[92] This presumption of reliance exists because, under the fraud-

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breaks down the factual representations implied by statements of opinion into two elements: "(1) that the speaker actually holds the opinion expressed, and (2) that the opinion has a reasonable basis in fact," i.e. a statement about the underlying subject matter. *Id.* (citing *In re Credit Suisse*, 431 F.3d at 47).

[89] *See* APA Excelsior III L.P. v. Premiere Technologies, Inc., 476 F.3d 1261, 1276 (11th Cir. 2007) ("In order to have standing and prevail on a claim under Section 11 a plaintiff must be able to trace his stock to the defective registration statement."); HAZEN, *supra* note 68, § 7.3[5].

[90] APA Excelsior III L.P. v. Premiere Technologies, Inc., 476 F.3d 1261, 1276 (11th Cir. 2007) (citing Barnes v. Osofsky, 373 F.2d 269, 273 (2nd Cir. 1967)); *see also* Guenther v. Cooper Life Sciences, Inc., 759 F.Supp. 1437 (N.D.Cal.1990) (determining that investors who purchased stock at a time period after the initial registration statement, but prior to the filing of a defective amendment, "could not possibly have relied on misleading registration statements, since none had been filed").

[91] *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 656-57 (S.D.N.Y. 2004) (quoting DeMaria v. Andersen, 318 F.3d 170, 178 (2nd Cir.2003)).

[92] *See* Todd R. David, Jessica P. Corley, Ambreen A. Delawalla, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-on-the-Market - Available Defenses to Claims Under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53, 68 (2010) (citing Jennifer O'Hare, Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11

on-the-market theory, the price of the security already reflects the disbursement of the false or misleading information into the market subsequent to the public filing.[93] Therefore, a purchaser does not have to show that he or she actually read the registration statement in order to prevail on a section 11 claim.[94]

2. Section 11 Defendants and Defenses

Potential section 11 defendants can be quite expansive, particularly for underwriters, given the liberal definition provided by the Securities Act in section 2(a)(11).[95] Issuers can only absolve themselves of a section 11 claim by proving one of the following defenses: (1) the misstatement or omission was not material; (2) the *purchaser* knew of the misstatement or omission; or (3) the statute of limitations had expired.[96] However, persons other than the issuer may be precluded from liability through the "whistle-blowing" defense,[97] or the more commonly used due diligence defenses of section 11(b)(3).[98] For example, an expert may escape liability under section 11(b)(3) for "any part of the registration statement purporting to be made upon [the expert's] authority as an expert … (i) [the expert] had, after reasonable investigation, reasonable ground to believe and did believe," at the time the registration statement became effective, that the statements were true, did not omit any material *fact* required to be stated, or did not omit any material *fact* necessary to avoid misleading a reader of the

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of the Securities Act of 1933, 1996 WIS. L. REV. 217, 226 n.36 (1996); THOMAS LEE HAZEN, 2 THE LAW OF SECURITIES REGULATION § 7.3[4] (6th ed. 2008)).

[93] *See* APA Excelsior III L.P. v. Premiere Technologies, Inc., 476 F.3d 1261, 1274 (11th Cir. 2007) (citing *In re* WorldCom, Inc. Sec. Litig., 219 F.R.D. 267, 294 (S.D.N.Y. 2003); Krista L. Turnquist, Note, *Pleading Under Section 11 of the Securities Act of 1933*, 98 MICH. L.REV. 2395, 2413 (2000); Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(B) and Rule 10B–5*, 63 GEO. WASH. L. REV. 359, 401 (1995); William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 176 (1933)).

[94] *See* Todd R. David, Jessica P. Corley, Ambreen A. Delawalla, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-on-the-Market - Available Defenses to Claims Under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53, 89 (2010).

[95] THOMAS LEE HAZEN, 2 TREATISE ON THE LAW OF SECURITIES REGULATION 235 (6th ed. 2009); 15 U.S.C. § 77b(a)(11) (2006) ("The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.")

[96] 15 U.S.C. § 77k(b) (2012) (emphasis added).

[97] HAZEN, *supra* note 95, at 237-39 (citing 15 U.S.C. § 77b(1)-(2) (2012); Sarbanes-Oxley Act of 2002, codified at 18 U.S.C. §§ 806(c), 1513 (2012)) ("[T]he Sarbanes-Oxley Act includes protections to whistleblowers generally, imposing civil and criminal sanctions against those retaliating against whistleblowers.").

[98] HAZEN, *supra* note 95, at 239-40; 15 U.S.C. § 77b(3) (2012).

registration statement; or (ii) the part of the registration purporting to be made upon the expert's authority "did not fairly represent his statements as an expert" or did not contain "a fair copy of or extract from [the expert's] report or valuation as an expert."[99]

In *Ernst & Ernst v. Hochfelder*,[100] the Supreme Court noted that an issuer of securities is subject to absolute liability for any damages resulting from a material misstatement or omission in a registration statement.[101] However, aside from the issuer, both experts (such as accountants, auditors, engineers, or appraisers) and non-experts (such as those who prepared or assisted in preparing portions the registration statement) may bring forth a "due diligence" defense.[102] While issuers are subject to strict liability for such misstatements or omissions, others such as directors, officers, experts, and those assisting with the preparation of the registration statement are subject to a negligence standard.[103]

An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that "after *reasonable investigation*" he had "reasonable ground to believe and did believe" that the statements for which he was responsible were true and there was no omission of a material fact.[104] For example, an accountant or auditor may prove a due diligence defense by showing compliance, in good faith, with GAAP[105] or GAAS[106], respectively.[107] The court in *In re WorldCom* noted the Ninth Circuit's holding that 'good faith compliance' with GAAP and GAAS "discharges the accountant's professional obligation to act with reasonable care and establishes the due diligence defense," but narrowed its holding to state that "compliance with GAAP and GAAS does not immunize an accountant who consciously chooses not to disclose on a registration statement a known material fact."[108]

Similarly, an expert can escape liability by proving that for "any part of the registration statement purporting to be made on the authority of an expert (*other than himself*) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the

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[99] 15 U.S.C. § 77k(b)(3)(B) (2012).
[100] 425 U.S. 185 (1976).
[101] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976).
[102] *See* 15 U.S.C. § 77k(b)(3) (2012).
[103] *See, e.g.*, *Hochfelder*, 425 U.S. at 208 ("[E]xperts such as accountants who have prepared portions of the registration statement are accorded a 'due diligence' defense. In effect, this is a negligence standard.").
[104] 15 U.S.C. § 77k(b)(3)(B) (2012) (emphasis added).
[105] RESEARCH AND DEV. ARRANGEMENTS, Statement of Fin. Accounting Standards No. 68, § 32 (Fin. Accounting Standards Bd. 1982).
[106] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 150 (Am. Inst. of Certified Pub. Accountants 1972).
[107] *See* SEC v. Arthur Young & Co., 590 F.2d 785, 788–89 (9th Cir.1979) (discharging the professional obligations of an auditor who complied with GAAS in good faith).
[108] *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 492 (S.D.N.Y. 2005) (quoting Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir.1994)).

statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert."[109] In addition, a non-expert can successfully defend a section 11 claim if that non-expert can show that, "after *reasonable investigation*," he had "reasonable ground to believe and did believe, at the time such part of the registration became effective, that the statements therein were true and that there was no omission to state a material *fact* required to be stated therein or necessary to make the statements therein not misleading."[110]

Section 11(c) defines reasonableness in regards to the "reasonable investigation" and "reasonable ground for belief" of section 11(b) to be "that required of a prudent man in the management of his property."[111] A defendant in a section 11 action who pleads a defense of reasonable investigation or reliance on experts has the burden of proof.[112] In the noteworthy case of *Escott v. BarChris Construction Corp.*,[113] the court explained in detail the failure of proper due diligence on the part of certain officers, directors, experts, outside directors, signers of the registration statement, underwriters, auditors, accountants, and attorneys.[114]

3. Debate over Section 11 Pleading Requirements

Another important factor a plaintiff must consider when bringing a section 11 claim is whether the allegations are subject to the notice pleading requirements of Rule 8 of the Federal Rules of Civil Procedure[115] or the heightened pleading requirements of Rule 9(b).[116] When section 11 claims "sound in fraud," Rule 9(b) applies, regardless of whether a plaintiff later amends the complaint in an attempt to remove any provisions alleging fraud, intent, or recklessness.[117]

Rule 9(b)'s heightened pleading requirements mandate that a plaintiff "state with particularity the circumstances constituting fraud or mistake," but allow for "[m]alice, intent, knowledge, and other conditions of a [defendant's]

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[109] 15 U.S.C. § 77k(b)(3)(C) (2012) (emphasis added).
[110] 15 U.S.C. § 77k(b)(3)(A) (2012) (emphasis added).
[111] 15 U.S.C. § 77k(c) (2012).
[112] *See In re* WorldCom, Inc. Sec. Litig., 02 CIV. 3288DLC, 2005 WL 638268 (S.D.N.Y. Mar. 21, 2005); Escott v. BarChris Const. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968).
[113] 283 F. Supp. 643 (S.D.N.Y. 1968).
[114] *BarChris*, 283 F. Supp. at 682-704.
[115] FED. R. CIV. P. 8.
[116] FED. R. CIV. P. 9(a).
[117] Ind. State Dist. Council of Laborers and Hod Carriers Pension Plan v. Omnicare, Inc., 719 F.3d 498, 502 (2013); *accord* Cal. Pub. Emps. Ret. Sys. v. Chubb Corp., 394 F.3d 126, 139 (3rd Cir. 2004).

mind [to] be alleged generally."[118] The Sixth Circuit in *Omnicare* noted that, in order to meet the "particularity requirement," a plaintiff "must allege the time, place, and content of the alleged misrepresentations on which he or she relied; the fraudulent scheme; the fraudulent intent of the defendants; and the injury resulting from the fraud."[119]

Because many crafty section 11 plaintiffs may attempt to specifically disclaim any allegations that sound in fraud in order to circumvent the heightened requirements of 9(b), or include an in-the-alternative clause for non-fraudulent claims, courts have specifically rejected such a tactic because it goes against Rule 9(b)'s purpose of protecting a defendant's "good will and reputation."[120]

4. Strict Liability and Negligence Under Section 11

Although prima facie evidence of a section 11 claim is generally focused on the materiality of the alleged misrepresentations or omissions, the standard of liability is distinct between issuers, upon which strict liability is applied, and other parties identified in section 11, such as officers, directors, and experts, for which a negligence standard is afforded.[121] While section 11 has traditionally been viewed as a strict liability statute,[122] this bifurcated standard reflects Congress' desire to hold accountable not only the issuers of the registration statement, but also those persons assisting with the preparation of, and providing authority for, the registration statement because those persons have a "[particularly heavy] moral responsibility to the public" and thus, greater liability exists if those individuals cannot prove that they utilized "due care."[123]

III. THE SIXTH CIRCUIT'S EXPLICIT DEPARTURE FROM THE SUBJECTIVE REQUIREMENT OF THE SECOND AND NINTH CIRCUITS

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[118] FED. R. CIV. P. 9(a).

[119] *Omnicare*, 719 F.3d at 503 (2013) (quoting Sanderson v. HCA-The Healthcare Co., 447 F.3d 873, 877 (6th Cir. 2006)) (internal quotations omitted).

[120] Todd R. David, Jessica P. Corley, & Ambreen A. Delawalla, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-on-the-Market - Available Defenses to Claims Under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53, 61-62 (2010); *cf.* Cosmas v. Hassett, 886 F.2d 8, 11 (2nd Cir. 1989) (stating that one of the goals of Rule 9(b) is "to protect a defendant from harm to his or her reputation or goodwill.").

[121] *See In re* Fuwei Films Sec. Litig., 634 F. Supp. 2d 419, 435 n.10 (S.D.N.Y. 2009).

[122] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976); *See also* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (citing Feit v. Leasco Data Processing Equipment Corp., 332 F.Supp. 544, 575 (E.D.N.Y. 1971); R. JENNINGS & H. MARSH, SECURITIES REGULATION 828-29 (4th ed. 1977)) ("If a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case. Liability against the issuer of a security is virtually absolute, even for innocent misstatements.").

[123] Gustafson v. Alloyd, 513 U.S. 561, 581 (1995) (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess., at 5 (1933)).

The Sixth Circuit's decision in *Omnicare* prompted securities regulation attorneys and professionals to predict a potential Supreme Court hearing on the case in light of the circuit split and diverging opinion of whether *Virginia Bankshares* applies to a section 11 claim.[124] Part II.A discusses the strict liability holding of *Omnicare* and the distinction between section 11 and 12(a)(2) claims. Part II.B covers the subjective falsity requirement in *Fait* and the application of that standard to goodwill and loan loss reserves accounting practices. Part II.C analyzes the objectively and subjectively false or misleading standard set forth in *Rubke*. Finally, Part II.D explains why the Third Circuit's approach, although not explicitly on point, supports both the Second and Ninth Circuit's subjective falsity standard.

A. Strict Liability Holding of Omnicare

This section focuses on the strict liability holding of *Omnicare* and the distinctions from both *Fait* and *Rubke* highlighted in the Sixth Circuit's analysis. In addition, this section covers the divergent holdings regarding legal compliance and GAAP.[125]

1. Overview of the Omnicare Decision

The Sixth Circuit in *Omnicare* held that strict liability is the correct standard to be applied where "[the] registration statement, as of its effective date, 'contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[126] However, because of the lack of any reference to statements of opinion in section 11, it is important to consider the purpose of the statute in evaluating such statements.

The purpose of section 11 is to "provide a remedy for investors who have acquired securities pursuant to a registration statement that was materially misleading or omitted material information."[127] Schedules A and B of the Securities Act and related sections mandate detailed information to be included in a registration statement, including "estimates" of remuneration and net proceeds to be paid.[128] The effects caused by the strict liability decision in *Omnicare* include not only much more due diligence on the part of directors,

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[124] *See* Phyllis Skupien, *6th Circuit Ruling in Omnicare Shareholder Suit Creates Circuit Split; En Banc Petition Filed*, 19 NO. 16 WL J. DERIVATIVES 3, at *3 (2013).
[125] *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 492 (S.D.N.Y. 2005).
[126] *Id.* at 503 (citing 15 U.S.C. § 77k(a) (2012)).
[127] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund. v. Omnicare, Inc., 719 F.3d 498, 503 (6th Cir. 2013) (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 381–82 (1983)).
[128] *See* 15 U.S.C. § 77aa(14)-(15) (2012).

consultants, attorneys, underwriters and other individuals responsible for completing a registration statement, but also has the detrimental effect on the Sixth Circuit courts of causing numerous lawsuits to pass muster when a stock price sinks post-filing of the registration statement without the shareholder having to allege any type of knowledge of wrongdoing as it relates to mere opinions of these individuals.[129]

Notably, the Sixth Circuit discussed the Second and Ninth Circuits' reliance on *Virginia Bankshares*' section 14(a) to determine that, although "objective falsity" was required and pled in that case, as in the *Omnicare* matter, the Supreme Court was not confronted with whether "knowledge of falsity" was also required to state a claim.[130] The Sixth Circuit claimed that the Second and Ninth Circuits "have read more into *Virginia Bankshares* than the language of the opinion allows and have stretched to extend this [section] 14(a) case into a [section] 11 context."[131] Further, the Sixth Circuit mentioned that, considering the Supreme Court "assumed knowledge of falsity for the purposes of the discussion," section 14(a) was "effectively treated as a statute that required scienter."[132] Therefore, the Sixth Circuit held that, because section 11 does not require scienter, the *Virginia Bankshares* section 14(a) determination should not apply to a section 11 case, and contrary to the solution proposed by this Article, statements of opinion should be analyzed under a strict liability standard.[133]

2. *Section 11 Claims Distinguished from Section 12(a)(2) and 14(a) Claims*

Section 11 is often pled alongside section 12(a)(2)[134] claims under the Securities Act because of the low-bar strict liability standard plaintiffs must hurdle.[135] Liability exists for *any person* under section 12(a)(2) who offers or sells a security in interstate commerce, by means of a prospectus or oral communication containing a material misrepresentation or omission in connection with the offer or sale, where the purchaser cannot prove that he did not know of the

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[129] *See, e.g.*, Phyllis Skupien, *6th Circuit Ruling in Omnicare Shareholder Suit Creates Circuit Split; En Banc Petition Filed*, 28 NO. 26 WL J. CORP. OFFICERS & DIRS. LIAB. 7 (2013).
[130] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 719 F.3d 498, 506 (6th Cir. 2013).
[131] *Id.*
[132] *Id.* at 506-07.
[133] *Id.*
[134] 15 U.S.C. § 77l (2012).
[135] *See, e.g.*, Litwin v. Blackstone Grp., L.P., 634 F.3d 706, 708 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 242, 181 L. Ed. 2d 138 (U.S. 2011) (discussing the requisite requirements for absolute liability under section 11 and 12(a)(2) claims).

misrepresentation or omission and could not have known even with the exercise of reasonable care.[136]

A key distinction in the pleading requirements of section 11 claims and section 12(a)(2) involves the difference among the potential defendants under the respective sections and the standard of liability thereof. Under section 11, an issuer of a registration statement is liable under strict liability standard, whereas officers, directors, experts, and all other potential defendants, aside from the issuer, are held to a negligence standard for a material misstatement or omission in a registration statement.[137] However, under section 12(a)(2), all sellers of the securities at issue are liable under a negligence standard.[138]

Similar to section 11 claims, a 12(a)(2) action cannot be sustained on the basis of a private offering.[139] Whereas section 11 imposes liability on a specific subset of persons associated with the registration statement, section 12(a)(2) imposes liability on any person who offers or sells a security, through interstate commerce or the mails, using a prospectus or oral communication which contains a false statement of material fact or omission required to not make the statements misleading.[140] Moreover, liability under section 12(a)(2) cannot occur absent active and direct involvement in the sale.[141]

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[136] WILLIAM A. KLEIN, J. MARK RAMSEYER, STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 415 (8th ed. 2012); 15 U.S.C. § 77l (2006) (civil liability arising in connection with a prospectus or communication attaches to "any person who offers or sells a security … by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.").

[137] *See In re* Fuwei Films Sec. Litig., 634 F. Supp. 2d 419, 435 n.10 (S.D.N.Y. 2009).

[138] *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983); *In re* Wachovia Equity Sec. Litig., 753 F. Supp. 2d 326, 367 (S.D.N.Y. 2011) (citing *In re* Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 (2nd Cir. 2010)); *In re Fuwei Films*, 634 F. Supp. 2d at 435 n.10.

[139] *See, e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561, 582-84 (1995) (noting that Congress most likely omitted the term "offering to the public" because of the redundancy with the term "prospectus" and determining that "prospectus" refers to a public offering of securities by an issuer or controlling shareholder); Yung v. Lee, 432 F.3d 142, 149 (2nd Cir. 2005) (citing *Gustafson*, 513 U.S. at 582-84) (holding that the definition of "prospectus" set forth in *Gustafson* as "'a document that describes a public offering of securities' compels the conclusion that a Section 12(a)(2) action cannot be maintained by a plaintiff who acquires securities through a private transaction, whether primary or secondary.").

[140] *See* 15 U.S.C. § 77k (2012); 15 U.S.C. § 77l(a)(2) (2012).

[141] *See* HAZEN, *supra* note 95, at 290 (internal citations omitted); THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 1228 (2014 Supp., 2013) (citing Fed. Hous. Fin Agency v.

Notably, section 12(a)(2) was adapted from common law rescission and thus, section 12(a)(2) requires a buyer to prove misrepresentation of a *fact*, but does not include statements of opinion.[142] Therefore, for the purposes of discussing the merits of the *Omnicare* decision on statements of *opinion*, it is important to keep this distinction in mind.

Section 14(a), discussed in *Virginia Bankshares*, provides for liability in the instance of unlawful solicitation of proxies.[143] In *Omnicare*, the Sixth Circuit stated that section 14(a), like section 11, does require proof of scienter.[144] However, the *Omnicare* court did not extend the subjective falsity standard to the section 11 claims before the court, highlighting the fact that only *objective* falsity was before the Court in *Virginia Bankshares* and thus, did not apply to the *Omnicare* court's decision.[145]

3. Statements of Opinion: Legal Compliance

In the documents filed as part of the Registration Statement, Omnicare provided statements indicating that Omnicare complied with the law when the company implemented certain "therapeutic interchanges" in an effort to provide safer and more effective drugs than the drugs that patients had previously been prescribed, and that its contractual arrangements were "legally and economically valid," adding value to both patients and the healthcare system overall.[146]

Some practitioners have argued that Item 503(c) of Regulation S-K requires disclosure of information that a company is not complying with applicable law or ethical standards since these statements would be significant in determining whether the offering is risky.[147] However, courts have suggested that, while disclosure of information that would make the purchase of the securities speculative or risky is required, the list of factors provided by the SEC

Morgan Stanley, 2012-2013 Fed. Sec. L. Rep. (CCH) ¶ 97,204 at 94,923 (S.D.N.Y. 2012) (holding that the mere assistance in preparation and filing of a registration statement is insufficient to impose liability under section 12(a)(2)")).

[142] LOSS ET AL., *supra* note 37, at 242-43.

[143] *See* 15 U.S.C. § 78n(a)(1) (2012).

[144] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 719 F.3d 498, 507 n.3 (6th Cir. 2013).

[145] *See Id.* at 506 (2013).

[146] 2A VENTURE CAP. & BUS. FIN. § 14:15 (citing *Id.* at 499).

[147] *See, e.g.*, Lead Plaintiff's Memorandum of Law in Opposition to Defendants' Motion to Dismiss the Securities Act Claims in the Amended Consolidated Securities Class Action Complaint, *In re* UBS AG Securities Litig., No. 1:07-CV-11225-RJS, 2012 WL 1615914 (S.D.N.Y. Feb. 13, 2012) (claiming that the defendants "had an absolute duty to disclose" information concerning the company's legal and ethical compliance, in order to make the statements included not misleading, under applicable SEC regulations, including Item 503(c) of Regulation S-K. Item 503(c) requires a "discussion of the most significant factors that make the offering speculative or risky" to be included in the registration statement. 17 C.F.R. § 229.503(k) (2013).

under Item 503(c) are mere suggestions, and moreover, legal compliance issues are not listed under this factor list.[148]

4. Statements of Fact or Opinion: GAAP

The *Omnicare* decision also determined that the plaintiffs were not required to plead subjective falsity for GAAP allegations, namely that the financial statements filed pursuant to the Registration Statement contained a substantial overstatement of Omnicare's revenue.[149] However, while Omnicare claimed the GAAP allegations were "soft information,"[150] the court disagreed and determined that the plaintiffs were merely alleging "hard facts"[151] concerning actual accounting numbers being incorrect.[152] The Sixth Circuit noted that their decision to not require subject falsity would have been rendered even if they found that the GAAP allegations were soft information,[153] but it is important to distinguish between the two, especially in light of the decisions of other circuits.

B. Subjective Falsity Requirement in Fait

The *Omnicare* court specifically declined to follow the Second Circuit's subjective falsity holding of *Fait v. Regions Financial Corporation*.[154] In particular, while the Sixth Circuit acknowledged that Supreme Court precedent bound them, the court found "nothing in *Virginia Bankshares* that alter[ed] the outcome in the instant case," and "decline[d] to follow the Second and Ninth Circuits as a result."[155] The court distinguished the section 14(a) claim in *Virginia Bankshares* from a section 11 claim, explicitly denying the extension of *Virginia Bankshares*' subjective falsity requirement to section 11 claims.[156] The court held that strict liability is the applicable section 11 standard for a registration statement containing an "untrue statement of material fact," and thus, whether the

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[148] *See, e.g.*, *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 691 (S.D.N.Y. 2004) (discussing the conflicting statements provided by the SEC regarding disclosure of risk factors under Item 503(c)).

[149] *See Omnicare*, 719 F.3d at 501, 509.

[150] *See, e.g.*, *In re* Sofamor Danek Grp., Inc., 123 F.3d 394, 401-02 (6th Cir. 1997) (citing Lewis v. Chrysler *402 Corp., 949 F.2d 644, 652 (3rd Cir.1991)) (stating that "soft information ... includes predictions and matters of opinion.").

[151] *See, e.g.*, *Id.* at 401 (quoting Garcia v. Cordova, 930 F.2d 826, 830 (10th Cir.1991)) (describing hard information as "typically historical information or other factual information that is objectively verifiable") (internal quotations omitted).

[152] *Omnicare*, at 509.

[153] *Id.* at 509.

[154] 655 F.3d 105 (2nd. Cir. 2011).

[155] *Omnicare*, 719 F.3d at 506.

[156] *See Id.* at 507.

defendant knew the statement was false is irrelevant once the false statement is made.[157]

In *Fait v. Regions Financial Corporation*,[158] the Second Circuit determined that for claims asserted under sections 11 and 12 of the Securities Act "based upon a *belief* or *opinion* alleged to have communicated by a defendant, liability lies only to the extent that the statement was both objectively false and disbelieved by the defendant at the time it was expressed."[159] The court noted that "although sections 11 and 12 refer to misrepresentations and omission of material *fact*, matters of belief and opinion are not beyond the purview of these provisions."[160]

In this case, Regions Financial Corporation ("Regions"), a regional bank holding company acquired another holding company in a $10 billion stock transaction.[161] In conjunction with the transaction, Regions recorded the assets and liabilities of the acquired company at fair value with the excess purchase price recorded as "goodwill."[162] About a year and a half later, in April of 2008, Regions subsidiary issued 13.8 million shares of trust preferred securities[163] after filing a registration statement that incorporated a previously-filed Form 10-K[164] among other filings. As the market began to deteriorate throughout 2008, Regions continued reporting goodwill of $11.5 billion for the first three quarters, but suddenly reported a $5.6 billion net loss in January of 2009, including a $6 billion "non-cash charge for impairment of goodwill" and doubled its loan loss provision from a year prior.[165] After the disclosures, and during the ensuing subprime mortgage crises and collapse of the market, the price of the securities and Regions' stock fell for several months, credit agencies downgraded Regions'

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[157] *Id.* at 505 (quoting 15 U.S.C. 77k(a) (2012)). *See also* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983).

[158] 655 F.3d 105 (2nd. Cir. 2011).

[159] Fait v. Regions Fin. Corp., 655 F.3d 105, 110 (2nd Cir. 2011) (citing Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1095-96 (1991) (emphasis added).

[160] *Id.* at 110.

[161] *Id.* at 107.

[162] *Id.* at 107.

[163] Trust preferred securities are type of hybrid security involving a trust set up by the issuer to hold a single asset, usually a long-term bond, whereby purchases receive a claim on the trust and its income. *See* Gregory Zuckerman, *A Question of Trust: Trust preferred securities have sizable yields—but also some sizable risks*, Interview of Harry Newby, THE WALL STREET JOURNAL, available at http://online.wsj.com/article/SB10001424052970204770404577080803185437584.html#articleTabs%3Darticle (last visited Jan. 6, 2014).

[164] *See Form 10-K*, SEC, http://www.sec.gov/answers/form10k.htm (last visited Jan. 6, 2014) (Form 10-K is an annual report filed with the SEC that "provides a comprehensive overview of the company's business and financial condition and includes audited financial statements."); *See also Fait*, 655 F.3d at 107 ("In February 2008, Regions filed its 2007 Form 10-K wherein it reported $11.5 billion in goodwill, of which $6.6 billion was attributed to the AmSouth [Bancorporation] acquisition."); Omnicare, Inc., Annual Report (Form 10-K) (Feb. 26, 2008).

[165] *Fait*, 655 F.3d at 107.

debt, and Alfred Fait subsequently filed a class-action suit against Regions.[166] Fait later added the accounting firm, Ernst & Young, which served as the company's independent public accountant, certifying financial statements in the 2007 Form 10-K, and also served as Regions' underwriter for the 2008 offering of securities at issue.[167]

Following the district court's granting of Regions' motions to dismiss,[168] the Second Circuit affirmed after determining that Fait failed to adequately allege subjective falsity by Regions, regarding misstatements of opinion related to goodwill or loan loss reserves and thus, failed to state a claim.[169]

1. Goodwill Issues in Fait

In its analysis, the Second Circuit noted that goodwill is "an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized."[170] The court highlighted that, in an acquisition, GAAP requires that purchasing companies report as "goodwill" or "excess purchase price" any amount greater than fair value of the acquired assets and liabilities.[171] Because GAAP also requires goodwill to be tested for impairment annually, Regions conducted an impairment test at the end of 2007, following the merger and recorded goodwill of $6.2 billion, but found no impairment.[172] Howard Rensin ("Rensin"), the lead plaintiff, argued that Regions "failed to conduct impairment tests in the first three quarters of fiscal year 2007[,] failed to properly record impairment charges during that period[,]" and that Regions "should have concluded that goodwill was impaired due to the deterioration of the banking sector by that time."[173]

However, agreeing with the district court's opinion, the Second Circuit noted that "[Rensin's] allegations regarding goodwill do not involve misstatements or omissions of material fact, but rather a misstatement regarding Regions' opinion" and that "estimates of goodwill depend of management's determination of the 'fair value' of the assets acquired and liabilities assumed, which are *not* matters of objective fact."[174] The court suggested that Rensin should have claimed that market price, an objective standard, should have been used to determine the value of AmSouth Bancorporation's assets pursuant to Region's

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[166] *Id.*
[167] *Id.* at 107-08.
[168] Fait v. Regions Fin. Corp., 712 F. Supp. 2d 117, 120-25 (S.D.N.Y. 2010).
[169] *Fait*, 655 F.3d at 113.
[170] *Id.* at 110 (quoting J.A. 940).
[171] *Id.*
[172] *Id.*
[173] *Id.* (citing Am. Compl. ¶ 158) (internal quotations omitted).
[174] *Fait*, 655 F.3d at 110 (citing Henry Champlain Enters., Inc., 445 F.3d 610, 619 (2nd Cir. 2006)) (emphasis added).

acquisition.[175] Thus, the court determined that goodwill statements at issue were "subjective" rather than "objective factual matters."[176]

A key issue in *Fait* is whether liability under sections 11 or 12 can exist for making a subjective statement such as Regions' non-impairment of goodwill claim.[177] The court relied on *Virginia Bankshares v. Sandberg*,[178] a section 14(a) case involving a freeze-out merger[179] where the Court considered whether statements of "reasons, opinions, or beliefs" are statements with respect to material facts so as to fall within [Rule 14a-9].[180] The court highlighted the fact that the *Virginia Bankshares* Court "recognized that the statement of reasons and belief at issue, although not statements of facts in and of themselves, 'are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed."[181] Thus, the Second Circuit is relying on this two-fold quasi-factual distinction from the 14(a) case in *Virginia Bankshares* to rationalize the statements of goodwill at issue in *Fait*.[182]

Under this two-fold test for opinions, the *Fait* court held that "such statements may be actionable if they misstate the opinions or belief held, or in the case of statements of reasons, the actual motivation for the speaker's actions *and* are false or misleading with respect to the underlying subject matter they address."[183] Per Justice Scalia's application of the test in his *Virginia Bankshares* concurrence, which the *Fait* court noted, "the statement 'In the opinion of the Directors, [the stock price offered] is a high value for the shares' would produce liability if in fact it was not a high value and the directors knew that," but it "would not produce liability if in fact it was not a high value but the directors *honestly believed* otherwise."[184] Thus, under the *Fait* rule, a section 11 plaintiff is required to allege (1) "a speaker's disbelief in," i.e. subjective falsity, and (2) "the falsity of," i.e. objective falsity, "the opinions or beliefs expressed."[185] Because Rensin did not adequately allege "actionable misstatements or

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[175] *Id.*
[176] *Id.* at 110-11 (citing I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 762 (2nd Cir. 1991)).
[177] *Id.* at 111.
[178] 501 U.S. 1083 (1991).
[179] A freeze-out merger occurs when an acquiring company purchases a target company with the sole purpose of eliminating, or "freezing out," the minority shareholders of the target company. *See* Edward F. Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 489 (1976).
[180] *Fait*, 655 F.3d at 111 (quoting *Virginia Bankshares*, 501 U.S. at 1091).
[181] *Id.* (quoting *Virginia Bankshares*, 501 U.S. at 1092).
[182] *Id.*
[183] *Id.* (quoting *Virginia Bankshares*, 501 U.S. at 1091-96).
[184] *Id.* (2nd Cir. 2011) (quoting *Virginia Bankshares*, 501 U.S. at 1108-09 (1991) (Scalia, J., concurring in part and concurring in the judgment)).
[185] *Fait*, 655 F.3d at 112.

omissions" regarding goodwill in the complaint, but rather relied on "allegations about adverse market conditions, and did not "plausibly allege that defendants did not believe the statements regarding goodwill at the time they made them," the section 11 and 12 claims regarding goodwill were dismissed.[186]

2. Loan Loss Reserves Issues in Fait

In its analysis, the Second Circuit determined that Rensin's loan loss reserves claims failed by the same rationale as those claims regarding goodwill.[187] The District Court previously determined that the management's statements regarding loan loss reserves were not a matter of objective fact, but rather reflect the management's opinion regarding "portions of amounts due," if any, on loans that "might not be collectible."[188] In agreement, the Second Circuit held that management's judgment as to whether funds are sufficient to cover losses in a loan portfolio is "inherently subjective, and like goodwill, estimates will vary depending on a variety of predictable and unpredictable circumstances."[189]

The complaint even acknowledged that Regions had actually increased its allowance for credit losses during the applicable period due, in part, to the declining mortgage and housing markets.[190] The Second Circuit affirmed dismissal of the claims, noting that Rensin did not allege an objective standard for setting loan loss reserves.[191] Because a section 11 plaintiff must allege that a defendant's opinions were "both false and not honestly believed when they were made," Rensin failed to state a claim that justified relief as the complaint did not "plausibly allege subjective falsity."[192]

C. Objectively and Subjectively False or Misleading under Rubke

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[186] *Id.*; *see also* Friedman v. Mohasco Corp., 929 F.2d 77, 78-79 (2nd Cir. 1991) (holding that a defendant company's representation of securities that it issued pursuant to a merger would reach a specific market value, but which did not occur, was not deemed actionable under the Securities Acts because the company's projections were stated as opinions instead of guarantees); *In re* Time Warner Inc. Securities Litigation, 9 F.3d 259, 266 (2nd Cir 1993) (determining that "expressions of opinion and … projections" in a defendant company's statements about its future prospects were not actionable because the complaint did not contain allegations to support the inference that the defendants either did not have the favorable opinions when they made the statements or that the favorable opinions were without a "basis in fact").

[187] *Fait*, 655 F.3d at 113.

[188] *Id.*; *see also* Shapiro v. UJB Fin. Corp., 964 F.2d 272, 281 (3rd Cir. 1992) (discussing the fact that no single method of evaluating and setting loan loss reserves "has been proven foolproof" and that some banks set these reserves by "comparing the size of the reserves to that of the loan portfolio" while other banks "also analyze the quality of their loans in varying degrees of detail and according to a range of different criteria and classifications").

[189] *Fait*, 655 F.3d at 113.

[190] *Id.* at 112-13.

[191] *Id.*

[192] *Id.* at 113.

The Sixth Circuit in *Omnicare* also refuted the Ninth Circuit's opinion in *Rubke v. Capitol Bancorp Ltd*.[193] In *Rubke*, the court also relied on *Virginia Bankshares* and held that "opinions can give rise to a claim under section 11 only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading."[194]

In the *Rubke* case, minority shareholders had previously filed a class-action suit in district court against a company who acquired the bank of which they owned shares.[195] The shareholders filed section 11 claims after Capitol Bancorp Ltd. ("Capitol") made a tender offer to convert the shareholders' National Community Bank ("NCB") stock into Capitol stock, alleging that Capitol undervalued the NCB stock and that Capitol was able to purchase their NCB stock well below fair market value because of the material misrepresentations and omissions in the registration statement.[196] The district court held that the shareholders were unable to show that fairness opinions and understated profitability opinions were "objectively and subjectively false."[197]

On appeal, the Ninth Circuit affirmed the district court's objective and subjective falsity holding, stating that, because the fairness determinations were "alleged to be misleading *opinions*, not statements of *fact*, they can give rise to a claim under section 11 only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading."[198] Additionally, the court rejected the shareholders' claim that omission of a publicly-available transaction report regarding a similar transaction one year prior to this tender offer constituted a material omission required in order to make the statements not misleading.[199] The court stated that the complaint failed to specify which language in the registration statement was allegedly made misleading by the failure to mention the earlier transaction.[200] Moreover, section 11 does not mandate disclosure of all information that a potential investor might consider when deciding whether to purchase the security, particularly information that is already widely available.[201] Therefore, similar to the Second

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[193] *See* Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund. v. Omnicare, Inc., 719 F.3d 498, 506-07 (6th Cir. 2013) (stating that the Ninth Circuit incorrectly extended a section 14(a) claim to impose a knowledge of falsity requirement on a section 11 claim); Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009).

[194] *Rubke*, 551 F.3d at 1162.

[195] Rubke v. Capitol Bancorp Ltd., 460 F.Supp.2d 1124, 1128 (N.D. Cal. 2006), *aff'd*, 551 F.3d 1156 (9th Cir. 2009).

[196] *Id.* at 1129.

[197] *Id.* at 1146, 1151.

[198] Rubke v. Capitol Bancorp Ltd, 551 F.3d 1156, 1162 (9th Cir. 2009).

[199] *Id.* at 1162-63.

[200] *Id.*

[201] *Id.*; *see also* Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 517 (7th Cir. 1989) ("It is pointless and costly to compel firms to reprint information already in the public domain"); Klein v. Gen. Nutrition Companies, Inc., 186 F.3d 338, 343 (3rd Cir. 1999) (citing *In re* Donald J. Trump

Circuit's holding in *Fait*, the Ninth Circuit's determination in *Rubke* changes the traditional issuer strict liability standard,[202] and negligence standard for directors, accountants, auditors, underwriters, and other experts, for misstatements or omissions of material fact in a registration statement, to an objective (false on its face) and subjective (knowledge of falsity) standard for statements of opinion.[203]

D. The Third Circuit's Subjective Falsity Standard

In its Petition for a Writ of Certiorari, Omnicare cites *In re Donald J. Trump Casino Securities Litigation*[204] for explicit authority that the Third Circuit has also previously held that subjective falsity is required for pleading section 11 claims regarding statements of opinion.[205] However, in *Trump*, the court briefly mentioned this standard in its dicta while ultimately focusing on the lack of materiality of the statements of opinion to reach its conclusion that the statements were not actionable.[206]

Moreover, while the Third Circuit had previously determined that "opinions, predictions and other forward-looking statements are not *per se* inactionable" under federal securities laws, and that "such statements of 'soft information' may be actionable misrepresentations if the speaker does not genuinely and reasonably believe them,"[207] the court focused its analysis more on the diminishing effect of other statements contained in the registration statement in its "bespeaks caution doctrine" analysis.[208] Because the cases cited therein deal with other securities provisions, the Third Circuit's discussion is not as beneficial as the holdings of the Second and Ninth Circuits in analyzing the Omnicare decision.[209]

Casino Sec. Litig.-Taj Mahal Litig., 7 F.3d 357, 377 (3rd Cir. 1993)) (noting that federal securities laws "do not require a company to state the obvious" in regards to publicly-available information).

[202] *See* 15 U.S.C. § 77b(a)(4) (2012) ("The term "issuer" means every person who issues or proposes to issue any security ....").

[203] *See In re* Fuwei Films Sec. Litig., 634 F. Supp. 2d 419, 435 n.10 (S.D.N.Y. 2009); *see also* Lyle Roberts, *Reading the Tea Leaves*, THE 10B-5 DAILY (May 24, 2013, 8:09 PM), http://www.the10b-5daily.com/archives/001221.html (last visited Jan. 6, 2014).

[204] 7 F.3d 357 (3rd Cir. 1993).

[205] Petition for a Writ of Certiorari, Omnicare, Inc. v. The Laborers Dist. Council Constr. Industry Pension Fund, No. 13-435, 2013 WL 5532735, at *8-9 (U.S. October 4, 2013).

[206] *See In re Trump*, 7 F.3d at 368-69.

[207] *Id.* at 368, 368 n.11 (citing Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 642 (3rd Cir. 1989) (describing "soft information" as statements of subjective analysis or extrapolation, such as opinions, motives, and intentions, or forward looking statements, such as projections, estimates, and forecasts"); Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723 (1989)).

[208] *Id.* at 371-73.

[209] *See Id.* at 368-69 (citing Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) (discussing lack of belief of statements of opinion in a section 14(a) freeze-out merger case); Herskowitz v.

IV. ANALYSIS OF SECTION 11 PLEADING REQUIREMENTS AND SIMILAR PROVISIONS

Section 11 claims are often brought alongside section 10(b) and Rule 10b-5 claims in a complaint when a purchaser of securities alleges claims that involve fraud. Because section 10(b) and Rule 10b-5 claims require pleading "scienter," but section 11 claims do not, it is important not to confuse subjective falsity with scienter, which Part III.A clarifies. The distinction between section 11 claims and section 10(b) and Rule 10b-5 claims, analyzed in Part III.B, is crucial in the analysis of the *Omnicare* decision.

A. Subjective Falsity vs. Scienter

It is important to distinguish "scienter" from subjective liability when analyzing section 11 claims. Scienter, which is not required for pleading a section 11 claim, is typically referred to as a requisite knowledge of wrongdoing for legal liability.210 Establishing scienter, an "essential element of a securities-fraud action brought by [the SEC] or private plaintiffs," requires "pleading and proving the requisite mental state of the individual at the time he or she committed the wrongful act, usually a material misstatement or omission."211

In Federal Housing Financial Agency v. UBS Americas, Inc., United States District Court for the Southern District of New York noted that, because "Fait requires a showing of subjective falsity only on the part of the originator of an opinion statement," the distinction between subjective falsity and scienter in regards to claims under the Exchange Act is crucial to an analysis of subjective falsity under the Securities Act.212

In this case, the court noted that, "[a]lthough the Fait [c]ourt was careful to emphasize that the concepts are different … courts have struggled to distinguish these two lines of inquiry, in part because, where the originator of the opinion is a defendant, proving the falsity of the statement 'I believe this

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Nutri/Sys., Inc., 857 F.2d 179, 184 (3rd Cir. 1988) (discussing "without reasonable genuine belief" and "no basis" regarding a false and misleading proxy statement under sections 10(b) and 14(a)); Eisenberg v. Gagnon, 766 F.2d 770, 776 (3rd Cir. 1985) (applying a "lack of genuine belief or reasonable basis" in the section 10(b) and Rule 10b-5 context)).

[210] *See* BLACK'S LAW DICTIONARY 1463 (9th ed. 2009) (defining scienter as "[a] degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act's having been done knowingly, esp. as a ground for civil damages or criminal punishment.")

[211] Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J. L. & BUS. 1, 2 (2009).

[212] Fed. Hous. Fin. Agency v. UBS Americas, Inc., 858 F. Supp. 2d 306, 326-27 (S.D.N.Y. 2012), *aff'd*, 712 F.3d 136 (2nd Cir. 2013) (internal citations omitted).

investment is sound' is the same as proving scienter."213 The court also noted that "once it is acknowledged that the 'subjective falsity' inquiry is directed at determining the truth of the statement, 'I believe," rather than the fraudulent intent of any defendant who later reports that claim, the distinction becomes clearer" and further highlighted that "while a plaintiff must plead scienter for each Exchange Act defendant, under the Securities Act the plaintiff need only allege subjective falsity as to the originator of the opinion expressed in the offering documents."214

B. Distinguishing Claims Brought Pursuant to Section 11 vs. Section 10(b) & Rule 10b-5

Part III.B.1 discusses the distinctions between section 11 and the commonly pled section 10(b) of the Exchange Act and SEC Rule 10b-5, which are often pled alongside section 11 claims when allegations of fraud are involved. Part III.B.2 discusses the affirmative defense of "loss causation" that was pled by Omnicare, Inc. and its effect on future section 11 cases involving statements of opinion.

1. Section 11 Claims Distinguished from Section 10(b) and Rule 10b-5 Claims

Section 11 provides a private right of action against an issuer of securities if a registration statement filed in connection with the sale of securities contains a "material" misstatement or omission.[215] The applicable SEC regulation defining "material" states that the term "when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[216]

Section 11(a) attaches liability to not only every person who signed the registration statement,[217] but also every director, or the person who performs functions similar to a director, of the issuer at the time of filing of the part of the registration statement under which liability is being asserted.[218] Moreover, "every person who, with his consent, is named in the registration statement as being or

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[213] Fed. Hous. Fin. Agency v. UBS Americas, Inc., 858 F. Supp. 2d 306, 327 (S.D.N.Y. 2012) (quoting Podany v. Robertson Stephens, Inc., 318 F.Supp.2d 146, 154 (S.D.N.Y. 2004) (internal citations omitted)).

[214] Fed. Hous. Fin. Agency v. UBS Americas, Inc., 858 F. Supp. 2d 306, 327 (S.D.N.Y. 2012) (quoting Podany v. Robertson Stephens, Inc., 318 F.Supp.2d 146, 154 (S.D.N.Y. 2004).

[215] *See* 15 U.S.C. § 77k (2012).

[216] 17 C.F.R. § 230.405 (2013).

[217] 15 U.S.C. § 77k(a)(1) (2012).

[218] *Id.* § 77k(a)(2).

about to become a director, person performing similar functions, or partner" is subject to liability"[219] as well as "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement ..."[220] and "every underwriter with respect to such security."[221]

Thus, a director who joins the issuer just before a registration statement is filed could be subject to liability for material misstatements or omissions, so it is imperative that new directors perform their due diligence prior to accepting the position.[222] Due diligence is an affirmative defense to a section 11 claim for everyone but the issuer.[223] A "reasonable investigation,"[224] including "reasonable grounds to believe" the statements therein were true.[225]

Rule 10(b) of the Exchange Act and Rule 10b-5 are the principal antifraud mechanisms for shareholders bringing private rights of action against an issuer for "manipulative or deceptive" practices utilizing "any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange."[226] Prior to the enactment of Rule 10b-5, section 10(b) was inoperative on its own, thus requiring this SEC rule to effectuate section 10(b). "Unlike Rule 10b-5 (which, as noted, applies to any person who makes an untrue statement or omission of a material fact), Section 11 imposes liability for a limited class of persons; it applies to parties involved in the preparation of a registration statement and to directors, regardless of whether they were involved in the preparation."[227]

Distinct from Rule 10b-5 pleading requirements, Section 11's requirements place a relatively minimal burden on a plaintiff.[228] Following the *In re WorldCom* decision, outside directors have virtually no due diligence defense. The due diligence defenses can be "outflanked" by a plaintiff who can successfully allege

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[219] *Id.* § 77k(a)(3).
[220] *Id.* § 77k(a)(4).
[221] *Id.* § 77k(a)(5).
[222] *See, e.g.*, Escott v. BarChris Construction Corp., 283 F. Supp. 643, (S.D.N.Y. 1968) (denying the dismissal of claims against an accountant, among other directors, auditors, and underwriters, who, on his first assignment as a senior accountant, failed to verify the accuracy of statements made in a bowling alley construction company's registration statement).
[223] *See* 15 U.S.C. § 77k(b)(3) (2013).
[224] *Id.*
[225] *Id.* § 77k(b)(3)(A)-(C).
[226] *Id.* § 78j; *See also* Chiarella v. United States, 445 U.S. 222, 226 (1980) (describing section 10(b) as a "catch-all clause" to prevent fraudulent securities practices); Note, *Civil Liability Under Rule X-10b-5*, 42 VA. L. REV. 537, 539 (1956) (noting the importance of Rule 10b-5 as an antifraud mechanism).
[227] David I. Michaels, *No Fraud? No Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933*, 26 ANN. REV. BANKING & FIN. L. 345, 363 (2007).
[228] *Id.* at 385-86.

that a "red flag" existed that required defendants to make further inquiry.[229] Because section 11 due diligence opinions are scarce, the *In re Worldcom* decision is likely to have "wide influence and long lasting force."[230] Thus, going forward, plaintiffs will likely pursue Section 11 claims to take advantage of its "lenient pleading requirements."[231] Under a similar analysis, plaintiffs will likely proceed under section 11 for false or misleading statements of opinion due to the minimally-burdensome strict liability holding of *Omnicare*.

2. Pleading Loss Causation

The *Omnicare* decision noted that the defendants sought to plead "loss causation" as an affirmative defense to justify affirming the district court.[232] The Sixth Circuit noted that "'[l]oss causation' refers to the causal connection between the defendant's material misrepresentation or omission and the plaintiff's loss."[233] While loss causation is an actual element under most federal securities laws,[234] including section 10(b) and Rule 10b-5 claims,[235] it is an affirmative defense to a section 11 claim,[236] placing the burden of rebuttal on the defendant.[237] Loss causation can be difficult for a section 11 defendant to rebut, particularly large corporate issuers, such as Omnicare, in highly regulated industries.[238] Therefore, a strict liability standard for statements of opinion, rather than a subjective falsity standard, will enable section 11 plaintiffs to plausibly allege their claims without conducting a substantial inquiry into the actions of the corporation and corporate defendants while increasing

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[229] *Id.*
[230] *Id.*
[231] *Id.*
[232] Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund. v. Omnicare, Inc., 719 F.3d 498, 509 (6th Cir. 2013).
[233] *Id.* (citing Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 527 F. Supp. 2d 698, 704 (E.D. Ky. 2007), *aff'd in part*, *rev'd in part*, 583 F.3d 935 (6th Cir. 2009)); *accord* T. HAZEN, LAW OF SECURITIES REGULATION §§ 12.11[1], [3] (5th ed. 2005).
[234] *See* 69A AM. JUR. 2D *Securities Regulation—Federal* § 1191 (West 2013) ("Loss causation and actual injury are elements of private civil claims under most of the provisions of the federal securities laws … these concepts are required elements in a private civil action under the antifraud provisions.").
[235] *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005).
[236] *See* Levine v. AtriCure, Inc., 508 F. Supp. 2d 268, 272 (S.D.N.Y. 2007) (citing 15 U.S.C. § 77k(e); Akerman v. Oryx Commc'ns Inc., 810 F.2d 336, 341 (2nd Cir.1987)) ("… Congress enacted § 11(e), which makes the absence of loss causation, also known as 'negative causation,' an affirmative defense to reduce or avoid liability under § 11.").
[237] *See* Akerman v. Oryx Commc'ns, Inc., 810 F.2d 336, 340-41 (2nd Cir. 1987)("The precise issue … is whether defendants carried their burden of negative causation under section 11(e). Defendants' heavy burden reflects Congress' desire to allocate the risk of uncertainty to the defendants in these cases." (citation omitted)).
[238] *See* Omnicare, 719 F.3d at 509-10 (2013).

investigation costs on the company, which will essentially punish current shareholders of the company and decrease the company's overall market value.[239]

Section 11(e), the loss causation provision of section 11, provides an affirmative defense for a defendant to overcome a section 11 complaint by allowing the issuer, otherwise strictly liable for untrue statements of material fact or omission, to prove that the depreciation in value of the security was caused by something *other than* the defendant's misrepresentation or omission.[240] Sometimes, this can be apparent on the face of a complaint without requiring a defendant to prove loss causation, particularly where a price decline in the value of the stock occurs prior to the dissemination of the material misrepresentation or omission.[241] As in section 11, loss causation is an affirmative defense for section 12(a)(2) claims.[242] However, proving that the loss in value was caused by something other than misstatements of opinion, such as the statements of legal compliance, can be extremely difficult in highly-regulated industries where the potential for multi-million and even billion-dollar fines or settlements have been reached in recent years.[243]

V. STRICT LIABILITY'S DETRIMENTAL EFFECT ON HIGHLY-REGULATED INDUSTRIES

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[239] *See, e.g.*, Amy L. Craiger, Note, *From Conceivable to Impossible: The Hurdles Plaintiffs Must Overcome When Pleading Section 11 and Section 12(a) Securities Claims*, 5 BROOK. J. CORP. FIN. & COM. L. 549, 558-59 & n.96 (2011) (quoting H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.) (discussing Congress' objective in enacting the PSLRA, which required heightened pleading standards for securities fraud claims, as protecting issuers from abusive practices such as frivolous lawsuits, targeting "deep pocket defendants," abuse of the discovery process to force settlement, and class action plaintiffs' attorney manipulation).

[240] *See* City of Roseville Employees' Ret. Sys. v. EnergySolutions, Inc., 814 F. Supp. 2d 395, 422-23 (S.D.N.Y. 2011) (quoting ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 107 (2nd Cir. 2007)) ("to establish loss causation, as required by section 10(b) and Rule 10b–5, a plaintiff need only plead economic loss and 'that the loss was foreseeable and caused by the materialization of the risk concealed by the fraudulent statement.'" (citation omitted)).

[241] *See* Akerman v. Oryx Commc'ns, Inc., 810 F.2d 336, 342 (2nd Cir. 1987) (determining that defendants were not liable where a price decline occurred prior to disclosure of a misstatement, especially since the price actually increased following disclosure to the public); *In re* Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 272 F. Supp. 2d 243, 255 (S.D.N.Y. 2003) (holding that price declines of a plaintiff's shares in the company that occurred before public disclosure of a material omission "may not be charged to [the d]efendants under Section 11 or Section 12(a)(2).").

[242] *See* 15 U.S.C. § 77l(b) (2012).

[243] *See, e.g.*, Jessica Silver-Greenberg, *JPMorgan Reaches $4.5 Billion Settlement With Investors*, THE NEW YORK TIMES DEALBOOK, http://dealbook.nytimes.com/2013/11/15/jpmorgan-reaches-4-5-billion-settlement-with-investors/ (last visited Nov. 15, 2013) ("JPMorgan reached a $4.5 billion settlement with a group of investors over claims that the bank sold them shaky mortgage-backed securities that imploded later, leading to large losses … The multibillion-dollar payout is separate from the tentative $13 billion settlement that JPMorgan reached with the Justice Department over the bank's questionable mortgage practices … JPMorgan has set aside a $23 billion cushion for litigation reserves.").

The *Omnicare* decision has caused grave concern in the securities industry in light of its potential effect on highly-regulated industries, such as healthcare and finance.[244] Further, even before the Petition for a Writ of Certiorari was filed,[245] securities industry professionals noted that the decision could pose such an imbalance in the current securities law that the Supreme Court is likely to hear the matter.[246] Part IV.A analyzes the potential section 11 liability of healthcare companies following the enactment of the Affordable Care Act. Part IV.B predicts the ramifications of a strict liability decision on banks and financial companies.

A. Section 11 Liability of Healthcare Companies Following the Affordable Care Act

After the Patient Protection and Affordable Care Act of 2010 ("ACA")[247] was passed by Congress, and upheld by the Supreme Court in 2012,[248] issuers, directors, accountants, and auditors of healthcare and healthcare administration companies were faced with the reality that much more stringent standards related to legal compliance, including fines for noncompliance, would be soon approaching.[249] In light of *NFIB v. Sebilius*,[250] which upheld the constitutionality of the ACA,[251] the *Omnicare* decision could have negative repercussions on the healthcare industry, including a flurry of potential lawsuits against companies already bombarded with a plethora of new healthcare laws of which to comply.[252]

In October 2013, after previously settling several similar Medicare-kickback lawsuits, Omnicare settled a qui tam suit brought by a former employee

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[244] *See* Phinney et al., *supra* note 5.

[245] *See* Petition for a Writ of Certiorari, *supra* note 205.

[246] *See* Susanne Karic, James Grohsgal, & Amy Ross, *The Sixth Circuit – The New Hotspot for Section 11 Suits*, ORRICK SEC. LITIG. AND REGULATORY ENFORCEMENT BLOG (May 29, 2013), http://blogs.orrick.com/securities-litigation/2013/05/29/the-sixth-circuit-the-new-hotspot-for-section-11-suits/ (last visited Jan. 6, 2014).

[247] Commonly referred to as "Obamacare"; *See* JOSH BLACKMAN, UNPRECEDENTED: THE CONSTITUTIONAL CHALLENGE TO OBAMACARE 29 (2013).

[248] *See* NFIB v. Sebelius, 567 U.S. __, 132 S.Ct. 2566 (2012).

[249] *See* BLACKMAN, *supra* note 247, at 98-102.

[250] 132 S.Ct. 2566, 183 L.Ed.2d 450 (2012).

[251] *See Sebelius*, 132 S.Ct. 2566 (2012) (upholding the individual mandate as a constitutionally permissible tax pursuant to Congress' taxing power).

[252] The ACA itself is 906 pages long. *See* The Patient Protection and Affordable Care Act, available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ148/pdf/PLAW-111publ148.pdf (last visited Oct. 13, 2013). According to some Congressmen, additional rules and regulations "associated with" Obamacare now amount to approximately 20,000 pages. Glenn Kessler, *How Many Pages of Regulations for 'Obamacare'?*, THE WASHINGTON POST, THE FACT CHECKER BLOG (May 15, 2013, 6:00 AM), http://www.washingtonpost.com/blogs/fact-checker/post/how-many-pages-of-regulations-for-obamacare/2013/05/14/61eec914-bcf9-11e2-9b09-1638acc3942e_blog (last visited Jan. 6, 2014).

pursuant to the False Claims Act ("FCA") for $120 million.[253] The Anti-Kickback Statute[254] provides criminal penalties[255] for anyone who receives illegal remunerations, including kickbacks, bribes, or rebates pursuant to a federal healthcare program, including Medicare.[256] While this criminal statute does not provide a private right of action, the FCA allows for citizens to bring private lawsuits on behalf of themselves and the U.S. Government for violations of the Anti-Kickback Statute.[257] Commentators have noted an increase in these qui tam suits following the ACA's amendment to the Anti-Kickback Statute, making Anti-Kickback Statute violations *per se* violations of the FCA.[258] Thus, healthcare companies such as Omnicare are not only seeing an increase in the cost of litigation and settlement, but also an increase in agency costs due to more oversight and stricter compliance.

Registration statements are complex entities that often require the issuer to receive consultation from outside counsel, accountants, auditors, engineers, and other professionals. Companies in the healthcare industry must already pay a premium for outside counsel and consultants to certify legal compliance that will ultimately affect the value of the company's shares, [259] and thus, because these companies would be subjected to more lawsuits passing the pleading stage under the Sixth Circuit's strict liability regime, as well as higher settlement costs, the company's overall information costs and transaction costs would increase substantially.

Moreover, a strict liability standard burdens not only healthcare companies, but all companies who are now required to provide health insurance

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[253] *See* Omnicare, Inc., Quarterly Report (Form 10-Q) (Oct. 23, 2013); Margaret Cronin Fisk, *Omnicare Agrees to Pay $120 Million Over Kickback Claim*, BLOOMBERG.COM, http://www.bloomberg.com/news/2013-10-23/omnicare-agrees-to-pay-120-million-over-kickback-claim.html (last visited Jan. 6, 2014); *see also* Opinion and Order, Gale v. Omnicare, Inc. at *1-2, 2012 WL 4473265 (N.D. Ohio Sept. 26, 2012) (No. 1:10CV127) (discussing the specific allegations brought by the former Omnicare employee).

[254] 42 U.S.C. § 1320a-7b (2012).

[255] The statute makes a violation thereunder a felony and penalties include a maximum $25,000 fine and five-year imprisonment per occurrence. *See* 42 U.S.C. § 1320a-7b (2012).

[256] *See Id.*

[257] *See Anti-Kickback Statute*, AMERICAN HEALTH LAWYERS ASSOCIATION, http://www.healthlawyers.org/hlresources/Health%20Law%20Wiki/Anti-Kickback%20Statute.aspx (last visited Nov. 25, 2013) (citing (31 U.S.C. §§ 3729–3733) ("Although the Anti-Kickback Statute does not afford a private right of action, the False Claims Act provides a vehicle whereby individuals may bring qui tam actions alleging violations of the Anti-Kickback Statute.").

[258] *See* Sarah Coyne et al., *Omnicare Settles More Allegations Under The False Claims Act & Anti Kickback Statute*, QUARLES & BRADY LLP HEALTH LAW UPDATE (Nov. 2013), http://www.quarles.com/omnicare-settles-more-allegations-2013/ (last visited Jan. 6, 2014).

[259] *See Considering an IPO? The Costs of Going and Being Public May Surprise You*, PRICEWATERHOUSECOOPERS LLP, A Publication from PwC's Deals Practice, *available at* http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf (last visited Oct. 13, 2013).

to their employees under Obamacare. According to one source, the one-time cost of going public is more than $1 million and the recurring costs of staying public amount to $1.5 million.[260] While this cost may be miniscule compared to the total assets of large companies such as Omnicare,[261] increasing potential liabilities by not requiring subjective falsity for statements of opinion will not only burden large companies with higher costs, but will also result in increased prices being passed on to consumers.

According to a majority of companies who have analyzed employee healthcare benefits under the ACA, the cost of employer compliance will increase.[262] In June of 2013, Delta Air Lines wrote a letter to the Executive Department, which leaked to the public, stating that Obamacare would increase their healthcare costs by $100 million in 2014.[263] A strict liability standard for materially false or misleading statements of opinion, such as the Sixth Circuit's standard in *Omnicare*, will not only increase companies' litigation and risk-projection costs, but will also substantially increase legal compliance costs. The standard could have the detrimental effect on a company's employees in the form cost-cutting measures such as a reduction in force, salary freeze, termination of bonuses, or other measures.

B. Liability of Financial Institutions Under a Strict Liability Standard

A strict liability standard for statements of opinion would also lead to detrimental effects on both financial companies who file registration statements pursuant to a public offering as well as other companies in the form of increased financing costs by placing an even greater burden on the highly-regulated financial industry. Financial companies are already facing astronomical costs as a result of compliance with such key laws as The Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[264] and The Sarbanes–Oxley Act of 2002 ("Sarb-Ox").[265]

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[260] *See Id.*

[261] In a recent Quarterly Report filed with the SEC, Omnicare listed its total assets at over $6.9 billion. *See* Omnicare, Inc., Quarterly Report (Form 10-Q) (Oct. 23, 2013).

[262] *See* Mary Mosquera, *Employers Unaware of ACA Compliance Cost on Group Health Benefits*, HEALTHCARE FINANCE NEWS, http://www.healthcarefinancenews.com/news/employers-unaware-aca-compliance-cost-group-health-benefits (last visited Jan. 6, 2014) (stating that, "[a]mong employers who have tracked the cost of compliance, nearly two-thirds indicate that healthcare reform has increased their costs, according to the [Health Care Reform Survey 2013]).

[263] *See* Avik Roy, *Three Key Questions for Obamacare's Rollout*, FORBES, available at http://www.forbes.com/sites/theapothecary/2013/10/09/three-key-questions-for-obamacares-rollout/ (last visited Jan. 6, 2014).

[264] Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[265] Public Company Accounting Reform and Investor Protection Act, Pub. L. No. 107–204, 116 Stat. 745 (2002).

Because banking and financial institutions have been strictly regulated following the subprime mortgage crisis[266] and subsequent collapse of the market in 2008,[267] the strict liability holding of *Omnicare* could actually lead to disastrous effects in the financial industry by complicating the disclosure requirements required by the Securities Act.[268] The court in *Fait* discussed the fact that the subprime mortgage crisis was responsible for several large mortgage lenders filing for bankruptcy protection or drastically scaling back operations, resulting in the decline of the stock price of Regions Financial Corporation, against whom Alfred Fait filed suit.[269]

For banks and mortgage lenders, in particular, which face severe fines as a result of their illegal activity during the financial crisis of 2008, imposing a greater burden of compliance on companies may stall lending and further increase costs associated with financing IPO transactions. Companies wishing to go public face costs such as underwriting fees,[270] fees related to legal and accounting advisors, SEC filing fee, the exchange listing fee (NASDAQ or NYSE), state blue sky filing fees, and recurring costs associated with remaining public, such as auditing and legal compliance costs, administrative and investor relations costs relating to quarterly reports, proxy materials, annual reports, transfer agents, and public relations, premiums for directors' and officers' liability insurance, and increased compliance-related costs due to Section 404 of Sarb-Ox's certification requirements.[271]

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[266] *See* Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 THE REVIEW OF FIN. STUDIES 1848-80 (2011) (discussing the deterioration of the quality of subprime mortgage loans for six years prior to the subprime mortgage crisis).

[267] *See* Duncan Currie, *Why Wall Street Collapsed: Searching for the roots of the 2008 financial crisis.*, NATIONAL REVIEW ONLINE (Feb. 7, 2011), http://www.nationalreview.com/articles/259102/why-wall-street-collapsed-duncan-currie (last visited Jan. 6, 2014) (discussing the Financial Credit Inquiry Commission (FCIC) report's conclusion that "deregulation 'had stripped away key safeguards, which could have helped avoid catastrophe,' but [affirming] that regulatory authorities still had 'ample power' at their disposal — power that went unexercised.") (citing Financial Crisis Inquiry Commission Report, at 470, available at http://fcic.law.stanford.edu/report (last visited Jan. 6, 2014).

[268] *But see* Turnquist, *supra* note 93, at 2401 (arguing that a minimal pleading standard for § 11 plaintiffs is supported by the legislative history surrounding the Securities Act of 1933).

[269] Fait v. Regions Fin. Corp., 655 F.3d 105, 107-08 (2nd Cir. 2011).

[270] Generally, underwriting fees are five to seven percent of the gross amount raised by the offering. *See Roadmap for an IPO: A Guide for Going Public*, PRICEWATERHOUSECOOPERS LLP, available at http://www.pwc.com/us/en/transaction-services/assets/roadmap-for-an-ipo-a-guide-to-going-public.pdf (last visited Jan. 6, 2014). However, underwriters for the recent Twitter, Inc. IPO collected only three and a half percent of the $1.82 billion raised. *See Leslie Picker & Lee Spears, Goldman-Led Twitter Underwriters Share $59.2 Million in IPO Fees*, BLOOMBERG.COM, http://www.bloomberg.com/news/2013-11-07/goldman-led-twitter-underwriters-to-make-59-2-million-from-ipo.html (last visited Jan. 6, 2014).

[271] *See Roadmap for an IPO: A Guide for Going Public*, PRICEWATERHOUSECOOPERS LLP, available at http://www.pwc.com/us/en/transaction-services/assets/roadmap-for-an-ipo-a-guide-to-going-public.pdf (last visited Oct. 13, 2013);

Section 404[272] requires management of public company issuers to implement measures regarding internal control over financial reporting, known as ICFR,[273] and to create a report at the end of each fiscal year assessing the effectiveness of those measures.[274] In addition, the public accounting firm that prepares the audit report for the issuer is required to "attest to, and report on, the assessment made by the management of the issuer."[275] These external auditors are subject to separate standards, issued by the United States Public Company Accounting Oversight Board ("PCAOB"), which have been endorsed by the SEC, but the SEC provides its own standards for ICFR.[276] While Congress recognized the burden section 404 put on smaller issuers when enacting Dodd-Frank, relieving non-accelerated filers of the auditing requirements of section 404(b), the compliance burdens still remain for large companies with a market capitalization of $700 million or more.[277]

Due to these stringent requirements of issuers already enacted by Congress and carried out by the SEC, judicial imposition of a strict liability burden is likely to burden courts with frivolous section 11 claims and deter issuers, directors, auditors, and anyone else involved in the filing of a registration statement from sharing their valuable opinions on items that may be of importance to investors when purchasing securities.[278]

Moreover, in addition to Sarb-Ox requirements, the FCA and Dodd-Frank's respective whistleblower programs provide for internal control mechanisms to ensure compliance with both financial reporting practices and legal compliance.[279] Therefore, requiring knowledge of falsity for statements of opinion would better serve the purpose of protecting investors while not turning these opinions into guarantees and thus, subjecting companies to limitless

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[272] Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act) § 404, codified at 15 U.S.C. § 7262 (2012).

[273] Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, SEC Release Nos. 33–8810; 34–55929; FR–77; File No. S7–24–06, 72 Fed. Reg. 35324 (June 27, 2007).

[274] 15 U.S.C. § 7262 (2012).

[275] *Id.* § 7262(b).

[276] *See Sarbanes-Oxley Section 404: A Guide for Management by Internal Controls Practitioners*, THE INSTITUTE OF INTERNAL AUDITORS 1 (2d ed. 2008); Public Company Accounting Oversight Board, Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments, SEC Release No. 34-56152, File No. PCAOB-2007-02 (July 27, 2007); Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, SEC Release Nos. 33–8810; 34–55929; FR–77; File No. S7–24–06, 72 Fed. Reg. 35324 (June 27, 2007).

[277] *See* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, SEC Release Nos. 33-9142; 34-62914 (Sept. 15, 2010).

[278] *See* Petition for a Writ of Certiorari, *supra* note 205, at *16.

[279] *See* False Claims Act (FCA), 31 U.S.C. 31 §§ 3729 to 3731; Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111–203, 124 Stat. 1376 (2010).

lawsuits every time an opinion was made in good faith, but turned out to be incorrect.

Unless courts require both objective and subjective falsity as the standard for which a an investor must plead under section 11 when alleging material misstatements of opinion, financial companies, shareholders, employees, and consumers will ultimately bear the increased costs of resolving expensive suits as well as increased costs in ensuring statements of opinion are financially and legally sound.

VI. SOLUTION TO THE STRICT LIABILITY HOLDING OF OMNICARE

A. Objective and Subjective Falsity as the Proper Standard for Section 11 Claims

Although the plaintiffs' GAAP section 11 claims were dismissed by the court in *Omnicare*, the legal compliance section 11 claims were remanded in light of the strict liability holding.[280] In its decision, the Sixth Circuit distinguished section 10(b) and Rule 10b-5 claims by stating that it was logical that a defendant cannot be held liable for a *fraudulent* misstatement or omission under section 10(b) and Rule 10b–5 because, if the defendant did not know the statement was false at the time it was made, it cannot be fraudulent.[281] However, the court determined that, under section 11, "if the defendant discloses information that includes a material misstatement, that is sufficient and a complaint may survive a motion to dismiss without pleading knowledge of falsity."[282]

Allowing plaintiffs to merely allege that a statement of opinion made in a registration statement was objectively false will subject courts to a flurry of complaints from purchasers of securities who suddenly feel buyer's remorse after a drop in stock value. Allowing for post-stock-value-decline fishing for objectively false statements on publicly-available registration statements will be a negative externality not intended by the Sixth Circuit, but will result from the *Omnicare* decision.[283]

Because section 11 imposes liability on the issuers of registration statements containing untrue statements of material opinion even if the opinion is not required under the Securities Act, both objective falsity (false on its face) and subjective falsity (knowledge of falsity) should be the correct standard to apply to section 11 false opinion claims. Requiring this heightened standard will achieve Congress' primary goal when the Securities Act was passed, which was

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[280] *See* Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund. v. Omnicare, Inc., 719 F.3d 498, 510 (6th Cir. 2013).
[281] *See Id.* at 505.
[282] *Id.*
[283] For a discussion of negative externalities, see Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

to promote disclosure of corporate activities, without deterring corporations from offering their opinions on issues that may be important to potential purchasers of securities.

Defending a section 11 claim is has traditionally been "expensive, long, and unpleasant," even if the defense against the claim is successful.[284] After the markets collapsed in 2008, Congress expanded regulation on banks and accounting firms, in particular, with the passage of Dodd-Frank,[285] which placed a further burden on companies already dealing with the compliance issues of Sarb-Ox.[286] Accountants, auditors, outside counsel, and other experts typically prepare sections of a company's registration statement. Issuers rely on their opinions and pay a premium fee to ensure that the company is taking the proper steps to comply with the Securities Act when completing the registration statement. If a statement of opinion merely has to be objectively false, issuers could pay a steep price in burdensome litigation and increased legal insurance costs even though the issuer may have subjectively believed the statement of opinion to be true.

Because a buyer may establish reliance "without proof of the reading of the registration statement," the buyer can bring suit after a decline in stock value based on a false statement of opinion that he or she never even read, much less relied on the opinion.[287] Without implementing the additional requirement of subjective falsity to section 11 claims, the resulting standard will hinder full disclosure because companies will weigh the risk of providing their opinions to potential stockholders and see that the risk of non-mandatory disclosure outweighs the potential benefit of attracting buyers. Moreover, companies themselves will be hurt by the *Omnicare* decision because they will pay increased costs for verification of every opinion contained in the registration statement while potentially losing proceeds by omitting opinions too risky to be added.

An issuer's liability for false or misleading statements of fact is absolute, subject to one exception: all section 11 defendants have the defense available of showing that the plaintiff knew the untruth or omission at the time of his or her acquisition of the security.[288] Other section 11 defendants are afforded reasonable care defenses.[289] Because issuers must already face strict liability for false statements of material fact, they are already incentivized to conduct their due

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[284] *IPO Basics: The Registration Statement*, INC., *available at* http://www.inc.com/articles/1999/11/15745.html (last visited Jan. 6, 2014).

[285] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[286] Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act), Pub. L. No. 107-204, 116 Stat. 745 (2002).

[287] 15 U.S.C. § 77k(a) (2012); *See also* LOSS ET AL., *supra* note 37, vol. 9, at 313 & n.139 (citing Harralson v. E.F. Hutcton Group, Inc., 919 F.2d 1014, 1032 (5th Cir. 1990) ("Congress 'deliberately relieved securities purchasers of the difficult burden of proving subjective reliance.'").

[288] *See* LOSS ET AL., *supra* note 37, vol. 9, at 319 & n.149 (citing section 11(a)).

[289] *See Id.* at 319-20 (citing sections 11(b)-(c)).

diligence in assessing the correctness of these statements. Imposing a strict liability standard on statements of opinion would impose a significant burden on issuers by transforming each belief, thought, or suggestion into an unwarranted guarantee.[290]

B. Likelihood of Success of Objective and Subjective Falsity Requirement

Ultimately, the objective and subjective falsity requirement of section 11 will likely prevail over the strict liability holding of *Omnicare* for materially false statements of opinion made in a registration statement because of the significant burden it would place on corporate defendants.

As a strict liability statute, section 11 lacks a privity requirement between the purchasers of securities and whom they can sue.[291] In addition, the measure of damages under section 11 favors the purchaser if the purchaser later sells the security after filing suit.[292] Therefore, in order to keep buyers from taking advantage of the litigation process by bringing non-meritorious claims under section 11 after releasing a company's shares, a requirement of pleading both objective and subjective falsity, like the standard applied in both *Fait* and *Rubke*, should be implemented across all circuits.

VII. CONCLUSION

Objective and subjective falsity, not strict liability, should be the appropriate section 11 standard for false or misleading statements of opinion made in a registration statement. The Omnicare decision, which does not require subjective falsity when bring section 11 claims for statements of opinions made in

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[290] *See* Petition for a Writ of Certiorari, *supra* note 205, at *16.

[291] *See* LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, 9 SECURITIES REGULATION 336-37 (4th ed. 2013) (stating that section 11 "permits the plaintiff to sue both the issuer and the underwriter notwithstanding a chain of title from issuer to underwriter to dealer to investor, and gives the same right of action even to a buyer in the open market, all without the plaintiff's proving that the misrepresentation was addressed to or intended to influence him or her").

[292] *See Id.* at 342-44 (Damages under section 11 are typically "the difference between purchase price and resale price, with interest, minus any income or return of capital received by the buyer of the security. However, the 1934 amendments to 11(e) incorporates a modified tort measure of damages – in the main, purchase price less value at the time of suit rather than delivery. Section 11(g) limits the amount that may be recovered to the price at which the security was offered to the public; this primarily limits the plaintiff who purchased in the open market rather than in the course of the distribution. When the security has been disposed of in the open market before suit, the measure of damages is purchase price less resale price (but no mention of interest or deducting income received as in § 12). If the market goes up pending suit and the security is disposed of before judgment, the defendant gets the benefit of the increase over the value at the time of suit, but if the market goes down and the security is disposed of pending suit the plaintiff still gets only the difference between the purchase price and the value at the time of suit. In other words, it is to the plaintiff's advantage not to hold the security after filing suit if he or she wants to be sure to be made whole.").

a registration statement, will have a detrimental effect on companies in highly-regulated industries such as healthcare and finance. Even if the Supreme Court refuses to hear arguments on the issue,[293] other circuits should look to the Fait and Rubke decisions rather than the Omnicare holding for resolving section 11 claims involving statements of opinion. Requiring both objective and subjective falsity will promote disclosure of opinion statements from individuals involved with the filing of registration statements because they will not have to fear securities purchasers later bringing suit if a truly-believed disclosed opinion later turns out to be false.

[293] *See* Petition for a Writ of Certiorari, *supra* note 205.

JUST SAY NO TO CROWDFUNDING

NICHOLAS HERDRICH *

I. INTRODUCTION

"[S]tartups aren't everything when it comes to job growth. They're the only thing."[1] Entrepreneurs and innovation are the future of American business,[2] yet many early-stage businesses struggle to raise capital.[3] Without capital, many

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[1] Tim Kane, *The Importance of Startups in Job Creation and Job Destruction*, EWING MARION KAUFFMAN FOUNDATION, 2 (July 2010), http://www.kauffman.org/uploadedFiles/firm_formation_importance_of_startups.pdf (analyzing the U.S. government report called Business Dynamics Statistics and concluding that, without startups, the U.S. economy would have no net job growth).

[2] *See, e.g.*,*The 2012 State New Economy Index: Benchmarking Economic Transformation in the States*, THE INFORMATION TECHNOLOGY AND INNOVATION FOUNDATION, 3 (2012), http://www2.itif.org/2012-state-new-economy-index.pdf. ("For the United States to be competitive, one key will be to compete more on the basis of innovation and entrepreneurship, and less on cost. With a globalized economy enabling easy access to low cost production systems in nations like Mexico and China, U.S. competitive advantage will continue to be found in making things and providing traded services that other nations are unable to make or provide as easily or as efficiently."); Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 723 (2010) (stating that non-tech regions in the United States are attempting to spur entrepreneurial growth as the country transitions from a manufacturing economy to a knowledge economy).

[3] *See, e.g.*, Kevin Roose, *Some Tech Start-Ups Struggle in Rising Tide of Fund-Raising*, N.Y. TIMES DEALBOOK, (Jun. 6, 2011), http://dealbook.nytimes.com/2011/06/06/some-tech-start-ups-founder-in-rising-tide-of-fund-raising/ (describing the struggle early stage businesses face in their efforts to raise capital, especially with expansion rounds of capital between $5 and $10 million).

businesses fail to launch or achieve the requisite growth necessary to be successful.[4] In an effort to address this problem and fuel economic growth in the United States with increased access to capital, the federal government passed the Jumpstart Our Business Startups Act (the "JOBS Act") in 2012, which gave early-stage businesses the ability to participate in crowdfunding and raise capital by selling securities over the Internet.[5]

In essence, securities-based crowdfunding is a large number of individuals contributing small amounts of capital to fund a company in exchange for the company's securities.[6] Crowdfunding utilizes the Internet's broad accessibility to promote a new business and attract investors.[7] Some critics of crowdfunding fear that it will open the door to fraud and the exploitation of unsophisticated, non-accredited investors.[8] Advocates believe that crowdfunding democratizes investment and provides a boost to local businesses.[9]

This article argues that crowdfunding provides access to the wrong types of capital and is principally tailored to niche situations. Part I of this article discusses federal securities law in general, donation-based crowdsourcing, federal crowdfunding legislation, and State reactions to the Securities Exchange Commission's (the "SEC") failure to implement the federal crowdfunding legislation. Part II of this article argues that (1) angel and venture capital funds are a better source of capital for early-stage businesses; (2) the crowdfunding requirements are onerous and potentially unworkable for early-stage businesses; and (3) crowdfunding may only be appropriate for niche situations. Finally, this article concludes that, despite its promise, crowdfunding legislation has failed to live up to the hype and legislatures should focus on seeding the economy with ideas, not capital.

II. BACKGROUND

[4] *See generally* Chris Camillo, *Is Intrastate Crowdfunding the Future of Economic Growth?*, 19 WESTLAW J. DERIVATIVES 1 (2013).

[5] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.). The JOBS Act also implemented several non-crowdfunding related measures, including lifting the ban on general solicitation of accredited investors who have met the income and net-worth requirement under Regulation D.*Id.* The impetus behind crowdfunding was that small business failures due to a lack of funding, the limited availability of traditional funding sources, the emergence of consumer-sourced financing, and the ability for technology to make capital raising possible. Sara Hanks & Andrew Stephenson, *Online Securities Offerings*, 33 NO. 2 BANKING & FIN SERVICES POL'Y REP.1, 1–2 (2014).

[6] Sean M. O'Connor, *Crowdfunding's Impact on Start-Up IP Strategy*, 21 GEO. MASON L. REV. 895, 897 (2014).

[7] *See* Camillo, *supra* note 4 at 1.

[8] *See, e.g.*, Rick Romell, *MobCraft Beer is first to tap Wisconsin's 'crowdfunding' experiment*, MILWAUKEE JOURNAL SENTINEL (June 9, 2014), http://www.jsonline.com/business/mobcraft-beer-is-first-to-tap-wisconsins-crowdfunding-experiment-b99283034z1-262450551.html.

[9] *Id.*

The Securities Act of 1933 provides that anyone offering securities must prepare, among other things, a registration statement and a prospectus.[10] Standing alone, these requirements would preclude many businesses from raising capital, but exemptions exist that allow early-stage companies to raise funds more easily.[11] For example, companies can sell securities in private placement offerings to accredited investors.[12]

Even with the existence of certain exemptions, early-stage businesses sought an easier way to raise capital through accepting capital donations on an Internet-based crowdsourcing portal in exchange for a promise to deliver on a certain project.[13] Expanding on this donation-based system, the federal government added a new interstate crowdfunding exemption under the JOBS Act that allows companies to offer securities to fund a venture over the Internet.[14] However, the JOBS Act remains on the sidelines while the SEC continues to drag its feet on issuing required regulations under the JOBS Act.[15] In response to the slow implementation of the JOBS Act, some states, including Wisconsin, have passed intrastate crowdfunding laws that allow companies to sell securities over the Internet to residents of that state.[16]

A. Crowdsourcing's Avoidance of Securities Regulation

The Internet has reduced the cost of many commercial interactions and dramatically changed markets in which intermediaries once played a significant role.[17] Traditionally, investment bankers served a critical role as an intermediary

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[10]Securities Act of 1933, 15 U.S.C. § 77e (2012).

[11]*Id.* § 17c.

[12]The registration and disclosure requirements do not apply to offerings to accredited investors if there is no advertising or public solicitation in connection with the offering and if the offering is below $5,000,000, and if the issuer files notice with the SEC. *Id.* § 17c(a)(5). Under federal law, an accredited investor includes (1) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person; (2) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or (3) a business in which all the equity owners are accredited investors. 17 CFR 230.501(a) (2014).

[13]*See infra* Section A.

[14]Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (promising to jumpstart innovation and fuel the United States economy).

[15]Devin Thorpe, *Grassroots Lobbying Effort Asks SEC To Issue Final Crowdfunding Rules*, FORBES (Sept. 9, 2014), http://www.forbes.com/sites/devinthorpe/2014/09/09/grassroots-lobbying-effort-asks-sec-to-issue-final-crowdfunding-rules/. (stating that two-and-one-half years after President Obama signed the JOBS Act into law, the rules to implement the law remain in draft form, pending action by the SEC).

[16]*See infra* Section B.

[17]Anita M. McGahan, *How Industries Change*, HARVARD BUSINESS REVIEW: THE MAGAZINE (Oct. 2004), http://hbr.org/2004/10/how-industries-change/ar/1 (arguing that businesses have to understand the nature and magnitude of the industry's change to adapt and succeed). For

to help connect investors and entrepreneurs seeking to sell the securities issued by their companies.[18] Through crowdsourcing, the Internet has again attempted to create operational efficiencies and lower the cost of a transaction.[19]

The Internet has facilitated this transaction through crowdsourcing.[20] Crowdsourcing, as used in finance jargon, is the process of obtaining capital donations through the solicitation of a large group of people, typically on the Internet.[21] Crowdsourcing differs from crowdfunding because crowdsourcing projects are not permitted to offer debt or equity, which would be subject to securities regulation.[22]

Kickstarter is the most well-known crowdsourcing platform.[23] Kickstarter allows a project creator, typically a filmmaker, musician, artist, or designer, to solicit funds to support a project.[24] In exchange, the project creator promises to carry out the project.[25] For example, a scriptwriter may seek money to cover the cost of producing a new movie in exchange for a promise to provide a ticket to the new movie when it is complete.[26] Some projects raise a substantial

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example, the travel industry went through a radical change when customers turned to web-based systems, such as Expedia and Orbitz, which offered better services to monitor schedules and fares. *Id.*

[18]*See generally* Edmund W. Kitch, *Crowdfunding and an Innovator's Access to Capital*, 21 GEO. MASON L. REV. 887, 889 (2014).

[19]*Id.*

[20]Kevin J. Boudreau & Karim R. Lakhani, *Using the Crowd as an Innovation Partner*, HARVARD BUSINESS REVIEW: THE MAGAZINE (Apr. 2013), http://hbr.org/2013/04/using-the-crowd-as-an-innovation-partner/ (stating that crowdsourcing as a way to deal with innovation problems has existed for centuries but today's technology allows crowds to be deployed across many different problems).

[21]*See* Kitch, *supra* note 18 at 889. Many people claim that Marillion, a British progressive-rock bank, started crowdsourcing. *See, e.g.*, Nickolas C. Jensen, *Fundraising on the Internet Crowdfunding, Kickstarter and the Jobs Act*, 49-MAR ARIZ. ATT'Y22 (2013). The band bypassed the traditional record industry process by e-mailing its 30,000 fans and asking them to pre-order the band's new album. *Id.* The band, retaining complete control over its music, raised more than $100,000, recorded its new album, and delivered the new album to pre-ordering fans. *Id.*

[22]*See* Kitch, *supra* note18at 892.

[23]*Id.* at 889. In 2013, three million people pledged $480 million in Kickstarter projects. *2013: The Year in Kickstarter*, KICKSTARTER, https://www.kickstarter.com/year/2013/?ref=footer#1-people-dollars (last visited Sept. 28, 2014). IndieGoGo is another popular crowdsourcing platform. INDIEGOGO, https://www.indiegogo.com (last visited Sept. 28, 2014).

[24]*Seven Things to Know About Kickstarter*, KICKSTARTER, https://www.kickstarter.com/hello?ref=footer (last visited Sept. 28, 2014).

[25]*Id.*

[26]*See* Kitch, *supra* note 18 at 890 (providing examples of Kickstarter campaigns, including "a person seeking to write and produce a play might promise a ticket to attend the play, or a person seeking to design a really nifty wallet or bike light might promise one of the wallets or bike lights").

amount of capital.[27] Kickstarter and other crowdsourcing platforms charge a fee based on the amount of money raised for a project.[28]

From the beginning, crowdsourcing websites accounted for securities laws by not permitting project creators to offer debt or equity.[29] The SEC could have taken the position that crowdsourcing projects are debt contracts, payable in assets instead of dollars, and investors need protection from undelivered promises.[30] At least for the moment, the SEC has not interrupted the success of the reward-based crowdsourcing phenomenon.[31]

B. Equity Crowdfunding Options

Building on the success of crowdsourcing websites, two forms of equity-based crowdfunding have emerged.[32] The federal government provides several federal exemptions, including interstate crowdfunding, to federal securities laws if certain requirements are met.[33] However, the SEC appears to disagree with Congress and has delayed the implementation of the federal crowdfunding exemption.[34] In response to this delay, several states have amended securities

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[27]For example, Pebble Technology raised over $10 million in 2012 to support its customizable watch for use with smartphones. *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER,https://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android?ref=most_funded(last visited Sept. 28, 2014).

[28]If a project is successfully funded, Kickstarter charges a five-percent fee of the funds collected. *Kickstarter Basics*, KICKSTARTER,https://www.kickstarter.com/help/faq/kickstarter+basics?ref=footer(last visited Sept. 28, 2014). Third-party payment processers, who collect the funds, also charge a fee between three and five percent. *Id.* Indiegogo charges a four-percent fee for a project that meets its funding goal. *Pricing & Fees*, INDIEGOGO,http://go.indiegogo.com/pricing-fees(last visited Sept. 28, 2014). An Indiegogo project that fails to meet its funding goal will be charged nine percent, encouraging businesses to set reasonable goals and promote the "offering." *Id.* Indiegogo offers 501(c)(3) non-profits a 25 percent reduction in its platform fees. *Id.*

[29]*See* Kitch, *supra* note 18 at 890.

[30]The definition of a security under the Securities Act of 1933 includes "commonly known documents traded for speculation or investment" and a "transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 297, 299 (1946).

[31]*See, e.g.*, Kendall Almerico, *Will Equity Crowdfunding Laws Be the Death of Kickstarter?*;ENTREPRENEUR (Jan. 29, 2014), http://www.entrepreneur.com/article/231085.

[32]*See infra* Section B & B.ii.

[33]*See generally* Marshall Martin, *Stalled crowdfunding rules stifle startups*, ALBUQUERQUE JOURNAL (Sept. 15, 2014), http://www.abqjournal.com/462138/biz/stalled-crowdfunding-rules-stifle-startups.html (detailing the federal securities law exemptions available to early stage businesses, including the most common private offering exemption under SEC Rule 506(b) and a new exemption allowing general solicitation of investors under SEC Rule 506(c)).

[34]*See* Thorpe, *supra* note 15. Alternatively, the SEC may be learning from intrastate crowdfunding offerings before issuing the federal regulations.

laws to allow for intrastate crowdfunding, which severely limits the geographic scope of an offering.[35]

1. Federal crowdfunding still uncertain

In 2012, the JOBS Act was signed into law to create, among other things, a crowdfunding exemption from the requirements of the federal securities acts and state blue-sky laws.[36] Crowdfunding offers securities, instead of a pre-order or rewards scheme under crowdsourcing models, to fund a venture over the Internet.[37] This distinction allows crowdfunding investors to participate in potential profits of the project.[38]

The crowdfunding exception under the JOBS Act is subject to important requirements, including disclosure and filing requirements. The JOBS Act (1) limits the amount raised by an issuer, (2) requires the offering to be conducted through specific intermediaries, and (3) requires issuers to meet eligibility and filing requirements.[39] The provisions of the JOBS Act require the SEC to issue final rules before the exemption can take effect.[40]

First, the crowdfunding exemption limits the amount raised by an issuer in aggregate and from individual investors. An issuer can raise up to $1 million in a 12-month period through crowdfunding offerings.[41] During a 12-month period, the aggregate amount of securities sold by all issuers to an investor, whose annual income or net worth does not exceed $100,000, cannot exceed the greater of $2,000 or five percent of the investor's annual income or net worth.[42] For investors whose annual income or net worth equals or exceeds $100,000, the aggregate amount of securities sold by all issuers to them during a 12-month

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[35]As of June 2014, twelve States have implemented intrastate crowdfunding exemptions. *See* Jeremy Halpern & Thomas V. Powers, *Crowdfunding options for startups*, LEXOLOGY (Sept. 8, 2014), http://www.lexology.com/library/detail.aspx?g=f7795eea-4074-489f-93ef-57955b9bb6e2.
However, the States with the highest amount of early stage business activity, California, New York, and Massachusetts, have yet to implement intrastate crowdfunding laws. *Id.*

[36]The federal crowdfunding exemption is important because Section 5 of the Securities Act of 1933 prohibits sales and offers to sell securities in interstate commerce unless the securities are registered with the SEC or an exemption is otherwise met. 15 U.S.C. § 77e (2012). The federal crowdfunding exemption would also bypass state securities laws because crowdfunding is a "covered security" under federal law. *See Id.* § 77r(a)(1)(A).

[37]*See* Kitch, *supra* note 18 at 892.

[38]*Id.*

[39]Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012).

[40]*Id.* § 602, 126 Stat. at 327 (stating that "[n]ot later than 1 year after the date of enactment of [the JOBS Act], the Securities and Exchange Commission shall issue final regulations to implement [the JOBS Act].").

[41]*Id.* § 302, 126 Stat. at 315.

[42]*Id.* For example, if an investor has an annual income of $50,000 and a net worth of $30,000, this limit would equal $2,500 (5% of $50,000).

period cannot exceed the lesser of $100,000 or ten percent of the investor's annual income or net worth.[43]

Second, the JOBS Act requires crowdfunding offerings to be conducted through a registered broker or a registered funding portal, which is an independent online platform.[44] Funding portals must comply with several restrictions designed to ensure independence and must register with the SEC and Financial Industry Regulatory Authority.[45] Funding portals, including its officers and directors, are not allowed to have a financial interest in any issuer that makes a crowdfunding offering on its portal.[46] Funding portals are not allowed to give financial advice beyond the required disclosures, solicit investors to invest in crowdfunding offerings on its portal, or compensate its employees based on the sale of securities on its portal.[47] Additionally, funding portals must screen issuers and investors.[48]

Third, the JOBS Act requires issuers to meet eligibility and filing requirements. Prior to a crowdfunding offering, eligible issuers must file with the SEC and provide information regarding its business and the terms of the offering.[49] On an ongoing annual basis, issuers must provide certain reports to the

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[43]*Id.* For example, if an investor has an annual income of $50,000 and a net worth of $600,000, this limit would equal $60,000 (10% of $500,000).

[44]*Id.*

[45]*Id.* § 304, 126 Stat. at 321–22. Many commentators believe that the funding portal registration requirements are onerous and will deter portals from forming. *See, e.g.*,Kitch, *supra* note 18 at 892.

[46]*Id.*

[47]*Id.*

[48]*Id.*§ 302, 126 Stat. at 316. Funding portals must actively screen investors for an understanding of the risks involved with crowdfunding, including that the securities may become worthless. *Id.* Additionally, funding portals must screen the issuer or business, including a background and securities enforcement regulatory history check of each officer, director and holder of more than 20 percent of the outstanding equity. *Id.*

[49]*Id.* § 302, 126 Stat. at 317–18. Among other disclosure requirements, the issuer or business must (1) disclose the identities of all officers, directors, and 20 percent equity owners; (2) file a business plan; (3) describe the business's ownership, capital structure, and financial condition; (4) detail the terms of the securities being offered; and (5) state the intended use of the proceeds. *Id.* Depending on the target offering amount, the issuer must provide varying levels of financial information, ranging from (a) the most recent tax return and financial statements certified by the principal executive officer for offerings of $100,000 or less, (b) financial statements reviewed by a public accountant, who is independent of the issuer and uses professional standards, for offerings over $100,000 and less than $500,000; and (c) audited financial statements for offerings of more than $500,000. *Id.* The SEC does not examine the merits of the issuer's offering. *See, e.g.*, Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws-Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741–42 (2012). Rather, the SEC seeks to enforce disclosure requirements to allow investors to determine the merits of the offering themselves. *Id.*

SEC and investors disclosing the results of the operations and financial statements.[50]

While the JOBS Act was signed into law in 2012, the crowdfunding exemption will not take effect until the SEC issues its final rules.[51] Under several provisions, the JOBS Act also gives the SEC optional rulemaking authority.[52] As of the date of this Article, the SEC is nearly two years behind the original deadline of December 31, 2012.[53] Thus, interstate crowdfunding in the United States remains a criminal activity until the SEC issues its final implementing regulations.[54]

2. States provide an answer to federal crowdfunding delays

While the implementation of the federal crowdfunding exemption is delayed, individual states have passed legislation to make specific forms of crowdfunding a reality.[55] The federal securities acts provide an exemption for intrastate offerings, which are offerings made solely in that state.[56] Therefore, some state securities laws permit intrastate crowdfunding offerings, usually through some sort of state-sanctioned funding portal.[57] State crowdfunding may not be a replacement for the federal crowdfunding exemption, but individual state securities laws serve as a stop-gap to fund early-stage businesses that are relevant within local communities.[58] State crowdfunding has the potential to become more significant when a state with a large population and a start-up friendly culture, such as California, passes such a bill.[59]

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[50]Jumpstart Our Business Startups Act § 302. Many other exemptions from the public offering registration requirements do not require ongoing disclosures. *See, e.g.*, 17 C.F.R. §§ 230.504, 230.505, 230.506 (2013).

[51] The SEC was required to issue crowdfunding regulations within one year, which is long overdue. *Id.* § 602, 126 Stat. at 327.

[52]Several provisions allow discretionary rulemaking by the SEC and, thus, may increase burdens on early stage businesses. *See, e.g.*, *id.* § 302, 126 Stat. at 318 (providing that the SEC can make issuer disclosure requirements "for the protection of investors and in the public interest").

[53]*See, e.g.*,Thorpe, *supra* note 15.

[54]*See, e.g.*,Kitch, *supra* note 18 at 892.

[55]Intrastate crowdfunding exemptions have been passed in Alabama, Colorado, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Michigan, Tennessee, Washington, and Wisconsin. *See, e.g.*, Georgia Quinn & Anthony Zeoli, *The Definitive Guide: Intrastate Crowdfunding Exemptions*, CROWDFUND INSIDER (July 15, 2014), http://www.crowdfundinsider.com/2014/07/44088-the-definitive-guide-intrastate-crowdfunding-exemptions/.

[56]Securities Act of 1933, 15 U.S.C. § 77c (2012) (exempting an offering involving "any security which is part of an issue offered and sold only to persons resident within a single State... where the issuer of such security is... a corporation . . . incorporated by and doing business within . . . such State").

[57]*See, e.g.*, CASE for Jobs Act, WIS. STAT. § 551.202(26) (2011–12).

[58]*See generally* Camillo, *supra* note 4 at 3.

[59]For example, California has a start-up friendly culture and 38 million residents, which would make intrastate crowdfunding instantly more relevant. *Id.*

For example, Wisconsin's intrastate crowdfunding law took effect on June 1, 2014.[60] An issuer can raise capital from Wisconsin investors through one or more Internet sites if the business is organized in Wisconsin.[61] Issuers can raise up to $1 million during a 12-month period from accredited and non-accredited investors without an audit.[62] This limit increases to $2 million if the issuer was audited in the most recent fiscal year and has provided the audit to investors and the Wisconsin Department of Financial Institutions (the "DFI").[63] Additionally, the issuer must file a notice with the DFI,[64] provide disclosures to each prospective investor,[65] provide quarterly reports to investors,[66] and not be subject to the *bad* actor disqualification under securities law.[67] Issuers must hold all payments in escrow in a Wisconsin-chartered financial institution and not access them until the target offering amount has been raised.[68]

The Internet site used in Wisconsin crowdfunding offerings is subject to several regulations.[69] The site must be organized under Wisconsin law, authorized to do business in the state, and registered with the Wisconsin Division of Securities.[70] The site must maintain records of intrastate

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[60]2013 WISCONSIN ACT 52; *See Crowdfunding in Wisconsin*, STATE OF WISCONSIN DEPARTMENT OF FINANCIAL INSTITUTIONS (last visited July 8, 2015), http://wdfi.org/fi/securities/crowdfunding/ (providing general information about Wisconsin's intrastate crowdfunding law); *Wisconsin crowdfunding exemption takes effect June 1*, STATE OF WISCONSIN DEPARTMENT OF FINANCIAL INSTITUTIONS (May 27, 2014), https://www.wdfi.org/newsroom/press/2014/CrowdfundingPressRelease.pdf; *see also* Alison Bauter, *What you need to know about Wisconsin's new crowdfunding exemption*, MILWAUKEE BIZ TALK (May 31, 2014), http://www.bizjournals.com/milwaukee/blog/2014/05/what-you-need-to-know-about-wisconsins-new.html?page=all; Jeff Engel, *Wisconsin legislators to introduce investment crowdfunding bill*, MILWAUKEE BUSINESS JOURNAL (Aug. 12, 2013 2:59PM), http://www.bizjournals.com/milwaukee/news/2013/08/12/wisconsin-legislators-to-introduce.html; Mike Ivey, *Wisconsin crowdfunding bill opens early stage investing to average citizens*, THE CAP TIMES (Nov. 20, 2013), http://host.madison.com/ct/news/local/wisconsin-crowdfunding-bill-opens-early-stage-investing-to-average-citizens/article_5f3e13cf-5bf1-5f9b-be8a-21cda0a35713.html.

[61]WIS. STAT. § 551.202(26).

[62]*Id.* § 551.202(26)(c)1.a.

[63]*Id.* § 551.202(26)(c)1.b.

[64]*Id.* § 551.202(26)(f).

[65]*Id.* §§ 551.202(26)(f), (h), & (i) (describing the disclosures to prospective investors, including a description of the company, identity of persons owning more than ten percent of the business, terms of the financial offering, description of pending legal proceedings, and any information material to the offering).

[66]*Id.* § 551.205(2) (providing that the issuer's quarterly report to crowdfunding investors must include compensation receive by each director and executive and an analysis by management of the business operations and financial condition).

[67]*Id.* § 551.202(26)(n).

[68]*Id.* § 551.202(26)(f)3.

[69]*Id.* § 551.205.

[70]*Id.* § 551.205(1).

crowdfunding offers and sales of securities through the site.[71] To avoid the requirement of registering as a broker-dealer, the site may not offer investment advice, solicit purchases, or pay or receive compensation for the solicitation or based on the sale of securities.[72]

Any individual investor may invest a maximum of $10,000 in a single Wisconsin intrastate crowdfunding offering.[73] The maximum investment amount does not apply to accredited investors under federal law or certified investors under the Wisconsin law.[74] To be a certified investor, an individual must have either (1) an individual, or joint, net worth with the individual's spouse of at least $750,000, or (2) or an individual income in excess of $100,000, or joint income with the individual's spouse in excess of $150,000, in each of the two most recent years.[75]

MobCraft Beer LLC, a business based in Madison, Wisconsin, was the first company to register under Wisconsin's intrastate crowdfunding rules.[76] MobCraft is a craft brewery that crowdsources its beer recipes based on suggestions from its fans and votes on social media.[77] However, the buzz surrounding MobCraft's crowdfunding has been halted by Wisconsin's crowdfunding escrow requirements.[78]

Wisconsin's crowdfunding law requires a Wisconsin-chartered bank to hold the offering funds until the funding limit is met.[79] No other state requires

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[71] *Id.* § 551.205(1)(c).

[72] *Id.* § 551.205(1)(b)d.2.

[73] *Id.* § 551.202(26)(d).

[74] *Id.* For a discussion on the federal definition of an accredited investor, *see supra* note 12 and accompanying text.

[75] *Id.* § 551.102 (4m). Unlike the federal accredited investor definition, a Wisconsin certified investor can include equity from a primary residence. *Id.* (stating that, "[f]or purposes of calculating net worth under this paragraph, the individual's primary residence shall be included as an asset and indebtedness secured by the primary residence shall be included as a liability.").

[76] *See, e.g.*, Romell, *supra* note 8; Judy Newman, *Crowdfunding, Wisconsin style, begins*, WISCONSIN STATE JOURNAL (Jun. 22, 2014), http://host.madison.com/business/crowdfunding-wisconsin-style-begins/article_10724c55-5470-5ed7-af06-f879dc6cfa00.html.

[77] MOBCRAFT BEER LLC, https://www.mobcraftbeer.com (last visited July 8, 2015) (claiming to be the world's first completely crowdsourced brewery).

[78] *See, e.g.*, Rick Romell, *Unique provision in Wisconsin law puts brakes on crowdfunding*, MILWAUKEE JOURNAL SENTINEL (Aug. 26, 2014), http://www.jsonline.com/business/unique-provision-in-wisconsin-law-puts-brakes-on-crowdfunding-b99335435z1-272740801.html; JD Alois, *Wisconsin Crowdfunding Law Hits Hurdle as Bank Provision Adds Challenge*, CROWDFUND INSIDER (Aug. 26, 2014), http://www.crowdfundinsider.com/2014/08/47858-wisconsin-crowdfunding-law-hits-hurdle-bank-provision-adds-challenge/.

[79] WIS. STAT. § 551.202(26)(f)3. While some people may question Wisconsin lawmakers' wisdom for passing a law that cannot be implemented, the lobbying groups for the Community Bankers of Wisconsin and the Wisconsin Bankers Association voted in favor of the legislation. *Assembly Bill 350*, GOVERNMENT ACCOUNTABILITY BOARD (last visited July 8, 2015), https://lobbying.wi.gov/What/BillInformation/2013REG/Information/10355?tab=Principals (listing the votes of each lobbying group for Wisconsin's intrastate crowdfunding law).

specifically Wisconsin-chartered banks.[80] Since Wisconsin-chartered banks are hesitant to participate in the new crowdfunding law and federally-chartered institutions do not qualify, MobCraft's crowdfunding efforts have been delayed until a Wisconsin-chartered bank comes forward or the law is amended.[81] Regardless of these challenges with Wisconsin's intrastate crowdfunding law, crowdfunding may not be the best financing option for MobCraft and other early-stage businesses.

III. CROWDFUNDING'S UNDELIVERED PROMISE TO EARLY STAGE BUSINESSES

Crowdfunding does not achieve its goal of providing better access to capital and is largely tailored to niche situations. Generally, angel and venture capital funds are a better source of capital for early-stage businesses.[82] Even if an early-stage business is a good candidate for crowdfunding, the exemption requirements are onerous and potentially unworkable for a company that needs to focus on execution.[83] However, crowdfunding may be appropriate for niche situations, such as early-stage businesses that do not have subsequent capital requirements or businesses that pursue a certain civil cause.[84]

A. A Better Option: Deep Pockets and Smart Money

The JOBS Act and intrastate crowdfunding laws represent a good intention to nurture innovation-based economies lead by entrepreneurs.[85] However, angel investors and venture capitalists, who better understand early-stage businesses, are better equipped to drive this strategy.[86] Angel investors and venture capital firms bring more resources to early-stage businesses compared to the crowd, including deeper pockets for follow-on investments and expertise

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[80] *See, e.g.*, Romell, *supra* note 78.

[81] *Id.*

[82] *See infra* Section A

[83] *See infra* Section Bb. The extent to which the federal crowdfunding requirements are onerous to businesses may depend on the SEC's pending rulemaking. *See* Jensen, *supra* note 21, at 24.

[84] *See infra* Section Cc.

[85] During the congressional hearings, Congress heard testimony from a number of small business owners, who stated that they needed to be able to obtain financing from a wider source of investors to expand and grow the economy. *See, e.g.*, *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 61 (2011) (statement of Eric Koester); *Crowdfunding: Connecting Investors and Job Creators: Hearing before the H. Subcomm. on TARP, Fin. Serv. and Bailouts of Pub. and Priv. Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 45 (2011) (statement of Sherwood Neiss).

[86] *See generally* John Torinus, *Angels will trump crowd funding*, STRAIGHT TALK FROM THE HEARTLAND, http://johntorinus.com/general-blog/the-startup-economy/angels-will-trump-crowd-funding/ (last visited July 8, 2015) (arguing, despite the good intentions of the JOBS Act, it will probably not impact job creation).

building early-stage businesses.[87] Entrepreneurs, who reach to the crowd for funding, may have trouble finding angel or venture capital funds in subsequent financings.[88]

While donation-based crowdsourcing has created some success stories, which may indicate the potential of crowdfunding, angel investors and venture capital firms bring more money in the seed round, for follow-on investment, and in larger chunks.[89] Early-stage businesses often struggle with subsequent financing rounds, but the right investor may help alleviate this impediment to growth and success.[90] By realizing more capital from fewer investors, an early-stage business can focus more attention on execution instead of fundraising and investor maintenance.[91]

Additionally, some angel investors and venture capital firms can provide value to an early-stage business because of their previous experiences building and managing entrepreneurial firms.[92] Crowdfunding investors probably have

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[87] Many, but not all, angel investors can add value to early stage businesses. PAUL A. GOMPERS & JOSH LERNER, THE MONEY OF INVENTION 10 (2001) (noting that "[m]any angel investors may be nothing more than wealthy local doctors, dentists, or businesspeople who have a strong desire to 'make a fortune.' Many are also naïve about the potential conflicts that can arise and are potentially easy prey for unscrupulous entrepreneurs. On the other hand, some angel investors can provide value to the firm and are critical to its success because of their previous experience building and managing entrepreneurial firms.").

[88] Many venture capitalists have voiced concern that no subsequent funders would want to deal with a thousand other shareholders. Robb Mandelbaum, *Should You Crowdfund Your Next Business?*, INC. MAGAZINE (May 2014), http://www.inc.com/magazine/201405/robb-mandelbaum/jobs-act-crowdfunding-problems.html. However, in Europe, some businesses have negotiated provisions providing that the crowdfunding shareholders are bought out at a set price if the business raises a subsequent round. *Id.* While this work-around may appease the angel and venture funds, businesses may have a hard time convincing investors to cap their potential payoff when they are investing in a risky venture. *Id.*

[89] *See Crowdfunding Disadvantages*, GAEBLER.COM, http://www.gaebler.com/Crowd-Funding-Disadvantages.htm (last visited July 8, 2015) (stating that "as a long-term funding strategy it's just not a viable for the ongoing resource needs of a small business"). Additionally, a venture or angel fund would probably not invest in a crowdfunding offering because of the investor limit of $100,000. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012).

[90] *See* Roose, *supra* note 3 and accompanying text.

[91] *See, e.g.*, Dane Atkinson, *Do Startups Fail Due to Bad Ideas or Poor Execution? Neither. It's the Vision*, HUFFINGTON POST (Jan. 14, 2014 10:29AM), http://www.huffingtonpost.com/dane-atkinson/do-startups-fail-due-to-b_b_4595507.html (arguing that poor execution, not capital, is often the reason early stage business fail).

[92] One crowdfunding site recognizes this gap in crowdfunding and, thus, offers a mentorship component to the website's crowdfunding schema. CROWDIT, http://www.crowdit.com (Last visited Sept. 28, 2014); *see also* Cale Guthrie Weissman, *CrowdIt, looks to bring a missing piece to the crowdfunding puzzle: Mentorship*, PANDO DAILY (Mar. 31, 2014), http://pando.com/2014/03/31/crowdit-looks-to-bring-a-missing-piece-to-the-crowdfunding-puzzle-mentorship/ (recognizing that "[i]f we're just giving young entrepreneurs capital with no regard for giving them the experience they need from other successful entrepreneurs then we're being irresponsible"). The implementation of the federal crowdfunding exemption may give early stage businesses access to a broader range of

less capital invested and, thus, have less incentive to share their expertise with the early-stage business.[93] Also, crowdfunding investors probably have less practical expertise to share with early-stage businesses.[94]

If an early-stage business participates in a crowdfunding round of financing, at least some angel investors and venture capitalist will not fund subsequent rounds of financing.[95] Angel investors or venture funds may have concerns if an early-stage business was not able to raise money from a *real* investor during its initial seed round.[96] Also, angel or venture funds may not want to deal with the headache of having a couple hundred investors on the cap table.[97] However, if the early-stage business has found success, some angel or venture funds would invest and live with any negative consequences of a previous crowdfunding round.[98]

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investors, especially from start-up hubs in California, New York, and Massachusetts, but a broad group of passive investors may not be beneficial to early stage businesses.

[93] Crowdfunding will provide inexperienced investors with little skin in the game, limiting their interest. *See, e.g.*, Jeff Wald, *Why Equity Crowdfunding Is a Terrible Idea*, ENTREPRENEUR (Sept. 26, 2013), http://www.entrepreneur.com/article/228580.

[94]Professional investors add a tremendous amount of value to the company-creation process, including building teams, crafting a business plan, and making introductions to customers and partners. *Id.* Crowdfunding will not provide these partners. *Id.*

[95]*See generally* Sean M. O'Connor, *Crowdfunding's Impact on Start-up IP Strategy*, 21 GEO. MASON L. REV. 895, 915-17 (2014).

[96] Similarly, if the business raises a round from a major venture fund and the venture fund does not invest in the subsequent financing round, most investors will be scared off by this negative signal. *See, e.g.*, Sarah Lacy, *New stats show raising Seed money from big VCs increases survival*, PANDODAILY (March 19, 2013), http://pando.com/2013/03/19/new-stats-show-raising-seed-money-from-big-vcs-increases-survival-the-opposite-of-what-everyone-in-the-valley-says/. However, a successful crowdsourcing round may be one way to prove to angel or venture funds that there is a market for a new product. *See, e.g.*, Conner Forrest, TECHREPUBLIC (Jul. 22, 2014 5:07AM), http://www.techrepublic.com/article/funding-your-startup-crowdfunding-vs-angel-investment-vs-vc/.

[97]Many angel and venture funds will be turned off by a thousand shareholders on the cap table, but some funds may get comfortable with a crowdfunded business set up within the proper legal framework. *See* Antti Hemmila, *Legal Challenges Related to Crowdfunding: Volume 3*, ARCTICSTARTUP (Nov. 6, 2013), http://www.arcticstartup.com/2013/11/06/legal-challenges-related-to-crowdfunding-volume-3. Joe Hildebrandt, the manager of two angel funds in Wisconsin, said that no angel or venture fund would want to deal with a couple hundred first round investors and "would just pass on it, with all the baggage involved." *See* Torinus, *supra* note 86. Angel and venture funds may also be concerned about the liability risk that hundreds of shareholders pose to the business. *See* Susan Schreter, *Crowdfunding--Boom or Bust for Entrepreneurs?*, FOX BUSINESS (May 16, 2012), http://smallbusiness.foxbusiness.com/finance-accounting/2012/05/16/crowdfunding-boom-or-bust-for-entrepreneurs/ (stating that fund managers "shy away from deals in which there are too many small or perhaps financially unsophisticated shareholders that could prove a nuisance in coming years").

[98]Donation-based crowdsourcing already has its success stories, such as Oculus VR. *Oculus VR*, CRUNCHBASE, http://www.crunchbase.com/organization/oculus-vr (last visited July 8, 2015) (stating that Oculus Rift raised over $93 million in capital, including $2.4 million in a Kickstarter campaign, and eventually sold for $2 billion to Facebook).

Some early-stage businesses may not have an opportunity to raise money from angel or venture funds, and crowdfunding mistakenly attempts to fill this void.[99] Assuming that an early-stage business would always pick an angel or venture fund over crowdfunding, the JOBS Act and intrastate crowdfunding may only be facilitating the funding of businesses with a below-average probabilities of success.[100] While early-stage businesses may be the key to job creation and economic success, policy makers should seek to seed the economy with more fundable ideas and catalyze these ideas to make them a business reality.[101] Simply throwing money at the problem is not enough.

B. Too Many Requirements and Risks to Justify a Small Crowdfunding Round

Crowdfunding legislation promised to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[102] However, this promise cannot be fully realized because of the onerous requirements imposed on early-stage businesses[103] and the increased risk of future litigation.[104] Crowdfunding may not be as substantial of a benefit to early-stage businesses compared to the current treatment of non-accredited investors under federal securities law.[105]

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[99]Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (stating that the act's goal is "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.").

[100] "So what kinds of companies would ever want use non-accredited investor crowdfunding? Desperate ones." Jim Saksa, "*Kickstarter, but With Stock*," Slate (Jun. 23, 2014 10:54AM), http://www.slate.com/articles/business/moneybox/2014/06/sec_and_equity_crowdfunding_it_s_a_disaster_waiting_to_happen.html (stating that it is very hard to believe that any attractive early stage business will use non-accredited investor crowdfunding).

[101]*See generally Startup America: Reducing Barriers*, SMALL BUSINESS ADMINISTRATION, http://www.sba.gov/sites/default/files/Startup%20America%20Reducing%20Barriers%20Report.pdf (summarizing feedback from entrepreneurs, investors, and other participants and concluding that entrepreneurs face barriers beyond capital, including problems transforming ideas into commercial realities and attracting the necessary human capital).

[102]Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[103]*See, e.g.*, *supra* note 49 and accompanying text describing some of the federal crowdfunding requirements for issuers. .

[104]Jumpstart Our Business Startups Act,§ 302.(creating a civil liability provision for material misrepresentations and omissions in crowdfunding disclosure documents). Some critics have objected to crowdfunding because the level of liability imposed on businesses, officers, and directors is high compared to the amount of money raised in a crowdfunding offering. *See* Hanks, *supra* note 5, at 13. However, businesses seeking crowdfunding are likely to be small, and thus, directors and officers should be able to recognize untruths or omissions in crowdfunding registration documents. *Id.*

[105]"[C]ompanies should not underestimate the burdens and costs associated with having a large number of small and potentially unsophisticated investors." Jeffrey Marks, *The Practical Challenges of the Crowdfunding Law*, 56-MAY ORANGE COUNTY LAW. 38, 39 (2014).

Crowdfunding comes with a laundry list of requirements, which makes taking a small amount of capital from a large number of non- investors less appealing.[106] Under the JOBS Act, an early-stage business has to provide an offering memorandum and audited financials, which will require the help of attorneys and accountants.[107] Once fully implemented by the SEC, these initial reporting requirements may prove prohibitive, especially for smaller rounds of funding.[108] Similarly, under Wisconsin law, an early-stage business also has to provide initial disclosures[109] and ongoing quarterly reports to potentially hundreds of investors.[110] While a crowdfunding issuer would likely sell shares with fewer rights,[111] an early-stage business has to undertake a certain level of ongoing upkeep and communication for managing a large volume of investors, including maintaining contact information, updating investors on corporate actions, providing notices of shareholders' meetings and written consents, and proving tax information.[112]

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[106]"The up-front transaction costs of attorneys and accountants to prepare disclosure statements that comply with SEC regulations, plus the fees owed to funding portals, will consume a substantial portion of the $1 million maximum that can be raised." David Mashburn, *The Anti-crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L. J. 127, 173 (2013). Additionally, attorneys may also need to review and potentially amend existing corporate provisions, such as voting rights, board composition, restrictions on share transfers, and company right of first refusal. *Id.* at 148.

[107]*See supra* note 49 and accompanying text. The financial disclosures required by the JOBS Act are more onerous than other security registration exemptions, including the popular Regulation D offering. *See* Mashburn, *supra* note 106, at 148. These costs could represent a significant portion of smaller crowdfunding rounds and distract young businesses that never went through a financial audit. *Id.*

[108]*See* Camillo, *supra* note 4, at 2 (stating that intrastate crowdfunding could be cost prohibitive for early stage businesses, depending on the costs associated with the particular state legislation).

[109]CASE for Jobs Act, WIS. STAT. §§ 551.202(26)(f), (h), & (i) (2011–12) (requiring disclosures).

[110]*Id.* § 551.205(2) (requiring quarterly reporting).

[111]For example, under Wisconsin law, shareholders must approve certain actions. *Id.* § 180.1103 (voting for plan of merger); § 180.1131 (voting for other business combinations). To better accommodate a large number of small shareholders, the articles of incorporation can provide different voting rights contrary to the default of one vote per share. *Id.* § 180.0721. However, by taking these actions, the business may open the door for lawsuits filed by these minority shareholders. *See, e.g.*, *Notz v. Everett Smith Grp., Ltd.*, 2009 WI 30. The law includes minority shareholder protections that cannot be taken away in the articles of incorporation. *See, e.g.*, WIS. STAT. § 180.1302 (allowing any shareholder to obtain payment of the fair market value of his or her shares if certain events occur, including merger or sale of the company). With thousands of shareholders, minority shareholders exercising their statutory rights could cause hurdles to completing corporate actions, such as merger and acquisition actions.

[112]Crowdfunding issuers may incur ongoing administrative expenses associated with managing numerous shareholder relationships, including shareholders asking questions and seeking to inspect corporate records. *See* John Alexander, *The Obama JOBS Act and Crowdfunding: Bright Promises, Likely Failure, Bring Me The News*, BRINGMETHENEWS (May 8, 2012), http://www.bringmethenews.com/2012/05/08/the-obama-jobs-act-and-crowdfunding-bright-promises-likely-failure/ (stating that "[n]on-accredited investors can be a nightmare for a CEO if they represent a

Because of these disclosure requirements, businesses using crowdfunding are required to make otherwise confidential information public.[113] This could include financial statements and tax returns.[114] For a public offering, businesses accept the public disclosure reality with the hopes of raising significant amounts of capital.[115] With crowdfunding, a business is unlikely to raise enough funds to justify making confidential information available to competitors.[116]

These transaction costs also increase due to the increased number of shareholders that could bring suit against the early-stage business, especially with the heightened anti-fraud liability under the JOBS Act.[117] Any early-stage business must be focused on execution, and distractions, including pending litigation, can be fatal to its success.[118] Every crowdfunding shareholder is a potential plaintiff, and the early-stage business has to account for this with proper record keeping, controls, and communication.[119]

Federal securities law currently provides options to early-stage businesses that want to accept money from non-accredited investors.[120] While these

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significant number of shareholders."). To accommodate shareholder requests, crowdfunding issuers may have to incur expenses from accountants and attorneys to abide by these requests. *See* Mashburn, *supra* note 106, at 148. In particular, small investors require the most updates, education, and attention from the company. *See* Marks, *supra* note 105, at 38. Additionally, small investors may be most likely to be disgruntled, especially after investing a large portion of their net worth compared to larger investors. *Id.*

[113]*See* Marks, *supra* note 105, at 39.

[114]*Id.*

[115]*Id.*

[116]*Id.*

[117]Under the JOBS Act, Congress drafted a new civil liability provision for crowdfunding investors harmed by a material misrepresentation or omission in any of an issuer's required filing materials. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 318–19 (2012) (borrowing the same broad language from the traditional misrepresentation and omission civil liability as provided in Section 12(a)(2) of the Securities Act of 1933, and providing that an issuer may be liable for the amount paid by the investor for a security). Under the federal crowdfunding anti-fraud provisions, an investor who purchased securities in a crowdfunding offering can bring a suit against the business, directors, CEO, CFO, and "any person who offers or sells the security in such offering." *Id.*

[118]*See, e.g.* Martin Zwilling, *With Great Startups It's All About The Execution*, Forbes (Aug. 20, 2011), http://www.forbes.com/sites/martinzwilling/2011/08/20/with-great-startups-its-all-about-the-execution/; Martin Zwilling, *Startups Are All About the Execution, So Tell Me How*, Forbes (May 20, 2012), http://www.forbes.com/sites/martinzwilling/2012/05/20/startups-are-all-about-the-execution-so-tell-me-how/.

[119]*See generally* Mashburn, *supra* note 106 (stating that the liability provisions in the JOBS Act "sweeps too broadly for the crowdfunding environment and will ensnare unsophisticated entrepreneurs in its trap").

[120]For example, in 1982, the SEC adopted Regulation D to provide several exemptions from some federal registration and disclosure requirements when businesses offer securities to non-accredited investors. 17 C.F.R. §§230.501–230.508 (2013). *See generally* Alexander Davie, *Can a friends and family round include non-accredited investors? Should it?*, Strictly Business (Aug. 15, 2011) (explaining the Regulation D exemptions in plain English). For example, Rule 505 allows a business to offer

exemptions each have their own headaches, the law correctly recognizes that the benefit of a small amount of capital for early-stage businesses is often outweighed by the non-accredited investor's aversion to risk of loss and exposure to fraud.[121] With its limited benefits and associated risks, crowdfunding may not provide an incremental benefit to early-stage businesses beyond what the law already provides.[122]

C. Crowdfunding's Final Frontier: Niche, Situational Offerings

While the mainstream acceptance of crowdfunding is in question, certain niche businesses might succeed is raising small, one-time financing rounds online.[123] For example, craft breweries or real estate offerings may appeal to local investors.[124] Crowdfunding also appears to be well suited for businesses with a civic cause or an existing broad base of support.[125]

Crowdfunding tends to lend itself to one-time, small financing rounds, which may be ideal for these small, local projects.[126] Some online intrastate

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and sell up to $5 million in a 12-month period from an unlimited number of accredited investors and up to 35 non-accredited investors. 17 C.F.R. § 230.505. However, Rule 505 requires certain disclosures by the issuer, bans general solicitation, and restricts transfer by investors. *Id.* Under another exemption, Rule 506 allows a business to raise an unlimited amount of money from accredited investors and up to 35 non-accredited investors. *Id.* § 230.506. Unlike Rule 505, a non-accredited investor under Rule 506 must be sophisticated. *Id.* (stating that a non-accredited investor must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment). Providing another example, Rule 504 exempts $1 million in a 12-month period. *Id.* § 230.504. If the issuer utilizes Rule 504 to accept money from non-accredited investors, the non-accredited investors must be pre-existing contacts of the issuer. *Id.* Additionally, Rule 504 requires adherence to state securities laws, which could be a significant obstacle. *Id.*; *see* Davie, *supra* note 120.

[121]Crowdfunding limits the amount of capital a business can raise in a 12-month period, but with an accredited investor offering under Regulation D Rule 506, a business can raise any amount of money. *See* Joe Wallin, *The Troubles with the New Crowdfunding Law*, STARTUP LAW BLOG (May 21, 2012), http://www.startuplawblog.com/2012/05/21/troubles-with-new-crowdfunding-law%E2%80%A8/. Additionally, Regulation D Rule 506 does not require the same level of reporting to accredited investors, such as no filing obligation of an annual report with the SEC. *Id.*

[122]*See generally* Marks, *supra* note 105.

[123]*See* Camillo, *supra* note 4 at 1; Torinus, *supra* note 86 (stating that crowdfunding may work for small businesses who only need one round of capital). However, with all the costs involved, a crowdfunding offering under $250,000 may not be worth the time, cost and risk of potential liabilities. *See, e.g.*, Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 Fla. L. Rev. 1433, 1444 (2012).

[124]*See infra* notes 127–128.

[125]*See, e.g.*, Schumpeter Blog, *Civic Crowdfunding: Worth a Try*, THE ECONOMIST (Sept. 10, 2013), http://www.economist.com/blogs/schumpeter/2013/09/civic-crowdfunding (describing the broad base of support for crowdfunded civic projects to revitalize Detroit, and arguing that "civic crowdfunding represents is potential salvation for even the most-fiscally frail urban areas").

[126]*See* Torinus, *supra* note 86. Intrastate crowdfunding may lend itself to smaller, localized projects because local investors may be committed to the success of the local economy. *See* Camillo, *supra*

crowdfunding portals have identified crowdfunding's appeal to niche, local offerings, such as craft breweries.[127] Similarly, other portals offer investment crowdfunding investment opportunities for commercial and residential real estate projects.[128]

Crowdfunding may also find a niche funding companies serving civic causes. Crowdsourcing currently serves pure donation-based offering for civic causes and charities.[129] However, both non-profit and for-profit companies offer products that serve civic needs and could benefit from crowdfunding.[130] For example, B-Cycle, a for-profit bicycle sharing company, has launched crowdfunding campaigns to bring its bike share program to particular cities.[131]

Benefit corporations, which provide for a hybrid for-profit corporate form with social or environmental missions, are candidates for a civic-based crowdfunding offering.[132] By chartering a benefit corporation, an entrepreneur can distinguish himself as a business with a social conscience and a standard higher than profit-maximization.[133] While a benefit corporation entity form failed

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note 4 at 2. However, intrastate crowdfunding, at least for smaller states, may run into difficulty connecting businesses with a critical mass of intrastate investors. *Id.*

[127]For example, CraftFund offers crowdfunding investment opportunities for craft brewers. CRAFTFUND, https://www.craftfund.com (last visited July 8, 2015).

[128]For example, Realty Mogul is a marketplace for accredited investors to buy shares of pre-vetted real estate investments. REALTY MOGUL, https://www.realtymogul.com (last visited July 8, 2015); *see, e.g.*, Emily Behlmann, *Kansas shopping center sale an early example of real estate crowdfunding*, WICHITA BUSINESS JOURNAL (Jan. 22, 2014), http://www.bizjournals.com/wichita/blog/techflash/2014/01/kansas-shopping-center-sale-an-early.html?page=all (detailing a shopping center that was sold to the "crowd").

[129]*See, e.g.*, NEIGHBOR.LY, https://neighbor.ly (last visited Oct. 5, 2014) (providing a civic crowdfunding portal for helping donate to community projects in the United States); CROWDERA, https://crowdera.co (last visited Oct. 5, 2014) (providing a civic crowdfunding platform supporting educators, nonprofit organizations and individuals serving communities across the globe).

[130] "Looking at efforts across topic-specific platforms like Spacehive and ioby, as well as general-interest ones like Kickstarter and IndieGoGo, civic projects are among the most successful at meeting their goals." Alexandra Lange, *Opinion: Crowdfunding*, DE ZEEN MAGAZINE (Jun. 19, 2014), http://www.dezeen.com/2014/06/19/alexandra-lange-opinion-crowdfunding/ (arguing that crowdfunding is a powerful tool to fund civic ideas, but we need new ways to surface good ideas).

[131]Kansas City's B-Cycle program raised nearly $420,000 via Neighbor.ly, a civic crowdfunding site, to provide 90 shareable bikes at 12 sharing stations in the city's downtown area.*See* Curt Hopkins, *Can crowdfunding kickstart struggling cities?*, The Daily Dot (Mar. 12, 2013), http://www.dailydot.com/politics/civic-crowdfunding-neighborly-citizinvestor/. Kansas City's B-Cycle program is owned and operated by Bike Share KC, a 501(c)(3) nonprofit corporation. *See* Kansas City B-Cycle, https://kansascity.bcycle.com/About/WhatisKansasCityBcycle.aspx (last visited Sept. 28, 2014).

[132]As of July 8, 2015, 31 States had passed benefit corporation legislation. *See* Benefit Corporation Information Center, http://benefitcorp.net/state-by-state-legislative-status (last visited July 8, 2015).

[133]*See generally* Doug Bend & Alex King, *Why Consider a Benefit Corporation?*, FORBES (May 30, 2014 9:00AM), http://www.forbes.com/sites/theyec/2014/05/30/why-consider-a-benefit-corporation/.

to pass in Wisconsin and other states, crowdfunding's appeal to niche, civic offerings may motivate such legislation to pass and help these businesses to succeed.[134]

Lastly, crowdfunding may appeal to projects with a broad base of support, locally or nationally.[135] While only a pseudo-crowdfunding project, the Green Bay Packers, an American football team, raised $67 million in 2012 by selling 250,000 shares of *stock*.[136] The Packers have a substantial, broad-reaching, and passionate fan base.[137] This foundation easily sets the stage to rally support for a crowdfunding offering because the Packers have already sold its *investors* on its value proposition.[138]

Although crowdfunding serves these niche offerings, certain risks may tip the scale to disallow its exemption from securities laws.[139] Crowdfunding opens investment opportunities to non-accredited investors, who are historically viewed as investors that are vulnerable to fraud and unable to easily absorb

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Benefit Corporation are given legal protection to consider the interests of all stakeholders, rather than simply shareholder of the business. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 362(a), 365(a) (providing that public benefit corporations must managed in a manner that balances the stockholders' pecuniary interests, the interests of those materially affected by the corporation's conduct, and a public benefit or public benefits identified in the corporation's certificate of incorporation.) However, benefit corporations generally have higher reporting standards. *See, e.g.*, *id.* § 366(n) (providing that benefit corporations have to provide a biennial report to stockholders as to the corporation's promotion of the public benefit).

[134] Charities have already succeeded in raising money from the crowd. *See generally* Doug Rand, *The Promise of Crowdfunding for Social Enterprise*, OFFICE OF SOCIAL INNOVATION AND CIVIC PARTICIPATION (Jun. 28, 2012), http://www.whitehouse.gov/blog/2012/06/28/promise-crowdfunding-social-enterprise. Crowdfunding could open the door to for-profit business serving social missions. *Id.*

[135] *See* Torinus, *supra* note 86.

[136] The Green Bay Packers stock cost $250 per share and is essentially a collectible. *See* Kevin Seifert, *Packers raise $67M in stock offering*, ESPN (Mar. 1, 2012), http://espn.go.com/nfl/story/_/id/7633420/green-bay-packers-sell-268000-plus-shares-raise-67m. Stockholders are invited to an annual stockholders meeting. *Id.* However, the stock pays no dividends, is not tradeable, and has no securities-law protections. *See* Laura Saunders, *Are the Green Bay Packers the Worst Stock in America?*, THE WALL STREET JOURNAL (Jan. 13, 2012), http://blogs.wsj.com/totalreturn/2012/01/13/are-the-green-bay-packers-the-worst-stock-in-america/.

[137] *See* Seifert, *supra* note 136 (citing examples of Green Bay Packers fan hysteria, including 93,000 people on the season ticket waiting list in 2012).

[138] The success of crowdfunding is often linked to the people already connected to the crowdfunding business, artist, or musician. *See, e.g.*, Ian Anderson, *3 Surprising Ways to Drive Traffic to Your Crowdfunding Campaign (It's Not What You Think)*, LAUNCH AND RELEASE, http://launchandrelease.com/3-ways-to-drive-traffic-to-your-crowdfunding-campaign-that-will-convert/ (last visited July 8, 2015); *7 Deadly Sins of Crowdfunding*, SPONSUME.COM, http://www.sponsume.com/getting-started/7-deadly-sins-crowdfunding (last visited Oct. 12, 2014).

[139] If crowdfunding investors are exposed to Internet frauds and scams, the investors will first be harmed and eventually scared away. Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L. J. 373, 389 (2012).

financial loss.[140] As demonstrated by the SEC's reluctance to approve federal crowdfunding,[141] the funding of a small business, such as a microbrewery, may not be worth exposing non-accredited investors to securities-related risks.[142]

IV. CONCLUSION: AT BEST, CROWDFUNDING SERVES A NICHE MARKET, WHICH MAY NOT BE WORTH ITS RISKS

Crowdfunding provides access to the wrong types of capital and is largely tailored to niche situations. Angel and venture funds better serve early-stage businesses. For businesses that are not fundable under traditional mechanisms, the crowdfunding requirements are onerous and potentially unworkable for early-stage businesses. Lastly, crowdfunding may be appropriate for certain niche projects, but these projects have limited benefits to justify the increased risk of fraud.

Despite its well intentions, crowdfunding legislation has failed to live up to the hype and legislatures should focus on seeding the economy with ideas, not capital.[143] Traditional angel and venture funds will fund good ideas being executed by well-trained entrepreneurs.[144] The United States can fuel economic progress through promoting good, fundable ideas, which will organically bring the capital needed to grow the business and realize positive job growth.[145]

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[140] *See SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) (establishing that wealthy or financially sophisticated investors are considered to be less vulnerable in making investment decisions and, thus, qualify to participate in private placement offerings).

[141] *See* Thorpe, *supra* note 15.

[142] "When unsophisticated investors meet unsophisticated issuers, there will be investor losses and there will be fraudulent offerings." *See* Mashburn, *supra* note 106, at 173. For example, regulators have already identified about 200 suspicious crowdfunding websites and are considering taking enforcement actions against some of these sites. *See, e.g.*, Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, THE WALL STREET JOURNAL (Jan. 17, 2013 6:51PM), http://online.wsj.com/news/articles/SB10001424127887323783704578247380848394600.
However, fraudulent offers exist already in non-crowdfunding securities offerings. *See* Mashburn, *supra* note 106, at 173; C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 201 COLUM. BUS. L. REV. 1, 9, 115–16 (2012) (stating that more securities offerings, regardless of the type of exemption used, will result in more fraud, and arguing that the real question is whether the benefits of crowdfunding outweigh the risks).

[143] *See, e.g.*, Wald, *supra* note 93 (arguing that the startup "imbalance is not a lack of capital but rather a lack of good ideas").

[144] However, the current system does have its flaws, including insufficient funding for minority or women owned businesses. *Id.* Additionally, venture capital is hard and many fail to generate a positive return on investment. *Id.* Therefore, "it's safer, and prudent, to prevent everyone from swimming in the deep end of the pool." *Id.*

[145] For example, Wisconsin could consider changing its pro-employer non-compete agreement laws to encourage the free flow of ideas and promote innovation. *See, e.g.*, Norman D. Bishara, *Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment*, 27 BERKELEY J. EMP. & LAB. L. 287, 297-99 (2006) (discussing generally the effects of government policy on human capital and trade secrets in the context of

V. APPENDIX 1: EQUITY CROWDFUNDING SNAPSHOT

CROWDFUNDING PROS	CROWDFUNDING CONS

• Source of capital, especially as an alternative option for start-ups unable to raise capital through traditional sources
• Builds brand awareness
  o Offering's presence on the internet
  o Significant number of owners/brand advocates
• Appeal to niche offerings
  o Civic/local causes
  o Broad base of support
  o Small, one-time financings
  o Business models with a "social networking" aspect or goal
• Potentially reduces time commitment to fundraising
• More ideas get funded
• Helps to retain founders' control and ownership through selling "Class B" stock at a lower valuation compared to traditional capital sources
• Exposure to broad geographic investor base (for federal crowdfunding)
	• Limited ability for follow-on rounds by the crowd
	• Limited business expertise by the crowd
	• Potentially Higher Costs
	  o Fees to portal
	  o Fees to professionals, including attorney and accountant
	  o Registration costs to State/Federal government
	  o Ongoing administrative costs
	• Disclose information to public in information statement
	• Greater riskof liability for the start-up
	• Potential for fraud increases for investors
	• Collect less feedback on the business model by not pitching investors in-person
	• "Black mark" on resume, making a subsequent traditional round of capital more difficult
	  o Negative impression of business for not being able to secure traditional funding sources earlier
	  o Large number of investors on the cap table
	• Potentially fund more lower quality start-ups

non-compete contract clauses); Jeremy Hitchcock, *Competing Against Non-Competes*, INC.COM, (Dec. 19, 2013), http://www.inc.com/jeremy-hitchcock/competing-against-non-competes.html (discussing the importance of eliminating non-compete agreements to promote the free flow of ideas).

TERRENOS BALDÍOS Y EDIFICIOS ABANDONADOS; IMPLICACIONES AMBIENTALES Y DE DESARROLLO ECONÓMICO

JEIRCA M. MEDINA PAGÁN*

> "Dull, inert cities, it is true, do contain the seeds of their own destruction and little else. But lively, diverse, intense cities contain the seeds of their own regeneration, with energy enough to carry over for problems and needs outside themselves."[1]

I. INTRODUCCIÓN

Durante el verano 2014, me encontraba caminando por las aceras de la Avenida Ponce de León tomando un curso de estudio sobre el diseño de las ciudades. Como grupo, caminamos desde Barrio Obrero hasta llegar a Miramar

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[1] JANE JACOBS, THE DEATH AND LIFE OF GREAT AMERICAN CITIES 448 (1961).

pasando por la mayoría de los barrios de Santurce. Entre las cosas que pudimos observar fue, por un lado, edificios abandonados, espacios baldíos e infraestructura inservible y por el otro, personas invirtiendo en nuevas construcciones, movimiento de grupos creativos y un latir de comunidad que se quería hacer sentir. Logramos reunirnos con varias personas, residentes del área, organizaciones sin fines de lucro, comunidades, artistas que impactan directamente a Santurce, profesionales de la arquitectura y la planificación, y con personal del Municipio de San Juan. Todas estas personas y organizaciones relataban unas metas muy afines entre sí. Estas se resumen en revitalizar a Santurce económicamente pero sobretodo que Santurce pudiera ser seguro. Las sugerencias de los distintos grupos abarcaban desde otorgar incentivos a ciertas construcciones a cambios de iluminaria y la declaración de Santurce como zona turística, entre otros. Sin embargo, una perspectiva que permeaba en todos los discursos era el problema que representan los solares baldíos y los edificios abandonados. Este problema ha sido identificado por académicos y ciudadanos en general a lo largo de varias ciudades como uno de los de mayor transcendencia que enfrentamos en estos tiempos. La manera en la que estos grupos se expresaron sobre éste, va de acorde con una definición dada en una conferencia de alcaldes en los Estados Unidos dedicada a este problema. Definieron de la siguiente forma los espacios y propiedades abandonadas:

> Vacant and abandoned properties, whether residential or commercial, create costly problems for cities. They are a drain on city budgets. They detract from the quality of life, as well as the economic opportunities, of those living around them. They are an impediment to individual neighborhood redevelopment and, ultimately, to achievement of city-wide economic development goals.[2]

Esto nos da un preámbulo de la problemática que representan estos espacios o estructuras. Este escrito tratará de presentar de la manera más abundante posible, las diferentes facetas en las que los espacios baldíos y estructuras abandonadas afectan al desarrollo económico y las implicaciones ambientales que posee. Comenzaré este escrito, abundando un poco sobre la historia para empezar a trazar un mapa de las decisiones que dieron paso al Santurce de hoy e intentar al final brindar algún tipo de solución o dirección.

II. SANTURCE ANTES Y AHORA

[2] The United States Conference of Mayors 2006, Combating Problems of Vacant and Abandoned Properties, 1 (2006). Available at http://www.usmayors.org/bestpractices/vacantproperties06.pdf. (Última visita el 3 de febrero de 2015).

Mucho podemos decir de Cangrejos, sin embargo, trataré de hacer un recuento breve sobre los eventos más trascendentales de su historia y de su condición actual.

Santurce era conocido como Cangrejos y en los siglos 16 y 17, básicamente, se definía por la carretera principal que unía a San Juan con el resto de la isla, por lo cual no tenía mucha población.[3] En el siglo 18 aumentó la cantidad de habitantes, siendo necesaria la construcción de una capilla que llevaría a un asentamiento a su alrededor.[4] Las rutas entre San Juan y el resto de la isla necesariamente tenían que pasar por Cangrejos, por lo que su desarrollo fue inevitable. Para el siglo 19 se convierte en un barrio de San Juan extramuros, definiéndose Santurce "como el área de expansión suburbana de la ciudad."[5] Aunque la construcción privada se tenía que someter a las ordenanzas municipales de planificación, Santurce creció sin un plan de ensanche que formara parte de un sistema urbano.[6] Es en este siglo que se desarrolla el ómnibus y tranvía que conectaba la ciudad amurallada con Rio Piedras. Debido a esto, Santurce era más accesible y se comenzó a construir en él una cantidad mayor de casas y edificios multifamiliares.[7]

Las ocupaciones territoriales en Santurce en el pasado al igual que en el presente marcan las divisiones de clases. Estas divisiones han sido fundamentales sobre la manera en la que se edifica en Santurce. El desparrame urbano en el resto de la isla, la emigración de grandes cantidades de puertorriqueños a los Estados Unidos y la crisis económica de los pasados años han sido algunas de las principales razones para el abandono de Santurce.

Actualmente, hay varios movimientos apostando al renacer de Santurce. Entre estos se encuentra la integración de los museos a sus comunidades, *Santurce es Ley*, corporaciones sin fines de lucro como *Imagine Santurce* y *Foundation for Puerto Rico*, y el proyecto *Jardines y Murales del Estuario* del Programa del Estuario de la Bahía de San Juan. Santurce se encuentra palpitando y pidiendo un cambio para que la ciudad renazca y se sienta.

III. EL PROBLEMA DE LOS SOLARES BALDÍOS Y LAS ESTRUCTURAS ABANDONADAS: EL CASO DE SANTURCE

A. Problema de Seguridad

La Oficina de Contabilidad del Gobierno de los Estados Unidos (GAO) ha estimado que, en los Estados Unidos, existen más de 450,000 propiedades que

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[3] ANÍBAL SEPÚLVEDA & JORGE CARBONELL, CANGREJOS-SANTURCE: HISTORIA ILUSTRADA DE SU DESARROLLO URBANO (1519-1950) 10 (2da ed. 1988).
[4] *Id.* (El asentamiento se llamó San Mateo de Cangrejos).
[5] *Id.* en la pág. 14.
[6] *Id.* en las págs. 14-16.
[7] *Id.* en la pág. 17

han sido catalogadas solares baldíos o estructuras abandonadas.[8] Santurce actualmente cuenta con sobre alrededor de 500 propiedades con esas características.[9] Esto representa un número alarmante de propiedades que, por su estado, representan un peligro contra la seguridad. En Texas, mediante análisis de data de unas cuadras, se concluyó que: "[b]locks with unsecured buildings had 3.2 times as many drug calls, 1.8 times as many theft calls, and over twice the number of violent calls as the others."[10] Este tipo de propiedades tienden a servir de hogar para plagas, son usados como basureros y un lugar donde dejar escombros de construcción.[11] Estos no son los únicos peligros que representa este tipo de propiedad, sino que muchas de estas propiedades presentan un riesgo de incendios. Además, representan un costo oneroso para la ciudad cuando se deciden demoler.[12] En Estados Unidos el *National Fire Protection Association* indicó que, debido a edificios que están envejeciendo, cada año mueren seis personas y 6,000 bomberos sufren lesiones.[13] Además, muere un bombero por cada 100,000 edificios incendiados, siendo la clasificación de edificio de mayor muerte para los bomberos.[14]

B. Problema económico

Además de presentar problemas a la seguridad, estas fincas presentan un problema económico para aquellos que viven en sus cercanías. Uno de los hallazgos de un estudio desarrollado en Philadelphia, fue que: "[a]ll things being equal, *the presence of an abandoned house on a block reduces the value of all the other property by an average of $6,720*, according to multivariate analysis of the effects of abandonment on sales prices."[15] No solo estos afectan a sus vecinos de esta manera sino que también afectan a la ciudad en la que se encuentran. "Vacant properties reduce city tax revenues in three ways: they are often tax delinquent;

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[8] U.S. GOV'T ACOUNTABILITY OFFICE, GAO-06-7, ECONOMIC DEVELOPMENT ADMINISTRATION: REMEDIATION ACTIVITIES ACCOUNT FOR SMALL PERCENTAGE OF TOTAL BROWNFIELD (2005). Disponible en: http://www.gao.gov/products/GAO-06-7 (última visita el 3 de febrero de 2015).

[9] Entrevista a la Directora de la Oficina de Urbanismo del Municipio de San Juan (17 de noviembre de 2014).

[10] William Spelman, *Abandoned Buildings: Magnets for Crime?*, 21 J. CRIM. JUST. 481, 489 (1993).

[11] ALAN MALLACH, BRINGING BUILDINGS BACK: FROM ABANDONED PROPERTIES TO COMMUNITY ASSETS 9 (2006).

[12] NATIONAL VACANT PROPERTIES CAMPAIGN, VACANT PROPERTIES THE TRUE COST TO COMMUNITIES, 1 (2005).

[13] Steven M. Botts, *Analyzing The Problem of Abandoned, Vacant and Unoccupied Buildings in Middletown, Ohio*, MIDDLETOWN DIVISION OF FIRE 5 (2010).

[14] *Id.*

[15] Temple University Center for Public Policy and Eastern Pennsylvania Organizing Project, Blight Free
Philadelphia: A Public-Private Strategy to Create and Enhance Neighborhood Value, i, iv (2001).

their low value means they generate little in taxes; and they depress property values across an entire neighborhood."[16]

El abandono de edificios representa una oportunidad para que criminales entren a ellos a robar y destruir. Según el Departamento de Energía de los Estados Unidos,[17] el robo de cobre en los Estados Unidos se estima que representa un billón de dólares anualmente.[18] Un reportaje sobre el hurto de cobre señala que ha aumentado los reclamos a las aseguradoras de 13,861, en el periodo de 2006 a 2008, a 25,083 reclamos, en el periodo de 2009 a 2011. Para un aumento total del ochenta y un porciento.[19]

Lugares, como las oficinas, que son necesarias para desarrollar actividad económica se ven afectados también:

> Office buildings across the U.S. lost 1.8 million square feet of occupied space in the quarter, pushing the national office vacancy rate to 17.4%, the highest level since 1993, according to New York-based research firm Reis Inc. . . .
>
> . . . .
>
> Across the 82 metropolitan areas tracked by Reis, the total amount of occupied office space has dropped since early 2008 by 133 million square feet—the size of 2,300 football fields.
>
> Landlords responded to rising vacancies by reducing rents for the seventh straight quarter. Effective rent, which is rent including concessions, declined 0.9% during the second quarter to an average of $22.01 a square foot a year. Effective rent peaked at nearly $25 per square foot in the second quarter of 2008.[20]

Este tipo de abandono afecta a muchas personas y a las ciudades. Un reportaje del *National Association of Counties* encontró cuanto en promedio le

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[16] NATIONAL VACANT PROPERTIES CAMPAIGN, *supra* nota 12.

[17] Conocido como el U.S. Department of Energy.

[18] Jocelyn Durkay, *Methal Theft – 2013 Legislative Update*, NATIONAL CONFERENCE OF STATE LEGISLATURE (February 1, 2014) Disponible en: http://www.ncsl.org/research/energy/metal-theft-2013-legislative-update.aspx (Cabe mencionar que estos totales no son solamente en edificios abandonados).

[19] NICB, *NICB Reports Metal Thefts Increase 81 Percent Since 2008: FBI: "Copper Thefts Threaten U.S. Critical Infrastructure"*, NATIONAL INSURANCE CRIME BUREAU (March 8, 2012) Disponible en: https://www.nicb.org/newsroom/news-releases/metal-theft-report.

[20] Anton Troianovski, *Office Vacancy Rate Keeps Climbing*, THE WALL STREET JOURNAL (July 6, 2010) Disponible en: http://www.wsj.com/articles/SB10001424052748703778504575347190869129432.

costaba a la ciudad de Chicago los problemas de abandonos.[21] En este reportaje demostró que anualmente una propiedad abandonada e insegura tenía un costo de $5,358.[22] El costo aumenta cuando se desea demoler esa propiedad lo que resulta en $13,453.[23] Sin embargo, si esta propiedad se incendia, como muchos casos de propiedades abandonadas, le termina costando $34,199 al municipio.[24]

Según un estudio hecho por el *U.S. Conference of Mayors* en el 2003, 148 ciudades reportaron que si sus terrenos o edificios, que poseen contaminantes, fueran limpiados y desarrollados se crearían 576,373 nuevos empleos y 1.9 billones de dólares anuales.[25] Sin embargo, el señalamiento que hacen para que esto no se concrete es que hace falta fondos para llevar a cabo la limpieza, hay asuntos de responsabilidad, y la necesidad de estudios ambientales.[26] Un estudio hecho por la *National Brownfield Association* revela que dos trillones de dólares en bienes raíces es devaluado debido a la presencia de peligros ambientales.[27] Se necesitaría entre $450 billones a $650 billones como mínimo para convertirlas en productivas.[28]

Una manera de incentivar el desarrollo de edificios abandonados es mediante deducciones sobre ingresos. Sin embargo, estas medidas sobre deducciones deben hacerse de manera que realmente incentiven a la industria privada o a los ciudadanos a considerar la rehabilitación de estructuras como una opción viable. Una disposición federal que incentiva el desarrollo de propiedades abandonadas es el *Taxpayer Relief Act* (TRA) creada en 1997.[29]

> The TRA allows environmental cleanup costs to be fully deducted from income in the year they are incurred. The $1.5 billion TRA incentive for brownfields was expected to lever $6 billion in private

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[21] NAT'L ASS'N OF COUNTIES, ISSUE BRIEF: ECONOMIC TRENDS, FORECLOSURES AND COUNTY BUDGETS 8 (2008), Disponible en: http://www.naco.org/newsroom/pubs/Documents/County%20Management%20and%20Structure/Economic%20Trends%20Foreclosures%20and%20County%20Budgets.pdf

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Andy Solomon & Lina Garcia, Redeveloping Brownfields could generate 576,000 new jobs, $1.9 billion in Tax Revenue, US MAYORS (9 de junio de 2003), http://usmayors.org/71stAnnualMeeting/brownfields_060903.asp (Última visita el 8 de febrero de 2015).

[26] *Id.*

[27] Nat'l Brownfield Association, BROWNFIELD NEWS & REGIONAL REPORT 3, Disponible en: http://www.epa.gov/osw/hazard/correctiveaction/curriculum/download/brown.pdf

[28] Eric W. Ekman, Strategies for Reclaiming Urban Postindustrial Landscapes 12 (Junio 21, 2004) (tesis no publicada, Massachusetts Institute of Technology) (archivado en el Sistema de Biblioteca de Massachusetts Institute of Technology).

[29] Taxpayer Relief Act of 1997, 26 U.S.C. §§ 941-951 (1997).

> investment and return 14,000 brownfields to productive use. However, the TRA incentive has not been widely used.[30]

Aun cuando la legislación está dirigida a promover la inversión en este tipo de terreno, el que solo pueda deducirse el total del costo en ese año, entiendo que es una de las razones por la cual no tiene tanto éxito esta legislación. Una posibilidad a contemplar es el deducir el gasto incurrido en un periodo determinado de años. De esta manera existe una certeza mayor de que lo invertido tendrá el beneficio que la ley parece tener.

C. Problema ambiental

Otro aspecto importante en el que incide el problema de abandono de estructuras y lotes baldíos es el peligro ambiental que estos presentan. "[T]hey are usually centrally located near population centers with good access to rail lines, highways, and utilities, thereby providing excellent potential development opportunities. In recognition of these factors, in 1995, the U.S. EPA initiated a brownfield program to encourage cleanup and conversion to beneficial purposes of abandoned contaminated sites".[31] La revitalización de solares abandonados ha tomado importancia en los últimos años como una estrategia sostenible de uso de terreno y como un remedio al desparrame urbano.[32]

Además, la EPA desde el 1980 tiene a su disposición el *Comprehensive Environmental Response, Compensation, and Liability Act* (en adelante, "CERCLA").[33] En esta, se le provee un mecanismo a la EPA para que se limpien cualquier tipo de desechos peligrosos, derrames o lanzamientos de emergencia de contaminantes en el ambiente, ya sea por los responsables del terreno o por la agencia misma. EPA está facultada para implementar CERCLA en los cincuenta estados y los territorios de los Estados Unidos.[34] Actualmente, se encuentra en la base de datos de la EPA tres solares localizados en Santurce que forman parte de la lista oficial de solares que contienen o han contenido el tipo de desechos o contaminantes que deben ser limpiados según CERCLA.[35] El proceso de limpieza que lleva a

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[30] NATIONAL ROUND TABLE ON THE ENVIRONMENT AND THE ECONOMY, CLEANING UP THE PAST, BUILDING THE FUTURE: A NATIONAL BROWNFIELD REDEVELOPMENT STATEGY FOR CANADA A20 (2003).

[31] STANLEY E. MANHAN, ENVIRONMENTAL SCIENCE AND TECHNOLOGY: A SUSTAINABLE APPROACH TO GREEN SCIENCE AND TECHNOLOGY 384 (2nd. Ed. 2007).

[32] Michael R. Thomas, A GIS-based decision support system for brownfield redevelopment, 58 Landscape and Urban Planning 7 (2002).

[33] Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §9601-9675 (1980) (conocida como "Superfund").

[34] *Id.*

[35] Superfund Site Information, U.S. ENVIRONMENTAL PROTECTION AGENCY. Available at: http://www.epa.gov/superfund/sites/cursites/ (Last visited April 4, 2015).

cabo la EPA, bajo esta legislación, sigue los siguientes pasos: (1) Descubrimiento o notificación a la EPA sobre el terreno contaminado o que posiblemente suelte sustancias; (2) Inspección de las condiciones del terreno; (3) Enlistar el terreno según su prioridad de limpieza; (4) Investigación de factibilidad; (5) Registro de decisión; (6) Diseño de remedios; (7) Perfeccionar la construcción; (8) Pos-perfección de la construcción; (9) Eliminación de la lista de prioridad, y (10) Redesarrollo del terreno.[36] El tiempo que tomó completar todos los procesos en las propiedades identificadas en Santurce no sobrepasó un año.[37] Esto muestra que se cuenta con una legislación y agencia federal que logra la eliminación de los contaminantes. Sin embargo, el tiempo en completar su misión en un terreno o edificio abandonado con condiciones más peligrosas es exorbitante, tomando fácilmente entre diecisiete y veintitrés años.[38]

Además de toda esa legislación y esfuerzo federal, en 1995 se creó el *Brownfields National Partnership Action Agenda*.[39] Esto proveía una cooperación entre organizaciones gubernamentales, no gubernamentales y empresas.[40] Este plan de acción, por ejemplo, en Texas, en menos de dos años, había logrado que la industria privada invierta más de $109 millones, mientras que la aportación federal ha sido de $1.9 millones. Estas inversiones anticipaban la creación de más de 1,700 empleos.[41] Sin embargo, el GAO concluyó que "the Administration cannot tell if the initiative is meeting the economic goals because most agencies

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[36] Cleanup Process, U.S. ENVIRONMENTAL PROTECTION AGENCY. Available at: http://www.epa.gov/superfund/cleanup/index.htm

[37] *Véase* Search Superfund Site Information: Minillas Government Center, U.S. ENVIRONMENTAL PROTECTION AGENCY. Available at: http://www.epa.gov/superfund/cleanup/index.htm; Search Superfund Site Information: Federico Ansejo School, U.S. ENVIRONMENTAL PROTECTION AGENCY. Available at: http://www.epa.gov/superfund/cleanup/index.htm; Search Superfund Site Information: Las Margaritas Housing Mercury, U.S. ENVIRONMENTAL PROTECTION AGENCY. Available at: http://www.epa.gov/superfund/cleanup/index.htm;

[38] *Véase Tentative Schedule for Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) Cleanup Actions at the Former Hardesty Federal Complex*, Missouri Department of Natural Resources, Disponible en: http://dnr.mo.gov/env/hwp/docs/tentativehardestycerclacleanup schedule.pdf (Última visita 12 de marzo de 2015); Marine Corps Base Hawaii & Naval Facilities Engineering Command, Waikane Valley Impact Project Overview and Timeline, Disponible en: http://www.mcbhawaii.marines.mil/Portals/114/WebDocuments/IEL/Environmental/Waikane%20RAB/Meetings/110921-CleanupProcessTimelinePresentation.pdf (Última visita 12 de marzo de 2015).

[39] United States Environmental Protection Agency, *Memorandum of Understanding between the U.S. Environmental Protection Agency and the U.S. General Services Administration* (May 2007).

[40] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, LOCAL ECONOMIC AND EMPLOYMENT DEVELOPMENT: LOCAL GOVERNANCE AND THE DRIVERS OF GROWTH 220-21 (2005).

[41] United States Environmental Protection Agency, *Brownfields National Partnership Expanded* (6 de diciembre de 1999) EPA, Disponible en: http://yosemite.epa.gov/opa/admpress.nsf/6427a6b7538955c585257359003f0230/9ad96605239e9efb8525683f00631141!OpenDocument (éltima visita el 19 de marzo de 2015).

are not tracking these results or collecting data specific to brownfields that would allow them to do so."[42]

Entre los problemas ambientales que presentan los espacios y edificios abandonados se encuentra el envenenamiento por plomo, asbestos, la calidad del aire interno y asma, calidad de aire del ambiente, ríos urbanos y humedales, espacios abiertos y verdes, y los químicos nocivos a la salud de las tierras, aguas y aire.[43]

Hay que tener presente, antes de intentar proponer soluciones al problema, las razones o indicadores del abandono de estas fincas. Existen muchas variables que pueden entrar en juego para que un lote sea abandonado. En Philadelphia, por ejemplo, su estudio reveló que "*10% decrease in the denial rate for home improvement loans would reduce housing abandonment by 9%*. Conversely, a *10% decrease in loans made by sub-prime (often predatory) lenders would decrease housing abandoned in the average tract by 24%*."[44] Por otro lado, parte de las decisiones legislativas a través de los años, lo que ha promulgado o beneficiado es el movimiento de las personas de las ciudades a la suburbia. Como señaló Jane Jacos en su libro magistral:

> [N]o other aspect of our economy and society has been more purposefully manipulated for a full quarter of a century to achieve precisely what we are getting. Extraordinary governmental financial incentives have been required to achieve this degree of monotony, sterility and vulgarity. Decades of preaching, writing and exhorting by experts have gone into convincing us and our legislators that mush like this must be good for us, as long as it comes bedded with grass.[45]

En muchos estados, incluyendo a Puerto Rico, se favorece con incentivos la compra de hogares recién construidos, los cuales cada vez quedan más lejos. Por esta razón es mas beneficioso, económicamente, para una persona comprar casas recién construidas que comprar casas o apartamentos ya establecidos. Esto presenta un costo mayor para el gobierno, debido a la inversión que deben hacer en infraestructura, pero ese análisis no forma parte de este trabajo.[46] Los

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[42] GAO, *Community Development: Local Growth Issues, Federal Opportunities and Challenges* (2000). *Vease además* GAO, *Environmental Protection: Agencies Have Made Progress in Implementing the Federal Brownfield Partnership Initiative* (1999).

[43] United States Environmental Protection Agency, Questions about your Community: Urban. Available at: http://www.epa.gov/region1/communities/urban.html (Last visited November 20, 2014).

[44] Temple University, *supra* nota 15.

[45] JACOBS, *supra* nota 1, en la pág. 7.

[46] *Véase* William W. Buzbee, Urban Sprawl, *Federalism, and the Problem of Institutional Complexity*, 68 FORDHAM L. REV. 1, 59 (1999).

esfuerzos estatales y federales muchas veces no toman en consideración los efectos en cadena que pueden desencadenar su legislación. "Federal and state subsidies to support housing development have been seen primarily in terms of service delivery, rather than as economic stimulus to neighborhoods."[47]

D. Los estorbos públicos en San Juan

El Código de Urbanismo de la ciudad de San Juan en su capítulo VIII trata el Procedimiento de Declaración y Erradicación de Estorbos Públicos.[48] En este, se describe lo que son estorbos públicos para efectos del municipio y los designa en tres categorías.[49] La primera categoría cubre a las edificaciones o estructuras abandonadas, las cuales deben representar una amenaza a la vida, a la salud, al disfrute de propiedades, al ambiente entre otros.[50] La segunda categoría son las edificaciones habitadas que por su estado no debe alojar o servir de vivienda para los humanos.[51] La tercera categoría son los solares o predios que se define como "cualquier predio o solar, abandonado, yermo o baldío, cuyas condiciones o estado representen peligro o que amenace la seguridad o salud de los ciudadanos, o que dañe sustancialmente el ambiente".[52]

El proceso de declaración de estorbos públicos es uno que toma tiempo, dinero y se compone de varios pasos. El primer paso para poder declarar estorbos públicos, es que el Comisionado del Departamento de Policía Municipal y Seguridad Pública considere diferentes criterios para cada categoría y haga una investigación.[53] Este Comisionado tiene la facultad de:

> a. Entrar en cualquier propiedad, estructura, edificación o solar, con el propósito de realizar inspecciones para determinar si éstas constituyen un estorbo público. . . .
>
> b. Citar testigos y recibir evidencia.
>
> c. Tomar declaraciones, admisiones y examinar testigos.

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[47] Temple University, *supra*, note 15 at 36.
[48] Ordenanza Municipal Núm. 7 del Código de Urbanismo del Municipio de San Juan VIII (2002).
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.* art. 8.05
[53] Ordenanza Municipal, *supra* nota 48, art. 8.05.

> d. Contratar los servicios de peritos para evidenciar los riesgos para la salud y seguridad que constituye la propiedad objeto de declaración de estorbo público.
>
> e. Contratar los servicios de limpieza, construcción o remoción de escombros necesarios para erradicar la condición de estorbo público según determinada por este Procedimiento.[54]

Si la investigación da base para proceder, el segundo paso es la querella y notificación de vista.[55] Luego un Oficial o funcionario que preside la vista emite un informe que deberá ser considerado por el Comisionado y éste emitirá una decisión final y una orden a los días luego de celebrarse la vista.[56] Una parte con interés tiene veinte días a partir de la decisión final del Comisionado para acudir al Tribunal y solicitar una Revisión Judicial.[57]

Al cumplir el término en el que se debe cumplir con la orden, se vuelve a hacer una inspección para evaluar si se ha cumplido con la misma. De no cumplir con ella, se podrá multar al dueño por la cantidad de mil dólares.[58] Si el dueño no cumple con las disposiciones de la orden, el Municipio puede encargarse de estas siempre y cuando no exceda del 30% del valor de la estructura.[59] Si sobrepasa ese porciento, se podrá expropiar forzosamente, demoler o remover la estructura.[60] Estos trabajos hechos por el Municipio, deben ser pagados a éste dentro de los diez días próximos.[61] De no pagar estos trabajos en los diez días, el Comisionado tendrá que notificar al Director Ejecutivo de la Oficina de Asuntos Legales del Municipio para que haga constar este gravamen sobre el inmueble en el Registro de la Propiedad.[62] Si se hace un esfuerzo en vano de recobro, se certifica al Director del Centro de Recaudaciones de Ingresos Municipales (en adelante, "CRIM") los gastos para que este haga las gestiones de cobro.[63] De agotar este recurso, el Comisionado notificará al Director de la Oficina de Asuntos Legales para que comiencen los procedimientos de la expropiación.[64] El municipio podrá denegar permisos municipales requeridos para desarrollar edificios o solares

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[54] Ordenanza Municipal, *supra* nota 48, art. 8.07.
[55] Art. 8.08.
[56] *Id.*
[57] *Id.*
[58] *Id.* art. 8.09 (a).
[59] Ordenanza Municipal, *supra* nota 48, art. 8.09 (b).
[60] *Id.*
[61] *Id.* art. 8.09 (c).
[62] *Id.*
[63] *Id.*
[64] Ordenanza Municipal, *supra* nota 48, art. 8.09 (d).

declarados estorbos públicos hasta que se pague la deuda.[65] De esto queda excluido las Zonas y Monumentos Históricos y los Centros Urbanos el cual Santurce forma parte.[66] Esta excepción de Santurce lo que hace es añadir un requisito de consultar al Departamento de Urbanismo para la evaluación de la estructura.[67] Sus recomendaciones serán determinantes para las actuaciones que se llevará con ese edificio.[68]

Este proceso le provee al dueño de la propiedad un debido proceso de ley. Sin embargo, es un proceso largo y costoso para el municipio. Algunas de estas propiedades tienen deudas con el CRIM, anteriores al comienzo del proceso de declaración de estorbos públicos, que ascienden por encima del costo de la propiedad y sin embargo, el municipio tiene que pagarle al dueño por esa expropiación, no recupera la deuda y tiene que encargarse de poner en buen estado la propiedad o al menos eliminar los riesgos contra la salud, la seguridad y el ambiente. No existe para los municipios un mecanismo que les permita restar del pago de expropiación esa deuda. El problema mayor con esto, es que en el aspecto práctico esto es una limitación para el municipio. Según la entrevista realizada a la Directora de la Oficina de Urbanismo del Municipio de San juan, este no inicia un proceso de declaración de estorbo público a menos que cuente con el dinero suficiente para todo el proceso.[69] Si se pudiera restar la deuda al momento de la expropiación, el municipio podrá ser capaz de eliminar una mayor cantidad de propiedades que representan un gran peligro.

No obstante, todo este proceso conlleva dinero del municipio para hacerse cargo de una situación que debía ser sufragada por el titular. Un análisis sobre esta misma situación pero dada en Uruguay menciona que:

> Si el derecho de propiedad conlleva obligaciones –la principal de ellas, darle al objeto de la propiedad una función social–, resulta natural que quien no cumpla esas obligaciones respecto al bien del que es propietario, al mantenerlo en estado de abandono, pierda el derecho que tenía sobre él. Esto es lo que sucede en la prescripción adquisitiva, a favor de quien, en cambio, si usa ese bien con carácter de poseedor.[70]

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[65] [65] Ordenanza Municipal, *supra* nota 48, art. 8.09.

[66] *Id.*

[67] *Id.*

[68] *Véase Id.* art. 8.09

[69] Entrevista a la Directora de la Oficina de Urbanismo del Municipio de San Juan, *supra* nota 8

[70] María Araceli Schettini *et al*., *Propiedad del suelo urbanizado del derecho individual a la finalidad social: Prescribir lo que se abandona*, *en* DIMENSIONES DEL HÁBITAT POPULAR LATINOAMERICANO 450 (Jaime F. Erazo Espinosa, 2012).

Sin embargo, en casos en el que nadie posea la propiedad, es el Estado el llamado a encargarse de ella posiblemente llegando a un proceso de declaración de estorbo público y pagando la justa compensación al dueño de la propiedad. En el análisis de Uruguay, los autores proponen una solución diferente, como ellos llaman: Prescribir lo que se abandona. Sobre esto, ellos proponen "que el dominio y demás derechos reales sobre un bien inmueble sean adquiridos sin cargo por el Estado, cuando aquel hubiera permanecido abandonado en forma continua durante diez años."[71]

IV. LEY 31

Debido a los problemas esbozados con la ley de estorbos públicos en la sección anterior, el legislador quiso de una manera darle la mano a los municipios y se aprobó la Ley para Viabilizar la Restauración de las Comunidades de Puerto Rico (en adelante, "Ley Núm. 31").[72] Esta ley en resumidas cuentas le brinda la oportunidad a un tercero a obtener la propiedad cuando este paga la expropiación. Los municipios prepararán un Inventario de Propiedades Declaradas como Estorbo Público. En este inventario se incluirán los inmuebles declarados como estorbos públicos pero que por utilidad pública deciden no expropiar.[73] Las propiedades que pueden ser adquiridas por terceros serán aquellas que estén incluidas en este inventario.[74] Bajo esta ley, el tercero solo podrá adquirir *una* propiedad.[75] El procedimiento para adquirir la propiedad es el siguiente:

> (1) El tercero notifica su intención de adquirir la propiedad al Municipio;
>
> (2) El tercero le otorga al Municipio la suma de dinero que equivale al valor que establece el informe de tasación, más un diez por ciento (10%) de ese mismo valor que cubrirá los costos del procedimiento. De ser menor el costo, este se desembolsará al final del procedimiento;
>
> (3) El adquiriente debe cubrir los costos de procedimientos que se adeuden si el diez por ciento (10%) brindado no llegó a cubrirlos. El Municipio no traspasará la titularidad hasta que se salde la

[71] Schettini *et al.*, *supra* nota 70, en la pág. 450.
[72] Ley para Viabilizar la Restauración de las Comunidades de Puerto Rico, Ley Núm. 31 de 18 de enero de 2012, 21 LPRA §995 (2012).
[73] §1004.
[74] §1005.
[75] *Id.*

deuda y estará facultado para realizar acciones de cobro de dinero y anotar embargo sobre los bienes del tercero;

(4) Si presentado el caso, el tercero, decide no continuar con la expropiación, o "que por falta de cooperación y/o por falta de proveer los fondos el Municipio tenga que desistir del pleito de expropiación o el Tribunal desestime el mismo",[76] éste se responsabilizará de cubrir "cualquier cantidad que se imponga como justa compensación, intereses, costas, penalidades, sanciones, gastos del litigio y honorarios de abogados"[77];

(5) El Municipio, según la Regla 58 de Procedimiento Civil, presentará la demanda de expropiación;

(6) El Municipio transferirá la titularidad del inmueble luego de dictada la sentencia.[78]

Luego de este proceso el adquiriente tiene un año, desde que se le transfirió la titularidad del inmueble, para rehabilitar la propiedad adquirida.[79] De no hacerlo, el Municipio puede ejercer una acción de retracto convencional como queda dispuesto en el Código Civil de Puerto Rico.[80]

A. Temas no resueltos por la ley

¿Qué ocurre cuando hay dos terceros que desean adquirir la propiedad que fue declarada estorbo público? Este asunto no está claro en la ley. Podría asumir que ese proceso se tendría que llevar a subasta, pero es una asunción sin base en la ley. Además, cómo se ponderaría los intereses de la comunidad si fuera una subasta: ¿Ayudaría a un pequeño comerciante, a un joven emprendedor o a una cadena multinacional? ¿Ponderaría solo asuntos económicos o incluiría en su análisis las necesidades de la comunidad? Una de las preocupaciones mayores es que se utilice este sistema y termine como un proceso de gentrificación, y que así, Santurce cada vez más desplace a comunidades de escasos recursos, ya que los que estarían adquiriendo estos lotes con la capacidad económica para mantenerles y ponerlos en condición son mayormente personas con gran poder adquisitivo. Para evitar problemas de gentrificación se debe contar con legislación

[76] 21 LPRA §1005.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] 21 LPRA §1006. Los artículos que regulan el retracto convencional son los 1396 al 1409 del Código Civil de Puerto Rico.

clara, que haya analizado sus consecuencias. "Even supporters of gentrification generally admit that without laws and programs to protect low-income tenants, gentrification can become a serious problem when it puts pressure on the already strained organizations, charities, and social services dealing with the homeless and those in need of affordable housing."[81]

V. ENMIENDAS AL CAPÍTULO DE DECLARACIÓN DE ESTORBOS PÚBLICOS.

Según la entrevista a la Directora de la Oficina de Urbanismo del Municipio de San Juan; Actualmente el Municipio de San Juan se encuentra enmendando el Capítulo de Declaración de Estorbos Públicos la cual contendrá tanto cambios procesales como sustantivos.[82]

VI. EL RENACER DE SANTURCE

A. El problema de los huertos urbanos

Cada vez es más común ver huertos urbanos en las ciudades. Sin embargo, estos huertos tienden a terminar siendo hechos en los espacios baldíos o cerca de las estructuras abandonadas que hemos estado discutiendo en este escrito. Esto debido a que la comunidad que se encarga de este, lo ha desarrollado para eliminar en cierta manera el problema de seguridad. El problema de esto, es que muchas veces se hace sin un estudio ambiental, lo cual podría ser desastroso si el terreno se encuentra contaminado.

Las actividades urbanas aumentan los metales pesados y plomo en las casas y terrenos como en los que se encuentra los suelos de los huertos urbanos.[83] Además del plomo, "there have been reports of elevated amounts of other heavy metals, such as cadmium, chromium, copper, and zinc, in urban land used for community gardens. However, no specific guidelines for the limits of lead and other heavy metals in community garden soils for safe gardening exist."[84] Los suelos no deben sobre pasar la norma de 400 mg/kg de niveles de plomo, más sin embargo, EPA estima que sobre 18 millones de terrenos de casas lo exceden.[85] Análisis hechos en huertos urbanos alrededor de la ciudad de Baltimore demostró que sobre 20% sobre pasaban los niveles de plomo de 400 mg/kg, mientras que en

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[81] Ryan Howell, *Throw the "bums" out? A discussion of the effects of Historic Preservation statues on low-income household through the process of Urban Gentrification in Old Neighborhoods*, 11 J. GENDER RACE & JUST. 541, 561 (2008).
[82] Entrevista a la Directora de la Oficina de Urbanismo del Municipio de San Juan, *supra* nota 8.
[83] Estas actividades comprende transportación, construcción y manufactura.
[84] D.E. Stilwell *et al.*, *Lead and Other Heavy Metals in Community Garden Soils in Connecticut*, THE CONNECTICUT AGRICULTURAL EXPERIMENT STATION, NEW HAVEN 1 (2008)(citas omitidas).
[85] *Id.*

Chicago el suelo de huerto urbano promedio es de 800 mg/kg.[86] Es por esto que los huertos urbanos deben crearse con precaución.

B. Santurce es Ley

Santurce es Ley (en adelante, "SEL") es un festival de arte independiente, "el cual busca reclamar espacios urbanos en abandono para abrirlos a la expresión artística y compartirlos renovados con la comunidad."[87] "[L]ogra unir micro proyectos de la escena de arte independiente durante un mismo fin de semana en Puerto Rico. Santurce es Ley es el primer festival cultural organizado por artistas, galeristas independientes y la comunidad, con el propósito de activar un circuito de arte en Santurce."[88] Este festival ha logrado que Santurce tome, cada vez más, mayor importancia a nivel mundial. La interacción entre artistas y la comunidad ha tenido éxito logrando cambiar espacios remanentes en el ente urbano a tomar prominencia y respeto. Sin embargo, SEL se encarga de cambiar la percepción del espacio no de encargarse de este. Lo cual deja todos los problemas discutidos en este trabajo sin resolver, excepto el de seguridad el cual alivia un poco.[89]

C. El Estuario de la Bahía de San Juan

El Programa del Estuario de la Bahía de San Juan creó el proyecto Jardines y Murales del Estuario. En este se han identificado terrenos baldíos y fachadas en la avenida Ponce de León en los cuales "buscarán promover jardines, mariposarios, arte urbano de tema ecológico, para promover la protección ambiental y el aprovechamiento de los espacios descuidados."[90] En este proyecto se identifican los espacios o fachadas, se pinta la fachada y luego se instalan jardineras hechas con tubos *pvc* en las cuales se siembran plantas tropicales. El objetivo "es crear más áreas verdes y concienciar a la ciudadanía sobre la importancia de más espacios silvestres, además de aumentar el valor estético de la

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[86] Stilwell *et al.*, *supra* nota 84, en la pág. 2.
[87] Zylia Z. Ramírez, *Caminando por Santurce Es Ley*, PUERTO RICO INDIE.COM (20 de agosto de 2014), Disponible en: http://puertoricoindie.com/2014/08/20/caminando-por-santurce-es-ley/.
[88] About, Santurce es Ley, https://www.facebook.com/santurceesley/info?tab=page_info.
[89] *Véase* Nina Coll Martínez, *Un Santurce es Ley Extendido: Transformación Urbana e Integración Comunitaria*, VISIÓN DOBLE (15 de septiembre de 2015), Disponible en: http://www.visiondoble.net/2014/09/15/un-santurce-es-ley-extendido-transformacion-urbana-e-integracion-comunitaria/ (En este artículo se puede apreciar el proceso de varios artistas que participan del festival y el objetivo que cada cual quiere alcanzar al participar).
[90] Karixia Ortiz, *Sin contabilizar los edificios abandonados en San Juan*, METRO (10 de abril de 2013), Disponible en: http://www.metro.pr/locales/sin-contabilizar-los-edificios-abandonados-en-san-juan/pGXmdj!sv8HGKT4ix8E/.

ciudad."[91] Este proyecto promueve una mejor estética y un compromiso mayor de parte de la comunidad para mantener. Sin embargo, al igual que el proyecto de Santurce es Ley, no resuelve los problemas esbozados en este escrito que representa los edificios abandonados.

VII. CONCLUSIÓN

El problema de los edificios abandonados y terrenos baldíos afectan grandemente el ambiente, la economía y seguridad de las comunidades. Las iniciativas que actualmente existen en Santurce no eliminan ninguno de estos problemas por lo que se debe pensar en soluciones que realmente los resuelvan. Los propietarios de un terreno o edificio tienen la responsabilidad de mantenerlos en condiciones para con la ciudad. El no cumplir con esta responsabilidad redunda en una carga económica para la ciudad y un decaimiento para las comunidades.

El proceso de expropiación que existe actualmente, necesita un cambio que logre el impactar una mayor cantidad de propiedades, que el proceso sea más rápido, con una coordinación mejor entre los servicios. Habrá que evaluar las enmiendas que se haga al Capítulo de Urbanismo en cuanto a las expropiaciones de propiedades para observar si se atiende el problema de una manera más práctica. Es necesario crear un mecanismo, el cual le permita al municipio poder expropiar una propiedad solo entregándole al propietario la justa compensación menos el dinero adeudado al Municipio. El que no exista este mecanismo, impide al Municipio trabajar una cantidad mayor de propiedades, lo cual limita el impacto de esto.

La Ley 31 por otra parte, ayuda de cierta manera con este problema al permitir que terceros se encarguen económicamente de la situación. Sin embargo, crea unas interrogantes en cuanto al proceso cuando existe más de una persona interesada en la propiedad y la manera de evitar el desplazamiento de comunidades marginadas. El problema de los edificios abandonados y solares baldíos impacta en distintas facetas del desarrollo de la ciudad. Los impactos ambientales y económicos no solamente afectan a la propiedad sino a la comunidad que la alberga y eventualmente a la ciudad. Es por esto, que nueva legislación debe ser creada para atender este problema.

[91] Programa del Estuario de la Bahía de San Juan, Edificio Art Déco se transforma en jardín vertical del Estuario, Estuario, Disponible en: http://www.estuario.org/index.php/tracking-system/92-contenido-general/579-edificio-art-deco-se-transforma-en-jardin-vertical-del-estuario.

SYSTEMIC RISK: THE DODD-FRANK ACT AND PUERTO RICO

SIMÓN E. CARLO-VALENTÍN*

I. INTRODUCTION

This paper will evaluate what constitutes systemic risk, the sources of systemic risk, regulatory efforts outside of the Dodd-Frank Act, how the 2008 crisis affected Puerto Rico and set the current economic landscape, then the efforts put forward by the enactment of the Dodd Frank Act and the conclusions that constitute my opinion regarding the efforts put forward by the Federal Reserve and Congress and the effects they may have on the financial markets in general and the particular case of Puerto Rico.

II. WHAT IS SYSTEMIC RISK

Systemic risk, in broad general terms, is the inherent risk to the entire market or a market segment triggered by an event, "such as an economic shock or institutional failure, causes a chain of bad economic consequences."[1] The consequences can be the failure of particular institutions or the whole market; these failures deprive society of capital and increases costs and can cause severe panics. The most common bank panic is the so called *bank run*, in which consumers, triggered by a certain event or even rumors or a possible collapse, go in mass to withdraw their deposits. Often the banks don't have enough to fulfill

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[1] Steven L. Schwarcz, Systemic Risk, 97 GEO. L.J. 193 (2008).

all the requests, they usually have less than 5% of the total of their deposits as cash reserves[2], and either they close early to avoid the request or end up failing.

Steven L. Schwarcz distinguishes between institutional systemic risk, the risk directly affecting particular institutions like banks, and market systemic risk, the risk of a collapse of the market as a whole, and signals that they should not be evaluated each one apart[3]. Schwarcz's paper was published in the year 2008 and it touched the regulation of systemic risk in the era pre-Dodd Frank Act[4], and it presented that the prevailing motivation of market participants "is to protect themselves but not the system as a whole . . . . No firm . . . has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms"[5] which increases undue systemic risk.

Risk is an inherent part of every segment of the markets. And every participant in the market faces risk; however the degree of risk and the type of risk each participant and market faces varies widely. Systemic risk can come from outside the financial markets (such as terrorists attacks) or from within the financial markets. The difference in types of risk was in part what caused the financial crisis of 2008, with companies micromanaging their respective risks without consideration to the risks they posed to the market overall .

III. SOURCES OF SYSTEMIC RISK

In my opinion the most important sources of systemic risk are the (1) liquidity risks, (2) the *too big to fail* companies and (3) leverage. Liquidity problems arise when firms are either solvent but don't have liquid assets or are insolvent and unable to pay and meet its obligations. Fears over liquidity issues tend to turn into runs, where banks and other institutions cannot meet the redemption requests by its clients, and another risks faced by these runs is that they may begin at an insolvent institution but carry over into solvent institutions. This causes a domino effect, in which depositors, whether or not they have real fears of liquidity problems or not, try to withdraw their funds if they believe that the banks or firms will run out of funds to cover their withdrawals. This could be addressed by maybe requiring that financial firms hold enough cash or cash equivalents reserves to meet unforeseen demand.

Too big to fail companies are companies that are really important to the market or that are so interrelated to other companies that their failure may cause

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[2] *Id.* (citing R.W. HAFER, THE FEDERAL RESERVE SYSTEM 145 (2005)).
[3] *Id.* at 202.
[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[5] Schwarcz, *supra* note 1, at 206. (citing PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG TERM CAPITAL MANAGEMENT 31–32 (1999)).

other companies to fail. In the United States most of the *too big to fail* companies are financial institutions[6], however in smaller economies, such as Puerto Rico, other types of companies may cause the economy to crumble. A recent example of such a company in Puerto Rico is Pueblo Supermarkets, who when they filed for bankruptcy listed between 1,000 and 5,000 creditors and debts totaling way over 100 million dollars[7]. In the case of Pueblo Supermarkets they listed several high total debts to different companies in Puerto Rico such as: (1) a 95 million debt to Westernbank[8] (W Holding Company Inc.), which itself ended being seized by the Federal Deposit Insurance Corporation; (2) 1.2 million to Coca Cola; (3) 1.2 million to Plaza Provision distributors; (4) 1 million to Suiza Dairy; (5) 873,000 dollars to Badillo Nazca Saatchi Saatchi, a publicity agency; (6) 826,244 dollars to B. Fernández & Hnos.; (7) 628,000 dollars to Central Produce; (8) 618,000 dollars to Méndez & Company; (9) 556,000 dollars to V. Suárez & Company; (10) 460,000 dollars to Holsum Bakers; (11) 454 thousand to Matosantos Commercial; (12) 391 thousand to Frito Lay; (13) 365 to Tres Monjitas dairy factory; (14) 348,000 dollars to Blue Cross; (15) 346,000 dollars to Packers Provision; (16) 331,000 dollars to Luis Garratón Inc., a distribution, sales, warehousing and logistics company; (17) 309,000 dollars to Abbot Laboratories; (18) 309,000 dollars to Johnson & Johnson; (19) 288,000 dollars to Garrido & Cia, and (20) 285,000 dollars to Pan Pepín bakery.[9] The previously mentioned creditors with the biggest claims against Pueblo Supermarkets had claims with a minimum value of 285,000 dollars and they range from big multinational companies to local companies. In a relatively small economy like Puerto Rico these amounts, or even lower ones, may be enough to force a company to default in their obligations and end up in bankruptcy, which in turn will create the domino effect.

In the United States the government has had to lend funds to these types of companies to prevent the massive damage that a bankruptcy may cause. Marc Labonte, a specialist in Macroeconomic Policy, in a Congressional Research Paper questioned this practice by stating that:

[T]he knowledge or suspicion that a firm is too big to fail changes the behavior of a firm and its creditors because of moral hazard. If a firm and its creditors believe that they will be protected from any future losses, they have an incentive to take more risks in an attempt to increase potential profits, since

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[6] Halah Touryalai, The World's 29 Too Big to Fail Banks, JPMorgan at the Top, *Forbes*, (http://www.forbes.com/sites/halahtouryalai/2013/11/11/the-worlds-29-too-big-to-fail-banks-jpmorgan-at-the-top/).

[7] Pueblo pide cobijo a Tribunal de Quiebras, Primera Hora, August 4 2007 (http://www.primerahora.com/noticias/puerto-rico/nota/pueblopidecobijoatribunaldequiebras-96531/)

[8] Yaritza Santiago Caraballo, Pueblo enfrenta a sus suplidores, Archivo Digital El Nuevo Día, August 10 2007 (http://www.adendi.com/archivo.asp?num=69256&year=2007&month=8&keyword).

[9] Pueblo, *supra* note 7.

there will be less downside if those risks turn out badly. Thus, moral hazard increases the likelihood that large firms will be a source of systemic risk.[10]

This kind of comfort that a company may achieve because of the *backing* of the government may even pose a bigger risk than the actual size of the company.

The next source of systemic risk is the leverage. In simple terms leverage refers to the amount of debt against equity that a company has. This amount of debt gives the company a better ability to invest and operate but it comes with an added risk. A high degree of leverage creates a greater risk in the negative effects of changes in the cash flows of a company, and the risk of not being able fulfill the obligations it incurred to achieve that leverage. This high dependence in debt to operate will be thwarted when investors aren't willing to supply the amount of money needed by the company and will force the company to sell some of its assets to fulfill obligations, scale back significantly its operations, or drive a company directly to insolvency and bankruptcy. When you combine *too big to fail* companies with high degrees of leverage you have a recipe for disaster and will end up incurring in the behavior mentioned above by Marc Labonte. Efforts have been put in place to decrease the effect of leverage in systemic risk, such as the capital requirements by the Basel Accords, but until a new crisis arrives we won't know for sure if those efforts will pay off.

IV. REGULATORY ATTEMPTS

The government has implemented several plans to curve systemic risk. Those attempts have focused on *bank failures*; like (1) insuring bank deposits with the Federal Deposit Insurance Corporation (F.D.I.C.); (2) establishing capital requirements, particularly with the Basel Agreements, and (3) the creation of several governmental units like the United States General Accounting Office (G.A.O.) and the Securities and Exchange Commission (S.E.C.). However it is worth to be noted that the agencies charged with managing systemic risk are often, if not always, tasked with other particular issues not directly related to systemic risk and since 1995 the workforce of the SEC in particular has been dwarfing compared to the amount of workers available.[11] This is put in the forefront in an article by Troy A. Paredes in the University of Illinois Law Review, in which he signals:

> [M]anaging systemic risk in financial markets is a role that has fallen principally to the Treasury Department and the Fed[eral Reserve], not

[10] MARC LABONTE, CONG. RESEARCH SERV., R41384, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: SYSTEMIC RISK AND THE FEDERAL RESERVE (2010).

[11] U.S. GOV'T ACCOUNTABILITY OFFICE, PUBL'N NO. GAO-02-302, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES 5 (2002) (http://www.gao.gov/new.items/d02302.pdf).

> the SEC. The SEC is not charged with managing systemic risk in financial markets by, say, trying to constrain leverage or certain speculative activities and complex derivatives transactions. Indeed, the SEC's expertise does not extend to managing systemic risk.[12]

Schwarcz goes even further in his article and calls these historical efforts:

> The primary lesson of these historical approaches is that attempts to regulate systemic risk can be imperfect and messy. Other lessons are quite secondary because the historical focus has been on bank systemic risk whereas modern models of systemic risk should also focus on non-bank and market failures. To appreciate the difference, consider the recent subprime mortgage crisis. The Federal Reserve attempted to reduce the likelihood that this crisis might affect other financial markets by cutting the discount rate, which is the interest rate the Federal Reserve charges a bank to borrow funds when the bank is temporarily short of funds. The European Central Bank and other central banks similarly cut the interest rate they charge to borrowing banks. These steps, however, directly impacted banks, not financial markets. Furthermore, changes in monetary policy, such as cutting interest rates, *may not work quickly enough—or may even be too weak*—to quell panics, falling prices, and systemic collapse.[13]

Schwarcz, in his paper, offers several possible solutions or methods to manage systemic risk. An important one is *Averting Panics*, which he mentions that is the "ideal regulatory approach" and that it aims to eliminate systemic risk *ab initio*.[14] He states that preventing these financial panics, by first identifying the ones that could cause monetary contraction, would in turn prevent market failures and help achieve stability.

The Federal Reserve has been aware of systemic risk for a while now, even mentioning in 2005 that containing systemic risk was one of its four primary duties.[15] The Federal Reserve had (before the Dodd-Frank Act) "powers over bank holding companies and certain financial products to limit" the possibility of a systemic risk episode. It also had *lender-of-last-resort* powers that could have improved the situation; it could have lent money to any firm. Labonte also

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[12] Troy A. Paredes, *On the Decision To Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 999 (2006).

[13] Schwarcz, *supra* note 1, at 213. (citing Greg Ip et al., *Stronger Steps: Fed Offers Banks Loans To Ease Credit Crisis*, WALL ST. J., Aug. 18, 2007, at A1; Finance Glossary, *supra* note 53, at http://www.duke.edu/%7Echarvey/Classes/wpg/bfglosd.htm; Randal Smith et al., *Loosening Up: How a Panicky Day Led the Fed To Act*, WALL ST. J., Aug. 20, 2007. (emphasis added).

[14] *Id.* at 214.

[15] Labonte, *supra* note 10, at 7.

mentions that the Federal Reserves has a mandate to control inflation and unemployment and that "it would be impossible to meet this existing mandate if the Fed[eral Reserve] ignored systemic risk".[16]

Regarding the aforementioned sources of systemic risk several actions could have been taken before the crisis to manage systemic risk. Regarding liquidity issues Labonte mentions that regulators could've required that companies keep some of their assets in liquid form or have access to long-term credit.[17] But before the crisis this was often used on depository institutions but not so in non-depository affiliates of banking institutions, this happened because everyone assumed that *healthy banks* would have access to liquidity at any time. When this assumption was proven wrong banks resorted to borrowing from the Federals Reserve's discount window which rose from less than $1 billion before the crisis to over $500 billion during the crisis, reflecting the sudden need of liquidity faced by the banks.[18]

The Federal Reserve also had regulatory power over bank holding companies and financial holding companies, which have usually been many of the *too big to fail* companies, and it should have taken that into consideration when setting regulations. Before the crisis the Federal Reserve didn't have authority over investment banks and five of the largest investment banks "either failed (Lehman Brothers), were acquired by bank holding companies (Bear Stearns and Merrill Lynch), or converted to bank holding companies (Goldman Sachs and Morgan Stanley)"[19], which put them under the authority of the Federal Reserve. However other types of institutions, such as hedge funds and broker-dealers, weren't regulated in the same manner and posed a high level of systemic risk.

Regarding leverage banks already had capital requirements, set forth by several regulators, based mostly on the Basel Accords. However the crisis proved that these levels were too low. Also the capital requirements imposed by the Federal Reserve were applicable to depository subsidiaries of the holding companies, not the non-depositary subsidiaries, which made bank holding companies *underfunded* when all of its subsidiaries were taken into consideration.

Chair Janet L. Yellen of the Federal Reserve Board, regarding additional efforts by the Federal Reserve to manage systemic risk, stated in a recent speech that:

> [E]ven before Dodd-Frank became law, the Federal Reserve began to strengthen its oversight of the largest, most complex banking firms and requires these firms to materially improve their capital adequacy. For

[16] *Id.* at 8.
[17] *Id.*
[18] *Id.* (citing BAIRD WEBEL & MARC LABONTE, CONG. RESEARCH SERV., R41073, GOVERNMENT INTERVENTIONS IN RESPONSE TO FINANCIAL TURMOIL (2010).
[19] *Id.* at 10.

> example, in 2009, we conducted the first stress tests of the largest 19 U.S. bank holding companies. That test has subsequently evolved into our annual Comprehensive Capital Analysis and Review, known as CCAR, which requires all bank holding companies with total assets of $50 billion or more to submit annual capital plans for review by the Federal Reserve. CCAR helps ensure that the largest banking organizations will have enough capital to continue operating through times of economic and financial stress. . . .
>
> In addition to strengthening requirements for stress testing and capital planning, the agencies have also strengthened capital requirements for the largest firms by approving more robust risk-based and leverage capital requirements. Because the financial crisis demonstrated the importance of having adequate levels of high-quality capital at banks of all sizes . . .
>
> While we have taken a number of steps to address too-big-to-fail concerns, our work is not finished. Because the failure of a systemic institution could impose significant costs on the financial system and the economy. . . .[20]

Even with the presence of these regulations and efforts, among several others, prediction of systemic risk events is usually not possible. And as signaled by Labonte: "it may be impossible to distinguish whether good outcomes were caused by the systemic risk regulator's vigilance or were simply the result of normal times".[21] Others argue that systemic risk regulators may also thwart financial innovation and market correction.

V. THE RECENT FINANCIAL CRISIS AND PUERTO RICO

The recent financial crisis faced by the United States wasn't without effects in Puerto Rico. We saw three of the biggest banks on the island close on the same day (Westernbank, R&G Financial Corp.'s R-G Premier Bank, and EuroBancshares Inc.'s Eurobank). These three banks held 27.4% of the total market share of deposits in Puerto Rico at the time of closing.[22] When they closed we were in the midst of a recession and the sudden closing[23] of these banks further sank the island further into the recession. From thereon we have had an economy in a serious recession with a yearly Gross Domestic Product

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[20] Janet L. Yellen, Tailored Supervision of Community Banks at the Independent Community Bankers of America 2014 Washington Policy Summit, Washington D.C., May 1 2014.
[21] *Id.* at 14.
[22] Matthias Rieker, *Buyers for Puerto Rico Banks?*, The Wall Street Journal, March 17, 2010 (http://online.wsj.com/news/articles/SB10001424052748703734504575125534112857858).
[23] *Id.*

(GDP) of $103 billion, as of 2012[24], served by merely nine banks in the island. Also once strong banks, like *Banco Popular de Puerto Rico* (B.P.P.R.), who traded upwards of $288.30[25] in the NASDAQ stock exchange as recently as December 2004; dropped to $1.08[26] on December 2011 and currently trades between $25 and $32 (2.50 and 3.20 adjusted for a 10 to 1 reverse stock split) during the year 2014,[27] having succumbed at the mercy of the financial crisis. As shown in the numbers presented above BPPR lost 99.63% of its value just before the start of the recession to a year after the loss of the three banks mentioned above.

As mentioned before, Puerto Rico has a limited number of banks in service, with only *Banco Popular*, First Bank Puerto Rico, *Banco Santander*, Doral Financial, Citigroup, Oriental Financial Group and Scotiabank Puerto Rico as big banks currently in operation; we can also count the *Banco Cooperativo of Puerto Rico* and *Banesco* which dwarf in size compared to the other banks. Only nine banks to charter all the deposit and loan markets on the island. The mentioned banks have deposit market shares of 40.65%, 15.11%, 12.25%, 6.91%, 5.49%, 11.31%, 7.36%, .88%, and .0004% respectively as of 2013.[28]

The Federal Reserve considers bank size, complexity and interconnectedness with other banks and institutions when considering whether or not they should label an institution as one posing a *significant threat a market collapse*, or institutions having a high systemic risk. Of special importance is *Banco Popular of Puerto Rico*, with a market share of 42% of deposits (excluding brokered deposits) and 32% of total loans,[29] as of the acquisition of Westernbank in 2010, and they claim further increases in market share in different financial products since. As illustrated above Banco Popular has a deposit market share 25.54 percentage points bigger than the next biggest bank and it is also bigger than the next three banks combined.

In response to this crisis Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act[30] (Dodd-Frank Act) which included Titles I, VIII, and XI that deal directly with issues concerning systemic risk; however

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[24] United Nations Statistics Division (http://unstats.un.org/unsd/snaama/dnltransfer.asp?fID=2).

[25] Ticker symbol BPOP; price as of December 2004. (http://www.nasdaq.com/symbol/bpop/interactive-chart?timeframe=1y).

[26] *Id.* (price as of December 2011) (the dates of the quotes were selected to accommodate between stock splits and reverse stock splits to more truthfully reflect the price changes it has gone through).

[27] These prices are after a 10 to 1 reverse stock split, which would be estimated between $2.50 and 3.20 if the reverse split never happened (http://www.nasdaq.com/symbol/bpop/interactive-chart?timeframe=1y).

[28] José L. Carmona, *Puerto Rico banks play it safe*, Caribbean Business, July 11 2013, http://www.caribbeanbusinesspr.com/prnt_ed/puerto-rico-banks-play-it-safe-8729.html.

[29] Banco Popular of Puerto Rico Annual Report 2010 page 1 (http://www.snl.com/interactive/lookandfeel/100165/BPOP.AR.2010.pdf).

[30] Pub. L. 111-203, 124 Stat. 1376 – 2223.

most of the Act, if not all of it, is based on the conditions faced by the mainland, which do not necessarily apply to the realities of Puerto Rico.

VI. DODD-FRANK ACT & SYSTEMIC RISK

While the Dodd-Frank Act was a system wide reform, it included provisions directly aimed at dealing with systemic risk issues. They are mostly in Titles I, VIII and XI.

Title I created the Financial Stability Oversight Council, which is chaired by the Secretary of the Treasury and comprised by the heads of eight federal regulatory agencies. The Council is tasked with (1)monitoring the financial system to identify potential systemic risks, (2) proposing regulatory changes to Congress, (3) facilitating information sharing among regulators, (4) making recommendations to regulators, (5) identifying gaps in regulations that could promote systemic risk, (6) reviewing and commenting on new or existing accounting standards, and (7) providing a forum for the resolutions of jurisdictional disputes among council members, while also providing annual reports to Congress.[31] The Council may also recommend stringent standards to non-bank financial firms, deemed systematically significant by two-thirds vote in the Council, which may be specific to each individual firm.

The same Title I gives the Federal Reserve authority to regulate safety and soundness of firms which the Council subjected to their supervision and bank holding companies with total assets of $50 billion or more. The limitations or standards enforced by the Federal Reserve may include risk-based capital requirements (taking into consideration off-balance-sheet activities), leverage limits, liquidity requirements, risk management requirements and exposure limits.[32] Also, is the Council determines that a company is *grave threat* to financial stability it may issue harsher limitations, such as limitations in the ability to merge, acquire, consolidate or become affiliated with other companies, restrict the financial products it may offer, require the company to terminate activities, impose conditions as to how the company conducts activities or in the gravest of threats require the company to sell or transfer assets or off-balance-sheet items to unaffiliated entities.[33] About the capital requirements Labonte also signals that:

> Title I requires the federal banking regulators to establish minimum risk-based capital requirements and leverage requirements on a consolidated basis for depository institutions, depository holding companies, and firms designated as systemically significant by the

[31] Labonte, *supra* note 10, at 16.
[32] *Id.* at 17.
[33] *Id.* (citing Pub.L. 111-203 §121(a) (2010)).

> Council that are no lower than those were set for depository institutions as of the date of enactment.[34]

Title XI in turn amends Section 13(3) of the Federal Reserve Act[35] and requires the Federal Reserve to establish regulations regarding the Section 13(3) emergency lending authority. These regulations deal with ways "to prevent aid to failing companies or insolvent borrowers and may require borrowers to certify that they are solvent"[36], this because the purpose of the program is to provide liquidity to the financial system and not save failing financial companies. Aid provided under this section shall be managed in a way that also protects taxpayers from losses.

Title XI also provides specific "authority for the FDIC to create a program to guarantee debt of solvent depository institutions or depository institution holding companies and their affiliates *during times of severe economic distress*".[37]

Title VIII gives the Federal Reserve responsibility to deal with *clearing activities* that are determined by the Council to be systematically important.[38]

VII. CONCLUSION

The Dodd-Frank Act tries in part to manage and control systemic risk. However many experts have expressed that the prediction of economic shocks is rarely possible. This means that the efforts put in place with the Dodd-Frank Act may be successful at diminishing the effect of a possible shock but it won't completely prevent or avert it. Even though the enactment of the act was a reactionary one with the purpose of serving as a preventive measure for future events there is no certainty that it may fulfill its end. The inability to predict possible economic shocks, and the suddenness of them when they do happen, may have a multiplying effect on the threats of systemic risk.

The capital requirements that can be imposed may prove to be too much of a burden to financial institutions, which may in turn elect to scale back its business, which may have a negative effect on the economy itself, and that may limit the availability of financial products to consumers. This scaling back can result in an abrupt slowing of the general economy by the lack of capital and funds available. Companies may see this regulation a nuisance and may do everything in their power to limit their exposure to it, be it by making sure they don't pass the $50 billion threshold present in some parts of the act or by

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[34] *Id.* at 20.
[35] Federal Reserve Act, Pub.L. 63-43, 13 USC 343 (1913).
[36] Labonte, *supra* note 7, at 21.
[37] *Id.*
[38] Hal S. Scott, The Reduction of Systemic Risk in the United States Financial System, 33 HARV. J.L. & PUB. POL'Y 671 (2010).

divesting interests. This slowing may in turn magnify the effect of the recent shock and can drive the country right into a recession and contraction.

The limits may also provide an opening, as had happened before, to other unregulated institutions to rise and create greater systemic threat and further increase shadow banking. The possible rise of these unregulated entities may, up to certain point, defeat the purpose of the Dodd-Frank Act far beyond systemic risk. It may threaten consumer protection, financial market stability and overall fairness. It may also give rise to new risk-bearing situations never envisioned before, to which there is not an answer in place. The act is designed to work with things that have happened before, but what happens when a new type of institution or financial product is the culprit of the risk? The economy will just enter another crisis and face another lengthy recession? The financial industry has to be proactive instead of reactive to the possible threats of risk if it really wants to avoid facing crisis like the one in the 30s or the one in 2008.

Regarding Puerto Rico it has been clearly established that the whole banking industry in the island is cared for by merely nine banks. But what it is truly dangerous is that one of them has a market share of over 40% and the biggest four banks have almost 80% of the total market.

The overall economy of the island is precarious, with continuous issuance of debt to manage current obligations by the government, and still mired in an eight year-long recession that shows no end in sight. The local government doesn't have the means to save *Banco Popular* if it went under when they themselves are facing the threat of insolvency, with no help from the United States in sight, in a couple of years and no real plan in place to avert it. The Dodd-Frank Act establishes that no aid shall be given to insolvent companies; so what would happen to *Banco Popular* if the act prohibits a lifeline from the Federal Reserve and the local government can't save it? Will the United States allow a bank that has over 40% of the market share in the island to fail? These questions don't have answers right now, and it is in our best interest that they never have to be answered.

Isn't *Banco Popular* the epitome of a *too big to fail* institution? Absolutely, if *Banco Popular* did indeed fail it would almost certainly cause a domino effect that could completely destroy our economy. What will happen then? Will the United States intervene when the damage is already done or will they let us fend for ourselves? We don't know yet, and our current status issue muddies the situation even more. The Dodd-Frank Act wasn't created taking Puerto Rico into consideration but it certainly will have repercussions here.

The Dodd-Frank Act is a truly commendable effort by Congress to manage systemic risk and other financial problems but they are merely one player in the whole financial game and time may prove that they are merely a pawn at the mercy of the whole market.

VIII. UPDATE

Between the completion of this article and its publishing, Doral Financial was shut down by the Office of the Commissioner of Financial Institutions of Puerto Rico.[39] Doral received the order to close on February 27, 2015, after being under the FDIC watch for the last couple of years.[40] With Doral's closing, *Banco Popular* assumed $3.25 billion of the $5.9 billion in total assets that Doral had when it closed. The rest of the assets were assumed by First Bank and other American banks.[41] With this, *Banco Popular* grasp in consumer deposits in Puerto Rico increases and keeps its march towards holding 50% or more of the deposits in the island. *Banco Popular* still is *too big to fail*, and with less and less banks in the island each of the ones left carries a bigger risk for the whole economy.

[39] Press Releases, Federal Deposit Insurance Corporation, Banco Popular De Puerto Rico, Hato Rey, Puerto Rico, Assumes all of the Deposits of Doral Bank, San Juan, Puerto Rico (Feb. 27, 2015), https://www.fdic.gov/news/news/press/2015/pr15024.html.

[40] Aaron Kuriloff & Ryan Tracy, *Doral Bank Fails After Years of Tumult*, THE WALL STREET JOURNAL (Feb. 27, 2015, 7:12 PM), http://www.wsj.com/articles/fdic-releases-doral-bank-failure-news-early-1425070689.

[41] *Supra* note 39.