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The Need for Truly Systemic Analysis of Proposals for the Reform of Both Pretrial Practice and Evidentiary Rules: The Role of the Law of Unintended Consequences in "Litigation" Reform

Edward J. Imwinkelried*

"In some one of its numerous forms, the problem of the unanticipated consequences of purposive action has been treated by virtually every substantial contributor to the long history of social thought."

–Robert K. Merton[1]

There is a paradox at the heart of the American litigation system. On the one hand, we have the most liberal pretrial discovery rules of any advanced country. In many American jurisdictions, a

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1. Robert K. Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOCIOLOGICAL REV. 894, 894 (1936).

litigant can not only discover information relevant to the allegations in the pleadings; the litigant can even discover information relevant to allegations that the pleadings could be amended to include.[2] The consequences of that liberality are startling:

> Perhaps no case could be a more monumental example of the reality of modern . . . e-discovery than the ongoing Viacom copyright infringement lawsuit against YouTube filed back in 2008. In that dispute, the judge ordered that 12 terabytes of data be turned over, according to Matthew Knouff. "People often say that one terabyte equals 50,000 trees, and 10 terabytes would be the equivalent of all the printed collections of the Library of Congress," says Knouff, who is general counsel of Complete Discovery Source, a New York City-based . . . discovery services provider. For the Viacom/YouTube case then, the demand was for the printed equivalent of the entire Library of Congress. And then some.[3]

It is no wonder that foreign corporations are so reluctant to set foot in an American courtroom.[4] They routinely insist on arbitration and choice-of-forum clauses to avoid subjecting themselves to the burden and expense of such breathtakingly broad discovery rules.[5]

On the other hand, the United States has the most complex,

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2. Oppenheimer Fund Inc. v. Sanders, 437 U.S. 340, 351 (1978); EDWARD J. IMWINKELRIED & THEODORE Y. BLUMOFF, PRETRIAL DISCOVERY: STRATEGY AND TACTICS § 2:3, at 2-14 to 2-16 (rev. ed. 2010).

3. Joe Dysart, *The Trouble with Terabytes*, 97 A.B.A. J. 33, 33 (Apr. 2011).

4. *See* JAMES MAXEINER, GYOOHO LEE & ARMIN WEBER, FAILURES OF AMERICAN CIVIL JUSTICE IN INTERNATIONAL PERSPECTIVE 150–52 (2011) (discussing why non-Americans often fear the breadth of American discovery and view it as destructive to the rule of law).

5. *See* GARY BORN, INTERNATIONAL ARBITRATION AND FORUM SELECTION AGREEMENTS: DRAFTING AND ENFORCING 86 (3d ed. 2010) (discussing the drafting of effective discovery clauses in arbitration agreements); 2 GARY BORN, INTERNATIONAL COMMERCIAL ARBITRATION 1748 (2009) (stating "the 'rules of evidence' used in international arbitration are material improvements in complex commercial disputes on the technical, often archaic, evidentiary codes employed generally in many domestic legal systems").

restrictive set of evidentiary rules governing the admissibility of evidence at trial.[6] The continental countries still largely adhere to the civil law tradition of "free proof."[7] Although it is an overstatement to claim that "there is no such thing as European Continental Evidence law,"[8] the continental systems have largely abandoned the canon[9] and Roman[10] law rules requiring the trier of fact to assign specified weight to particular types of evidence.[11] In addition, as a general proposition civilian systems recognize fewer of the exclusionary evidentiary rules that characterize American law.[12] For that matter, even countries that share the common-law tradition with the United States have substantially liberalized their admissibility standards. Thus, England, the birthplace of the hearsay rule, has significantly relaxed that exclusionary doctrine by conferring more discretion on judges to admit demonstrably reliable, valuable hearsay testimony.[13] In contrast, in the United States, the doctrine remains a complicated edifice with a definition,[14] two exemptions,[15] and no fewer than thirty different exceptions.[16]

To be sure, the American litigation system is in flux. The changes in the American system can be viewed as part of the convergence between common and civil law systems that is

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6. RONALD L. CARLSON, EDWARD J. IMWINKELRIED, JULIE SEAMAN & ERICA BEECHER-MONAS, EVIDENCE: TEACHING MATERIALS FOR AN AGE OF SCIENCE AND STATUTES 9 (7th ed. 2012).

7. JOHN D. JACKSON & SARAH J. SUMMERS, THE INTERNATIONALISATION OF CRIMINAL EVIDENCE: BEYOND THE COMMON LAW AND CIVIL LAW TRADITIONS 30, 69 (2012).

8. *Id.* at 30.

9. *Id.* at 31.

10. *Id.* at 59.

11. *Id.* at 31, 59, 76.

12. *Id.* at 57, 72–74.

13. KENNETH S. BROUN ET AL., MCCORMICK ON EVIDENCE § 326 (7th ed. 2013); LAW ON CIVIL HEARSAY, HERBERT SMITH BRIEFING 5–6 (Mar. 1996). *See also* Di Birch, *The Evidence Provisions*, 1989 CRIM. L. REV. 15, 15 (explaining that, with the passage of the Criminal Justice Act of 1988, Parliament had created two new exceptions to the hearsay rule); R.A. Clark, *The Changing Face of the Rule Against Hearsay in English Law*, 21 AKRON L. REV. 67, 67 (1987) (explaining how English statutes and common law have taken a much more relaxed approach to the rule against hearsay).

14. FED. R. EVID. 801(a)–(c).

15. FED. R. EVID. 801(d)(1)–(2).

16. FED. R. EVID. 803–04, 807.

supposedly in progress.[17] For example, there has been a trend to curtail the scope of pretrial discovery in the United States. The Advisory Committee's Note accompanying the 1983 amendments to Federal Rule of Civil Procedure 26 states the committee's judgment that the prior rules permitted "[e]xcessive discovery," discovery that was so "excessively costly and time-consuming" that it was "disproportionate to the . . . issues or values at stake."[18] At one time, the Federal Rules broadly authorized discovery of any information relevant to the subject matter of the action, including information pertinent to allegations that the pleadings could be amended to include.[19] The Rules were amended to generally limit discovery to the allegations actually set out in the pleadings;[20] a litigant may pursue the broader scope of discovery formerly allowed only on a showing of "good cause."[21] Further, an amendment to Federal Rule of Civil Procedure 26(b)(2)(B) ordinarily restricts discovery of electronically stored information (ESI) to sources that are "reasonably accessible."[22] In addition, it is now presumptively required that the parties confer at the outset of litigation to agree to sensible limitations on the scope of discovery.[23]

At the same time, there has been a trend to relax some of the constraints on the admission of evidence in American trials. That trend is evident in the provisions of the Federal Rules of Evidence. Rules 413 through 415 now carve out important exceptions to the character evidence prohibition in cases involving allegations of sexual assault or child molestation.[24] Although some common-law jurisdictions limited an opponent attacking a witness's character for truthfulness to reputation testimony,[25] Rule 608(a) authorizes the use of opinion testimony as well.[26] The trend has also affected the admissibility of expert opinion in American courts. At common law,

17. JACKSON & SUMMERS, *supra* note 7, at 6.

18. FED. R. CIV. P. 26 advisory committee's note.

19. IMWINKELRIED & BLUMOFF, *supra* note 2, § 2:3, at 2-15 to 2-17.

20. *Id.*

21. FED. R. CIV. P. 26(b)(1).

22. FED. R. CIV. P. 26(b)(2)(B).

23. FED. R. CIV. P. 26(f).

24. FED. R. EVID. 413–15; 1 EDWARD J. IMWINKELRIED, UNCHARGED MISCONDUCT EVIDENCE § 2:23 (rev. ed. 2003).

25. BROUN ET AL., *supra* note 13, § 43.

26. FED. R. EVID. 608(a).

either the expert had to have personal knowledge of the factual predicate for his or her opinion, or the expert's proponent had to present the facts to the expert in a hypothetical question after the proponent had presented independent, admissible testimony of each fact.[27] In contrast, Rule 703 permits the expert to rely on out-of-court reports if it is the reasonable (customary) practice of his or her speciality to consider information from such sources.[28] The legislatures and courts have similarly relaxed the hearsay doctrine. Before the enactment of the Federal Rules, only a small minority of jurisdictions recognized the present sense impression hearsay exception.[29] Yet today that exception is set out as the very first provision in Federal Rule of Evidence 803.[30] Rule 902 includes a long list of materials that are deemed self-authenticating, including a provision treating business records as self-authenticating in certain circumstances.[31] One American jurisdiction has virtually abolished the best evidence rule and made even secondary copies presumptively admissible in civil actions.[32]

Although both pretrial practice and trial evidence rules are undergoing change, on occasion, as Part III of this Article will demonstrate, the changes have had undesirable consequences. In some cases, the modification of pretrial rules has had a negative impact on trial. In other cases, the alteration of trial evidence rules has had an untoward effect on pretrial practice. The thesis of this short Article is that in many instances, the root explanation for the negative effects is the law of unintended consequences. In the past, when reformers have undertaken to revise pretrial practice, they have sometimes tended to focus almost exclusively on the policies operative in the pretrial phrase and ignored the potential impacts on trial evidence. Part III uses Federal Rule of Civil Procedure 26 as a case study. Conversely, when reformers have attempted to update trial evidence rules, they have riveted their attention on policies operative at trial and ignored the possible effects on the pretrial phase. Part III points to Federal Rule of Evidence 612 as a case in

27. BROUN ET AL., *supra* note 13, § 14.
28. FED. R. EVID. 703; BROUN ET AL., *supra* note 13, at 38.
29. BROUN ET AL., *supra* note 13, at 469.
30. FED. R. EVID. 803(1).
31. FED. R. EVID. 902(11).
32. CAL. EVID. CODE §§ 1520–23.

point. This Article argues that in the future, to avoid these undesirable impacts, reformers must conduct a truly systemic cost–benefit analysis, one that considers the impact of any litigation reform proposal on both the pretrial and trial stages. Part IV contends that the recent discussion over the adoption of new Federal Rule of Evidence 502 on privilege-waiver rules is an example of the type of analysis that litigation reformers ought to engage in.

I. THE LACK OF SYSTEMIC PERSPECTIVE IN PRIOR DEBATES OVER "LITIGATION" REFORM

The Introduction noted a central paradox in the American litigation system: while we have the most liberal pretrial discovery practices, we have the most restrictive trial evidence standards. Are the rules for the two phases merely inconsistent, or is the seeming paradox explicable?

A. Consistent, Even Necessary, Relation

One possible rationalization is that the rules for the two stages are not only consistent but, in one respect, necessarily related. First, approach the relationship between the two phases from the front end—the pretrial stage. As previously stated, the American legal system permits broader pretrial discovery than that of any other country. It could be argued that to a greater extent than any other country, the United States can afford to grant such expansive discovery precisely because the United States enforces the most conservative standards for trial evidence. If a system both allowed broad discovery and applied lax evidentiary standards, the volume of information presented to the trier of fact might be overwhelming. Neither the pretrial nor trial standards would reduce the quantum of information to digestible proportions for the decision-maker. To make it manageable for the trier to process the information, at some stage in the litigation process there must be an effective filter; and strict trial evidence standards can function as the filter. The parties may unearth a huge volume of information during the pretrial stage, but the character, opinion, hearsay, and best evidence rules in place at trial sharply limit the amount of information that can eventually be

presented to the trier.

Now approach the relation from the end of the process—trial itself. One might contend that the American litigation system must have relatively conservative evidentiary standards precisely because our pretrial discovery is so permissive. Again, the ultimate fear is that the trier of fact will reach an inaccurate decision because he or she is overwhelmed by the sheer quantum of information.[33] There is a point of diminishing returns. As Justice Holmes famously remarked, sometimes the law must make concessions to "the shortness of life."[34] No sensible legal system can grant the litigants carte blanche to present every relevant item of information to the decision maker. The submission of additional information to the trier may not enhance the probability of accurate fact finding. Quite to the contrary, at some point the presentation of the further information realistically becomes counterproductive and creates the risk of confusing the trier.[35] When a system permits more modest pretrial discovery, though, it can afford to adopt more liberal evidentiary standards; the system already has an effective filter in place before trial.

B. Promoting the Policy of Preventing and Exposing Perjury

One explanatory hypothesis as to the structure of the common law of evidence is the perjury theory.[36] According to this hypothesis, in large measure the common-law courts formulated restrictive evidentiary rules to prevent the introduction of perjured testimony but liberally allowed impeachment to expose any perjury that was perpetrated at trial.[37] Positing that theory, it is relatively

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33. *See* Kenneth W. Graham, Jr., *"There'll Always Be an England": The Instrumental Ideology of Evidence*, 85 MICH. L. REV. 1204, 1211–12 (1987) (arguing that Bentham's insistence on admitting more evidence is misguided).

34. Reeve v. Dennett, 11 N.E. 938, 943–44 (Mass. 1887) (Holmes, J.).

35. *See* Graham, Jr., *supra* note 33, at 1222 (arguing that the lawyer "[w]ho tries to sail to victory on an ocean of evidence may find himself becalmed far from shore, battered by an unexpected typhoon, or carried . . . into the Bermuda Triangle").

36. JACKSON & SUMMERS, *supra* note 7, at 38 n.33.

37. Edward J. Imwinkelried, *The Worst Evidence Principle: The Best Hypothesis as to the Logical Structure of Evidence Law*, 46 U. MIAMI L. REV.

easy to reconcile the trial evidence standards with the prevailing pretrial discovery practices. Those practices are arguably designed to enable attorneys to identify potential trial perjury and empower them to expose it at trial.

Of course, there are alternative hypotheses as to the structure of common-law evidence. One is the jury control theory. Proponents of this theory argue that the exclusionary rules emerged due to judges' distrust of lay jurors' competence.[38] Judges developed the rules in order to restrain what they perceived to be irrational behavior by lay jurors.[39] The theory echoes James Bradley Thayer's celebrated assertion that the common law of evidence is "[t]he child of the jury system . . . ."[40] A second hypothesis is the best evidence principle.[41] The principle was championed by Sir Geoffrey Gilbert, the author of one of the first English evidence treatises.[42] In the eighteenth century, Gilbert declared that "[t]he first . . . and most signal Rule, in Relation to Evidence, is this, That a Man must have the utmost Evidence, the Nature of the Fact is capable of . . . ."[43] Gilbert attempted to "subsume the rules of evidence under different versions of 'the best evidence rule.'"[44] The chief modern advocate of the principle is Professor Dale Nance.[45] Professor Nance has constructed a persuasive case that the principle can account for "[a]n impressive array" of evidentiary rules,[46] including the requirement for an oath,[47] cross-examination,[48]

1069, 1071–72 (1992).

38. Dale A. Nance, *The Best Evidence Principle*, 73 IOWA L. REV. 227, 229 n.11, 230 (1988).

39. *Id.* at 229.

40. JAMES BRADLEY THAYER, A PRELIMINARY TREATISE ON EVIDENCE AT THE COMMON LAW 226 (1898).

41. *See generally* Nance, *supra* note 38 (explaining the best evidence principle).

42. Stephan Landsman, *From Gilbert to Bentham: The Reconceptualization of Evidence Theory*, 36 WAYNE L. REV. 1149, 1151–52 (1990).

43. *Id.* at 1152 (quoting GEOFFREY GILBERT, THE LAW OF EVIDENCE 3–4 (1754)).

44. William Twining, *The Rationalist Tradition of Evidence Scholarship*, *in* WELL AND TRULY TRIED 211, 243 (Enid Campbell & Lewis Waller eds., 1982).

45. Nance, *supra* note 38, at 227.

46. *Id.* at 291.

47. *Id.* at 281.

48. *Id.* at 282–83.

personal knowledge,[49] authentication,[50] and the leading preferential exclusionary rules, namely, opinion, hearsay, and best evidence.[51] In his view, all of these trial evidence rules have a "'best evidence' foundation."[52]

A competing theory is the worst evidence principle, which posits that the historical evolution of the common-law evidence was driven by the common law judges' obsessive concern with the prevention and exposure of perjury.[53] The common-law rules were in their formative stage in England when there were a number of notable public scandals about perjury.[54] Some of these scandals involved Crown witnesses who frequently testified in prosecutions of gangs of thieves and robbers.[55] When a gang member was arrested, a magistrate could promise the arrestee nonprosecution if the arrestee turned Crown witness.[56] Such witnesses obviously had "a material incentive" to commit perjury to save themselves.[57] There were numerous reports of perjury by Crown witnesses. These reports were "much in the air"[58] and "loomed large"[59] in the minds of judges of the era. A leading legal historian, Professor John Langbein, concluded that the rise of a mandatory corroborative evidence requirement—the first rule of evidence—was at least a partial response to these scandals.[60]

Other scandals related to thief catchers.[61] Parliament was so concerned about curbing thievery that it passed a number of statutes offering rewards to persons who aided in the prosecution of thieves.[62] Many people went into the business of catching thieves.[63]

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49. *Id.* at 285.
50. *Id.*
51. *Id.* at 286.
52. *Id.* at 289.
53. Imwinkelried, *supra* note 37, at 1071–72.
54. *Id.* at 1078–79.
55. *Id.*
56. John H. Langbein, *Shaping the Eighteenth-Century Criminal Trial: A View from the Ryder Sources*, 50 U. CHI. L. REV. 1, 85, 95 (1983).
57. *Id.* at 114.
58. *Id.* at 105.
59. *Id.* at 86.
60. *Id.* at 96–103.
61. Imwinkelried, *supra* note 37, at 1079–81.
62. Stephan Landsman, *The Rise of the Contentious Spirit: Adversary Procedure in Eighteenth Century England*, 75 CORNELL L. REV. 497, 573 (1990).

At trials of their arrestees, the thief catchers became witnesses and advocates for the prosecution.[64] As in the case of Crown witnesses, there were disturbing reports of perjury by thief catchers.[65] It became clear that on numerous occasions thief catchers had fabricated testimony to gain the statutory rewards.[66] Some notorious thief catchers were prosecuted and jailed for perjury.[67] Judges became skeptical of prosecution cases resting on testimony by thief catchers[68] and gave cross-examiners great latitude to expose the motivation to lie.[69]

Nor, at this crucial formative time, was the concern about perjury confined to criminal cases. In 1676, the Parliament enacted the original Statute of Frauds for civil contract disputes.[70] The preamble to the statute recited that there were "many fraudulent practices, which are commonly endeavored to be upheld by perjury and subornation of perjury."[71] Preambles to earlier statutes had included assertions such as the statement that "perjury . . . horribly continues and daily increases in the kingdom."[72]

Like the best evidence principle, the worst evidence hypothesis has great explanatory power. Starting from the premise of the worst evidence hypothesis, it is relatively easy to account for the common-law evidentiary rules rendering interested persons incompetent as witnesses,[73] demanding extrinsic authentication of exhibits,[74] liberally permitting evidence of a witness's character trait for untruthfulness,[75] requiring the production of an original writing,[76] and restricting hearsay to pressure declarants to testify in

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63. *Id.*
64. *Id.* at 575–76.
65. *Id.* at 577.
66. *Id.* at 573, 577.
67. *Id.* at 579.
68. *Id.* at 567 n.354.
69. *Id.* at 555, 579.
70. E. ALLAN FARNSWORTH, CONTRACTS 364 (3d ed. 1999).
71. *Id.*
72. *See, e.g.*, RONALD L. CARLSON ET AL., EVIDENCE IN THE NINETIES: CASES, MATERIALS, PROBLEMS 548 (3d ed. 1998) (citing 38 Edw. 3, statute 1, ch. 12 (1363), 34 Edw. 3, ch. 8 (1360), 5 Edw. 3, ch. 10 (1331)).
73. Imwinkelried, *supra* note 37, at 1081.
74. *Id.* at 1083.
75. *Id.* at 1085–86.
76. *Id.* at 1087.

person, subject to cross-examination and within the view of the jury.[77]

The other virtue of the worst evidence hypothesis is that this theory allows us to reconcile the trial evidence rules with pretrial discovery practices. Rather than being at odds, both doctrines can be viewed as effectuating the policies of preventing and exposing perjury.[78] Liberal discovery allows the parties to test potential evidence and make an informed judgment as to whether the testimony is truthful or perjurious.[79] Wide-ranging discovery not only enables the parties to make that determination but, for the benefit of the trier, such discovery also arms the attorneys with impeaching evidence to expose perjured testimony that surmounts the hurdles of the exclusionary rules.[80] The trial evidence rules serve the same purposes by erecting barriers to evidence of suspect truthfulness and liberally admitting impeaching testimony.[81]

C. Post Hoc Rationalizations

The consistency and worst evidence hypotheses are attractive in the sense that they possess explanatory power; they both permit at least a partial harmonization between liberal pretrial discovery and conservative trial evidence standards. However, even a cursory review of the Advisory Committee's Notes to the Federal Rules of Civil Procedure (hereinafter "FRCP") and the Federal Rules of Evidence (hereinafter "FRE") reveals that, at best, these hypotheses are post hoc rationalizations. The Notes to the FRCP contain no suggestion that the drafters gave any extensive thought to the impact of pretrial procedures on trial evidence rules. Concededly, FRCP 1 states that one of the purposes of that set of rules is to contribute to the "just" determination of actions.[82] The tenor of the FRE that will

77. *Id.* at 1090.

78. *Id.* at 1077.

79. *See* William H. Speck, *The Use of Discovery in United States District Courts*, 60 YALE L.J. 1132, 1132 (1951) (explaining that liberal discovery rules allow for all parties to gather evidence, thus protecting legal rights).

80. *See* Ehud Guttel, *Overcorrection*, 93 GEO. L.J. 241, 261–62 (2004) (noting that courts have interpreted broad discovery rules to allow parties to obtain impeachment evidence).

81. FED. R. EVID. 607, 609.

82. FED. R. CIV. P. 1.

later be applied at trial can influence whether there is a just determination of the factual issues, but the FRCP themselves include only a few scattered references to trial evidence standards.[83] FRCP 1 also indicates that the drafters were concerned about the speed and expense of pretrial proceedings.[84] Most of the Advisory Committee's Notes to the FRCP concentrate on considerations such as the efficiency of pretrial procedures.[85]

Just as the FRCP stress policy considerations operative in the pretrial phase, the FRE emphasize considerations that come into play at trial. FRE 102 announces that "[t]hese rules should be construed so as to administer every proceeding fairly, eliminate unjustifiable expense and delay, and promote the development of evidence law, to the end of ascertaining the truth and securing a just determination."[86] Like FRCP 1, FRE 102 manifests a concern about the just determination of actions. However, the accompanying Advisory Committee's Notes make it clear that, in the context of the FRE, that concern primarily translates into an interest in the reliability of the evidence that serves as the basis for the determination.[87] Notably, the FRE cite the FRCP even less often than the latter refer to the former.[88]

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83. *See, e.g.*, FED. R. CIV. P. 26(2)(A) (requiring disclosure of witnesses a party will use to present evidence under FRE 702, 703, and 705); FED. R. CIV. P. 32(a)(1)(B) (permitting the use of a party's deposition against them to the extent it is admissible under the FRE).

84. FED. R. CIV. P. 1 (explaining that the rules should be constructed to secure the "speedy, and inexpensive determination of every action and proceeding").

85. *See, e.g.*, FED. R. CIV. P. 13 advisory committee's note (stating that, for the sake of efficiency, judges should grant discovery requests in sanction proceedings only in "extraordinary circumstances"); FED. R. CIV. P. 16 advisory committee's note (referencing empirical studies which show that greater judicial involvement in the pretrial steps of litigation leads to more efficient outcomes).

86. FED. R. EVID. 102.

87. *See* FED. R. EVID. 803 advisory committee's notes (justifying the various hearsay exceptions by relying on arguments dealing with the reliability or trustworthiness of the evidence).

88. *Compare* FED. R. CIV. P. 26(a)(2)(C) (citing FRE 702, 703, and 705 to elaborate on what must be disclosed when an expert witness does not provide a written report), *and* FED. R. CIV. P. 30(c)(1) (citing FRE generally, and citing FRE 103 and 615 to explain the rules and limitations on cross-examination of deponents), *with* FED. R. EVID. 702, 703, and 705 (describing the rules and limits regulating expert testimony without referencing the FRCP), *and* FED. R. EVID. 103

The drafters of the two sets of rules sometimes regard their respective sets as self-contained bodies of regulations and myopically disregard the impact of their rule changes on the other set. As Part II points out, that mindset increases the danger that by virtue of the law of unintended consequences, rule changes will have untoward impacts on the other phase of litigation. Human beings have limited foresight. Even when they consciously and earnestly advert to a factor that can trigger consequences, there may be unanticipated, negative results. However, that risk increases exponentially when the person does not even consider the factor. As Part III demonstrates, on occasion, changes to the FRCP have been adopted with insufficient thought to the impact on trial evidence; and amendments to the FRE have been approved with inadequate consideration of the effect of the amendment on the pretrial practice. Unfortunately, these situations are rife with the potential for unintended consequences.

II. THE LACK OF SYSTEMIC PERSPECTIVE AS A TRIGGER FOR THE LAW OF UNINTENDED CONSEQUENCES

The modern law of unintended consequences has several antecedents. In 1692 the English philosopher John Locke implicitly invoked the concept.[89] Locke opposed a Parliamentary bill that would have reduced the maximum legal interest rate from six percent to four percent.[90] The advocates of the bill contended that if enacted, the bill would benefit borrowers.[91] Locke countered that the advocates of the bill overlooked that lenders would find ways to circumvent the law and pass the costs of circumvention to borrowers.[92] The net result was that there would be less credit and money available to "widows, orphans and all those who have their

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and 615 (describing rulings on evidence and the exclusion of witnesses without referencing the FRCP).

89. Rob Norton, *Unintended Consequences*, THE CONCISE ENCYCLOPEDIA OF ECONOMICS, http://www.economlib.org/library/Enc/UnintendedConsequences.html (last visited Oct. 7, 2012).

90. *Id.*

91. *Id.*

92. *Id.*

estates in money."[93] The eighteenth century Scottish philosopher who pioneered political economy, Adam Smith, used a version of the law in his analyses.[94] Smith argued that even when each individual pursues "only his own gain," he "is led by an invisible hand to promote an end which was no part of his intention," namely, the public interest.[95] Although in pursuing their livelihood butchers and bakers are pursuing "their own self interest," as a result "we [can] expect our dinner."[96] In the first half of the 19th century the French economist Frederic Bastiat wrote about the "unseen" consequences of actions and policies.[97] He noted that "unseen" consequences are typically less obvious and often unintended.[98]

Although Locke, Smith, and Bastiat understood the concept underlying the law of unintended consequences, the father of the formal doctrine was American sociologist Robert Merton.[99] In 1936 Merton released his classic article titled "The Unanticipated Consequences of Purposive Social Action."[100] He noted that unintended consequences could be either positive and desirable or negative and undesirable.[101] Unintended negative consequences could be either merely detrimental or perverse, worsening the problem that the action was designed to eliminate or reduce.[102]

In addition to categorizing the types of unintended consequences, Merton listed the leading causes of such consequences. He identified five factors, such as the perceived need for immediate action.[103] A felt need for immediate action can impel a person to act or decide when the available information is

93. *Id.*

94. *Id. See generally* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776) (explaining the impact of regulation on productivity and the related, unforeseen losses); ADAM SMITH, THE THEORY OF MORAL SENTIMENTS (1759) (discussing unforeseen consequences and their relationship to morality).

95. Norton, *supra* note 89.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. Robert Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOCIOLOGICAL REV. 894 (1936).

101. *Id.* at 895.

102. Norton, *supra* note 89.

103. Merton, *supra* note 100, at 900.

incomplete.[104] Another pertinent factor is the limited nature of "our fundamental resources, time and energy."[105] If the person contemplating an action devotes too much time to "predicting the outcomes of actions," there may be insufficient time left to take the action.[106]

Although Merton identified other factors, in his estimation, the foremost cause of unintended consequences is ignorance.[107] He described ignorance as "[t]he most obvious" causal factor for such consequences.[108] He asserted that in "the simplest case," ignorance operates as "the *sole* barrier to a correct anticipation" of consequences.[109]

While Merton's analysis was both insightful and seemingly comprehensive, even his analysis was incomplete. Merton referred to "ignorance" in the same sense as the adjective, "ignorant," that is, a mere lack of knowledge. In his article, he repeatedly mentioned inadequate,[110] incomplete,[111] partial,[112] or insufficient[113] knowledge. He focused on the quantity of information available to the actor or decision maker.[114]

Merton was less concerned with "ignorance" in the verb sense—that is, *to ignore*, *disregard*, or *to pay no attention to*, a given subject or consideration.[115] The verb form of the term is concerned about the *cause* of the lack of information—the fact that the person lacks the information about a consideration because he or she did not consciously advert to it. That is the sense of "ignorance"—an inattentive frame of mind—that is more directly related to the present discussion.

On reflection, it was expectable that pretrial phase reformers

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104. *Id.*
105. *Id.*
106. *Id.*
107. Norton, *supra* note 89.
108. Merton, *supra* note 100, at 898.
109. *Id.* (emphasis in original).
110. *Id.* at 899.
111. *Id.* at 900.
112. *Id.* at 899.
113. *Id.* at 898.
114. Merton, *supra* note 100, at 899–900.
115. WEBSTER'S SEVENTH NEW COLLEGIATE DICTIONARY 414 (1972) ("ignore . . . 1: to refuse to take notice of . . . .").

would tend to ignore impacts on trial rules and that evidence reformers would be inclined to slight effects on pretrial practice. A myopic mindset can begin to develop in law school. Pretrial practice is ordinarily covered in a civil procedure course taught in the first year. Many civil procedure casebooks[116] and hornbooks[117] either say nothing about trial evidence or dismiss the subject with a handful of pages. For that matter, the discussion of pretrial discovery in such texts is likely to note that as a general proposition, the evidentiary rules are inapplicable at pretrial proceedings such as depositions.[118] At most law schools, Evidence is taught in a separate course offered to second- and third-year students. Just as the civil procedure texts tend to ignore evidence, the evidence texts return the favor. Many evidence coursebooks either begin with evidence law proper[119] or start with a discussion of trial procedure.[120] The cumulative effect of this curricular division of labor is that after a first-year civil procedure course which ignores evidence, the student makes an abrupt leap into the trial setting where the evidentiary rules govern.

The same mindset can continue into practice. When an attorney has a pretrial discovery problem, he or she reaches for the Federal Rules of Civil Procedure. As previously stated, the text of the FRCP includes few references to trial evidence rules, and even the accompanying Advisory Committee's Notes generally focus on policy considerations operative only during the pretrial phase. In

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116. *See, e.g.*, RICHARD H. FIELD, BENJAMIN KAPLAN & KEVIN M. CLERMONT, CIVIL PROCEDURE 1328–65 (10th ed. 2010) (addressing the allocation and measure of the burden of the proof without discussing evidence law); JACK H. FRIEDENTHAL, ARTHUR R. MILLER, JOHN E. SEXTON & HELEN HERSHKOFF, CIVIL PROCEDURE: CASES AND MATERIALS 516–53 (10th ed. 2010) (reviewing the jury trial without discussing evidence law); JOEL WM. FRIEDMAN & MICHAEL C. COLLINS, THE LAW OF CIVIL PROCEDURE: CASES AND MATERIALS 721–816 (3d ed. 2010) (considering the jury trial without discussing evidence law)

117. *See, e.g.*, JACK H. FRIEDENTHAL, MARY KAY KANE & ARTHUR R. MILLER, CIVIL PROCEDURE § 10.2 (3rd ed. 1999) (dedicating only seven pages to the discussion of trial evidence).

118. FLEMING JAMES, JR., GEOFFREY C. HAZARD, JR. & JOHN LEUBSDORF, CIVIL PROCEDURE §§ 5.8–5.9 (4th ed. 1992).

119. *See, e.g.*, GEORGE FISHER, EVIDENCE 18 (2002) (beginning with a general discussion of of relevance).

120. *See, e.g.*, JON R. WALTZ, ROGER C. PARK & RICHARD D. FRIEDMAN, EVIDENCE: CASES AND MATERIALS 1 (11th ed. 2009) (beginning with a discussion on making trial objections and preserving the record).

contrast, when the practitioner encounters an evidentiary issue, he or she consults the Federal Rules of Evidence. Just as the FRCP Notes contain minimal discussion of the trial impact of pretrial discovery rules, the FRE Notes say little about the interplay between trial evidence standards and pretrial practices.

Both drafting committees, the FRCP and FRE Advisory Committees, are part of the United States Judicial Conference. Both are subject to the Standing Committee on the Rules of Practice and Procedure. Yet, in the early drafting stage, consultation between the committees is "not routine at all."[121] One drafting committee may learn of the other's draft only after the other committee has finished its draft and submitted it to the Standing Committee.[122] There are exceptional cases, for instance, when a draft Civil Rule expressly refers to an Evidence Rule provision.[123] Otherwise, it is not a regular practice for the Evidence Rules Advisory Committee to solicit the Civil Rules Committee's assessment of the impact of an Evidence Rule change on pretrial practice, and vice versa.[124]

Ironically, when pretrial practice and evidence reformers have this mindset, it can be anticipated that the law of unanticipated consequences will come into play. As Part III illustrates, the foreseeable result is that pretrial practice reforms sometimes have untoward impacts on trial evidence and that evidentiary reforms occasionally have undesirable effects on pretrial practice.

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121. Communication from Professor Daniel Capra, Reporter, Fed. R. Evid. Advisory Comm. (Mar. 6, 2012) (on file with author).

122. *Id.*

123. *Id.*

124. *Id.*

III. EXAMPLES OF THE OPERATION OF THE LAW OF UNINTENDED CONSEQUENCES IN THE ATTEMPTED REFORM OF "LITIGATION" PRACTICES

A. The Unintended Consequences of the Reform of Pretrial Practices: The 1993 Amendment of Federal Rule of Civil Procedure 26

The year 1993 witnessed a major amendment to Federal Rule of Civil Procedure 26.[125] In the past, although the Civil Rules permitted discovery, the party seeking discovery had to take the initiative and request discovery.[126] However, the 1993 amendment imposed on the party possessing relevant information the duty to make certain mandatory pre-discovery disclosures—both before and absent a request from the party desiring the information.[127] One of the mandatory disclosures relates to expert information.[128] The amendment contained broad language requiring any testifying expert to file a report outlining his or her anticipated testimony.[129] According to the amendment, the report

> shall contain a complete statement of all opinions to be expressed and the basis and reasons therefor; the data or other information considered by the witness in forming the opinions; any exhibits to be used as a summary of or support for the opinions; [and] the qualifications of the witness . . . .[130]

The accompanying Note declared that

> [g]iven this obligation of disclosure, litigants should no longer be able to argue that materials furnished to their experts to be used in forming their opinions–whether or not ultimately relied upon by the expert–

125. IMWINKELRIED & BLUMOFF, *supra* note 2, § 5:1.
126. *Id.*
127. *Id.* §§ 5:3–5:5.
128. *Id.* § 5:4.
129. *Id.* §§ 5:2, 5:4.
130. *Id.* § 5:2, at 5-8.

> are privileged or otherwise protected from disclosure when such persons are testifying or being deposed.[131]

The amendment made eminently good sense in terms of the policies relevant during the pretrial discovery phase of litigation. There had long been concern about the venality of expert witnesses.[132] The fear was that if the attorney is willing to pay enough before trial, the expert may allow himself or herself to be manipulated to form whatever opinion the attorney desires. The proponents of the amendment argued that full disclosure could reduce the partisan nature of expert testimony.[133] They hoped that extensive pretrial disclosure would make it more difficult for attorneys to "'treat[] experts as paid advocates rather than as learned observers and interpreters.'"[134]

That policy concern and the breadth of the amendment's wording made it predictable that courts would interpret the amendment expansively. With few exceptions, the lower courts construed the amendment as meaning that the opposing litigant could discover every draft of the final expert report required by the amendment.[135] Many courts required the testifying expert to

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131. IMWINKELRIED & BLUMOFF, *supra* note 2, § 5:4, at 5-40 to 5-41.

132. *See, e.g.*, MARGARET A. HAGEN, WHORES OF THE COURT: THE FRAUD OF PSYCHIATRIC TESTIMONY AND THE RAPE OF AMERICAN JUSTICE (1997) (discussing the danger of using psychological experts in the court system); PETER HUBER, GALILEO'S REVENGE: JUNK SCIENCE IN THE COURTROOM 9, 18 (1991) (discussing the role fees play in obtaining an expert's testimony); DAVID H. KAYE, DAVID E. BERNSTEIN & JENNIFER L. MNOOKIN, THE NEW WIGMORE: EXPERT EVIDENCE §§ 1.3.1, 1.4.1 (2d ed. 2011) (discussing the problems posed by partisan experts); Logan Ford & James H. Holmes III, *Exposure of Doctors' Venal Testimony*, 1965 TRIAL LAW. GUIDE 75, 75–79 (highlighting the dangers presented by biased expert testimony, and offering tips for cross-examiners to expose expert biases); Michael Graham, *Impeaching the Professional Expert Witness by a Showing of Financial Interest*, 53 IND. L.J. 35, 36 (1977) (discussing the venality of expert witnesses); Samuel R. Gross, *Expert Evidence*, 1991 WIS. L. REV. 1113, 1114 (1991) (claiming that the use of expert witnesses has a history of causing problems in common law courts).

133. *See Civil Procedure—Expert Testimony: Key Rule Change on Expert Witnesses Seen Going to Supreme Court in 2009*, 77 U.S.L.W. 2422 (Jan. 20, 2009) (discussing concerns with amending the 1993 rules).

134. *Id.* (quoting a letter written by Professors John Leubsdorf of Rutgers University and William H. Simon of Columbia University).

135. *See, e.g.*, Elm Grove Coal Co. v. Director, O.W.C.P., 480 F.3d 278,

disclose "every note [he or] she takes in connection with the case (however incomplete)."[136] For that matter, seizing on the sweeping language of the Advisory Committee's Note, the majority of courts ruled that the opposing litigant had the right to discover "all communications between the [testifying] expert and counsel."[137]

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302 (4th Cir. 2007) (holding that draft expert reports were not entitled to protection under the work product doctrine when requested during discovery); Trigon Ins. Co. v. United States, 204 F.R.D. 277, 282–83 (E.D. Va. 2001) ("Any information reviewed by an expert will be subject to disclosure including drafts of reports sent from and to the testifying experts."); W. R. Grace & Co.-Conn. v. Zotos Intern., Inc., 2000 WL 1843258, at *11–12 (W.D.N.Y. Nov. 2, 2000) (ordering defendant to produce expert's drafts for plaintiff); Krisa v. Equitable Life Assur. Soc., 196 F.R.D. 254, 261 (M.D. Pa. 2000) (following prior precedent that draft expert reports and other documents prepared by testifying expert witnesses are discoverable); Gregory Joseph, *Federal Practice: Engaging Experts*, NAT'L L.J., Apr. 18, 2005, at 12 ("every draft they write"); Roger Siefert & Benito Romano, *Changing the Rules for Testifying Experts*, 19 A.B.A. CRIMINAL JUSTICE SECTION NEWSLETTER, Winter 2011, at 10 ("any draft"); Dan K. Webb & J. David Reich, *Trial Strategy: Expert Witness Prep*, NAT'L L.J., Feb. 23, 2009, at 12 (citing Karn v. Ingersoll Rand, 168 F.R.D. 633, 638 (N.D. Ind. 1996), the authors state that "[d]epending on the court you are before, every report a testifying expert prepares (however preliminary) . . . [is] potentially discoverable").

136. Joseph, *supra* note 135, at 12 ("[e]very note [experts] take"); Siefert & Romano, *supra* note 135, at 10 ("every note jotted down"); Webb & Reich, *supra* note 135, at 12.

137. *See, e.g.*, Fidelity Nat'l Title Ins. Co. of N.Y. v. Intercounty Nat'l Title Ins. Co., 412 F.3d 745, 751 (7th Cir. 2005) ("whatever materials are given him to review in preparing his testimony, even if in the end he does not rely on them in formulating his expert opinion"); *In re* Pioneer Hi-Bred Intern., Inc., 238 F.3d 1370, 1375 (Fed. Cir. 2001) (holding that "documents and information disclosed to a testifying expert in connection with his testimony are discoverable by the opposing party"); Synthes Spine Co., L.P. v. Walden, 232 F.R.D. 460, 461 (E.D. Pa. 2005) (compelling disclosure of unredacted versions of documents reviewed by the plaintiff's expert, including all materials that the plaintiff's counsel supplied to the expert); Am. Fid. Assur. Co. v. Boyer, 225 F.R.D. 520, 520–21 (D.S.C. 2004) (compelling disclosure of correspondence, electronic correspondence, and information provided by Plaintiffs' counsel); Joseph, *supra* note 135, at 12 ("every document, e-mail, or phone call they share"); Siefert & Romano, *supra* note 135, at 10 ("everything written, said, or considered by the expert"). However, some courts held that the opponent was not entitled to the discovery of materials that revealed the attorney's legal theories, that is, core opinion work product. *See, e.g.*, Smith v. Transducer Tech., Inc., 197 F.R.D. 260, 262 (D.V.I. 2000) ("where documents considered by Defendants' experts contain both facts and legal theories of the attorney, Plaintiff is entitled only to discovery of the facts . . . while protection is accorded the legal theories and the attorney-expert dialectic"); Krisa

While the 1993 amendment was defensible in terms of pretrial practice policy considerations, the courts' sweeping interpretation of the amendment had serious, unforeseen consequences.[138] So construed, the amendment had adverse impacts on both the preparation of trial testimony and the quality of trial testimony itself.

To begin with, the amendment made preparation more awkward and expensive. The amendment impelled attorneys to engage in "discovery-avoidance."[139] In particular, since they feared that virtually anything said to a testifying expert was discoverable, many attorneys resorted to the "elaborate step[]" of hiring "two sets of experts–one for consultation in developing the opinion and one to provide the testimony . . . ."[140] The practice became "commonplace."[141]

In addition, the amendment imperiled the quality of the expert testimony proffered at trial.[142] It became a "tortuous" process for the testifying expert to formulate his or her opinions.[143] The process was extremely cumbersome.[144] To reduce the risk of discovery, the testifying expert had to "avoid taking any notes, making any record of preliminary analyses or opinions, or producing draft reports."[145] Two authors commented on the absurdity of the

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v. Equitable Life Assur. Soc., 196 F.R.D. 254, 260 (M.D. Pa. 2000) ("disclosure of core work product to a testifying expert does not abrogate the protection afforded such information").

138. *Civil Procedure—Expert Testimony: Key Rule Change on Expert Witnesses Seen Going to Supreme Court in 2009*, *supra* note 133, at 2422 (quoting Theodore B. Van Itallie, Jr., associate general counsel at Johnson & Johnson, New Brunswick, New Jersey).

139. Henry L. Hecht, *Proposed Amendments to Federal Rule 26 Offer Protections When Working with Experts*, 21 THE PRACTICAL LITIGATOR, July 2010, at 23–24.

140. *Id.*

141. *Civil Procedure—Expert Testimony: Key Rule Change on Expert Witnesses Seen Going to Supreme Court in 2009*, *supra* note 133, at 2422 (quoting Theodore B. Van Itallie, Jr., associate general counsel at Johnnson & Johnson, New Brunswick, New Jersey).

142. Hecht, *supra* note 139, at 23–24.

143. *Id.*

144. Siefert & Romano, *supra* note 135, at 10. *See also* Bradley C. Nahrstadt, *Communicating with Your Expert (with Form)*, 22 THE PRACTICAL LITIGATOR, Mar. 2011, at 58, 62.

145. Hecht, *supra* note 139, at 23–24.

process that the amendment pressured testifying experts to adopt:

> Rarely, if ever, in undertaking a complex project, are participants expected to assimilate and organize information without the benefit of notations, nor is it assumed that the first idea or effort should also be the last. Architectural renderings are reworked, authors' transcripts are edited and engineering designs amended. Formulations of ideas and opinions is a process in which new information becomes available that clarifies understandings, changes perceptions, fosters new theories and thus, requires adjustment to initial thinking. It is a well accepted axiom that critical thinking should be challenged and, if necessary, adjusted to improve the soundness of an ultimate conclusion.
>
> [However, the amendment] discouraged [experts] from drafting reports prior to arriving at a complete and full understanding of the facts.[146]

No doctor in his or her right mind would formulate a diagnosis in this manner, and no sane scientist would conduct an experiment in this fashion.

The broad interpretation of the amendment not only threatened to lower the caliber of expert testimony at trial; in some cases, the amendment could also conceivably lead to the exclusion of otherwise admissible, reliable testimony. FRE 702 prescribes the general standards for the admissibility of expert testimony at trial.[147] The Advisory Committee's Note to the 2000 amendment to FRE 702 states that a testifying expert must be prepared to explain every essential "step" in his or her reasoning process.[148] The awkward method of preparation that the amendment pressured experts to utilize increased the probability that before trial the expert might

146. Siefert & Romano, *supra* note 135, at 10.

147. FED. R. EVID. 702.

148. FED. R. EVID. 702 advisory committee's note ("As the court noted in *In re Paoli R.R. Yard PCB Litig.*, 35 F.3d 717, 745 (3d Cir. 1994), '*any* step that renders the analysis unreliable . . . renders the expert's testimony inadmissible.'").

give inadequate thought to one of those necessary steps. If the expert cannot reduce the thought process to writing and gradually refine his or her analysis, the expert risks overlooking an intermediate step in the analysis. Moreover, the method heightened the risk that the expert would submit a report that was less than "complete and full . . . ."[149] The rub is that as a sanction for the expert's submission of an incomplete report, the judge may bar or severely limit the expert's testimony at trial.[150] In short, even if the witness's testimony would otherwise qualify as reliable, admissible expert evidence, the convoluted process of preparation could render the testimony vulnerable to exclusion on substantive or procedural grounds.

Ultimately, the Civil Rules Advisory Committee took notice of these unanticipated problems and drafted another Rule 26 amendment to remedy them. The new amendment took effect on December 1, 2010.[151] With specified exceptions, the 2010 amendment, 26(b)(4) extends work product protection on three types of information: "26(b)(4)(C) accords work product protection to most communications between a party's attorney and any expert who is required to file a report"[152] and "drafts of any report . . . required under Rule 26(a)(2), regardless of the form in which the draft is recorded."[153] Another new provision in 26(b)(4)(B) shields "drafts of any . . . disclosure . . . required" under Rule 26(a)(2).[154] Both its

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149. Siefert & Romano, *supra* note 135, at 10.

150. EDWARD J. IMWINKELRIED & THEODORE Y. BLUMOFF, PRETRIAL DISCOVERY: STRATEGY AND TACTICS § 5:4, at 33–35 (2011 Cum. Supp.) (collecting authorities, including R.C. Olmstead, Inc. v. CU Interface, LLC, 606 F.3d 262, 271 (6th Cir. 2010), Adams v. J. Meyers Builders, Inc., 671 F. Supp. 2d 262, 268–70 (D.N.H. 2009), Griffith v. E. Maine Med. Ctr., 599 F. Supp. 2d 59 (D. Me. 2009), and Bowers v. Nat'l Collegiate Athletic Assn'n, 564 F. Supp. 2d 322 (D.N.J. 2008)).

151. EDWARD J. IMWINKELRIED & THEODORE Y. BLUMOFF, PRETRIAL DISCOVERY: STRATEGY AND TACTICS § 5:4, at 34 (2011 Cum. Supp.).

152. *Id.* § 5:4, at 34–35 (noting that there are exceptions for: communications relating "to compensation for the expert's study or testimony," "facts or data that the party's attorney provided to the expert and that the expert considered in forming the opinions to be expressed," and "assumptions that the party's attorney provided to the expert and that the expert relied on in forming the opinions to be expressed").

153. *Id.* § 5:4, at 32.

154. *Id.*

supporters[155] and its detractors[156] recognized that the primary motivation for the amendment was a desire to remedy the unanticipated impacts of the 1993 amendment on expert testimony proffered at trial.

B. *The Unintended Consequences of the Reform of Evidence Rules: Federal Rule of Evidence 612*

When the Federal Rules of Evidence took effect in 1975, they included Rule 612 dealing with refreshing a witness's recollection.[157] In pertinent part, the original[158] version of Rule 612 read:

> Except as otherwise provided in criminal proceeding by section 3500 of title 18, United States Code, if a witness uses a writing to refresh memory for the purpose of testifying, either—
>
> (1) while testifying, or
>
> (2) before testifying, if the court in its discretion determines it is necessary in the interests of justice, an adverse party is entitled to have the writing produced at the hearing, to inspect it, to cross-examine the witness thereon, and to introduce in evidence those portions which relate to the testimony of the witness.[159]

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155. Hecht, *supra* note 139, at 23–24.

156. *Civil Procedure—Expert Testimony: Key Rule Change on Expert Witnesses Seen Going to Supreme Court in 2009*, *supra* note 133, at 2422 (citing statements by Professors John Leubsdorf and William H. Simon of Columbia University).

157. FED. R. EVID. 612.

158. A new version of Rule 612 took effect on December 1, 2010 as part of the general restyling project. The Advisory Committee's Note accompanying restyled Rule 612 states that the adoption of the new version is for stylistic purposes only and is not intended to change the substance of the statute. FED. R. EVID. 612 advisory committee's note.

159. FED. R. EVID. 612. The corresponding language of the restyled Rule 612 provides:

> (a) Scope. This rule gives an adverse party certain options when a witness uses a writing to refresh memory:
>
> (1) while testifying; or

Just as the 1993 FRCP 26 amendment on mandatory pre-discovery disclosure was a significant departure from the prior practice, FRE 612 represented a major change from the earlier common law. Although the early common-law decisions accorded the opponent the right to inspect any documents that the witness used on the stand to refresh recollection, most cases refused to extend that right to documents viewed before trial.[160] The parallel between the 1993 amendment and Rule 612 continues. Just as the lower courts liberally construed the 1993 amendment as rendering prior drafts of the report and communications about the report discoverable, the courts broadly construed Rule 612(a)(2). More specifically, many courts adopted the position that if before trial a witness so much as glanced at a writing for the purpose of reviving his or her memory, there was an automatic waiver of any privilege attaching to the writing.[161] If so, the opponent was entitled to inspect the document even if the witness's only pretrial glance at the writing occurred in the privacy of the other attorney's office.[162]

Just as the 1993 amendments made sense in terms of the policies operating during the pretrial phase, this broad interpretation of Rule 612 was defensible in terms of policies applicable at trial. The accompanying Advisory Committee's Note advanced the policy argument that fairness demands that the cross-examiner be allowed

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(2) before testifying, if the court decides that justice requires the party to have those options.

(b) Adverse Party's Options . . . . Unless 18 U.S.C. § 3500 provides otherwise in a criminal case, an adverse party is entitled to have the writing produced at the hearing, to inspect it, to cross-examine the witness about it, and to introduce in evidence any portion that relates to the witness's testimony.

160. BROUN ET AL., *supra* note 13, § 9, at 57–58.

161. *See* Timm v. Mead Corp., 1992 U.S. Dist. LEXIS 1411, at *2–5 (N.D. Ill. Feb. 7, 1992) (citing cases where privilege was waived by using a document to refresh the witness's memory); Gregory P. Joseph, *Experts and Privilege*, NAT'L L.J., Feb. 8, 1999, at B6 (citing James Julian, Inc. v. Raytheon Co., 93 F.R.D. 138, 144 (D. Del. 1982) and Wheeling-Pittsburgh Steel v. Underwriters Lab., 81 F.R.D. 8, 9–11 (N.D. Ill. 1978)); Jerold S. Solovy & Robert L. Byman, *Preparing the Witness: Federal Rules of Evidence Pose an Unclear and Present Danger for Work Product*, LEGAL TIMES, June 3, 2002, at 42; Jerold S. Solovy & Robert L. Byman, *Federal Practice: Discovery*, NAT'L L.J., Sep. 21, 1998, at B7 (citing the same two cases).

162. *Timm*, 1992 U.S. Dist. LEXIS 1411, at *6–7.

to query about any material that has "an impact upon the testimony of the witness."[163] That policy is a weighty one, since the cross-examination right is of constitutional dimension. In criminal cases, the Sixth Amendment Confrontation Clause guarantees the right,[164] and in civil cases, under the aegis of Procedural Due Process, the courts have conferred a measure of constitutional protection on the right.[165] It is true that the judge has discretionary control over the scope of cross-examination,[166] but it is often said that the scope of cross-examination is liberal.[167] No less an authority than Dean Wigmore declared that cross-examination "is beyond any doubt the greatest legal engine ever invented for the discovery of truth."[168] Hence, it is consistent with cross-examination policy to generously permit the questioner to probe materials used to refresh the witness's memory.

While the courts' broad reading of FRCP 26 had an unintended adverse impact on the quality of trial expert testimony, their liberal interpretation of FRE 612 had an unanticipated negative effect on pretrial practice, namely depositions. As we shall see in greater detail later, the vast majority of cases settle before proceeding to trial[169] and the key event during the pretrial phase is often the client's performance at his or her deposition.[170] The client's testimony and demeanor at the deposition may have an enormous impact on the settlement value of the case.[171] As Professor James McElhaney has observed, "90 percent to 95 percent

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163. FED. R. EVID. 612 advisory committee's note.

164. Crawford v. Washington, 541 U.S. 36, 50–51 (2004); Davis v. Alaska, 415 U.S. 308, 315 (1974); Smith v. Illinois, 390 U.S. 129, 129–31 (1968).

165. LAURENCE TRIBE, AMERICAN CONSTITUTIONAL LAW § 10–15 (2d ed. 1988); Henry Friendly, *Some Kind of Hearing*, 123 U. PA. L. REV. 1267, 1285–87 (1975).

166. Delaware v. Van Arsdall, 475 U.S. 673, 679 (1986).

167. CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, EVIDENCE § 6.63, at 594 (4th ed. 2009).

168. LARRY S. POZNER & ROGER J. DODD, CROSS-EXAMINATION: SCIENCE AND TECHNIQUES 2 (1993) (quoting 5 J. H. WIGMORE, EVIDENCE § 1367 (Chadbourn rev. ed. 1974)).

169. *See infra* notes 214–220 and accompanying text.

170. IMWINKELRIED & BLUMOFF, *supra* note 2, § 6:1.

171. Sheldon J. Stark, *Learning by Doing: Deposition Tips*, TRIAL, July 1994, at 37–38 ("the greater the likelihood that the case will be resolved favorably").

of all cases settle before trial, [and] . . . the depositions are the only trial you get."[172] It is therefore imperative that the deponent's attorney properly prepare the deponent for that hearing.[173]

However, the courts' broad interpretation of Rule 612(a)(2) made it far more difficult to prepare deponents for the hearing.[174] Suppose that before the conference to prepare the deponent, the deponent gave the attorney a written statement that would otherwise be protected by the attorney-client privilege (in the case of a client) or the work product doctrine (in the case of a non-party witness). During the pre-deposition conference, the attorney is reviewing the facts with the deponent. At some point, the deponent forgets an important fact. When the deponent informs the attorney of the memory lapse, the attorney's natural instinct is to tender the writing to the deponent. However, given the liberal reading of Rule 612(a)(2), the deponent's glance at the writing might forfeit the attorney-client privilege and the work product protection.[175] As a practical matter therefore, the attorney should think twice before assisting the deponent by handing the deponent the writing.[176] Instead, the attorney might resort to leading questions to help the witness recall the forgotten fact. Surely, though, if we want the deponent's version of the facts at the deposition hearing, it would be

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172. James McElhaney, *Preparing Witnesses for Depositions*, 78 A.B.A. J. 84, 84 (1992).

173. Stark, *supra* note 171, at 37–38.

174. IMWINKELRIED & BLUMOFF, *supra* note 2, § 7:14, 7–61.

175. *See* BROUN ET AL., *supra* note 13, § 9, at 59 (discussing the "sweeping wording of Rule 612" and the possible conflict between its disclosure requirement and the attorney-client privilege); John S. Applegate, *Witness Preparation*, 68 TEX. L. REV. 277, 314–22 (1989) (discussing the importance of pretrial document review and concerns about an expansive reading of Rule 612); Alfred F. Belcuore, *Use It and Lose It—Privileged Documents, Preparing Witnesses, and Rule 612 of the Federal Rules of Evidence*, 31 FED. B. NEWS & J. 171, 172 (1984) (stating that the Supreme Court has interpreted Rule 612 to require the disclosure of otherwise privileged work product); William J. Raleigh, *Attorney–Client Privileges: Implementing Safeguards to Protect Them*, 24 TRIAL, May 1988, at 45–47 (arguing that lawyers often inadvertently waive privilege in the process of preparing witnesses or clients for trial because of Rule 612(2)).

176. *See* Dennis R. Suplee, *Depositions: Objectives, Strategies, Tactics, Mechanics, and Problems*, 2 REV. LITIG. 255, 324 (1982) (providing an illustration of how to refresh a deponent's memory without tendering documents, particularly if a request for production of documents has not been served).

preferable to allow the deponent to review his or her own words rather than relying on leading questions posed by the attorney. Alternatively, the attorney could pause the hearing, prepare another document reflecting the forgotten fact, and show that document—rather than the original, privileged writing—to the deponent.[177] The attorney could then tender the second document to the opposition at trial. Every time the deponent's memory faltered, the attorney would interrupt the conference, prepare a substitute document, and submit that document to the deponent—a practice that would heighten the danger that at the subsequent deposition, the deponent would recount what the attorney said or wrote rather than the deponent's original memory. In short, the expansive interpretation of Rule 612(a)(2) could not only make the process of preparing the deponent less convenient, but it could also decrease the probability that the deponent will recount his or her own authentic memory of the facts.

None of the these impacts was contemplated by the drafters of Rule 612(a)(2). The Advisory Committee's Note gives no inkling that the drafters ever intended that Rule 612(a)(2) would alter the pretrial process of preparing deponents in this manner.[178] When these unanticipated problems materialized, many courts responded by reinterpreting 612(a)(2).[179] The courts appreciated that a review of the witness's previous statement has long been regarded as a legitimate technique to prepare the deponent.[180] To preserve that practice, these courts abandoned the early position that the witness's mere skim of a writing destroyed all the privileges attaching to the

177. *See* R. Dickey Hamilton, *Taking and Defending Depositions*, 11 LITIG., Winter 1985, at 24 (discussing the possibility of re-writing documents before using them to refresh a witness's memory); Thomas McGanney & Selvyn Siedel, *Rule 26(b)(3): Protecting Work Product*, 7 LITIG., Spring 1981, at 27 (noting that refreshing a witness's recollection with a privileged document during a deposition may render it producible).

178. *See* FED. R. EVID. 612 advisory committee's notes ("The purpose of the rule is . . . to promote the search of credibility and memory.").

179. *See, e.g.*, United States v. Sheffield, 55 F.3d 341, 343 (8th Cir. 1995) ("Moreover, even if a writing has been used to refresh memory of a witness before testifying, the court may require furnishing the statement only if in its discretion it determines it is necessary in the interest of justice.").

180. *See* George A. Davidson & William H. Voth, *Waiver of the Attorney–Client Privilege*, 64 OR. L. REV. 637, 666 (1986) (finding that "permitting a witness to reread the witness's own prior statement is hardly a means to influence testimony improperly" and is a practice accepted by the courts).

writing.[181] Rather, they required a showing that the witness in fact relied on the writing to refresh his or her memory.[182] In their minds, the desirability of upholding a widespread, legitimate pretrial practice trumped the policy argument favoring a broad interpretation of Evidence Rule 612(a)(2).[183] The clear trend in the case law is now toward the more "cautious" interpretation of Rule 612(a)(2).[184]

C. *The Emerging Pattern*

A troubling pattern emerges from these examples. In some instances, litigation reform proposals for revising pretrial practices

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181. *See* Victoria E. Brieant, *Techniques and Potential Conflicts in the Handling of Depositions*, 19 THE PRACTICAL LITIGATOR, Nov. 2008, at 27, 39–40 ("This rule may not be extended, however, to circumstances in which a witness merely skims a document before being deposed.").

182. *Sheffield*, 55 F.3d at 343 (holding there was no error to deny a production request under Rule 612 where there was no showing that the witness had used the document to refresh his recollection); Monticello Ins. Co. v. Kendall, No. 96-2546-MLB, 1998 U.S. Dist. LEXIS 5860, at *2 (D. Kan. Feb. 24, 1998) (stating that there must be some showing, "however minimal, that the documents reviewed actually influenced the witness' testimony"); Sauer v. Burlington N. R.R. Co., 169 F.R.D. 120, 123 n.3 (D. Minn. 1996) ("[O]ur Court of Appeals has underscored the specificity with which a witness's reliance upon a privileged document must be established before a wholesale access to that document will be permitted."); Butler Mfg. Co. v. Americold Corp., 148 F.R.D. 275, 278 (D. Kan. 1992) ("A showing must be made that the document actually influenced the witness' testimony."); Timm v. Mead Corp., No. 91 C5648, 1992 U.S. Dist. LEXIS 1411, at *15 (N.D. Ill. Feb. 7, 1992) (finding that the witness's statement that he "glanced" at the writing before testifying did not trigger Rule 612); Breiant, *supra* note 181, at 7, 15–16 (stating that the "recent trend" is away from the "automatic waiver" rule; "[a] growing number of courts" have repudiated the automatic waiver rule); Joseph, *supra* note 161, at B6 ("In 1985, the Third U.S. Circuit Court of Appeals limited this waiver analysis in *Sporck v. Peil*, 759 F.2d 312 (3d Cir. 1985), reasoning that Rule 612 authorizes disclosure not of the full document collation, but only of those specific facts, documents or excerpts that actually had been relied upon by the witness.").

183. *See Sheffield*, 55 F.3d at 343 (holding that the review of an investigatory file by a witness prior to taking the stand was insufficient to prove that the witness used said file to refresh his recollection before testifying under Rule 612); 2 EDWARD J. IMWINKELRIED, THE NEW WIGMORE: EVIDENTIARY PRIVILEGES § 6.12.4, at 1081 (2d ed. 2010) (discussing recent cases that have limited the waiver effect of Rule 612).

184. Brieant, *supra* note 181, at 7, 15–16.

have had undesirable impacts on the quality of trial evidence.[185] Those impacts were unforeseen at the time of the adoption of the proposal.[186] In other instances, litigation reform proposals for revising evidentiary rules resulted in negative impacts on pretrial practice.[187] Again, those effects were unanticipated at the time of the implementation of the change. In all of these instances the common denominator is that the law of unanticipated consequences came into play largely because the reformers focused only on the phase of the litigation process they intended to modify; pretrial practice reformers did not consciously advert to the potential impacts on trial evidence, and likewise evidentiary reformers gave little thought to the possible effects on pretrial procedure. In short, the proposals went awry in no small part because the reformers failed to adopt a truly systemic perspective, one which would assess the impact on the overall litigation system rather than the phase of the system that was of immediate interest to them.

IV. A COUNTER-EXAMPLE OF SYSTEMIC LITIGATION REFORM: THE CASE FOR THE ENACTMENT OF NEW FEDERAL RULE OF EVIDENCE 502 ON PRIVILEGE WAIVER

Although the examples of FRE 612 and the 1993 amendment to FRCP 26 are troublesome, there is some reason to be hopeful. In 2008, Congress added a new provision, 502, to the Federal Rules of Evidence.[188] As we shall see, in the process of constructing the case for the new Rule 502, its proponents engaged in precisely the type of systemic analysis that, in the long term, can reduce the number of occasions when the law of unintended consequences frustrates litigation reform initiatives.

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185. *See* Hecht, *supra* note 139, at 23 (discussing the findings of the Committee on Rules of Practice and Procedure that the 1993 amendment to Rule 26 led to discovery-avoidance practices that weakened and obstructed quality trial evidence from expert witnesses).

186. *Civil Procedure—Expert Testimony: Key Rule Change on Expert Witnesses Seen Going to Supreme Court in 2009*, *supra* note 133, at 2422.

187. *See* IMWINKELRIED & BLUMOFF, *supra* note 2, § 7:14, at 7–61 (explaining, for instance, that the broad interpretation of Rule 612 has made it harder to prepare deponents for deposition hearings).

188. IMWINKELRIED, *supra* note 183, § 6.12.5.a, at 1094.

The backdrop for the enactment of Rule 502 was a sharp split of authority over the question of when inadvertent pretrial disclosure of a writing effected a waiver of the privileges attaching to the writing.[189] As noted in the Introduction, modern litigants frequently have to produce massive numbers of documents during pretrial discovery pursuant to FRCP 34.[190] Given the volume of information, it is predictable that a litigant will sometimes accidentally disclose a writing that is protected by a privilege, such as attorney-client. The question was whether that act forfeited the applicable privileges.

At one extreme, some courts held that even inadvertent production resulted in a waiver.[191] These courts found a waiver even if the inadvertent act occurred despite the exercise of reasonable diligence by the producing litigant. These courts required a producing party to treat privileged communications "like jewels–if not crown jewels."[192] Other courts adopted the polar extreme view that nothing short of "an intentional and knowing relinquishment" of the privilege causes a waiver.[193] In the view of these courts, an act of production should never result in a waiver[194] unless "the disclosing party actually intended to waive" the privilege.[195] Still other courts—the majority[196]—adopted a compromise view. According to this view, voluntary production of a privileged writing does not effect a waiver if the production occurred despite the litigant's exercise of due diligence.[197] In evaluating the litigant's diligence, the courts considered both the precautions the litigant took before disclosure to prevent the release of privileged material and the actions the litigant took after discovering the inadvertent revelation.[198] Although the trend in the case law was toward the

189. *Id.* § 16.2.4.b(4), at 1062–67.

190. FED. R. CIV. P. 34.

191. IMWINKELRIED, *supra* note 183, § 6.12.4.b(4), at 1062–63.

192. Leonard H. Becker, *When Advocacy Trumps Confidentiality*, LEGAL TIMES, July 17, 2000, at 19.

193. IMWINKELRIED, *supra* note 183, § 6.12.4.b(4), at 1062–63.

194. *Id.* at 1064.

195. MUELLER & KIRKPATRICK, *supra* note 167, § 5.29, at 394.

196. *See* FED. R. EVID. 502 advisory committee's note (referring to the compromise view as the "majority view" that "[m]ost courts" use).

197. IMWINKELRIED, *supra* note 183, § 6.12.4.b(4), at 1064–67.

198. *Id.* at 1067.

compromise view,[199] parties making production were troubled by the persistent uncertainty. Indeed, they were so anxious that they often spent huge sums of money on pre-production privilege reviews of the documents. For instance, during a Department of Justice antitrust investigation, Verizon Corporation spent $13.5 million on a privilege review.[200] Both the Judicial Conference and Congress became concerned that the uncertainty as to whether the privilege was still assertable at trial was imposing inordinate costs during pretrial proceedings.[201] It was conceivable that the expense of a thorough pre-production privilege review could exceed the monetary stakes in a given case.

Ultimately, that concern led to Congress' enactment of new Evidence Rule 502.[202] The rule includes two provisions that substantially reduce the uncertainty. First, Rule 502(b) limits the number of cases in which inadvertent disclosure will result in a waiver. Rule 502(b) reads:

> When made in a federal proceeding or to a federal office or agency, the disclosure does not operate as a waiver in a federal or state proceeding if:
>
> (1) the disclosure is inadvertent;

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199. Sherry L. Talton, Note, *Mapping the Information Superhighway: Electronic Mail and the Inadvertent Disclosure of Confidential Information*, 20 REV. LITIG. 271, 294 (2000); Kristin M. Nimsgerand & Jonathan M. Redgrave, *Privileges and Waivers*, LEGAL TIMES, Nov. 12, 2001, at 30 ("The growing trend of cases across the country, however, favors a balancing test.")

200. Alvin F. Lindsay, *New Rule 502 to Protect Against Privilege Waiver*, NAT'L L.J., Aug. 25, 2008, at S2.

201. Thomas Brom, *E-Discovery Options*, CAL. LAWYER, Jan. 2009, at 14 ("In litigation, first-tier document review can be incredibly expensive for clients . . . . 'Of the U.S. [survey] respondents, 30 percent estimated that privilege reviews comprised 6 percent to 10 percent of their litigation costs, while 16 percent estimated the figure as high as 30 percent to 50 percent,' noted law firm Fulbright & Jaworski's *2007 Litigation Trend Survey Finding*. The study added, 'One third of the technology/communications respondents were in the 30 percent to 50 percent range.'").

202. Pub. L. 110-322, 122 Stat. 3537 (codified at 28 U.S.C. § 502 (2008)). *See also* Kenneth Broun & Daniel Capra, *Getting Control of Waiver of Privilege in the Federal Courts: A Proposal for a Federal Rule of Evidence 502*, 58 S.C. L. REV. 211, 213–17 (2006) (explaining that although clawback or quick-peek agreements between parties alleviate this concern to some extent, because they do not bind other entities, parties are not totally protected).

> (2) the holder of the privilege or protection took reasonable steps to prevent disclosure; and
> (3) the holder promptly took reasonable steps to rectify the error, including (if applicable) following Federal Rule of Civil Procedure 26(b)(5)(B).[203]

Moreover, even when there is a waiver, Rule 502(a) restricts the scope of the waiver:

> When the disclosure is made in a federal proceeding or to a federal office or agency and waives the attorney-client privilege or work-product protection, the waiver extends to an undisclosed communication or information in a federal or state proceeding only if:
> (1) the waiver is intentional;
> (2) the disclosed and undisclosed communications or information concern the same subject matter; and
> (3) they ought in fairness to be considered together.[204]

Since Rule 502 is so new, it remains to be seen what its ultimate impact will be.[205] However, the one thing that is clear is

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203. FED. R. EVID. 502.

204. *Id.*

205. *See* Coburn Grp., LLC v. Whitecap Advisors LLC, 640 F. Supp. 2d 1032, 1039–40 (N.D. Ill. 2009) (rejecting another district court's "all reasonable means" standard for Rule 502 in favor of a "reasonable steps to prevent disclosure" standard); Kumar v. Hilton Hotels Corp., No. 08-2689 D/P, 2009 U.S. Dist. LEXIS 53387, at *10–11 (W.D. Tenn. June 16, 2009) (holding that e-mails and handwritten numbering were protected by attorney-client privilege and as work product, and compelling return of documents); Alcon Mfg. v. Apotex, Inc., No. 1:06-cv-1642-RLY-TAB, 2008 U.S. Dist. LEXIS 96630, at *29 (S.D. Ind. Nov. 26, 2008) (holding that a protective order governed the inadvertent "pretrial disclosure" of a document and compelling its return); Laethem Equip. Co. v. Deere & Co., No. 2:05-CV-10113, 2008 WL 4997932, at *12 (E.D. Mich. Aug. 21, 2008) (employing Rule 502 to compel the return of inadvertently produced disks); Michael J. Burg & Richard Hunter, *A Review of How Courts Are Analyzing New Federal Rule of Evidence 502*, 78 U.S.L.W. 2499 (Mar. 2, 2010) (analyzing federal case law applying Rule 502 and concluding that "the real-world effect of the rule is mixed"); Symposium, *Reinvigorating Rule 502*, 81 FORDHAM L. REV.

that in formulating Rule 502, the drafters commendably employed a systemic perspective that has been lacking in many prior reform efforts. The drafters crafted a new trial standard for insertion in the Federal Evidence Rules, but in deliberating over the new standard they did not ignore the potential impacts on the pretrial phase of litigation. Instead, Rule 502 stands as one of the rare evidentiary reforms which pay heed to pretrial efficiency concerns.

That inspiration is evident in both the Advisory Committee's Note and the September 26, 2007 letter that the Committee on Rules of Practice and Procedure sent to the Judiciary Committees of the Senate and House of Representatives. In its Note, the Advisory Committee stated that there was a "troubling" uncertainty about the test to determine whether an inadvertent pretrial act of production effected a waiver at trial.[206] The committee noted that some litigants were so worried that even when they had to produce "millions of documents," they went to the length of conducting a "record-by-record pre-production privilege review . . . ."[207] In the committee's view, "the burdensome costs of privilege review" necessitated a new evidence standard on waiver.[208]

If anything, the letter submitted by the Committee on Rules of Practice and Procedure is more explicit. The Committee asserted that the indeterminacy of the trial waiver rule was "responsible in large part for the rising costs of discovery, especially discovery of electronic information."[209] The Committee stated that it had become commonplace "[i]n complex litigation [for] . . . lawyers [to] spend significant amounts of time and effort to preserve the privilege and work product."[210] The Committee added that in some cases, the costs of pre-production privilege review had become "enormous."[211] Like the Advisory Committee, the Committee on Rules of Practice and Procedure concluded that a revision of the trial evidence rules was advisable in order to make the pretrial production review "much

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1533 (2013).

206. FED. R. EVID. 502 advisory committee's note.

207. *Id.* (quoting Hopson v. City of Baltimore, 232 F.R.D. 228, 244 (D. Md. 2005)).

208. *Id.*

209. FEDERAL RULES OF EVIDENCE HANDBOOK: 2011–12 REVISED EDITION 157 (LexisNexis 2011).

210. *Id.*

211. *Id.*

less expensive."[212] The Rules Committee explained that in formulating Evidence Rule 502, the "primary goal" was to "reduc[e] the costs of [pretrial] discovery . . . ."[213] Simply stated, 502 is an evidence rule driven primarily by pretrial practice policies.

It may be that the drafters subjected the proposed rule to an especially painstaking, systemic analysis because Congress had expressed interest in the problem. Congress's concern was certainly systemic, not a narrow, solitary focus on either the pretrial stage or trial evidence standards. In any event, to a greater extent than most "litigation" reform proposals, proposed Rule 502 underwent an evaluation in which the drafters took a broad view, considering potential impacts on both the pretrial and trial phases.

V. CONCLUSION

As we have seen, it may be a serious mistake for a pretrial practice reformer to ignore the potential effects on trial evidence standards and the quality of trial evidence. If anything, though, it can be an even worse mistake for an evidentiary reformer to fail to consider the possible effects on the efficiency of pretrial practices. The discovery phase has become the center of gravity in contemporary litigation.[214] Trials are vanishing.[215] In 1962, 11.5%

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212. *Id.* at 158.

213. *Id.* at 159.

214. John W. Cooley, *Puncturing Three Myths About Litigation*, 70 A.B.A. J. 75, 75–76 (1984).

215. *See* Patricia L. Refo, *The Vanishing Trial*, 30 LITIG. 1, 1–2 ("[O]ur federal courts actually tried fewer cases in 2002 than they did in 1962, despite a fivefold increase in the number of civil filings and more than a doubling of the criminal filings over the same time frame."). *See also* State *ex rel.* Crown Power & Equip. Co., L.L.C., 309 S.W.3d 798, 804 (Mo. 2009) (en banc) (Wolff, J. concurring) ("Actually getting to the merits of a controversy and having a trial is becoming an increasingly remote possibility as modern trials evolve, in part because of . . . discovery provisions . . . . In the federal court system, . . . only about 1.8 percent of cases survive to be tried. What aptly has been called 'the vanishing trial' is caused in large part by the misery and expense of civil discovery."); ROBERT BURNS, THE DEATH OF THE AMERICAN TRIAL 2 (2009) ("The percentage of federal civil cases that ended in trial declined from 11.5 percent in 1962 to an amazing 1.8 percent in 2002, *one-sixth as many* . . . [t]hough the absolute number of cases 'disposed of' . . . has increased fivefold[.]"); *DOJ*

of the cases filed in federal court culminated in a trial.[216] By 2002, that figure had declined to 1.8%.[217] In some states, today the figure is 0.6%.[218] The case is on trial during discovery,[219] and in the vast majority of cases that trial will dictate the terms of the pretrial settlement. As Professor Geoffrey Hazard has remarked, "pre-trial [discovery] is [now] *the* trial."[220] The reality is that in modern litigation, the importance of the pretrial phase dwarfs the importance of the trial. In most cases, there is no trial.

Since the pretrial stage is so much more important, it will often make sense, as in the case of new Evidence Rule 502, to

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Reports Huge Decline in Tort Cases Resolved Through U.S. District Court Trial, 74 U.S.L.W. 2104 (Aug. 23, 2005) ("The number of tort cases resolved by trial before a judge or jury in the U.S. district courts declined by 79 percent from 1985 through 2003, the Department of Justice's Bureau of Justice Statistics found in a report released August 17 . . . . Tort cases decided by verdict as a percentage of all tort cases 'terminated'—through settlement, dismissal, verdict, or summary judgment—in federal district court declined from about 10 percent in 1985 to less than 2 percent in 2003."); *Fewer Civil Cases Go to Trial*, Lawyers Weekly USA, May 10, 2004, at 12 (discussing a Justice Department report showing that far fewer civil disputes go to trial); Leigh Jones, *Coping with Dearth of Jury Trials*, NAT'L L.J., Aug. 16, 2004, at 4 ("By some estimates, jury trials have declined to less than 2% of all cases filed."); Leonard Post, *Federal Tort Trials Continue a Downward Spiral*, NAT'L L.J., Aug. 22, 2005, at 7 ("University of Pennsylvania Law School Professor Stephen Burbank said that with respect to the federal courts there are a number of causes operating against trials . . . . He cited as one cause the increased cost of litigation, including 'prominently' the cost of discovery . . . . Of the 512,000 civil cases resolved in fiscal years 2002–2003, 98,796 of them were tort cases and only 1,647 of them went to trial–a mere 2% []. . . . In the early 1970s, about 10% of tort cases went to trial."); Kenneth Ricci, *Design for Vanishing Trials*, NAT'L L.J., Jan 7, 2008, at 26 ("Research shows that the downward trend in jury trials encompasses municipal, county, state[,] and federal systems, in both civil and criminal matters.").

216. Marc Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. EMPIRICAL LEGAL STUD. 459, 460 (2004).

217. *Id.*

218. Refo, *supra* note 215, at 1–2.

219. *See* Hicks Epton, *Effective Use of Pretrial Discovery*, 19 ARK. L. REV. 9, 15 (1965) (stating that a party is "on trial" during deposition). *See also* Donald J. Zoeller, *Disposing of the Dispute Before Trial*, NAT'L L.J., Apr. 8, 1985, at 20 (stating that the "proper role of the litigator is to start 'trying' his case from the outset—not to treat discovery and other pretrial steps as merely necessary preparation for trial").

220. Charles Maher, *Discovery Abuse*, CAL. LAWYER, June 1984, at 46.

modify trial standards in order to enhance the efficiency of the pretrial phase. However, as experience with Evidence Rule 612 demonstrates, when the trial evidence standards are revised with little thought to the impact on the pretrial stage, the law of unintended consequences can come into play and produce unexpected, negative impacts on the critical pretrial stage. To borrow a phrase from environmental law, before any policymaker or drafter proposes a change to trial evidence law, he or she should consciously advert to possible effects on the pretrial stage; in effect, he or she ought to prepare a pretrial stage impact statement. Even a minor, negative impact on the 98% of the cases terminated without trial can outweigh a seemingly significant improvement in the evidence rules applied in the 2% of the cases that are tried. The pretrial stage is the dog, the trial is the tail, and the tail should rarely be permitted to wag the dog.

Of course, even if drafters and policymakers adopt a more consciously systemic perspective in formulating changes in pretrial practice and evidentiary standards, there will occasionally be unintended consequences. Try as they might, human beings cannot attain perfect foresight. However, it would be a step in the right direction if, as in the process of formulating new Evidence Rule 502, policymakers and drafters consistently forced themselves to think in broader terms and conceive of suggestions for changes in pretrial practice and evidence law as proposals for "litigation" reforms. The litigation system consists of dynamically related pretrial and trial phases. When a pretrial or evidence reformer neglects adverting to the other phase of the litigation process, the neglect dramatically increases the likelihood that the law of unintended consequences will trigger; and however well intentioned the "reform" is, on balance the system may suffer.

Army Lessons for Lawyer-Leaders

Jillian Trezza*

Leadership and legal acumen are not two concepts often thought of in conjunction with one another, but more and more, the legal community is emphasizing the importance of leadership for lawyers. And at a time of unsettling law firm financial woes and the unrelenting erosion of their professional reputations, attorneys are turning to the tools of leadership to combat the challenges threatening their profession. While the legal profession and the military have many differences, the cultivation and application of leadership in the military, and more specifically the Army, provides valuable and compelling insights readily employable in the lawyer-leader context.

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Today's attorneys grapple with complex issues and unique challenges. The legal market has recently turned into a highly competitive global market, with firms vying for increasingly sophisticated and fiscally savvy clients who have ready access to legal technologies and information that threaten attorney demand. Adding to these challenges, most attorneys will change jobs several times, work in different professional capacities—possibly in different legal fields—and constantly interact with new colleagues and clients. In short, attorneys today work in a legal environment riddled with competition and change. Successfully navigating this new professional world requires leadership skills. But leadership competencies are not just necessary for those in formal lawyer-leader positions; they are highly beneficial for all lawyers. From learning how to build consensus and work collaboratively to learning active listening and self-awareness skills, these capabilities cannot help but improve the legal culture and sustain professionalism in a tumultuous legal world.

Equally important, lawyers as professionals incur an obligation to society to render legal services competently, and above all, ethically. From this perspective, ethical leadership is a necessary component of lawyer leadership, and one that is critical to ensure enduring professional legitimacy and accountability. As legal professionals, attorneys must rededicate their efforts to serve society, ever cognizant of the central role they play in our democratic system.

Analogously, military professionals operate in an environment where flexibility and adaptability are crucial, where mission success requires much more than authoritative, formal leadership, and where ethical leadership is essential. For these reasons, military leadership can inform lawyer leadership.

Part I of this Note will explore the theoretical foundations of leadership and highlight several prominent leadership-development methods. Part II will provide a survey of leadership development in the Army officer context. Part III will discuss the role of leadership in the legal context, both at law school and beyond; and the final part will conclude with applicable Army lessons for lawyer leadership.

I. LEADERSHIP THEORY AND LEADERSHIP DEVELOPMENT MODELS

A. Leadership Theory

A foundation for leadership theory must first address the question of whether leaders are made or born. While this topic traditionally roused much debate, our understanding of leadership has advanced, and there is now a common acknowledgement that successful leaders are, in fact, made.[1] Specifically, Harry S. Laver and Jefferey J. Matthews in their survey of Army leaders note that, "leadership skills are learned and developed over the course of an individual's life and career through education, mentoring, and experience . . . leadership can be learned and applied."[2] While little serious debate on the subject lingers, a caveat is in order: some inherent traits and personality characteristics better enable leadership growth and application.[3] While leadership skills may come more naturally to some, others will have to work harder at it. Regardless of inherent potential, however, the best leaders are successful because they practice it, choosing to improve their skills and committing to exercise them.[4] The tether that ties leadership to learning is inextricably linked, and all individuals, despite innate qualities, may learn to acquire and apply the skills of effective leadership. And, as political theorist Niccolo Machiavelli shrewdly suggested in his seminal work, *The Prince*, even if one's skills fall short of those of "great men," by studying and imitating those attributes, "at least it will have the smell of it."[5]

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1. THE ART OF COMMAND 1 (Harry S. Laver & Jefferey J. Matthews eds., 2008).

2. *Id.*

3. *See, e.g.*, Michael J. Anderson, *Characteristics of the Best Managing Partners*, EDGE INT'L (2002), http://www.edge.ai/files/characteristics_of_the_best_managing_partners.pdf (describing inherent qualities of effective managing partners); Tricia Bisoux, *What Makes Leaders Great*, BIZED, Sept.–Oct. 2005, at 40, 42 ("We don't believe leaders are born, but that people are born with different potentials to lead . . . it can be learned . . . .") (quoting Paula Hill Strasser, director of the Business Leadership Center at Southern Methodist University in Dallas, Texas).

4. THE ART OF COMMAND, *supra* note 1, at 2.

5. *Id.*

To properly understand leadership theory, a definition of leadership is in order. As might be expected, however, there is no singular description, and myriad definitions abound.[6] Typically, two common themes persist: change and influence.[7] In its most basic form, leadership is defined as "generating ideas for change and acting successfully to get others to follow."[8] Other definitions of leadership are variations on this two-part concept and often qualify the two parts.[9] With this meaning in mind, the next step is to distinguish between leading and managing.

Academically, there is a generally recognized distinction between leading and managing. Simply understood, leadership is focused on influencing change, while management is concerned with "creating processes to produce predictable results."[10] In other words, managing is about effectively maintaining the daily workings of the organization and executing the organization's directives.[11] While there is scholastic merit to this divide, and it is often posited that strong leaders may not make strong managers and vice versa,[12] there is significant overlap between the skill sets, and many leadership-development models employ tactics and techniques that benefit both sets of capabilities.[13] For practical purposes, this Note will specifically reference leadership and will assume that organizations that implement leadership-development training intend to address both leadership and managerial skills.

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6. Mary Uhl-Bien, *Relationship Development As a Key Ingredient for Leadership Development*, *in* THE FUTURE OF LEADERSHIP DEVELOPMENT 129, 132 (2003). *See also* HERB RUBENSTEIN, LEADERSHIP FOR LAWYERS 13 (2008) (stating that there are more than 300 published definitions).

7. Uhl-Bien, *supra* note 6, at 132.

8. *Id.*

9. *See, e.g.*, ARTHUR G. GREENE, THE LAWYER'S GUIDE TO GOVERNING YOUR FIRM 26 (2009) (stating "a leader of the law firm is the person who, by words, actions and example, can articulate the firm's vision and inspire others to follow the lead"); Edwin A. Locke, *Foundations for a Theory of Leadership*, *in* THE FUTURE OF LEADERSHIP DEVELOPMENT 29, 29 (Susan E. Murphy & Ronald E. Riggio eds., 2003) (defining leadership as "the process of inducing others to pursue a common goal").

10. Roland S. Smith & Paul Bennett Marrow, *The Changing Nature of Leadership in Law Firms*, 80 NYSBA J., no. 7, Sept. 2008, at 33.

11. *See* GREENE, *supra* note 9, at 27 (noting that "managers carry out and implement the policies established by the firm's owners").

12. *Id.*

13. *See id.* (discussing the similarities and differences between leaders and managers).

Another helpful distinction that will further lay the foundation of leadership theory is that between *leader* development and *leadership* development. Leader development is focused on building individual knowledge, skills, and abilities to improve human capital,[14] and is often directed at developing leaders in formal leader roles.[15] These capabilities include qualities of self-awareness (e.g., emotional awareness), self-regulation (e.g., self-control), and self-motivation (e.g., initiative).[16] By contrast, leadership development is defined as "expanding the collective capacity of organizational members to engage effectively in leadership roles and processes."[17] Leadership development focuses on improving social capital, and concentrates on the development of interpersonal skills, including social awareness (e.g., empathy) and social skills (e.g., collaboration and cooperation).[18] It emphasizes the interaction between the individual and the social and organizational environment.[19]

Theorists and consultants alike suggest that the most effective leadership-development programs seek to address and improve both individual and relational competencies.[20] This understanding has important implications for lawyer-leaders. With the exception of individuals such as formal law firm leaders (managing partners and the like) who maintain positional authority and lead in a traditional sense, most attorneys require development of their *leadership* proficiencies. Since most lawyers rarely maintain leverage as a result of formal command authority, they must instead necessarily rely on interpersonal influence and relationships. Moreover, attorneys increasingly work collaboratively and in teams; while this may involve a loose chain of command structure, these interactions

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14. David V. Day, *Leadership Development: A Review in Context*, 11 LEADERSHIP Q. 581, 584 (2001).

15. Uhl-Bien, *supra* note 6, at 130.

16. Day, *supra* note 14, at 584 (Table 1).

17. *Id.* at 582.

18. *Id.* at 585.

19. *Id.*

20. *See id.* at 586 ("[I]t is proposed that more value resides in combining . . . [a] traditional, individualistic approach to leader development with a more shared and relational approach.").

benefit from informal leadership abilities, which enhance the organizational collective.

With these concepts in mind, attention can be turned to theories of leadership. It may come as a surprise to learn that theories of leadership flourish across many different academic disciplines. In 2010, the Harvard Business School published the *Handbook of Leadership Theory and Practice*, the result of a leadership colloquium, which explored six general scholastic perspectives on the topic including organizational theory, psychology, sociology, economics, history, and political science.[21] As a result, many permutations for organizing, categorizing, and articulating leadership-theory models exist. Generally speaking, however, most of the pervasive theories concentrate on one of three categories: the leader, the group, or the situation/setting.[22] This Note will survey a few of the most deeply entrenched theories in leadership literature.

1. The "Great Man" Theory

As the label might imply, the "Great Man" theory, also referred to as "trait theory,"[23] focuses on the individual leader, and this theory dominated leadership research from the turn of the twentieth century through the 1940s.[24] It claims that leadership is the result of some innate, intrinsic qualities and characteristics residing within the leader himself.[25] Research predicated on this theory focused on ascertaining those qualities and quantitatively assessing the relationship between identified leader traits and leader

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21. HANDBOOK OF LEADERSHIP THEORY AND PRACTICE 6–7 (Nitin Nohria & Rakesh Khurana eds., 2010).

22. SAMUEL H. HAYS & WILLIAM N. THOMAS, TAKING COMMAND 20 (1967). *See also* Bruce J. Avolio et al., *Leadership: Current Theories, Research, and Future Directions*, 60 ANN. REV. PSYCHOL. 421, 422 (2009).

23. John Storey, *Changing Theories of Leadership and Leadership Development*, *in* LEADERSHIP IN ORGANIZATIONS: CURRENT ISSUES AND KEY TRENDS 14, 17 (Table 2.1) (John Storey ed., 2003).

24. Arthur G. Jago, *Leadership: Perspectives in Theory and Research*, 28 MGMT. SCI. 315, 317 (1982).

25. *See* HAYS & THOMAS, *supra* note 22, at 20 (explaining that "leader-oriented theories" of history like the "Great Man" concept propose that leadership is a natural part of the personality of the leader and that throughout history it was thought that leadership was hereditary, and thus leaders were "born and not made").

effectiveness.[26] Historically, this theory rested on the assumption that leaders were born, not made, and that leadership was therefore hereditary, thus rationalizing archaic leadership lineage systems.[27]

Although scientists have since debunked the notion that leaders are born, not made, the underlying premise that certain personal characteristics make good leaders endures.[28] In 2005, a business education journal ran a piece titled, *What Makes Leaders Great.*[29] The article reported that educators have identified some common characteristics of excellent leaders, which they endeavor to foster in their students: self-awareness, personal conviction, courage, creativity, ability to inspire, ability to listen, ability to innovate, eagerness to experience, and willingness to reflect.[30] Such notions aside, leadership theory in its contemporary form instead recognizes that effective leaders share behaviors and competencies,[31] which are described below.

2. Behavior Theories

While "trait theory" focuses on what the leader *is*, behavior theories focus on what a leader *does*.[32] Behavior theories examine the leader's behaviors vis-à-vis the follower, and so concomitantly consider the group dynamic.[33] Although the various behavior theories are susceptible to problems of variation and lack of universal consensus,[34] there exist generally acknowledged essential leader proficiencies including: having and displaying vision, having strategic sense, having an ability to communicate the vision and

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26. Jago, *supra* note 24, at 317.

27. *See* HAYS & THOMAS, *supra* note 22, at 20 (asserting that this logic was fundamental to the feudal system).

28. *See id.* at 21 (noting that repeated scientific research failed to identify innate traits consistently shared by successful leaders).

29. Bisoux, *supra* note 3, at 40–45.

30. *Id.* at 42–44.

31. Roya Ayman et al., *Leadership Development in Higher Education Institutions: A Present and Future Perspective*, *in* THE FUTURE OF LEADERSHIP DEVELOPMENT 201, 216 (2003); Storey, *supra* note 23, at 25.

32. Norman L. Grunstad, *The Contingency Model of Leadership*, *in* AN ORGANIZATIONAL STUDY OF LEADERSHIP 405, 405 (1975).

33. Jago, *supra* note 24, at 319.

34. Storey, *supra* note 23, at 25.

strategy, and having the ability to inspire and motivate.[35] Similarly, the "style approach" emphasizes the style of behavior that a leader brings to bear on a specific situation (e.g., autocracy v. democracy).[36] Relational theories, discussed below, build upon this concept of leader–follower relations.

3. Relationship Theories

Expounding on the group dynamic of leader and follower interactions, several theories have emerged. Two of the most prominent are "path–goal theory" and "leader–member exchange theory."[37] The "path–goal theory" posits that the primary leadership goal is to motivate subordinate performance and enhance follower satisfaction through a series of leader behaviors.[38] One publication on leadership suggested eight specific behaviors, including: (1) identifying goals and securing follower "buy-in"; (2) identifying key obstacles and barriers to achieving goals; (3) ensuring proper support for followers to achieve the goals; (4) organizing and guiding followers to achieve the goals; (5) monitoring activity and driving any changes in strategy to achieve the goals; (6) identifying when the goal is achieved or if the effort has shortcomings; (7) rewarding effort in achievement of the goal; and (8) setting new goals for the group and repeating the process.[39]

"Leader–member exchange theory" also builds on the notion of leadership as a function of relational competencies. Leader–member exchange theory focuses on relationship building between the leader and an individual follower, or dyad.[40] It suggests that, since leadership requires influence and influence necessarily involves interpersonal associations, effective leadership results from the development of trust, respect, and mutual obligations between dyad members.[41] These leader–follower relationships grow into partnerships, and personal influence replaces formal positional authority when followers act because they *want* to, not because they

35. *Id.*
36. RUBENSTEIN, *supra* note 6, at 14; Jago, *supra* note 24, at 320.
37. Storey, *supra* note 23, at 17 (Table 2.1).
38. RUBENSTEIN, *supra* note 6, at 15.
39. *Id.*
40. Uhl-Bien, *supra* note 6, at 134.
41. *Id.*

have to.[42] The more developed the dyad relationship, the more effective the leadership.[43]

4. Contingency Theories

While the previous theories focused on the leader or the group, contingency theories are concerned with the situation or the environment.[44] These theories revolve around the notion that different situations call for different leadership behaviors.[45] One of the more prominent contingency-theory models evaluates leadership effectiveness according to three components in a given situation: (1) leader–member relations; (2) task-structure; and (3) position power.[46] Leader–member relations capture the degree to which group members trust and like the leader, while task-structure focuses on four aspects: (1) clarity of job requirements; (2) different ways to accomplish the job; (3) verifiability of job results; and (4) specificity with regards to an optimal job outcome.[47] Finally, position power refers to the leader's degree of formal positional authority to "direct, evaluate, reward and punish" members of the group.[48] The upshot of the model suggests that different leadership styles and behaviors are more amenable to certain combinations of these components and therefore increase leadership efficacy.[49] For example, a leader focused on his relationship with subordinate members may not perform optimally when the task-structure is very high.[50] As a result, proponents of this theory would concur that "it is simply not meaningful to speak of an effective leader or of an ineffective leader; we can only speak of a leader who tends to be effective in one situation and ineffective in another."[51]

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42. *Id.*
43. *Id.*
44. HAYS & THOMAS, *supra* note 22, at 25.
45. *Id.*
46. RUBENSTEIN, *supra* note 6, at 15; Jago, *supra* note 24, at 322–33.
47. Jago, *supra* note 24, at 322.
48. *Id.*
49. *Id.*
50. *See id.* at 324 (comparing the elements of a situation with leadership characteristics in Table 3).
51. *See id.* (quoting F.E. FIELDER, A THEORY OF LEADERSHIP EFFECTIVENESS 261 (1967)).

5. Current Theories: Post-Transformational and Post-Charismatic Leadership

Largely the result of destabilizing economic factors, including increased global competition and advancing technologies, the 1970s and 1980s were dominated by a resurgence in both transformational and charismatic leadership theories.[52] Although sharing some common characteristics, the two descriptions slightly vary. Charismatic leaders share six qualities: (1) heroic attributes; (2) in touch with higher truths; (3) values-driven; (4) "knows the way"; (5) vision for a more desirable and achievable future; and (6) cares for and develops followers.[53] With a somewhat different emphasis on inspiring organizational change through generating dedicated followers, transformational leadership is captured by four elements: (1) individualized consideration for the needs of the follower; (2) stimulates creativity and innovations; (3) motivates and inspires followers to achieve extraordinary feats; and (4) is a role model.[54] With organizations desperately searching for leaders to carry them through the tides of change and uncertainty, many highly influential management gurus began touting the need for increasingly charismatic and transformational leadership.[55]

By the late 1990s and early into the twenty-first century, leadership theorists became skeptical of these qualities, warning of the "dangers of narcissism and the associated misuse, and even, abuse, of power" that might attach to this variety of leadership.[56] Drawing on the personality schemes of Sigmund Freud, leadership theorists suggested that many narcissistic personalities had risen to prominent leadership positions with hubris, self-confidence, and the goals of glory, power, and admiration.[57] The economic events of the past few years, including the collapse of major global financial institutions, may have proved this point.[58]

Most recently, there has been a call for more tempered, cautious variations of charismatic and transformational leadership

52. Storey, *supra* note 23, at 30.
53. *Id.* at 28.
54. *Id.* at 29.
55. *Id.* at 31–32.
56. *Id.* at 32.
57. *Id.* at 33 (drawing on Michael Maccoby's work).
58. *Id.*

with a renewed focus on utilizing a diversity of leadership styles.[59] In addition, notions of leader accountability and constraints are increasingly gaining prominence.[60] This may be especially relevant in the context of lawyer leadership, where maintaining integrity and ethical responsibility is imperative to fostering professional legitimacy.

B. Models for Leadership Development

Just as there are many theories of leadership, there are many methods and models for developing these leadership skills. Many fall into one of four general categories: learning about leadership and organizational theory, including studying the works of prominent leadership theorists and traditional case-studies methods; self- and group-analysis techniques that focus on getting to know oneself through the use of feedback and assessment tools; experiential learning and simulation methods that advocate learning leadership by "doing" leadership; and finally, top-level strategy courses that involve sending individuals or groups, usually high-level personnel, to prestigious business schools for boot-camp style executive leadership courses.[61]

A couple of concrete examples of some popular leadership-development programs, or "interventions," are useful. One such example is "360-degree feedback," which falls squarely within the self-analysis category.[62] This technique involves systematically gathering (usually through written evaluations or interviews) perceptions about an individual's performance from all relevant perspectives, including peers, subordinates, and superiors.[63] By learning about themselves through multiple viewpoints, individuals hopefully gain intrapersonal insights that will improve their relationships with others and enhance team efficacy.[64]

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59. *Id.* at 34.

60. *See id.* ("A notable development is the idea of 'governance' as a means of ensuring that leaders act within certain boundaries and that they can be held to account.").

61. *Id.* at 27–28.

62. Day, *supra* note 14, at 587.

63. *Id.*

64. *Id.* at 589.

"Action learning" is an example of an experiential leadership-development tool that gained particular notoriety when used by erstwhile General Electric CEO, Jack Welch, for his "work-out" program.[65] The basic gist of this technique is to provide coordinated teams with real-world organizational problems and allow them to undergo a continuous process of learning, innovating, reflecting, and building relationships to achieve a collective solution.[66] The teams operate in an insulated environment, which allows for safe yet realistic training, and enables participants to be creative and push themselves and each other.[67]

While this barely scratches the surface of available leadership-development tools and techniques, it is important to note that many leadership programs incorporate several leadership-development techniques to construct a comprehensive, integrated development model. For instance, many management consultants recommend creating programs that mix assessment, challenge, and support tools.[68] So, for example, a program might begin with 360-degree feedback to evaluate an individual's performance (assessment), then, as a result of that feedback, the individual might receive a new job assignment (challenge) to stretch his capacity and leadership abilities, and finally, throughout the leadership challenge, the individual would receive emotional and motivational support to reflect on lessons learned and encourage perseverance (support).[69] In short, there are numerous combinations of leadership-development tools that can be used to create individualized or organizational leadership programs. Because of this abundance, organizations best serve their personnel by strategically and thoughtfully crafting their programs. Some recommended and critical questions to answer while constructing training include: What is the program designed to achieve? Who is the targeted audience (e.g., junior, mid-level, or senior management)? What needs to be learned? What leadership-development tools will best impart this education? What time schedule is optimal for training

65. *Id.* at 601.
66. *Id.*
67. *Id.* at 603.
68. Ayman et al., *supra* note 31, at 205.
69. *Id.* at 205–06.

(e.g., bi-monthly periodic sessions, intensive, week-long sessions, etc.)?[70]

With these theoretical and fundamental underpinnings in mind, we now turn to understanding leadership development in the military context.

II. LEADERSHIP DEVELOPMENT IN CONTEXT: THE ARMY

A. Fundamentals and Theories

In the Army, leadership and the profession go hand in hand. The Army's demands, expectations, and functions set it apart from all other professional groups and require both traditional, individualized leader training as well as social, interpersonal leadership training (for the purposes of this section, the term "leader development" will be used to stress the Army's emphasis on developing formalized leaders). As will be discussed, Army leadership training tends to be highly formalized and deliberate, with identified, lock-step training requirements necessary for career progression,[71] and often includes specialized training mandates for

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70. Shaun Killian, *Designing Leadership Development Initiatives: Clarifying the Why, Who, What, How and When*, 24 LEADERSHIP AND DEVELOPMENT 15, 15–17 (2010).

71. *See, e.g.*, Army News Service, *Common Core Course to be Requirement for Captains' Career Courses*, WWW.ARMY.MIL (Mar. 19, 2007), http://www.army.mil/article/2312/common-core-course-to-be-requirement-for-captains-career-courses/ (stating that the Captain's Career Common Core Course would become a requirement for graduation from all branch Captain's Career Courses beginning June 1, 2007); *Basic Officer Leader Course (BOLC)*, WWW.ARMY.MIL, http://www.army.mil/aps/09/information_papers/basic_officer_leader_course.html (last visited Nov. 15, 2012) (stating that the Officer Basic Courses (OBC) are required for newly-minted commissioned officers (i.e., recent graduates of The United States Military Academy at West Point or equivalent R.O.T.C. programs) before they arrive at their first assignments). Additionally, the Captain's Career Course (CCC) is necessary for mid-level officers, usually captains, prior to Battalion or higher staff positions or next-level command assignments. Finally, the U.S. Army Command and General Staff College (CGSC), which provides formal education and development for senior-level officers in joint, full-spectrum operations training, is usually necessary as a prerequisite for Battalion command assignments.

specific job assignments, including both primary[72] and additional duty obligations.[73] It is important to underscore, however, that while the Army, on an institutional and systemic level, dictates many formal and periodic training requirements, many informal and discretionary leader trainings occur with great frequency at individual unit levels.[74] This section will first explore some of the Army's unique professional leadership demands, as well as some supporting theoretical underpinnings. Then, it will discuss leader-development training initiatives designed to address these unique professional demands. In doing so, it will look separately at leader-development practices at the United States Military Academy at West Point (where cadets prepare to enter into the Army as commissioned officers)[75] and current trends and philosophies in leadership development for the modern Army leader. Finally, while

72. For example, the Company Commander and First Sergeant Course is required before Captain Commanders and First Sergeants (senior non-commissioned officers (NCOs)) take charge at the company or equivalent level. *See Information for Course CATC-CCFS 25*, ARMY TRAINING REQUIREMENTS AND RES. SYS., https://www.atrrs.army.mil/atrrscc/courseInfo.aspx?fy=2011&sch=757&crs=CATC-CCFS+25&crstitle=COMPANY+COMMANDER-+FIRST+SERGEANT+COURSE&phase= (last visited Nov. 15, 2012) (stating that CCFS "prepares each officer and senior noncommissioned officer scheduled for assignment as company commander or first sergeant for their duties . . . ").

73. For example, the Unit Movement Officer (UMO) Course is required for training and certification of officers who will be responsible for facilitating and preparing their units for deployment. *See Information for Course 8C-F17/553-F5*, ARMY TRAINING REQUIREMENTS AND RES. SYS., https://www.atrrs.army.mil/atrrscc/courseInfo.aspx?fy=2010&sch=551&crs=8C-F17/553-F5&crstitle=UNIT+MOVEMENT+OFFICER+DEPLOYMENT+PLANNING&phase= (last visited Nov. 15, 2012) (explaining that the course "addresses the mobilization and deployment processes at various levels of command within the Army").

74. *See, e.g.*, Mark A. Melanson & Alison D. Winstead, *Officer Professional Development: A Case Study in Officer Mentorship*, ARMY MED. DEP'T JOURNAL, Jan.–Mar. 2003, at 7 (describing how the Officer Professional Development program in the Army's Health Physics Program has grown). Commanders at the Battalion or Brigade level often lead periodic Officer Professional Development (OPD) sessions for the unit's officers. Fundamentally, it is an opportunity for a commander to develop his officers on whatever or however he deems fit. For example, a battalion commander might bring all his junior-level officers (i.e., lieutenants and captains) together over lunch to watch a video about leadership psychology and have the group discuss its implication and how they might apply its teachings. Additionally, a Brigade commander might set up weapons training sessions for all unit officers.

75. U. S. MILITARY ACAD. WEST POINT, http://www.usma.edu (last visited Nov. 11, 2012).

this Note specifically makes reference to commissioned Army officers, it should be noted that non-commissioned officers (NCOs) undergo similar Army training.[76]

While the Army's missions have varied greatly since its inception (from conventional war-fighting to peacekeeping),[77] the general qualities of successful military leaders remain largely unchanged.[78] Reflecting on his appointment as West Point's superintendent in 1945, General Maxwell D. Taylor[79] discussed his understanding of military leadership.[80] By drawing on historical case studies of outstanding military leaders, he compiled a list of attributes and separated them into four categories: professional competence, intellectual capacities, strength of character, and inspirational qualities.[81] He went on to describe the necessity of each: professional competence, General Taylor stated, is an expectation; a leader must have exhaustive knowledge of his job and

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76. *See The Army Noncommisioners Officer Guide*, HEADQUARTERS DEPARTMENT OF THE ARMY, Dec. 2002, at 1-26 to 1-29, *available at* http://armypubs.army.mil/doctrine/DR_pubs/DR_a/pdf/fm7_22x7.pdf (describing the course development for non-commissioned officers, including formal education, operational experience, and leader development programs).

77. *See generally* David R. Segal et al., *The Social Construction of Peacekeeping in America*, 7 SOC. FORUM 121 (1992) (explaining how the use of American soldiers as peacekeepers is a recent change in their military role and still has yet to be fully understood by American society).

78. *Compare* Maxwell D. Taylor, *Military Leadership: What Is It? Can It Be Taught?*, *in* DISTINGUISHED LECTURE SERIES, NATIONAL DEFENSE UNIVERSITY 423, 423 (1977) (discussing General Taylor's arrangement of the attributes shared by eminent military leaders into the categories of professional competence, intellectual capacities, strength of character, and inspirational qualities), *with* DOUG CRANDALL, LEADERSHIP LESSONS FROM WEST POINT 255 (2007) (discussing the results of a survey of the 101st Airborne Division conducted in 2003 identifying the top attributes of a leader who could be trusted to lead soldiers into combat as competence, loyalty, honesty, integrity, leads by example, self-control, confidence, courage, shares information, builds personal connections with subordinates, and has a strong sense of duty).

79. General Maxwell D. Taylor's career included: Command of the 101st Airborne Division in WWII, Commander-in-Chief of the Far East during the Korean War, Chief of Staff of the Army, and Chairman of the Joint Chiefs of Staff. Taylor, *supra* note 78, at 423.

80. *Id.*

81. *Id.*

be able to train subordinates.[82] He must then be able to supervise and evaluate these tasks.[83] As an additional component of professional competence, a military leader must maintain physical fitness due to the inherently strenuous demands of the military lifestyle.[84]

In the next category of intellectual capacity, the ideal leader "must acquire a disciplined and orderly mind."[85] Importantly, the leader's intellect must expand past military knowledge and embrace "diplomatic, political, and economic matters . . . [to understand] the military role in a setting of integrated national power derived from many sources."[86] Especially critical, General Taylor stressed, was the ability to write and speak masterfully, articulating information clearly and concisely at critical moments.[87] Next, leaders of character express such traits as reliability, courage, dedication to mission, determination, and self-discipline—they must "gain and retain the respect and confidence of their [soldiers]."[88] For, "[soldiers] going into danger want a leader they can count upon, one who though demanding much . . . will bring them back alive and victorious."[89] Finally, inspirational qualities of a leader are those that "can incite [soldiers] to unusual acts of valor."[90] According to General Taylor, while the previous categories of qualities were essential and contributed to the image of an ideal leader, there must be some elusive leader "spark" capable of producing extraordinary, tangible effects.[91] General Taylor reached his conclusions by surveying a few of the Army's eminent military leaders, choosing a group that greatly differed in leadership style and personality, though comparable in their masterful art of leadership.[92] His point demonstrates that these leadership qualities, while constant, can nevertheless take many different forms and manifestations.

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82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.* at 423–24.
88. *Id.* at 424.
89. *Id.*
90. *Id.*
91. *Id.*
92. *See id.* at 424–25 (discussing General George C. Marshall, General Douglas McArthur, General Omar Bradley, and General George S. Patton).

General Taylor articulated leadership in the language of the theoretical "great man" or "trait" framework, and, significantly, his sentiments are still relevant today. Writing nearly six decades later, Colonel Patrick Sweeney, former deputy head of West Point's Department of Behavioral Sciences and Leadership, conducted an interview of the 101st Airborne Division soldiers.[93] Colonel Sweeney asked 72 soldiers, all of whom had fought in 2003 during Operation Iraqi Freedom, to name the attributes of a leader who could be trusted to lead them in combat.[94] The top ten responses were: competence, loyalty, honesty/integrity, leads by example, self-control (stress management), confidence, moral and physical courage, shares information, builds personal connections with subordinates, and has a strong sense of duty.[95] It is not difficult to identify the significant overlap that persists concerning essential military leadership qualities, despite the passage of time.

Turning now to the relational or group theoretical perspective, military leadership requires two primary responsibilities: mission accomplishment and the welfare of soldiers.[96] Leaders' interactions with their soldiers and soldiers' relationships with each other have profound effects on these two imperatives.[97] The premise here is that all people, including soldiers, have personal needs (e.g., status, security, dignity, spirituality), many of which can be satisfied through personal interactions.[98] The leader's mission is to ensure that the group is united to accomplish a common purpose.[99] If the formal leader is unable to fulfill the group's individual needs, soldiers will turn to an informal leader who can, leaving the official leader with less influential power to accomplish the mission.[100] As a result of this competing authority, teamwork can become problematic and unit morale can become diminished.[101] Leaders must be closely attuned

93. CRANDALL, *supra* note 78, at 255.
94. *Id.* at 254–55.
95. *Id.* at 255.
96. HAYS & THOMAS, *supra* note 22, at 25.
97. *See id.* at 23–25 (discussing various group interactions).
98. *Id.* at 23.
99. *Id.*
100. *Id.*
101. *Id.*

to soldiers' relationships with each other as well.[102] During WWII, research established that during the stress of combat, one of the most important factors to the American soldier was faith in his fellow soldier.[103] The formal military leader then, must be especially conscious of cultivating relationships with his soldiers as well as between them.[104]

To cope with these challenges, effective leaders must attain the trust of their soldiers and inspire them to identify with the group's mission as a means of achieving higher order social needs.[105] This trust can be demonstrated by the leader's sincere appreciation for human dignity and encouragement of individual initiative; simply, soldiers want to know that their leader earnestly cares about them and has their best interest at heart.[106] Additionally, the leader must create an atmosphere that builds unity and cohesion among a group's members, encouraging them to interact with each other, take care of each other, and draw strength from each other.[107] Ultimately, the successful military leader must utilize his understanding of group and relational dynamics to maintain discipline, morale, and esprit de corps while pursuing mission goals.[108]

External variables add particular complexity to effective military leadership. Military units vary in size, structure, composition, and function.[109] Leaders must not only consider the *type* of unit they lead (i.e., basic training unit, logistical support unit, combat operations unit, etc.), but the *context* in which they lead; for example, leader behaviors vary depending if one is deployed overseas in combat or simply training within the safety of our borders.[110] Additionally, combat leadership may be more authoritarian, as the exigencies of battle require quick, decisive decision making.[111] In this environment there may be less space for

102. *Id.*
103. *Id.* (reporting on a study by Stouffer et al. in 1949).
104. *See id.* at 24–25 (discussing the importance of human relations for effective leadership).
105. *Id.* at 24.
106. *Id.*
107. *Id.* at 23.
108. *Id.* at 25.
109. *Id.* at 24.
110. *Id.* at 24–25.
111. *Id.* at 25.

individual, personal considerations, as the combat commander must make split-second decisions that focus on mission accomplishment and soldier welfare (i.e., keeping troops alive).[112] Relatedly, different leadership behaviors are necessary according to the level of command.[113] For instance, leadership at the lowest level is much more hands-on and particularized than at higher levels of command, where a senior echelon leader may focus on encouraging subordinate leader initiative, providing support, and delivering clear mission directives for subordinate units to follow.[114]

On an even more mundane level, a leader may vary his leadership behavior according to the "maturity," or competency and experience of the group.[115] For example, a platoon leader may take charge of his unit and find that his soldiers lack basic soldier competencies and experienced group members.[116] This leader will likely provide much more managed, structured, authoritarian leadership to build those capacities.[117] By contrast, a leader arriving to a unit that has seasoned, experienced subordinates and capable, competent soldiers should take on a less micro-managing role, and allow his soldiers to take more initiative.[118] In this way, situational leadership becomes crucial, and effective military leaders recognize these variables, adjusting their behavior accordingly.[119]

As has been discussed, successful Army leadership requires drawing on a vast array of leadership skills and knowledge. A military leader must be able to comprehend the various external and internal forces and dynamics affecting his unit and lead accordingly. In combat, this can mean the difference between life and death. For

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112. Wayne R. Wheeler & Louis S. Csoka, *Leader Behavior—Theory and Study*, *in* A STUDY OF ORGANIZATIONAL LEADERSHIP 309, 365 (1975).

113. HAYS & THOMAS, *supra* note 22, at 25.

114. *See* Leonard Wong et al., *Military Leadership: A Context Specific Review*, 14 LEADERSHIP Q. 657, 661 (2003), *available at* http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1004&context=usarmyresearch ("At a broad level, the model recognizes that leadership at different levels requires varying degrees of cognitive complexity and differential time–horizon foci.").

115. Wheeler & Csoka, *supra* note 112, at 365.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 364.

that grave reason, leader development is the cornerstone of military training, with all roads leading back to constant formal and informal leader education.

In the Army context, soldiering itself relies on leader capabilities. And while the military nominally focuses on *formal* leader development, the Army leader cannot be successful by dint of positional authority alone; he must also forge interpersonal relationships and influence others through *informal* leadership mechanisms. Finally, and critically, the military leader garners trust and respect through ethical leadership, which is vital to his professional reputation. Army leaders do not just view themselves as leaders of America's sons and daughters, but as servants and ambassadors of the nation. As professionals, they adhere to moral and personal values including honor, personal integrity, and self-sacrifice, always remembering the nation they represent, the mission they must accomplish, and the tremendous responsibility that accompanies their authority. With this perspective in mind, this section explores the methods and means for educating Army leaders in their vital craft.

B. Leader Development: West Point

The United States Military Academy at West Point (USMA) was established in 1802 as a permanent military institution.[120] Originally pioneered to develop military engineers, the Academy expanded as an institution of higher learning and grew into the self-described, "world's premier leader development institution."[121] Today, the Academy is a four-year undergraduate experience, which takes young civilians (cadets) and transforms them into Army leaders.[122] USMA's mission statement drives the organization and its ever-progressing leader-development program:

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120. Robert W. Thomas, Jr., Teaching Tomorrow's Leaders: A Comparison of Leadership Development at the United States Military Academy and the United States Naval Academy, 12 (2000) (Naval Postgraduate Thesis), *available at* https://www.archive.org/details/teachingtomorrow00thom (last visited Nov. 26, 2012) [hereinafter Teaching Tomorrow's Leaders].

121. *See id.* at 12–14 (explaining USMA's growth and development since 1802).

122. U.S. MILITARY ACAD. WEST POINT, http://www.usma.edu (last visited Nov. 11, 2012).

> To educate, train, and inspire the Corps of Cadets so that each graduate is a commissioned leader of character who is committed to the values of Duty, Honor, Country. Furthermore, these values are exemplified by each graduate's commitment to a career in the United States Army and a lifetime of service to the nation.[123]

In pursuit of these lofty, albeit necessary, goals, USMA created a formula for building these leaders: "Experience + New Knowledge + Reflection (with support and feedback) + Practice (more experience) = Leadership Growth and Development."[124] Leadership growth and development is thus realized through a 47-month cadet experience, coined the Cadet Leadership Development System (CLDS).[125] USMA pursues its mission by incorporating four developmental pillars: academic, physical, military, and moral/ethical.[126] In each of the four years of cadet leader training, the Academy seeks to instill and build specific leader competencies.[127] As a first-year cadet, students learn followership and the importance of taking care of themselves.[128] The first-year goal is for the budding leader to learn the subordinate perspective (especially since, by virtue of the Army hierarchy, every Army leader is simultaneously a leader and a follower), the importance of teamwork, and the reality that followers will have little faith in leaders that cannot first manage themselves. In addition, these cadets are introduced to basic soldiering skills, including the imperatives of discipline, duty, and integrity.[129] Second and third-

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123. *The West Point Mission*, U.S. MILITARY ACAD. WEST POINT, http://www.usma.edu/about/sitepages/mission.aspx (last visited Sept. 29, 2012).

124. Teaching Tomorrow's Leaders, *supra* note 120, at 15 (quoting Colonel Joseph LeBoeuf, former Director of Organizational Studies and Leadership at USMA).

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *See Academic Program: Curriculum and Course Descriptions*, U.S. MILITARY ACAD. WEST POINT, http://www.dean.usma.edu/sebpublic/curriccat/static/index.htm ("The academic program, like the other aspects of the West Point

year cadets are given increased leadership responsibilities and provided the opportunity to lead groups of subordinate cadets.[130] This allows mid-level cadets to begin experiencing real leadership responsibilities and to employ and experiment with the leadership styles and techniques they have been learning. These cadets continue to build upon their soldier skills and advance their technical and tactical military knowledge. Finally, fourth-year cadets are in charge of the entire Corps of Cadets and are in the process of transitioning to become newly-commissioned Army officers.[131] By this point, cadets have begun their leader development in earnest and have had countless leadership experiences with which to lay a foundation for their future careers.

In addition to using the organic structure of the cadet system to develop Army leaders by having cadets lead each other, cadets are required to take two formal, academic leader-development courses, one as a first-year cadet and one as a third-year cadet.[132] In the first-year course, cadets are introduced to general psychology to develop an "awareness and understanding of one's own behavior and the behavior of others. Emphasis is placed on applying the behavior principles learned to the cadets' . . . lives . . . as future officers."[133] As third-year cadets, students study leadership in a multidisciplinary manner, focusing on integrating theory and practice.[134] In this course, "cadet[s] also learn[] how to influence subordinates indirectly through organizational systems and procedures, organizational culture, and ethical climate."[135] In addition, cadets develop usable leadership products, including leadership notebooks, which allow students to reflect on, refine, and inform their personal leadership approaches.[136] The combined core leader-development curriculum is designed to allow leaders in any leadership situation to draw upon their own experiences and behavioral science education

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environment, is designed to foster development in leadership, moral courage, and integrity essential to such service.").

130. Thomas, *supra* note 120, at 15.

131. *Id.*

132. *Id.* at 36.

133. *See id.* at 27 (quoting the PL 100 General Psychology course description).

134. *See id.* at 28 (quoting the PL 300 Military Leadership course description).

135. *Id.*

136. *Id.*

to: (1) identify what is happening; (2) account for what is happening; (3) formulate leader actions to address the challenge(s); and (4) develop a personal approach to leading in a culturally diverse organization, which is assumed to be "volatile, uncertain, complex, and often ambiguous."[137]

Supplementing their academic learning, cadets enjoy constant opportunities for experiential leader training. As an example, one USMA experience is the cadets' time at Camp Buckner.[138] This intensive period of military training enables cadets to improve soldier competencies, but, equally importantly, it allows them to practice the art of peer leadership.[139] Although some cadets act as cadre for other cadets, cadets within the same year group can lead each other.[140] This foray into peer leadership forces cadets to draw upon behavioral resources outside of formal, positional leadership authority.[141] Students learn that motivating, teaching, and directing each other presents unique leadership challenges, as cadets are faced with the realization that variable group, relational, and situational circumstances require different approaches to leadership to be successful.

Although there are some aspects of leader development at USMA that have stayed relatively constant (e.g., the four-class cadet system), one of the most critical and powerful drivers maintaining USMA's preeminence has been its continued ability to innovate its leadership-development training and progress as an institution. The Academy is an evolving and learning organization that strives to prepare its future leaders for the challenges they may face. Most recently, USMA has been renewing its academic curriculum to supply the Army with an "officer corps capable of responding promptly and effectively to a diverse set of issues in environments

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137. *See id.* at 23 (describing the goals of the USMA leadership courses).

138. *Id.* at 37.

139. *See id.* (discussing the Camp Buckner experience and the importance of peer leadership).

140. *See id.* (quoting a cadet speaking of her Camp Buckner experience as saying, "With plebes you can just say, 'Do this,' and they will, but with your peers if you try that they will say, 'What's with the attitude?'").

141. *Id.*

that require innovation, flexibility, and adaptability." [142] To accomplish these goals, USMA is incorporating the beneficial aspects of a liberal education, which "enables students to become informed, responsible, self-directed learners[;] . . . cultivate[s] in students a sense of personal and social responsibility[;] . . . empower[s] students to be change agents[;] and . . . prepare[s] students for the unscripted challenges of an ill-defined world." [143] In short, the goal for cadets is to achieve transformational learning.[144]

By re-shifting its focus to the learning process itself, the Academy is increasingly providing educational opportunities that allow students to draw meaningful connections between the curriculum they learn and apply it in the context of global challenges.[145] For instance, during summer training, cadets now experience a "village scenario," a realistic setting replicating a generic Middle Eastern location, which develops students' leadership and ethical decision-making abilities under stress.[146] In the role-play, students must interact with civilians, translators, and local leaders and consider the variable consequences of all their actions.[147] USMA is also utilizing new technology to encourage collaborative and individualized self-refection.[148] As an example, online leadership forums and devices like e-portfolios enable students to exchange ideas, post leadership products, and network with other students, faculty, and active military mentors.[149] By encouraging cadets to think broadly and deeply, the Academy endeavors to develop leaders capable of effectively responding in an uncertain contextual environment.[150]

142. Bruce Keith, *The Transformation of West Point As a Liberal Arts College*, 96 LIBERAL EDUC., no. 2, 2010, *available at* https://www.aacu.org/liberaleducation/le-sp10/LESP10_Keith.cfm (last visited Nov. 26, 2012).

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

C. Leader Development: The Army Career

As discussed, leader development in the Army is an inherently critical component of overall military effectiveness, and professional military education is the heart of this development. In 2001, General Henry Shelton, former Chairman of the Joint Chiefs of Staff and pioneer of the current Army transformation model[151] stated, "our professional military education system performs a key role in this leader development endeavor and provides many important benefits to the force."[152] General Shelton's proposition emphasized the imperative for grooming future leaders to be intellectually dexterous, with a sound proficiency in matters ranging from advanced technology to geopolitics.[153] Mercurial threats to our national security, he explained, necessitate a military transformation, which is "first and foremost an intellectual exercise, requiring the brightest minds actively engaged in taking our armed forces to new and higher levels of effectiveness."[154] The military transformation he envisioned demands the development of new ideas, new equipment application, new weapons platforms, and new Army doctrine focused on culling joint power.[155] Without continued professional military education dedicated to fostering innovative, motivated, and adaptive individuals, he cautioned, our leaders will have difficulty harnessing necessary competencies across military agencies and with coalition partners to stay ahead of our unpredictable and adaptive adversaries.[156]

General Shelton was writing about the need to develop leaders who could thrive in a joint world—joint agency, joint coalition, and joint operations. Today, this joint operational world is a reality, and the Army is committed to developing leaders able to

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151. *See General H. Hugh Shelton Leadership Center*, NORTH CAROLINA STATE UNIV., http://www.ncsu.edu/extension/sheltonleadership/about/ (last visited Sept. 29, 2012) (discussing General Shelton's Joint 2020 initiative—the roadmap for the Future Joint Force).

152. Henry H. Shelton, *Professional Education: The Key to Transformation*, PARAMETERS, Autumn 2001, at 4, 7.

153. *Id.* at 8.

154. *Id.* at 7.

155. *Id.* at 15–16.

156. *Id.* at 12.

cope with its complexities and pressures. Most recently, General Martin Dempsey, the current Chairman of the Joint Chiefs of Staff, discussed developing leaders in this multifaceted and fluid environment.[157] His words captured the innovative and adaptive thinking the Army is striving to inculcate in its leaders, and are indicative of a transforming Army culture.[158] The modern Army leader, he explained, needs to be inquisitive and intellectually curious and capable, able to draw on various inputs and utilize disparate approaches and skills to apply creative solutions and adjust to rapidly changing situations.[159] Developing leaders of this caliber, he stressed, involves pushing individuals out of their comfort zones and providing them with truly varied experiences to create leaders with depth and breadth of expertise.[160] To this end, General Dempsey has suggested such radical approaches as allowing officers to take sabbaticals to enter into other areas of industry, so that leaders may return to the military reinvigorated with new ideas, new perspectives, and new competencies.[161] In some of his concluding thoughts, General Dempsey stressed the Army's need to allow the operating environment to "inform our leader development strategies."[162] With these enormous challenges in mind, General Dempsey is striving to make institutional adaptation a fixture in leadership development and education.[163]

These Army leader-development lessons afford fertile ground for lawyer leadership development. As will be explored below, the topic of leadership in the law has recently received due attention; today's attorneys are in a position to call upon these skills regularly, not only with their clients, but also in the legal community and when interacting with society as a whole. Like Army leaders, lawyers must learn to harness informal, behavioral, and relational leadership techniques to build cohesive working relationships with each other and their clients. And, especially in this new legal landscape of flux

157. Devin Hargrove & Sim B. Sitkin, *Next Generation Leadership Development in a Changing and Complex Environment: An Interview with General Martin E. Dempsey*, 10 ACAD. MGMT. LEARNING & EDUC. 528, 528 (2011).

158. *Id.*

159. *Id.*

160. *Id.* at 529.

161. *Id.* at 529–30.

162. *Id.* at 532–33.

163. *Id.* at 533.

and change, leadership skills facilitate adaptation to various situations and the ability to work collectively towards a common purpose. Additionally, as legal professionals, attorneys must be dedicated to their obligation to serve others responsibly and ethically—for they too are servants of the clients they represent and, to a larger extent, are entrusted by society to ensure legal and judicial accountability, maintain rule of law, and at times generate meaningful democratic dialogue.

The final substantive section will focus on leadership in the law. The primary discussion will revolve around leadership in the context of law firms, and then shift to an exploration of leadership in legal education, and finally, the role of lawyers as ethical and public sector leaders.

III. LEADERSHIP AND THE LAW

A. Law Firm Leaders

Roland Smith, senior faculty member for the Center for Creative Leadership (CCL), [164] apocryphally stated, "firms are placing their futures at risk if they cannot identify, develop and empower the next generation of leaders."[165] And it seems law firms are beginning to take heed. In 2008, the Association of Legal Administrators[166] supported a study that determined that the most powerful predictor of firm profitability was the quality of leadership.[167] Currently, leadership development is making headway

164. CCL is a non-profit educational institution devoted to leadership development and research. For details, see CTR. FOR CREATIVE LEADERSHIP, http://www.ccl.org/Leadership/legal (last visited Nov. 26, 2012).

165. *Leadership and the Law: A Brief Q & A with Roland Smith, Ph.D*, CENTER FOR CREATIVE LEADERSHIP, http://www.ccl.org/leadership/pdf/landing/CCLLegalSmithQA.pdf (last visited Nov. 26, 2012).

166. Association of Legal Administrators is an organization committed to facilitating legal management, professionalism, and governance. For details, see ASSOCIATION OF LEGAL ADMINISTRATORS, http://www.alanet.org/about/ (last visited Nov. 26, 2012).

167. Lauri Bassi & Daniel McMurrer, *Leadership and Law Firm Success: A Statistical Analysis*, MCBASSI & CO. (2008), http://mcbassi.com/wp/resources/

in the legal profession, as more and more law firms are devoting significant money and time to the endeavor.[168]

To understand the previously sluggish, albeit slowly progressing, momentum of leadership development in the legal field, it is helpful to explore the traditional law firm model. As one managing partner succinctly put it, "the historical model for law firms is to put [people] in leadership position[s] . . . often not because of leadership skills but because of [rainmaking] . . . and hope they don't drive into a ditch."[169] Traditionally, partners could rely on their firm to be stable throughout their lifetime, and associates from elite law schools, if they proved to be superstars, could continue with the firm into partnership and remain until retirement.[170] Lateral entry was considered uncommon, mergers were rare, growth did not equate to success, and clients were loyal to the firm, not to individuals.[171] Today, this model is hardly recognizable, as legal practice continues to transform into a competitive business.[172] The current model is marked by complexity, economic instability, and internal and external competition.[173] As one consultant described it, partners are more like sports figures, "periodically switching to the team that pays the

documents/WhitePaper-LeadershipAndLawFirmSuccess.pdf (finding statistical significance between leadership and law firm success).

168. *See, e.g.*, Jeff Blumenthal, *Lawyers Take Lessons on Leadership*, PHILA. BUS. J., Oct. 2, 2006, *available at* http://www.bizjournals.com/philadelphia/stories/2006/10/02/story10.html (describing leadership training for firms as one of the fastest-growing requests for a law firm consultancy group); Leigh Jones, *Are Law Firm Leadership Programs Worth the Money?*, LAW.COM (Mar. 4, 2008), http://www.law.com/jsp/article.jsp?id=900005504832 (last visited Nov. 26, 2012) (discussing the increasing number of law firms utilizing business school executive training programs like those at Harvard Business School and Wharton Business School); Mark Besse, *Leadership and Management Training for Partners: Three Major Philadelphia Law Firms Take the Lead*, JD BLISS (2006), http://www.jdblissblog.com/2006/11/leadership_and_.html (last visited Nov. 26, 2012) (exploring the growing trend of Philadelphia-based law firms sending their lawyers to leadership training programs).

169. *See* Deborah L. Rhode, *Lawyers and Leadership*, BERKELEYLAW 6 (2010), *available at* www.law.berkeley.edu/files/Paper_-_Deborah_Rhode.pdf (citing Gina Passarella, *Leadership Programs Born from Lack of Born Leaders*, THE LEGAL INTELLIGENCER (Nov. 5, 2007)).

170. Smith & Marrow, *supra* note 10, at 33–34.

171. *Id.*

172. *Id.*

173. *Id.* at 33.

most or who adds the most value to their client base."[174] The market for lawyers is now global, and lateral transfers into and out of a firm are commonplace. A firm focused on survival must be able to handle the loss of high-performing partners and support its teams.[175] Law firm growth has also accelerated because mergers have become more common and lateral entry of new attorneys has become typical.[176] In addition, internal competition is ubiquitous, with individuals and practice groups fighting for resources and income on the basis of hours billed and fees collected.[177] External pressure from a new breed of clients is further transforming the industry. Clients today are sophisticated, fiscally conscious, have ready access to information about legal services, and are more likely to regularly swap legal counsel for the right price than to stay with a firm out of loyalty.[178]

In this new law firm reality, where economics threatens to replace firm culture and competition is the norm, "strategic lawyer-leaders can make all the difference."[179] Yet with all of this impetus to develop firm leadership, some remain reluctant and others, even great lawyers, find leadership difficult. One generic explanation for why successful lawyers may not be successful leaders is based on the "leadership paradox" concept.[180] This is the notion that the very qualities that allow someone to successfully achieve a leadership position, such as drive for power, prestige, and money, are often exactly the opposite qualities necessary to perform effectively as a leader.[181] This paradox becomes exacerbated when considering the stereotypical characteristics of high-performing attorneys. As one author describes lawyer personality traits, "the kinds of people who are attracted into the legal profession—and who stay and become

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174. Larry Richard & Susan Raridon Lambreth, *What Does It Take to Develop Effective Law Firm Leaders?*, LAWPRACTICETODAY (Mar. 2006), http://apps.americanbar.org/lpm/lpt/articles/pmqa03061.shtml (last visited Nov. 26, 2012).

175. Smith & Marrow, *supra* note 10, at 34.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. Rhode, *supra* note 169, at 12.

181. *Id.*

successful—are less sociable, and more skeptical, more urgent, more analytical, more autonomous, and more defensive and thin-skinned."[182] And another echoes, "[lawyers] don't like being told what to do or how to do it."[183]

Adding further difficulty, Herb Rubenstein, author of the seminal *Leadership for Lawyers* and an ardent lawyer-leader advocate, describes institutional challenges stalling lawyer-leader development.[184] First, he says that lawyers consider themselves an elite part of society and think that being a good lawyer makes them a good leader.[185] Next, attorneys may not believe leadership development is necessary, since they might merely view themselves as artisans of a craft, agents of their clients, or they might be solo or small firm practitioners with no discernible need for leading others.[186] Third, most lawyers typically operate under extreme time pressure. As such, they may be less willing to sacrifice valuable time participating in continuing legal education that concentrates on leadership development where the benefits may not be readily apparent.[187] Finally, while lawyers may be strong communicators, many lack competency in the area of active listening, especially concerning peer and subordinate input.[188]

In light of these systemic obstacles and stereotypical personality traits, it is not surprising that leadership development has encountered difficulty. The CCL conducted surveys of law firm partners to get a sense of some of the challenges they face;[189] the results have telling implications of the need for leadership development. Lawyers in firm leadership positions identified five main areas in which they struggled, including building strategic leadership skills (e.g., developing the tools to lead change, improving teamwork, and creating buy-in to achieve a long term

182. Richard & Lambreth, *supra* note 174 (quoting research conducted by Dr. Larry Richard).

183. GREENE, *supra* note 9, at 27.

184. Herb Rubenstein, *Why Leadership Development Is Such a Hard Sell in the Legal Profession*, LEADERSHIP FOR LAWYERS 1 (2008), *available at* http://www.leadershipforattorneys.org/articles/3-H_Why-Leadership-Development.pdf.

185. *Id.*

186. *Id.* at 2.

187. *Id.*

188. *Id.*

189. As of 2008, the Center had interviewed more than 150 partners from multiple firms around the world. Smith & Marrow, *supra* note 10, at 34–35.

vision), managing talent and promoting sustainability (e.g., improving firm culture, understanding new generations of lawyers, and succession planning), making decisions and setting strategic goals (e.g., more efficiently building consensus, implementing strategic planning, and repositioning resources when core competencies are economically sluggish), retaining clients and promoting client satisfaction, and managing growth (e.g., developing new and existing markets and practice areas and deciding whether to expand).[190]

Confronting these significant challenges requires building lawyer-leader competencies. While identifying which specific lawyer-leader skills are most essential is open to debate,[191] the CCL created three major categories of leadership competencies based on the feedback they received from law firm partners.[192] Managing partners highlighted that lawyer-leaders must have technical excellence, intellect, and a high degree of emotional intelligence.[193] The CCL further deconstructed the category of emotional intelligence to capture the capacities for self-awareness (i.e., the ability to read one's emotions), self-management (i.e., the ability to manage one's emotions), social awareness (i.e., the ability to understand and react to others' emotions), and relationship management (i.e., the ability to inspire, influence, and develop others while managing conflict).[194]

Current leadership-development initiatives designed to enhance these and other similar critical law firm leadership competencies abound. One recent publication based on in-depth

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190. *Id.*

191. *See, e.g.*, Richard & Lambreth, *supra* note 174, at 4 (identifying technical competence, drive for results, and integrity as particularly important for lawyer-leaders). *See also* GREENE, *supra* note 9, at 27 (describing an individual with essential law firm competencies as one who can subordinate personal interests for the good of the firm, who is free from personal bias or agenda, who is non-political in the law firm context, and who is trusted as fair and even-handed); Maureen Broderick, *Leadership: Characteristics Grooming Selection*, *in* PLI LAW FIRM LEADERSHIP & MANAGEMENT INSTITUTE 467, 471 (2010) (identifying the top five qualities for a successful leader in a professional service firm as: coalition-builder, inspirational, visionary, good listener, and good communicator).

192. Smith & Marrow, *supra* note 10, at 36.

193. *Id.*

194. *Id.*

interviews with senior firm leaders describes approaches to leadership development that fall across four broad categories: informal exposure and opportunities for growth (i.e., experiential development whereby individuals progressively take on assignments that require increased management responsibilities), structured rotational assignments, mentoring, and formal development programs.[195] One consultant, however, warns of the inefficacy of sacrificing depth of training for breadth.[196] She advises, "you should take the best of your firm and practice leaders and help them achieve 90 percent or better levels of skills in three or more competencies rather than spend time on shallow programs that only move them all up 10 percent on one competency."[197] In addition, formal development programs offer integrated tools for leadership training and are growing in popularity.[198] Recent Wharton Business School Press literature by the CEO and founder of Broderick & Company[199] (a professional consulting, management, and training group for service firms) identifies best practices for these programs.[200] The common elements of the best programs included early identification of future leaders (usually in the first three to five years), multi-year, ongoing training sessions, formal mentoring and review, and special assignments.[201]

The CCL, by contrast, recommends increased emphasis on developing self-awareness as the "cornerstone for individual development and the foundation for group and organizational success," since attorneys tend to neglect this competency.[202] They endorse beginning the leadership-development journey with 360-degree feedback so that participants can first understand how others perceive them and could then appropriately posture themselves to better impact their group and the firm as a whole.[203] Most importantly, the CCL advocates promoting leadership skills that

195. Broderick, *supra* note 191, at 474.
196. Richard & Lambreth, *supra* note 174.
197. *Id.*
198. *See supra* note 168 (mentioning articles discussing the growing trend of law firm leadership programs).
199. BRODERICK & CO., http://www.broderickco.com/content/maureens-bio (last visited Nov. 11, 2012).
200. Broderick, *supra* note 191, at 475.
201. *Id.*
202. Smith & Marrow, *supra* note 10, at 36.
203. *Id.* at 37.

move distinctly away from an independent model of individual greatness, to a cooperative, interdependent model, which recognizes both individual and collective input as necessary for law firm success.[204]

While much of this section focuses on attorneys with traditional leadership responsibilities (i.e., individuals tasked with leading firms through economic transformation), lawyer leadership is for everyone. Leadership skills enhance organizational efficiency at every level. By recognizing behavioral aspects in oneself and others, improving communication and listening skills, and adjusting interactions based on context, lawyers cannot help but enhance their abilities to better represent clients and enrich their firm's culture. Yet even as the topic of lawyer-leader development has made strides within the context of big law firms, the notion is conspicuously absent in the context of legal education. The next section will focus on the current state of leadership development in law schools.

B. Law Schools and Leadership Development

While leadership development may be the topic de jure for a growing number of large corporate law firms, law schools have yet to fervently pursue the cause. As noted by prominent legal ethics scholar and leadership-development advocate Deborah Rhode, "[l]awyers' leadership responsibilities are a dominant theme in extracurricular programs, commencement speeches, and alumni awards, but the topic is missing in action in day-to-day teaching."[205] Putting a finer point on it, the CCL announced, "[l]eadership is not taught in any significant manner in law school."[206] Yet, as identified, the hypocrisy runs rampant, and many prominent attorneys are quick to acknowledge the leadership deficit. For example, a Distinguished Fellow at Harvard Law School stated, "today, law schools . . . may not have a broad vision of lawyers as leaders—or may be ambivalent or muted about it."[207] And a former president of the Association of American Law Schools observed that

204. *Id.*
205. Rhode, *supra* note 169, at 3.
206. Smith & Marrow, *supra* note 10, at 35.
207. *Id.*

law schools happily take credit for achievements of their distinguished graduates, yet have generally not focused on fostering leadership.[208]

Professor Deborah Rhode recommends three essential goals for an effective leadership-development curriculum, and advocates the incorporation of multiple teaching approaches to address different learning styles.[209] The teaching approaches she suggests include integrating research and theory, using problems and case studies, practicing with role-playing simulations, fostering group interaction, and analyzing literature and film, all for the purpose of inculcating leadership in a diverse audience.[210]

The first goal for those using these methods is to provide students with the tools of effective leadership, including understanding organizational theory, learning psychological aspects of leadership, and building interpersonal skills.[211] The second objective is to foster in students the imperative of life-long learning, so they can continue their own leadership development.[212] Finally, Rhode highlights the importance of ethical lawyering and creating a sense of responsibility to use legal leadership in the interest of the public good.[213]

In addition, because Rhode recognizes that some students may be reluctant to self-select into leadership-specific courses, core leadership competencies must be integrated into required classes.[214] For example, professional responsibility classes would offer an ideal environment to discuss a diverse range of leadership issues, from defining the appropriate supervisor–subordinate role to discussing law firm management.[215]

One school that is taking up the lawyer-leader call in earnest is Santa Clara University School of Law. Donald J. Polden, Santa Clara's Dean and a law school professor, described the goals of teaching leadership competencies in a recent law review article.[216]

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208. Rhode, *supra* note 169, at 3.
209. *Id.* at 11.
210. *Id.*
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.* at 12.
216. Donald J. Polden, *Educating Law Students for Leadership Roles and Responsibilities*, 39 U. TOL. L. REV. 353, 356 (2008).

Partnering with Santa Clara University's Leavey School of Business, the law school is drawing from the business school's assets to "educate its law students for leadership roles and responsibilities in the legal profession and in their communities."[217] Consistent with what the school views as a national trend to rededicate efforts on lawyering skills and values development, Santa Clara's law school is developing courses that teach leadership skills that are similar to courses in the business school.[218] These courses would foster attributes such as developing self-confidence, the ability to envision a need for change, the use of ethical conduct to shape reform, and the persuasion of others to achieve change.[219] As Dean Polden emphasizes, "leadership is for everyone,"[220] and by instilling these leadership qualities in its graduates, Santa Clara hopes to nurture "lifelong skills that will make [students'] work as lawyers more rewarding and beneficial to their clients and communities."[221]

The lack of impetus on the part of legal learning institutions is particularly troubling for students' professional prospects. Waiting until lawyers enter the workforce to develop these necessary leadership skills and a sense of ethical professional responsibility may be too little, too late for many. As will be discussed in the final section of this Note, law schools owe it to their graduates and to society to follow Santa Clara's lead, and schools can learn valuable lessons from military leadership schools such as West Point. As has been touched upon, there are those who recognize that ethical leadership is imperative for lawyers as professionals, especially (though certainly not exclusively) in the realm of public service and community leadership. The next section will focus on this topic.

C. Ethical and Public Sector Leadership

Lawyers serve as presidents, governors, state legislators, judges, prosecutors, and heads of government agencies and nonprofit

217. *Id.* at 353.
218. *Id.* at 356.
219. *Id.* at 357.
220. *Id.* at 356.
221. *Id.* at 357.

organizations,[222] just to name a few public leadership roles. Lawyers have a pivotal role to play in any democracy not only because they help to shape and enforce the law,[223] but also because they often find themselves at the forefront of social change.[224] As a result, lawyer leadership should be viewed not only as a means to attain power and status, but "as an exercise of social responsibility."[225] As Harvard lecturer Ben Heineman put it, lawyer-leaders should endeavor "to make our national or global society a 'better place.'"[226] From this perspective, legal professionals must strive to be ethical leaders in light of their profound societal duties and responsibilities.

Gregory H. Williams, current University of Cincinnati President, has explored the topic of lawyers as public leaders, and has reported troubling results.[227] According to his research, there is a marked decline in the number of lawyers serving in public capacities.[228] He advocates the need to support law students in their desire to lead and design curriculum to prepare students for these critical leadership roles.[229] Like Professor Rhode and Dean Polden, Williams endorses the need to build leadership capabilities, including self-awareness, listening skills, mediation skills, and consensus building during law school.[230] But Williams too focuses on the likelihood that lawyers will continue to be called upon as community leaders because of their traditional roles in government and public service.[231] And, in addition, attorneys are more likely to be called on to give political and policy advice, which can have significant public impact.[232] In preparation for these occurrences, Williams suggests incorporating into classroom discussions public policy issues from the perspective of a lawyer-leader (not just as an advocate) and creating opportunities for experiential learning outside

222. Rhode, *supra* note 169, at 1.

223. *Id.* at 7.

224. Polden, *supra* note 216, at 358; Rhode, *supra* note 169, at 11.

225. Rhode, *supra* note 169, at 7.

226. *Id.* at 11.

227. Gregory H. Williams, *Teaching Leaders and Leadership*, ASS'N FOR AM. LAW SCHOOLS (1999), *available at* www.aals.org/presidentsmessages/leaders.html (last visited Nov. 26, 2012).

228. *See id.* (citing the decline in the number of lawyers serving in the Ohio legislature from 40% in the 1970s to 20% currently).

229. *Id.*

230. *Id.*

231. *Id.*

232. *Id.*

the classroom.[233] Making experiences such as legal clinics, public service programs, and Street Law activities increasingly available creates opportune leadership and skills-learning environments and discussion forums.[234]

But Williams does not stop at simply urging law schools to foster lawyer-leader development for their students; he explicitly calls for educators to enhance their ability to serve as role models for future public leaders.[235] For instance, faculty members should expose themselves to inter-disciplinary study in order to draw from disciplines like urban planning, sociology, economics, and philosophy to better support students in their preparation to face varied leadership challenges.[236] In addition, he encourages faculty not to back down from assisting students to shape their professional paths, but to instead take the opportunity to guide and counsel students in their quest to prepare themselves as likely public or professional leaders.[237] Like the educational processes and goals of USMA's liberal education, Williams suggests broadening the law students' scope and perspective to assist in whatever legal or public context lawyers might find themselves.[238] By enabling attorneys to view the challenges and consequences of their actions across disparate contexts, outside of their niche role as client advocates, attorneys will be better equipped to employ sound, responsible judgment in a public and social setting.

Fortunately, law schools like Santa Clara are slowly proving these sentiments have not fallen on deaf ears. Dean Polden has explicitly addressed the connection between leadership education and the role lawyers will undoubtedly continue to play in politics, social movements, and professional contexts,[239] and he states, "leadership education attempts to inform all lawyers that they have the ability and the responsibility to lead, ethically and morally, in

233. *Id.*
234. *Id.*
235. *Id.*
236. *Id.*
237. *Id.*
238. *See id.* ("[W]e could be preparing leaders to serve a wide range of communities.").
239. Polden, *supra* note 216, at 358.

their law firms, communities, and the profession."[240] The final section will draw conclusions for lawyer-leadership development.

D. *Army Lessons for Lawyer-Leader Development*

Perhaps the most significant lesson legal professionals can derive from military professional development is early inculcation of professional and leadership attributes. Like the intentional cultivation of skills at USMA,[241] law schools must recognize that purposefully instilling traditional leadership skills and ethical leadership notions is vital to the maintenance and improvement of the legal professional identity. Simply stated, without society's trust, the profession will continue to crumble.

In the law school context, leader development at USMA affords compelling lessons. It is critical for legal educators, like USMA instructors, to appreciate that leadership development is a continuous process that will, if taught correctly, sow the seeds of life-long learning and growth. The USMA education model assumes that traditional leadership skills and the concept of what it means to be a professional must be *learned*.[242] This is significant. Attorneys must not think of themselves as professionals merely because of their expertise. Professionalism necessarily involves much more. For lawyers, it must involve recognition of their duty to society to seek justice ethically and responsibly, ever mindful of their critical role in the judicial system, and in a larger context, as safeguards of democracy. These lessons of professionalism and ethical leadership must be the foundation of a proper legal education; without this foundation, lawyers are unlikely to recognize their professional imperatives, and the legal profession risks relegation to a vocational, technical endeavor.

Law school, too, must develop its students' leadership skills. As discussed, lawyers today operate in an environment wrought with change and instability. In such a context, leadership skills are not just essential for formal lawyer-leaders who lead organizations as a business endeavor, but for all attorneys, at every level of an organization. Understanding behavioral and relational leadership

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240. *Id.* at 359.

241. *See supra* Part II.b (describing leadership development at West Point).

242. *See supra* Part II.b (describing the 47-month Cadet Leadership Development System).

techniques and building interpersonal capacities is vital to flourishing amid unpredictability. Relatedly, just as USMA equips its graduates with the leader skills necessary to recognize a challenge from varying perspectives,[243] to understand leaders' actions and the subsequent implications of those actions, and to draw skills from multiple disciplines, law schools, as Williams suggests,[244] should incorporate similar methods. Attorneys should have the ability to view their actions holistically, understand the effects of their actions in different contexts, and draw upon knowledge from various fields in order to solve problems.

Once lawyers enter the workforce, they must continue developing their skills and improving their professionalism. Above all, this involves acknowledging that professional maintenance and leadership development must be a purposeful endeavor, one requiring constant reevaluation and methodical application. To this end, legal organizations should follow the Army's lead and be learning and adaptive organisms, able to identify strengths and weaknesses in leadership programs and adapt to the changing needs of the operating environment.

IV. CONCLUSION

A poll conducted in 2009 illustrated an alarmingly low level of public trust in legal professionals—only eleven percent of Americans have great confidence in people running law firms, and nearly one-third has hardly any confidence at all in those leaders.[245] If the legal profession is to overcome the profound challenges presented by increased economic complexity, technological innovation, and relentless attacks on its moral and ethical foundation and emerge victorious, it must employ the tools of leadership. And, while major law firms are beginning to lead the current charge, all lawyers must recognize the leadership imperative. Beginning with laying the proper foundations for lawyer-leaders at the law school level, to continued learning sponsored by professional legal

243. *See supra* Part II.b.
244. Williams, *supra* note 227.
245. *Id.*

organizations, lawyers must recognize and embrace their roles as leaders, or risk losing leadership's vast potential and further eroding their professional reputation. Lawyers must recognize that leadership does not simply happen; the best leadership derives from purposeful and systematic nurture, practice, and application.

Like most cultural transformations, however, change is most easily championed from the top, and senior lawyer-leaders must make conscious decisions to devote valuable financial resources and time to the pursuit of leadership development. Hopefully, as dedicated professionals, lawyers concerned with both their bottom lines and the public trust will increasingly see that the cost of developing leadership is well worth the investment.

Ethics, Justice, and Prosecution

Don J. DeGabrielle and Eliot F. Turner*

In *Berger v. United States*, Justice George Sutherland wrote what has become an oft-cited maxim:

> The United States Attorney is the representative not of an ordinary party to a controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all; and whose interest, therefore, in a criminal prosecution is not that it shall win a case, but that justice shall be done.[1]

As commendable as Justice Sutherland's command "that justice shall be done" is, it needs elaboration. Justice Sutherland himself identified two principles to inform the prosecutor's pursuit of this objective.

The first was substantive: "that guilt shall not escape or innocence suffer."[2] The second was procedural. Thus, while a prosecutor "may strike hard blows, he is not at liberty to strike foul ones. It is as much his duty to refrain from improper methods

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1. Berger v. United States, 295 U.S. 78, 88 (1935) (Sutherland, J.).
2. *Id.*

calculated to produce a wrongful conviction as it is to use every legitimate means to bring about a just one."[3]

As abstractions, neither principle is problematic. Prosecutors (we expect) aren't wont to seek indictments or try cases against people they believe are innocent in the first place. Still, "in some cases it is uncertain whether someone is guilty . . . or innocent of some crime."[4] Although criminal procedure has developed since Sutherland wrote, and there are now better-defined rules, it is not always clear when those rules apply. For example, that evidence is exculpatory is in many instances self-evident, but in other cases, it may only be apparent when the evidence is viewed in context or as a case develops.

And so, despite (in most cases) best intentions, prosecutors sometimes do not abide by Justice Sutherland's command. Yet it is all the more important that they do so now. Prosecutorial power has increased as our criminal justice system has moved away from an adversarial system to one of negotiated pleas. Sentencing is more often than not dictated by mandatory minimums or guidelines calculations, which vests more power in the prosecutor through charging decisions. The traditional tools for checking prosecutorial abuse—judges and the juries—have a much smaller role in the process than they once did. Finally, remedial measures, like suits for damages, are all but nonexistent. As a delegate to the Constitutional Convention remarked: "[T]he life of a citizen ought not to depend on the fiat of a single person. Prejudice, resentment, and partiality are among the weaknesses of human nature, and are apt to pervert the judgment of the greatest and best of men."[5]

But because the life or liberty of the accused now depends increasingly on the decisions of one person, the prosecutor's commitment to seeking justice is all the more important. Here, we try to identify what one facet of seeking justice means and then examine the somewhat more beguiling question of how it could be better sought.

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3. *Id.*

4. RONALD DWORKIN, A MATTER OF PRINCIPLE 72 (1985).

5. Letter from William Pierce, Ga. Delegate, Constitutional Convention, to St. George Tucker (Sept. 28, 1787), *available at* http://etext.virginia.edu/etcbin/toccernew2?id=DelVol24.xml&images=images/modeng&data=/texts/english/modeng/parsed&tag=public&part=183&division=div1 (last visited Nov. 16, 2012).

I. THAT JUSTICE SHALL BE DONE

Sutherland was right that questions of guilt or innocence are paramount in determining whether justice has been done. Since Blackstone wrote his *Commentaries*, lawyers have been taught that it is "[b]etter that ten guilty persons escape than that one innocent suffer."[6] And as the legal philosopher Ronald Dworkin has also noted: "People have a profound right not to be convicted of crimes of which they are innocent."[7] Of course, not everyone feels the same. As one jurist remarked: "Our procedure has been always haunted by the ghost of the innocent man convicted. It is an unreal dream."[8] However unreal, and there is much to suggest it is not, Sutherland's second principle—procedural fairness—has been a key element of American criminal justice since (and even before) the Founding.

Think of the degree to which the Bill of Rights is concerned with criminal procedure. The Fifth Amendment prohibits civilians from being tried for a felony unless they are first indicted by a grand jury.[9] It also prevents any person from being tried twice for the same offense.[10] And finally, it prevents anyone from being compelled to be a witness against himself.[11]

The Sixth Amendment continues. It gives the accused "the right to a speedy and public trial, by an impartial jury," to be informed of the charges against him, to confront his accusers, to compel the attendance of witnesses in his favor, and, finally, to the assistance of counsel for his defense.[12] Without even considering the Fourth or Eight Amendments, the Bill of Rights contains eleven provisions about how to conduct *fair* criminal prosecutions.

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6. 4 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 358 (1765).

7. DWORKIN, *supra* note 4, at 72.

8. United States v. Garsson, 291 F. 646, 649 (S.D.N.Y. 1923) (Hand, J.).

9. U.S. CONST. amend. V.

10. *Id.* Of course, there are exceptions to this rule as well; indeed, you can be tried for the "same" offense, so long as the prosecutions are conducted by separate sovereigns. *See* Heath v. Alabama, 474 U.S. 82, 88–89 (1985) (allowing prosecutions by two states for the same conduct); Bartkus v. Illinois, 359 U.S. 121, 133 (1959) ("Since *Lanza* the Court has five times repeated the rule that successive state and federal prosecutions are not in violation of the Fifth Amendment. Indeed Mr. Justice Holmes once wrote of this rule that it 'is too plain to need more than statement.'") (internal citation omitted).

11. U.S. CONST. amend. V.

12. U.S. CONST. amend. VI.

Additionally, even before the Bill of Rights was adopted, the Constitution already addressed criminal procedure—though to a lesser degree—because it too required "[t]he trial of all crimes . . . by jury."[13]

The requirement that the prosecution disclose evidence material to guilt or innocence is now central to our conception of fair play, but is not among those rights enumerated in the Bill of Rights. Rather it comes from the due-process clause. The right, as it was announced in *Brady v. Maryland*,[14] has its forbearer in Justice Sutherland's maxim.[15] Despite its pedigree, and its common-sense appeal, it remains among the most troublesome procedural rights to vindicate. Although Justice Stevens once wrote that "[i]f the suppression of evidence results in constitutional error, it is because of the character of the evidence, not the character of the prosecutor," a prosecutor's character has much to do with how and whether *Brady*'s command is followed.[16]

Our criminal justice system places a remarkable degree of confidence in procedures as safeguards for substantive justice and has for quite some time. Indeed, "[t]he history of liberty has largely been the history of observance of procedural safeguards. And the effective administration of criminal justice hardly requires disregard of fair procedures imposed by law."[17] Here, we identify some reasons why *Brady* is sometimes disregarded and discuss why its requirements are not coextensive with the prosecutor's obligation to the seek justice.

II. BRADY AND THE PROBLEM OF SELF-POLICING

Brady held that "the suppression by the prosecution of evidence favorable to an accused upon request violates due process where the evidence is material either to guilt or to punishment,

13. U.S. CONST. art. III, § 2.

14. 373 U.S. 83, 87 (1963) (holding that "the suppression by the prosecution of evidence favorable to an accused upon request violates due process").

15. *See* Scott Sundby, *Fallen Superheroes and Constitutional Mirages*, 33 MCGEORGE L. REV. 645, 646 (2002) (linking the *Brady* opinion to Justice Sutherland's "justice shall be done" maxim).

16. United States v. Agurs, 427 U.S. 97, 110 (1976).

17. McNabb v. United States, 318 U.S. 332, 347 (1943) (Frankfurter, J.).

irrespective of the good faith or bad faith of the prosecution."[18] The Court's rationale was largely built on an ethical conception of justice. It proclaimed:

> Society wins not only when the guilty are convicted but when criminal trials are fair; our system of the administration of justice suffers when any accused is treated unfairly. An inscription on the walls of the Department of Justice states the proposition candidly for the federal domain: "The United States wins its point whenever justice is done its citizens in the courts." A prosecution that withholds evidence on demand of an accused which, if made available, would tend to exculpate him or reduce the penalty helps shape a trial that bears heavily on the defendant. That casts the prosecutor in the role of an architect of a proceeding that does not comport with standards of justice, even though, as in the present case, his action is not "the result of guile."[19]

In the years following *Brady*, the Court expanded its holding. In *Giglio v. United States*, the Court held that *Brady* extended to impeachment evidence.[20] In *United States v. Agurs*, the Court held that the *Brady*'s disclosure obligation was self-executing, that is, the prosecution had to disclose exculpatory evidence even in the absence of a request from the defense.[21] Finally, the Court clarified in *Kyles v. Whitley* that *Brady* extends beyond just what is known to prosecutors to information held by the police and others assisting in the prosecution.[22]

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18. *Brady*, 373 U.S. at 87.

19. *Id.* at 87–88.

20. *See* Giglio v. United States, 405 U.S. 150, 154–55 (1972) ("When the 'reliability of a given witness may well be determinative of guilt or innocence,' nondisclosure of evidence affecting credibility falls within [the *Brady* rule].").

21. *See Agurs*, 427 U.S. at 108 (holding that a prosecutor violates his constitutional duty of disclosure if his omission "is of sufficient significance to result in the denial of a defendant's right to a fair trial").

22. *See* Kyles v. Whitley, 514 U.S. 419, 421 (1995) ("We hold that the prosecutor remains responsible for gauging that effect regardless of any failure by the police to bring favorable evidence to the prosecutor's attention.").

A. Structural Problems

Brady still leaves much to be desired. The standard itself has limitations. Although perhaps not self-evident, it is not always clear when or what evidence is exculpatory.[23] *Brady*'s second limitation is that it only requires disclosure of exculpatory evidence that is material. The Supreme Court has explained that "evidence is 'material' within the meaning of *Brady* when there is a reasonable probability that, had the evidence been disclosed, the result of the proceeding would have been different."[24] The courts of appeals have elaborated the materiality standard further. The Seventh Circuit has adopted a restrictive approach that requires evidence must be admissible to be material under *Brady*.[25] Other courts have been less stringent, and only require that the *Brady* materials be "'reasonably' likely to lead to the discovery of admissible evidence" in order to satisfy the materiality standard.[26] The dissenters in *Brady* also thought that due process would require disclosure of exculpatory materials only "if the [exculpatory] statement would have been admissible on the issue of guilt at [the] original trial."[27] The United States Attorney's Manual, although it cautions prosecutors to "err on the side of [disclosure]," also notes that "ordinarily[] evidence that would not be admissible at trial need not be disclosed."[28]

All this leaves much discretion to the prosecution. Thus, although *Brady*'s animating principle is that in order to receive a fair trial, a defendant ought to receive all potentially exculpatory evidence, its force is undercut by its subjective application. *Brady* leaves it to the prosecution to determine first whether evidence is

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23. Daniel S. Medwed, *Brady's Bunch of Flaws*, 67 WASH. & LEE L. REV. 1533, 1540 (2010) ("But the prospect of error is enhanced by the vagueness of the duty's doctrinal formulation.").

24. Cone v. Bell, 556 U.S. 449, 469–70 (2009).

25. *See* United States v. Salem, 578 F.3d 682, 686 (7th Cir. 2009) ("Only admissible evidence can be material, for only admissible evidence could possibly lead to a different verdict.").

26. Banks v. Workman, No. 10-5125, 2012 WL 3834733, at *7 (10th Cir. Sept. 5, 2012); United States v. Mahaffy, 693 F.3d 113, 127 (2d Cir. Aug. 2, 2012) (quoting Youngblood v. West Virginia, 547 U.S. 867, 870 (2006)); United States v. Brown, 650 F.3d 581, 588 (5th Cir. 2011) (quoting United States v. Bagley, 473 U.S. 667, 682 (1985)).

27. *Brady*, 373 U.S. at 93 (Harlan, J., dissenting).

28. DEPARTMENT OF JUSTICE, UNITED STATES ATTORNEY'S MANUAL § 9-5.001(B)(1).

exculpatory, and second, whether there is a reasonable probability that the evidence will affect the outcome of the trial. In addition, the prosecutor must ask whether the potential *Brady* material is admissible or likely to lead to the discovery of admissible evidence. This is to say nothing of the difficulty that impeachment evidence presents, which involves more nuance still. In short, *Brady* itself is not always clear about what it requires.[29]

The Court has been explicit about what *Brady* does not mean. Although, Justice Douglas's opinion in *Brady* relied heavily on a moral rationale for the rule—that rationale was somewhat reformulated later. By the time *United States v. Bagley* was decided, justice was not neglected, but it came with a caveat: "The *Brady* rule is based on the requirement of due process. Its purpose is not to displace the adversary system as the primary means *by which truth is uncovered*, but to ensure that a miscarriage of justice does not occur."[30] Thus, a "prosecutor is not required to deliver his entire file to defense counsel, but only to disclose evidence favorable to the accused that, if suppressed, would deprive the defendant of a fair trial."[31]

In addition, courts have held that *Brady* does not require the prosecution to disclose evidence within its possession that a defendant could have obtained himself with "reasonable diligence."[32] In short, in some instances *Brady*'s nuances make it less than clear what information needs to be disclosed and when. But because exculpatory information always relates to the prosecutor's mission in seeking justice, it should almost always be disclosed to the defense.

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29. *See* Thompson v. Connick, 553 F.3d 836, 853 (5th Cir. 2008), *aff'd on reh'g* 578 F.3d 293 (5th Cir. 2009), *rev'd* 131 S. Ct. 1350 (2011) (noting that "[m]any of the attorney witnesses testified that *Brady* was a 'gray' area, subject to interpretation . . . . Besides the difficulty in interpreting *Brady*, there was evidence that many of the attorneys in the DA's office were only a few years out of law school, and thus lacking the legal experience that could have helped them clarify *Brady* issues without additional training").

30. United States v. Bagley, 473 U.S. 667, 675 (1985) (emphasis added).

31. *Id.*

32. *See, e.g.*, United States v. Infante, 404 F.3d 376, 386–87 (5th Cir. 2005) ("*Brady* rights are not denied where the information was fully available to the defendant and his reason for not obtaining and presenting such information was his lack of reasonable diligence.").

B. *Identifying* Brady *Violations*

The second problem with *Brady* is that violations of the rule are not always apparent. Because *Brady* requires a prosecutor to disclose something that *is not known* to the defense, its violation is likely to be discovered only by happenstance. That, in addition to the subjective determination about whether to disclose evidence in the first place, perhaps increases the temptation for some to ignore the rule.[33] Defendants generally learn of *Brady* violations in two ways. The first is through the prosecution's own admission—whether that be through the late realization that some exculpatory evidence has been withheld or through a change in the prosecution team that then identifies the withheld evidence. The second scenario involves some "chance discovery" by someone on the defense team.[34]

Shelton v. United States presents an example of the first scenario.[35] Arnell Shelton was prosecuted for his alleged participation in the drive-by shooting of Christopher Boyd.[36] Two days after the shooting, Boyd told a detective that Shelton shot him.[37] But a mere forty minutes after the shooting, Boyd told another police officer that he did not know who the shooter was.[38] That officer also brought up a possible motive Shelton might have had for shooting Boyd.[39] The officer's interview notes made it into the government's file, but the information was not disclosed to the defense during Shelton's first trial.[40] That trial ended in a mistrial and by the time a second trial was set, the original prosecutor had been replaced.[41] The replacement prosecutor, along with several others in the U.S. Attorney's Office, recognized that the notes of the first officer's interview should have been disclosed to the defense,

33. *See* Connick v. Thompson, 131 S. Ct. 1350, 1370 (2011) (Ginsburg, J., dissenting) ("*Brady* violations, as this case illustrates, are not easily detected.").

34. *See id.* ("But for a chance discovery made by a defense team investigator . . . the evidence that led to [Thompson's] exoneration might have remained under wraps.").

35. Shelton v. United States, 26 A.3d 216, 219–20 (D.C. 2009).

36. *Id.* at 217–18.

37. *Id.* at 218.

38. *Id.* at 219.

39. *Id.*

40. *Id.*

41. *Id.* at 220.

but they were not until the prosecution team changed before the second trial.

It is not always the case that *Brady* violations are only revealed by prosecutors when there is a change in the prosecution team. In *Imbler v. Pachtman*, the initial prosecutor discovered information after trial that corroborated the defendant's alibi and would have impeached the prosecution's principal witness.[42] Although the prosecutor did not believe that the evidence established the defendant's innocence, he revealed it because he believed a "prosecuting attorney had a duty to be fair and see that all true facts whether helpful to the case or not, should be presented."[43]

Connick v. Thompson presents the more likely route to discovering a *Brady* violation: dumb luck. John Thompson was arrested in New Orleans for murder.[44] After Thompson's arrest, an armed-robbery victim saw Thompson's picture in the paper and identified Thompson as the perpetrator of the armed robbery.[45] The district attorney decided to try Thompson first for the armed robbery, in the hope that if he secured a conviction, it would deter Thompson from testifying at the murder trial.[46] The plan worked.

At both the armed robbery trial and the murder trial, the prosecution withheld *Brady* material from Thompson's defense lawyers.[47] The defense did not know that Thompson's blood type did not match the blood found at the robbery nor did the defense know about evidence that impeached the principal witness against Thompson or about eyewitness accounts that described the murderer as someone who looked very unlike Thompson.[48] Thompson was convicted at both trials; he was sentenced to death for murder.[49]

Nearly fifteen years after Thompson's trial, his execution was scheduled.[50] The defense team hired a private investigator, who unearthed the blood samples and test results that were never

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42. 424 U.S. 409, 412 (1976).

43. *Id.* at 413.

44. Connick v. Thompson, 131 S. Ct. 1350, 1372 (2011) (Ginsburg, J., dissenting).

45. *Id.* at 1372.

46. *Id.*

47. *Id.* at 1373.

48. *Id.* at 1373–74.

49. *Id.* at 1374.

50. *Id.* at 1375 (Ginsburg, J., dissenting).

disclosed during the armed robbery trial.[51] After contacting the prosecution, the defense lawyers learned that one of the prosecutors, who had been terminally ill, confessed some five years earlier that he had withheld evidence during Thompson's armed robbery trial.[52] On the basis of the newly discovered information, both Thompson's convictions were vacated, and although he was retried for murder, he was acquitted.[53]

C. *Repercussions*

One last fact contributes to the difficulty of vindicating *Brady*. Prosecutors are seldom disciplined for its violation. First, suits for damages against prosecutors for their work are not available. Remember the prosecutor in *Imbler*, who revealed exculpatory information he discovered after trial? The defendant he helped to exonerate sued him under 42 U.S.C. § 1983 for violating the defendant's constitutional rights by withholding the exculpatory information.[54] The Supreme Court, however, held that "in initiating a prosecution and in presenting the State's case, the prosecutor is immune from a civil suit for damages under § 1983."[55]

Nor is there much institutional accountability. A recent attempt to hold a district attorney liable for failing to provide assistant district attorneys "formal in-house training" about the application of *Brady* also failed, which is particularly remarkable given that that particular district attorney's office is responsible for three major *Brady* cases heard by the Supreme Court since the mid-1990s.[56]

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51. *Id.*

52. *Id.* at 1374–75.

53. *Id.* at 1376.

54. Imbler v. Pachtman, 424 U.S. 409, 415 (1976).

55. *Id.* at 431.

56. *See* Smith v. Cain, 132 S. Ct. 627, 631 (2011) (overturning conviction due to *Brady* violation); Connick v. Thompson, 131 S. Ct. 1350, 1363 (2011) ("In light of this regime of legal training and professional responsibility, recurring constitutional violations are not the 'obvious consequence' of failing to provide prosecutors with formal in-house training about how to obey the law."); Kyles v. Whitley, 514 U.S. 419, 454 (1995) (holding that the defendant was entitled to a new trial based on a *Brady* violation). Even in *Connick*, the Court noted that Louisiana courts had overturned four convictions obtained by the district attorney in the decade before Thompson was tried. 131 S. Ct. at 1360. One of the authors served in the Orleans Parish District Attorney's office before Thompson was tried.

Other mechanisms for personal accountability, like bar disciplinary proceedings, are infrequently used. Despite this, courts have emphasized the force of professional discipline as an adequate deterrent to violating *Brady*. In *Connick*, the Court latched on to this notion to support its conclusion that "recurring constitutional violations are not the 'obvious consequence' of failing to provide prosecutors with formal in-house training about how to obey the law," that is, how to obey *Brady*.[57] But even when disciplinary proceedings are brought, the results are mixed, even when there are clear *Brady* violations in the proceedings that led to the disciplinary action.

The *Shelton* case is an example of a bar association successfully bringing a disciplinary proceeding.[58] The D.C. Bar investigated whether the prosecutor violated a D.C. Rule of Professional Conduct that imposes a *Brady*-like obligation on prosecutors. That rule states:

> The prosecutor in a criminal case shall not . . . [i]ntentionally fail to disclose to the defense, upon request and at a time when use by the defense is reasonably feasible, any evidence or information that the prosecutor knows or reasonably should know tends to negate the guilt of the accused . . . .[59]

After its investigation, the disciplinary board determined that the prosecutor should be publicly censured.[60] The board did so, in part, because of its conclusion that "[a] determination to hide exculpatory information can readily escape detection and, even if a

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During his tenure (1982–1985), there was some *Brady* training provided by the office and assistant district attorneys were also encouraged to and did attend the National College of District Attorneys in Houston, Texas for a two-week training program, which included instruction on *Brady* and *Giglio*.

57. *Connick*, 131 S. Ct. at 1362–63 ("Among prosecutors' unique ethical obligations is the duty to produce *Brady* evidence to the defense. An attorney who violates his or her ethical obligations is subject to professional discipline, including sanctions, suspension, and disbarment.") (internal citations omitted).

58. *See supra* text accompanying notes 35–41 (discussing the *Shelton* case).

59. D.C. RULES OF PROF'L CONDUCT R. 3.8(e) (2012).

60. *In the Matter of Andrew J. Kline*, Report and Recommendation of Hearing Committee Number Nine at 2 (Mar. 28, 2012), *available at* http://legaltimes.typepad.com/files/for_lawyers_ethics_discipline_pdf_hearing_committee_hcandrewjkline52209.pdf (last visited Nov. 17, 2012).

Brady violation is discovered, there are frequently no personal consequences to the prosecutor who may, as did Respondent, already have moved on to other employment."[61]

Still even cases where there are clear *Brady* violations do not always result in successful disciplinary actions.[62] *Ferrara v. United States* provides one such example.[63] Vincent Ferrara was a Boston Mafioso, who was accused of ordering a hit on one of his confederates, Vincent Limoli.[64] It turned out, however, that "the government did not disclose that Walter Jordan, *the only source of direct evidence on those charges*, had told the government at least twice that [co-defendant Pasquale] Barone told him that Ferrara had not ordered the Limoli murder, and that Barone and Jordan had to flee Boston because Ferrara was going to kill them for murdering Limoli *without his permission*."[65] Two memorandums containing this information were disclosed for the first time in a collateral proceeding over a decade after the initial prosecution.[66] The information only came to light because Jordan admitted that he perjured himself during Barone's trial by testifying that Ferrara had ordered Limoli's murder.[67]

The district judge who presided over Ferrara's collateral proceeding "initiated disciplinary action against Assistant United States Attorney Jeffery Auerhahn for professional misconduct" based on his role in the Ferrara prosecution.[68] Even before the disciplinary proceeding began, the Department of Justice conducted its own internal investigation.[69] DOJ's Office of Professional Responsibility concluded that Auerhahn "acted in reckless disregard of discovery obligations . . . and exercised poor judgment by failing to comply

61. *Id.* at 47.

62. *See* Brendan V. Sullivan, Jr., Op-Ed., *Where's the Punishment After Justice Department Misconduct?*, WASH. POST, July 5, 2012, at A15 (questioning the DOJ's decision not to punish prosecutors involved in the prosecution of Senator Ted Stevens).

63. Ferrara v. United States, 384 F. Supp. 2d 384, 384 (D. Mass. 2005), aff'd 456 F.3d 278 (1st Cir. 2006).

64. *Id.* at 387.

65. *Id.* (emphasis added).

66. *Id.* at 387–88.

67. Ferrara v. United States, 456 F.3d 278, 285 (1st Cir. 2006).

68. *In re* Auerhahn, 650 F. Supp. 2d 107, 108 (D. Mass. 2009).

69. *In re* Auerhahn (*Auerhahn II*), No. 09-10206-RWZ-WGY-GAD, 2011 WL 4352350, at *1 (D. Mass. Sept. 15, 2011).

with a court order to submit his notes from meetings with Jordan."[70] That, in itself, is a serious rebuke, but ultimately, the court declined to sanction the prosecutor.[71] Nonetheless, reputational interests are very important to lawyers, and sanctions, or even an investigation, can have serious consequences for one's livelihood and personal life.[72]

So far we have identified three problems with *Brady*. The first is that *Brady*'s obligations, however laudable, are not necessarily coextensive with the pursuit of justice. The second is that because *Brady* violations are not easily discovered, we must rely largely on the prosecutor to ensure that *Brady* is followed. That principle is further reinforced by our third observation: that sanctions for violating *Brady* are seldom imposed. Thus, the current *Brady* regime is one where violations, should they occur, are unlikely to be discovered, and when they are, they are unlikely to have consequences. Adam Smith observed: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantages."[73] But with *Brady,* we have done little more than appeal to prosecutors' benevolence. We next examine the steps that have been taken to ensure that prosecutors comply with their constitutional obligations to follow *Brady* and pursue justice.

III. PURSUING JUSTICE

After the high-profile *Brady* violations in the trial of former Senator Ted Stevens, the Department of Justice (DOJ) decided to

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70. *Id.*

71. *Id.* at *16–17.

72. Regrettably, the investigation of the prosecutors who prosecuted former Senator Ted Stevens contributed to one of the prosecutors committing suicide. *See* Jeffery Toobin, *Casualties of Justice*, THE NEW YORKER, Jan. 3, 2011, at 39, *available at* http://go.galegroup.com/ps/i.do?id=GALE%7CA245692495&v=2.1&u=txshracd2598&it=r&p=AONE&sw=w (reporting that the criminal investigation of Nicholas Marsh subsequent to the Stevens investigation contributed to his suicide).

73. ADAM SMITH, THE WEALTH OF NATIONS 13 (Edwin Cannan ed., Artington House Vol. 1 1966) (1776).

reexamine its *Brady* policies.[74] These changes, on the whole, are improvements to DOJ's guidelines, but even they recognize the limitations of *Brady* and their own policies. Indeed, DOJ characterizes its current polices as "provid[ing] for broader disclosures of exculpatory and impeachment information than *Brady* and *Giglio* require."[75] It further recognized that in some instances "there are times when providing discovery broader than that provided for even by current Department policy serves the interests of justice."[76] But the guidelines also include limitations that undercut that goal or reinforce *Brady*'s shortcomings.

The new DOJ guidelines make clear that *Brady* applies to more than just prosecutors and place an affirmative obligation on prosecutors to "seek all exculpatory and impeachment information from all . . . federal, state, and local law enforcement officers and other government officials participating in the investigation and prosecution of the criminal case against the defendant."[77] However, the discovery guidance notes that "in complex cases that involve parallel proceedings with regulatory agencies . . . or other non-criminal investigative or intelligence agencies, the prosecutor should consider whether the relationship with the other agency is close enough to make it part of the prosecution team for discovery purposes."[78] In short, even if those other entities have information that would be exculpatory, DOJ does not impose a categorical obligation on its prosecutors to seek it out. Dworkin asked if the

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74. *See* Toobin, *supra* note 72, at 39 (describing the two pending investigations into "what went wrong in the Stevens prosecution" including one by the Justice Department). *See also Hearing on the Special Counsel's Report on the Prosecution of Senator Ted Stevens Before the S. Comm. on the Judiciary*, 112th Cong. 1(2012) (Statement for the record from the Department of Justice) ("[T]o ensure that the mistakes in the Stevens case would not be repeated, the Attorney General convened a working group to review discovery practices and charged the group with developing recommendations for improving such practices so that errors are minimized.").

75. Memorandum from David W. Ogden, Deputy Attorney Gen., to Heads of Dep't Litigating Components Handling Criminal Matters & all U.S. Attorneys, Requirement for Office Discovery Policies in Criminal Matters (Jan. 4, 2010), *available at* www.justice.gov/dag/dag-to-usas-component-heads.html.

76. *Id.*

77. Memorandum from David W. Ogden, Deputy Attorney Gen., to Dep't Prosecutors, Guidance for Prosecutors Regarding Criminal Discovery (Jan. 4, 2010), *available at* http://www.justice.gov/dag/discovery-guidance.html.

78. *Id.*

limitation followed "from the fact that each citizen has a right not to be convicted if innocent, that he has a right to the most accurate procedures possible to test his guilt or innocence, no matter how expensive these procedures might be to the community as a whole."[79] Still, limitations like this stress that a prosecutor's obligation under *Brady* is more limited than seeking justice. Whether these caveats will have a substantial effect on disclosure is uncertain, and perhaps even unlikely, as one can imagine that groups working in parallel will often share information. But the suggestion that such information need not be disclosed is nonetheless troublesome and weakens the prosecutor's role in seeking justice.

DOJ imposes similar practical limitations in other areas. For example, although DOJ notes that "[i]t would be preferable if prosecutors could review the information themselves in every case, [it] is not always feasible or necessary."[80] A major issue in the Stevens trial was that much of the *Brady* review was not conducted by the prosecutors themselves, but rather by the law enforcement officials who assisted with the investigation.[81] The agent leading the review ultimately conceded that she was not qualified to evaluate whether the material needed to be disclosed under *Brady*.[82] Given the emphasis that courts place on prosecutors being "learned in the law" in complying with *Brady*, prosecutors must be intimately involved in conducting the review and supervising any non-lawyers involved. One alternative, which DOJ itself considers appropriate in certain circumstances, is to provide open-file discovery.[83]

Although the Court has made clear that open-file discovery is not constitutionally required under *Brady*,[84] that method of discovery does present another way to ensure all exculpatory material is given to the defense. The approach might, however, be overbroad, and it

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79. DWORKIN, *supra* note 4, at 72.

80. Ogden, *supra* note 77.

81. *In re* Special Proceedings, Misc. No. 09-0198-EGS, Doc. No. 84 at 3, 64 (D.D.C. Mar. 15, 2012).

82. *Id.*

83. Ogden, *supra* note 77 ("In cases involving voluminous evidence obtained from third parties, prosecutors should consider providing defense access to the voluminous documents to avoid the possibility that a well-intentioned review process nonetheless fails to identify material discoverable evidence. Such broad disclosure may not be feasible in national security cases involving classified information.").

84. United States v. Bagley, 473 U.S. 667, 675 (1985).

also has several limitations, especially as it relates to the prosecutor's justice-seeking function. First, by handing over your entire file, instead of disclosing the existence of inconsistencies or exculpatory evidence to the defense, you merely allow them to search for those things themselves (as they should in any event). Given the disparity in resources between the government and many criminal defendants, that hardly seems fair. Second, by effectively shifting the burden of the review, it might lead the prosecutor to overlook facts that would allow for some prosecutorial introspection. Still, there is much to be said for Louis Brandeis's aphorism: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[85] And given that the defense's view of what evidence is exculpatory is likely broader than that of the prosecution, open-file discovery is likely one of the more effective solutions for *Brady*'s limitations and one that is consistent in many ways with the prosecutor's duty to seek justice. However, as an ethical matter, open-file discovery should not absolve a prosecutor of his duty to examine the evidence for exculpatory evidence himself.

The effectiveness of the *Brady* review in *Stevens* was further compromised because of the way it was structured. Segregating review among several people can create problems. As we mentioned earlier, what is *Brady* material is often not apparent when a piece of evidence is viewed in isolation.[86] Much *Brady* material is the result of inconsistencies. In *Stevens*, the reviewers did not look for inconsistencies between a witness's own statements or inconsistencies between statements made by different witnesses.[87] And, in some cases, different people were responsible for reviewing grand jury testimony and witness statements.[88] Structuring a review in this fashion practically guarantees that *Brady* material will not be disclosed.

Reviewers should not be assigned to review particular types of evidence, for example, all grand jury testimony or all witness

85. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (Richard M. Abrams, ed., Harper & Row 1967) (1914).

86. U.S. ATTORNEYS' MANUAL, § 9-5.001(C)(4) (1997) ("While items of information viewed in isolation may not reasonably be seen as meeting the standards outlined in paragraphs 1 and 2 above, several items together can have such an effect. If this is the case, all such items must be disclosed.").

87. *In re* Special Proceedings, Misc. No. 09-0198-EGS, Doc. No. 84 at 64–65 (D.D.C. Mar. 15, 2012).

88. *Id.* at 65.

interviews. Structuring a review in that manner will perhaps only ensure that the most patently exculpatory information will be disclosed. To sufficiently review for *latently* exculpatory evidence, reviewers need to cover topics or all the statements of particular witnesses. In some cases, agents present summary testimony to grand juries, so limiting review to witnesses might not be sufficient. And of course, it's possible that parceling witnesses in this fashion will lead to inconsistencies *between* witnesses being overlooked.

The most troubling element of *Brady*, and the one that causes it to diverge most from the prosecutor's function in seeking justice, is its materiality requirement. The materiality requirement at first seems like mere surplusage, a redundancy. As we mentioned earlier, no truth would seem more self-evident than the fact that all exculpatory evidence is material. Several district courts have recognized as much, and they have local rules that eliminate the materiality requirement.[89] The American Bar Association's Model Rules of Professional Conduct make no mention of materiality in suggesting that a prosecutor has a duty to "make timely disclosure to the defense of *all* evidence or information known to the prosecutor that tends to negate the guilt of the accused or mitigates the offense."[90] Texas's own rules of professional conduct impose just the same standard on prosecutors as did the D.C. Bar standard in the *Shelton* case.[91] And the ABA has made clear that "Rule 3.8(d) does not implicitly include the materiality limitation recognized in the constitutional case law. The rule requires prosecutors to disclose favorable evidence so that the defense can decide on its utility."[92]

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89. *See, e.g.*, N. D. FLA. LOC. R. 26.3(D)(1) ("The government's attorney shall provide the following within five (5) days after the defendant's arraignment, or promptly after acquiring knowledge thereof . . . [a]ll information and material known to the government which may be favorable to the defendant on the issues of guilt or punishment, *without regard to materiality*, that is within the scope of *Brady v. Maryland*, 373 U.S. 83 (1963) and *United States v. Agurs*, 427 U.S. 97 (1976).") (emphasis added).

90. MODEL RULES OF PROF'L CONDUCT R. 3.8(d) (2011) (emphasis added).

91. TEXAS DISCIPLINARY RULES OF PROF'L CONDUCT R. 3.09(d) ("The prosecutor in a criminal case shall . . . make timely disclosure to the defense of all evidence or information known to the prosecutor that tends to negate the guilt of the accused or mitigates the offense.").

92. ABA Comm. on Prof'l Ethics & Grievances, Formal Op. 09-454 (2009) (discussing a prosecutor's duty to disclose evidence and information favorable to the defense).

Others have noticed this problem too, perhaps because the issue hits close to home, and suggested codifying a *Brady*-like rule, but one that is substantially broader. Alaska Senator Lisa Murkowski introduced the "Fairness in Disclosure of Evidence Act of 2012" on March 15, 2012.[93] The bill would impose a broader disclosure obligation than the one that currently exists under *Brady* and would require disclosure of "information, data, documents, evidence or objects that may reasonably appear to be favorable to the defendant in a criminal prosecution brought by the United States with respect to the determination of guilt."[94] DOJ does not support the bill.[95] Perhaps it should.

IV. CONCLUSION

"Perfection is impossible; like other human institutions criminal proceedings must be a compromise."[96] But how much must we compromise in what we expect from prosecutors? We think very little. Both *Brady* and prosecutors have foibles, and thus prosecutors must recognize that exceeding what *Brady* requires is often what justice demands. When prosecutors fail to meet their obligations,

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93. Fairness in Disclosure of Evidence Act of 2012, S. Res. 2197, 112th Cong. (2012). Interestingly, this is not the only attempt at criminal justice reform that has resulted from the prosecution of an elected official. The Hyde Amendment, which allows sanctions for prosecutorial misconduct when the position of the United States is "vexatious, frivolous, or in bad faith," was "widely understood to be Congress's response to the prosecution of former Congressman Joseph McDade." United States v. Shaygan, 676 F.3d 1237, 1245–46 (11th Cir. 2012) (Martin, J., dissenting from denial of petition for rehearing en banc).

94. Fairness in Disclosure of Evidence Act, *supra* note 93, at § 2.

95. Statement of James M. Cole, Deputy Attorney General before the Committee on the Judiciary at 1 (June 6, 2012) ("The Department does not believe that legislation is needed to alter the way discovery is provided in federal criminal cases. While we fully share Senator Murkowski's goal of ensuring that what occurred in the Stevens case is never repeated, we have very serious concerns with her draft legislation. We understand Senator Murkowski's strong views; but in reacting to the Stevens case, we must not let ourselves forget the very real dangers to safety and privacy that victims and witnesses often face in the criminal justice system; the national security interests implicated by discovery rules; and the strong public interest in ensuring not only that defendants receive a fair trial but also that the guilty be held accountable for their crimes.").

96. *In re* Fried, 161 F.2d 453, 465 (2d Cir. 1947) (Hand, J., concurring).

they should be held accountable. And those rules should be enforced without regard to a defendant's guilt.

In cases where *Brady* violations have had an effect on the verdict, we hope courts will not hesitate to correct the results of a prosecutor's error. Still, judges must be aware that overturning a conviction can affect more than just the prosecutor's behavior. Judge Posner recognized, rightly, that in some cases "ordering the conviction set aside would be punitive rather than remedial."[97] As a result, courts "have no general power to set aside convictions to punish prosecutors."[98] If a defendant truly is guilty despite the *Brady* violation, justice does not demand that his conviction be set aside—for that has costs to society that outweigh the benefit any deterrent effect doing so might have. Where "most of the costs do not even fall on the malefactor, the misbehaving prosecutor . . . [i]t is better to punish the prosecutor directly."[99] We agree.

Prosecutors should be aware that their ethical obligations can exceed their constitutional ones. As we have explained, the latter obligations have their limitations and policing prosecutorial ethics in some cases will be just as difficult as policing *Brady* violations. Nonetheless, effectively and consistently enforcing ethical rules, with their emphasis on disclosure of all exculpatory emphasis without regard to materiality, might have a deterrent effect that helps ensure "that justice shall be done."

97. United States v. Mazzone, 782 F.2d 757, 763 (7th Cir. 1986).
98. *Id.*
99. *Id.*

Reevaluating Proposals for Tort Claims Markets in a World of Mass Tort Litigation

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Third-party financing of litigation has, in recent years, emerged as a heated area of debate.[1] Proposals to relax state champerty restrictions and legal ethics rules in order to allow investors to purchase and then pursue tort claims have not traditionally found receptive audiences for a variety of reasons.[2] The concept of selling one's tort claim is discomforting; it conflicts with our traditional notion of a lawsuit.[3] Furthermore, there are concerns that such reform would spur frivolous litigation, an objection often applied to third-party financing as a whole.[4]

With the rise of mass tort litigation, however, proposals that would open up a market for tort claims deserve reevaluation. Mass tort litigation is different than the traditional single-party dispute, especially with regard to aggregation and settlement, and it implicates different public policy concerns.[5] In this Note, I argue that permitting the sale of mass tort claims comports with the framework of mass tort litigation, and that such proposals deserve serious consideration as possible solutions to some of the problems posed by mass torts.

In Part I, I give an overview of the restrictions on the assignment of tort claims and examine both sides of the debate over whether these restrictions should be repealed to allow a market for tort claims to develop. In Part II, I describe the unique features of mass tort litigation and, in light of them, reevaluate the debate over tort claims markets. I conclude that, with the rise of a streamlined litigation model that emphasizes efficiency, aggregation, and settlement, at the expense of individualized litigation, the objections

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1. *See, e.g.*, Isaac Marcushamer, *Selling Your Tort Claims: Creating a Market for Tort Claims and Liability*, 33 HOFSTRA L. REV. 1543, 1547–48 (2005) (discussing the various positions of scholars who have addressed market-based litigation in recent years).

2. *See infra* Part I.D (discussing the negative responses to proposals for a market-based tort system).

3. *See infra* Part I.A (discussing common law principles in conflict with the concept of selling one's tort claim); Part I.B (discussing third party financing); Part I.D.3 (discussing the argument that selling a tort claim conflicts with the traditional notion of a lawsuit).

4. *See infra* Part I.D.1 (discussing the argument that tort claims markets would spur frivolous litigation).

5. *See infra* Part II.A (providing an overview of mass torts); Part II.B (discussing public policy concerns implicated by mass tort litigation).

to the sale of tort claims lose traction. Moreover, creating a market for tort claims aligns with the concerns posed by mass tort litigation, and, therefore, such proposals warrant consideration as attempts to address the issues facing mass tort litigation.

I. PERMITTING THE SALE OF TORT CLAIMS AS AN ALTERNATIVE FORM OF LITIGATION FINANCING

A. The History of Prohibitions Against the Sale of Tort Claims

Modern prohibitions against the acquisition of part or all of a tort claim have their roots in the ancient English common law prohibitions of maintenance and champerty. Maintenance is an "officious intermeddling in a suit that no way belongs to one, by maintaining or assisting either party with money or otherwise, to prosecute or defend it."[6] Champerty is a form of maintenance whereby the unrelated party's support is given in consideration for a share of interest in a cause of action.[7]

To understand these prohibitions requires some historical background. They reflect the medieval understanding of a personal right of action, whereby a legal claim arose between two persons and two persons alone.[8] A right of action could not be assigned because the assignee would lack privity; in any event, intangible rights could not be transferred.[9] While exceptions eventually developed,[10] the intervention of third parties in litigation was proscribed because litigation itself was frowned upon.[11]

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6. Peter C. Choharis, *A Comprehensive Market Strategy for Tort Reform*, 12 YALE J. ON REG. 435, 460 (1995) (quoting 4 WILLIAM BLACKSTONE, COMMENTARIES 134–35 (1765–1769)).

7. Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1286–87 (2011).

8. Choharis, *supra* note 6, at 462.

9. *Id.*

10. *See, e.g.*, *infra* note 25 and accompanying text (discussing the relaxation of champerty provisions to allow contingency fees for attorneys of personal-injury claimants).

11. *See* Choharis, *supra* note 6, at 462–63 (discussing the manipulation of the judicial system in medieval England).

In the 13th and 14th centuries, King Edward I and King Henry VIII enacted statutes outlawing maintenance and champerty.[12] This was feudal England, and feudal lords used the legal system to wage private wars over land and status, acquiring territory by supporting the litigation of their allies.[13] Maintenance was a problem; medieval England was in a state of disarray, litigation was expensive, and common law procedure was complex.[14] The legal system was vulnerable to manipulation by the feudal lords,[15] and these statutes were part of the wider conflict against feudalism itself.[16] That is, these prohibitions were not directed at lawyers, but rather at those who supported litigation for their own ends.[17]

Despite the obsolescence of their policy rationales, prohibitions against champerty persevere in the United States.[18] Champerty is a matter of state law, existing in the form of common law doctrine, legal ethics rules, and state statutes.[19] A majority of states maintain these prohibitions in some form.[20] However, a small minority of states, such as Massachusetts and New Jersey, have abandoned prohibitions against champerty altogether.[21]

Restrictions on champertous agreements have found a new rationale in the "fundamental distrust of legal procedure and of lawyers."[22] This seems strange, as the doctrines were originally concerned not with lawyers, but with those who funded them.

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12. *Id.* at 461.

13. James Moliterno, *Broad Prohibition, Thin Rationale: The "Acquisition of an Interest and Financial Assistance in Litigation Rules,"* 16 GEO. J. LEGAL ETHICS 223, 228 (2003).

14. Choharis, *supra* note 6, at 463.

15. *Id.* at 462.

16. *See* Moliterno, *supra* note 13, at 228 (discussing the use of litigation by feudal lords as a power acquiring device).

17. *Id.*

18. Marcushamer, *supra* note 1, at 1553.

19. *Id.* at 1553–65. State legal rules typically prohibit lawyers from acquiring proprietary interests in claims. *See* MODEL RULES OF PROF'L CONDUCT R. 1.8(i) ("A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client . . . ."). Contingent fees are an exception to this rule. *Id.*

20. *See* Choharis, *supra* note 6, at 464–65 (saying that courts continue to apply champerty statutes, though the application is inconsistent).

21. Marcushamer, *supra* note 1, at 1554.

22. Moliterno, *supra* note 13, at 228–29.

Nevertheless, it makes sense—as one scholar observed in the 1930s, with the growth of the legal industry lawyers had become an "enormously large group" competing for a scarce amount of business.[23] Popular resentment against lawyers found a new rationalization.[24]

B. *Evaluating Proposals to Establish Tort Claims Markets*

At this point, I should elaborate on what it means to "sell" one's tort claim. Litigation can be financed in a variety of ways. In the most basic arrangement, a lawyer will simply bill the client for legal services rendered. But apart from large corporations that have the funds or insurance to support litigation, this is often not a feasible option, particularly for individual plaintiffs. The typical personal injury claimant, for example, likely cannot afford to retain an attorney on an hourly rate. Because of this issue, states in the early 20th century began to relax champerty prohibitions and started to accept the practice of contingent fees[25]—agreements whereby the attorney has an interest in the proceeds from the litigation.[26]

Although the subject of long heated debate among the bar, the contingent fee—hailed by supporters as the "keys to the courthouse"[27]—stands for the recognition of the need for alternative fee arrangements.[28] Rising costs of litigation have opened a debate over third-party litigation financing among legal scholars and practitioners.[29] Third-party financing is simply the funding of

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23. *Id.* at 229 (quoting Max Radin, *Maintenance by Champerty*, 24 CAL. L. REV. 48, 66 (1934)).

24. *Id.*

25. Susan Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 57 (2004).

26. BLACK'S LAW DICTIONARY 614 (6th ed. 1990).

27. Steinitz, *supra* note 7, at 1293.

28. *See* Martin, *supra* note 25, at 57 ("The contingency fee became accepted because allowing an impoverished plaintiff to bring a legitimate cause of action was viewed as more important than preventing the alleged evils of champerty . . . .").

29. *See, e.g.*, Binyamin Appelbaum, *Investors Put Money on Lawsuits to Get Payouts,* N.Y. TIMES, Nov. 14, 2010, at A1, *available at* http://www.nytimes.com/2010/11/15/business/15lawsuit.html?pagewanted=all

litigation by parties unrelated to the dispute, such as lawsuit loans to fund a plaintiff's claim or the purchase of litigation insurance by a potential defendant.[30]

The type of third-party financing this Note is concerned with is a person's assignment of a cause of action to another party in exchange for money—the sale of a tort claim.[31] The majority view in America is that claims based on contractual rights or interests in property may be assigned, but personal injury claims may not.[32] While exceptions to the rule against assignment have developed, only a few states, such as Texas, have permitted the outright sale of a tort claim.[33]

This practice may seem odd because it conflicts not only with a well-established common law principle but also with our popular notion of how our legal system achieves justice—what is a personal injury claim without the actual victim in the picture? But the debate over alternative litigation funding has entered the mainstream, and in recent years, both the United Kingdom and Australia have reversed course and permitted, to differing degrees, third-party financing of litigation.[34] Proposals to permit the sale of tort claims, though

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(discussing lawsuit loans and investment in litigation); Bethany Leigh Rabe, *NYC Bar Weighs in on Litigation Financing*, AM. BAR ASS'N LITIG. NEWS, http://apps.americanbar.org/litigation/litigationnews/top_stories/082911-new-york-city-bar-third-party-litigation-financing.html (discussing the New York Bar's report reminding attorneys of ethical issues arising from litigation finance). *But see* Jonathan Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 102 (2010) (noting the reticence of lawyers to push for innovative financial arrangements in a climate of "regulatory disapproval and low public esteem").

30. Steinitz, *supra* note 7, at 1275–76.

31. A person can certainly sell a portion of his or her claim, but this significantly complicates the picture by creating a funder-client-attorney relationship. Because this Note is primarily concerned with the broader conceptual issues raised by the selling of tort claims, it does not address proposals to ameliorate the ethical and conflict of interests problems raised in partial assignment of claims. However, for a discussion of these issues, see Steinitz, *supra* note 7, at 1318–30 (discussing "agency problems").

32. Samuel R. Gross, *We Could Pass a Law . . . What Might Happen if Contingent Legal Fees Were Banned*, 47 DEPAUL L. REV. 321, 325 (1998).

33. *Id.* at 328. Why a market for tort claims has not developed in Texas is unclear; Gross hypothesizes it is simply because Texas is an "isolated exception to the general rule." *Id.* at 329.

34. Steinitz, *supra* note 7, at 1278–81.

seemingly strange, deserve some attention, especially in light of the rise of mass tort litigation, as this Note will show.

Although the aim of this Note is not to explore the various proposals envisioning a market for tort claims, it is helpful before proceeding to the debate over the sale of tort claims to have a general idea of how such a market would function. Broadly speaking, the function of a tort market would depend on which prohibitions on the acquisition of tort claims were repealed: champerty doctrines for non-lawyers or legal ethics rules for lawyers.[35] Allowing non-lawyers to purchase claims would open up tort claims markets to investment firms, who could purchase claims and then seek legal counsel to pursue them.[36] If legal ethics rules were changed to permit lawyers to purchase claims, then lawyers would be able to purchase claims directly from claimants (though they would likely need access to other sources of capital to finance large-scale litigation).[37]

C. *Common Arguments for the Sale of Tort Claims*

1. Increased Victim Compensation

One of the primary advantages of a market for tort claims is that the tort victim would be compensated instantly upon sale of the claim.[38] Currently, a tort victim may wait years before he or she receives a recovery, if any—the process of discovery and trial can be grueling, and there is always the prospect that the claim fails at trial or proves to have no ultimate settlement value.[39] A complete transfer of the tort claim shifts all of the risk to the buyer, whereas in

35. Molot, *supra* note 29, at 104–06. Near-universal ethical restrictions on the sharing of legal fees with non-lawyers would need to be repealed or modified as well. *See* MODEL RULES OF PROF'L CONDUCT R. 5.4 (2012) ("A lawyer or law firm shall not share legal fees with a nonlawyer . . . .").

36. Molot, *supra* note 29, at 106–08.

37. *Id.* at 104–05.

38. LESTER BRICKMAN, LAWYER BARONS: WHAT THEIR CONTINGENCY FEES REALLY COST AMERICA 92–93 (Cambridge University Press, 2011).

39. Choharis, *supra* note 6, at 480–81; Gross, *supra* note 32, at 325.

the current contingent fee arrangement, the victim still bears the risk of no recovery.[40]

Proponents also contend that not only would a market for tort claims result in faster, certain compensation, it would also tend to provide greater compensation to victims for their claims.[41] Investment firms would diversify risk with portfolios and bundle similar claims, leveraging economies of scale to reduce litigation costs.[42] As a result, investment firms could offer more competitive prices than a current contingent-fee firm could because contingent-fee firms generally have fixed-fee rates and are unable to effectively diversify risk due to the governance limitations of partnership structures.[43]

Additionally, more tort victims whose claims seemed too weak to warrant representation on a contingent fee would be compensated.[44] Because investment firms can diversify risk better than law firms, they would be more open to taking riskier cases, especially when seeking to aggregate cases in order to maximize bargaining power.[45] Furthermore, claim buyers would be able to leverage economies of scale to focus funds on developing cases where, for example, the science is undeveloped or the victim's exposure to a substance is uncertain.[46]

Finally, a claims market provides a solution for the attorney-client conflicts of interest raised by contingency and hourly fee arrangements.[47] In a contingency fee arrangement, plaintiffs' attorneys have an incentive to settle early because they want to minimize the risk of no recovery and maximize their effective hourly

40. *See* Choharis, *supra* note 6, at 480–81 ("[U]nlike in the current system where recovery is never certain, a tort victim who sells her claim would be assured, without risk, of payment for her injuries."); Gross, *supra* note 32, at 325–26 (discussing how tort plaintiffs cannot afford the risk of fighting and obtaining no recovery at all).

41. Choharis, *supra* note 6, at 480. *See also* Mark Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329, 336 (1987) (explaining how a tort claim market would reduce the amount of compensation that the victim must forgo to obtain an immediate cash payment).

42. Choharis, *supra* note 6, at 480–81; Gross, *supra* note 32, at 326.

43. Choharis, *supra* note 6, at 480–81.

44. Gross, *supra* note 32, at 326.

45. *Id.*; Shukaitis, *supra* note 41, at 337–38.

46. Choharis, *supra* note 6, at 481.

47. Shukaitis, *supra* note 41, at 339–40.

rate.[48] This is in tension with the client's desire to hold out for a higher settlement or even to go to trial.[49] By contrast, in an hourly fee arrangement, attorneys have an incentive to work too much, which could be in tension with the client's desire to settle early.[50] But when a tort victim can simply sell his or her claim, this conflict vanishes because, well, the victim vanishes too.

2. Equalizing the Power Disparity Between Plaintiffs and Defendants

As noted above, tort victims often have a weaker bargaining position than defendants, especially in cases where the defendant is a corporation and the victim is an individual.[51] Corporate defendants are repeat players in the world of litigation.[52] They face litigation often and thus develop legal expertise and enjoy low start-up costs for cases.[53] Moreover, not only can they afford prolonged litigation, but they also have a strong incentive to do so; repeat players have bargaining reputations to maintain, as a reputation for hard-nosed litigiousness will serve as a deterrent to future claimants.[54]

A market for tort claims, however, would equalize this power disparity. Claim buyers would bundle up claims and diversify risk through portfolio analysis, leveraging economies of scale to reduce litigation costs and pursue the claims.[55] Because they would have greater access to capital (and at better rates) than plaintiffs' firms do now, tort investors could afford to employ more experts in technical

48. *See* Lynn Baker, *Facts About Fees: Lessons for Legal Ethics*, 80 TEX. L. REV. 1985, 1986–87 (2002) (discussing conflicts of interest that arise in fee arrangements).

49. *See id.* at 1986 ("[T]he contingent fee may provide an incentive for attorneys to attempt to settle the plaintiff-client's case too quickly and for too little.").

50. *See id.* at 1988 ("[T]he hourly rate encourages the attorney to settle the defendant-client's case too slowly, rather than too quickly.").

51. *See* Steinitz, *supra* note 7, at 1300–01 (arguing that "repeat players" in tort litigation have substantially greater resources and abilities to litigate and settle cases than the "one-shotter" litigant).

52. *Id.*

53. *Id.*

54. *Id.*

55. Choharis, *supra* note 6, at 489; Shukaitis, *supra* note 41, at 336; Steinitz, *supra* note 7, at 1314.

areas to develop the litigation.[56] The typical claim buyer, either an investment firm or law firm backed by third-party funders, would be in a better financial position than the typical tort victim to hold out for an optimal settlement or even go to trial.[57] Moreover, claim buyers would develop expertise in picking and pursuing claims, eventually developing their own bargaining reputations that could be leveraged against defendants.[58]

The upshot is that this equalization of bargaining power would have the arguably positive effect of deterring more tortious behavior.[59] Claim buyers, seeking to harness the power of aggregation, would buy claims that risk-averse tort victims or lawyers might otherwise not have pursued, and the claim buyers would be in a stronger position to litigate claims that would have been brought regardless.[60]

3. Existing Forms of Claim Transfer

It should be noted that, in the United States, a person can already "sell" his or her tort claim in a variety of ways.

Contingent Fees

First and most obviously, the contingent fee is, in essence, a sale of an interest in one's tort claim.[61] A contingent fee is technically the assignment of an interest in proceeds from litigation rather than an interest in the claim itself.[62] Despite being

56. Choharis, *supra* note 6, at 486.

57. *Id.* at 489. *See also* Steinitz, *supra* note 7, at 1305 (arguing that the typical "one-shotter" tort victim would be most benefitted by a market for tort claims).

58. Steinitz, *supra* note 7, at 1305.

59. Shukaitis, *supra* note 41, at 341.

60. *See* Gross, *supra* note 32, at 327 ("Absent other changes in the system, more claims would probably be brought, and the total compensation for injuries would probably be higher than under the present system.").

61. Choharis, *supra* note 6, at 473–74.

62. Gross, *supra* note 32, at 346 n.9.

controversial, contingent fees have become ingrained in American legal practice.[63]

Subrogation

Second is subrogation, where an insurance company compensates a tort victim for his injuries while retaining the right, either contractually or equitably, to pursue the victim's claim against the tortfeasor.[64] Functionally, this is just how a market for tort claims would work: victims would sell their claims for instant compensation, and the purchasers would then pursue recovery from the victim's alleged tortfeasor.[65] In subrogation, however, the tort victim must have already purchased an insurance policy to receive compensation.[66] This is problematic for the average tort victim, who may have automotive or health insurance, but may not be able to afford personal injury insurance, or even see it as necessary.

Settlement

A settlement is an agreement to waive all or part of a claim in exchange for compensation.[67] Settlements can be viewed as market transactions, influenced by forces external to the case at bar.[68] That is, if two parties entered into settlement negotiations with equal bargaining power and equal interests in settling, then the settlement would reflect the mean of the jury awards expected by each of the parties.[69] As explained above, though, this is often not the case, especially where the plaintiff is an individual tort victim and the

63. *See* Moliterno, *supra* note 13, at 229–30 (describing the rise of contingency fees).

64. Choharis, *supra* note 6, at 469–70; Shukaitis, *supra* note 41, at 333.

65. *But see* Steinitz, *supra* note 7, at 1296 (describing conflicts of interest that arise between the insurer and the insured, as well as the insurer and the attorney).

66. *See* Shukaitis, *supra* note 41, at 333 n.23 ("Subrogation is the right that one party has against a third party following the payment of a legal obligation that was owed by the third party.").

67. Choharis, *supra* note 6, at 469.

68. Molot, *supra* note 29, at 83–85.

69. *Id.* at 84.

defendant is a sophisticated corporation.[70] Settlements in these cases reflect the differing levels of risk aversion of the two parties, with the plaintiff settling for less than what he or she might receive at trial out of fear of recovering nothing at all.[71] In this sense, settlement is not simply the adjudication of a claim, but may also be understood as a transaction influenced by a variety of external forces.[72]

D. Common Arguments Against Tort Claims Markets

That a variety of claim transfers in effect already exist is not, of course, a compelling argument to completely abolish the existing prohibitions. Indeed, that only a few exceptions have been carved out from the prohibitions suggests that there are profound issues with the selling of claims. In this section, I will detail the common arguments against the sale of tort claims.

1. Tort Claims Markets Would Spur Frivolous Litigation

One of the most frequently cited arguments against the sale of tort claims is that such a market would result in a flood of frivolous litigation.[73] Indeed, this is the primary rationale underlying the general prohibitions against champerty throughout the United States.[74] Whether litigation would increase as a result of the creation of a tort claim market is largely an empirical matter, and whether any such increase is a bad thing is a philosophical one. After all, that more tort victims would receive compensation for their injuries is one of the primary arguments for the creation of tort claim markets in the first place.[75]

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70. Steinitz, *supra* note 7, at 1305. *See also* notes 51–54 and accompanying text (discussing the variation in bargaining positions between tort victims and corporate defendants).

71. Molot, *supra* note 29, at 84. *See also* Shukaitis, *supra* note 41, at 334–41 (discussing causes of poor bargaining power and the effects of risk aversion).

72. Molot, *supra* note 29, at 83.

73. Gross, *supra* note 32, at 327; Molot, *supra* note 29, at 106–07; Steinitz, *supra* note 7, at 1327.

74. Moliterno, *supra* note 13, at 250–51.

75. *See, e.g.*, Chokaris, *supra* note 6, at 444–45 ("Tort victims will be able to receive immediate, certain, and often greater payments from claims purchasers.").

Nonetheless, concerns over frivolous—that is, non-meritorious—litigation are substantial. But, as I will discuss, this is a problem with the aggregation of tort claims in general. Moreover, there are a variety of safeguards against frivolous litigation, including restrictions on attorney advertising, contingency fees and court sanctions (not to mention the interest of defendants in fighting meritless suits to defend their bargaining reputations).[76]

There are, however, other systemic problems posed by tort claims markets. Samuel Gross has argued that the adjudication of claims would shift heavily to settlement, resulting in less tort litigation.[77] This in turn would ultimately hurt both the plaintiff and defense bars.[78] Meanwhile, defendants on the whole would pay more in damages (although plaintiffs would receive more for their claims).[79] Additionally, Maya Steinitz has suggested that the shift towards settlement might result in less development of tort law,[80] though she believes that claim buyers would nonetheless pursue novel theories to maximize the value of their portfolios.[81]

2. Tort Claims Markets Raise Legal Ethics Problems

Ethical issues arise when a lawyer purchases an entire claim, effectively eliminating the attorney-client relationship and changing the lawyer's role from that of a professional and an agent to that of a profit seeker.[82] However, this situation is different from that of the unabashedly profit-seeking nature of an investment firm, a business that may employ counsel to pursue claims as it sees fit. Of course,

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76. *See* Moliterno, *supra* note 13 ("With sophisticated controls on frivolous litigation already in place, current acquisition of interest and financial assistance rules disproportionately prevent the bringing of meritorious claims, not frivolous ones.").

77. Gross, *supra* note 32, at 327–28.

78. *Id.*

79. *Id.* at 328.

80. *See* Steinitz, *supra* note 7, at 1315 (stating that when parties have no interest in creating precedent, they then have no incentive to litigate, and therefore there is no pressure on the law to change).

81. *Id.* at 1315–16.

82. Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 717–18 (2004).

legal ethics rules permit a lawyer to represent himself in his own claim, and pro se litigation is permitted in general under law.[83] But it is possible that an attorney who pursues a claim solely out of the desire to maximize profit is more likely to resort to fraud upon the court, such as fabricating evidence or misrepresenting it.[84]

Furthermore, ethical problems arise when a lawyer purchases a claim. When a lawyer purchases a claim from a client, he runs into ethics rules dealing with business transactions between attorneys and clients.[85] Additionally, the client—or an unrelated, unrepresented person—may make the erroneous inference that the lawyer is giving disinterested legal advice regarding the sale when he or she is in fact acting out of self interest.[86] Of course, the possibility of fraud or misrepresentation is not merely an ethical concern, and this issue would apply to non-lawyers, too. There would exist a bargaining power disparity between the lawyer and client: the former would be much more sophisticated in valuing the claim.[87] This is a substantial concern, but it can be addressed with regulation and judicial recourse.[88] Indeed, ethical rules already require lawyers engaging in business transactions with clients to advise that the client seek independent counsel.[89]

3. Alienability of Tort Claims and Individual Justice

Perhaps one of the strongest arguments against the selling of tort claims is that it simply conflicts with our traditional notion of what a lawsuit is: a tort victim getting his or her day in court against a tortfeasor. The tort victim's day in court is arguably just as important to our notion of justice as seeing the tortfeasor pay for the

83. *Id.* at 718.

84. *Id.* at 720.

85. Molot, *supra* note 29, at 113.

86. Abramowicz, *supra* note 82, at 719.

87. *See* Molot, *supra* note 29, at 107 (discussing possible exploitation of unsophisticated plaintiffs and possible safeguards).

88. *See* Steinitz, *supra* note 7, at 1330–31 (proposing that courts review claim transfer contracts). *But see* Choharis, *supra* note 6, at 489 (arguing that "a well-developed tort claims market will minimize the possibility of fraudulent or unconscionable purchases").

89. MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (1995).

damages he or she (or it) caused.[90] The creation of a tort claims market means that tort claims would essentially become commodities.[91] That this is disconcerting is a perfectly acceptable argument against the creation of tort claims markets: states have an interest in maintaining the integrity of their justice systems.[92] Moreover, the increased monetization of legal claims might result in a decrease in cases seeking socially desirable remedies such as injunctions or specific performance.[93]

These concerns, however, can be mitigated by regulation. First, claim buyers would have an interest in keeping the victim involved in litigation, especially if they intend to go to trial; thus, they may structure contracts so that the victim is obligated to, or has the incentive to, cooperate when needed.[94] Second, it should be emphasized that selling one's claim is merely an option. To the extent that fraud or coercion is an issue, states are free to enact measures protecting tort claimants. Finally, states are also free to limit the tort claims market to certain kinds of claims should the

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90. *See* Abramowicz, *supra* note 82, at 712 (discussing how the alienability of tort claims undermines the moral aspect of tort law by severing the relationship between tort victims and tortfeasors).

91. *See id.* at 703–04 (discussing commodification as a noneconomic justification for opposing claim sales).

92. Many states that have relaxed restrictions on champerty nonetheless restrict claim assignments on speculative litigation or certain personal injury torts. *See* Christy Bushnell, *Champerty Is Still No Excuse in Texas: Why Texas Courts (and the Legislature) Should Uphold Litigation Funding Agreements*, 7 HOUS. BUS. & TAX L.J. 358, 377 (2007) (giving examples of prohibited claims that now "constrain what was initially a liberal acceptance of champerty in Texas"). In Texas, where the general rule is that personal causes of action may be sold, courts sometimes refuse to recognize assignments of malpractice claims because the commercial marketing of malpractice claims would "demean the legal profession." Zuniga v. Groce, Locke & Hebdon, 878 S.W.2d 313, 317 (Tex. App.—San Antonio 1994, writ ref'd).

93. Steinitz, *supra* note 7, at 1321.

94. Choharis, *supra* note 6, at 481–82; Gross, *supra* note 32, at 327. This is one of the major practical issues facing proposals to allow investments in torts. While contracts can be negotiated to require cooperation on the seller's part, and at trial the jury may be shielded from knowing the victim has sold his or her claim (akin to the collateral source rule), the problem remains that victims may inevitably convey their lack of interest to juries. Shukaitis, *supra* note 41, at 348 n.82. *But see* Choharis, *supra* note 6, at 483 (arguing that tort victims are not simply "profit-maximizers" and would be motivated to stay involved out of a desire for justice or revenge).

possibility of claim commoditization be too offensive under certain circumstances.[95] But despite these ready rebuttals, there is an understandable, fundamental unease with the complete detachment of a right of action from a tort victim.

II. REEVALUATING THE DEBATE OVER TORT CLAIMS MARKETS IN LIGHT OF THE RISE OF MASS TORT LITIGATION

The development of mass tort litigation in recent decades has resulted in a new model of litigation and an array of vexing ethical and legal issues. Mass tort litigation, because of its sheer size and complexity, implicates broader public policy issues in tort law. The issues raised by this new landscape of litigation call for a reevaluation of the debate over the sale of tort claims.

In this part, I provide an overview of mass tort litigation and some of its main issues that bear on the topic of this Note. Evaluating these issues in light of the debate over the sale of tort claims, I find that the objections to tort claims markets are weakened when evaluated in the context of the mass tort model. Proposals to permit the sale of tort claims comport with the realities of mass tort litigation. The debate, therefore, should shift from the conceptual to the concrete: to how tort claims markets interact with, and could address, issues that have emerged from the world of mass tort litigation.

A. An Overview of Mass Torts

When I speak of mass torts, I do not refer to class actions, in which claims that individually are not valuable enough to be litigated are consolidated and pursued by a court-appointed class counsel.[96] Mass torts are, most broadly, allegations of tortious misconduct that

95. Steinitz, *supra* note 7, at 1321–22 (acknowledging that the selling of legal claims may commoditize causes of action and the legislatures should address this issue as they see fit). Existing laws may already provide some safeguards. *See supra* note 92 and accompanying text.

96. *See* RICHARD NAGAREDA, MASS TORTS IN A WORLD OF SETTLEMENT 71 (University of Chicago Press, 2007) (describing a class action as a procedural oddity in which class representatives sue on behalf of numerous, similarly situated persons).

affect a large number of people, most of which are of sufficient individual value that they could be brought individually.[97] As Professor Francis McGovern has noted, most torts are mass torts in the sense that claims can usually be classified as a group—medical malpractice, for example.[98]

But "mass torts" has taken on a specific meaning not simply because of the scale of the tortious misconduct, but rather because of the challenges the ensuing litigation has posed for the legal system.[99] Examples include the asbestos litigation, the Vioxx settlement, and Dalkon Shield—mass litigation that has become familiar to the public consciousness.[100]

Mass torts are byproducts of industrialization, where new products are developed and distributed on a large scale, and the cases can be exceedingly complex.[101] The science can be unclear; for example, the Agent Orange litigation, one of the first of what we now call mass torts, was settled in the absence of legally sufficient evidence of causation.[102] And where a causal link can be established between injuries and an occurrence, it may be impossible to determine who the tortfeasor is, as in the DES litigation of the 1970s.[103]

Further, there is the issue of exposure-only victims—people who have been exposed to tortious conduct but have not yet manifested any injuries.[104] For example, scientists can detect prior asbestos exposure in the lungs of an unimpaired person, raising the question of whether courts should recognize claims in these cases.[105] Finally, even where claims appear straightforward, the sheer number

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97. *See id.* at xii ("The term 'mass accidents' describes tortious misconduct that affects large numbers of persons in similar ways."). *See also* Howard Erichson, *A Typology of Aggregate Settlements*, 80 NOTRE DAME L. REV. 1769, 1772 (2004) (noting that mass torts generally cannot be certified as class actions due to the number of individual issues in dispute).

98. Francis McGovern, *An Analysis of Mass Torts for Judges*, 73 TEX. L. REV. 1821, 1823 (1994).

99. NAGAREDA, *supra* note 96, at viii.

100. *See, e.g.*, *id.* at vii–viii (discussing, *inter alia*, the asbestos litigation).

101. *Id.* at 1–2.

102. JACK WEINSTEIN, INDIVIDUAL JUSTICE IN MASS TORT LITIGATION 152 (Northwestern University Press 1995).

103. *Id.* at 149–50.

104. NAGAREDA, *supra* note 96, at 22.

105. *Id.* at 24.

of claimants often poses challenges to the court system.[106] For instance, estimates project that 2.5 million asbestos claims will have been filed by the time the epidemic recedes.[107]

B. *Reevaluating the Debate over Selling Tort Claims in Light of Features of Mass Tort Litigation*

While mass tort litigation refers to a diverse range of cases, it has two key features. First, the litigation tends to aggregate claims, both informally (where plaintiffs' firms join together) and formally (where cases are consolidated in the court system).[108] Second, the process is geared towards settlement.[109] The issues that have arisen from the mass tort framework and its implications for our notions of individual justice call for a reevaluation of the debate over tort claims markets.

1. The Trend Towards Aggregation and Settlement in Mass Torts

Lawyers and courts, naturally, have attempted to address the sheer size of mass torts by seeking to streamline the process.[110] Accordingly, plaintiffs' firms, even outside of the Multidistrict Litigation committee structure, often make arrangements to divide up the labor of the case.[111] For example, one firm may handle proof

106. McGovern, *supra* note 98, at 1823–24.

107. Samuel Issaacharoff & John Fabian Witt, *The Inevitability of Aggregate Settlement: An Institutional Account of American Tort Law*, 57 VAND. L. REV. 1571, 1625 (2004).

108. NAGAREDA, *supra* note 96, at 13, 17; Issaacharoff & Witt, *supra* note 107, at 1576; McGovern, *supra* note 98, at 1826.

109. *See* Erichson, *supra* note 97, at 1774–75 ("[T]he accumulation of large numbers of clients by plaintiffs' firms functions as an informal aggregation mechanism, facilitating the negotiation of group settlements."); Isaacharoff & Witt, *supra* note 107, at 1576 (noting that "settlement practices coexist with the formal law of tort such that, as an empirical matter, relatively few cases actually go to trial").

110. *See* discussion in sources cited *supra* notes 108 and 109 (discussing collective approaches to tort litigation, including consolidation, working relationships between law firms, and the federal courts' Judicial Panel on Multidistrict Litigation).

111. NAGAREDA, *supra* note 96, at 14.

of the defendant's liability, while the other may handle proof of clients' injuries; after several successful trials, these firms may reach out to yet more firms to produce a steady stream of clients.[112] The litigation has matured once discovery has been completed, multiple bellwether trials have been concluded, and significant appellate review of novel legal issues has been undertaken.[113]

Judges, similarly, have sought to control the influx of cases by consolidating them.[114] Similar cases may be tried together in federal court, for example, and the Judicial Panel of Multidistrict Litigation can consolidate lawsuits throughout the federal court system for pretrial proceedings.[115] When a judge supervises the lengthy discovery of these cases and works extensively with both parties, the inevitable result is a push towards settlement.[116] Certainly, defendants may choose to contest every claim,[117] at least for a time, and bellwether trials may be conducted to test the relative strengths of the parties' positions,[118] but the overall momentum of the process leads towards settlement.[119]

2. How a Market for Tort Claims Comports with Mass Tort Litigation

In light of this rough framework, proposals for the creation of tort claims markets gain some traction; the purported strengths of the concept align well with the world of mass torts.

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112. *Id.* at 17.

113. *Id.* at 15.

114. McGovern, *supra* note 98, at 1826.

115. *See id.* ("The process generally has involved consideration for pretrial purposes" and "coordination of federal and state cases . . .").

116. *See* Eldon Fallon, Jeremy T. Grabill & Robert P. Wynne, *Bellwether Trials in Multidistrict Litigation*, 82 TUL. L. REV. 2323, 2328 (2008) (explaining that the transferee court's broad authority includes attempting to facilitate settlement discussion).

117. NAGAREDA, *supra* note 96, at 19.

118. Fallon, Grabill & Wynne, *supra* note 116, at 2330–32.

119. *Id.* at 2328.

a. Economies of Scale and Reducing Transaction Costs

In the immature stage of litigation, plaintiffs' firms must develop their "generic assets," the legal and factual bases of the case.[120] This process is expensive: experts must be hired, discovery must be performed, and clients must be sought and recruited.[121] The mass tort litigation model and the model of adjudication that proponents argue will emerge from a market in tort claims focus on streamlining the process by reducing transaction costs.[122] By opening up capital markets to the world of litigation, tort investors would have access to greater funding than plaintiffs' firms currently have and would thus get more leverage out of economies of scale by consolidating claims to reduce transactional costs.[123]

b. Reducing Organizational and Ethical Difficulties

When firms join together to pursue a mass tort claim, coordination problems inevitably arise. Lawyers, being lawyers, may dispute over the division of labor, decisional hierarchy, and strategy of the litigation.[124] More problematic—not only for plaintiffs but also for defendants and judges—is that these disputes may hamper the settlement process.[125]

Allowing third parties to invest in claims and pursue them may alleviate these problems.[126] A single investment firm or law firm may have the funds necessary to invest in and pursue a mass tort—plaintiffs' firms' arrangements are, after all, largely a function

120. NAGAREDA, *supra* note 96, at 13.

121. *See id.* at 14 (explaining that "[t]he development of generic assets takes money. Experts generally do not work for free . . . [a] plaintiffs' law firm, in short, must incur considerable fixed costs to develop generic assets . . . .").

122. *See* Gross, *supra* note 32, at 326 (noting that economies of scale may lead to more efficient compensation and that compromise will be more likely).

123. *Id.* at 326.

124. *See* Choharis, *supra* note 6, at 496–97 (noting that "class actions present attorney-attorney rivalries").

125. *Id.* at 496.

126. *Id.* at 498.

of capital shortage.[127] But even in the case that several third parties coordinate to invest in and pursue a mass tort, organizational difficulties might largely be mitigated by the fact that all the parties share the same goal: profit maximization.[128] As claims will have already been purchased, there would be no disputes over apportioning settlement offers to clients. All that would matter is the recovery.

Significantly, ethics rules requiring unanimous client approval in aggregate settlements would no longer hinder the process because the claim sellers simply would no longer be part of the process.[129] The aggregate settlement rule has been subject to substantial debate among legal scholars, as it requires a substantial sacrifice in organizational efficiency in order to achieve full client disclosure and consent.[130] Clients inevitably argue over the allocation of settlement offers.[131] Furthermore, conflicts of interests arise between attorneys, who want to settle, and clients, who may want a larger settlement or to go to trial.[132] And, because attorneys must fully disclose to each client the terms of the offer and how every other client will fare, ethical issues regarding the dissemination of confidential information may arise.[133] These issues would essentially vanish in a market for tort claims.

Thus far, this portrayal of a tort claims market in the world of mass tort litigation seems optimistic, but I simply wish to illustrate that proposals for third-party investment in tort claims align well

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127. *See id.* at 477 (noting that plaintiffs' firms monopolize legal labor, a form of capital investment).

128. *Id.* at 498.

129. *See* MODEL RULES OF PROF'L CONDUCT R. 1.8(g) (1995) (stating that "[a] lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients . . . unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement").

130. *See* Charles Silver & Lynn Baker, *Mass Lawsuits and the Aggregate Settlement Rule*, 32 WAKE FOREST L. REV. 733, 736–37 (discussing conflicts of interest and other issues that arise from the aggregate settlement rule).

131. *Id.* at 767.

132. *See id.* at 762 (describing a case where a settlement was made, but a few plaintiffs complained, eventually resulting in the lawyer becoming so frustrated that he withdrew from the case).

133. *Id.* at 756–60.

conceptually with the mass tort litigation framework. More central to my point is that mass tort litigation, with its emphasis on aggregation and settlement, presents different concerns from traditional tort litigation, and in light of these different concerns the main objections to selling tort claims lose traction.

3. Individual Justice in Mass Tort Litigation

The mass tort litigation framework has raised troublesome issues regarding individual justice within the legal system. Our traditional notion of the "Lincolnesque lawyer strongly bonded to an individual client" is upset by mass tort litigation,[134] where a client may be just one among thousands and attorney contact may be minimal. As a result, many clients in mass tort cases may feel "alienated and dehumanized," like "anonymous recipients of a form of justice they do not understand—players in a kind of lottery of awards and rejections from our system of law."[135]

I do not argue that third-party investment in tort claims will solve all these issues—by and large, alternative litigation does not intend to address them. But this acceptance of a strain on our traditional notion of individual justice for the sake of systemic efficiency weakens arguments that the selling of tort claims is problematic because it would have similar effects on our ideas of justice. Mass torts, as Judge Jack Weinstein has noted, "are public interest cases;" they implicate different issues than traditional single-party disputes, and we should be candid about this reality.[136]

Indeed, Judge Weinstein has noted the merits of some forms of claim assignment in mass tort litigation. While he nonetheless prefers traditional forms of financing and has observed that proposals for assignment would upend traditional notions of champerty, he has also acknowledged that the concept "comport[s] with some of the realities of mass litigation."[137] His opposition is based on the conviction that we as a society should avoid severing

134. WEINSTEIN, *supra* note 102, at 39.
135. *Id.* at 9.
136. *Id.* at 39.
137. *Id.* at 78–79.

the connection between the injured and the courts, that these are not "reasonable-person economic cutouts," but real people.[138]

This objection is one I acknowledged earlier as completely valid: a fundamental discomfort with the concept of the sale of one's tort claim. As Judge Weinstein notes, the concept comports with the new mass tort reality, but he simply cannot abandon what he feels is a fundamental value of the justice system.[139] In fact, individual justice and claim transfer are not incompatible concepts. As mentioned earlier, in a tort claims market, victims are compensated immediately upon sale. Marginal cases, especially those from exposure-only victims, will find buyers seeking to maximize bargaining power. While some tort victims may seek more from the legal system than mere compensation, other victims might want quick closure and consequently will find prolonged litigation and its uncertainties to be a source of pain. The ability to sell their claims would be a welcome alternative.

4. Systemic Effects of Tort Claims Markets on Mass Tort Litigation

In this Note I have tried to establish that a market in tort claims aligns with the realities of mass tort litigation and that the debate should not focus so much on the concept but on the policy issues surrounding its implementation. On this point, however, some serious issues could arise from the creation of tort claims markets.

One of the primary systemic problems that has arisen in mass tort litigation is settlement pressure. Aggregation takes on a force of its own, pressuring risk-averse defendants into settling for the sake of closure.[140] This in itself is not necessarily a problem; rather, the problem is that there may be, as Judge Richard Posner noted, a "great likelihood that the plaintiffs' claims, despite their human appeal, lack legal merit."[141] A tort claims market may possibly

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138. *Id.* at 79.

139. *Id.* at 78–79.

140. NAGAREDA, *supra* note 96, at 43.

141. *Id.* at 45 (quoting *In re* Rhone-Poulenc Rorer, Inc., 51 F.3d 1293, 1299 (7th Cir. 1995)). While Judge Posner was referring to a case involving a class action settlement, Nagareda acknowledges the potential for settlement pressure to extend to other modes of aggregation. *Id.* at 48–49.

exacerbate this phenomenon, shifting power too far in favor of plaintiffs' firms or investors (frivolous litigation, after all, is one of the primary concerns with regard to tort claims markets).

Whether this is a good or bad thing is a normative debate I do not wish to enter. Rather, I conclude by pointing out that regulation may ultimately be insufficient to contain the perceived negative consequences of tort claims markets and that this is where the debate should center. For example, secondary markets may develop where claim options are traded to hedge against losses.[142] Deceptive or coercive bargaining may prove too difficult to police where non-lawyers may purchase claims. While many tort victims may want to take their cases to court, they may be unable to find representation willing to take on the expense and risk of a traditional case in a mass tort scenario. I take no position on these issues, but simply contend that this is where future debate should focus.

III. CONCLUSION

In this Note I have argued that the common objections to the selling of tort claims lose traction when evaluated in light of mass tort litigation. A market for tort claims comports with the realities of mass tort litigation and its focus on aggregation and settlement. Objections based on the premise that tort claims markets would alter our notion of individual justice lose strength when one considers that the mass tort litigation model has already produced a similar change. I do not argue that this concern lacks validity; indeed, I acknowledge that a fundamental uneasiness with claim assignment is a perfectly legitimate objection. But mass tort litigation is a reality, and the debate over alternative litigation financing will continue. I merely contend that we should accept these realities and that the debate over tort claims markets should move from the conceptual to the concrete.

142. *See* Steinitz, *supra* note 7, at 1319 (acknowledging that while secondary markets may lower risk for funders, they may also create moral hazards).

The Bankruptcy Auction as a Game – Designing an Optimal Auction in Bankruptcy

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Whether in a bankruptcy case of a fraudulently operated firm such as Enron[1] or that of the temporarily distressed Los Angeles Dodgers baseball team;[2] in a routine and small-scale bankruptcy case of a neighborhood restaurant[3] or in the unique multi-billion dollar bailouts of Chrysler and General Motors;[4] in a bankruptcy of a traditional manufacturing firm[5] or of a high-tech business;[6] in the United States or in Europe;[7] bankruptcy auctions have become "no

1. *See* PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON 178 (2002) (discussing Enron's Chapter 11 bankruptcy); Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787, 1809 (2002) (discussing the lessons from the Enron scandal including how quickly an auction was held after Enron's collapse and bankruptcy).

2. *See* Matthew Futterman, *Dodgers Up Against Cash Crisis*, WALL ST. J., Apr. 29, 2011, at B8 (discussing the reasons for the financial difficulties faced by the Dodgers).

3. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 685–89 (2003) (analyzing such a case).

4. For a description and discussion of these bankruptcy auctions, see Douglas G. Baird, *Car Trouble*, (Univ. of Chi. Law & Econ., Olin Working Paper No. 551, 2011), *available at* http://ssrn.com/abstract=1833731 (arguing that the bankruptcies of Chrysler and General Motors provide a number of lessons for corporate reorganization).

5. *See, e.g.*, Michael Bathon, *Evergreen Solar Wins Approval to Sell Most of Its Assets*, BLOOMBERG.COM (Nov. 11, 2011), www.bloomberg.com/news/2011-11-10/evergreen-solar-wins-court-approval-to-sell-most-of-its-assets.html (reporting the bankruptcy auction of Evergreen Solar, Inc.).

6. *See, e.g.*, Scott D. Cousins, *Chapter 11 Asset Sales*, 27 DEL. J. CORP. L. 835, 835–37 (2002) (discussing bankruptcy auctions of dot-com companies).

7. For a European perspective, see, for example, David Hahn, *When Bankruptcy Meets Antitrust: The Case for Non-Cash Auctions in Concentrated Banking Markets*, 11 STAN. J. L. BUS. & FIN. 28, 30 (2005) (describing the case of non-U.S. jurisdictions with concentrated markets); S. Abraham Ravid & Stefan Sundgren, *The Comparative Efficiency of Small-Firms Bankruptcies: A Study of the US and Finnish Bankruptcy Codes*, 27 FIN. MGMT. 28, 29 (1998) (discussing

longer a last resort but an option to be exercised at any time if it is in the creditors' interest."[8] Indeed, recent studies show that over half of the firms entering corporate bankruptcy proceedings[9] are auctioned[10]—either piecemeal or as a going concern—instead of reorganized[11] and restructured.[12] Auctions seem to create value for

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the European inclination towards creditor-friendly bankruptcy regimes); Karin S. Thorbum, *Bankruptcy Auctions: Costs, Debt Recovery, and Firm Survival*, 58 J. FIN. ECON. 337, 342–43 (2000) (discussing the Swedish practice of a mandatory auction for all firms entering bankruptcy).

8. *See* Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 71 (2004) (discussing Chapter 11 as a forum for market sales); Baird & Rasmussen, *supra* note 3, at 691 ("Selling a business in Chapter 11 is no longer a last resort but an option to be exercised at any time if it is in the creditors' interest."); Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 849 (2005) ("Chapter 11 offers better rules for selling a firm than state law."). Of course, the real world is complex, and an auction is not always sufficient to resolve a bankruptcy case. *See also* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 3 (2007) (presenting empirical evidence that rather than an auction, reorganization remains essential to dealing with the financial distress of large public companies).

9. For reasons of convenience, this Article focuses on corporate rather than personal bankruptcies. However, the discussion can easily be extended to the latter context as well.

10. *See* Paul Povel & Rajdeep Singh, *Sale-Backs in Bankruptcy*, 23 J.L. ECON. & ORG. 710, 710 (2007) (noting that "only a small fraction of bankrupt firms are actually reorganized and most firms (in particular, small firms) are sold, either as going concerns or piecemeal"). In 2002, 56% of the large Chapter 11 cases that ended included a sale. Baird & Rasmussen, *supra* note 3, at 675–76. *See also* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751–52, 786 (2002) (noting that many firms use Chapter 11 merely to sell their assets and that ongoing concern sales in general have long been "the method of choice" for dealing with financially distressed firms); B. Espen Eckbo & Karin S. Thorburn, *Bankruptcy as an Auction Process: Lessons from Sweden*, 21 J. APP. CORP. FIN. 38, 39 (2009) (describing the rise of an active secondary market for publicly traded distressed debt claims in the United States). For an attempt to portray a more balanced picture, see Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's "The End of Bankruptcy,"* 56 STAN. L. REV. 645, 647 (2004) (showing that "traditional" reorganizations, which do not include an auction, are also prevalent).

11. The term "reorganization" is used in this Article to describe the process of attending to the financially distressed firm's assets and changing the manner in which these assets are employed as part of the firm's course of real economic activities. Of course, not all financially distressed firms need to be reorganized to be rescued, as sometimes the source of the firm's distress lies in the right side of

financially distressed firms.[13] However, what is the optimal design of a bankruptcy auction? Does the method by which a bankruptcy auction is executed matter at all? Is there a difference, for example, between the impact of an "English auction" and that of a "sealed-bid" auction? Does it matter whether a reserve price is set in advance or whether that price is hidden from potential bidders? More generally, does one auction method fit all bankrupt firms?

Surprisingly, although bankruptcy auctions are ubiquitous, these questions have not yet been answered, as auction design in the specific context of bankruptcy has barely been studied.[14] Thus, the

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the balance sheet, which lists the firm's obligations, rather than the left side, which lists the assets.

12. The term "restructuring" is used in this Article to describe the process of attending to the financially distressed firm's obligations and changing its capital structure. During a restructuring process, debt may, for example, be reduced, replaced with equity entitlements, or restructured differently. Of course, if the source of the firm's hardship emanates from the left side of the balance sheet—in other words, the firm is economically non-viable—a restructuring can only temporarily alleviate the firm's financial distress.

13. *See, e.g.*, Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. FIN. INTERMEDIATION 240, 243–44 (1998) (finding empirical support that firms merged with bankrupt targets show significant improvements in operating performance).

14. Exceptions, most of which are found in the financial-economic literature, include: Baird, *supra* note 4, at 2 (discussing creditor control of the auction and credit bidding); Elazar Berkovitch, Ronen Israel, & Jaime F. Zender, *Optimal Bankruptcy Law and Firm-Specific Investments*, 33 EUR. ECON. REV. 441, 488 (1997) (suggesting a "restricted auction" design, which allows creditors to prevent bankruptcy proceedings but prevents them from participating in a second-price sealed-bid auction); Sugato Bhattacharyya & Rajdeep Singh, *The Resolution of Bankruptcy by Auction: Allocating the Residual Right of Design*, 54 J. FIN. ECON. 269, 269 (1999) (discussing control over the design of the auction); Vincent S.J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99, 100 (2010) (discussing the issue of credit bidding); Edith S. Hotchkiss & Robert M. Mooradian, *Auctions in Bankruptcy*, 9 J. CORP. FIN. 555, 555–56 (2003) (discussing the question of mandatory versus voluntary auctions, as this feature can impact the results of the auction); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 70 (1991) (discussing owner participation in bankruptcy reorganization plans using auction theory); Povel & Singh, *supra* note 10, at 711 (discussing owner participation in auctions); Alan N. Resnick, *Denying Secured Creditors the Right to Credit Bid in Chapter 11 Cases and the Risk of Undervaluation*, 63 HASTINGS L.J. 323, 330 (2012) (discussing the issue of credit

optimal design of a bankruptcy auction remains a "black box" to lawmakers and practitioners.[15] Bankruptcy scholars have argued vigorously about whether bankruptcy auctions should be employed as the preferred method for redeploying the bankrupt firm's assets.[16] Additionally, they have also utilized empirical data gathered on bankruptcy auctions worldwide to argue over the relative efficacy of auctions in bankruptcy cases.[17] However, little attention has been given to the art of designing an optimal bankruptcy auction. Even more importantly, much of the work performed by scientists in the context of general auctions—many of the valuable insights generated and findings gathered during decades of research—has failed to reach and influence the setting of bankruptcy auctions.

This Article contributes to this scarce literature by shedding light on the possible interaction of bankruptcy auctions with a field of study that has strongly influenced the design of auctions in general: game theory. Our main theme concerns the need to consider the insights offered by the field of "auction theory" when planning the manner in which the assets of financially distressed firms are to be auctioned within a bankruptcy proceeding.[18]

However, the contribution of auction theory to the regulation of bankruptcy auction design is nuanced and should be examined using a wide perspective. Indeed, one can speak of both the merits and the procedural contributions of auction theory to the practice of bankruptcy auctions. We illustrate the former by examining the case of "credit bidding."[19] Having become the subject of a circuit split

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bidding). Of course, studies have also empirically studied how bankruptcy auctions are executed. *See infra* Part I.A.2 (discussing common features of bankruptcy auctions).

15. For a similar phenomenon in other contexts of corporate sales, see Jonathan R. Macy, *Auction Theory, MBOs and Property Rights in Corporate Assets*, 25 WAKE FOREST L. REV. 85, 86 (1990) ("[T]he rich literature from the field of economics on auction models has not permeated into the legal literature.").

16. *See infra* Part I.B.1 (arguing for the use of auctions except in contexts where bankruptcy is expected to pursue redistributive goals).

17. *See infra* Part I.B.1 (discussing whether creditors can bid with their claim for credit in a bankruptcy auction).

18. *See infra* Part III (explaining how auction theory can be used to improve bankruptcy auctions).

19. *See infra* Part I.A.2, III.C (arguing that auction theory helps highlight the current problems with bankruptcy auction proceedings).

and a ruling by the Supreme Court, credit bidding—the practice of allowing a secured creditor to bid in a bankruptcy auction using its claim as currency (in whole or part) rather than cash—can be usefully analyzed with the tools provided by auction theory.

Thus, this Article offers three contributions to the design of auctions in bankruptcy. First, we argue that as a default design (which may be changed under special circumstances), the bankruptcy auctions of large firms should be executed according to a novel design that we call "Anglo-Dutch Veto Auction" ("ADVA").[20] An ADVA design consists of an Anglo-Dutch auction—rather than a simple sealed-bid or English auction[21]—at the end of which the secured creditor is extended the right to veto the sale in exchange for paying a pre-defined amount as the cost to the highest bidder and conditioned upon the bidding price not exceeding the amount of the secured claim. We argue that an ADVA design is superior mainly because it is the best way to simultaneously tackle problems of weak competition and lack of information about the auctioned assets—two problems that are the most critical in the context of bankruptcy auctions.

Second, it is argued that, although "credit bidding" may safeguard the secured creditor, such protection becomes redundant once the auction is executed as an ADVA. Given that "credit bidding" poses a possible danger to the intensity of competition in the auction and (occasionally) to unsecured creditors, the conclusion is that "credit bidding" should not be encouraged.[22]

Third, in the context of a procedural contribution of auction theory to the design of bankruptcy auctions, this Article argues that

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20. *See infra* Part III.A.2 (detailing the ADVA design for auctions).

21. An Anglo-Dutch auction begins by announcing a low amount for the price and the amount increases as the bidders continue to raise it, until the number of bidders remaining in the competition is one more than the number of items that are being auctioned. At this stage, the bidders are invited to submit a single sealed bid, which may not be lower than the last bid made thus far. In a sealed-bid auction, each bidder submits a bid in a sealed envelope; all the envelopes are opened at the same time; and the bidder who has submitted the highest bid wins the auction. An English auction begins by announcing a low amount for the price and the amount increases as the bidders continue to raise it, until only one bidder remains, with that bidder being the winner of the auction. *See infra* Part II.B (discussing the four basic types of bankruptcy auctions).

22. *See infra* Part III.B (arguing that ADVA is a superior auction design and that credit bidding is unnecessary).

one of the main problems—which should also alert lawmakers—undermining any effort to execute efficient bankruptcy auctions concerns the absence of a regulator who can implement a structured, trial-and-error procedure.[23] For example, unlike FCC auctions, where the FCC can employ auction theory to design what it believes to be the optimal auction given the circumstances, execute the auction, closely follow the results, and re-design a better auction in the future, bankruptcy auctions currently do not follow a similar track. The task of designing each bankruptcy auction is privatized, and although an accepted best practice may evolve among practitioners,[24] this practice can hardly entertain any attempt to improve—whether ad hoc or permanently—the design of these auctions, unless the bankruptcy courts decide to increase their involvement in regulating the specific auction designs.

The Article proceeds as follows. Part I describes the legal and economic landscape of the auctions executed in corporate bankruptcy proceedings. This Part begins with a general account of the legal framework for bankruptcy auctions as engendered by the Bankruptcy Code and then proceeds to discuss the legal debate regarding "credit bidding." Next follows a comprehensive summary of the economic environment of bankruptcy auctions. The reasons why bankruptcy auctions have become so widespread are discussed, as are the problems that undermine these auctions.

Part II is a primer describing the influence of game theory on auctions in general. Specifically, this Part refers to the field of knowledge recognized as auction theory. This Part starts with a general discussion of the goals of auction theory and then proceeds to offer a typology of common auctions. The various considerations relevant to choosing a particular auction design are discussed, as are various other aspects that concern the execution of an auction. To establish the practicality and relevance of auction theory, this Article describes the manner in which auction theory has been uniquely employed by the FCC to design its spectrum license auctions since the 1990s.

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23. *See infra* Part III.C (arguing that the absence of a regulator makes it difficult to hold efficient bankruptcy auctions).

24. *See* Robert G. Hansen, *Auctions of Companies*, 39 ECON. INQUIRY 30, 30–34 (2001) (describing how non-bankruptcy auctions have become standardized).

Parts I and II set the necessary background for the normative discussion in Part III by providing a comprehensive account of bankruptcy auctions and auction theory, respectively. However, it should be noted that the considerable length of each of these Parts is inevitable, mostly because of the absence of an existing legal text to which one could refer the reader. Nonetheless, a reader educated in either bankruptcy auctions or auction theory can skip the corresponding Part.

Part III focuses on the possible contributions of auction theory to the execution of bankruptcy auctions. This Part begins by discussing the need to consider auction theory when designing a bankruptcy auction and then develops a suggested default design—the ADVA—which we argue should serve as a baseline model of a bankruptcy auction. The question of "credit bidding" is then analyzed, followed by a discussion of the procedural aspects associated with employing auction theory to design optimal bankruptcy auctions. A conclusion follows.

I. BANKRUPTCY AUCTIONS—LEGAL AND ECONOMIC PERSPECTIVES

The purpose of this Part is to provide the reader with a succinct yet rich description of the bankruptcy auctions landscape. Section A will describe the legal background against which bankruptcy auctions are executed in the United States. Section B will discuss the relevant economic context.

A. Legal Background

1. Typical Scenarios

As a bankruptcy proceeding commences,[25] a bankruptcy auction may occur under one of two typical scenarios. In the first and more conventional scenario, an auction is conducted as the firm

25. A formal bankruptcy procedure may be initiated by either the firm (voluntary case) or its claimants (involuntary case). 11 U.S.C. §§ 301(a), 303(a) (2006).

is either liquidated (in a Chapter 7 proceeding[26]) or reorganized (in a Chapter 11 proceeding[27]). The Chapter 7 auction is an obvious move because the firm must be shut down and its assets sold.[28] However, Chapter 11 auctions are also prevalent. The goal of a Chapter 11 proceeding is to enable the claimants of the bankrupt firm to negotiate a plan among themselves. This plan is then put to a vote and must be accepted by the claimants and confirmed by the bankruptcy court. The motivation for this framework is that the claimants may agree on the manner in which the financially distressed firm is to be both restructured and reorganized. As part of the firm's reorganization, the claimants may agree upon an auction, whose purpose is to convert assets into cash.

The second scenario that typically ends in a bankruptcy auction is a sale under Section 363(b) of the Bankruptcy Code, which states that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ."[29] A Section 363(b) sale is allowed not only for trustees in Chapter 7 liquidations, but also as an out-of-plan maneuver for debtors-in-possession—usually the bankrupt firm's incumbent management—during a Chapter 11 proceeding.[30] In the Chapter 11 context, Section 363(b) presents an anomaly, as it bypasses rather easily the classic and carefully designed Chapter 11 structure of negotiation-plan-confirmation.[31]

This anomaly is accentuated in those cases in which the debtor-in-possession auctions most, if not all, of the firm's assets.[32] Indeed, Section 363(b) was originally enacted as a "side door" to

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26. *Id.* §§ 701–784.

27. *Id.* §§ 1101–1174.

28. *See id.* § 704(a)(1) (stating that the trustee shall "collect and reduce to money the property of the estate"); William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1402 (1994) (indicating that appointing a trustee in Chapter 11 should also trigger an auction solution).

29. 11 U.S.C. § 363(b)(1).

30. *Id.* § 103(a).

31. *See* Jason Brege, *An Efficiency Model of Section 363(b) Sales*, 92 VA. L. REV. 1639, 1640 (2006) (questioning why the Bankruptcy Code allows failing businesses to "escape the rigor" of bankruptcy plan confirmation using Section 363(b)).

32. *See id.* at 1643 (discussing how Section 363(b) allows debtors-in-possession to wastefully or improperly dispose of assets early in the bankruptcy process before creditors have complete information regarding reorganization).

cope with unique cases of bankrupt firms that may be considered to be "melting ice cubes."[33] For these firms, each passing day either deteriorates the firm's finances (e.g., declining cash reserves) or depreciates the value of its assets (e.g., high market values are about to decline).[34] For this reason, Section 363(b) entertains a path for a rather short-order sale. The more serious barrier to Section 363(b) sales is the judicially imposed requirement that a business justification be provided for the sale to obtain the court's approval.[35] The "business justification" requirement entrusts the bankruptcy court with discretion, and the courts were instructed to consider several factors when contemplating the approval of a 363(b) sale.[36] These factors include the proportionate value of the asset to the estate as a whole, the effect of the proposed disposition on future reorganization plans, and, perhaps most importantly, whether the asset is increasing or decreasing in value.[37] The courts were also instructed to consider whether the sale was adequately and reasonably noticed, whether it was proposed in good faith, and whether the disposition of the assets is "fair and expeditious."[38]

The extent to which Section 363(b) sales have been employed to dispose of the bankrupt firm, even in Chapter 11, has increased significantly over the years.[39] During the 1980s, bankruptcy courts were reluctant to allow such sales to proceed. However, during the 1990s, the courts gradually released the harness, and the flow of such sales has only increased since.[40]

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33. *See id.* ("Section 363(b) appears to offer a side door to escape the rigors of the typical bankruptcy plan confirmation.").

34. *See id.* at 1640 (discussing the varying "business justifications" courts have accepted as warranting a § 363(b) sale).

35. *See In re* Lionel Corp., 722 F.2d 1063, 1070–72 (2d Cir. 1983) (stating that, with a liberal reading of § 363(b), a bankruptcy judge has considerable discretion to approve a sale, but also must articulate sound business justifications for his decision, and cannot approve a sale on the basis that the company's creditors demanded it).

36. *Id.* at 1071.

37. *Id.*

38. *See* Brege, *supra* note 31, at 1653 (quoting the relevant case law).

39. *See id.* at 1640–42 (discussing the prevalence of these sales since the 2000s); LoPucki & Doherty, *supra* note 8, at 12–14 (describing how the rate of § 363 sales increased during the 1990s).

40. *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 168–71 (2005) (attempting to

2. The Question of Credit Bidding

Auctioning the assets of financially distressed firms undergoing a bankruptcy proceeding may evoke several legal questions. One such question that is currently preoccupying the courts is the issue of credit bidding. The legal question is fairly simple: can secured creditors participate in a bankruptcy auction bidding "with their claim" rather than with cash? In other words, if the bankrupt firm has a secured creditor and its encumbered assets are auctioned, can that secured creditor—when she chooses to compete over the auctioned asset—submit bids that offer a set-off of her claim for consideration? Obviously, the secured creditor can bid in this way up to the face value of her secured claim. However, is she entitled to do so? Specifically, if the debtor is not interested in the secured creditor bidding in this manner, can the debtor prevent the secured creditor from doing so?[41]

Because bankruptcy auctions can be held as a Section 363(b) sale or follow a confirmed reorganization plan, the question regarding credit bidding is actually more concrete. In the context of a Section 363(b) sale, there currently seems to be no legal problem, as Section 363(k) specifically states that the secured creditor is entitled to credit bid.[42] According to this provision, but "for cause," the secured creditor cannot be prevented from credit bidding in a Section 363(b) sale.[43]

However, things become more complicated in the context of a confirmed reorganization plan sale. Generally, for the bankruptcy court to confirm a reorganization plan, the debtor must prove, inter

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explain this phenomenon by referring to the intense competition over the big cases among the courts).

41. The reasons for the debtor's objection to the secured creditor bidding with its claim have not yet been analyzed by the courts that have had to make a decision on this issue. Obviously, the debtor (i.e., the debtor-in-possession's management) and the secured creditor disagree on the best way to dispose of the debtor's assets. A more detailed analysis of this conflict will be provided in Part III.B.

42. 11 U.S.C. § 363(k) (2006) (specifying that in an auction "of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property").

43. *Id.*

alia, that either each class of claims or interests has accepted the plan or the plan does not impair that class's claims or interests.[44] In a typical credit-bidding conflict under a reorganization plan, the interests of the secured creditor are impaired because, according to the plan, the encumbered assets are usually to be sold without the liens securing the claims surviving the auction and attaching to the assets as they are transferred to the buyer.[45] Denied the possibility of credit bidding, the secured creditor opposes the reorganization plan and does not accept it.[46] This rejection causes the debtor interested in confirming the plan to seek a "cram down." Indeed, the Bankruptcy Code entertains the option of confirming a "cram down" plan, which is an impairing plan that has not been accepted by all classes of claims and is therefore "crammed down the throats of objecting creditors."[47] According to the Code, the court may confirm an impairing plan that has not been accepted by all classes if the plan "does not discriminate unfairly, and is fair and equitable" with respect to each impaired, non-accepting class.[48] For a plan to be "fair and equitable" with respect to a class of secured claims, the court must be convinced that the plan provides the following:

> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.[49]

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44. *Id.* § 1129(a)(8).

45. *See, e.g.*, *In re* River Road Hotel Partners, LLC, 651 F.3d 642, 645 (7th Cir. 2011) (showing how lenders filed objections to plans that would "impair debtors' interests" and "sought to sell encumbered assets free and clear of liens" without allowing lenders to credit bid).

46. *Id.*

47. *See* Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1359 (7th Cir. 1990) (citing 11 U.S.C. § 1129(b)(1), which allows for a "fair and equitable" plan to be "crammed down" as described above, as justification for such a sale).

48. 11 U.S.C. § 1129(b)(1).

49. *Id.* § 1129(b)(2)(A).

In contrast to the text of Section 363(k), the text of Section 1129(b)(2)(A)(iii) does not specifically indicate that secured creditors have the right to credit bid. Thus, on several occasions, debtors have filed a reorganization plan providing a cash-only auction—which denies secured creditors the right to credit bid—and have argued that the plan offers these secured creditors with "the indubitable equivalent" of their claims nonetheless.[50]

Therefore, the question is whether a bankrupt debtor can "cram down" a reorganization plan that denies the secured creditor of the possibility of credit bidding.[51] Three separate recently decided cases demonstrate this controversy. Although the Courts of Appeals of the Fifth and Third Circuits ruled in favor of the debtors[52] and confirmed a reorganization plan that denied the secured creditors the option to credit bid, the Seventh Circuit sided with the secured creditors and refused to confirm these plans.[53] The two circuit courts that ruled in favor of the debtor relied on the Code's plain language (which uses the word "or" to separate Subsection (ii) from (iii)),[54] but the Seventh Circuit rejected the argument that Section 1129(b)(2)(A) solves the problem in plain language.[55] The court also interpreted the term "indubitable equivalent" to be the face value of the over-secured creditors' claims and the current value of

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50. To decide these cases, the courts must decide "whether subsection (iii) can be used to confirm every type of reorganization plan or only those plans that fall outside the scope of Subsections (i) and (ii)." Additionally, the courts must determine what "indubitable equivalent" means. In re *River Road Hotel Partners, LLC*, 651 F.3d at 648 (Cudahy, J.).

51. In more technical terms, the question is whether 11 U.S.C. § 1129(b)(2)(A)(ii) is the exclusive method through which a debtor can cram down a plan calling for the auction of encumbered assets free of liens on a secured creditor or whether § 1129(b)(2)(A)(iii) also authorizes debtors to confirm such a plan. *See In re* Phila. Newspapers, LLC, 599 F.3d 298, 319 (3d Cir. 2010) (Ambro, J., dissenting) (stating that 11 U.S.C. § 1129(b)(2)(A) requires "cramdown plan sales free of liens" to fall under § 1129(b)(2)(A)(ii), not § 1129(b)(2)(A)(iii), in light of the entire Bankruptcy Code, legislative history, and drafters' comments).

52. *In re Phila. Newspapers, LLC*, 599 F.3d at 319; *In re* Pacific Lumber Co., 584 F.3d 229, 245 (5th Cir. 2009).

53. *In re River Road Hotel Partners, LLC*, 651 F.3d at 648–51 (consolidating two cases and currently pending before the United States Supreme Court).

54. 11 U.S.C. § 1129(b)(2)(A).

55. *In re River Road Hotel Partners, LLC*, 651 F.3d at 649–50.

the encumbered asset for the under-secured creditors.[56] The court further explained that for the under-secured creditors, the value of the encumbered asset can be either judicially evaluated or auctioned in the free market.[57] However, for the latter mechanism to be effective, credit bidding must be allowed.[58] The court explained that by allowing secured parties to credit bid, the Code provides lenders with the means to protect themselves from the risk that the winning auction bid will not capture the asset's actual value.[59] The court emphasized that this risk is "substantial" because of several features of bankruptcy auctions.[60]

To fully understand the actual conflict underlying the "credit bidding" legal controversy, one should be better acquainted with the economic surroundings of bankruptcy auctions.

B. Economic Environment

1. Why an Auction?

Not all financially distressed firms require a formal bankruptcy proceeding. Firms often liquidate without undergoing a Chapter 7 proceeding. Many financially distressed firms reorganize or restructure their capital without initiating a Chapter 11 proceeding.[61] However, for those financially distressed firms that opt for the sanctuary provided by the bankruptcy court—which manifests in a stay imposed on the creditors' debt collection efforts

56. *Id.* at 650.
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.* at 651 n.6.
61. For example, the firm can privately negotiate a deal with its creditors. Such a deal is often known as a "workout." *See, e.g.*, Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595, 602–03 (1993) (discussing the non-bankruptcy alternative of a workout). *See also generally* Takashi Shibata & Yuan Tian, *Reorganization Strategies and Securities Valuation Under Asymmetric Information*, 19 INT'L REV. ECON. & FIN. 412 (2010) (comparing the reorganization strategies of a Chapter 11 bankruptcy and a private workout). A workout is less effective if the claimants, particularly unsecured creditors, are dispersed. *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1191 (1991) (discussing a holdout problem in workouts).

against the firm[62]—perhaps the most important question concerns redeployment. In both Chapter 7 and Chapter 11, the question is as follows: what should be done with the assets of the financially distressed firm? What is the best way to maximize the value of these assets for the benefit of the firm's claimants (i.e., creditors and shareholders alike)[63] as well as the benefit of the economy at large?

As usual, having a crystal clear goal—maximizing the proceeds of the firm's assets—does not prevent vigorous discussions over the "how" (i.e., over the best way to accomplish this goal). For many years, bankruptcy scholars have debated the proper route to which the bankruptcy court should push the financially distressed firm once it has entered a formal bankruptcy proceeding.[64] These discussions have been held regardless of the current legal regime dictated by the Bankruptcy Code because the Code is flexible enough to entertain just about any route chosen.[65] One route, which may be termed "administrative" on account of its non-market nature, focuses on arranging a pretended sale of the firm to its claimants, who negotiate an arrangement among themselves that must require each of the claimants to provide certain concessions. Although many variations exist, the basic deal is debt swapped for equity. For example, creditors may be asked to forgo part, perhaps even all, of their claims against the firm in exchange for equity in the restructured firm. A relatively lengthy and complicated negotiation process will occur under the auspices of the bankruptcy court because the parties must agree on a value for the firm's assets to ascertain how much the firm's equity is worth and what percentage of this equity the creditors should receive in exchange for giving up

62. 11 U.S.C. § 362 (2006).

63. Thus, the assets of the firm can be sold piecemeal or as a whole. The assets may be owned by individuals (the asset being the object of the sale) or by a corporate entity (the equity of which is the object of the sale).

64. *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 579, 593 (1998) (reviewing the debate regarding the purpose of a bankruptcy proceeding and the role of the judge); Baird & Rasmussen, *supra* note 3, at 685–99 (describing the various redeployment alternatives); LoPucki & Doherty, *supra* note 8, at 5–6 (same).

65. For a detailed discussion of the legal framework, see *supra* Part I.A (noting that a Chapter 11 case can be converted into a Chapter 7 case if the party can be a debtor under Chapter 7's provisions). Note that an arrangement among claimants is usually associated with a Chapter 11 proceeding, but a Chapter 11 case can be converted into a Chapter 7 liquidation. 11 U.S.C. § 1112.

their claims. At the end of this process, the parties hope to achieve an arrangement. For example, if the legal framework is a Chapter 11 proceeding, this arrangement must be accepted by at least a supermajority of the firm's claimants, as required by law,[66] and confirmed by the court.[67]

A second route to making a redeployment decision focuses on either "creating" or "locating" the firm's actual "residual owner."[68] These words are in quotation marks because the observation that they reflect relies on an economic analysis. Indeed, from an economic perspective, the source of the redeployment problem lies in the fact that no one actually knows the real value of the firm's assets, if this value can be ascertained at all. Indeed, if one could determine that the assets of a firm that owes $7 million to secured creditors and $7 million to unsecured creditors are only worth $4 million, then obviously the bankruptcy court must announce that the secured creditors are the new shareholders of the firm and must immediately terminate the bankruptcy proceeding. As a result, the new shareholders will need to decide on their own what to do with the firm's assets, which would now carry no debt at all because the secured creditors swapped their claims for equity and because the unsecured creditors' claims were wiped out on account of being "underwater." Obviously, these new shareholders are better motivated than the court to make the best decision regarding the

66. *See* 11 U.S.C. § 1126(a), (c) (requiring that the plan be accepted in each class of claims by the creditors "that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class"). Those claimants who oppose the arrangement enjoy certain protections. 11 U.S.C. § 1129(a)(8), (b).

67. *See* 11 U.S.C. § 1128(a) ("[A]fter notice, the court shall hold a hearing on confirmation of a plan"). Notice the difference between these arrangements and *out-of-court* arrangements (see *supra* note 59 and accompanying text), which do not necessarily require either supermajority acceptance by the claimants or confirmation by the court.

68. In the corporate world, the wealth of the firm's "residual owner" is affected on the margin by the decisions related to the firm's assets. A "good" decision on how to employ the firm's assets would increase that person's wealth and a "bad" decision would decrease it. *See, e.g.*, Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L. Q. 1341, 1343–44 (2004).

redeployment of the firm's assets and no less knowledgeable than the court in conducting business.[69]

However, in an imperfect world in which agents are occasionally wealth-constrained and sometimes refrain from incurring even beneficial risks, bankruptcy theory[70] and practice converged to recommend that lawmakers seeking a good decision-making procedure control the redeployment of financially distressed firms' assets through a simple yet potentially efficient practice: the auction.[71] In a typical scenario, the assets of the distressed firms are

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69. *See* Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 778–81 (1988) (suggesting a scheme to "locate" the "true" residual owner of any firm suffering financial hardship).

70. A line of the bankruptcy literature suggests alternatives to the common auction design. These alternatives are less relevant to this Article because they focus on solving the problem of evaluating the bankrupt firm's assets rather than on designing an optimal cash auction. For example, it has been suggested that a certain percentage of the firm's equity should be auctioned to ascertain the true value of the assets. *See generally* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983) (discussing the desirability of holding an auction to help determine the firm's value). *See also* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323–33 (1993) (proposing a "Chameleon Equity" scheme, where a default on obligations extinguishes the common equity of the firm and transforms the most junior creditors into equity holders); Francesca Cornelli & Leonardo Felli, *Ex-Ante Efficiency of Bankruptcy Procedures*, 41 EUR. ECON. REV. 475, 478 (1997) (proposing to auction only a control stake of the firm: 50% of the shares plus one); Oliver Hart, Rafael La Porta Drago, Florencio Lopez-de-Silanez & John Moore, *A New Bankruptcy Procedure That Uses Multiple Auctions*, 41 EUR. ECON. REV. 461 (1997) (proposing a multiple auctions procedure); Francesca Cornelli & Leonardo Felli, *How to Sell a (Bankrupt) Company* (London Bus. Sch. and London Sch. of Econ., Working Paper, 2000), *available at* http://faculty.london.edu/fcornelli/control1.pdf (arguing against auctioning the entire ownership of the firm and for retaining an equity stake for the creditors).

71. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 219 (1986) (arguing that well-developed U.S. capital markets render an auction a good redeployment option); Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform,* 8 J.L. ECON. & ORG. 523, 526–28 (1992) (discussing suggestions to make auctions mandatory in corporate bankruptcy); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 128 (1986) (arguing that redeployment by the market is superior to appraisal by the bankruptcy court); Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APP. CORP. FIN. 13, 31–32 (1991) (arguing that auction by third parties would incentivize fair pricing and, if conducted immediately, provide

offered for sale in the free market to whomever is willing to pay the highest amount. In this way, two important decisions are separated and thus prevented from interfering with one another: what to do with the assets to maximize their value and how to divide the value (and how past claims against the firm should be settled).[72] Most importantly, the assets can be auctioned either piecemeal or as a going concern,[73] albeit in a relatively quick and cost-economizing manner.[74] These features qualify the auction as a satisfactory solution, even for those who believe that the financially distressed firm should be kept alive.[75] From the buyers' side, in a sufficiently developed economic environment such as the United States, even cash-constrained buyers can participate in these auctions, as these buyers can employ a variety of financing techniques, including leveraged buyouts (LBO).[76]

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the most accurate information about the assets); William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 38 (1977) (arguing for auctions as a market-oriented approach). *See also* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 648–53 (1993) (discussing the possible problems with mandatory auctions); LoPucki & Doherty, *supra* note 8, at 8 (describing how auctions became commonplace during the 1980s).

72. *See* Bhattacharyya & Singh, *supra* note 14, at 270 (stating that auction and market-based procedures separate these two issues).

73. *See* Eckbo & Thorburn, *supra* note 10, at 44 (providing empirical evidence regarding that effect).

74. *See, e.g.*, William T. Bodoh, John W. Kennedy & Joseph P. Mulligan, *The Parameters of the Non-Plan Liquidating Chapter Eleven: Refining the Lionel Standard*, 9 BANKR. DEV. J. 1, 8–9 (1992) (emphasizing the bankruptcy costs spared as an auction is executed during a Chapter 11 proceeding); Eckbo & Thorburn, *supra* note 10, at 40 (noting that the auctions in the Swedish system are concluded, on average, within two months, which also reduces the need to obtain interim financing for the financially distressed firm), 44–45 (reporting that bankruptcy auctions incur lower direct costs than reorganizations do).

75. *See* Eckbo & Thorburn, *supra* note 10, at 51 (arguing that "auctions are competitive when judged by the evidence on takeovers more generally, and there is no evidence that auction premiums tend to undercut the bankrupt firm's fundamental going concern value").

76. *Id.* at 41. In an LBO, the buyer raises money from a third party through a shell company and uses the acquired assets to repay the loan.

In practice,[77] the auction is usually held in the offices of the bankrupt firm's attorneys. When large firms' assets are auctioned, investment bankers may be hired in advance in exchange for a percent of the future proceeds (usually a 1% "success fee") to advise the bankrupt firm in the auction process.[78] These advisors disseminate information about the auctioned assets by, for example, preparing brochures, arranging "data rooms," and soliciting bids from prospective buyers.[79] Sometimes, these bankers will provide financing options for prospective bidders. An example of a financing option is "stapled finance" (i.e., a loan commitment at pre-specified terms to whoever wins the bidding contest, which the winner can accept or reject).[80] Following the auction very closely, the bankers may also locate a buyer who commits to purchasing the auctioned assets at a specified price unless the buyer is outbid at the auction. Often referred to as "a stalking horse," this initial buyer is an important figure, mainly because of the significant costs associated with bidding in the auction of a large firm. Indeed, a prospective bidder preparing for the auction must appraise the auctioned assets in advance. Executing this evaluation process (often referred to as "due diligence") is costly; for large firms, the cost may run up to several million dollars.[81] Therefore, the stalking horse, whose offer serves as an initial bid and is "shopped around" to

77. *See also* FED. R. BANKR. P. 2013–14, 6004–05 (establishing rules for holding bankruptcy auctions).

78. Empirical research has demonstrated the potential contributions of investment bankers, especially those who may be considered "top-tier" bankers, to planning and executing profitable *non-bankruptcy* mergers and acquisitions. Their success has mostly been attributed to their abilities to identify and structure mergers with higher synergy gains and to execute these transactions promptly. For a discussion and review of the literature, see Andrey Golubov, Dimitris Petmezas & Nickolaos G. Travlos, *When It Pays to Pay Your Investment Banker: New Evidence on the Role of Financial Advisors in M&As*, 67 J. FIN. 271, 273 (2012) (stating that bidding firms gain more when employing investment banks for the auction process, particularly if the bank is a top-tier advisor).

79. *See* LoPucki & Doherty, *supra* note 8, at 34–35 (stating that investment bankers hired by debtors perform the listed functions).

80. *See* Paul Povel & Rasjdeep Singh, *Stapled Finance*, 65 J. FIN. 927, 927 (2010) (discussing the advantages of using stapled finance in bidding contests).

81. *See* LoPucki & Doherty, *supra* note 8, at 38 n.158 (finding that the break-up fees (i.e., the payment made to a stalking horse if one is outbid in an auction; this payment is usually explained as a reimbursement) in a sample of large, publicly traded firms auctioned in bankruptcy averaged $5 million).

elicit other bids,[82] is given a guaranteed "break-up" fee (i.e., a reimbursement for its expenditures[83]) by the bankrupt firm if someone else outbids him in the auction.[84] Other protection measures are also sometimes agreed upon between the firm and the stalking horse. For example, there may be an overbid requirement, which sets a minimum price sufficiently higher than the stalking horse's bid for any other bidder who wishes to outbid the stalking horse.[85] Of course, these protection measures may influence both

82. Prospective buyers can rely on the stalking horse's examination of the assets to avoid conducting their own due diligence and to appraise their own bids. *Id.*

83. Break-up fees are assumed to include compensation mainly for two elements: the out-of-pocket expenses that are incurred by the "stalking horse" as it prepares to execute the transaction and the risk associated with the transaction falling through (e.g., the "horse's" opportunity costs). *Id.* at 41.

84. For a discussion of the break-up fees in bankruptcy auctions and the manner in which courts scrutinize these fees, see Oscar Garza, Jesse S. Finlayson & Solmaz Hamidian, *Rethinking the Scope of the* O'Brien *Decision: Why the Third Circuit's Administrative Claims Analysis Should Not Be Applied to the Debtor's Request for Approval of a Breakup Fee in Connection with Bankruptcy Sales in Chapter 11 Cases*, 28 CAL. BANKR. J. 1 (2005) (discussing the break-up fees in bankruptcy); Mark F. Hebbeln, *The Economic Case for Judicial Deference to Break-up Fee Agreements in Bankruptcy*, 13 BANKR. DEV. J. 475 (1997) (making the economic case for judicial deference to break-up fees); Bruce A. Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 AM. BANKR. L.J. 349 (1992) (arguing against break-up fees in bankruptcy); Monica E. White, *Give Me a Break-up Fee:* In re *Reliant Energy Channelview LP and the Third Circuit's Improper Rejection of a Bankruptcy Bid Protection Provision (*In re *Reliant Energy Channelview LP, 594 F.3d 200, 2010)*, 48 HOUS. L. REV. 659 (2011) (discussing break-up fees in light of a negative circuit court treatment).

85. *See, e.g.*, *In re* Reliant Energy Channelview LP, 594 F.3d 200, 203 (3d Cir. 2010) (setting a $5 million overbid requirement). *See also* C.R. Bowles & John Egan, *The Sale of the Century or a Fraud on Creditors?: The Fiduciary Duty of Trustees and Debtors in Possession Relating to the "Sale" of a Debtor's Assets in Bankruptcy*, 28 U. MEM. L. REV. 781, 808–09 (1998) (discussing mechanisms such as "topping fees," "overbid protections," "rights of first refusal," "prepayment of due diligence expenses," and reimbursement of due diligence expenses under § 503(b), which "either compensate the party bidding on the property (stalking horse) if its bid fails or make it more expensive for a competing offer to prevail over the stalking horse's bid or both;" the second category consists of "control" incentives, such as "lock-up agreements," "window shop," and "no shop" clauses, "all of which greatly inhibit third-party bidders from making compelling offers on the property by granting the stalking horse a significant degree of control over the debtor's assets, operations, or both").

second bidders and the result of the auction.[86] Thus, the bankruptcy court is called upon to examine these measures,[87] and courts sometimes intervene to change the measures upon which the debtor and the "stalking horse" have agreed.[88]

Having won the auction and upon obtaining the bankruptcy court's approval for a purchase agreement with the bankrupt firm—as required by law[89]—the buyer receives the assets free from all past liabilities.[90] These liabilities are left with the financially distressed firm, which is now revealed as having traded its assets for cash (i.e., a different type of asset). Thus, a bankruptcy court that allows or mandates an auction of the bankrupt firm's assets is subsequently left with a rather simple task: distribute the proceeds from the sale to the firm's claimants according to the pre-bankruptcy ranking of their priorities. Thus, the auction process generates a new "residual owner" for the assets: the buyer. In both the past and the future, efficiency appears to reign everywhere.

Consider the past first. Ex-post efficiency is obtained if the following three conditions are fulfilled: the value of the bankrupt firm's assets is maximized for the benefit of its claimants, the direct and indirect costs[91] spent on executing the bankruptcy proceedings

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86. *See* LoPucki & Doherty, *supra* note 8, at 41–42 (finding that second bidders appeared in only 35% of the cases in which a stalking horse participated in the auction; stating that second bidders outbid the latter in only 17% of the cases).

87. The legal framework in which the court can intervene is usually that of administrative expenses. If these expenses are needed to preserve the bankruptcy estate, they receive priority on other pre-bankruptcy claims. *See* 11 U.S.C. § 503(b) (2006) (outlining what qualifies as administrative expenses). The court may approve or disapprove of paying break-up fees as part of these expenses. *See, e.g.*, Calpine Corp. v. O'Brien Envt'l Energy, Inc. (*In re* O'Brien Envt'l Energy, Inc.), 181 F.3d 527, 537 (3d Cir. 1999) (discussing criteria involved for awarding break-up fees).

88. *Calpine Corp.*, 181 F.3d at 537.

89. 11 U.S.C. § 363(b)(1) (2006).

90. 11 U.S.C. § 363(b)(1), (f). This characteristic cannot be taken lightly. In Canada, for example, the debtor is less capable of executing a sale that disposes of past liabilities. Stephanie Ben-Ishai & Stephen J. Lubben, *Sales or Plans: A Comparative Account of the "New" Corporate Reorganizations*, 56 MCGILL L.J. 591, 594 (2011).

91. Bankruptcy costs consist of direct costs, which include mostly administrative costs and fees (such as the fees paid to the professionals advising the firm), and indirect costs, which mostly include the opportunity costs associated with having to operate the firm under the constraints of the bankruptcy proceeding

are low, and the pre-bankruptcy entitlements are honored. Having been executed against the background of well-functioning capital markets, the auction can be assumed to have produced the highest revenue possible for the distressed assets[92] while consuming few transaction costs on the way.[93] The auction also generally maintains the Absolute Priority Rule because the proceeds from the auction can be distributed among the claimants according to their pre-bankruptcy rankings. In other words, senior creditors receive full payments before any of the junior creditors can see any payments on account of their claims.[94] Ex-ante efficiency—an aspect of bankruptcy that focuses on disciplining the behavior of the firm's insiders—is also gained, as the creation of a new residual owner punishes the incompetent shareholders and managers who brought the firm to a state of financial distress.[95]

As for the future, as a result of the auction, the firm can emerge from bankruptcy with a new capital structure.[96] Examining the future also necessitates a close look at the best interests of society

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(such as the cost of having to obtain court approval for every major business decision). *See, e.g.*, Ben Branch, *The Costs of Bankruptcy—A Review*, 11 INT'L REV. FIN. ANAL. 39 (2002) (discussing the various costs); Stephen P. Ferris & Robert M. Lawless, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. PITT. L. REV. 629 (2000) (same).

92. *See, e.g.*, Bank of Am. Nat'l. Trust & Sav. Ass'n. v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457 (1999) (noting that the best way to determine value is exposure to a market); Hotchkiss & Mooradian, *supra* note 13, at 244 (finding empirical support for the efficient redeployment of assets in bankruptcy auctions).

93. *See, e.g.*, Bhattacharyya & Singh, *supra* note 14, at 270–71 (emphasizing the use of the auction as a method for preventing costly negotiations over the distribution of the proceeds).

94. *See, e.g.*, Eckbo & Thorburn, *supra* note 10, at 40–41 (reporting that this result also occurs in the United States once an auction is chosen).

95. *See, e.g.*, *id.* at 40 (discussing the tendencies of financially distressed firms' managers to prefer reorganization, which would leave them at the company's helm and allow them to continue to enjoy "private control benefits"). The authors also report that in the Swedish mandatory auction system, only high-quality CEOs retain their job following the bankruptcy auction. *Id.* at 41.

96. *See* B. Espen Eckbo & Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 J. FIN. ECON. 227, 255 (2003) (showing that the operating profitability of firms auctioned as going concerns is on par with that of industry competitors for several years; stating that less than 20% report operating losses).

in general. In this context, we find that the assets previously owned by the distressed firm are now owned by the one market actor who was willing to pay the highest amount of money for them (this actor is also presumably their highest-valued user). Thus, because the assets have moved consensually to their highest-valued user, the move is efficient. Except for the contexts in which the bankruptcy procedure is expected to pursue redistributive goals,[97] the auction seems like the perfect solution.

2. Challenges for Bankruptcy Auctions

Unfortunately, bankruptcy practitioners and scholars quickly discovered that this naive account of the bankruptcy auction fails when faced with reality.

First, capital markets, which are supposed to produce bidders in sufficient numbers, and with a sufficient degree of liquidity to ignite competitive auctions, cannot be currently described as functioning perfectly. Experience and evidence show that too often only a few bidders participate in bankruptcy auctions,[98] and that those bidders usually rely on their own existing resources to finance the purchase of the auctioned assets rather than assembling the necessary funds in the markets.[99] On many occasions, the bidders in the bankruptcy auction come from the same industry to which the

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97. For a discussion of the pros and cons of attempting to achieve redistributive goals in bankruptcy, see, for example, Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 882 (1987) (arguing that redistribution rules in bankruptcy should do the same as rules that flow from other business failure); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 789–90 (1987) (arguing that redistribution of costs of a bankrupt estate may result in a necessary loss to creditors, better enabling the bankrupt firm to survive).

98. *See* Aghion, Hart & Moore, *supra* note 71, at 527 (arguing that few bidders will join the auction because of the costs of preparing a bid and the risk of losing those resources if the bid is not accepted); LoPucki & Doherty, *supra* note 8, at 35 (finding that an average of 1.6 bidders exist per auction in a study and that in 58% of the cases, only one bidder exists).

99. *See* Aghion, Hart & Moore, *supra* note 71, at 527 (highlighting the difficulty of assembling funds in the markets for high cost assets); LoPucki & Doherty, *supra* note 8, at 9–10 (reviewing the effect of this observation on the bankruptcy literature, where scholars have attempted to devise alternative solutions).

financially distressed firm belongs.[100] This fact is significant because it may mean that if the industry itself is undergoing a period of downturn, potential bidders at the auction will be cash-constrained.[101]

Second, a bankruptcy auction is usually held on a tight time schedule. The claimants of the financially distressed firm want to collect the money owed to them as soon as possible. Creditor pressure increases immensely in the presence of over-secured creditors, who have nothing to gain from postponing the auction in an attempt to conduct it under better conditions.[102] However, these creditors do have the leverage needed to pull over the financially distressed firm (sometimes because this creditor also finances operations during the firm's Chapter 11—the "DIP financing")[103]

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100. *See* LoPucki & Doherty, *supra* note 8, at 28–29 (stating that the debtors' competitors are the most likely to purchase the company).

101. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343, 1358 (1992) (suggesting that when a firm in financial disputes needs to sell assets, its industry peers are likely to be experiencing problems themselves, leading to abrupt sales at prices below value in best use). *Cf.* B. Espen Eckbo & Karin S. Thorburn, *Automatic Bankruptcy Auctions and Fire-Sales*, 89 J. FIN. ECON. 404, 421 (2008) (reporting fire-sale discounts only in the auctions that lead to piecemeal liquidation); Eckbo & Thorburn, *supra* note 10, at 48 (reporting findings that suggest that auctions do not systematically produce low prices if the firm is sold as an ongoing concern; however, the prices do tend to be somewhat low for piecemeal liquidations); LoPucki & Doherty, *supra* note 8, at 29 (finding that when industry distress is high, the recovery ratios from auctions are also high).

102. *See* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 173 (2005). A creditor with a secured claim of $1 million has no incentive to assume the risk of a delayed sale under the following conditions: 1) the firm's assets can be sold immediately in a fire sale to a buyer who appears before the bankruptcy forum and offers to pay $1 million but sets a deadline of two weeks for his or her offer to be accepted or rejected; or 2) if the assets can be shopped around for a while in a manner that will produce either $1.2 million or $0.8 million in a future sale at equal probabilities.

103. *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 957–58 (2001) (explaining that "in many workouts outside of bankruptcy, a senior secured lender insists that, in exchange for the restructuring of its debt, the debtor promises not to oppose a motion to lift the automatic stay in a subsequent bankruptcy proceeding"); Baird & Rasmussen, *supra* note 10, at 784–85 (noting that large firms entering Chapter 11 bankruptcy lack sufficient cash flow and are subject to lenders' controls in order to obtain additional financing).

and thus push aggressively for what has become known as a "fire sale."[104] Fire sales may be a source of inefficiency insomuch as the speed of the sale undermines the process of shopping around the assets or forces a sale when potential buyers are suffering from temporary illiquidity.[105]

However, the bankruptcy practitioners involved in the case (as long as they do not represent the unsecured creditors) may benefit from such sales, especially if these sales can be accomplished quickly without having to disclose information to the creditors and confront possible objections from the creditors (if the creditors are consulted regarding the best redeployment path).[106] Some argue that these practitioners often have conflicting interests because the buyer may provide them with future business.[107] In turn, the practitioners can easily manipulate the auction in that buyer's favor.[108] Occasionally, some of the firm's insiders share enthusiasm for a quick sale because their pay is tied to either the accomplishment of such a sale or the interests of particular potential buyers who promise to hire them.[109] In this context, it has been argued that competition

104. *See* Edith S. Hotchkiss, Kose John, Robert M. Mooradian & Karin S. Thorburn, *Bankruptcy and the Resolution of Financial Distress*, *in* HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 235, 246–47 (B. Espen Eckbo ed., 2008) (discussing empirical evidence suggesting that creditors may force a premature sale of assets); George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 69–70 (2004) (highlighting problems caused by change of control provisions and lender control over a Chapter 11 case); Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1617 (2011) (explaining that "[w]hen banks . . . are driven by financial regulatory policy to overly prefer the liquidation of their own borrowers during dowturns, the end result is often fire sales . . . .").

105. *See* Todd C. Pulvino, *Do Asset Fire Sales Exist? An Empirical Investigation of Commercial Aircraft Transactions*, 53 J. FIN. 939, 973 (1998) (concluding that immediate cash liquidation of insolvent firms may result in failure to maximize proceeds to claimholders); Per Stromberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 J. FIN. 2641, 2643 (2000) (arguing that a cash auction "suffer[s] from considerable inefficiencies when the market is illiquid").

106. *See* LoPucki & Doherty, *supra* note 8, at 12, 32–37 (describing the various benefits of sale to bankruptcy practitioners).

107. *Id.* at 35.

108. *See id.* at 41–42 (noting that one technique for manipulating the auction in favor of a preferred bidder is to make him or her a stalking horse).

109. Kuney, *supra* note 104, at 109; LoPucki & Doherty, *supra* note 8, at 12, 32–34 (finding empirical support for these phenomena).

among bankruptcy courts over bankruptcy cases drives judges to be less adamant in blocking such sales, despite their poor results.[110] In some cases, particularly in the bankruptcies of small-to-medium-sized firms, the short schedule is the result of a buyer appearing before the bankruptcy forum and offering to buy the assets, but conditioning the deal on it being accomplished within a short period of time.[111]

Worse still, unlike a non-bankruptcy sale, the auction cannot, in principle, be postponed to survive periods of macroeconomic downturns, such as a recession in the economy, a general credit shortage, or an industry downturn. The exact purpose of the bankruptcy proceeding is to collapse the future values of the assets to a sum of cash in the present. As a result, those economic declines that do not necessarily concern the distressed firm nevertheless undercut the amounts bid at the auction and the intensity of competition among the bidders.[112]

Third, previous research shows that bankruptcy auctions often attract scavengers. Everybody knows that the auction is run under a deadline and cannot be postponed. If the assets are sold in bulk in an attempt to retrieve their going concern value, bidders understand that a reasonable alternative is a piecemeal sale of the assets, which would generate a significantly smaller amount because no going concern value would then be sold. The fact that the sale is associated with a failed firm may also contribute to the feeling that one can find a bargain in a bankruptcy auction. Occasionally, potential buyers are not sufficiently informed with respect to the real value of the auctioned assets.[113] Thus, although the assets are to be purchased in the safest legal way possible—under the auspices of the bankruptcy court, whose involvement actually wipes out any past

110. LoPucki & Doherty, *supra* note 8, at 4, 12–13.

111. A possible explanation for this buyer's haste can be found in the problem of "sale-backs." *See infra* note 118 and accompanying text (defining sale-backs as union shareholders and managers appearing at the auction house disguised or hidden as bidders).

112. *See* Eckbo & Thorburn, *supra* note 10, at 48 ("[I]ndustry-wide distress appears simultaneously to increase the incidence of piecemeal liquidation and to reduce prices somewhat.").

113. *See* Hotchkiss & Mooradian, *supra* note 13, at 243 (finding empirical support for the argument that asymmetric information deters bidding from potentially less informed buyers).

entitlements that may threaten those of the future buyer—the bids submitted in a bankruptcy auction are systematically skewed toward a lower price. As a result, after the formal completion of the auction, negotiations with bidders are sometimes encouraged by a persistent bankruptcy court, unwilling to accept the poor results of the auction. Such negotiations may result in increased bids.[114] The only notable exception concerns the bankruptcies of small-to-medium-sized firms, where the major creditor of the firm is a bank that may also finance the winning bidder at the auction.[115] In these cases, the role played by the bank pressures the bids to be higher.[116]

Fourth, unlike a non-bankruptcy sale of assets, the interests of the formal owner—the firm, particularly its incumbent shareholders and managers—are not always fixed on the single goal of maximizing the proceeds of the sale. Bankruptcy auctions may be managed by a trustee if the bankrupt firm is undergoing a Chapter 7 proceeding. Alternatively, the auctions may be managed by the firm's incumbent management, who serve as a Debtor-in-Possession, if the firm is in Chapter 11. Particularly in the latter case, the manner in which the auction is conducted may be influenced by the fact that the shareholders and managers of the bankrupt firm may have interests other than the simple maximization of value in mind. They may wish for the assets to be sold to a "white knight" (i.e., a buyer who would later cooperate with them).[117] Worse still, the shareholders and managers may even appear at the auction house as bidders themselves, albeit disguised and hidden ones.[118] The

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114. *See, e.g.*, *In re* Lionel Corp., 722 F.2d 1063, 1065 (2d Cir. 1983) (showing, as an example, that one court's encouragement of additional negotiations between the parties raised the price of an auction by $7 million); Robert G. Hansen & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance*, 18 INT'L REV. L. & ECON. 159, 160 (1998) (discussing the case of FNN Inc.).

115. *See* B. Espen Eckbo & Karin S. Thorburn, *Creditor Financing and Overbidding in Bankruptcy Auctions: Theory and Tests*, 15 J. CORP. FIN. 10, 11 (2009) (describing this phenomenon in Sweden).

116. *See id.* at 11–12 (finding empirical support in a study conducted in Sweden).

117. *In re* River Road Hotel Partners, LLC, 651 F.3d 642, 651 (7th Cir. 2011) (Cudahy, J.).

118. *See* Eckbo & Thorburn, *supra* note 10, at 11 (documenting creditor-management coalitions that bid in bankruptcy auctions); Povel & Singh, *supra* note 10, at 711 (suggesting that sale-backs are quite common and that they "chill"

purpose of such a maneuver, which is called a "sale-back" or a "freeze-out," is to become the owners of the auctioned assets once again. However, this time, there will be no liabilities attached to the creditors.[119] Obviously, the interest of these disguised bidders is to buy the assets at the lowest price possible.

The fact that the firm's incumbent shareholders and managers may have an interest other than maximizing the proceeds received for the assets in an auction may have several important implications. Whereas some believe that participation by insiders in the bankruptcy auction may convey information to outsiders contemplating the value of the assets and may encourage them to participate and increase their bids in the auction,[120] others have argued that insider participation is harmful. For instance, insider participation may exacerbate a preexisting problem of information gaps.[121] Indeed, not all of the information about the auctioned assets available will be disclosed to the potential bidders. Insiders often have unique information (which may or may not be verifiable) about the firm, its assets and its modus operandi. Consider, for example, a trade secret, the potential profits from an ongoing R&D process, or even a hidden antitrust violation, which, although illegal, may nevertheless remain undetected by the authorities and thus may

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the competition in the auction); Per Stromberg & Karin S. Thorburn, *An Empirical Investigation of Swedish Corporations in Liquidation Bankruptcy*, *in* EFI RESEARCH REPORT 31, 33–34 (1996) (reporting the findings of a Swedish study showing that in approximately 54% of the cases where the firm was kept as an ongoing concern, the buyer was a coalition of incumbent management and creditors; explaining that the coalition was the only bidder in 76% of the cases); Stromberg, *supra* note 105, at 2643–44 (suggesting that sale-backs are common in bankruptcy auctions, particularly in illiquid asset markets). To disguise their identities, insiders either use a "straw man" to bid in the auction or hide behind a corporate entity that serves as the formal bidder.

119. Recall that the buyer at the auction purchases the auctioned assets without past liabilities.

120. *See* Hotchkiss & Mooradian, *supra* note 14, at 556–57 (arguing that the coalitions formed by creditors at the institution of bankruptcy proceedings serve as both sellers and potential buyers at auction, incentivizing overbidding and driving up the price of the asset being sold).

121. *See* Baird, *Revisiting Auctions*, *supra* note 71, at 635 (stating that inside owners of assets being auctioned as a part of bankruptcy proceedings have an incentive to withhold information from outsiders).

contribute to the value of the assets. Some of this information cannot be disclosed at all because it may compromise the firm's future operations. Some of this information is non-verifiable, and there is no value attached to disclosing it anyway. Finally, some of this information may be hidden from potential bidders by interested insiders.

Moreover, the possibility of disguised insiders participating in the auction can generate a "chilling effect" on the competition. Aware of the possibility that one of the bidders is actually an insider in disguise, other bidders fear the possibility of winning the auction.[122] Known as "the winner's curse,"[123] these other bidders fear the prospect of submitting an excessively high bid. After all, they may win the auction while outbidding an insider, who is assumed to be better acquainted with the auctioned asset, because they misevaluated the asset. This logic causes bidders to either refrain from participating in the auction altogether or submit lower bids to increase the chances of winning the auction with a bid that is low enough to guarantee a good bargain.

A slightly different chilling effect in the context of insider participation concerns over-bidding. The incumbent management may join a creditor of the firm to form a coalition that will bid in the auction.[124] In this case, this coalition has an incentive to overbid (i.e., bid above its true valuation of assets) to push for a higher counteroffer from the other bidders because these counteroffers will eventually become the payment for the coalition's pre-bankruptcy stake in the assets.[125] In short, these insiders are caught in a conflict between their interests as claimants and their interests as bidders. As a result, the coalition may win the auction, and the assets will not be

122. *See, e.g.*, David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 478 n.43 (1993) (arguing that a mandatory auction scheme frequently results in the winning bidder paying too much for the asset being sold).

123. For a discussion, see *infra* Part II.C.4(a)(ii) (defining the winner's curse as a buyer's realization that he or she purchased an asset for an amount higher than its market value, resulting in a loss transaction).

124. Hotchkiss & Mooradian, *supra* note 14, at 556–57. *See also* Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 455 (1978) (modeling bankruptcy under the assumption that the bank plus equity holders have the bankruptcy decision power and act in their own joint interest without considering the outcome of the third set of claimants, the bondholders).

125. Hotchkiss & Mooradian, *supra* note 14, at 556–57.

assigned to their highest-valued user.[126] Furthermore, outside bidders may be deterred from competing in such auctions in the first place, making these auctions less competitive.[127]

At the end of the day, the relative efficacy of bankruptcy auctions remains controversial, particularly in comparison with the alternative: the reorganization and restructuring of the firm. The gathered empirical data have also been unable to resolve the debate between those advocating the bankruptcy auction as the tool of choice[128] and those arguing that auctions in bankruptcy should be mistrusted or at least handled with caution.[129]

II. AUCTION THEORY—A PRIMER

Although an exhaustive discussion of the auction theory literature is far beyond the scope of this Article,[130] the purpose of

126. *Id.* at 556.

127. *See id.* (discussing how over-bidding behavior may deter outside bidders).

128. *See* Eckbo & Thorburn, *supra* note 10, at 40 (suggesting that making bankruptcy auctions mandatory may solve some of the problems currently associated with these auctions, such as the tendencies of managers to refrain from auctioning firms with going concern value or the court's control over whether the firm is liquidated piecemeal or survives as a going concern).

129. *See, e.g.*, Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 66 J. FIN. 1253, 1301 (2006) (finding that Chapter 7 liquidations appear to be no faster or cheaper in terms of direct expenses than Chapter 11 reorganization and thus have little to offer to unsecured creditors); LoPucki & Doherty, *supra* note 8, at 3–4, 44 (finding that in a sample of sixty large, publicly traded firms, whose bankruptcy proceedings were concluded between the years 2000–2004, reorganizations and restructurings yielded, on average, 80% to 91% of book value, whereas auctions yielded only 35% of book value). *But see* Eckbo & Thorburn, *supra* note 10, at 40 (noting that these results need to be interpreted with caution because "given management's control of the Chapter 11 restructuring process, those bankrupt companies that end up being put up for sale are likely to be those with a relatively low going-concern value—and therefore have low recovery rates per se").

130. For a comprehensive review of auction theory, see, for example, VIJAY KRISHNA, AUCTION THEORY (2nd ed. 2010); FLAVIO M. MENEZES & PAULO K. MONTEIRO, AN INTRODUCTION TO AUCTION THEORY (2005); PAUL MILGROM, PUTTING AUCTION THEORY TO WORK (2004).

this Part is to provide the reader with a short introduction to the areas of auction theory that are relevant to our issue.[131]

A. General

A review of the auction theory literature shows that for any given set of circumstances, a different type of auction will produce a different result. Thus, any decision on the type of auction to be used in a particular set of circumstances and the set of rules to be applied will impact the revenue that will be generated by that auction.

Auction theory scholars seek to answer the following question: given a particular factual situation, which allocation mechanism will maximize the revenue for the seller? In other words, what is the optimal auction design?[132] The environment in which the auction is held is characterized as one of uncertainty in the sense that the parties do not know the market value of the asset prior to the execution of the sale. In addition, even if they have determined its

131. Auction theory is a part of game theory. For a general discussion of the game theory literature, see, for example, DREW FUDENBERG & JEAN TIROLE, GAME THEORY (1991); MARTIN J. OSBORNE & ARIEL RUBINSTEIN, A COURSE IN GAME THEORY (1994).

132. *See* Robert D. Cairns, *The Optimal Auction—A Mechanism for Optimal Third-Degree Price Discrimination*, 20 J. ECON. BEHAVIOR & ORG. 213, 213–14 (1993) ("One of the most important questions in the theory of auctions is how to design an optimal auction mechanism."); Eric. S. Maskin & John G. Riley, *Optimal Auctions with Risk Averse Buyers*, 52 ECONOMETRICA 1473, 1473 (1984) (studying auctions in order to "maximize the expected revenue of a seller"); Roger B. Myerson, *Optimal Auction Design*, 6 MATH. OPERATION RES. 58, 58 (1981) (analyzing various auction designs to optimize benefits in specific seller situations); John G. Riley & William F. Samuelson, *Optimal Auctions*, 71 AM. ECON. REV. 381, 382 (1981) (comparing various auction models and how they maximize seller revenue). Auction theory puts a stronger emphasis on auction designs that maximize revenue for the seller and a weaker emphasis on designs that are efficient from the perspective of the entire market (in that the asset is allocated to the party that will maximize the benefit that can be derived from it). On occasion, these two goals can be mutually exclusive. For the distinction between the maximization of revenue and the maximization of societal benefit in the context of auction designs, see Krishna, *supra* note 130, at 5 (arguing that society's separate interest in efficiency is not always promoted by a revenue model because of imperfect information and high transaction costs).

value from their own perspectives, they do not know its value to the other players.[133]

Auction theory also considers the other rules (in addition to those that are a given aspect of the chosen auction type) that should be considered by the auction designer. For example, is it efficient to set a reserve price for the auction? What is the proper disclosure policy with respect to the relevant information known by the seller? These and other questions regarding optimal auction design will be discussed below.

Since the 1980s, hundreds of theoretical and empirical studies have investigated the subject of auction theory.[134] The insights developed in these studies have also been implemented on a practical level in many governmental auctions, some of which were designed with the help of auction theory scholars. Some of these auctions were very successful, whereas others have failed. Both the successes[135] and failures[136] have been attributed to the design of the relevant auction.

B. A Typology of Auctions

We begin by presenting the main types of auctions analyzed by auction theory that can also be relevant in the context of a bankruptcy auction.[137] Theoretically, there is a wide range of

133. Krishna, *supra* note 130, at 2–3; Jean-Jacques Laffont, *Game Theory and Empirical Economics: The Case of Auction Data*, 41 EUR. ECON. REV. 1, 2 (1997).

134. For a survey of empirical experiments, see Brent R. Hichman, Timothy P. Hubbard & Yigit Saglam, *Structural Econometric Methods in Auctions: A Guide to the Literature*, J. ECONOMETRIC METHODS 67 (2012).

135. *See, e.g.*, *infra* Part II.E. (discussing the FCC auctions for the allocation of spectrum licenses); Ken Binmore & Paul Klemperer, *The Biggest Auction Ever: The Sale of the British 3G Telecom Licences*, 112 ECON. J. 74, 94–95 (2002) (discussing the auctions for the allocation of the third-generation mobile phone operator licenses in England).

136. *See, e.g.*, Paul Klemperer, *How (Not) to Run Auctions*, 46 EUR. ECON. REV. 829, 830 (2002) (describing the auctions for the allocation of spectrum licenses in Switzerland).

137. As this Article is not directed at economists but rather at lawyers and policymakers, we see no reason to cite the formulas and mathematical proofs brought for the various claims. Similar to Klemperer, we believe that if insights derived from theoretical research are not intuitively understandable, they should be approached with caution. *See* Paul Klemperer, *Using and Abusing Economic*

possible auction formats. However, the discussion in the auction theory literature focuses on four basic types of auctions.[138]

The first type of auction is the sealed-bid auction, which is also called a first-price auction.[139] This auction primarily occurs in the context of government procurement. In this auction, each bidder submits a bid in a sealed envelope. All of the envelopes are opened at the same time. The bidder who has submitted the highest bid wins the auction and pays the amount indicated in her bid.

The second type is an English auction or an ascending-price auction.[140] In this format, the auctioneer begins by announcing a low amount for the price. The amount increases as the bidders continue to raise it. Eventually, only one bidder remains, and this bidder is the winner of the auction. The price paid by the winner is the amount of the last bid that she submitted. Of course, English auctions can also be conducted online, and there are also various sub-types of English auctions; for example, the identities of the bidders can be known or kept secret.[141]

Theory, 1 J. EUR. ECON. ASSOC. 272, 273 (2003) (affirming Alfred Marshall's notion that mathematics should be translated into plain language and applied to real life examples in order to be relevant).

138. The following discussion already makes several assumptions regarding the nature of the auction, which may be altered in either auction theory in general or the context of bankruptcy auctions in particular. We make these assumptions because bankruptcy auctions rarely relax these assumptions. For example, we assume that the bankruptcy auctions discussed in the paper are all "common-value auctions" or "affiliated-value auctions" (i.e., the auctioned asset is worth the same amount for each bidder, although each bidder may estimate this amount differently). "Common-value auctions" are opposed to "private-value auctions," in which each bidder assigns a potentially different value to the auctioned asset. *See, e.g.*, HAL R. VARIAN, INTERMEDIATE MICROECONOMICS—A MODERN APPROACH 316 (8th ed. 2009).

139. Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA 1089, 1090 (1982).

140. *Id.* at 1103–04.

141. For example, one characteristic of the Japanese auction is that it provides the bidders with exact information regarding the asset valuations given by the various bidders. This information can be valuable for the bidders, and according to economic theory, its dissemination can increase the revenue generated by the auction. For additional discussion, see *id.* at 1104 (explaining the variants of English auctions).

The third type of auction is the Dutch auction, which begins with the auctioneer announcing a price higher than the market value of the asset.[142] Immediately afterwards, the price begins to drop, gradually and continually, until one of the bidders signals to the auctioneer to stop. At this point, the auction ends; the bidder who has stopped the auctioneer is the winner and pays the price that was called by the auctioneer at the stop. This type of auction is called a Dutch auction because it is the form used in the Dutch flower market. Dutch auctions can also be conducted through an electronic presentation of the continually decreasing price. In this format, each bidder can press a button to stop the auction.

The fourth type of auction is the second-price auction, which is conducted in the same manner as a sealed-bid auction in that the bidders submit their bids in an envelope.[143] The winner is the highest bidder. However, unlike the sealed-bid auction, the amount paid is not the amount offered by the highest bidder. Rather, the amount offered by the second highest bidder is paid. This auction is also sometimes called a *Vickrey Auction*, which was named after the economist who first described the format in his seminal article published in 1961.[144]

The literature refers to other types of auctions beyond the four basic types described above.[145] For example, an interesting

142. *Id.* at 1089 n.5.

143. *Id.* at 1090 n.7.

144. *See* William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FIN. 8, 8 (1961) (finding that, in an auction where the award price is equal to the second highest bid price rather than the highest bid price, allocation of resources is improved without being prejudicial to the interests of sellers and buyers).

145. An example would be the "all-pay auction," in which all bidders pay their bids, regardless of whether they win the auction. This type of auction is used primarily in charity events. *See* Michael R. Baye, Dan Kovenock & Casper G. de-Vries, *The All Pay Auction with Complete Information*, 8 ECON. THEORY 291, 291–92 (1996) (describing the "first price all-pay" auction model, where all players, even the losers, pay the auctioneers their bids); Vijay Krishna & John Morgan, *An Analysis of the War of Attrition and the All-Pay Auction*, 72 J. ECON. THEORY 343, 344 (1997) (defining the "war of attrition" and "all-pay" auction formats, which yield greater revenue than second- and first-price auctions). Another type is the "auction with a buy price," according to which the seller determines in advance a price that, if bid, will end the auction immediately. The bidder offering the pre-determined price will be proclaimed the winner. These auctions are used on various internet sites. *See* Zoltan Hidvegi, Wenli Wang &

auction format is the "Anglo-Dutch auction," in which an English auction is conducted until the number of bidders remaining in the competition is one more than the number of items that are being auctioned. At this stage, the English auction ends, and the bidders are invited to submit a single-sealed bid, which may not be lower than the last bid made in the English auction. The Anglo-Dutch auction is supposed to combine the best of both worlds by mixing elements of the English auction and the sealed-bid auction. This type of auction offers the following advantages of an English auction: a simple strategy, the ability to gather information during the course of the auction, and reduced risk of the winner's curse. Moreover, it encourages weak bidders, who hope to do well in the second round, to participate in the auction and galvanizes bidders to violate any existing cartel agreements.[146]

Andrew B. Whinston, *Buy Price English Auction*, 129 J. ECON. THEORY 31, 32–33 (2006) (discussing the different types of buy-price auctions and the benefits of these auctions over other models); Stanley S. Reynolds & John Wooders, *Auction with a Buy Price*, 38 ECON. THEORY 9, 9–10 (2009) (describing eBay and Yahoo's development of the buy-now online auction format and its popularity); Quazi Shahriar & John Wooders, *An Experimental Study of Auction with a Buy Price Under Private and Common Values*, 72 GAMES & ECON. BEHAVIOR 558, 559 (2011) (finding that a buy-now auction has a "positive and statistically significant effect on seller revenue" and "lowers the standard deviation of revenue"); Nicholas Shunda, *Auction with a Buy Price: The Case of Reference-Dependent Preferences*, 67 GAMES & ECON. BEHAVIOR 645, 646 (2009) (discussing the author's model of auctions with temporary buy prices where bidders use reserve prices and buy prices to formulate a reference price). Another interesting auction format is the "two-stage sealed-bid auction." In the first stage of the auction, the bidders submit sealed bids. After the envelopes are opened, the two highest bidders are invited to submit another sealed bid, which may not be lower than their original bids. Perry, Wolfstetter & Zamir have shown that this method leads to the same result achieved in an English auction without incurring the disadvantages of that type of auction. *See* Motty Perry, Elmar Wolfstetter & Shmuel Zamir, *A Sealed-Bid Auction That Matches the English Auction*, 33 GAMES & ECON. BEHAVIOR 265, 266 (2000) (comparing English auctions and two-stage sealed-bid auctions).

146. The proposal was formulated for the British auctions of spectrum licenses, although it was ultimately used in the Italian auctions of spectrum licenses. *See* PAUL KLEMPERER, AUCTION: THEORY AND PRACTICE 88–89, 116–17, 178–83 (2004) (describing how Anglo-Dutch auctions present an alternative to ascending and sealed-bid auctions by creating a hybrid form "which often captures the best features of both").

C. *Choosing an Auction Method*

Before we continue our search for the optimal auction design, we should discuss the characteristics that are common to the auction types mentioned above and the connections that exist between them.

1. Sealed-Bid Auction and Dutch Auction

From the perspective of auction theory, the sealed-bid auction and the Dutch auction are completely identical. The set of considerations and the strategy to be weighed by the bidder is the same in these two auction types.[147] We will first examine the bidder's considerations in the sealed-bid auction. Given that the bidder values the auctioned asset at X and that the bid that she submits is Y, the profit the bidder expects to receive from the auction is equivalent to X less Y. When the bidder formulates her bid, she faces a dilemma. On the one hand, the higher the bid, the greater the chance that she will win. On the other hand, the higher the bid, the lower her profit from the auction will be, and vice versa. Therefore, the bidder must weigh these conflicting interests in submitting her bid.

The same set of considerations comes into play in a Dutch auction as well. As the auction progresses, the bidder debates when to stop the auctioneer. The longer the bidder waits, the greater her expected profit will be, although the probability that another bidder ends the auction before she does will also increase accordingly. The set of considerations that the bidder faces in this situation are the same as those faced by a bidder in a sealed-bid auction. Thus, in a given situation, the bidders will behave in an identical fashion in the two types of auctions, and the two formats should therefore yield the same results. For the sake of convenience, we will refer from this point forward only to the sealed-bid auction, but unless otherwise indicated, the points raised in the discussion will be true for a Dutch auction as well.

147. *See* Vickrey, *supra* note 144, at 20 (noting that sealed-bid auctions can be analyzed the same way as a Dutch auction).

2. English Auction and Second-Price Auction

The English auction and the second-price auction also share characteristics, and except for certain qualifications that are discussed below, auction theory views the two formats as producing the same result. In addition, the English auction mechanism and the second-price auction have an important common characteristic: under any set of circumstances and in any environment, they both ensure that the auctioned asset will be allocated to the party that values it the most. The same cannot be said with respect to the sealed-bid and Dutch auctions.

First, we will show that the English auction and the second-price auction both ensure that the asset is allocated to the bidder who values it most highly. Assume that bidder A values the asset at 100, bidder B values it at 95, and bidder C values it at 90. A purchase of the asset at a price higher than the bidder's valuation will not be worthwhile for that bidder, as such a purchase will constitute a loss transaction for her. Thus, the English auction will be conducted as follows: as long as the auctioneer calls a price that is lower than 90, all three bidders will remain in the game. If the price reaches 90, bidder C will leave the competition, as a purchase at 90 is no longer worthwhile to her. Any bid above 95 is not worthwhile to bidder B. Thus, once the auctioneer reaches 95, bidder B will leave the auction and bidder A will purchase the asset at 95. Ultimately, the asset has been allocated to the party who values it the most (bidder A). This bidder will pay the price at which the next highest bidder (bidder B) values it. This result is stable and is not sensitive to a change in circumstances. In game theory terms, the English auction provides the bidder with a dominant strategy equilibrium; each bidder has a well-defined optimal strategy that does not depend on, and is not connected to, the bids submitted by the other bidders. Specifically, this strategy demands that the bidder remain active in the auction as long as the price is lower than the price at which the bidder values the asset. Conversely, the bidder leaves the auction if the price reaches the amount at which she values it.

In a second-price auction, the amount that will be bid by a rational bidder is also the price at which she values the asset. Thus, the asset will be allocated to the bidder who values it the most, and

that party will pay the price at which the second highest bidder values the asset.[148] For example, assume that there are four bidders competing in a second-price auction. Bidder A values the asset at 90, bidder B values it at 94, bidder C values it at 95 and bidder D values it at 100. None of them know the other bidders' valuations. Let us look at the strategy of bidder B. Bidder B has no interest in bidding less than 94 because placing a lower bid would not provide her any benefit. It reduces the bidder's chances of winning and does not increase her profits even if she wins because the bidder will not determine the amount to be paid. That amount will be determined by the bidder making the next highest bid (bidder A). Bidder B also has no interest in bidding more than 94 because even though she will increase her probability of winning by doing so, the price at which she would achieve her victory would not be in the range within which she wishes to win. By increasing her bid beyond 94 (e.g., to 96), she will be able to "beat out" bidder C, who will bid 95. Thus, she may win an auction that she would otherwise have lost. However, in this situation, it would be preferable for her to lose because her winning will necessitate that she pay 95 for an asset that she values at only 94. Therefore, she will always bid 94, the price at which she actually values the asset. This strategy is the dominant strategy.[149] Thus, in the example given above, bidder D, who values the asset at 100, will win and will pay 95. This result is completely identical to the result of an English auction.[150]

As noted above, the English auction and the second-price auction both offer the bidder a dominant strategy. Thus, the individual bidder's strategy will not change regardless of whether the bidders are risk-averse or risk-neutral. Moreover, it will not matter

148. *See id.* at 20–22 (discussing the advantages and disadvantages of the second-price method).

149. For a full explanation of the term "dominant strategy" in this context, see Preston R. McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699, 708 (1987) (discussing "dominant strategy" in relation to Engish and second-price auctions).

150. The equivalence between these two mechanisms is only partially accurate because in common or affiliated valuation environments, the English auction has an advantage over the second-price auction in that its open process offers the bidders information regarding the other bidders' valuations. Each bidder can use this information to update his or her own valuation. For a more in-depth explanation, see Krishna, *supra* note 130, at 4.

that only one asset or several assets are being auctioned. Similarly, the issue of whether there are few or many bidders will not change each bidder's strategy. These and other variations, which could have a significant effect on the bidders' strategies in the case of a sealed-bid auction, will not change the bidders' strategies in an English auction or in a second-price auction. Therefore, they will not have any impact on the final allocation of the asset.

3. Why Are Second-Price Auctions So Rare?

In light of the above, the following question arises: if an English auction and a second-price auction are effectively the same "game," why are second-price auctions so rare?[151] An in-depth discussion of this issue is beyond the scope of this Article. However, we will briefly note two main reasons for this phenomenon.

First, there is an increased incentive for the seller in a second-price auction to perpetrate fraud to increase her revenue.[152] The danger is that after the envelopes are opened, the seller will submit a fictitious bid that is slightly less than the highest bid. This bid will not affect the identity of the winner but will increase the amount that she will pay. As long as this danger exists, the bidders' best strategy

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151. For a general discussion of why second-price auctions are so rare, see Michael Rothkopf, *Thirteen Reasons Why the Vickrey-Clarke-Groves Process Is Not Practical*, 55 OPERATIONAL RES. 191 (2007) [hereinafter Rothkopf, *Thirteen Reasons*]; Michael Rothkopf, Thomas Teisberg & Edward Kahn, *Why Are Vickrey Auctions Rare?*, 98 J. POL. ECON. 94 (1990) [hereinafter Rothkopf et al., *Why Are Vickery Auctions Rare?*]. The second-price auction is used in various situations including the sale of certain financial instruments. Michael H. Rothkopf & Ronald M. Harstad, *Two Models of Bid-Taker Cheating in Vickrey Auctions*, 68 J. BUS. 257, 258 n.1 (1995) [hereinafter Rothkopf & Ronald, *Two Models*]. It is also frequently used in stamp auctions. *See* Stuart E. Thiel & Glenn H. Petry, *Bidding Behavior in Second-Price Auctions: Rare Stamp Sales, 1923–1937*, 27 APP. ECON. 11, 11–16 (1995) (describing how, although stamp auctions allow bids by mail and floor bidders, all bidders participate in a second-price auction by making the selling price one increment over the second-highest bid if a mail bidder has the highest bid).

152. *See* Rothkopf et al., *Why Are Vickrey Auctions Rare?*, *supra* note 151, at 102 (arguing that second-price auctions are rare because, *inter alia*, bidders are afraid of bid-takers using fraudulent price-enhancing activities); Rothkopf, *Thirteen Reasons*, *supra* note 151, at 193–94 (explaining how Vickrey auctions are susceptible to cheating by the bid taker since the seller can submit an artificial bid between the two best bids and thus take some of the winning bidder's profit).

is to lower their bids below their actual valuations of the asset and thereby deviate from the theoretical dominant strategy. This strategy will be optimal even if the fraud does not actually occur because the mere presence of the danger of fraud will be sufficient to create a perceived need on the bidders' part to change their strategies.

Second, auctions categorized as second-price auctions are rarely used because they expose the size of the winning bidder's expected profit.[153] Specifically, when the auction ends, all of the participants discover the amount that the winner would have been willing to pay for the asset (i.e., the amount of her bid), what the winner will actually pay for it (i.e., the amount of the second highest bid), and the winner's expected profit (i.e., the difference).[154] The exposure of this information is problematic from at least two perspectives. First, if the winner wishes to perform work involving the asset or to sell it to a third party, any party with which the winner negotiates will know the limits of her flexibility. The improved bargaining position of the other side will harm both the winner and the seller because the bidders, who will be aware of the forthcoming scenario in the event of their victory, will consequently submit lower bids.[155] Second, an additional weakness of the second-price auction is that a large gap between the winner's valuation of the asset and the price that is actually paid could put the seller in an embarrassing position and expose her to criticism.[156]

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153. *See* Rothkopf, *Thirteen Reasons*, *supra* note 151 at 191 (outlining various reasons for the rarity of second-price auctions); Rothkopf et al., *Why Are Vickrey Auctions Rare?*, *supra* note 151, at 103 ("it could reveal to others with whom the firm must subsequently negotiate precisely how much it can yield").

154. It should be noted that in light of the character of a bankruptcy auction and its subjection to legal proceedings, its results cannot be kept confidential.

155. *See* Rothkopf, *Thirteen Reasons*, *supra* note 151 at 193 (explaining how Vickrey auctions are prone to collusion); Rothkopf et al., *Why Are Vickrey Auctions Rare?*, *supra* note 151, at 103 (arguing that fears of cheating and bidders' disincentives to follow truth-revealing strategies explain the rare use of sealed second-price auctions).

156. For example, when an auction was held for the allocation of spectrum licenses in New Zealand in 1990, the second-price mechanism was used. As a consequence, in one case, a bidder who had bid 100,000 New Zealand dollars for a license paid the amount bid by the second highest bidder, which was 6 dollars. In another case, the highest bid was 5 million dollars, and the second highest bid was 5,000 dollars. The government was harshly criticized for these absurd results. Klemperer, *supra* note 146, at 110; John McMillan, *Selling Spectrum Rights*, 8 J. ECON. PERSPECTIVES 145, 148 (1994). If the government had used an English

In sum, a second-price auction would appear to be an undesirable mechanism at first glance. However, at second glance, the second-price auction has several advantages, which raises the question of why the mechanism is used so rarely. A further review provides the answer by discerning various weaknesses involved in using this type of auction as an allocation mechanism. Consequently, in the following discussion, we will focus on the English auction, which will be compared with the possibility of using a sealed-bid auction.

4. Sealed-Bid Auction Versus English Auction

After presenting the main characteristics of, and the connections between, the four basic models for auction mechanisms, we turn to the following question: which format is preferable from the seller's perspective? As will be shown below, there is no simple answer to this question. The correct answer is that, in certain circumstances, an English auction will be more efficient, but in other circumstances, the sealed-bid auction is preferred. We will now present some of the characteristics, features, and circumstances to be considered when choosing the preferred auction mechanism in a particular situation. We will first present the features or circumstances that give an advantage to the English auction mechanism. Afterwards, we will present the same analysis for the sealed-bid auction.

a. When Is the English Auction Preferable?

1. Transaction Costs and Erroneous Strategy

The optimal bidding strategy in an English auction is relatively simple. The bidder knows her valuation of the asset and knows that the transaction will be worthwhile as long as the auction

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auction, the results would have been the same, but the highest valuation would not have been disclosed. In hindsight, the New Zealand government's mistake was that it had not established any reserve prices for the various licenses.

price does not exceed that value. There is no incentive for the bidder to engage in industrial espionage against the other bidders, as she will gain no advantage from doing so. The information that the bidder needs to formulate her strategy—the identity of the other competitors and their valuations of the asset—will be exposed as the auction proceeds. This information leads to smaller transaction costs because there is no need to engage in industrial espionage or to defend against such espionage from other bidders. Accordingly, a bidding strategy can be formulated in a relatively simple manner.

The bidder's situation in a sealed-bid auction is different. In a sealed-bid auction, the formulation of each bidder's strategy depends on what information she possesses regarding the other bidders' identities and strategies. This dependency creates three clear disadvantages. First, it obligates the bidder to gather information about her competitors, which increases the transaction costs. Second, the bidder will also want to take action to protect herself against industrial espionage from the other bidders. This protection measure also increases the transaction costs. Third, industrial espionage involves the risk of a mistake or a failure in the gathering of information. As a consequence of these factors, overall efficiency declines. This feature gives a significant advantage to the English-auction mechanism over the sealed-bid auction.

2. Incomplete Information and the "Winner's Curse"

As a starting point in auction design, the seller and the bidders will usually have incomplete information regarding the value of the asset being sold. One of the phenomena that characterize this situation is the winner's curse.[157] In this event, the auction winner eventually discovers that she valued the asset at a higher value than its market value such that her victory in the auction has caused her to enter a loss transaction. The explanation for the winner's curse phenomenon is that in circumstances of incomplete information, there is a reasonable chance that the bidders will make errors—both upwards and downwards—regarding the asset's true value.

157. The winner's curse was first discussed in 1971 in Edward C. Capen, Robert V. Clapp & William M. Campbell, *Competitive Bidding in High-Risk Situations*, 23 J. PETROLEUM TECH. 641 (1971).

However, although a downwards error is not excessively costly (i.e., the bidder simply does not win the auction), an upwards mistake can be very expensive for the bidder, as she will be forced to enter a loss transaction. Naturally, the auction's winner will always be the most optimistic bidder, but her optimism may have been excessive.[158]

How can the bidders deal with the winner's curse? The answer is that in situations characterized by uncertainty regarding the assets' value, each bidder must assume that her bid will be the highest and that she may be overly optimistic and may have over-valued the asset. To reduce the risk of a win that results in a loss transaction, the bidder must reduce her valuation by some degree. Because the size of this reduction can be difficult to calculate,[159] uncertainty regarding the asset's value works against the seller as well and provides her with an incentive to reduce the bidders' uncertainty about the asset's value as much as possible.

Milgrom and Weber have shown that from the perspective of the winner's curse, the English auction is to be preferred over the sealed-bid auction[160] because the English auction mechanism

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158. For additional details, *see* Paul Milgrom, *The Economics of Competitive Bidding: A Selective Survey*, *in* SOCIAL GOALS AND SOCIAL ORGANIZATION: ESSAYS IN MEMORY OF ELISHA PAZNER 261 (Leonid Hurwicz, David Schmeidler & Hugo Sonnenschein eds., 1985) (surveying rules and strategies in Dutch, English, discriminatory, and Vickrey auctions).

159. For an analysis of practical methods for dealing with the winner's curse phenomenon and for calculating the amount by which a bid should be reduced to neutralize it, see Peter C. Cramton, *Money out of Thin Air: The Nationwide Narrowband PCS Auction*, 4 J. ECON. & MGM'T STRATEGY 267, 279–84 (1995); McAfee & McMillan, *supra* note 149, at 720–21. For additional literature regarding the winner's curse, see, for example, JOHN H. KAGEL & DAN LEVIN, COMMON VALUE AUCTIONS AND THE WINNER'S CURSE (2001); Patrick Bajari & Ali Hortacsu, *The Winner's Curse, Reserve Prices and Endogenous Entry: Empirical Insights from eBay Auctions*, 34 RAND J. ECON. 329 (2003); Robert G. Hansen & John R. Lott, *The Winner's Curse and Public Information in Common Value Auctions: Comment*, 81 AM. ECON. REV. 347 (1991); Charles A. Holt & Roger Sherman, *The Loser's Curse*, 84 AM. ECON. REV. 642 (1994); John H. Kagel & Dan Levin, *The Winner's Curse and Public Information in Common Value Auctions: Reply*, 81 AM. ECON. REV. 362 (1991); John H. Kagel & Dan Levin, *The Winner's Curse and Public Information in Common Value Auctions*, 76 AM. ECON. REV. 894 (1986); Barry Lind & Charles R. Plot, *The Winner's Curse: Experiments with Buyers and with Sellers*, 81 AM. ECON. REV. 335 (1991).

160. *See* Milgrom & Weber, *supra* note 139, at 1091–95 (showing that English auctions allow the bidders to see other bidders' valuations).

provides the bidders with information regarding the other bidders' valuations of the asset.[161] Consequently, the bidders in English auctions are less concerned about falling victim to the winner's curse and are willing to bid higher amounts.

As an interim conclusion, we note that, with a few exceptions, the expected revenue for a seller conducting an English auction will be higher than the expected revenue from a sealed-bid auction.[162] We will now discuss the circumstances in which a different conclusion may emerge.

b. When Is the Sealed-Bid Auction Preferable?

In an English auction, the risk-averse nature of the bidders will be of no consequence. However, this is not the case in a sealed-bid auction, in which the fear of losing will give a risk-averse bidder an incentive to submit a higher bid that is closer to her actual valuation. By doing so, the bidder increases her chances of winning even if the bidder's expected profit is consequently lower. Thus, in a sealed-bid auction, the more risk-averse the bidder is, the closer her bid will be to her valuation of the asset and, accordingly, the higher that bid will be.[163]

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161. This characteristic gives the English-auction mechanism a certain advantage in comparison with the second-price auction format as well. *See* Krishna, *supra* note 130, at 87 (explaining that the availability of other bidders' prices in English auctions allows active bidders to know the price at which the departed bidders have dropped out, thus allowing "active bidders to make inferences about the information that the inactive bidders had and in this way to update their estimates of the true value").

162. *See* Krishna, *supra* note 130, at 75–77, 97–101 (explaining that the expected revenue from an English auction is at least as great as the expected revenue from a second-price auction, with some noted exceptions that result in equivalent revenues).

163. *See* Charles A. Holt, *Competitive Bidding for Contracts Under Alternative Auction Procedures*, 88 J. POL. ECON. 433, 440–43 (1980) (using a game theory analysis to determine that the expected procurement cost will be higher in a competitive auction than a sealed-bid auction if the bidders are risk-averse); Krishna, *supra* note 130, at 38–41 (concluding that the expected revenue from a first-price auction is greater than a second-price auction if the bidders are risk-averse); Maskin & Riley, *supra* note 132, at 1483 (comparing and contrasting different auctions that are designed to maximize the expected revenue of a seller faced with risk-adverse bidders); Menezes & Monteiro, *supra* note 130, at 32–34,

The primary enemy of an auction is a bidding ring or cartel. The objective of a cartel is to frustrate the auction process by creating a false impression of competition, when in actuality, the cartel members have already agreed amongst themselves on how each of them will behave (i.e., which member will win the competition, how high that member's bid will be, and how the excess profit will be distributed among the cartel members).[164]

However, a cartel is not a stable organization. Cartels have a tendency to collapse because each cartel member has an incentive to betray her colleagues and to participate in the auction in violation of the cartel's agreements. Milgrom has shown that the likelihood of cartel activity is greater in an English auction than in a sealed-bid auction.[165] As the English auction is conducted openly, the submission of a bid that does not conform to the cartel's mutual agreements will be exposed immediately. This bid will signal to the other cartel members that the cartel's agreements are no longer in force. Under these circumstances, the members will understand that the cartel has dissolved, and they will return to competing with one another. Thus, in an English auction, a potential defector knows that she will not realize any benefit from an act of defection and therefore has no incentive to commit such an act. In other words, the English auction mechanism reduces the incentive for cartel members to deviate from the cartel agreements and thus strengthens the cartel's stability. In contrast, in a sealed-bid auction, no one can know who is participating in the auction and what their bids are until the auction has ended. This situation encourages deviations from the cartel agreements and therefore reduces the likelihood that a cartel agreement will be created or will continue to exist.

Parenthetically, a relatively simple and effective means for reducing the risk of cartel formation is to establish a reserve price

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70–72 (concluding that if bidders are risk-averse, revenue is higher for a first-price auction than either a second-price or English auction).

164. For additional discussion of the cartel phenomenon, see Laffont, *supra* note 133, at 25–26 (breaking down the dynamics of collusion in bidding and highlighting additional sources for information regarding this issue).

165. *See* Paul Milgrom, *Auction Theory*, *in* ADVANCES IN ECONOMIC THEORY: FIFTH WORLD CONGRESS 1, 27 (Truman Bewley ed., 1986) ("[C]ollusion is hardest to support when secret price concessions are possible, and easiest to support when all price offers must be made publicly.").

that is equal to or slightly higher than the seller's valuation of the asset. In this way, the seller protects herself from a loss transaction and also greatly reduces the incentive for collusion activity.[166] It would also be advisable for the seller to hide the number and identity of the active bidders to make it more difficult for the bidders to transmit information to each other.[167] Consequently, if the auction is conducted under circumstances that create a high risk of cartel activity, the preferred mechanism is a sealed-bid auction.[168]

Given that participation in an auction involves transaction costs, a bidder will be deterred from participating in an auction if she estimates that her chances of winning are low. In a market characterized by asymmetric bidders,[169] the weak bidders are aware that a strong bidder who is determined to win the auction can always submit a bid that will be more attractive than their bids. If the auction is an English one and the bidders are asymmetric, a weak bidder knows that for any bid that she submits, the strong bidder can always add one more dollar until the strong bidder eventually wins

166. For additional measures that can be taken to reduce the risk of cartel activity, see generally Chantale LaCasse, *Bid Rigging and the Threat of Government Prosecution*, 26 RAND J. ECON. 398 (1995) (discussing the possible solutions presented by enforcement of laws against bid-rigging and prosecution for bid-rigging).

167. *See* Peter Cramton & Jesse A. Schwartz, *Collusive Bidding: Lessons from the FCC Spectrum Auctions*, 17 J. REG. ECON. 229, 241 (2000) (identifying transparency and accessibility of information about bidder identities as benefits of reporting bidder identities); Klemperer, *supra* note 146, at 114 (explaining that sealed-bid auctions make signaling and retaliation harder than in ascending auctions).

168. *See* Robert C. Marshall & Leslie M. Marx, *Bidder Collusion*, 133 J. ECON. THEORY 374, 407 (2007) (analyzing the profitability of collusion at first-price versus second-price auctions, and concluding that collusion is more difficult at first-price (sealed-bid) auctions); Marc S. Robinson, *Collusion and the Choice of Auction*, 16 RAND J. ECON. 141, 144 (1985) (explaining that cartels are less stable when sealed high-bid auctions are utilized because there is an incentive to defect from the cartel); Jeroen Hinloopen & Sander Onderstal, *Collusion and the Choice of Auction: An Experimental Study*, TINBERGEN INSTITUTE 15 (Discussion Paper No. 10-120/1, Nov. 30, 2010), *available at* http://ssrn.com/abstract=1718996 (last visited Sept. 23, 2012) (arguing that collusion is expected to be more fragile in an English auction than in a first-price sealed-bid auction).

169. For example, a group of asymmetric bidders could be a market composed of small and large construction companies or of small and large software companies.

the auction. The strong bidder, who is also aware of this fact, has an incentive to signal to the weak bidder that she is determined to win the auction and that she does not intend to give up. This type of message can achieve its purpose and deter the weak bidder from participating in the auction altogether. Such deterrence will minimize the number of bidders, reduce competition, and diminish the seller's expected revenue.[170]

In contrast, in a sealed-bid auction, the strong bidder does not know how the weak bidder will behave (i.e., what the weak bidder's bid will be or whether the bidder will even participate in the auction). This situation encourages the weak bidder to surprise the stronger bidder and causes the strong bidder to avoid taking any risks by submitting a higher bid. These features can generate an effective level of competition and will consequently be expected to increase the expected revenue for the seller.[171] Thus, in an environment

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170. For example, in the FCC's 1995 auction for the allocation of spectrum licenses in Los Angeles, the strongest bidder in the region (Pacific Telephone) signaled to the other potential bidders that it intended to win the auction at any price. The auction was conducted as an English auction. Pacific Telephone even asked Paul Milgrom to explain to its potential competitors that if they acted too aggressively in making their bids, they could fall victim to the winner's curse. Many bidders were consequently deterred from competing, and Pacific Telephone won the auction at approximately one-third of the assests' market value. *See* Paul Klemperer, *Auctions with Almost Common Values: The 'Walnut Game' and Its Applications*, 42 EUR. ECON. REV. 757, 761 (1998) (explaining that the price for the Los Angeles license ($26 per person) was quite low when compared to licenses in Chicago, a much smaller city than Los Angeles, where recently auctioned licenses went for as much as $31 per person); Klemperer, *supra* note 146, at 106–09 (giving multiple examples when deterrence of bidders reduced competition and often dramatically diminished the seller's revenue from the auction); Milgrom, *supra* note 130, at 211 n.5 (explaining that the price paid per unit by Pacific Telephone was "low compared to the prices in other market areas containing such a large urban center," despite a personal rival of Pacific's CEO driving up the price for the southern California license by hundreds of millions of dollars).

171. These conclusions are appropriate for most sales environments. *See* Harrison Cheng, *Ranking Sealed High-Bid and Open Asymmetric Auctions*, 42 J. MATH. ECON. 471, 473 (2006) (discussing the "Getty effect," which argues that a stronger bidder will bid higher in a sealed-bid auction than he ordinarily would in an open auction); Klemperer, *supra* note 146, at 21–24, 114 (giving an overview of mechanism design theory which aims to maximize the performance of an auction through rules that govern interactions between the parties, including the rules of sealed bids); Eric Maskin & John Riley, *Asymmetric Auction*, 67 REV. ECON. STUDIES 413, 413 (2000) (explaining that a risk-averse seller should favor a sealed

characterized by asymmetric bidders, the seller should prefer a sealed-bid auction.

In sum, no sweeping answer can be given to the question of which auction mechanism is better from the seller's perspective. All that can be said is that under "normal" circumstances, English auctions will be preferable. This preference exists because under an English auction, the transaction costs are lower, the bidders have simpler strategies, the winner is less exposed to the winner's curse, and the risk of market failure is also lower. Nevertheless, this conclusion is not valid if an analysis of the market indicates that the potential bidders are significantly risk-averse, asymmetric, or at risk of developing cartel activities. If any of these conditions are present, there are good reasons for preferring a sealed-bid auction.

D. Additional Aspects

Beyond the question of which auction mechanism should be preferred under specific circumstances, additional considerations and possibilities for auction rules must be discussed. These considerations will be relevant regardless of whether the choice has been made to conduct an English auction or a sealed-bid auction. We will now discuss some of the considerations that are most relevant to bankruptcy auctions.

1. Information on the Asset

One interesting question that has engaged auction theory scholars is the determination of the best strategy with respect to the information known by the seller. In many cases, the seller has private information regarding the potential revenue that may be generated by the asset being sold, information regarding restrictions on the use of the land being auctioned, or information regarding the mechanical condition of a machine being auctioned. Milgrom and Weber have shown that, for any type of auction, a full disclosure

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high-bid auction when buyers are also risk-averse); Milgrom, *supra* note 130, at 149–53 (explaining the importance of auction design and that in sealed-bid auctions entry is promoted because a weaker bidder has a better chance of winning at a price a stronger bidder may have but did not bid).

policy is preferable because this policy will maximize the expected revenue for the seller.[172]

Although this conclusion is intuitive with respect to positive or neutral information concerning the asset, it seems to be somewhat less logical if the information under discussion is negative. Milgrom and Weber have mathematically proven their argument in favor of full disclosure, but there is also an intuitive explanation based on the rationale for the winner's curse for this conclusion. As noted above, the starting point for understanding the winner's curse is that the bidder does not have complete information regarding the value of the asset. As a result, the bidder must establish her own valuation. The assumption is that a rational bidder who has incomplete information and is aware of the winner's curse will reduce her bid. In other words, there will be a certain amount, which can be defined as a "risk premium," at which the bidder will reduce her planned bid to avoid falling victim to the winner's curse. In such a situation, any additional information that will diminish the level of uncertainty regarding the asset's value will also reduce the level of the risk premium. Thus, the bidder will be willing to submit a higher bid. Although in the case of negative information, the disclosure will not necessarily increase the amount of the bids, it will not reduce them either. Therefore, in a situation in which the bidders have incomplete information, the seller's optimal strategy is to disclose all of the information that she has regarding the asset being sold and to diminish the gaps in the information available to the bidders as much as possible.[173]

2. Reserve Price

Various questions arise regarding the issue of a reserve price. There is a consensus that the establishment of a reserve price is an efficient strategy for the seller,[174] if only because this price plays a

172. Milgrom & Weber, *supra* note 139, at 1096, 1110 (showing that reporting information will raise the bidders' willingness to pay).

173. Nevertheless, even according to the theory, it is preferable for the seller to maintain confidentiality for certain types of information (e.g., the number of participating bidders in a sealed-bid auction with risk-averse bidders).

174. *See* Krishna, *supra* note 130, at 24–28 (demonstrating that expected payments in first- and second-price auctions with reserve prices of $r > 0$ are the same); McAfee & McMillan, *supra* note 149, at 713–14 (concluding that any of

key role in preventing bidder collusion. From this perspective, the optimal reserve price is the seller's valuation of the asset. It will not be worthwhile for the seller to sell below this price, whereas the transaction will be a positive one if the price is above the seller's valuation.

It can be argued that the establishment of a reserve price will not only prevent loss transactions but will also increase the seller's expected revenue under certain circumstances. For example, it is easy to see that in an English auction, the use of a reserve price that is higher than the second highest valuation but lower than the highest valuation will lead to increased revenue for the seller. The problem is that it is difficult to estimate the difference between the highest and the next highest valuations. Worse still, setting an excessively high reserve price will lead to a situation in which no transaction is performed at all, even though the highest bid would have been worthwhile to the seller.

The theoretical analysis shows that from the seller's perspective, the optimal reserve price is a price that is slightly higher than the seller's valuation of the asset.[175] However, this insight is generally not implemented in practice. In reality, reserve prices do not exceed the seller's valuation of the asset, and in many cases, they are even lower than this valuation.[176]

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the four types of auctions will succeed as an "optimal selling mechanism" if the seller imposes two optimal reserve prices). It is agreed that the establishment of a reserve price does not affect the other attributes of the different types of auctions.

175. Menezes & Monteiro, *supra* note 130, at 25; Myerson, *supra* note 132, at 67; Riley & Samuelson, *supra* note 132, at 382–86. *See also* Stephanie Rosenkranz & Patric W. Schmitz, *Reserve Price in Auctions as Reference Points*, 117 ECON. J. 637, 642–47 (2007) (reaching a similar conclusion from the perspective of cognitive psychology).

176. *See* Jennifer Brown & John Morgan, *How Much Is a Dollar Worth? Tipping Versus Equilibrium Coexistence on Competing Online Auction Sites*, 117 J. POL. ECON. 668, 682 (2009) (discussing the effects of reserve prices on revenue). Regarding the argument that the optimal reserve price depends on the degree to which the seller and the bidders are risk-averse, see Audrey Hu, Steven A. Matthews & Liang Zou, *Risk Aversion and Optimal Reserve Prices in First- and Second-Price Auctions*, 145 J. ECON. THEORY 1188 (2010). Barrimore and Raviv conducted an experiment in which they sold Starbucks gift certificates on e-Bay. An increase of the reserve price increased the price paid for the items that were sold but also led to a situation in which some of the items were not sold at all.

What is the optimal strategy regarding the disclosure of the reserve price? As noted previously, Milgrom and Weber have proven that in most environments, the seller's optimal strategy is to disclose all of the relevant information of which she is aware, including the reserve price.[177] However, in reality, sellers tend not to disclose the reserve price. According to Vincent, a non-disclosure policy regarding the reserve price is understandable and justifiable because disclosure reduces the number of auction participants by eliminating all of the potential bidders whose valuations are lower than the reserve price.[178] Consequently, the level of competition declines, and the seller's expected revenue is reduced. Conversely, if the reserve price is unknown, more bidders will participate in the auction.[179]

E. Auction Theory in Action—The FCC Spectrum Licenses Auctions

One of the most significant criticisms directed at game theory is that it cannot be implemented in real-world scenarios. This limitation primarily exists because the theoretical research relies on several assumptions that often do not hold true in the real world. For example, the basic assumption of game theory is that decision makers act rationally. However, numerous studies conducted over the last forty years have shown that this assumption is often of dubious validity.[180] In this respect, auction theory presents a marked

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Thus, overall, the reserve price had a negative impact on the total revenue from the auction. Nathan Barrimore & Yaron Raviv, *The Effect of Different Reserve Prices on Auction Outcomes* (Robert Day Sch. Econ. & Fin. Research, Paper No. 2009-13, July 9, 2009), *available at* http://ssrn.com/abstract=1432283.

177. *See* Milgrom & Weber, *supra* note 139, at 1104 (discussing the Japanese auction system, which provides bidders with precise information regarding valuations).

178. Daniel R. Vincent, *Bidding Off the Wall: Why Reserve Prices May Be Kept Secret*, 65 J. ECON. THEORY 575, 576, 583 (1995).

179. The validity of this thesis is doubtful, as it can also be argued that nondisclosure of the reserve price is likely to deter risk-averse bidders from participating if they estimate that there is a reasonable chance that their valuations are lower than the reserve price.

180. *See generally* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT (Daniel Kahneman, Dale W. Griffin & Thomas Gilovich eds.,

improvement over other theoretical analyses. Beginning in the 1990s, auction theory economists have shown that an auction conducted in accordance with the insights developed through theoretical research produces greater revenue, but the auction designer must address practical considerations as well.[181] We will demonstrate this point through a brief review of the auctions held since the 1990s regarding the allocation of licenses for the use of frequencies along the electro-magnetic spectrum.[182]

The FCC is responsible for allocating spectrum licenses for various communications purposes within the United States. After previous attempts to allocate spectrum licenses through an administrative process and a lottery failed,[183] Congress decided to allocate the spectrum frequencies through the use of auctions in 1993.[184]

As a result of the legislation, the FCC was required to decide a number of matters related to the manner in which the auction would be conducted. For this purpose, the FCC engaged the services of the best theoreticians from the field of auction theory. This

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Cambridge Univ. Press 2002) (discussing various documented irrational mental operations and biases); JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman, Paul Slovic & Amos Tversky eds., Cambridge Univ. Press 1982) (discussing instances of decision makers' irrational actions).

181. Regarding the practical considerations to be weighed in the design of an auction, see Paul Klemperer, *What Really Matters in Auction Design*, 16 J. ECON. PERSP. 169, 169–70 (2002) (discussing the need to design auctions to deter predatory behavior and collusion).

182. For a detailed analysis of the auction, its rules, and its progress, see Cramton, *supra* note 159 (setting forth a strategy for bidding on licenses); John McMillan, *Why Auction the Spectrum?*, 19 TELECOMM. POL'Y 191, 191 (1995) (advocating for auctioning electromagnetic spectrum rights).

183. For example, in one case, a particular party was awarded a license in the Cape Cod area. The party sold this license to another party for $41 million. *See* McMillan, *supra* note 182, at 192 ("[A]ssigning licenses at random is hardly likely to put licenses into the hands of the firms most likely to use them.").

184. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312. It is interesting to note that the objective of obtaining the maximum revenue from the auction was a secondary goal in this congressional action. The main objective was defined as the efficient allocation of spectrum frequencies. *See* Preston R. McAfee & John McMillan, *Analyzing the Airwaves Auction*, 10 J. ECON. PERSP. 159, 160, 165 (1996) ("Congress charged the FCC with encouraging an 'efficient and intensive use of the electromagnetic spectrum.'").

moment was their time to shine, but the project also put their theories to the test: the auction theory scholars now had the opportunity to prove that the insights derived from the theoretical research could serve as practical tools in the hands of policymakers. Given the complexity of the spectrum license auctions, the many problems that arose in the context of these auctions and their unprecedented scope, the experts' task was not at all simple.[185]

The auction designers had to make a series of difficult decisions. First, the designers had to decide whether to use an English auction or a sealed-bid auction format. Considering the various characteristics of the different mechanisms, the FCC chose to use a unique type of English auction: a "simultaneous ascending bid auction" with discrete bidding rounds. This auction was composed of many rounds of sealed-bid auctions, with the highest bidder at the conclusion of each round being declared its winner. At the end of each round, the FCC would propose that the bidders undergo an additional round. The auction would end when no bidder was interested in making a bid that was higher than the highest bid of the previously concluded round. In this way, the FCC hoped to accomplish the following: (1) to enable the flow of information among bidders; and (2) to create obstacles that would prevent collusion by preserving the bidders' anonymity.[186] Because this new format had never been tried before, the FCC made a bold move by using it in an auction of such scope and importance.

Second, the FCC needed to decide whether it would conduct a single, simultaneous auction in which all of the licenses would be sold; whether it would be preferable to have a separate auction for each license; or whether the agency would choose some combination

185. For a fascinating description of the constraints and of the auction's progress from the perspective of the FCC itself, see Evan R. Kwerel & Gregory L. Rosston, *An Insider's View of FCC Spectrum Auctions*, 17 J. REG. ECON. 253, 253 (2000) (discussing how economists both inside and outside of the government collaborated to design FCC auctions); Milgrom, *supra* note 130, at 265–79 (explaining simultaneous ascending auctions used by the FCC).

186. McMillan, *supra* note 156, at 151–53. John McMillan, who took part in several of the most important studies in the field of auction theory, served as the FCC's special consultant for the design of the auction and was responsible for designing the auction's rules.

of the two methods.[187] The main element that the FCC needed to consider in this regard was the synergetic connections among the licenses.

The experts agreed that it would be best to conduct a certain type of simultaneous auction, but they disagreed on the details of the auction.[188] Additionally, a concern arose that a simultaneous auction could be too complicated for the bidders. In turn, this excessive complexity could cause the auction to fail. In the end, the Milgrom and Wilson proposal was adopted.[189] This proposal included six auction rules. First, a continuum of licenses would be allocated in each process, with each license being the subject of a separate auction. Second, the auctions would be conducted simultaneously, with the bidders being able to submit bids for all of the licenses in each round, although the number of bids that each bidder could make would be limited to a specific number of licenses that the bidder had established in advance. The bidders were also required to deposit large bid bonds for each license that they bid upon. Third, each auction would remain open until the auction for the last license ended. In other words, these auctions would all remain open until the round in which no bid was submitted for any license closed and until each bidder could move from auction to auction without limitation in accordance with her efficiency considerations. Fourth, each bidder was required to be active in each round. A bidder who was not active was considered to have withdrawn from the entire auction and could not return to it. This condition was established as a requirement such that the auction would progress at a reasonable pace and the bidders would not be able to "sit on the fence" waiting for the other bidders to submit their bids. Fifth, the FCC retained the

187. For a detailed discussion of the issue, including the difficulties that it raised and the solutions that were found for these problems, see McMillan, *supra* note 156, at 153–55 (describing the benefits and consequences of the various auction forms available to the FCC).

188. Regarding the advantages of a simultaneous auction under these circumstances, see Bashkar Chakravorty, William W. Sharkey, Yosef Spiegel & Simone Wilkie, *Auctioning the Airwaves: The Contest for Broadband PCS Spectrum*, 4 J. ECON. & MGM'T STRATEGY 345, 354 (1995).

189. Paul Milgrom and Robert Wilson, two of the most important auction theory scholars, served as consultants for two of the companies that participated in the auction. For a discussion of the considerations involved in choosing the rules for the auction, see Milgrom, *supra* note 130, at 1–16.

right to use its discretion to determine the minimal rate of progress for each auction. Additionally, the FCC had the authority to change that pace during the course of the auction in accordance with the auction's progress. Sixth, to prevent fictitious bids, the FCC stipulated that a bidder would be subjected to a fine if she withdrew her bid and that the fine would consist of the difference between the bid that was being withdrawn and the winning bid. If a bid were withdrawn after an auction had ended, the fine would be 3% greater.[190]

An additional issue that needed to be decided was whether to establish reserve prices for the licenses. According to the theoretical literature, a reserve price would be advisable if there were concerns regarding weak competition, a limited number of bidders, or cartel activities. In the FCC case, it was anticipated that there would be aggressive competition for the licenses. Therefore, the likelihood of cartel activity was expected to be minimal, and the FCC decided not to establish a reserve price.

Another interesting factor that was considered was the complexity of the auction rules. The rules needed to be comprehensible to the policymakers at the FCC and to the management at the companies that would be participating in the auction such that they would be able to understand the auction rules and the optimal strategy to be derived from them.[191] The designers of the auction assumed that if the rules were too complex, the rules would not be understood, which would lead the policymakers to reject them. Therefore, it was agreed that it would be preferable (to a certain degree) to use simple rules rather than complex ones, even at the expense of some of the auction's efficiency.[192] As noted

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190. Furthermore, because the allocation of over 2,000 licenses was at stake, the FCC decided to allocate them into five simultaneous auctions, with the licenses divided between these auctions on the basis of the license types. For a detailed explanation of all of the considerations, see McMillan, *supra* note 156, at 155–57 (noting that the FCC chose from different auction forms based on the "degree of license interdependency" and the value of the license).

191. *See* Cramton, *supra* note 159, at 278 (demonstrating the extent to which the auction rules affected the auction outcome).

192. For some additional factors that the FCC was required to consider, see Chakravorty, Sharkey, Spiegel & Wilkie, *supra* note 188, at 356–61. These factors included the following issues: whether to divide the spectrum licenses into a few large licenses or into many small licenses; how to divide the frequencies geographically; how many electro-magnetic frequencies to allocate; whether and

above, the final decision was to use a simultaneous ascending bid auction, although this mechanism was completely new and untried.

The first spectrum licenses auction allocated only ten frequencies of three types at a relatively low cost. It is interesting to note that there was almost a complete consensus among all of the economists who were involved in the auction design—both those from the industry and those from the government—with respect to the determination of the auction rules.[193]

The first auction was held at the end of July 1994 over the course of five days. The auction lasted forty-seven rounds and did not require any intervention from the FCC.[194] The FCC's boldness and daring appeared to have paid off. The auction was viewed by all as a success, and the revenue that it generated was ten times the pre-auction estimations.[195] Beginning with the 1994 auction, all spectrum licenses have been allocated through auctions,[196] although some difficulties have arisen along the way.[197]

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to what extent the incumbent cellular operators' abilities to participate in the new auction should be limited; and whether to allow several companies to group together for the purpose of joint bidding.

193. Cramton, *supra* note 159, at 6 n.11.

194. For a stage-by-stage description and analysis of all 47 rounds, see generally Cramton, *supra* note 159.

195. Cramton, *supra* note 159, at 269. For the details of the auction, see *Auction 1: Nationwide Narrowband (PCS)*, FEDERAL COMMUNICATIONS COMMISSION, *available at* http://wireless.fcc.gov/auctions/default.htm?job=auction_summary&id=1 (last visited Nov. 27, 2012) (summarizing the 1994 spectrum licenses auction). Naturally, not all of the forecasts were accurate. For example, the intention to hide the identities of the bidders by giving them secret identity numbers turned out to be inefficient and unnecessary, and the FCC decided not to follow this practice in later auctions. *Id.* However, these problems were minor and did not change the final conclusion regarding the auction's success.

196. For example, the FCC allocated 99 licenses in the third auction through 112 bidding rounds. The auction lasted for four months, and the FCC was paid approximately $7 billion. For details of this auction, see *Auction 4: Broadband PCS A & B Block*, FEDERAL COMMUNICATIONS COMMISSION, *available at* http://wireless.fcc.gov/auctions/default.htm?job=auction_summary&id=4 (last visited Nov. 27, 2012) (summarizing the 1995 spectrum license auction).

197. For a critique with respect to the excessive centralization in the purchasing of licenses and the preferences given to large corporations, see generally, Gregory F. Rose & Mark Lloyd, *The Failure of FCC Spectrum Auctions*, CENTER FOR AMERICAN PROGRESS (May 2006), *available at*

Thus, on the first occasion in which auction theory was given such a prominent role in designing a real-world auction, the results were surprisingly positive. Although this electro-magnetic spectrum license auction was so complex and complicated that no theoretical model could have provided a faithful description, the use of and reliance on auction theory principles and insights were essential components of the auction's success.

F. The Lesson Learned

Auction theory is tested primarily by the degree to which its insights can be implemented in real-world situations. Until the FCC's spectrum license auctions in the 1990s, the truth of the insights described above had only been proven in theory. The FCC auctions broke from the mold by providing indisputable proof of the practicality of the theoretical analysis. Since then, many auctions have provided additional evidence of this real-world practicality.[198]

It is now undisputed that an auction's design can and does have a determinative impact on its results. An auction's design will affect the number of bidders who will participate in the auction, the quality of those bidders, the amount of the bids, the proper operation of the auction itself, and—most importantly—the revenue generated for the seller. All of these effects have been shown through theoretical analyses, laboratory experiments, and empirical research on various auctions held in the past.

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http://www.americanprogress.org/kf/spectrum_auctions_may06.pdf (last visited Nov. 27, 2012). Over time, it was also discovered that the bidders had engaged in several attempts at collusion. For a description of this phenomenon and the attempts to address it, see generally Cramton & Schwartz, *supra* note 167; Leslie M. Marx, *Economics at the Federal Communications Commission*, 29 REV. INDUS. ORG. 349 (2006).

198. For a survey and analysis of nine auctions that allocated spectrum licenses and that were conducted in nine different countries in Europe, see generally Klemperer, *supra* note 136. For a detailed analysis of the planning and execution of the 2000 auction conducted in England to allocate spectrum licenses, which generated revenues of $34 billion and is considered to be the largest auction ever held, see generally Binmore & Klemperer, *supra* note 135. For a detailed analysis of the auction for the allocation of spectrum licenses in Germany, see Klemperer *supra* note 146, at 196–205.

Nevertheless, we cannot draw any unequivocal conclusions regarding the optimal auction because no mathematical formula can fully express the characteristics and circumstances of every possible situation.[199] McAfee and McMillan have therefore argued that the primary importance of theoretical auction theory research lies in its development of proper intuitions and the ability to understand the impacts of various auction rules on the behavior of bidders in a particular auction.[200] Klemperer argues that the most important consideration in auction design is the encouragement of competition, which can be accomplished primarily by encouraging participation in the auction and by preventing collusive activities among bidders.[201] Milgrom agrees with this view and also notes the importance of simplicity in the design of the auction rules.[202] All of these scholars agree that the concepts and principles developed by auction theory are of great value in the achievement of all these objectives.

III. DESIGNING AN OPTIMAL BANKRUPTCY AUCTION

Having understood the legal and economic background of bankruptcy auctions (in Part I) and the basics of auction theory (in Part II), we must now apply the insights offered by auction theory to some of the questions evoked by bankruptcy auctions. Of course, resolving all of these questions is beyond the scope of this Article. The purpose of Part III is to demonstrate the manner in which auction theory can be employed to improve bankruptcy auctions. Section A starts by emphasizing several general guidelines that should be considered when designing a bankruptcy auction. This Section offers a new auction design that should arguably be employed instead of the prevailing conventional design. Section B

199. *See* Klemperer, *supra* note 146, at 119–21 (emphasizing the need to tailor auction design to the context and giving examples of auction designs that worked well in one situation but failed in others); Milgrom, *supra* note 130, at 247–49 ("In practice, the design of an effective auction requires a detailed knowledge of the particular circumstances in which the auction is to be run.").

200. McAfee & McMillan, *supra* note 184, at 172.

201. *See* Klemperer, *supra* note 181, at 169–70 (arguing that the most important features of an auction system are its robustness against collusion and its attractiveness to potential bidders).

202. Milgrom, *supra* note 130, at 253.

analyzes the question of "credit bidding." Section C concludes with a note on the institutional environment of bankruptcy auctions and the need to increase the involvement of the bankruptcy courts in the design of these auctions.

A. General Guidelines

Bankruptcy law does not explicitly prescribe a set of concrete rules for conducting an auction that would maximize revenues and minimize costs. However, both the auction design and the result of the auction must receive court approval.[203] Moreover, as demonstrated in the context of "credit bidding," certain sections of the Bankruptcy Code require, even if only indirectly, a careful examination of the design of the bankruptcy auction.[204]

1. Utilizing Auction Theory

We argue that when considering any proposed arrangement that includes an auction in a bankruptcy, the bankruptcy court should be aware that the design of the auction can have a determinative impact on the likelihood that the auction will achieve its goals and that the judicial authority must ensure that the particular rules of the auction incorporate the insights provided by auction theory. To the extent that practical conclusions can be drawn from economic research, these conclusions should also impact the legal mandate formulated by the court to those in charge of executing the auction. For example, one of the main criteria for obtaining court approval of an arrangement—whether for the purpose of liquidation or reorganization—should be the maximization of the revenue from the auction. Thus, if it becomes apparent that a specific auction design can be expected to generate more revenue than a different design in a particular situation, the approval of the arrangement should be conditioned on the use of the most efficient design under the circumstances.

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203. *See supra* Part I.A.1 (noting that bankruptcy courts must approve any plan).

204. *See supra* Part I.A.2 (discussing controversy among courts regarding the meaning of § 1129(b)(2)(A)).

However, what is the optimal bankruptcy auction design? First, as in many other design contexts, one size does not fit all. Thus, although a default auction design may be suggested, lawmakers should understand that in certain cases, the default auction design should be altered to fit the special needs of a particular bankrupt firm. For example, an auction that cannot be characterized as a "common-value auction" should be accorded special consideration.[205]

However, having reviewed some of the insights offered by auction theory, we are confident that a default auction design can be formulated. The following is an attempt to offer such a design.

2. The Suggested ADVA Design

Although separate sales of standard assets should also be of interest to lawmakers contemplating an optimal auction design, the more interesting case concerns those bankruptcies in which the auctioned "asset" is the entire business as an ongoing concern. Usually, the large amount of money at stake in these cases, alongside the complexity and opacity of this "asset," merits a careful planning of the auction. However, it is assumed that the auctioned asset is tradable and of common value to all of the potential bidders in the auction.

Broadly speaking, a bankruptcy auction should be designed to maximize the proceeds (revenues, in auction theory jargon) from the sale while minimizing the transaction costs and protecting the interests of the various claimants. With regard to maximizing the revenues and minimizing transaction costs, auction theory fits the context of bankruptcy auctions perfectly because the theories and research executed by the scholars working in that field target these same goals. However, the bankruptcy auction should also protect the interests of the bankrupt firm's relevant claimants. For example, the line of cases concerning "credit bidding" emphasizes the need to

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205. *See supra* note 138 and accompanying text (stating that bankruptcy courts rarely relax the assumption that an auction can be characterized as a "common-value auction" and therefore the article assumes the same). *See also* Rothkopf et al., *Why Are Vickrey Auctions Rare?*, *supra* note 151, at 100 (mentioning work that "developed models based on an assumption that bidders had a common (but unknown) value").

protect the interests of a secured creditor holding an under-secured claim if this creditor faces an oppositional debtor-in-possession. Conversely, the interests of junior claimants, including unsecured creditors and equity holders, should also be protected if, for instance, a secured creditor holding an over-secured claim cooperates with the debtor-in-possession or with the firm's shareholders in a manner that may "squeeze out" the interests of the unsecured creditors. In fact, in the context of bankruptcy auctions, one should bear in mind that a conflict of interests is always expected once the claimants are ranked by priority. The uncertainty with regard to the true value of the assets to be auctioned exacerbates this conflict of interests.

The economic environment in which bankruptcy auctions usually occur includes several unique features that are sometimes interrelated and that should be taken under consideration. For the most part, bankruptcy auctions are usually conducted in an environment that can be characterized as relatively uncompetitive, as few bidders usually participate.[206] The causes of this relatively uncompetitive environment may include one or more of the following: first, the auction is oftentimes conducted during an economic downturn and cannot be postponed; second, the sale of the auctioned asset should be concluded swiftly, as the claimants, especially the creditors, want to be paid quickly; and third, for the potential bidders, the value of the auctioned asset is quite uncertain because of the financial distress context.

Thus, lawmakers should opt for an auction design that would encourage competition and prevent possible cartels among bidders. This suggests an optimal default design that is quite different from the one currently employed in many bankruptcy auctions. The default model design that we envision for large firms sold as an ongoing concern—bearing in mind that some special cases may merit a different approach—is a design that we call the "Anglo-Dutch Veto Auction" (or in short: "ADVA"). An ADVA design consists of an Anglo-Dutch auction without a reserve price and without a pre-contract with a "stalking horse." At the end of the auction, if the bidding price does not exceed the amount of the secured claim, the secured creditor should be extended with a right to veto the sale in exchange for paying a pre-defined amount as a cost

206. *See supra* Part I.B.2 (discussing the low participation rates in bankruptcy auctions).

to the highest bidder. Consider the following explanation of this design.

a. The Anglo-Dutch Feature

Generally speaking, in the context of bankruptcy sales, a process that revolves around an auction-like interaction with potential buyers is superior to a process that involves negotiations with them. Such negotiations consume time and undermine competition among bidders because potential bidders may fear that these negotiations, which are conducted discretely and may remain undisclosed, have been manipulated to favor those bidders with personal or other connections to the bankrupt firm or to the debtor-in-possession. Thus, both a negotiation with a "stalking horse" and a negotiation with the highest bidders (after the conclusion of an initial bidding process) are unwarranted.[207]

An open public auction is superior to a sealed-bid auction because an open public auction eliminates the need to spread information among the bidders and decreases the possible effects of a "Winner's Curse." An open public auction helps achieve these goals because, as the auction evolves and the submitted bids increase in amount, each bidder draws positive signals from knowing that she is not the only one bidding high. In contrast, a sealed-bid auction is incapable of increasing certainty in this manner among the potential bidders, and the bidders may prefer to bid low to avoid the "Winner's Curse."

An Anglo-Dutch design will usually outperform any other auction design. Recall that the "Anglo-Dutch auction" is an English auction that is conducted until the number of bidders remaining in the competition is one more than the number of items that are being auctioned. At this stage, the English auction ends, and the bidders

207. *See* Jeremy Bulow & Paul Klemperer, *Auctions Versus Negotiations*, 86 AM. ECON. REV. 180, 190 (1996) (showing that under certain assumptions, it is more profitable to sell a company through an auction with N+1 bidders than through negotiation with N bidders). *See also* Patrick Bajari, Robert McMillan & Steven Tadelis, *Auctions Versus Negotiations in Procurement: An Empirical Analysis*, 25 J. L. ECON. & ORG. 372, 389 (2009) (discussing widely-held views among industry participants that competitive bidding results in lower administrative costs than negotiations do).

are invited to submit a single-sealed bid, which may not be lower than the last bid made in the English auction.

In the context of bankruptcy auctions, the most important feature of the Anglo-Dutch auction is that it motivates weak bidders to participate because they understand that once they get past the English auction phase, they too can compete with powerful, large bidders in a one-shot round, during which each bidder submits her highest bid in a closed envelope. Indeed, in a simple English auction, strong bidders can always offer one dollar more than weak bidders. By doing so, strong bidders can secure the winning bid. Because the participation of even one more bidder is critical and may tilt the auction from a failure towards success, the Anglo-Dutch design encourages participation in a manner that effectively brings even "small" bidders to the auction house.

Moreover, there is a secondary benefit to employing an Anglo-Dutch auction. An Anglo-Dutch auction undermines cartelistic behavior because the sealed part of the auction generates an incentive for the members of a cartel to defect (i.e., submit a higher bid and win the auction alone). Such an outcome is harder to obtain otherwise because an open auction allows the members of the cartel to monitor one another constantly and react immediately to any defections.

b. The Veto Feature

Consider next the veto feature of the suggested auction design. We argue that the secured creditor should be given a right to veto the sale to prevent any possible cartelistic behavior and to protect her interests against extremely low bids.

One could argue that a reserve price, perhaps even one set by the secured creditor herself, may be superior to the suggested veto mechanism. The reserve price could assure the secured creditor that the auction will not end with a sale of the encumbered assets at a price that does not reflect their market value. However, setting a correct reserve price is a complex task in the context of a bankruptcy auction. Doing so would force the secured creditor to commit in advance to a certain market value of the auctioned assets, which could later induce either inefficient sales due to an excessively low reserve price or the loss of efficient sales because of a reserve price that was set too high. Moreover, incorporating a reserve price into

the auction mechanism demands an answer to several questions concerning, for example, the disclosure of this price in advance to the bidders. It is also unclear how a reserve price would impact the intensity of the competition among bidders. Thus, a veto mechanism should be expected to outperform a reserve price mechanism. Indeed, as the auction unfolds, the secured creditor, equipped with an entitlement to later veto the results of the auction, can draw various signals regarding the value of the auctioned assets. The secured creditor can do so by observing various factors, including the manner in which the auction is conducted, the identities of the participants, their behavior, and the intensity of the bidding competition.

Nevertheless, because a veto right may have a considerable "chilling effect" on potential bidders' participation—as each of them may fear that upon the auction's conclusion and after spending a substantial amount of money on preparing for the auction, the secured creditor will evoke her veto and annul the sale—the right to execute this veto should be conditioned on the secured creditor's payment of the costs of the winning bidder. The amount of the costs should be pre-determined such that all agents understand what is at stake. Additionally, the amount should include at least the cost of conducting an evaluation of the auctioned assets (which is usually the most expensive cost associated with participating in the auction). Imposing a price on evoking the veto guarantees that the secured creditor will not evoke her veto right unless she finds it to be absolutely necessary. Moreover, having a veto that is conditioned on the payment of costs to the winning bidder encourages the bidders to submit higher bids to win the auction. The bidders understand that, on the margin, it is better to win the auction than to lose because winning entitles them to either the auctioned asset or compensation from the secured creditor. In contrast, if they do not win the auction, they are not entitled to anything.

However, the secured creditor's right to veto the sale should expire once the bidding price exceeds the amount of the secured claim. Indeed, if the bidding price exceeds the amount of the secured claim, the secured creditor becomes disinterested in maximizing the proceeds of the sale (i.e., she is expected to be paid in full and no longer gains from any additional increase in the sale price) and should therefore not enjoy any special privileges, including an entitlement to veto the auction.

c. Other Features

As for the participation of investment bankers in the auction process, it seems that their involvement usually has a positive impact on the auction's success. This impact also justifies their success fee. Indeed, the relatively uncompetitive environment of bankruptcy auctions merits any boost possible. Investment bankers disseminate information among potential bidders and may play an important role in overcoming informational asymmetries. Therefore, it is useful to set their fee based on the results of the auction.

However, investment bankers should not be paid a success fee based on a percentage from the sales price in the cases in which a veto has been evoked. If the secured creditor decides to evoke her veto, the investment bankers should not be compensated with the full success fee. Instead, they should be paid a much smaller amount that reflects their failure to generate effective competition or obtain an adequate price.

We suggest that investment bankers should not be allowed to push for a pre-auction contract with a "stalking horse." Although the willingness of the "stalking horse" to commit to a certain price generates a positive signal to other potential bidders, the costs of contracting with such a buyer are quite high. The process of negotiating with this buyer may induce manipulation and collusion with interested individuals associated with the bankrupt firm or with the investment bank. Additionally, the special benefits extended to this buyer may generate a "chilling effect" over the competition, as the other potential bidders understand that outbidding the "stalking horse" may be difficult. At the same time, the positive signal generated by the "stalking horse's" commitment to buying the assets can also be generated by the English auction because other potential bidders can observe from up-close as one buyer (who would otherwise be the "stalking horse") is willing to bid high.

Finally, an important question concerns owner participation in the auction (as part of a possible "sale-back"). There should be no reason to prevent the incumbent owner (i.e., the incumbent shareholders of the firm) from participating in the auction as long as the owner's identity is disclosed to the other bidders. Because of the owner's informational advantage, the owner's participation in the auction will generate a positive signal to the other bidders and will therefore strengthen their confidence to bid high. Any "chilling

effect" created by these bidders' fears of overbidding the owner (who is assumed to know best the true value of the auctioned assets) will be mitigated by the English auction format. However, if the bidders can only suspect owner participation and do not know for certain that the owner is participating, the positive signal generated by the owner's participation is weakened, and the "chilling effect" becomes stronger. Thus, owners who wish to participate in the auction should be forced to disclose their identities at the beginning, and the bankruptcy court should threaten non-disclosure with sanctions. Such a regime may not be sufficient in those cases in which owners are determined to conceal their identity, so lawmakers should consider defining such behavior as fraud.

B. Credit Bidding—A Critical Analysis

Auction theory can help resolve the disagreement concerning "credit bidding" as well because, at its basis, this question is a policy question.[208] The legal controversy surrounding "credit bidding" originates from a recurring conflict of interests between a secured creditor holding an under-secured claim and the firm's incumbent shareholders and management. Although the secured creditor is usually interested in maximizing the proceeds of the sale, experience shows that the shareholders and managers of the bankrupt firm may be motivated by interests other than maximizing the proceeds from the sale, such as selling the auctioned assets to a particular buyer. Such a buyer may include a "white knight" or even an entity in which the shareholders of the auctioned firm have invested their capital (i.e., a "sale back").[209] Secured creditors holding an under-secured claim should be protected against such opportunism.

"Credit bidding" seems to be able to protect the secured creditor against such danger. However, the auction design that we suggested in the previous section, which incorporates a conditioned

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208. *See supra* Part I.A.2 (discussing the legal context of "credit bidding," which demonstrates neutral statutory language that can encompass an interpretation either mandating credit bidding or allowing debtors to proceed with a "cram down" plan denying the practice). *See also* Buccola & Keller, *supra* note 14, at 101 (noting that the question of "credit bidding" is eventually a matter left to the "sound discretion of the bankruptcy court").

209. For convenience, the following discussion shall refer to both a "white knight" and a "sale back" as a "white knight".

veto right for the secured creditor, renders an entitlement to "credit bid" unnecessary. Indeed, we argue that our auction design is superior. Consider the following.

It has been suggested that "credit bidding" is beneficial in three respects.[210] First, credit bidding may prevent "white knight" buyers (who may not even offer the highest price) from being favored. Second, "credit bidding" can also increase the number of bidders sufficiently familiar with the auctioned assets and thus push the bidding higher, as "credit bidding" brings the secured creditor—who is usually assumed to be well acquainted with the firm—to the auction house. Third, "credit bidding" reduces the costs of bidding and therefore minimizes the transaction costs. Indeed, it has been argued in this context that if secured creditors are denied the option of "credit bidding," they will not refrain from participating in the auction. Instead of "credit bidding," they will obtain a cash loan from a third party, even if only for a day, to bid with cash.

Although it is true that "credit bidding" may prevent a detrimental collusive interaction between the bankrupt firm (or its shareholders and its management) and a "white knight," it is not the only means to this end. Our suggestion of a veto right for the secured creditor can generate the same effect.

It is also true that if the secured creditor is genuinely interested in purchasing the auctioned assets, "credit bidding" is an excellent tool for reducing transaction costs. However, the relevant set of assumptions to which the designers of the auction should adhere is different. Although the secured creditor may be quite familiar with the auctioned assets, she is usually not interested in these assets per se.[211] Thus, allowing the secured creditor to win the auction and redeem the auctioned assets in exchange for her claim does not promise much of anything to the creditors. Both the

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210. *See* Buccola & Keller, *supra* note 14, at 100 (listing three main reasons credit bidding "is a tool well-calibrated to maximize the value of a bankruptcy estate").

211. *See* Jared Kawalsky, *The Case Against Credit Bidding: Optimal Creditor Behavior in Chapter 11 Collateral Auctions* 3 (Working Paper, 2011), *available at* http://works.bepress.com/jared_kawalsky/1 (assuming that a denial of the secured creditor's request to "credit bid" at an auction effectively prohibits the creditor from not only bidding its credit but also from participating in auctions generally).

secured creditor and the "white knight" understand perfectly that the secured creditor is not really interested in the auctioned assets and would only like to prevent a sale from being concluded on bad terms. The only real option for a secured creditor who outbids the "white knight" in the auction by using credit is to sell the auctioned assets to that "white knight," albeit under perhaps more favorable terms, in a post-auction private transaction between the two parties. Note, however, that although such a post-auction transaction may be executed at a higher price than that bid by the "white knight" in the auction, the secured creditor should not expect too much out of such a transaction. The "white knight" will offer during the negotiations a price close to the one she bid in the auction, arguing this price to be the true value of the asset, as discovered in the recent market test (i.e., the auction). Moreover, a post-auction sale will require the secured creditor to incur more costs, particularly the costs associated with shopping the assets to different investors and managing the assets until a new transaction is concluded. Finally, the "white knight" will anticipate this result and will submit low bids to begin with (especially in uncompetitive auctions). By doing so, the "white knight" will strengthen her bargaining power in any post-auction negotiation.

At the same time, "credit bidding" may also have a detrimental chilling effect on potential bidders and the intensity of the auction competition because the secured creditor can bid "for free" up to the value of her secured claim. Other bidders may fear that the secured creditor will overuse her "credit bidding" entitlement in an attempt to drive the bidding higher. The chilling effect becomes even stronger if the potential bidders fear that the secured creditor will not incur any costs should she decide to "credit bid."

According the secured creditor a veto right, which is conditioned on the secured creditor paying the real costs of bidding (in a pre-determined amount) to the winner in the auction, restrains the secured creditor and enhances bidder participation and competition. Potential bidders will understand that the secured creditor will be able to veto the results of the auction, but because of the price attached to the veto, she will display self-restraint and refrain from vetoing strategically. These potential bidders expect the secured creditor to veto the results of the auction only if the winning bid is considerably lower than the secured creditor's valuation of

these assets. Therefore, these bidders are encouraged to join the auction and bid higher. Enhancing competition in the problematic environment of bankruptcy auctions is invaluable.

Moreover, it has already been argued that "credit bidding" may threaten junior unsecured creditors in certain situations.[212] Consider the cases in which the secured creditor can both "credit bid" and control the terms of the auction, specifically the timing. In the cases in which the secured creditor may or may not be under-secured, depending on the exact time at which the auction is executed, secured creditors can employ the following pattern. They can push for a quick auction (which would be less competitive and less intense), "credit bid" to win the auctioned assets, and consequently eliminate any unsecured claims against these assets. These unsecured claims will be wiped out, but they would not have been underwater if the auction had been postponed and the auctioned assets had been "shopped around." Therefore, allowing secured creditors to insist on reorganization plans that include an entitlement to "credit bid" can undermine the rights of unsecured creditors. However, this result cannot happen if an ADVA is employed.

Thus, an auction design that protects the secured creditor with a conditioned veto (and that follows the general Anglo-Dutch design of the auction) should be superior to any other design in the context of bankruptcy auctions, including one that extends the secured creditor with an entitlement to "credit bid."

C. The Absence of a Regulator

Employing auction theory in real life is not an easy task. Similar to any social science, game theory is not an exact science when applied to real-world scenarios. Theoretical models and conjectures may collapse under the weight of a complex economic reality inhabited by players who sometimes behave irrationally. Large-scale auctions conducted by governmental entities, such as the FCC, to allocate scarce public assets reveal that auction theory is often best used within the confines of a trial-and-error process. In other words, sometimes the best contribution that auction theory can

212. *See* Baird, *supra* note 4, at 7 n.14 (arguing that the secured creditors' right to absolute priority is an element of protecting secured creditors when those junior to them are in control).

offer is to aid the design of the next auction following a failed one. For example, the FCC executed a series of carefully designed auctions of spectrum licenses during the 1990s.[213] These auctions were engineered with the help of several auction theory experts, some of whom were recruited from academia.[214] These experts discovered several new, previously unanticipated problems only after several auctions had already been concluded.[215] For example, one problem concerned the post-auction financial distress experienced by the winning bidders, who could not pay the FCC to meet their bid obligations.[216] Another problem concerned a failure to allocate licenses to the preferred sectors.[217] These problems required the FCC and its experts to go back to the drawing board and redesign the format of future auctions.[218]

Thus, when considering the procedural contribution of auction theory to the design of bankruptcy auctions, we find that one of the main problems undermining any effort to execute efficient bankruptcy auctions—which should also alert lawmakers—concerns the absence of a regulator who can implement a structured trial-and-error procedure. For example, unlike FCC auctions, where the FCC can employ auction theory to design what it believes to be the optimal auction given the circumstances, execute the auction, closely follow the results, and redesign a better auction in the future, bankruptcy auctions currently cannot follow a similar track. The task of designing any specific bankruptcy auction is privatized, and although an accepted best practice may evolve among practitioners, this practice can hardly entertain systematic attempts to improve—whether ad hoc or permanently—the design of these auctions.

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213. *See* Marx, *supra* note 197, at 350 (noting that these auctions began in 1994). *See also* Charles Z. Zheng, *High Bids and Broke Winners*, 100 J. ECON. THEORY 129, 130 (2001) (highlighting one such troubled auction held in 1996).

214. Marx, *supra* note 197, at 350.

215. *See* Zheng, *supra* note 213, at 130–31 (discussing one such problem discovered two years after the auctions began).

216. *See, e.g., id.* (describing a 1996 FCC auction of radio frequencies for ten billion dollars to firms that later defaulted).

217. *See* Marx, *supra* note 197, at 352 (noting that the bidding process tends to allocate licenses inefficiently).

218. *See, e.g., id.* at 350 (discussing the development of new types of FCC auctions in response to the need to sell "multiple different objects at the same time").

For this reason, it may be useful to adopt a legal arrangement that dictates a default auction design that may be efficient in most cases alongside an option to alter the terms of the auction following the bankruptcy court's approval. Of course, such an approval should be given only after the court is convinced that there are compelling arguments to adopt a different auction design.

To resolve the absence of a "bankruptcy auction regulator," the bankruptcy court must dive in and increase its involvement in the regulation of auction designs. Even now, under the current regime, bankruptcy courts enjoy a considerable amount of discretion when designing bankruptcy auctions. The legislature should amend the Bankruptcy Code to deepen the bankruptcy courts' involvement in this matter.

IV. CONCLUSION

The importance embedded in the specific design of an auction, particularly large-scale auctions, has yet to capture the attention of bankruptcy lawmakers. Mistakenly understood as an issue of only marginal importance, the art of designing bankruptcy auctions has been left unregulated and entrusted to market actors, whose interests sometimes conflict. Although a bankruptcy auction should certainly attempt to maximize the proceeds for the benefit of all claimants, its terms are currently decided by the interested claimants.

This Article attempted to highlight the importance of carefully designing bankruptcy auctions and the contribution that auction theory can offer to this goal. To demonstrate the potential contribution of auction theory, this Article suggested a novel default design of a bankruptcy auction and discussed the currently controversial issue of "credit bidding." This Article also argued in favor of increased involvement by the bankruptcy courts in the design of bankruptcy auctions.

Auction theory is an evolving science, and the law of bankruptcy auctions should evolve accordingly. In fact, both disciplines can benefit from the interaction between them. This Article highlighted the unquestionable contribution of auction theory to the design of bankruptcy auctions. However, we did so intuitively because of the absence of sufficient empirical data. Once

bankruptcy auctions become an issue of interest for scholars and lawmakers, studies of these auctions will undoubtedly follow in a manner that will enrich both bankruptcy law and the general theory of auctions. Therefore, bankruptcy and auction theory scholars should turn their attention to the study of auctions in bankruptcy.

Once Byten, Twice Shy: Preservation and Production of Electronic Healthcare Records

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I. INTRODUCTION

Beginning in 2015, healthcare entities face penalties if they fail to make meaningful use of qualified Electronic Health Record systems. The new mandate presents significant challenges for healthcare entities, which must now keep larger stores of electronically stored information. This Note will discuss the obligations of the meaningful use requirement and the benefit that EHR systems can provide.

The meaningful use requirement, in combination with the 2006 amendments to the Federal Rules of Civil Procedure, results in many new obligations for healthcare providers. Congress amended the Federal Rules of Civil Procedure in 2006 to address the proliferation of electronically stored information.[1] Taken alone, the

1. Eugene Illosky et al., *The Amended Federal Rules of Civil Procedure: Four Essentials You Should Know*, MORRISON FOERSTER (Dec. 5, 2006), http://www.mofo.com/the-amended-federal-rules-of-civil-procedure-four-essentials-you-should-know-12-05-2006/ (last visited Nov. 28, 2012).

amendments add new obligations for electronically stored information during discovery. Fast-developing federal case law has grappled with preservation and production of electronically stored information under the recent amendments. The new obligations under the amendments impact not only healthcare entities, but also their lawyers.

The federal circuits are currently split regarding the extent of the duty to preserve and produce complex proprietary databases such as Electronic Health Record systems. As a result, healthcare providers that operate in multiple circuits should proceed with caution. While the potential privacy implications of the meaningful use requirement have been discussed elsewhere,[2] little attention has been paid to how the regulations will affect the discovery process during litigation. This Note will explain the divergence among the circuits on the preservation and production of complex databases. Finally, it will offer suggestions on how healthcare litigators can comply with these new and complicated obligations.

II. THE ELECTRONIC HEALTH RECORD AND EHR SYSTEMS

A. General Overview

According to the Centers for Medicare & Medicaid Services (CMS), an EHR is an "electronic version of a [patient's] medical history, that is maintained by the provider over time, and may include all of the key administrative clinical data relevant to that [person's] care under a particular provider, including demographics, progress notes, problems, medications, vital signs, past medical history, immunizations, laboratory data and radiology reports."[3] Although CMS describes the EHR as an "electronic version of a [patient's] medical history," there is much more to the EHR than simply a scanned version of the paper chart currently used for

2. *See* Marcia M. Boumil et al., *Prescription Data Mining, Medical Privacy and the First Amendment: The U.S. Supreme Court in* Sorrell v. IMS Health Inc., 21 ANNALS HEALTH L. 447, 447 (2012) (discussing data mining in the pharmaceutical context and its legal implications).

3. *Electronic Health Records*, CMS.GOV: CTRS. FOR MEDICARE & MEDICAID SERVS., http://www.cms.hhs.gov/Medicare/E-Health/EHealthRecords/index.html?redirect=/EHealthRecords/ (last visited Nov. 28, 2012).

medical records. Perhaps the most significant difference for discovery obligations is that an EHR may contain more metadata than data itself.[4]

B. *Benefits of EHR Systems*

The CMS believes that EHRs can improve patient care by "[r]educing the incidence of medical error by improving the accuracy and clarity of medical records; [m]aking the health information available, reducing duplication of tests, reducing delays in treatment, [resulting in] patients informed to [make] better decisions; [and] reducing medical error by improving the accuracy and clarity of medical records."[5]

EHR regulations attempt to improve both effectiveness and efficiency of health care organizations, but recognize the difficulties of doing so. The regulations "seek to balance the sometimes competing considerations of health system advancement (for example, improving health care quality, encouraging widespread EHR adoption, promoting innovation) and minimizing burdens on health care providers given the short timeframe available under the HITECH Act."[6] A recent study conducted by the Congressional Budget Office suggests that adoption of EHR systems could provide many efficiency benefits. For example, the study noted that EHRs can reduce the duplication of diagnostic tests, prompt providers to prescribe cost-effective generic medications, remind physicians about preventive care, reduce unnecessary office visits, and assist in managing complex care.[7] The study noted that the greatest gains

4. *See infra* Part III (discussing metadata).

5. *Electronic Health Records*, *supra* note 3.

6. Medicare and Medicaid Programs; Electronic Health Record Incentive Program—Stage 2, 77 Fed. Reg. 13,698, 13,702 (Mar. 7, 2012) (amending 42 C.F.R. §§ 412, 413, 495) [hereinafter Electronic Health Record Incentive Program—Stage 2].

7. CONGRESSIONAL BUDGET OFFICE, PUB. NO. 2976, EVIDENCE ON THE COSTS AND BENEFITS OF HEALTH INFORMATION TECHNOLOGY 1 (2008), *available at* http://www.cbo.gov//ftpdocs/91xx/doc9168/05-20-HealthIT.pdf (last visited Nov. 28, 2012).

could be realized by large provider systems and groups, while office-based physicians might not realize similar benefits.[8]

Expectations that EHR database requirements will save money fail to account for the potential costs associated with preservation and production during litigation and the varying standards for spoliation. The Department of Health and Human Services projects that the largest costs for eligible hospitals will stem from expenditures needed to meet statutory requirements for meaningful use of qualified EHR databases, but believes that initial outlays will be outstripped by long-term benefits.[9] This is true only if adopting entities learn how to effectively manage the information. In litigation, hospitals must learn how to preserve and produce relevant portions of the database in a cost-effective way and avoid spoliation sanctions. Although some circuits require evidence of willfulness for sanctions, other circuits have adopted a negligence standard.[10] Therefore, the cost of switching to an EHR database for a hospital that operates in multiple circuits includes the cost of complying with the strictest standard for spoliation.

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8. *Id. See also* Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13,811 (citing many other studies associating EHRs with improved patient outcomes, more often in large provider systems than with office-based physicians, while also noting that "data relating specifically to the EHR Incentive Programs is limited at this time").

9. Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13,801 (The Department of Health and Human Services predicts "that adopting entities will achieve dollar savings at least equal to their total costs, and that there will be additional benefits to society. We believe that implementation costs are significant for each participating entity because providers who would like to qualify as meaningful users of EHRs will need to purchase certified EHR technology. However, we believe that providers who have already purchased certified EHR technology and participated in Stage 1 of meaningful use will experience significantly lower costs for participation in the program. We continue to believe that the short-term costs to demonstrate meaningful use of certified EHR technology are outweighed by the long-term benefits, including practice efficiencies and improvements in medical outcomes.").

10. *See infra* Part V.C (discussing the circuit split relating to the sanctioning of parties for the spoliation of ESI).

III. ELECTRONICALLY STORED INFORMATION

A. A Brief Explanation of ESI

The 2006 amendments to the Federal Rules of Civil Procedure impose new requirements with respect to electronically stored information (ESI). The term ESI is not defined in the Federal Rules. The Sedona Conference, an influential think-tank of judges and industry leaders, defines ESI as "information that is stored electronically, regardless of the media or whether it is in the original format in which it was created, as opposed to stored in hard copy (i.e., on paper)."[11]

Electronically stored information is already present in vast repositories in hospitals.[12] The abundance of ESI includes electronic prescriptions, e-mails, voice messages, cell phone data, instant messages, and tests.[13] ESI also includes logs from access cards, such as those used to track staff entry, and monitoring equipment such as fetal monitors and EKG machines.[14]

B. Metadata

ESI is not restricted to e-mails, documents, and the other sources listed above. It also includes the accompanying metadata.

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11. *The Sedona Conference Glossary: E-Discovery & Digital Information Management*, THE SEDONA CONFERENCE 20 (3rd ed. 2010), http://www.thesedonaconference.org/content/miscFiles/TSCGlossary_12_07.pdf (last visited Nov. 28, 2012).

12. *See* Anna M. Bryan, Debra A. Weinrich, & Edward F. Beitz, *Electronic Discovery and Healthcare Litigation: Government Influence on Conversion to Electronic Health Records, and How It Has and Will Continue to Impact the Discovery Process*, 23 HEALTH LAW, no. 1 (Oct. 2010), at 1, 3 (describing different types of electronic storage sites that can be found at hospitals).

13. *See Guidance for Industry: Electronic Source Documentation in Clinical Investigations*, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES 2 (Dec. 2010), *available at* http://www.phtcorp.com/pdf/FDAGuidanceESourceDCInvest.pdf (last visited Nov. 28, 2012) (discussing the use of clinical data, case reports, lab reports, images from medical devices, and electronic diaries from study subjects). *See also* Bryan, Weinrich & Beitz, *supra* note 12, at 3 (describing different types of electronic storage sites that can be found at hospitals).

14. Bryan, Weinrich & Beitz, *supra* note 12, at 3, 12 n.13.

Metadata is often defined as data about data.[15] This definition, while technically correct, is ultimately unhelpful. Metadata is one of the primary ways electronic records differ from their paper counterparts.[16] In many instances, there may be more metadata than viewable text in a given record.[17] Metadata is the electronic version of handwritten notes on a patient's medical chart, or a log of who has looked at the chart when. In *Williams v. Sprint/United Mgmt. Co.*, the federal court suggested that metadata is an expected part of production, even when not specifically requested:

> [W]hen a party is ordered to produce electronic documents as they are maintained in the ordinary course of business, the producing party should produce the electronic documents with their metadata intact, unless that party timely objects to production of metadata, the parties agree that the metadata should not be produced, or the producing party requests a protective order.[18]

Metadata is discoverable if it is relevant to the claim or defense of any party and is not privileged.[19] It cannot simply be ignored just because it is difficult to preserve and produce. Craig Ball, a frequent special master to the federal courts on issues pertaining to electronic discovery and metadata, writes "[i]f evidence

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15. Williams v. Sprint/United Mgmt. Co., 230 F.R.D. 640, 646 (D. Kan. 2005) (noting that metadata is "commonly described as 'data about data'").

16. *Id.* at 648. *See also The Sedona Principles: Best Practices, Recommendations & Principles for Addressing Electronic Document Production*, THE SEDONA CONFERENCE, at 5 (June 2007), *available at* https://thesedonaconference.org/publication/The%20Sedona%20Principles [hereinafter *Sedona Principles*] (describing metadata).

17. *See Sedona Principles*, *supra* note 16, at 3 ("A large amount of electronically stored information, unlike paper, is associated with or contains information that is not readily apparent on the screen view of the file. This additional information is usually known as 'metadata.' Metadata includes information about the document or file that is recorded by the computer to assist in storing and retrieving the document or file. The information may also be useful for system administration as it reflects data regarding the generation, handling, transfer, and storage of the document or file within the computer system. Much metadata is neither created by nor normally accessible to the computer user.").

18. *Williams*, 230 F.R.D. at 652.

19. *Id.* at 652–53.

is anything that tends to prove or refute an assertion as fact, then clearly metadata is evidence. Metadata sheds light on the origins, context, authenticity, reliability and distribution of electronic evidence, as well as provides clues to human behavior."[20]

Going forward, it will be important for litigators to understand what metadata is available on different EHR systems. Otherwise, a litigator who requests "all the metadata" will have no idea whether the other side has adequately responded to a discovery request.

IV. THE 2006 AMENDMENTS ADDRESSING E-DISCOVERY

In 2006, the Federal Rules of Civil Procedure were amended to specifically address the discoverability of ESI.[21] While not written with the hospital setting in mind, the amendments have opened the floodgates for litigants seeking information stored electronically. EHR, as well as the many other repositories of electronically stored data, fall within the ambit of the amendments.

Hospitals and other healthcare systems will have increasing amounts of electronically stored information, especially given the federal government's strong incentives for entities to adopt EHR Systems. Additionally, the amendments have served as the model for ESI discovery amendments at the state level.[22] States that have not revised their rules of civil procedure often look to the case law developed under the federal amendments to guide their approach to

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20. Craig Ball, *Beyond Data About Data: The Litigator's Guide to Metadata*, CRAIGBALL.COM 2 (2005), *available at* http://www.craigball.com/metadataguide2011.pdf (last visited Nov. 28, 2012).

21. Bennett B. Borden, Monica McCarroll, Brian C. Vick & Lauren M. Wheeling, *Four Years Later: How the 2006 Amendments to the Federal Rules Have Reshaped the E-Discovery Landscape and Are Revitalizing the Civil Justice System*, 17 RICH. J.L. & TECH. 1, 2 (2010–2011), *available at* http://jolt.richmond.edu/v17i3/article10.pdf (last visited Nov. 28, 2012).

22. Thomas Y. Allman, *State E-Discovery Today: An Update on Rulemaking in light of the 2006 Federal Amendments*, THE SEDONA CONFERENCE 1 (April 2011), *available at* https://thesedonaconference.org/%5Bfield_event_node_ref-path%5D/meeting-paper/chapter-2-state-e-discovery-today (last visited Nov. 28, 2012).

ESI.[23] The amendments will become increasing relevant to hospitals and other large healthcare entities going forward.

A Rules 26(f) and 16(b): Counsel's Duty to Understand EHR Systems

Federal Rules of Civil Procedure 26(f) and 16(b) now require the parties to meet early in the litigation to discuss ESI related matters.[24] Rule 26(f) requires parties to confer at least twenty-one days before a scheduling conference.[25] This Rule imposes a duty on attorneys to become familiar with the relevant ESI that will be used to support the claims and defenses at issue in the litigation.[26] At the meet-and-confer conference, each party will propose a discovery plan, which "must state the parties' views and proposals on: . . . any issues about disclosure or discovery of electronically stored information, including the form or forms in which it should be produced."[27] To adequately prepare for the meet-and-confer conference, counsel must meet with information technology personnel to identify where ESI is stored, how accessible it is, and how much its retrieval will cost.

At such a meeting, Rule 16(b),[28] as amended, embodies an expectation that both in-house counsel and outside counsel will be

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23. *Id.* at 4.

24. FED. R. CIV. P. 16(b), 26(f).

25. FED. R. CIV. P. 26(f)(1) ("[T]he parties must confer as soon as practicable—and in any event at least 21 days before a scheduling conference is to be held or a scheduling order is due under Rule 16(b).").

26. *See* FED. R. CIV. P. 26(f)(3) (providing that a discovery plan must, in part, include the "parties' views and proposals" regarding "the subjects on which discovery may be needed" and "any issues about disclosure or discovery of electronically stored information").

27. *Id.*

28. FED. R. CIV. P. 16(b) stipulates: "Except in categories of actions exempted by local rule, the district judge—or a magistrate judge when authorized by local rule—must issue a scheduling order: (A) after receiving the parties' report under Rule 26(f); or (B) after consulting with the parties' attorneys and any unrepresented parties at a scheduling conference or by telephone, mail, or other means." FED. R. CIV. P. 16(b)(1). The scheduling order must be issued "as soon as practicable, but in any event within the earlier of 120 days after any defendant has been served with the complaint or 90 days after any defendant has appeared." FED. R. CIV. P. 16(b)(2). The scheduling order is required to "limit the time to join other parties, amend the pleadings, complete discovery, and file motions." FED. R.

ready for litigation, which includes gaining fluency in information technology employed by the healthcare system, such as EHR databases, as well as the information technology network of the entire enterprise. This is required so that the parties at the pretrial conference can come to an informed agreement about what types of ESI are discoverable. The result is that attorneys now have an affirmative duty to understand the inner workings of the EHR database—as well as other forms of ESI—utilized by their clients.

B. Rule 26(b)(2)(B): Producing "Not Reasonably Accessible" ESI

When hospitals are involved in litigation, they must identify the existence and location of electronically stored information that could potentially lead to relevant information, even if that information is not reasonably accessible.[29] Even listing such electronic information is likely a daunting task for a large entity such as a hospital. Rule 26 also provides a mechanism that may force an entity to produce electronic information, even if the court deems that information "not reasonably accessible" due to undue burden or cost.[30]

The amended Rule 26 establishes a multi-step process. First, the requesting party serves a discovery request.[31] For example, "Email from Hospital Administrator to Doctor A in June 2003." Second, the responding party may object if data sought is not reasonably accessible.[32] Third, if the requesting party still wants the information, the requesting party must go to the court and move to compel the information that the responding party claims is not

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CIV. P. 16(b)(3). The scheduling order "may . . . (iii) provide for disclosure or discovery of electronically stored information." *Id.*

29. *See* FED. R. CIV. P. 26(b)(2) advisory committee's note ("A party's identification of sources of electronically stored information as not reasonably accessible does not relieve the party of its common-law or statutory duties to preserve evidence.").

30. *Id.* ("Once it is shown that a source of electronically stored information is not reasonably accessible, the requesting party may still obtain discovery by showing good cause, considering the limitations of Rule 26(b)(2)(C) that balance the costs and potential benefits of discovery.").

31. FED. R. CIV. P. 26(b)(2)(B).

32. *Id.*

reasonably accessible.[33] Fourth, at this point the burden shifts to the responding party, who must identify the nature and location of the specific ESI sought.[34] At this time, the responding party must also prove to the court's satisfaction that the ESI sought is, in fact, not reasonably accessible due to undue burden or cost.[35] For example, "the hospital has backed up the EHR System on fourteen 70 GB tapes in legacy DLT format for June 2003, but has no tape drive or software to read them." To prove veracity, the court may allow limited discovery at this point.[36] Fifth, if the court finds that the ESI requested is not reasonably accessible, the burden shifts back to the requesting party; the requesting party must now prove good cause for the production of inaccessible data.[37] For example, the requesting party may tell the judge that the DLT legacy tapes are the only source for relevant, important information. The judge then may require production under such specified conditions that are left to the discretion of the court; the court may impose limits, order the use of samples, order cost shifting, or order other measures deemed necessary.[38]

C. Rule 34: The Form(s) of Production

The revised Rule 34(b) establishes protocols for how ESI, such as data from an EHR System, is to be produced to requesting parties. In a request for production, the requesting party "may specify the form or forms in which electronically stored information is to be produced."[39] The responding party may object "to a requested form for producing electronically stored information," but "[i]f the responding party objects to a requested form—or if no form was specified in the request—the party must state the form or forms it intends to use."[40] Furthermore, the Rule requires the responding party, absent a court order or party agreement, to produce ESI either

33. FED. R. CIV. P. 26(b)(2) advisory committee's note.
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. FED. R. CIV. P. 34(b)(1)(C).
40. FED. R. CIV. P. 34(b)(2)(D).

in the form it is ordinarily maintained, or a form that is reasonably usable.[41]

V. FEDERAL COURT IMPACT ON ELECTRONIC DISCOVERY PRACTICES

Federal courts facing the rapid proliferation of digitally–stored evidence have forged new doctrines in the face of novel problems. These new doctrines profoundly affect the duties of hospitals now strongly incentivized to adopt EHR databases. First, sometimes a party, such as a hospital, must produce ESI, such as records from an EHR database, even if the records are not reasonably accessible. Under certain circumstances, the producing party may shift the costs of that undertaking to the requesting party. Second, the legal hold doctrine extends to a duty to preserve EHR databases. Third, federal circuit courts are split on the level of mens rea necessary to levy dispositive sanctions against an entity.

A. Production of Not Reasonably Accessible ESI and Cost-Shifting Factors

In the seminal *Zubulake v. UBS Warburg, LLC* litigation, United States District Judge Scheindlin handed down five separate rulings that address topics such as: whether ESI is discoverable; determining how the cost of retrieving, copying, and distributing electronic records should be shared by the parties; and deciding whether sanctions should be imposed for failing to produce the requested ESI.[42] Although *Zubulake* predates the 2006 Federal

41. FED. R. CIV. P. 34(b)(E)(ii). *See also* Williams v. Sprint/United Mgmt. Co., 230 F.R.D. 640, 652 (D. Kan. 2005) ("When a party is ordered to produce electronic documents as they are maintained in the ordinary course of business, the producing party should produce the electronic documents with their metadata intact, unless that party timely objects to the production of metadata, the parties agree that the metadata should not be produced, or the producing party requests a protective order.").

42. *See* Zubulake v. UBS Warburg, LLC (*Zubulake II*), 230 F.R.D. 290, 292 (S.D.N.Y. 2003) (addressing Zubulake's reporting obligations); Zubulake v. UBS Warburg, LLC (*Zubulake IV*), 220 F.R.D. 212, 217, 219–20 (S.D.N.Y. 2003) (holding that UBS had a duty to preserve backup tapes and addressing sanctions

Rules amendments, the case was so influential that it was partially codified in the amendments. Due to the importance of *Zubulake*, it is well worth the time to explain the facts.

Laura Zubulake, an equities trader, sued her employer, UBS Warburg, LLC (UBS), for sex discrimination under Title VII, as well as applicable state and city law.[43] UBS objected to the plaintiff's request for responsive e-mails starting from when she was hired in August 1999 through when she was fired in October 2001.[44] She requested that UBS produce all e-mails sent by or between UBS employees concerning her.[45] Archived e-mails existed only on backup tapes and optical drives.[46] The case was complicated by Security and Exchange Commission's (SEC) Rule 17a-4(b), which requires every broker and dealer to "preserve for a period of not less than three years, the first two years in an easily accessible place . . . [o]riginals of all communications received and copies of all communications sent . . . by the member, broker or dealer (include inter-office memoranda and communications) relating to its business as such."[47] UBS claimed the requested e-mail was inaccessible, partly due to cost.[48] According to UBS, restoring the e-mails would cost approximately $175,000, even excluding the cost of attorney review.[49] Each backup tape would need to be manually restored, a process that could take five days per tape.[50] Each tape was the backup for a given month; therefore, each one needed to be restored separately on a hard drive.[51] Next, UBS would need to use a program to extract an individual's e-mail and then export it to a

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such as cost shifting, adverse inference instructions, and costs of additional discovery); Zubulake v. UBS Warburg, LLC (*Zubulake I*), 217 F.R.D. 309, 320–24 (S.D.N.Y. 2003) (addressing the legal standard for determining the cost allocation for producing emails contained on backup tapes); Zubulake v. UBS Warburg, LLC (*Zubulake III*), 216 F.R.D. 280, 289 (S.D.N.Y. 2003) (allocating backup restoration costs between Zubulake and UBS).

43. *Zubulake I*, 217 F.R.D. at 312.

44. *Id.* at 312–13.

45. *Id.* at 313.

46. *Id.* at 314–15.

47. SEC Rule 17a-4(b). *See also Zubulake I*, 217 F.R.D. at 314 (noting that SEC regulations required UBS to employ extensive e-mail backup and preservation protocols).

48. *Zubulake I*, 217 F.R.D. at 313.

49. *Id.* at 312.

50. *Id.* at 314.

51. *Id.*

Microsoft Outlook file.[52] Only after all that was done to restore the backup tapes could each individual's e-mails be searched to respond to the discovery request.

In deciding the case, Judge Scheindlin focused on the type of media on which the ESI is stored and the cost to produce it. Production cost is a function of the accessibility of the ESI, which is dependent upon the storage medium employed.[53] In determining whether ESI is accessible for discovery, Judge Scheindlin wrote:

> Of these, the [(1) active, online data, (2) near-line data, and (3) offline storage and archives] are typically identified as accessible, and [(4) backup tapes, and (5) erased, fragmented or damaged data] as inaccessible. The difference between the two classes is easy to appreciate. Information deemed "accessible" is stored in a readily usable format. Although the time it takes to actually access the data ranges from milliseconds to days, the data does not need to be restored or otherwise manipulated to be usable. "Inaccessible" data, on the other hand, is not readily usable. Backup tapes must be restored using a process similar to that previously described, fragmented data must be de-fragmented, and erased data must be reconstructed, all before the data is usable. That makes such data inaccessible.[54]

Even if data is deemed not reasonably accessible, the court may shift costs onto the requesting party. In *Zubulake III*, the court applied a seven-factor test to determine whether the costs of producing the inaccessible data should be shifted.[55] These seven factors were later used to craft cost-sharing and cost-shifting

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52. *Id.*

53. In *Zubulake I*, the court identified and listed five categories of data in order of decreasing accessibility: (1) active, online data, (2) near-line data, (3) offline storage and archives, (4) backup tapes, commonly using data compression, and (5) erased, fragmented, or corrupted data. *Id.* at 318–19.

54. *Id.* at 319–20.

55. Zubulake v. UBS Warburg, LLC (*Zubulake III*) 216 F.R.D. 280, 284–90 (S.D.N.Y. 2003).

provisions in amended Rule 26(b)(2)(C) and Rule 26(c).[56] The factors laid out in *Zubulake III* remain widely cited.

The seven factors cited by Judge Scheindlin in considering whether to shift costs onto the requesting party are: (1) whether the request was tailored to discover relevant information, (2) if the information was available from other sources that would not be deemed not reasonably accessible, (3) the cost of production versus the amount in controversy, (4) the relative position of the parties in terms of resources, (5) which party would be best able to control costs and which party had the incentive to control costs of the production, (6) if the discovery issues were key to the issues at stake, and (7) the relative benefits to the parties of the inaccessible data.[57]

After considering the factors, the court shifted one-fourth of the costs associated with restoring and searching backup tapes, but excluded cost of production, such as reviewing documents for privilege, from consideration in determining that total cost of the production.[58]

B. Legal Hold Doctrine and the Duty to Preserve EHR Databases

The duty to preserve potentially relevant information attaches as soon as litigation is reasonably anticipated.[59] This obligation is imposed not only on the entity itself, but also on outside counsel.[60] Electronic information is fragile and dynamic, and preservation presents difficulties for an entity like a hospital that cannot simply take its EHR databases offline to preserve a snapshot. Many lawyers and institutional litigants such as hospitals consider the duty to preserve "as one of the greatest contributors to the cost of litigation being disproportionately expensive in cases where ESI will play an evidentiary role."[61] The duty to preserve imposes a duty on counsel to issue a written litigation hold at the outset. The litigation hold

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56. *See* FED. R. CIV. P. 26(b)(2)(C), 26(c) (reflecting the *Zubulake III* factors in the federal rules).

57. *Zubulake III*, 216 F.R.D. at 284–90.

58. *Id.* at 289–91.

59. *See* Victor Stanley, Inc. v. Creative Pipe, Inc., 269 F.R.D. 497, 521 (D. Md. 2010) (discussing common law duty to preserve evidence).

60. *See Sedona Principles*, *supra* note 16, at 41 (discussing the role of counsel in preserving evidence).

61. *Victor Stanley*, 269 F.R.D. at 516.

must be issued "as soon as practicable" after the duty to preserve is triggered.[62]

In order to issue an effective litigation hold to key players, counsel must have a thorough knowledge of the hospital's ESI, including its EHR system, as well as the metadata associated with each source of electronic information. This is necessary because the legal hold must be issued to custodians of potentially relevant information and must instruct them on how to undertake that preservation.[63]

A thorough knowledge of the location and data stored by a hospital's EHR system is also necessary at the outset of the discovery process for two other reasons. First, such knowledge is necessary in order for counsel to participate meaningfully in the Rule 26(f) meet-and-confer conference. At such a conference, the hospital will have the opportunity to contest the form of production that the opposing party requests for the production of the EHR system and other electronic data. Second, extensive knowledge of the nature and storage location of electronic data is needed for a hospital to argue that information requested by the opposing party is not reasonably accessible under Rule 26(b). As discussed above, if the opposing party succeeds in showing good cause, the court may order the hospital to produce the inaccessible data. However, if counsel has a thorough knowledge of what producing the data will entail, the court may order the requesting party to shoulder some of the costs of production.

C. Preservation Failures: The Circuit Split on Spoliation

Courts are increasingly willing to sanction parties for the spoliation of ESI, including databases similar to EHR systems. Spoliation of evidence is "the destruction or material alteration of

62. *Sedona Principles*, *supra* note 16, at 31.

63. *See Sedona Principles*, *supra* note 16, at 32 (instructing that a legal hold notice "should: (i) describe the subject matter of the litigation and the subject matter, dates, and other criteria defining the information to be preserved; (ii) include a statement that relevant electronically stored information and paper documents must be preserved; (iii) identify likely locations of relevant information (e.g., network, workstation, laptop or other devices); (iv) provide steps that can be followed for preserving the information as may be appropriate; and (v) convey the significance of the obligation to the recipients").

evidence or . . . the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation." [64] Spoliation sanctions may stem from the destruction of metadata.[65] In cases that involve the alleged spoliation of ESI, determining the necessary level of intent to warrant sanctions, as well as what sanctions are appropriate, is considered one of the most difficult issues facing litigators, judges, and institutional clients such as hospitals.[66]

There is a circuit split regarding the level of culpability required before a court will sanction litigants—and their lawyers—for spoliation. In the Second Circuit, mere negligence may suffice.[67] In the Fifth Circuit, courts require some showing of bad faith before sanctioning parties and counsel.[68] The seminal cases explored below illuminate the two approaches.

1. The Power to Sanction

The court's ability to impose sanctions for spoliation is derived from two sources. First, a court may impose sanctions under

64. Silvestri v. Gen. Motors Corp., 271 F.3d 583, 590 (4th Cir. 2001).

65. *The Sedona Conference Glossary: E-Discovery & Digital Information Management*, THE SEDONA CONFERENCE 48 (2d ed. 2007), *available at* http://www.thesedonaconference.org/content/miscFiles/TSCGlossary_12_07.pdf (last visited Nov. 28, 2012) ("Spoliation is the destruction of records or properties, such as metadata, that may be relevant to ongoing or anticipated litigation, government investigation or audit.").

66. *See* Victor Stanley, Inc. v. Creative Pipe, Inc., 269 F.R.D. 497, 516 (D. Md. 2010) (noting the challenging nature of determining appropriate sanctions for spoliation of ESI and that "recent decisions . . . have generated concern throughout the country among lawyers and institutional clients regarding the lack of a uniform national standard governing when the duty to preserve potentially relevant evidence commences, the level of culpability required to justify sanctions, the nature and severity of appropriate sanctions, and the scope of the duty to preserve evidence and whether it is tempered by the same principles of proportionality that FED. R. CIV. P. 26(b)(2)(C) applies to all discovery in civil cases").

67. *See* Chin v. Port Auth. of N.Y. & N.J., 685 F.3d 135, 162 (2d Cir. 2012) (indicating that a finding of gross negligence permits a court to impose sanctions for spoliation).

68. *See* Rimkus Consulting Grp., Inc. v. Nickie Cammarta, 688 F. Supp. 2d 598, 614 (S.D. Tex. 2010) (holding that bad faith is required for the imposition of sanctions for spoliation).

its inherent power.[69] The rationale for this inherent power is "the need to preserve the integrity of the judicial process in order to retain confidence that the process works to uncover the truth."[70] The power of a court to sanction using its organic authority is restricted to cases of "bad faith conduct."[71]

Second, if spoliation violates a specific order of the court, or disrupts a discovery plan, a court may impose sanctions under Federal Rule of Civil Procedure 37.[72] The rule allows for sanctions when a party fails to comply with a discovery obligation ordered by the court.[73]

2. Two Approaches to Spoliation

In 2010—in opinions issued within a month of one another—two district court judges illustrated very different approaches to the issue of the degree of mens rea necessary for sanctions relating to a legal hold. In *Rimkus Consulting Group, Inc. v. Nickie Cammarta*, Judge Rosenthal required a showing of bad faith and declined to impose strict liability even in the face of intentional destruction of evidence.[74] In contrast, Judge Scheindlin, in *Pensions Committee of the University of Montreal Pension Plan et al. v. Banc of America Securities, LLC*, termed the mere failure to provide a written legal hold as gross negligence on the part of counsel and applied sanctions.[75]

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69. A court possesses the "inherent power to control the judicial process and litigation, a power that is necessary to redress conduct 'which abuses the judicial process.'" United Med. Supply Co. v. United States, 77 Fed. Cl. 257, 263–64 (2007) (quoting Chambers v. NASCO, Inc., 501 U.S. 32, 45–46 (1991)).

70. Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 685 F. Supp. 2d 456, 465 (S.D.N.Y. 2010), *abrogated by* Chin v. Port Auth. of N.Y. & N.J., 685 F.3d 135 (2d Cir. 2012).

71. *Chambers*, 501 U.S. at 50.

72. FED. R. CIV. P. 37(b)(2)(A).

73. *Id.*

74. 688 F. Supp. 2d 598, 613–14 (S.D. Tex. 2010).

75. 685 F. Supp. 2d at 465, 497.

3. The Second Circuit: Spoliation Sanctions for Mere Negligence

In *Pension Committee*, Judge Scheindlin returned to many of the issues first addressed in *Zubulake*. Judge Scheindlin reaffirmed that conduct can be culpable per se without a consideration of reasonableness.[76] The Second Circuit later clarified, in *Chin v. Port Authority of New York & New Jersey*, that the failure to issue a written litigation hold is "one factor in the determination of whether discovery sanctions should issue."[77]

Pension Committee is instructive for counsel who represent hospitals because it describes the steps taken by counsel, as well as why those efforts were insufficient and warranted sanctions. Specifically, Judge Scheindlin acknowledged that the counsel's efforts at preservation were insufficient even though counsel: (1) instructed the client to begin preservation soon after the counsel assumed representation, (2) telephoned and e-mailed the client and distributed memoranda instructing the client to be over-inclusive, rather than under-inclusive, and that e-mails and electronic documents should be included in production, (3) sent the client monthly status reports throughout the litigation including additional requests for electronic data, and (4) eventually issued a written legal hold following a stay in the case.[78]

Counsel's instruction was found to be insufficient because counsel did not expressly direct employees to preserve all relevant documents (paper and electronic).[79] Also, the hold was found to be inadequate because it placed "total reliance on the employee to search and select what the employee believed to be responsive records without any supervision from Counsel."[80]

After finding that counsel had been grossly negligent in failing to issue a written litigation hold when litigation was reasonably anticipated, the court allowed the jury a permissible presumption of "the relevance of the missing documents and resulting prejudice to the . . . Defendants, subject to the plaintiffs'

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76. *Id.* at 471.

77. Chin v. Port Auth. of N.Y. & N.J., 685 F. 3d 135, 162 (2d Cir. 2012).

78. Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 685 F. Supp. 2d 456, 473–74 (S.D.N.Y. 2010).

79. *Id.* at 473.

80. *Id.*

ability to rebut the presumption to the satisfaction of the trier of fact."[81] The court admonished plaintiffs' counsel, writing "[b]y now, it should be abundantly clear that the duty to preserve means what it says and that a failure to preserve records—paper or electronic—and to search in the right places for those records, will inevitably result in the spoliation of evidence."[82]

4. The Fifth Circuit: Culpability Required for Spoliation Sanctions

In stark contrast to the Second Circuit, in the Fifth Circuit, negligence is not sufficient to justify dispositive sanctions. The Fifth Circuit approach is exemplified by Judge Rosenthal's opinion in *Rimkus Consulting Group, Inc. v. Cammarata*,[83] issued the same week as *Pension Committee* in New York.

The behavior at issue in *Rimkus* (intentional destruction of electronic evidence) is arguably more egregious than in *Pension Committee* (negligent destruction of electronic evidence). The record included evidence that the defendants deleted e-mails and attachments after the duty to preserve arose.[84] The court acknowledged that the record includes evidence of the defendants' efforts to conceal the fact that it destroyed the evidence.[85] Moreover, much of what the defendants deleted was no longer available from other sources.[86] The court found "sufficient evidence from which a reasonable jury could find that emails and attachments were intentionally deleted to prevent their use in anticipated or pending litigation."[87]

The court required a culpable state of mind for the issuance of sanctions.[88] The court stated that "[i]n the Fifth Circuit . . . negligent as opposed to intentional, 'bad faith' destruction of evidence is not sufficient to give an adverse inference instruction and may not relieve the party seeking discovery of the

81. *Id.* at 478.
82. *Id.* at 462.
83. 688 F. Supp. 2d 598 (S.D. Tex. 2010).
84. *Id.* at 607.
85. *Id.*
86. *Id.* at 608.
87. *Id.* at 607.
88. *Id.* at 615.

need to show that missing documents are relevant and their loss prejudicial."[89] The court declined to term the defendants' behavior per se sanctionable, emphasizing that "[i]t can be difficult to draw bright-line distinctions between acceptable and unacceptable conduct in preserving information and in conducting discovery, either prospectively or with the benefit (and distortion) of hindsight."[90]

Proportionality, according to the court, is the key.[91] A bright-line approach to preservation is unworkable because preservation needs differ in every case. The court emphasized that "[w]hether preservation or discovery conduct is acceptable in a case depends on what is *reasonable*, and that in turn depends on whether what was done—or not done—was *proportional* to that case and consistent with clearly established applicable standards."[92]

The divergent approaches taken in *Pension Committee* and *Rimkus* present an interesting comparison for several reasons. First, the close proximity of the decisions marks the sharp contrast in doctrine. The opinions were handed down within a month of one another; Judge Rosenthal even cited *Pension Committee* in *Rimkus*. Second, unlike *Zubulake*, both opinions had the benefit of the 2006 amendments to the Federal Rules as well as developed case law, including Scheindlin's *Zubulake* opinions. Third, in *Rimkus* when the court declined to impose sanctions in the absence of bad faith, the behavior at issue—intentional destruction—was much more egregious than the negligent destruction in *Pension Committee*.

VI. ACCELERATING THE TREND TOWARDS ELECTRONIC RECORDS SYSTEMS

The laws and regulations that govern the requirements for EHR databases are shared among several bodies including the Office of the National Coordinator for Health Information Technology (ONC) and the Centers for Medicare and Medicaid Services (CMS).[93] Section 3013(d)(9) of the HITECH Act provides for the

89. *Id.*
90. *Id.* at 613.
91. *Id.*
92. *Id.* (emphasis in original).
93. *See Information Related to the American Recovery and Reinvestment Act of 2009*, HEALTHIT.HHS.GOV, http://healthit.hhs.gov/portal/server.pt/

reporting of clinical quality measures by eligible hospitals as part of demonstrating meaningful use of Certified EHR Technology.[94] The statutory requirements are further explained by the Stage 1 proposed and final rules promulgated by the Department of Health and Human Services.[95] The standards were intended to be flexible going forward and are often updated. The Department of Health and Human Services cautions that its forecasts are "subject to substantial uncertainty since demonstration of meaningful use will depend not only on the standards and requirements for FYs 2014 and 2015 for eligible hospitals . . . but on future rulemakings issued by the HHS."[96]

A. The HITECH Act

In 2009, Congress passed the Health Information Technology for Economic and Clinical Health Act ("HITECH Act") as part of the American Recovery and Reinvestment Act of 2009.[97] HITECH accelerates the inevitable trend toward broad utilization of information technology in health care. HITECH does so by incentivizing the implementation of the meaningful use of EHRs.[98] The Act authorized expenditures of $19.2 billion toward the development of healthcare information technology.[99]

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community/healthit_hhs_gov_learn_about_hitech/1233#2 (last visited Oct. 23, 2012) (outlining rules that both the ONC and the CMS follow regarding requirements for EHR databases).

94. Health Information Technology for Economic and Clinical Health Act, Pub. L. No. 111-5, § 3013(d)(9), 123 Stat. 226, 251 (2009) [hereinafter "HITECH Act"].

95. Medicare and Medicaid Programs; Electronic Health Record Incentive Programs, 75 Fed. Reg. 1, 870–1902 and 75 Fed. Reg. 44,380–44,435 (Jan. 13, 2010 and July 28, 2010) (to be codified at 42 C.F.R. pts. 412, 413, 422, 495).

96. Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13,800.

97. The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

98. Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13,800.

99. *Congress Looks to ARRA for Deficit Reduction*, HIMSS News, http://www.himss.org/ASP/ContentRedirector.asp?ContentId=76350&type=HIMSSNewsItem (last visited Nov. 28, 2012).

According to the Act, a "qualified electronic health record" is defined as "an electronic record of health-related information on an individual that—(A) includes patient demographic and clinical health information, such as medical history and problem lists; and (B) has the capacity—(i) to provide clinical decision support; (ii) to support physician order entry; (iii) to capture and query information relevant to health care quality; and (iv) to exchange electronic health information with, and integrate such information from other sources."[100]

B. Strong Incentives to Adopt EHR Databases

Under the 2011–2016 EHR Stimulus Program, hospitals can seek Medicare and Medicaid payments for meaningful use of certified EHR.[101] While eligible physicians may receive up to $48,000, hospital-based physicians are not eligible.[102] Hospitals are eligible for payments up to $11 million.[103] This is derived from a $2 million hospital base amount available per year, with additional incentives for factors such as the rate of patient discharge.[104] Eligible hospitals receive incentive payments from 2011–2016, with higher payments awarded to those hospitals that adopt EHR programs early.[105]

C. The 2015 Penalties

Notably, beginning in 2015, hospitals will receive penalties through a reduction in Medicare reimbursement if the hospital has not yet made meaningful use of EHR.[106] These estimated reductions

100. HITECH Act § 3000(13).
101. *Id.* § 4102(n)(1).
102. *Id.* §§ 4101–4103, 4201.
103. *Id.*
104. *Id.* § 4102.
105. *Id.* § 4101.
106. *See* Becky L. Englehardt & Amy S. Leopard, *Meaningful Use: Challenges and Solutions Involving Electronic Health Records and Health Information Exchange*, AMERICAN HEALTH LAWYERS ASSOCIATION 5 (Apr. 7, 2011), http://www.healthlawyers.org/Events/Programs/Materials/Documents/HIT11/leopard.pdf (discussing consequences of failure to establish meaningful use).

in payment have been factored into the projected EHR incentive payments to entities that meet the requirements of meaningful use.[107]

VII. THE REQUIREMENTS AND CAPABILITIES FOR MEANINGFUL USE OF ELECTRONIC HEALTH RECORD SYSTEMS

The meaningful use requirement mandates that providers use software that has specific functionality and is certified as meeting ONC standards.[108] The core component of the Incentive Programs is the required use of "certified EHR technology."[109] For a particular EHR technology to meet the requirements of "qualified EHR" technology the database must meet several requirements. First, the technology should "[include] patient demographic and clinical health information, such as medical history and problem lists."[110] The EHR database must also have the capacity to incorporate clinical decision support, to allow physician order entry, to capture and query information relevant to health care quality, and to be able to exchange and integrate electronic health information with other sources.[111] Finally, EHR Databases must not only meet the requirements of the Certified EHR standards, but be actually certified as such.[112]

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107. The Centers for Medicare and Medicaid Programs expect "spending under the EHR incentive program for transfer payments to Medicare and Medicaid providers between 2014 and 2019 to be $3.3 billion under the low scenario, and $12.7 billion under the high scenario (these estimates include net payment adjustments for Medicare providers who do not achieve meaningful use in 2015 and beyond in the amount of $3.9 billion under the high scenario and $8.1 billion under the low scenario)." Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13801.

108. Englehardt & Leopard, *supra* note 106, at 2.

109. *See id.* (describing the "certified EHR technology" requirement for incentive payments).

110. 42 C.F.R. § 170.102 (2011).

111. *Id.*

112. *Id.* Specifically, Certified EHR Technology may be either "(1) A Complete EHR that meets the requirements included in the definition of a Qualified EHR and has been tested and certified in accordance with the certification program established by the National Coordinator as having met all applicable certification criteria adopted by the Secretary; or (2) A combination of EHR Modules in which each constituent EHR Module of the combination has been tested and certified in accordance with the certification program established by the

A. Meaningful Use of Qualified EHR Databases

When determining whether a hospital has achieved meaningful use of qualified EHR databases, the policy goals underlying the regulation must be considered.[113] The "vision of reforming the health care system and improving health care quality, efficiency, and patient safety should inform the definition of meaningful use."[114]

B. Stage 2 Meaningful Use

Stage 2 meaningful use requirements heighten the demands on healthcare entities for incentive payments. The Centers for Medicare and Medicaid state that Stage 2 requires "rigorous expectations for health information exchange including: more demanding requirements for e-prescribing; incorporating structured laboratory results; and the expectation that providers will electronically transmit patient care summaries to support transitions in care across unaffiliated providers, settings and EHR systems."[115] The Department of Health and Human Services has indicated that Stage 2 meaningful use may require EHR database tools that go beyond even what is required for a certified EHR technology. In Stage 2, "meaningful use objectives and measures require use that is not directly enabled by certified capabilities and/or standards."[116] In these cases, the eligible professional, eligible hospital, and critical access hospital "is responsible for meeting the objectives and measures of meaningful use, but the way they do so is not constrained by the capabilities and standards of Certified EHR Technology."[117]

National Coordinator as having met all applicable certification criteria adopted by the Secretary, and the resultant combination also meets the requirements included in the definition of a Qualified EHR."

113. *See* Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13702 ("Certified EHR Technology used in a meaningful way is one piece of the broader HIT infrastructure needed to reform the health care system and improve health care quality, efficiency, and patient safety.").

114. *Id.* at 13,702.

115. *Id.* at 13,703.

116. *Id.* at 13,708.

117. *Id.* The Department of Health and Human Services gives the following example: "in e-Rx and public health reporting, Certified EHR Technology applies

In the experience of the Department of Health and Human Services, one of the most pervasive barriers to the meaningful use of qualified EHR databases is "the adoption of numerous different transmission methods by different providers and vendors."[118] As a result, the Department of Health and Human Services believes it would be "prudent for Stage 2 to include these more specific requirements and conformance to open, national standards as it will cause the market to converge on those transport standards that can best and most readily support electronic health information exchange and avoid the use of proprietary approaches that limit exchange among providers."[119]

C. *Stage 3 Meaningful Use*

Specific compliance standards have not yet been created for Stage 3 meaningful use of EHR Databases; however, the Department of Health and Human Services has discussed projections, though they are subject to change. For Stage 3, the Department currently intends to propose higher standards for meeting meaningful use.[120] For example, the Department intends that "every objective in the menu set for Stage 2 . . . be included in Stage 3 as part of the core set. While the use of a menu set allows providers flexibility in setting priorities for EHR implementation and takes into account their unique circumstances, we maintain that all of the objectives are crucial to building a strong foundation for health IT and to meeting the objectives of the Act."[121] The Department also indicated that as the capabilities of HIT infrastructure increase, threshold standards for HITECH meaningful use objectives could be raised in both Stage 2 and Stage 3.[122]

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standards to the message being sent and enables certain capabilities for transmission in 2014; however, to actually engage in e-Rx or public health reporting many steps must be taken despite these standards and capabilities such as contacting both parties and troubleshooting issues that may arise through the normal course of business." *Id.*

118. *Id.* at 13,724.
119. *Id.*
120. *Id.* at 13,703.
121. *Id.*
122. *Id.*

VIII. STATE E-DISCOVERY RULES

A. Texas Rule of Civil Procedure 196.4

Texas was the first state to enact a discovery rule concerning electronically stored information.[123] In 1999, seven years before the 2006 amendments to the Federal Rules, Texas added a new provision to Rule 196.[124] The new provision, 196.4 of the Texas Rules of Civil Procedure, addressed the right to discover electronically stored information, the scope of such discovery, the form of production, and cost shifting.[125] Unlike under the Federal Rules, a requesting party must specifically request production of electronically stored data; it is not simply inferred from a term like *documents*.[126] Unlike the cost-shifting factors of *Zubulake*,[127] a plain text reading of Rule 196.4 employs mandatory cost-shifting if the court orders the responding party to produce data through reasonable efforts.[128]

A decade passed before the Texas Supreme Court interpreted Rule 196.4. The interpretation is interesting because it occurs after amendments to the Federal Rules of Civil Procedure and federal case law addressed the preservation and production of ESI, but the rule the court interpreted preceded the federal developments. The case, *In re Weekley Homes, L.P.*, concerned a litigant's right to directly access an opponent's hard drive to search for allegedly deleted ESI.[129] The defendant objected on the grounds that direct access was

123. *Sedona Principles*, *supra* note 16, at 5 n.9.

124. TEX. R. CIV. P. 196.4.

125. *Id.* TEX. R. CIV. P. 196.4 stipulates: "To obtain discovery of data or information that exists in electronic or magnetic form, the requesting party must specifically request production of electronic or magnetic data and specify the form in which the requesting party wants it produced. The responding party must produce the electronic or magnetic data that is responsive to the request and is reasonably available to the responding party in its ordinary course of business. If the responding party cannot—through reasonable efforts—retrieve the data or information requested or produce it in the form requested, the responding party must state an objection complying with these rules. If the court orders the responding party to comply with the request, the court must also order that the requesting party pay the reasonable expenses of any extraordinary steps required to retrieve and produce the information."

126. *Id.*

127. *See supra* Part V (discussing cost-shifting factors in *Zubulake III*).

128. TEX. R. CIV. P. 196.4.

129. 295 S.W.3d 309, 311 (Tex. 2009).

too intrusive and could reveal private conversations, trade secrets, and privileged communications.[130]

The Texas Supreme Court articulated a protocol for litigants seeking direct access to opponent's data. A request for production should specify the ESI sought (e.g., deleted data) and the form of production.[131] If reasonably available, the responding party must produce ESI, and if the ESI is not reasonably available due to undue burden or cost the responding party must make an objection.[132] The parties must seek to resolve the dispute without court intervention, and either side may seek a hearing.[133] Even if the ESI may not be reasonably available, the court may order production of responsive, non-privileged information if the requesting party demonstrates that it's feasible to recover relevant materials and that the benefits outweigh the burdens of production.[134] The requesting party pays the reasonable expenses of any extraordinary steps required to retrieve and produce the information.[135] Direct access to another party's storage is discouraged, but if production is ordered, only a qualified expert should be afforded such access.[136]

The *Weekley Homes* decision leaves several questions unanswered. For instance, what if the responding party's deletion was improper? And how does the burden/benefit analysis compare to the good cause requirement in the Federal Rules? These questions, and many others, are left to further judicial development.

IX. DATABASE PRESERVATION – DESIGNING AN EFFECTIVE LEGAL HOLD FOR ELECTRONIC HEALTH RECORDS

The duty to preserve ESI begins the moment a party reasonably anticipates litigation.[137] The nature of EHR databases presents unique challenges to the healthcare lawyer designing an effective legal hold. This section will explain the complexities of

130. *Id.* at 313.
131. *Id.* at 314.
132. *Id.* at 315
133. *Id.*
134. *Id.*
135. *Id.* at 316.
136. *Id.* at 318.
137. *See supra* Part V.B (discussing the duty to preserve).

preserving proprietary databases and will offer solutions for production.

A. The Unique Nature of a Database

An EHR system is a database of electronic health records, but that description is somewhat deceptive. When users view a patient's electronic health record, they are not viewing a discrete document, but a report generated by a database query and built of select fields of information culled from a complex dataset.[138] It is then presented in a user-friendly arrangement determined by the EHR system's client capabilities and user settings. Therefore, the EHR report the user sees on a screen may "feel" like a traditional document, but it is drawn from different sources within the database that are constantly subject to change. The large and dynamic nature of an EHR database presents unique preservation challenges for an attorney designing an effective legal hold.

B. How to Preserve an EHR Database for an Effective Legal Hold

If the EHR database is accretive in design, that is, after a certain period you can add to but not delete information without a special password, then the dynamic nature of a database may not present as many legal hold problems. Counsel might avoid legal hold problems with accretive databases by ensuring historical data is not deleted for the life of the case.

Creating a snapshot or pulling a full backup set for a relevant period is a smart way to ward off spoliation charges if other methods fail, but the cost of restoring the backup tapes ends up being very expensive if someone must eventually go through and produce. This method may be sufficient if the duty to preserve has attached and the possibility of actually producing the EHR in litigation is remote. If the lawsuit is certain and production of the EHR database is likely, the better approach is to identify ways to either duplicate or segregate the dynamic data needed and to export it to forms that do not unduly impair the searchability and utility of the EHR database. The goal is to shield the EHR database—not only from user

138. Bryan, Weinrich & Beitz, *supra* note 12, at 3.

changes—but from system initiated changes that will impair its relevance and value.

The consequences of not instituting an effective legal hold as soon as litigation is reasonably anticipated are illustrated by cases such as *Pension Committee*, discussed in Part V.[139] The danger of an ineffective legal hold in the context of producing medical cases is discussed in Part XI.[140]

X. DATABASE PRODUCTION – USING THE FEDERAL RULES TO YOUR ADVANTAGE

Paper production, such as a paper printout of what the EHR system user views as a patient's medical record, is not sufficient because electronic medical records contain data relevant to the litigation that is not readily apparent from a paper printout.[141] Producing the medical record without its associated metadata can be analogized to erasing the handwritten notes by the doctor before production and may result in sanctions for spoliation.

Image files (e.g., TIFF or PDF), an often-used form of production in electronic discovery, are particularly problematic for EHR systems. EHR systems are databases and, as such, cannot be converted from their "native, dynamic, three-dimensional form without significant loss of information."[142] Imaged production does have the advantage of easier Bates stamping, but ends up being much more expensive for the producing entity as well as much less functional for the requesting party.[143] Furthermore, as discussed in

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139. *See supra* Part V.C (discussing the *Pension Committee* case).

140. *See infra* Part XI (discussing how an ineffective legal hold and related destruction of evidence may lead to severe sanctions).

141. *See Sedona Principles*, *supra* note 16, at 61 ("Electronically stored information is fundamentally different from paper information in that it is dynamic, created and stored in myriad different forms, and contains a substantial amount of nonapparent data. Because of these differences, approaching the production of electronically stored information as though it is just the modern equivalent of a paper document collection will likely lead to a failure to fully consider the complex issues involved and a failure to select the most relevant and functional form of production for a particular type of electronic information.").

142. *Id.* at 62.

143. *Id.* at 63.

Part IV, absent party agreement or a court order, the responding party must produce electronically stored information either in the form in which it is ordinarily maintained or a form that is reasonably usable.[144] EHR systems maintain information in a searchable format, and a court is likely to find that imaged production does not reasonably preserve the data in a usable form. While producing an EHR system in native format would meet this requirement, native format will likely not be the most desirable form for either the hospital or the requesting party, as discussed next.

Native production for system-specific enterprise databases presents many difficulties. Native refers to the uniquely designed form of information specifically tailored to the application that created it.[145] EHR systems are unique databases because, as enterprise systems, they often are not compatible with off-the-shelf applications that the requesting party needs to view the information; in turn, native format review is often difficult for the requesting party.[146] One of the goals of EHR regulations is to increase the interoperability of EHR systems.[147]

Near native may be the most prudent form of production for records from EHR Systems. Near native is production in an electronic format that largely retains the utility, functionality, and content of the native format but is somewhat removed. If, as a responding party, a hospital needs to produce only discrete records within the EHR system, the data could be narrowed through the use of filters and queries. Next, the user could export the discrete EHR

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144. The Committee Note to FED. R. CIV. P. 34(b) states that "[i]f the responding party ordinarily maintains the information it is producing in a way that makes it searchable by electronic means, the information should not be produced in a form that removes or significantly degrades this feature."

145. *See Sedona Conference Glossary*, *supra* note 65, at 35 (defining "native format" as "an associated file structure defined by the original creating application").

146. *See id.* (noting that viewing or searching documents in the native format form may require the original application).

147. *See* Electronic Health Record Incentive Program—Stage 2, *supra* note 6, at 13,723 (showing that one of the primary goals of the EHR Incentive Program is to "promote widespread exchange and interoperability"). The federal program encourages interoperability for the purpose of allowing different EHR systems to share patient records. In this context, interoperability is important because the requesting party (e.g., the government in a False Claims Act investigation, or a sole litigant in medical malpractice cases) will not have an enterprise EHR system in which to load the files.

records to a format that can be analyzed by other applications. Formats capable of analysis outside the enterprise system include extensible markup language (XML) and comma separated values (CSV) or another delimited file.[148]

As hospitals convert to EHR systems in the face of federal incentive programs, hospitals and their counsel must grow comfortable with issuing litigation holds and producing ESI from EHR systems. It is important to remember that while Rule 34(b) allows the requesting party to choose the form of the production, the responding party may object to the requesting party's form of production and specify the form of production it would prefer.[149] Therefore, even if a litigant requests data from a hospital's EHR system that would be costly or difficult to produce, the hospital has the opportunity to go to court, object to the form specified, and suggest another form that is reasonably usable, such as near native.

XI. FEDERAL CASE LAW AND HEALTHCARE DATABASE PRODUCTION

The issue of ESI for hospitals, and EHR systems in particular, is an emerging area of the law of increasing importance to healthcare litigators. While few published cases have ruled on the issue of EHR systems in particular, hospitals are already grappling with the production of ESI.

A court is unlikely to be sympathetic to problems that arise due to counsel's unfamiliarity with the databases employed by a healthcare entity. In *In re Seroquel Products Liability Litigation*, the court reviewed the discovery practices of the defendant in a multi-district products liability suit.[150] The court criticized AstraZeneca for "purposeful sluggishness" in its production efforts.[151] AstraZeneca had failed to meet and confer in advance of electronic searches to discuss search term methodology, and its production had

148. Craig Ball, *The Luddite Litigator's Guide to Databases in E-Discovery*, CRAIGBALL.COM 18, http://www.craigball.com/Ball_DB_2010.pdf (last visited Nov. 28, 2012).

149. FED. R. CIV. P. 34(b).

150. 244 F.R.D. 650, 651 (M.D. Fla. 2007).

151. *Id.*

load file, metadata, page break, and key-word search problems.[152] The court found that the production problems made the "10 million pages of documents inaccessible, unsearchable, and unusable as contemplated under the Rules."[153] The court determined that sanctions were warranted for the pharmaceutical company's failure to produce its database in a form that was usable or reasonably accessible to the plaintiffs.[154] The court focused on the testimony of AstraZeneca's fact witness, who indicated the following:

> [AZ] stopped participating in the process to confer on the databases despite its explicit agreement to produce them and to cooperate in providing personnel familiar for Plaintiffs to interview to determine which ones to seek production of. [The fact witness] also testified that AZ never intended to produce databases, it would only produce some subset of information; yet he emailed Plaintiffs' counsel that AZ would work cooperatively with Plaintiffs on production of databases. . . . AZ's failure to cooperate in identification leading to appropriate production of its relevant databases is conduct sanctionable under Rule 37.[155]

The court noted that many of the problems of database production could have been avoided or "resolved far sooner and less expensively had AZ cooperated by fostering consultation between the technical staffs responsible for production."[156]

Healthcare entities have also faced severe sanctions related to failure to properly preserve databases and other relevant ESI. In *Philips Electronics North America Corporation v. BC Technical (BCT)*, a medical device manufacturer sued a competitor, alleging copyright infringement, federal trademark infringement, misappropriation of trade secrets, tortious interference with business relations, and violation of the Washington Consumer Protection

152. *Id.* at 665.
153. *Id.*
154. *Id.*
155. *Id.* at 661.
156. *Id.* at 662.

Act.[157] The district court adopted the report and recommendation of the Magistrate Judge and sanctioned the defendant.[158] The court found that BCT failed to preserve its databases and other ESI.[159]

BCT did not issue a proper litigation hold for nineteen months, during which time company executives willfully deleted and destroyed evidence and lied under oath.[160] The court cited Judge Scheindlin's *Pension Committee* opinion[161] approvingly and went on to say that "[c]ases across the country confirm that the duty to preserve means action must be taken to preserve evidence, meaning that it is not lost, destroyed, inadvertently or negligently overwritten, or intentionally wiped out, and that it is available to be produced to the other side."[162] The court determined that key employees of BCT deleted massive files from its database and tried to cover up the deletion with sophisticated software.[163] The court characterized BCT's attitude as one of "indifference—and possibly defiance—to the rules of discovery, orders of the court, and the integrity of the judicial process generally."[164] The behavior was so unreasonable that the court found the spoliation willful:

> BCT's behavior, such as failing to timely issue a litigation hold, failing to follow up on that litigation hold, failing to request discovery documents from key employees, and so forth, reveals its intentional failure to meet discovery obligations and its flagrant disregard of the obvious great risk that it was highly probable the destruction of relevant documents would result from its behavior, and BCT's conscious indifference to the consequences of that risk.[165]

157. 773 F. Supp. 2d 1149 (D. Utah 2011).
158. *Id.* at 1155.
159. *Id.* at 1204.
160. *Id.* at 1207.
161. *Id.* at 1195 (quoting Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., L.L.C., 685 F. Supp. 2d 456, 462 (S.D.N.Y. 2010), *abrogated by* Chin v. Port Auth. of N.Y. & N.J., 685 F.3d 135 (2d Cir. 2012)).
162. *Id.*
163. *Id.* at 1206.
164. *Id.*
165. *Id.*

The court found that such behavior warranted severe sanctions and (1) awarded default judgment as to liability, (2) dismissed the counterclaims of the defendants, (3) awarded attorneys fees to the plaintiff, and (4) referred the case for criminal prosecution for perjury.[166]

In re Seroquel and *Phillips Electronics* illustrate the importance of proper legal hold procedure and production for databases as EHR systems proliferate in healthcare systems. As counsel for AstraZeneca learned, ignorance of the database architecture used by its clients will not insulate counsel from the court's ire. Likewise, ignoring the complexity of instituting a legal hold for a database could be met with the harshest of sanctions.

XII. CONCLUSION

Hospitals will likely have no choice but to confront the difficult issue of database preservation and production. Hospitals will face penalties if they fail to meet the meaningful use standard for adoption of EHR Database Technology by 2015. Therefore, hospitals and their counsel must grapple with the complex new terrain of both database preservation and production, as EHR Database Technology will fast become the new normal.

166. *Id.* at 1155.