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THE CORPORATE GOVERNANCE OF NATIONAL SECURITY

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ABSTRACT

At hundreds of companies, the government installs former spies and military officers to run the business without shareholder oversight, putting security before profits in order to protect vital projects from potentially treasonous influences. Through procedures I call “National Security Corporate Governance,” corporate boardrooms have quietly become instruments of national defense, marrying the efficiency norms of corporate law and the protective ambitions of national security. How is this achieved, and how successfully? Using a variety of research approaches – including Freedom of Information Act (FOIA) requests, archival searches, telephone interviews, and in-person conversations with industry insiders – this Article illuminates a secretive government program and the challenging questions regarding the relationship between private ordering and public goals such as national security.

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This Article has benefited from numerous interviews with experts in the government, at law firms, and on FOCI boards. It would not have been possible without them. Only some of these conversations were “off the record,” but I have chosen to generally not identify sources in this text so as not to place undue emphasis on subjects who spoke “on the record.”

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INTRODUCTION

A central goal of corporate law is to make managers accountable to shareholders.¹ So it may come as a surprise that the federal government frequently compels companies to “effectively exclude the Shareholder . . . from . . . influence over the Corporation’s business or management[.]”² Indeed, there is a federal agency whose principal work is to ask companies to entrench the board of directors, waive the duty of loyalty, and hire individuals with little business experience to run the company.

That agency is located in the Pentagon. The managers hired and entrenched are former spies, military officers, and law enforcement officials. They take the reins from the shareholders for reasons of national security, at companies completing secret projects or projects vital to military or espionage agencies.

This Article is about “national security corporate governance,” a secretive government program of repurposing corporate boards as instruments of national security. National security corporate governance is born of the need to reconcile the two conflicting logics of security and efficiency. The closed culture of national security stultifies creativity and efficiency. This is why America has long outsourced much of its defense preparation and production to private contractors, where market dynamics encourage creativity and economy.³ Yet these same market dynamics can undermine national security if companies feel their interests are better served spying on or sabotaging these important projects – perhaps because a major investor or another client has ties to a foreign state.

National security corporate governance attempts to focus private sector dynamism onto problems of national importance, without naively trusting that the national interest and private interests are identical. With national security corporate governance, government representatives commandeer the boardrooms of private companies for public purposes, where they intercept illegal or risky plans before they become corporate policy.

National security corporate governance is a widespread and important practice. Under its ambit are some of the nation’s most pivotal

1. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”). See generally Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (discussing the ways in which shareholders are empowered by corporate law, and advocating for still more control).

2. DEF. SEC. SERV., U.S. DEP’T OF DEF., SAMPLE PROXY AGREEMENT, http://www.dss.mil/isp/foci/foci_mitigation.html.

3. See *infra* Part I.B.

security programs, such as civilian wiretapping⁴ and the use of armed military contractors in combat zones.⁵ Covered companies perform 5 percent of all classified government projects.⁶ They include the U.S. operations of household names like Rolls Royce, BAE, and Siemens.⁷ About 400 firms are currently subject to national security corporate governance, with one new agreement negotiated each week.⁸ All it takes to fall under its scope is a classified project and a potentially influential foreign client or investor.⁹

The widespread use of national security governance means that the stakes are high. The program works by inverting the dictates of orthodox corporate governance wisdom. If this lowers accountability and efficiency at vital projects, then the nation will get far less security than it bargained for.¹⁰ If vital projects remain at risk, then we may have missed the chance to take alternative protective steps.

The effectiveness of national security governance is not just important as a matter of national security; by repurposing corporate boards, it presents an important case study for central debates in corporate law, such as the appropriate degree of managerial accountability to shareholders.¹¹ Scholars

4. See, e.g., Verint Systems, Inc., Annual Report (Form 10-K/A) 25 (Apr. 25, 2005) (stating that Verint provides interception services and is subject to proxy mitigation).

5. See, e.g., *Alkanani v. Aegis Def. Servs., LLC*, 976 F. Supp. 2d 1, 9 (D.D.C. 2013) (stating that defendant contractor subject to FOCI mitigation).

6. U.S. DEP'T OF DEF., BIENNIAL REPORT TO CONGRESS ON IMPROVING INDUSTRIAL SECURITY 9 (2015), http://www.dss.mil/documents/about/February_2015_Biennial_Report_to_Congress_9MARCH2015.pdf (5.3 percent of all cleared facilities under FOCI).

7. *SSA List*, PROJECT ON GOV'T OVERSIGHT BLOG, <https://perma.cc/5UH8-5C3W> (last visited Nov. 17, 2017); Alex Ashbourne, *Opening the U.S. Defence Market* (Ctr. for Eur. Reform, Working Paper, 2000), <https://perma.cc/QM7F-P7E5>.

8. FOIA Response from Defense Security Service to Professor Andrew Verstein (Aug. 17, 2015) [hereinafter FOIA Response] (on file with author) (totaling Proxy Agreements, Special Security Agreements and Security Control Agreements). In this article, my focus is narrower than some FOCI experts might infer. I exclude from discussion those firms for which a mere board resolution suffices to mitigate FOCI. The focus here on national security corporate governance includes only the more intensive mitigation efforts.

9. See *infra* Part II.

10. At a time of historic cuts to defense spending, national security corporate governance may divert resources from other security investments. See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, OMB SEQUESTRATION UPDATE REPORT TO THE PRESIDENT AND CONGRESS FOR FISCAL YEAR 2016 (2015) (describing how 2011 sequester resulted in defense budget reduction of more than \$600 billion). See also *infra* note 260 and accompanying text.

11. Compare Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 28 (2002) (resisting shareholder empowerment), with Bebhuck, *supra* note 1, at 851–52 (promoting shareholder empowerment). Few advocate absolute accountability, since there is a tradeoff between accountability and expertise. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS (2002); KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974). One domain for that debate is the appropriateness of staggered boards. See, e.g., K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016); DEL. CODE ANN. tit. 8, § 141(a) (2013); MODEL BUS. CORP. ACT § 8.01(b) (AM. BAR ASS'N 2010). The FOCI board members

have spilled much ink debating how and whether the boardroom should include non-shareholder priorities, such as employee or environmental wellbeing.¹² Although rarely discussed, national defense is a candidate for one of those competing priorities.¹³ This Article contributes to the corporate law literature by presenting an actual instance of low-accountability, multiple-mandate boards that few imagined exist.

National security governance also bears on recent controversies in criminal, administrative, and constitutional law concerning the boundary between governmental and private action.¹⁴ For example, should the government demand environmental or worker protections in connection with its bailout of automobile manufacturers?¹⁵ Should companies get softer criminal penalties if they take a Department of Justice representative into the board room?¹⁶ National security corporate governance raises similar questions but on a scale that is likely greater than all comparable programs *combined*.¹⁷ Thus any discussion of administrative governance is

are like staggered board members in terms of their durability, except that FOCI directors' term of service may be considerably longer.

12. *E.g.*, E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Stefan J. Padfield., *Corporate Social Responsibility & Concession Theory*, 6 WM. & MARY BUS. L. REV. 1 (2015). *But see* Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1215 (1984) (arguing against voting board seats for other groups). These questions are of renewed interest in light of the government's control of many financial and industrial companies during the recent financial crisis, which put government representatives in many company's boardrooms. *See, e.g.*, Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 312 (2013); J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283 (2010).

13. For exceptions addressing national security in the governance context, *see* Charlie Cray & Lee Drutman, *Corporations and the Public Purpose: Restoring the Balance*, 4 SEATTLE J. SOC. JUST. 305, 333 (2005); Harvey L. Pitt, *On the Precipice: A Reexamination of Directors' Fiduciary Duties in the Context of Hostile Acquisitions*, 15 DEL. J. CORP. L. 811, 867 (1990).

14. *See infra* Part IV.D.

15. *See* Marcel Kahan & Edward Rock, *When the Government Is the Controlling Shareholder: Implications for Delaware*, 35 DEL. J. CORP. L. 409 (2010); *see also* Sepe, *supra* note 12, at 312; Verret, *supra* note 12.

16. Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007); Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar?*, 105 MICH. L. REV. 1713 (2007); Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?*, 34 J. CORP. L. 679 (2009); Gideon Mark & Thomas C. Pearson, *Corporate Cooperation During Investigations and Audits*, 13 STAN. J.L. BUS. & FIN. 1, 63–64 (2007); Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009); Veronica Root, *The Monitor—"Client" Relationship*, 100 VA. L. REV. 523 (2014); F. Joseph Warin, Michael S. Diamant & Veronica S. Root, *Somebody's Watching Me: FCPA Monitorships and How They Can Work Better*, 13 U. PA. J. BUS. L. 321 (2011).

17. The TARP bailouts resulted in some twenty-six government board appointments. Sepe, *supra* note 12. Only 108 companies have been subject to monitorships between 2008 and 2014. Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Non-Prosecution* 10 (N.Y. Univ. Sch. of Law, Pub. Law Research Paper No. 16-38, 2016), <https://perma.cc/4SKC-ND8K>. Amtrak has operated for forty-five years with a nine-member board. *Dept. of Transp. v. Ass'n of Am. R.R.*, 135 S. Ct. 1225, 1231 (2015). By contrast there are 400 companies with national security corporate governance

necessarily incomplete without discussion of national security corporate governance.

This Article proceeds in the following manner. Part I describes the tensions—between efficient security contracting, information security, and industrial readiness—that lead us to try national security corporate governance. Special emphasis is given to the promise and peril of buying from firms owned in part by foreign nationals. Such firms are described in the law as being under foreign ownership, control, or influence (FOCI).

Part II turns to the law of FOCI and its mitigation through national security corporate governance. This Part describes the legal basis of national security corporate governance, the conditions for its application, and the government agency overseeing it.

Part III explores the costs and benefits of the national security corporate governance program. First, Part III(A) discusses the clash between national security corporate governance and the private ordering that corporate law normally prefigures. National security corporate governance requires firms to depart from the governance systems they would otherwise adopt. And there is reason to think that national security corporate governance creates costly inefficiencies as a result, which firms may pass on to their government customers.

Second, Part III(B) assesses national security corporate governance's effectiveness in addressing security risks. Although this should be national security corporate governance's vindication, the results seem mixed. National security corporate governance helps in some ways, but it is also easy to point to failures. This leads to a discussion of public choice theory, in Part III(C). While public interest surely motivates much of national security corporate governance, it also empowers government officials to engage in rent-seeking. We are, after all, dealing with the heart of the Military-Industrial Complex, and it is unsurprising that national security corporate governance facilitates a cozy relationship between the government and its contractors.

Part IV turns to theoretical and practical questions raised by national security corporate governance. Some questions are internal to national security corporate governance: given that we will sometimes use national security corporate governance, how can we best control and account for its

directors. *See supra* note 8. And the absolute number of monitoring individuals is likely to be much greater in national security corporate governance, since most interventions involve installing multiple agents. *See infra* Part II.B. Excluding Amtrak board members, it might well be that ninety percent of government agents in boardrooms are installed through the FOCI Mitigation program discussed in this Article. The national security corporate governance program discussed herein contributes about three times as many boardroom interventions as does its better-known peer, despite going almost completely unnoticed. *See infra* note 228 and accompanying text.

cost? Some questions are external to national security corporate governance as a practice: what does this case study teach about the proper relationship between national security and corporate law, and about how best to resolve conflicts between legal regimes? Still other questions occupy a middle level: what light can national security corporate governance shed on other questions important to scholars of national security or corporate law?

To preview some tentative conclusions, the high cost of national security corporate governance makes it a poor choice much of the time. However, a number of contexts remain in which national security corporate governance may be a worthwhile policy. Indeed, it is even possible that we may wish to *expand* its utilization into new domains of domestic military contractors, foreign non-contractors, and domestic financial institutions. The use of national security corporate governance may prove interesting as a partial solution to problems of systemic risk created by Too-Big-To-Fail financial institutions.

Regardless, it is essential that when dissonant bodies of law vie for priority, as do national security and corporate law here, neither controls the result without due consideration of the contribution made by the other. We have a tendency to analyze problems solely from the vantage point of the more pressing body of law, often national security, even though any totalizing approach may backfire and undermine its own goals. Study of national security corporate governance suggests that the best way to serve national security is sometimes to resist our tendency to put national security first.

One caveat is in order. Research at the intersection of national security and corporate law is rare,¹⁸ and no scholar has seriously engaged national security corporate governance before.¹⁹ This paucity of inquiry is surely driven by a problem that I also must address: when it comes to national security, research is difficult and answers can be only tentative. In the case of national security corporate governance, the government will not release a list of covered companies or the directors enlisted to these strange boards, nor a database of the requirements imposed. Freedom of Information Act (FOIA) requests are denied on the theory that spies and terrorists could use

18. Exceptions are rare, but they do exist. *See, e.g.*, Jon D. Michaels, *All the President's Spies: Private-Public Intelligence Partnerships in the War on Terror*, 96 CAL. L. REV. 901, 928, 944 (2008). To be sure, numerous articles consider the nexus of national security and international investment openness, *see infra* note 103, but even these articles tend to ignore or downplay corporate law considerations. *See infra* note 241.

19. Indeed, this secretive program has largely eluded any attention. For a rare exception, *see* Nick Schwellenbach, *FOIA Friday: Government Contractors Under Foreign Control, Ownership, or Influence*, PROJECT ON GOV'T OVERSIGHT BLOG (Apr. 1, 2011), <https://perma.cc/3AWP-EGNK> (last visited Oct. 4, 2017).

such information to endanger contractors and the secrets they possess.²⁰ It is not even easy to find “the law” itself, since so much of this regime is created through norms and private contracts, rather than codified rules and statutes.²¹ No statute refers to national security corporate governance.²² Until 2014, neither did any administrative rule or pronouncement.²³ Public securities filings by the affected companies give very few details.²⁴

I attempt to overcome these challenges through a variety of research techniques, including FOIA requests, visits to the National Archives, and interviews with industry insiders – attorneys, government officials, consultants, business people, and the directors of these unusual companies themselves. Yet all of this work amounts to just a peek inside of a very black box. A fuller picture will only be possible with work by other scholars, journalists, and investigators.

With so much uncertainty, it would be cavalier to draw final conclusions such as whether national security corporate governance is ultimately justified in a particular context or whether national security corporate governance confirms predictions made by scholars in other domains. As a result, the tone and ambition of the paper is intentionally more descriptive than normative. At the same time, it is sometimes possible to surmise whether particular structures are designed to lead to good results. Where reform is likely to make the system work better, I have tried not to leave my opinion a secret.

I. CONTRACTING AND ITS RISKS

The following Sections consider the tension between governance and security implicit in the military-industrial complex, particularly where questions of foreign ownership and investment arise. Two different scenarios are discussed: companies that develop or acquire secret plans or

20. See FOCI cover letters (on file with the author).

21. See *infra* Part II.

22. National security corporate governance is my term. The principal tool for its imposition, “FOCI mitigation,” likewise goes without mention.

23. 32 C.F.R. §§ 117.51–56 (2017). One reference to an early FOCI program was promulgated in 1955, but within one year it was “decodified, but not rescinded.” See Detlev F. Vagts, *The Corporate Alien: Definitional Questions in Federal Restraints on Foreign Enterprise*, 74 HARV. L. REV. 1489 (1961).

24. Often, neither the contractor nor its parent company is a reporting company. Even when one is, they rarely mention FOCI mitigation in their public filings. A recent EDGAR search produced only thirty-two total filings with clear reference to FOCI mitigation, with only seven filers responsible. All of the filings discuss either the possibility of DSS mandating a Security Control Agreement (SCA), the possibility of losing government contracts, the election of directors to meet SCA requirements (without discussing the risks of these directors), or the necessity of obtaining approval from DSS. Overall, little information can be gleaned from public filings.

technology, and so pose an “information security” risk; and companies whose own operations involve secrets, such that they would be difficult for the government to expropriate in wartime, and so pose an “industrial security” or readiness risk.

A. Information Security

The United States has long pursued military objectives by outsourcing vital research and manufacturing functions to the private sector. The nation pays about \$1 trillion per year to national security contractors and the agencies that oversee them.²⁵ The Department of Defense spends more on contractors than all other government agencies combined.²⁶ The American temperament for small government may encourage such contracting,²⁷ however the legitimacy of widespread contracting surely rests on efficiency.²⁸ Private firms are incentivized to improve quality and control costs, and they can actually respond to those incentives because they are comparatively free from the red tape of a government bureaucracy.²⁹

Using contractors means trusting them with secrets normally available only to the most dependable military and intelligence officials. Yet it is hard to trust anyone in times of unrelenting industrial espionage.³⁰ In 2013, the Defense Security Service (DSS), the government group overseeing defense contractors, received and reviewed 30,000 reports of attempted security breaches from contractors possessing sensitive material.³¹ The number of attacks rose about 50 percent each year for the previous four years.³²

25. Winslow Wheeler, *America's \$1 Trillion National Security Budget*, PROJECT ON GOV'T OVERSIGHT (Mar. 13, 2014), <http://www.pogo.org/strauss/issues/defense-budget/2014/americas-one-trillion-national-security-budget.html>.

26. MOSHE SCHWARTZ ET AL., CONG. RESEARCH SERV., R44010, DEFENSE ACQUISITIONS: HOW AND WHERE DOD SPENDS ITS CONTRACTING DOLLARS 2 (2016).

27. E.g., Paul C. Light, *Outsourcing and the True Size of Government*, 33 PUB. CONT. L.J. 311 (2004) (noting efforts to reduce actual and apparent size of government through contracting); Dan Guttman, *Governance by Contract: Constitutional Visions; Time for Reflection and Choice*, 33 PUB. CONT. L.J. 321, 329 (2004) (describing “the momentum derived from the force of personnel ceilings”).

28. David A. Super, *Privatization, Policy Paralysis, and the Poor*, 96 CALIF. L. REV. 393 (2008) (discussing privatization on the terms of its advocates: efficiency).

29. See Jon D. Michaels, *Running Government Like a Business . . . Then and Now*, 128 HARV. L. REV. 1152, 1173 (2015) (reviewing NICHOLAS R. PARRILLO, *AGAINST THE PROFIT MOTIVE: THE SALARY REVOLUTION IN AMERICAN GOVERNMENT, 1780–1940* (2013)) (noting that red tape avoidance is often a “rallying cry” for privatization and business-like government).

30. Derek E. Bambauer, *Ghost in the Network*, 162 U. PA. L. REV. 1011, 1012 (2014) (“Cyberattacks are inevitable and widespread.”).

31. DEF. SEC. SERV., *TARGETING U.S. TECHNOLOGIES: A TREND ANALYSIS OF CLEARED INDUSTRY REPORTING 70* (2014), <http://www.dss.mil/documents/ci/2014UnclassTr ends.PDF>.

32. *Id.* at 8. Capture methods vary, from theft and wiretapping to kidnapping. One popular technique in recent years involves fake “research” inquiries by purported scholars. *Id.* The contextual irony of this claim is acknowledged. The most important change to the landscape of industrial espionage

The profit motive should usually push companies to invest in appropriate prophylactics. Access to lucrative government projects depends on a contractor's reputation for quality performance and robust internal security practices.³³

The government also uses public and contractual law to limit unauthorized disclosure by its contractors.³⁴ It is a criminal offense to share prescribed information with anyone lacking appropriate security clearance.³⁵ Contractors must also implement a long list of specific security

is surely the rise of Internet-based intrusions. As recently as 2004, attacks such as phishing scams, malware, and viruses still amounted to only 2.6 percent of all threats. DEF. SEC. SERV., TECHNOLOGY COLLECTION TRENDS IN THE U.S. DEFENSE INDUSTRY 3 (2005), <http://www.dss.mil/documents/2005-technology-collection-trends.pdf>. Since that time, suspicious Internet activity has become the most important avenue for unauthorized disclosure. See DEF. SEC. SERV., *supra* note 31, at 27.

33. As a general matter, the most efficient means of regulation will usually be to set appropriate penalties and then allow firms a choice of how to comply. However, there are some cases where oversight and mandates are appropriate. Jennifer Arlen and Marcel Kahan discuss the conditions under which such interventions can be appropriate in the context of corporate crime: when corporate assets are limited, targeted duties are needed, and especially when policing agency problems is costly. Arlen & Kahan, *supra* note 17, at 3. In their view, only when agency problems are rife, such as when they benefit from antisocial behavior, should prosecutors doubt that the agents of the firm will ignore the costs of non-compliance. By contrast, there is some concern that agents in national security companies will break the law *because* there are no agency problems and they are obeying a principal either with non-financial, geopolitical motives or for whom financial threats are not a deterrent.

34. Government contracting perennially raises the complication of government as customer and government as regulator. These two identities can be substitutes, as when the government seeks to improve prevailing wages without enacting a minimum wage by simply paying more to its contract workers. See, e.g., Davis-Bacon Act, 40 U.S.C. §§ 3141–48 (2012) (requirement that federal contractors pay their employees at least the prevailing wage). They can be complements, allowing the government to pursue wearing one hat what it might not do wearing another. This complementarity is part of what scholars of publicization have lauded: the government can impose public values of participation, transparency, and accountability on private actors beyond what it could have practically achieved through public law. On publicization, see Jody Freeman, *Extending Public Law Norms Through Privatization*, 116 HARV. L. REV. 1285 (2003); Laura A. Dickinson, *Public Law Values in a Privatized World*, 31 YALE J. INT'L L. 383 (2006).

The government's two roles can also stand at cross-purposes. Steven J. Kelman, *Achieving Contracting Goals and Recognizing Public Law Concerns*, in GOVERNMENT BY CONTRACT 153, 159–65 (Jody Freeman & Martha Minow eds., 2009). Government officers acting as customers may want a good product at a good price, even if getting it would undercut other government policies. Military contract officers may prefer the cheapest or best weapons even if the supplier is more likely to share the technology with geopolitical or commercial foes.

National security corporate governance raises important questions about the dynamic interplay of the government's multiple identities in the contracting process, but it is beyond the scope of this Article to fully engage those questions.

35. See Trading with the Enemy Act, 18 U.S.C. § 793 (2012) (criminalizing unauthorized transmission of defense information); *Summary of Export Control Laws*, UNIV. S. CAL. OFF. COMPLIANCE, <https://perma.cc/89SQ-D3NL> (last visited Nov. 17, 2017) (summarizing key export regulations). See also U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-681, INDUSTRIAL SECURITY: DOD CANNOT ENSURE ITS OVERSIGHT OF CONTRACTORS UNDER FOREIGN INFLUENCE IS SUFFICIENT 21 (2005), <http://www.gao.gov/assets/250/247112.pdf> (including DOD response: “[f]or [classified information] to be at risk, even by FOCL, cleared United States citizens have to break the law by providing it to unauthorized individuals”). There are also sometimes efforts to censor otherwise public research, such as recent studies concerning avian flu virus. Heidi Ledford, *Call to Censor Flu Studies*

protocols, including for end-of-day security checks,³⁶ repair of storage containers,³⁷ and hand carrying of classified materials.³⁸

Yet, lurking in the background of these rules is a potential tragedy of the commons.³⁹ Investors may shirk on security insofar as they do not internalize all of the costs of a leak.⁴⁰ Contractors may prioritize only technical or superficial compliance with the rules, even if aware that more should be done to reduce risk, particularly if detection is unlikely.

Worse still, some investors may push for non-compliance, either because penalties are not credible,⁴¹ or because they expect to be amply rewarded by another potential customer grateful for the disclosure,⁴² or because a powerful foreign state essentially extorts favors,⁴³ or because the shareholder is myopic and anticipates immediate savings or gains from lax security.⁴⁴ Some managers may be willing to break the law and accept personal risk in order to earn investors' gratitude. Shareholders may elect to

Draws Fire, 481 NATURE 9 (2012), <http://www.nature.com/news/call-to-censor-flu-studies-draws-fire-1.9729>. Those studies, which were eventually published anyway, could ease the efforts of bioterrorists. See also Rochelle Cooper Dreyfuss & Orly Lobel, *Economic Espionage as Reality or Rhetoric: Equating Trade Secrecy with National Security*, 20 LEWIS & CLARK L. REV. 419 (2016) (describing recent expansion of trade secrecy law under rhetoric of protection and security).

36. See U.S. DEP'T OF DEF., DOD 5220.22-M, NATIONAL INDUSTRIAL SECURITY PROGRAM OPERATING MANUAL § 5-102 (2006) [hereinafter NISPOM].

37. *Id.* § 5-311.

38. *Id.* § 10-405.

39. Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968).

40. Cf. Aziz Z. Huq, *The Social Production of National Security*, 98 CORNELL L. REV. 637, 638 (2013) ("National security bears all the hallmarks of a quintessential public good."); MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 14 (1965) ("It would obviously not be feasible, if indeed it were possible, to deny the protection provided by the military services . . . to those who did not voluntarily pay their share of the costs of government . . .").

41. Penalties may not be credible if the government is unlikely to impose the cost. See Guttman, *supra* note 27, at 344 ("Where only a handful of contractors dominate (e.g., Boeing and/or Lockheed Martin), a tension exists between the principle of rewarding or penalizing performance and the need to assure continued availability of alternative providers. In this context, the failure, suspension, or debarment of a major contractor may prove unacceptable."). Alternatively, a firm may have too little wealth to pay the penalty. See S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986) (demonstrating that *ex post* liability does not provide optimal incentives when defendant's wealth is less than the optimal damage award).

42. Sharing just a little data might secure a valuable contract from another government. A company nearing the end of a contract and already informed that it will not be considered for future projects (perhaps due to poor quality) can engage in end-game opportunism, unconcerned about the loss of future business.

43. This is not unrealistic, since America itself has played a coercive role. During the first invasion of Iraq, American agents were able to convince Thomson-CSF, the French manufacturer of Iraqi anti-aircraft systems, to provide sensitive information about those systems. This information made it materially easier to penetrate air defenses. MICHAEL R. GORDON & BERNARD E. TRAINOR, *THE GENERALS' WAR: THE INSIDE STORY OF THE CONFLICT IN THE GULF* 106 (1995).

44. See John Plender, *Shareholder Short-Termism Is Damaging the Economy*, FIN. TIMES (Nov. 7, 2015), <http://www.ft.com/intl/cms/s/0/d583baa2-823f-11e5-8095-ed1a37d1e096.html>.

the board those individuals most willing to minimize the consequences of their actions for themselves and for America.⁴⁵

Foreign shareholders have even less reason to worry whether their actions endanger the United States. Whether a sovereign wealth fund, a state-owned enterprise, or just a wealthy resident of another foreign jurisdiction, foreign investors may have geopolitical interests they hope to advance through their investments.⁴⁶ Unauthorized disclosure of a secret plan or proprietary technology may directly benefit the investors' home nation. That is a sensible enough reason for foreign managers and owners of a business to risk angering their U.S. government client.

For foreign groups and nations, investment can be an effective supplement to other strategies of espionage. For example, "foreign contingents" are known to visit facilities and attempt "to gain access to and collect protected information that goes beyond that permitted and intended for sharing."⁴⁷ This is clearly easier if foreigners own the enterprise and can claim commercial motives for a visit.

How can the sometimes-pernicious influence of foreign shareholders be addressed? One option is to simply limit foreign investment.⁴⁸ Many nations draw lines around sensitive sectors. Mexico bars foreigners from owning minerals or coastal land.⁴⁹ China abjures overseas operation of theater companies and laboratories of genetically modified plant seeds.⁵⁰ Yet, hard limits on investment may seem impractical in a world where capital is global and corporate nationality is fluid.⁵¹

45. Also, foreign ties may reduce the credibility of deterrence. If a manager breaks U.S. law, she may find it more convenient to flee beyond the reach of U.S. authorities, if she is just returning to the bosom of the corporation's home jurisdiction (and perhaps her own).

46. Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345 (2008).

47. DEF. SEC. SERV., *supra* note 31. Likewise, some mergers and acquisitions are "attempts to acquire protected information . . ." *Id.* at 5.

48. We take this approach with airlines. U.S. GEN. ACCOUNTING OFFICE, GAO-04-34R, ISSUES RELATING TO FOREIGN INVESTMENT AND CONTROL OF U.S. AIRLINES (2003), <http://www.gao.gov/assets/100/92293.pdf>. And, but for national security corporate governance, we do the same with defense [as the rest of this paper demonstrates], energy and critical infrastructure [Christopher S. Kulander, *Intruder Alert! Running the Regulatory Gauntlet to Purchase, Own, and Operate American Energy and Mineral Assets by Foreign Entities*, 46 TEX. TECH L. REV. 995, 1014 (2014)], and nuclear energy. [nuclear: [p://pbadupws.nrc.gov/docs/ML1503/ML15030A162.pdf](http://pbadupws.nrc.gov/docs/ML1503/ML15030A162.pdf); Martin G. Malsch, *The Purchase of U.S. Nuclear Power Plants by Foreign Entities*, 20 ENERGY L.J. 263, 264 (1999)]

49. Dane J. Dehler, *Buying Property in Mexico's "Restricted Zone": The Missed Opportunity That Was the 2013 Beltrones Proposal to Amend Article 27 of the Mexican Constitution*, 32 ARIZ. J. INT'L & COMP. L. 309, 310 (2015).

50. Rainy Yao, *Update: Latest Guidance Catalogue for Foreign Investment Industries Released*, CHINA BRIEFING (Mar. 20, 2015), <https://perma.cc/2JVQ-W7RV>.

51. John J. Hamre, President & CEO, Ctr. for Strategic & Int'l Studies, Public Briefing Session on Foreign Ownership, Control and Domination Before the United States Nuclear Regulatory Commission (Jan. 29, 2015), <http://pbadupws.nrc.gov/docs/ML1503/ML15030A162.pdf>. ("When the

There are also practical downsides to autarky. An unwillingness to utilize foreign suppliers could lead to reciprocal reluctance by other governments once open to American contractors.⁵² American shareholders will realize lower returns if they cannot sell their shares into the global market. International competition among suppliers has the potential to benefit the government buyer.⁵³ Indeed, not all research takes place in America and excellent technology may be developed overseas – under the aegis of overseas investors.⁵⁴ The willingness to buy, say, cockpit windows from a British company may improve safety for our pilots or lower costs.⁵⁵

National security corporate governance offers another way forward. Even where foreign investment may be nominally barred, it is common for the government department and the foreign investor to seek mutual accommodation: the transaction will be allowed, but subject to stringent conditions. These conditions severely limit the foreign investor's prerogatives as a shareholder. In many cases, the control rights they cede are effectively transferred to their federal agency customer. At the extreme, the foreign investor is totally excised except as the occasional recipient of dividends. With the federal government's own hand at the tiller, and the foreign investor unable to corrupt management or distort performance, the government can be as confident about its foreign-owned contractors as domestic contractors or employees of the bureaucracy.

It is perhaps useful to think of national security corporate governance as a mid-point between two extremes. On one pole, the government buys from foreign private contractors subject to *ex ante* rules (contractual and statutory) and *ex post* punishments. At the other extreme, the government can decide that the risk of foreign-invested partners is too high and ban any

original legislation was created that established a procedure for mitigating [FOCI] . . . the world was profoundly different. . . . But today we live in a world of global supply chains, international consortia of producers and a world of global and instantaneous communications. Capital is global and complex projects are funded on an international basis.”). On nationality of corporations, see Zoe Niesel, *Daimler and the Jurisdictional Triskelion*, 82 TENN. L. REV. 833 (2015).

52. Joseph Mamounas, *Controlling Foreign Ownership of U.S. Strategic Assets: The Challenge of Maintaining National Security in a Globalized and Oil Dependent World*, 13 LAW & BUS. REV. AM. 381, 393 (2007). Cf. Jose E. Alvarez, *Political Protectionism and United States International Investment Obligations in Conflict: The Hazards of Exon-Florio*, 30 VA. J. INT'L L. 1, 150 (1989) (“Exon-Florio creates a license for mirror proposals by other countries. . . . [T]he result may be divestment nightmares abroad for U.S. foreign investors based, ironically enough, on U.S. precedents.”).

53. And, of course, preventing “protection from unauthorized transfer of classified information to foreign interests [saves] billions of dollars.” National Industrial Security Program, 79 Fed. Reg. 19,467–71 (April 9, 2014) (to be codified at 32 C.F.R. pt. 117).

54. *Id.* at 19,469 (“[W]ithout this rule, Components will not have the ability to consider innovative technologies developed by foreign-owned U.S. companies”)

55. See, e.g., *Gkn Aerospace Transparency Systems Inc.*, BLOOMBERG BUS., <https://perma.cc/M99V-AG5B> (last visited Dec. 31, 2015) (“GKN Aerospace supplies cockpit and cabin windows for . . . military aircraft.”).

foreign investment in important contractors.⁵⁶ National security corporate governance is a third, intermediate option, akin to creating a joint venture, which gives the government some measure of control *during* the contract.⁵⁷ A joint venture structure is often an efficient way for parties to cooperate in a common objective despite many conflicting goals.⁵⁸

B. Industrial Security

America has sometimes expropriated foreign-owned assets during wartime in order to prevent their use by the enemy and repurpose them to support American defense. Doing so has led to substantial transition problems, particularly with respect to personnel. National security corporate governance helps with this problem, too, easing government expropriation of private enterprises by assisting in succession planning. It thereby contributes to industrial readiness and security.

During both World Wars, Congress authorized mass-expropriation of foreign-held assets,⁵⁹ many of which were German-owned chemical factories.⁶⁰ Seizing these properties yielded industrial capacity for the war effort, but presented major staffing difficulties. The executives and directors of seized companies had been chosen by the now-deposed foreign owners and were therefore potential traitors.

The Office of the Alien Property Custodian was tasked with replacing untrustworthy managers with patriotic managers.⁶¹ Yet, as the Custodian

56. Indeed, the government could forswear privatization altogether and conduct the business within its bureaucracy. On the proper tradeoff between privatization and internal production. *See generally* Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L.J. 389 (2003); Super, *supra* note 28.

57. The joint venture is not the only form of interim control. The contract or public procurement laws may give the government some ongoing authority. A joint venture is a form of interim control operating at the boardroom and governance level.

58. Sarath Sanga, *The Contract Frontier: A Study of the Modern Joint Venture* (Sept. 22, 2015), https://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/20150104_sarath_sanga_modern_jv.pdf. *See generally* OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975). Security promises can be hard to credibly enforce, especially when the contractor has overseas investors. National security corporate governance eases the government's monitoring and enforcement responsibilities, permitting continued outsourcing.

59. Trading with the Enemy Act of 1917, ch. 106, 40 Stat. 411, 415 (1917) (permitting the president to appoint an alien property Custodian); Exec. Order No. 9,095, 7 Fed. Reg. 1,971 (Mar. 13, 1942) (reestablishing the office of the alien property Custodian); *see also* Francis X. Fallon, Jr., *Enemy Business Enterprises and the Alien Property Custodian, I*, 15 FORDHAM L. REV. 222, 224 nn.10, 14 (1946) (some half billion dollars taken in each case).

60. OFF. OF THE ALIEN PROP. CUSTODIAN, *ANNUAL PROPERTY CUSTODIAN REPORT 25–26* (1919) (discussing assets taken and rise of German chemical industry). Paul V. Myron, *The Work of the Alien Property Custodian*, 11 LAW & CONTEMP. PROBS. 76, 81 (1945) (one third of net equity taken was German chemical manufacturing).

61. Myron, *supra* note 60, at 79–81.

told Congress, “the task of securing competent and skilled personnel under wartime conditions [was] difficult.”⁶² There was simply a dearth of patriots who knew much about German chemical production plants.⁶³ In practice, patriotic hiring was often used as a pretext for nepotism⁶⁴ and political patronage.⁶⁵

Both approaches were bad for wartime industriousness.⁶⁶ As a result, the Custodian was often forced to retain potential enemy spies and saboteurs just to keep the factories running. For example, at General Dyestuff, the Custodian ousted 80 percent of the board,⁶⁷ including president and director

62. OFF. OF ALIEN PROP. CUSTODIAN, ANNUAL REPORT FOR THE PERIOD MARCH 11, 1942 TO JUNE 30, 1943 4 (1943); *Accord* STUART L. WEISS, *THE PRESIDENT’S MAN: LEO CROWLEY AND FRANKLIN ROOSEVELT IN PEACE AND WAR* 146 (1996).

63. One internal memo about American Potash stated what was apparently a common finding, “The business is a highly technical one requiring the supervision of men familiar with its operations.” Stacey R. Kole & Harold J. Mulherin, *The Government as a Shareholder: A Case from the United States*, 40 J.L. & ECON. 1, 9 (1997).

64. See JOHN MORTON BLUM, *FROM THE MORGENTHAU DIARIES: YEARS OF WAR, 1941–1945* 10 (1967) (White House counsel and former judge Samuel Rosenman describing one conversation with Custodian Crowley: “Crowley comes in . . . and says to me, ‘By the way, Judge, I need a couple of good businessmen for Aniline Dye and if there are any friends of yours that you would like me to put in there, just let me know’ . . . It’s just like offering me a bribe.”). A particularly egregious example, the third Custodian was jailed for selling expropriated companies back to their German owners in exchange for colossal bribes. *Miller v. United States*, 24 F.2d 353, 356 (2d Cir. 1928) (alleged bribe worth \$500,000). That payment would be worth nearly \$10 million in 2017 dollars.

As another example, one magnate was appointed to the board of two of his expropriated competitors – promptly after he hired the Custodian to run a utility company (concurrently with his government office) at a salary that would be worth more than \$1 million today. ANTONY C. SUTTON, *WALL STREET AND THE RISE OF HITLER* (1976). For a biography of the magnate, see JOHN N. INGHAM, *BIOGRAPHICAL DICTIONARY OF AMERICAN BUSINESS LEADERS* 345 (1983) (describing Victor Emanuel).

65. STANLEY COBEN, *A. MITCHELL PALMER: POLITICIAN* 128–35 (1963) (Custodian Palmer gave fellow members of the Democratic Committee jobs as counsel for a textile company and vice-president of a shipping line).

66. One report found that many expropriated companies grew more slowly than privately owned chemical companies. *GAF Corporation—Company Profile, Information, Business Description, History, Background Information on GAF Corporation*, REFERENCE FOR BUS., <https://perma.cc/TE9H-JGA8> (last visited Oct. 15, 2017). At a time when demand for chemical products was booming, government-run chemical companies were hampered by a lack of expertise. Junius B. Wood, *Public Ownership at Work*, *NATION’S BUS.*, Apr. 1952 at 39, 97 (finding that government-operated companies’ profits did not keep pace with privately run companies). Cf. WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 216–17 (14th ed., John Murray 1931) (1873) (describing failures of the government-appointed head of the Bank of France).

The loyalty/competence dilemma is by no means limited to the twentieth century or to chemistry knowledge. It is apparent that efforts to replace Saddam Hussein loyalists with more trustworthy officials resulted in a decline in quality administration. See generally MIRANDA SISSONS & ABDULRAZZAQ AL-SAIEDI, *INT’L CTR. FOR TRANSITIONAL JUSTICE, A BITTER LEGACY: LESSONS OF DE-BAATHIFICATION IN IRAQ* (2013), <https://www.ictj.org/sites/default/files/ICTJ-Report-Iraq-De-Baathification-2013-ENG.pdf>.

67. *Elimination of German Resources for War: Hearing Before a Subcomm. of the Comm. on Military Affairs*, 79th Cong. 887 (1945) [hereinafter *Elimination of German Resources*].

Ernst Halbach, after determining that he “had been a cloak for the enemy.”⁶⁸ The company promptly stumbled due to the “incompetence of the present [i.e. new] officers and directors. . . .”⁶⁹ The Custodian soon acknowledged the need for a “special consultant” and appointed an expert manager – enemy agent Ernst Halbach!

Soon, Halbach was the “indispensable man” at the company again,⁷⁰ acting as the functional top executive and earning even more than the CEO.⁷¹ Three years later, Congress demanded an explanation for why the Custodian had hired and retained Halbach despite its own determination that he was untrustworthy. The nominal CEO wrote in reply that Halbach’s departure would “adversely affect the war effort”⁷²

This incident at General Dyestuff was by no means unique. “Enemy sympathizers were often retained at firms that manufactured products deemed vital to the war.”⁷³ The government was apparently willing to risk sabotage and espionage in order to maintain industrial readiness.⁷⁴

In 1946, the Custodian’s work was brought within the Department of Justice,⁷⁵ but its problems left an impression in law and policy.⁷⁶ In

68. Halbach v. Markham, 106 F. Supp 475, 477 (D.N.J. 1952); *Accord* WEISS, *supra* note 62, at 143 (“the board was charging . . . that Halbach was a German agent; and Crowley had lent credibility to the charge, if indeed he did not originate it”).

69. WEISS, *supra* note 62, at 143. Halbach was replaced by Louis Johnson, perhaps at President Franklin D. Roosevelt’s personal suggestion. Johnson was once Assistant Secretary of State, currently the founder and head of the growing law firm Steptoe & Johnson, and would one day be Secretary of Defense. KEITH D. MCFARLAND & DAVID L. ROLL, LOUIS JOHNSON AND THE ARMING OF AMERICA 128 (2005). Though credentialed and connected, he was no expert in the chemistry or business of dyestuffs.

70. WALTER L. HIXSON, THE AMERICAN EXPERIENCE IN WORLD WAR II: THE UNITED STATES IN THE EUROPEAN THEATER 299 (2002). *Accord* Elimination of German Resources, *supra* note 67, at 887 (Custodian stating that General Dyestuff “could not dispense with [Halbach’s] experience in the business.”); SUTTON, *supra* note 64, at 153 (CEO Johnson writing that the board “would have been lost without Mr. Halbach’s knowledge.”).

71. SUTTON, *supra* note 64, at 153. CEO Johnson, however, did just fine. Johnson’s salary was \$50,000, or just under a \$ 1 million in today’s dollars. MCFARLAND & ROLL, *supra* note 69, at 127–28.

72. *Accord* Elimination of German Resources, *supra* note 67, at 887.

73. Kole & Mulherin, *supra* note 63, at 6.

74. See EDWARD S. MASON, CONTROLLING WORLD TRADE: CARTELS & COMMODITY AGREEMENTS 11 (1946) (arguing that the dearth of chemical expertise among Americans led to excessive partnerships with German individuals and organizations, assisting in German’s rapid remilitarization after WWI).

75. Exec. Order No. 9,788, 11 Fed. Reg. 11,981 (Oct. 15, 1946).

76. *Cf.* Vagts, *supra* note 23, at 1522 (“When the United States vested the property of nationals of Germany and its allies in the two world wars, it determined never to permit the return of this industrial potential to German or other foreign hands.”). As with all present Outside Directors, the Custodian’s directors retained their ordinary fiduciary duties while also gaining a consultative responsibility to the government.

Directors designated by the Custodian have the same duties and responsibilities as the directors of any other corporation. Due to the nature of their appointment, however, they may consult with the Custodian’s office regarding the policies of the Custodian with respect to the business. In

wartime, America may expropriate foreign enterprises. Doing so will force a choice between experience and patriotism – between industrial readiness and industrial security—unless trustworthy Americans are given opportunities for experience during peacetime.

National security corporate governance provides a platform for such advancement. Complying firms install numerous former intelligence and defense officials at the highest levels of operation at the companies most likely to face expropriation: foreign-owned firms that provide functions useful to America’s espionage or military efforts. From the 1950s onward,⁷⁷ U.S. policy has been to ensconce patriotic Americans within foreign-owned enterprises, where they could build expertise and familiarity in peacetime to be deployed rapidly in wartime.⁷⁸

some cases if the activities of such an enterprise are vital to the war effort, field representatives of the Custodian's office are placed in positions in the enterprise so that they may inspect and examine into its activities and make reports thereof to the Custodian.

Myron, *supra* note 60, at 8.

77. As an early version of the National Industrial Security Program, the 1955 rules foreshadow each aspect of the NISPOM, including nascent elements of the FOCI mitigation rules that would be made explicit only later. “Foreign-owned, controlled, or influenced” facilities are deemed ineligible for any security clearance. Armed Forces Industrial Defense and Security Regulations, 20 Fed. Reg. 6,770, 6,778 (Sept. 15, 1955). A number of criteria, all of which would be familiar to current defense contractors, are listed that serve to identify FOCI. *Id.* at 6,786. There is no explicit reference to national security corporate governance, but there can be no doubt that the criteria served as a road map to contractors wishing to retain their security clearance while taking on a foreign investor. Such a contractor would wisely sterilize “[c]ontrol by foreign interests over appointment and tenure of the officers, directors, or principal supervisory management personnel.” *Id.* at 6,785. It would be smart to modify “[t]he corporate structure of the company, to include such matters as . . . trust arrangements, proxies and the like.” *Id.*

78. Despite the predominant focus on information security in the NISPOM, the 140-page document setting out our military contract regime, there are exactly six instances in which the document points to some other goal. All of those references are in the five pages NISPOM devotes to FOCI mitigation (i.e. national security governance), suggesting that the program serves some other purpose than information security. NISPOM, *supra* note 36, §§ 2-300(a), 2-300(f), 2-302(a)(2), 2-302(c), 2-306(c). In those sections, reference is made to minimizing activities that “may adversely affect the performance of classified contracts.” *Id.* § 2-300(a). Similar language, evidencing concern for priorities apart from information security, can be traced back to the 1955 rule, which states three goals: preventing unauthorized disclosure, sabotage, and “any other act detrimental to the security of the United States.” Armed Forces Industrial Defense and Security Regulations, 20 Fed. Reg. at 6,780.

Earlier seeds of national security governance can be traced to secret inter-department discussions in 1949, led by then-director of the Office of Alien Property (and soon after, federal circuit judge) David L. Bazelon. Reflecting on the failures of the alien property Custodian, the group considered reorienting foreign asset control to de-emphasize the seizure of ownership and greatly increase the use of non-ownership control arrangements: assets would be “supervised by supervisors appointed by and pursuant to . . . the agency or Department administering the program. The proposed program would make extensive use of supervisory authority.” Memorandum from Donald Sham to David L. Bazelon, Dir., Office of Alien Prop. 2 (Feb. 25, 1949) (copy on file with author). The preference for supervisory authority rather than outright ownership is consistent with the privatization trend in both contracting and in national security governance control over contractors.

James Harris, former Assistant General Counsel at Defense Security Service, deserves thanks for suggesting this line of inquiry.

II. NATIONAL SECURITY CORPORATE GOVERNANCE IN OPERATION

The last Part explained the reasons why it might sometimes be sensible for the government to acquire influence over the board of foreign-owned contractors. As a result, contractors with foreign investors are often subjected to substantial intrusions into the logic of corporate law in the name of national security. This Part describes the law of national security corporate governance, the scope of companies subject to national security corporate governance, and the government officials in charge of administering national security corporate governance.

A. Who Implements National Security Corporate Governance?

The governance modifications used to reconcile national security with other values are implemented by the Defense Security Service (DSS), a division of the Department of Defense, and are mostly applicable to military contractors with some degree of foreign ownership.⁷⁹ Foreign Ownership, Control, or Influence (FOCI) is the phrase used to describe potentially problematic foreign connections which may require mitigation through national security corporate governance.

No statute refers to FOCI mitigation or national security corporate governance.⁸⁰ Until 2014, neither did any administrative rule or pronouncement. In a sense, national security corporate governance emerges from the National Industrial Security Program Operating Manual (NISPOM), a document produced by the Department of Defense to clarify

79. There are seven important contexts in which a federal agency may regulate foreign ownership or influence. Of these, DSS is the main gatekeeper for three contexts: where a company's business is subject to security and export controls; where there might be influence upon the nation's communications security systems; and where a company is performing executive contracts, which includes contracts with the Department of Defense pertaining to the U.S. armed forces. Collectively, DSS is annually overseeing some 13,000 entities on behalf of thirty agencies.

The remaining national security corporate governance authority is dispersed among three other agencies, but they follow reasonably similar procedures. The Nuclear Regulatory Commission (NRC) maintains its own national security corporate governance regime (Negation Action Plan, or NAP) for ownership of nuclear power plants. *See* 10 C.F.R. § 50.38 (2017) (providing that foreign owned, controlled, or dominated (FOCD) persons cannot operate a nuclear power plant in the United States). While the NRC recently ruled that 100 percent foreign ownership would be per se unacceptable, *Calvert Cliff's Coordinating Comm., Inc. v. U.S. Atomic Energy Comm'n*, 449 F.2d 1109 (D.C. Cir. 1971), it is more common for the NRC to implement mitigation procedures. The Department of Energy vets its own contractors for classified projects and projects, but mitigates them subject to the same rules used by DSS, 10 U.S.C. § 2536 (2012) (adopting NISPOM), while also imposing supplemental requirements for DOE-specific assets, restricted data, special nuclear material, and certain other security activities. U.S. DEP'T OF ENERGY, MINOR CHANGE TO DOE O 470.4B, *SAFEGUARDS AND SECURITY PROGRAM*, app. B, § I, ch. I, at I-1. The Office of the Director of National Intelligence serves as the fourth "cognizant security agency" in charge of administering some FOCI mitigation.

80. *See infra* Part II.

its expectations of contractors, pursuant to an executive order of President George H.W. Bush.⁸¹ While the NISPOM is important,⁸² it is neither a complete statement of contractors' duties nor the proximate legal source of them.

In NISPOM's shadow, the rules are made contractually. The requirements of the regime are whatever DSS currently demands. DSS posts a template FOCI mitigation agreement on its website but one DSS contract negotiator told me that the "real" template is the one that he maintains on his personal computer and sends to companies considering national security corporate governance.⁸³ With so little public and so little fixed, it is impossible for any researcher to learn all the basic facts about national security corporate governance and the FOCI mitigation program.⁸⁴ With those caveats, the national security corporate governance regime looks something like this.

National security corporate governance is often required of defense or intelligence contractors that receive foreign investment or are otherwise subject to foreign influence.⁸⁵ A company is considered to be under "foreign ownership, control, or influence" (FOCI) if a foreign interest can "direct or decide matters affecting the management or operations of that company in a manner which may result in unauthorized access to classified information or may adversely affect the performance of classified contracts."⁸⁶ A "foreign interest" is any foreign government or its agent, or any entity

81. Exec. Order No. 12,829, 58 Fed. Reg. 3,479 (Jan. 6, 1993); *see also*, U.S. DEP'T OF DEF., DEFENSE FEDERAL ACQUISITIONS REGULATION SUPPLEMENT (1998), <http://www.acq.osd.mil/dpap/dars/dfarspgi/current/>.

82. Dan Velez, *4 Steps Contractors Should Take Now to Prepare for New Security Requirements*, WASH. TECH. (May 8, 2015), <https://perma.cc/M7V3-JN7B> (calling NISPOM "the bible for any defense contractor supporting classified government programs").

83. Even this template should not end our inquiry, since we do not know the myriad modifications that are made to accommodate particular companies. However, one DSS official asserted to me that the practical problem of enforcing so many agreements with so few government agents creates a strong presumption against modification. Nearly everyone outside of the government with whom I spoke complained of rigid adherence to form documentation as a source of frustration.

84. The difficulty of learning the law in this area is ironic. While we sometimes tolerate secret laws, *see* Dakota S. Rudesill, *Coming to Terms with Secret Law*, 7 HARV. NAT'L SEC. L. J. 241 (2015), the typical justification for secret laws is to prevent strategic behavior by those subject to the law. That rationale is inapplicable here, since the contractors subject to national security corporate governance know the current state of the law. Only researchers and the public have difficulty learning about the regime.

85. Although much of the DSS regime clearly contemplates foreign purchases of equity stock, the forgoing definition covers more than foreign shareholders. 32 C.F.R. § 117.56(b)(1) (2017) (Stating that power may be "direct or indirect (whether or not exercised, and whether or not exercisable through the ownership of the U.S. company's securities, by contractual arrangements or other means.>"). *Accord* 32 C.F.R. § 117.56(b)(4)(ii) (2017) (discussing mitigation when FOCI is "present, but unrelated to ownership").

86. NISPOM, *supra* note 36, § 2-300(a).

incorporated outside of the United States, or a person who is not a U.S. citizen or national.⁸⁷

Three considerations inform DSS assessment of the presence of FOICI and its intensity:⁸⁸

(1) Investor factors, such as “the political and military relationship between the United States Government (USG) and the government of the foreign interest,”⁸⁹ whether the investor is itself a government.⁹⁰

(2) Investment factors, including any capacity to influence operations or management of the investee company,⁹¹ such as the “nature[] and extent of FOICI,”⁹² and the size of the foreign investor’s stake.⁹³ Five percent ownership or 10 percent voting interest are important but non-dispositive thresholds.⁹⁴

(3) Investee (i.e. contractor) factors, including current management roles at the contractor held by non-U.S. citizens,⁹⁵ current revenue generated from foreign business,⁹⁶ compliance with U.S. laws and other contracts,⁹⁷ complicity in past espionage⁹⁸ and unauthorized technology transfers,⁹⁹ and the sensitivity of the information to be accessed.¹⁰⁰

87. *Id.* app. C, at C-3.

88. These considerations are often made into a seven-factor test. *Id.* § 2-301(a)–(g). It is the author’s decision to group them in this way.

89. 32 C.F.R. § 117.56(b)(3)(i)(F) (2017).

90. 32 C.F.R. § 117.56(b)(3)(i)(G) (2017); *see also* 10 U.S.C. § 2536 (2012) (barring foreign governments from receiving Department of Defense contracts involving access to proscribed information unless the Secretary of Defense grants a waiver). *But see* 32 C.F.R. § 117.56(b)(11)(ii) (2017) (bypassing waiver requirement if the company is subject to a Proxy Agreement or a Voting Trust agreement).

91. 32 C.F.R. § 117.56(b)(3)(i)(H) (2017).

92. 32 C.F.R. § 117.56(b)(3)(i)(E) (2017).

93. Current regulations require extensive disclosure of a contractor’s ownership composition, or the ownership of funds that in turn own the contractor. 32 C.F.R. § 117.56(b)(3)(v) (2017). In some cases, it will be hard to determine precisely who owns a given company. For example, a company may have no idea as to the beneficial owners of a hedge fund holding large amounts of its stock. While fund clients are often accustomed to anonymity, Joseph D. West et al., *National Security Implications of Foreign Investment in U.S. Government Contractors/Edition II*, BRIEFING PAPERS, Mar. 2014, at 12, DSS is likely to assume the worst if the company cannot or will not discover and disclose this information. 32 C.F.R. § 117.56(b)(2)(v) (2017).

94. NISPOM, *supra* note 36, § 2-301(d). Important lines are also drawn at majority ownership.

95. *Id.* § 2-302; OFF. OF MGMT. & BUDGET, STANDARD FORM 328, CERTIFICATE PERTAINING TO FOREIGN INTERESTS (2008) (item (4)).

96. NISPOM, *supra* note 36, § 2-302; OFF. OF MGMT. & BUDGET, STANDARD FORM 328, CERTIFICATE PERTAINING TO FOREIGN INTERESTS (2008) (must report if more than 5 percent or 30 percent of investee’s revenue or net income comes from a single foreign person or foreign persons in the aggregate, respectively.).

97. 32 C.F.R. § 117.56(b)(3)(i)(C) (2017).

98. 32 C.F.R. § 117.56(b)(3)(i)(A) (2017).

99. 32 C.F.R. § 117.56(b)(3)(i)(B) (2017).

100. 32 C.F.R. § 117.56(b)(3)(i)(D) (2017).

These are similar factors to those that prompt review by the Committee on Foreign Investment in the United States (CFIUS), another government group charged with regulating foreign investments.¹⁰¹ CFIUS has garnered far more media attention¹⁰² and scholarly commentary,¹⁰³ but national security corporate governance is no less important. National security corporate governance is frequently the main driver for CFIUS policy: CFIUS learns about many cases as a result of the national security corporate governance and FOCI mitigation process;¹⁰⁴ successful national security corporate governance strips CFIUS of any authority;¹⁰⁵ and when CFIUS does act, it frequently imposes the existing plan of national security corporate governance in duplicate.¹⁰⁶ The national security corporate governance regime also predates meaningful CFIUS review by many decades.¹⁰⁷ Thus DSS's determination is often the most important one for a contractor and its investors.

101. See Joseph D. West et al., *A Dealmaker's Guide to National Security Implications of Foreign Investment in U.S. Government Contractors*, BRIEFING PAPERS, June 2015, <http://www.gibsondunn.com/publications/Documents/West-Lee-Fernandez-Farr-National-Security-Implications-of-Foreign-Investment-in-US-Govt-Contractors-BP-15-7.pdf> (explaining the CFIUS process).

102. Opinion, *Tinker, Tailor, Soldier, Wind Farm: Did Obama Abuse a Security Process to Kill a Chinese Investment for Political Reasons?*, WALL ST. J., Oct. 15, 2012, <http://www.wsj.com/articles/SB10000872396390444223104578034791978586734>.

103. See, e.g., David Zaring, *CFIUS as a Congressional Notification Service*, 83 S. CAL. L. REV. 81 (2009); Jon D. Michaels, *The (Willingly) Fettered Executive: Presidential Spinoffs in National Security Domains and Beyond*, 97 VA. L. REV. 801 (2011). Given limited bandwidth for these issues, excellent discussions of CFIUS may even distract from the study of national security corporate governance. See, e.g., David Zaring, *CFIUS as a Congressional Notification Service*, 83 S. CAL. L. REV. 81 (2010) (describing Thomson bankruptcy by reference to *In re Chateaugay Corp.*, 198 B.R. 848 (Bankr. S.D.N.Y. 1996), without mentioning FOCI mitigation, DSS, or national security corporate governance). Contractors must notify DSS if they come under FOCI and potentially begin mitigation, while notification of CFIUS is voluntary. The Department of Defense (DSS's parent agency) serves on CFIUS. Thus, many transactions that might "pass" under the radar" attract CFIUS's attention only if DSS has concerns about FOCI. Daniel C. Schwartz, *Navigating the National Security Challenges Posed by Foreign Investment in U.S. Businesses*, in RECENT TRENDS IN NATIONAL SECURITY LAW 25 (2015). Accord NISPOM, *supra* note 36, § 2-310 (providing that a government agency should recommend full CFIUS review if the contractor is unable to agree to and honor a FOCI action plan).

Relatedly, the number of FOCI cases seems to be growing both nominally and as a percentage of CFIUS cases.

104. *A Q&A with the Director, Industrial Security Field Operations*, DSS ACCESS (Def. Security Serv., Washington, D.C.), 2013, at 10, http://www.dss.mil/documents/about/DSS_ACCESS_Vol_2_Is_sue_1.pdf (DSS Director of Industrial Security Field Operations Richard Lawhorn noting that due to increased globalization almost every information systems security professional has to deal with a FOCI firm).

105. 32 C.F.R. § 117.56(b)(14)(iii) (2017) ("The CFIUS review and the DSS industrial security review for FOCI are separate processes subject to independent authorities, with different time constraints and considerations. However, CFIUS may not mitigate national security risks that are adequately addressed by other provisions of law.").

106. Cf. West, *supra* note 93, at 10.

107. Compare Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975) (establishing earliest version of CFIUS), with Exec. Order No. 10,865, 25 Fed. Reg. 1,583 (Feb. 24, 1960) (establishing

If DSS determines that a company is under foreign influence, the influence must be mitigated, or else the subject firm loses its ability to work on sensitive government projects.¹⁰⁸ When facing an investment from a foreign interest, contractors must notify DSS as to the type of transaction, and the identity of the investor, and a plan to mitigate the investor's influence.¹⁰⁹ This begins the negotiation between the company and DSS as to what sort of national security corporate governance will actually be acceptable.¹¹⁰

B. What Does National Security Corporate Governance Entail?

Efforts to mitigate FOCI can be grouped into two general types: operational and governance. Although both are common and important, this Article only refers to “national security corporate governance” when some form of governance intervention occurs.

Operational responses dictate how the company operates on a daily basis. Consider the two major categories of operational mitigation:

- Legal, Economic, Administrative, and Physical Partition: The contractor must “be organized, structured, and financed so as to be capable of operating as a viable business entity independent from the foreign

industry information safeguards), and 32 C.F.R. § 72.2-300 (1955) (denying defense contracts to unmitigated foreign-influenced firms). And the *modern* CFIUS regime—the one capable of actually impacting foreign investment—is really a product of the Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (codified as amended at 5 U.S.C. § 5315 (2012), 31 U.S.C. § 301 (2012)). From the 1950s until the 1984 advent of the Special Security Agreement, mitigation was available on an ad hoc basis. See *Special Security Agreements Permit Foreign-Owned U.S. Firms to Perform Classified Defense Contracts: Hearing Before the H. Comm. on Armed Servs.*, 101st Cong. 1 (1990) [hereinafter *H. Comm. on Armed Servs.*] (statement for the record of the General Accounting Office, National Security and International Affairs Division), <https://perma.cc/T7TR-4STK>. Thus, the earliest version of FOCI mitigation likely predates meaningful CFIUS oversight by fifty years.

108. To work on classified contracts, companies must obtain facility security clearance (FCL), NISPOM, *supra* note 36, § 2-100, which is an “administrative determination that, from a security viewpoint, a company is eligible for access to classified information of a certain category (and all lower categories).” *Id.* app. C, at C-3. To get or keep this clearance, a “company must not be under FOCI to such a degree that the granting of the FCL would be inconsistent with the national interest.” *Id.* § 2-102(d); 32 C.F.R. § 117.56(b)(2)(i) (2017). If the investment is made before acceptable mitigation, then DSS will invalidate the company's clearance. 32 C.F.R. § 117.56(b)(2)(iv) (2017). Apart from mitigation or loss of clearance, a third interim possibility is that the company dispute the determination. 32 C.F.R. § 117.56(b)(3)(iii) (2017). It is not feasible to determine whether disputes are common or how they are resolved, but it seems unlikely that firms litigate against their customers with great frequency.

DSS therefore imposes restrictions as a de facto condition of remaining in business. Similar arrangements have been explored with respect to other agencies. See *supra* notes 25–38 and accompanying text; Daphna Renan, *Pooling Powers*, 115 COLUM. L. REV. 211 (2015).

109. NISPOM, *supra* note 36, § 2-302(b). The discussion will usually be led by the company's Facility Security Offer (a required position in companies with security clearance) and the DSS field officer, though both may eventually discuss matters with superiors at their respective organizations.

110. 32 C.F.R. § 117.56(b)(2)(vi) (2017); West et al., *supra* note 101 (explaining that the initial plan leads to subsequent discussions).

owner.”¹¹¹ FOCI companies are discouraged from sharing services and physical locations with their parent company and must file plans spelling out which interactions are permitted and how their risks will be controlled.¹¹² They must not share essential IT services.¹¹³

- **Management Committee:** The contractor must establish a Government Security Committee (GSC), composed of those senior management and directors with security clearance.¹¹⁴ This committee is tasked with security compliance and must keep the DSS apprised of the company’s level of compliance, changes to security procedures, any failures to comply and subsequent preventative efforts, changes in key officers and directors and the reasons therefore,¹¹⁵ and changes in organizational structure, including impending mergers and acquisitions.¹¹⁶

Operational mitigation can be intrusive.¹¹⁷ After all, economies of scale and scope underlie many business combinations. Yet, a large enterprise will often have to partition off its government contracts into a separate subsidiary and limit the information flow normally essential to effective management¹¹⁸ and enterprise-level synergies¹¹⁹ – to say nothing of adverse

111. NISPOM, *supra* note 36, § 2-303(b)(2) (listing independence requirement for VTA and PA).

112. *Facilities Location Plan*, DEF. SECURITY SERV., <https://perma.cc/329V-U7NU> (last visited Oct. 16, 2017); DEF. SEC. SERV., U.S. DEP’T OF DEF., 19TH ANNUAL FOCI CONFERENCE (Apr. 14, 2015) [hereinafter FOCI CONFERENCE], <http://perma.cc/2H4S-47PR> (last visited Oct. 7, 2017) (“Sharing a service always presents FOCI risk, however unlikely, because any sharing allows the parent/affiliates to have a certain degree of leverage over the cleared company, thereby affecting the company’s independence.”).

113. DEF. SEC. SERV., U.S. DEP’T OF DEF., OUTSIDE DIRECTOR AND PROXY HOLDER TRAINING: MODULE 2: MANAGING FOREIGN OWNERSHIP, CONTROL, OR INFLUENCE (FOCI) MITIGATION 6 (Feb. 2014), https://web.archive.org/web/20170119040444/http://www.dss.mil/documents/isp/OD_PH_Training_Module_2.pdf.

114. NISPOM, *supra* note 36, §§ 2-303(c); 2-306(a). The “senior management officials” are the Facility Security Offer and at least one other individual. 32 C.F.R. § 117.56(b)(6)(i)(A) (2017); Note that the GSC must also include at least two directors who possess of security clearances. DEF. SEC. SERV., U.S. DEP’T OF DEF., SAMPLE SECURITY CONTROL AGREEMENT § 2.2.1 (2006) [hereinafter SAMPLE SCA], http://www.dss.mil/isp/foci/foci_mitigation.html.

115. *E.g.*, DEF. SEC. SERV., U.S. DEP’T OF DEF., SAMPLE SPECIAL SECURITY AGREEMENT § 9.02(d) (2006) [hereinafter SAMPLE SSA], http://www.dss.mil/isp/foci/fo ci_mitigation.html.

116. 32 C.F.R. § 117.56(b)(10)(ii)(E) (2017).

117. One director told me that his \$2 billion firm needed to spend \$30 million to make sure that one of its non-classified contracts did not indirectly undermine its classified contracts. To this, a senior DSS official said, “It would have cost you \$2 billion to be non-compliant.”

118. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Michael C. Jensen & William H. Meckling, *Specific and General Knowledge and Organizational Structure*, 8 J. APPLIED CORP. FIN. (1995); Stewart A. Baker et al., *Navigating Joint CFIOUS and DSS Jurisdiction*, STEPTOE & JOHNSON LLP (Mar. 3, 2015), <https://perma.cc/283P-MW56> (“A common strategy is to designate a cleared subsidiary to perform all work requiring classified information . . . However, [the government] . . . may try to push sensitive non-classified products into the subsidiary.”).

119. FOCI CONFERENCE, *supra* note 112 and accompanying text.

tax consequences.¹²⁰ Some operational restrictions also have important governance consequences. The GSC is in some ways a “shadow board” that operates the company with the government in mind.

Despite the importance of operational mitigation, governance mitigation is potentially more transformative.¹²¹ To understand the drama of national security corporate governance, it helps to focus on the three main character archetypes it introduces: Outside Directors (government representatives), inside directors (foreign investor representatives), and proxy holders (government representatives). Governance mitigation largely consists of increasing the ratio of government representatives to shareholder representatives on the board. If the risk is great enough, the board can consist of *only* government representatives.

1. *Outside Directors*

Complying companies are often required to recruit one or more “outside” directors to the board. An Outside Director “acts on behalf of the US government.”¹²² The mitigation agreement asserts that it preempts any state law fiduciary duties to the company and its shareholders that Outside Directors would otherwise owe.¹²³ Instead, they may satisfy those duties only “in a manner believed to be in the U.S. national interest.”¹²⁴ This mandate differs from the typical charge of a corporate director.¹²⁵ In theory

120. Melvin Rishe, *Foreign Ownership, Control, or Influence: The Implications for United States Companies Performing Defense Contracts*, 20 PUB. CONT. L.J. 143, 170–72 (1990) (describing tax consequences of Voting Trust and Proxy Agreement, including possible loss of consolidated filing).

121. The greater impact of governance mitigation is why I have reserved the term “national security corporate governance” for cases where board-level changes take place. Even if these changes are voluntarily accepted, they are still significant if they impair the performance of the government contract. In some cases, almost no modification to board structure or conduct will be required. A mere board resolution will suffice, affirming the company’s duties and promising that no unauthorized influence or disclosure will flow to the foreign investor. 32 C.F.R. § 117.56(b)(4)(iii)(A) (2017). This article does not address board resolutions directly, and any numerical assertions (except for the number of FOCI agreements per week) about FOCI exclude board resolutions.

122. CTR. FOR DEV. OF SEC. EXCELLENCE, UNDERSTANDING FOCI STUDENT GUIDE mod. 5, at 4 (2016), <https://www.cdse.edu/documents/student-guides/understanding-foci.pdf> (last visited Nov. 18, 2017).

123. DEF. SEC. SERV., INTERNAL SECURITY CONTROL AGREEMENT TEMPLATE § 1.01(f) (2015) (on file with author).

124. *Id.* Accord DEF. SEC. SERV., GUIDELINES FOR TRUSTEES, PROXY HOLDERS AND OUTSIDE DIRECTORS 2 (2009), <https://perma.cc/VHU7-XACV>. (“Outside Directors are expected to represent the national security interests of the United States. The primary responsibility of the OD position is to help ensure that the Facility implements all needed procedures and organizational changes pertaining to the security and safeguarding of classified and export controlled information.”).

125. Waiving the duty of care is not unusual, but conditioning other duties such as loyalty is unusual. Furthermore, many companies indemnify directors, but covered companies push the envelope by advancing all fees and costs of litigation. SAMPLE SSA, *supra* note 115, § 4.02.

at least, directors would be legally bound to pursue a strategy that trivially improved national security even at outrageous expense to the company.

The choice of the Outside Director is up to the investors, but DSS must approve.¹²⁶ Outside Directors must be U.S. citizens with personal security clearances,¹²⁷ and no prior ties to the company.¹²⁸ The individuals selected for an Outside Director role usually possess sterling intelligence or military backgrounds, though some private contractors with compliance experience are also elevated.¹²⁹ Companies think that nominating former admirals and intelligence directors will ensure DSS's approval.¹³⁰

Substantial effort is made to insulate Outside Directors from influence by shareholders. Outside Directors can only be removed from their office with the approval of the DSS, and in conjunction with the selection of a DSS-approved successor.¹³¹ In practice, Outside Directors are never removed from office. DSS is always suspicious that removal requests are an effort to bully a competent and loyal director who merely opposes inappropriate foreign influence. One former senior DSS official stated that a company seeking to remove a director would need to submit a written argument supporting the removal, preferably identifying problems that would impair *both* corporate performance and performance of national security goals, "like literally never showing up to a board meeting." It is then "likely" that DSS would accept the removal from the company. That former official was not aware of any director removal during their five-year tenure.

126. *FOCI FAQs*, DEF. SECURITY SERV., <https://perma.cc/8WFX-4AFA> (last visited Oct. 5, 2017).

127. NISPOM, *supra* note 36, § 2-305(c); 32 C.F.R. § 117.56(b)(6)(iv) (2017). The NISPOM defines personnel security clearance as an "administrative determination that an individual is eligible, from a security point of view, for access to classified information of the same or lower category as the level of the personnel clearance being granted." NISPOM, *supra* note 36, app. C, at C-4. Although newcomers are permitted to obtain security clearance in connection with their ascension to a board seat, it is far quicker and cheaper to select a candidate who already has (or recently had) security clearance. One contact assured me that cleared candidates can expect a \$5,000–500,000 bump in their salary, in recognition of the convenience their clearance affords their employer.

128. DEF. SEC. SERV., U.S. Dep't of Def., Sample Letter to Approved Outside Director Nominee, (2006) (requiring no prior relationship with the corporation or its affiliates), <http://www.dss.mil/documents/foci/OutsideDirectSample.pdf>. Current and former employees are thought to be too concerned with the company's success to represent the government's interests properly. This means that if the company wishes to find candidates within its professional network, it must look a few nodes past the obvious candidates.

129. One Inside Director and industry expert recommended hiring one private-sector defense contractor with facility security experience in addition to any other types of directors on July 14, 2015.

130. Why this should be effective is the subject of later discussion.

131. SAMPLE SCA, *supra* note 114, § 1.2.2(a). There is an exception for illegality or "actual or possible damage to the Corporation," in which case emergency removal is possible. *Id.* § 1.2.2(b).

Three hundred ninety-three companies now provide for Outside Directors, most of which have a majority of Outside Directors.¹³² The number of Outside Directors at each company depends on the degree of foreign investment or influence. Sometimes just one Outside Director will suffice, while at other times, Outside Directors will populate nearly the entire board.¹³³

2. *Inside Directors*

If a foreign investor owns sufficient equity to select one or more directors, then a second character may arrive on the scene: the “inside” director. The inside director is specifically responsible for looking after the interests of the foreign investor. That charge comes with numerous restrictions.¹³⁴ They may not influence the performance of any contracts containing classified information, nor may they access or learn about any classified information. This is true even if the information is crucial to understanding the business risks of the company.

None of these prohibitions turn on the trustworthiness of the inside director themselves. A foreign investor may not, for example, nominate a trusted statesman with active security clearance, even though such a person could not lawfully share secrets with the investor anyway. The investor *must* select an individual without security clearance, who is therefore denied access to core company information. Among directors with different mandates – Outside Directors representing the government, inside directors representing the shareholders – only the former operate with full information. The foreign investor therefore is largely marginalized even

132. FOIA Response, *supra* note 8 (totaling Proxy Agreements, Special Security Agreements, and Security Control Agreements). The number of *firms* subject to SSA mitigation may understate the number of *transactions* covered: “[F]requent acquirers negotiate ‘umbrella’ SSAs, under which trusted foreign defense contractors can place future acquisitions without needing to negotiate a new agreement.” DAVID MARCHICK & EDWARD M. GRAHAM, US NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT 73 (2006).

133. 32 C.F.R. § 117.56(b)(6)(B)(iii) (2017) (at a minimum, the number of Outside Directors must exceed inside directors). When a foreign investor “effectively owns or controls a company” more mitigation, more Outside Directors, and substantially more non-governance mitigation will likely be required. 32 C.F.R. § 117.56(B)(4)(iii)(C)–(D) (2017) (providing for special security, Voting Trust, or Proxy Agreements under these circumstances).

134. For example, inside directors may not serve as chairmen of the board. SAMPLE SSA, *supra* note 115, § 1.01.

when represented on the board.¹³⁵ At present, 317 companies have one or more inside directors.¹³⁶

3. Proxy Holders

Where a foreign investor “effectively owns or controls a company” and the contractor is working on sensitive projects, effective national security corporate governance requires more than simply tinkering with the ratio of inside and Outside Directors.¹³⁷ In those cases, “the foreign owner relinquishes most rights associated with ownership of the company to cleared U.S. citizens approved by DSS.” The investor cedes almost all of her rights as an investor to a slate of “proxy holders.”

These proxy holders vote in the shareholders’ place in nearly every matter.¹³⁸ They elect a slate of directors, which will necessarily include themselves and a few other managers.¹³⁹ The majority shareholder elects none of the directors, except insofar as the shareholder proposed the initial proxy holders.¹⁴⁰

With proxy holders electing the board and filling any replacements, and with proxy members largely populating the board, the directors are no longer accountable to the investors. The proxy holders are “not to accept direction from the Shareholder on any matter . . . and not to permit the Shareholder to exercise any control or influence over the business or

135. In one case, a foreign investor escaped liability for the torts of the contractor, despite being the sole owner of the contractor and despite two members of the parent company’s board serving as inside directors on the contractor’s board. Why? The court cited the mitigation agreement as proof that the parent simply did not have enough influence to be responsible for the subsidiary’s activities. *Alkanani v. Aegis Def. Servs., LLC*, 976 F. Supp. 2d 1, 9 (D.D.C. 2013).

136. FOIA Response, *supra* note 8.

137. Firms subject to a Security Control Agreement may not access “proscribed information,” limiting the project on which they can work. 32 C.F.R. § 2004.5(e) (2017). Special Security Agreements permit a company to service classified contracts, but only after obtaining an additional approval: a “national interest determination” or NID. 32 C.F.R. § 2004.22(c)(3) (2017). Although the process for obtaining a NID has recently been greatly eased, companies continue to perceive NIDs to be a major barrier to success. U.S. DEP’T OF DEF., DTM 15-002, POLICY GUIDANCE FOR THE PROCESSING OF NATIONAL INTEREST DETERMINATIONS (NIDS) IN CONNECTION WITH FOREIGN OWNERSHIP, CONTROL, OR INFLUENCE (FOCI) 5 (2015) (giving DSS a lead role in coordinating other agencies); 32 C.F.R. § 2004.22(c)(3) (2017) (permitting diverse range of NID options). *See also* Chris Griner et. al., *How DOD is Streamlining National Interest Determinations*, LAW360 (Feb. 24, 2015, 10:39 AM), <https://www.law360.com/articles/624507/how-dod-is-streamlining-national-interest-determinations>. Many companies opt for more mitigation than is strictly required as an attractive alternative to pursuing a series of NIDs.

138. SAMPLE PROXY AGREEMENT, *supra* note 2, §§ 7.01, 13.01. However, the shareholders’ approval *is* required for some of the most momentous corporate decisions such as mergers, dissolution, and bankruptcy. *Id.* § 7.03.

139. *Id.* § 3.01.

140. *Id.* § 6.05.

management of the Corporation”¹⁴¹ Even the unclassified portions of classified contracts must be free from any shareholder influence.¹⁴² Like the Outside Directors, proxy holders’ state law fiduciary duties are purportedly preempted.¹⁴³ The goal of a “proxy agreement”¹⁴⁴ is to “effectively exclude the Shareholder . . . from . . . influence over the Corporation’s business or management[.]”¹⁴⁵

To that end, many other prophylactic measures are contemplated. The proxy holders’ salaries, while initially negotiated with the shareholder, are not to vary during their tenure.¹⁴⁶ The shareholders are not allowed to attend any meetings of the proxy holders or board unless a written agenda is submitted to DSS in advance.¹⁴⁷ Likewise, any visits between the shareholders and their company or its representatives must be approved in advance by the proxy holders,¹⁴⁸ and substantial visits must be approved by DSS.¹⁴⁹ Even “strictly social contacts” require written reports,¹⁵⁰ though the proxy holders may consult with the foreign owner, or vice versa, where “consistent with applicable United States laws.”¹⁵¹

Proxy holders enjoy even stronger tenure than Outside Directors.¹⁵² The shareholder cannot fire a proxy holder “except for acts of gross negligence or willful misconduct,” and even then, the shareholder must give DSS twenty days’ notice and secure DSS’s approval for a replacement proxy holder.¹⁵³ Furthermore, there must always be at least two proxy holders, and no removal is effective if it would temporarily reduce the number to just one proxy holder.¹⁵⁴ It is, therefore, impossible for the shareholder to make sweeping changes to ineffective overseers.

141. *Id.* § 3.05(g).

142. FOCI Industry Working Group Meeting, *Meeting Questions with Answers from the Defense Security Service* (Aug. 10, 2011), <https://perma.cc/BG6U-33GB>.

143. SAMPLE PROXY AGREEMENT, *supra* note 2, § 2.05(a).

144. A second insulating option is the Voting Trust Agreement, in which the investors’ shares are put into a trust, which the trustees then vote and manage in a manner much like the Proxy Agreements described here. Once common, Voting Trust Agreements are now essentially unknown. They were motivated in part by tax considerations that are no longer relevant.

145. *Id.* at 4.

146. *Id.* § 3.02.

147. *Id.* § 11.01(a).

148. *Id.* § 11.01(b). Slightly less onerous visit restrictions also apply to a Special Security Agreement company. *Comparison: Special Security Agreement & Proxy Agreement*, DEF. SECURITY SERV., <https://perma.cc/4JKG-BU9X> (last visited Oct. 16, 2017).

149. Generally, visits that exceed thirty consecutive business days or cumulatively exceed two hundred days in a single year require advance DSS approval. *See* DEF. SEC. SERV., *supra* note 113, at 5.

150. SAMPLE PROXY AGREEMENT, *supra* note 2, § 11.01(b).

151. *Id.* § 8.06.

152. For example, proxy holders are indemnified against liability. *Id.* art. IV.

153. *Id.* § 2.02. The proxy holder can also be eliminated with the approval of Department of Defense for a violation of the Proxy Agreement. *Id.* § 2.03.

154. *Id.* § 2.02.

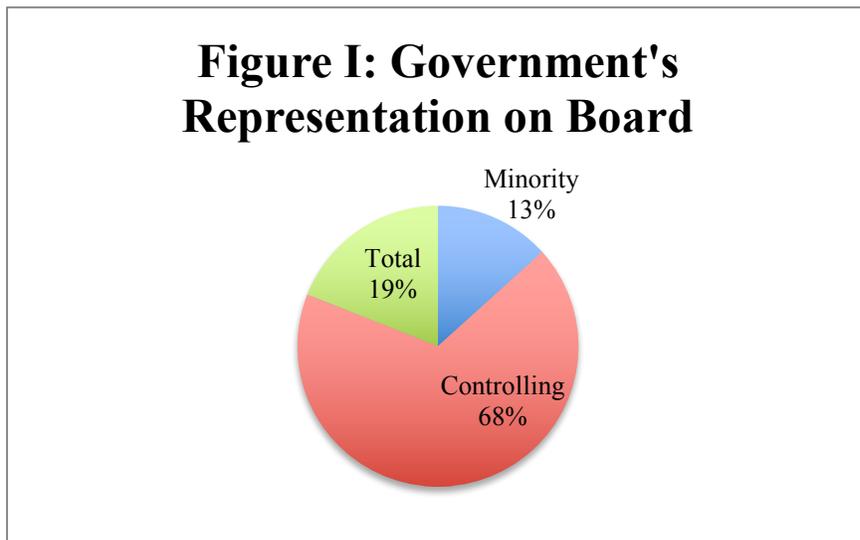
As a general matter, when a proxy holder is evicted, or decides to retire, the remaining proxy holders get to select her replacement.¹⁵⁵ Proxy holders are initially nominated by the shareholder, but they soon become a self-perpetuating and self-directing body.

At present, seventy-six companies operate with proxy holders, or nearly a quarter of the relevant companies.¹⁵⁶

C. Summarizing National Security Corporate Governance

The combination of inside directors, Outside Directors, and proxy holders profoundly restructures corporate governance. Among the almost 400 contractors subject to national security governance, government representatives dominate the board about 90 percent of the time. And in almost a quarter of those cases, the shareholder elects *none* of the board members. Figure I summarizes those results.

157



At some FOCI companies, the foreign investor has no meaningful influence over the board, the directors are vested with durable and self-

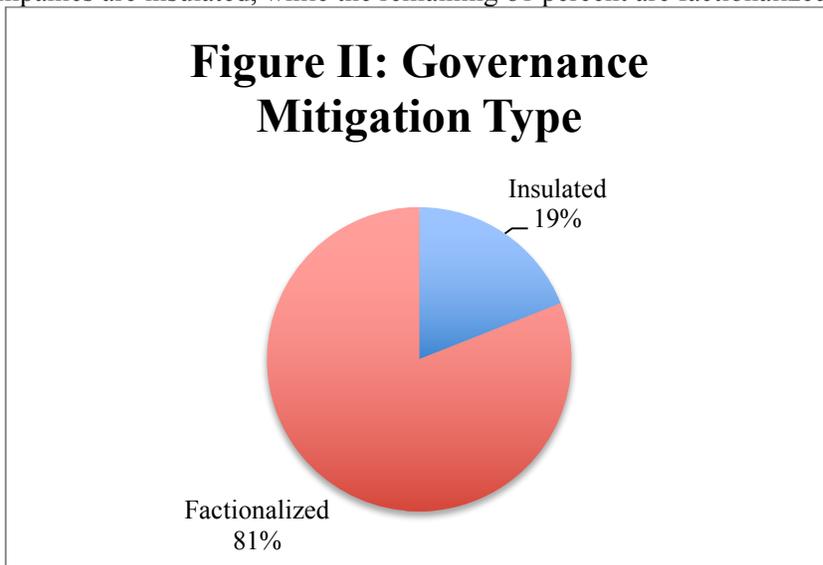
155. *Id.* § 2.05(a). The shareholder can veto nominated replacements, *id.* § 2.05(b), but only three times. *Id.* § 2.05(c).

156. FOIA Response, *supra* note 8.

157. This chart counts the number of FOCI agreements, thereby counting parent or operating companies. This is the figure DSS uses. *See* Hamre, *supra* note 51 (Director Sims counting parent companies). It is a more conservative number, since a large company could have several subsidiaries subject to FOCI mitigation.

perpetuating offices, and fiduciary duties are “preempted.”¹⁵⁸ At others, the board is divided into two or three classes (ordinary, inside and outside), each serving different constituencies and possessing different qualifications, protections, and degrees of knowledge.¹⁵⁹

The former companies may be referred to as “insulated” companies, because as the leadership is insulated from investor influence, and the latter may be called “factionalized” companies, because the board is riven into factions with radically different allegiances and powers. In either case, the government gains board-level influence and information pertinent to the private company’s contribution to national security. Nineteen percent of companies are insulated, while the remaining 81 percent are factionalized.



Particularly with respect to the insulated companies, national security corporate governance represents a striking departure from corporate law’s empowerment of shareholders, particularly with respect to majority- and wholly-owned corporations. While some might argue that publicly held companies never have real accountability for directors to shareholders, firms with substantial blockholding can ordinarily count on meaningful managerial accountability to the shareholders. Mitigating firms are, by definition, ones in which shareholding is concentrated enough to influence management. Entrenched management is therefore unusual in such firms.

158. *Supra* notes 137–56 and accompanying text.

159. *See supra* notes 122–56 and accompanying text.

Moreover, even in publicly held firms, where accountability is sometimes tenuous, the market for corporate control looms as a source of discipline.¹⁶⁰ If directors are incompetent or disloyal, they face the threat of takeover by an acquiring investor. However, national security governed firms are often privately held, making the threat of takeover quite low. Moreover, as is discussed *infra*, even publicly traded firms may be sheltered from the market for corporate control by way of national security corporate governance.

All that is to say that these are meaningful departures from familiar governance patterns. The implications of that – in terms of benefits and costs – requires careful analysis. The following part ventures such analysis by discussing national security corporate governance’s likely impact on managerial accountability and efficiency, security and safety, and accountability and government integrity.

III. NATIONAL SECURITY CORPORATE GOVERNANCE’S COSTS & BENEFITS

Imposing national security protections inside the governance apparatus disrupts the ordering that American corporate law ordinarily prefigures. If this results in higher *ex post* agency costs for the contractor, they may tend to charge more *ex ante*, returning the cost of government regulation back to the government itself.¹⁶¹ Such costs may be worthwhile if compliance and security are ensured. However, the results are far from perfect. Subject firms sometimes deliver commendable inspection results,¹⁶² but failures are also evident.¹⁶³ Regardless of whether security is achieved at a fair price, national security corporate governance also creates opportunities for collusive bargains between industry and government officials. Such rent-seeking is both understandable and undesirable.

This Part analyzes the costs and benefits of national security corporate governance in terms of efficiency, security, and rent-seeking. It contains a mixture of economic analysis and empirical evidence drawn from interviews, among other sources.

160. See generally Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

161. See *infra* notes 260–62 and accompanying text.

162. DEF. SEC. SERV., 2014 DSS VULNERABILITY ASSESSMENT RATING MATRIX: VULNERABILITIES AND NISP ENHANCEMENT CATEGORIES 2 (2014), https://web.archive.org/web/20150915112823/http://www.dss.mil/documents/facility-clearances/Vuln_Assm_Rating_Matrix_2014_Update.pdf (finding that 17 percent of U.S. defense industry facilities were “commendable” in their compliance with federal guidelines for the 2012 fiscal year).

163. It is small solace that if compliance is weak, agency costs may not be as high as once thought.

A. Corporate Governance

Good corporate governance is arguably the principal focus of, and justification for, corporate law. Since Berle and Means decried the managerial firm's bloated inefficiencies, scholars have emphasized accountability to shareholders as a cornerstone of good governance.¹⁶⁴ As realized, corporate law has generally favored a collegial and unified board. Directors may bring different skills to the table, but they are all supposed to serve all shareholders equally, and with equal access to information. These aspects of the typical corporation are thought to conduce to efficient enterprises, and so be of public concern.

National security corporate governance modifies these governance arrangements, and so raises the specter of inefficiency. This section looks at national security corporate governance's impact on board accountability, objectives, and unity. It does so by recounting some of the principal features of orthodox corporate governance wisdom.¹⁶⁵

1. Accountability

Orthodox corporate governance emphasizes managerial accountability to the owners of the firm. Directors do not serve as "platonian masters," and courts are hostile to entrenchment efforts.¹⁶⁶ The fiduciary duty of loyalty is not easily waived.¹⁶⁷ Courts defend the shareholder franchise in strident

164. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

165. Although acquainting readers with these features requires a discussion of their purported utility, it is beyond the scope of this Article to actually consider and defend any single element of corporate orthodoxy. Instead, this Article will note where national security corporate governance departs from orthodoxy and takes for granted that this is presumptively problematic, without exhaustively considering whether alternative governance structures may sometimes be defensible on efficiency grounds. Cf. CHRISTOPHER M. BRUNER, *CORPORATE GOVERNANCE IN THE COMMON-LAW WORLD* (2013) (questioning the descriptive and normative presumption in favor of this "orthodox" corporate governance). Corporate defaults can be modified in numerous ways in America and its rules differ greatly among jurisdictions, so it is no surprise that methods of governance differ. Still, the form of governance created in national security corporate governance is quite a departure.

166. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988). However, incumbent directors may spend company money to campaign in elections, demand for-cause termination provisions, and adopt proportional takeover defense. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 55 (Del. Ch. 2011) ("[T]he power to defeat an inadequate hostile tender offer ultimately lies with the board of directors.").

167. Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 705 (2011); Edward P. Welch & Robert S. Saunders, *Freedom and its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 859 (2008).

terms.¹⁶⁸ At a minimum, the shareholders of the firms should have recourse to the ballot box in order to eject obviously incompetent or disloyal directors¹⁶⁹ and to the courthouse to sue the worst offenders for wrongdoing.¹⁷⁰

Without such accountability mechanisms, the managers may inefficiently slacken their efforts or enrich themselves (or their pet causes) at the expense of the owners.¹⁷¹ Ultimately, firms marshal society's wealth toward projects, and the legitimacy and utility of that arrangement depends on competent managers pursuing productive ends. Empowered shareholders press managers to serve customers, economize scarce resources, or otherwise improve the fit between the corporation's means and ends.¹⁷²

National security corporate governance represents a strong departure for many companies from what would otherwise be the optimal form and level of accountability, from director selection to removal and everything in between.

Directors and proxy holders can only be removed with DSS's consent, which DSS gives very reluctantly, if ever.¹⁷³ Even if DSS ultimately agrees with the company, the time and difficulty of removal should dampen managerial incentives at the margin.

Interviews with industry participants confirm worries about accountability in terms of selection and retention. Interview subjects agreed that proxy holders or Outside Directors often retain their jobs despite poor

168. *Blasius*, 564 A.2d at 659 (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”).

169. Directors can always be removed for cause, and often without any cause. *See, e.g.*, *Campbell v. Loew's, Inc.*, 134 A.2d 852, 858 (Del. Ch. 1957).

170. *See Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 366–67 (Del. 2006). Note that often these suits are derivative in nature. The duty of loyalty is difficult to waive, at least within the corporate form. DEL. CODE ANN. tit. 8, § 102(b)(7) (2017) (barring charter provisions that limit or eliminate the fiduciary duty of loyalty); *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (Del. 1994) (noting that a corporation may not contractually limit a corporate fiduciary's Revlon duties). *See also* DEL. CODE ANN. tit. 6, § 18-1101(c) (2017) (authorizing waiver of duty of loyalty for LLCs).

171. BERLE & MEANS, *supra* note 164. If shareholders know about these problems, they will adjust their willingness to hand over their money. They will impound waste and inefficiency into the price they are willing to pay for shares. No one gets less than they paid for, but each will have been happy to pay more for a better-managed company. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 296 (1980).

172. The proper balance between accountability and discretion remains subject to debate. *Supra* note 11. Managers maintain control over most corporate decisions. Cremers & Sepe, *supra* note 11, at 69 (“American shareholders have . . . only a limited capacity to intervene in corporate affairs.”); DEL. CODE ANN. tit. 8, § 141(a) (2017); MODEL BUS. CORP. ACT § 8.01(b) (Am. Bar Ass'n 2010). The proper balance surely varies by company. Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017).

173. *See supra* note 131 and accompanying text.

performance. One former flag officer did not know how to use a laptop computer. Another had developed an idiosyncratic jargon so opaque that only his long-time personal assistant could translate for him.

National security corporate governance leads to the selection of many former “flag officers,” such as retired admirals and generals. While many flag officers have managed large organizations, few have experience in a business setting. These respected military and intelligence veterans may have seemed like good choices *ex ante* because companies must secure DSS’s approval for any candidate. But years later, the company is stuck with a less than ideal choice. One interview subject stated that companies must think of proxy holders’ nominations as “lifetime appointments.” Companies’ public securities filings sometimes highlight the difficulty of removing a director.¹⁷⁴

To quantify the costs of a lack of accountability, one can only speculate on the basis of public sources. The 1986 bankruptcy of LTV Corporation was, at the time, the largest bankruptcy in U.S. history.¹⁷⁵ Thousands of employees and countless retirees relied on its \$6 billion capitalization for their livelihood, so it is understandable that the bankruptcy judge would want to maximize the chances of survival for the company by ensuring the highest possible value for any divisions to be divested in the bankruptcy proceedings.

LTV Aerospace and Defense Company’s missiles division was one such division. There must have been great relief in April of 1992 when LTV confirmed that it had found a buyer for the missiles division willing to pay the princely sum of \$450 million – nearly 20 percent more than the next best bid.¹⁷⁶ The only problem was that the buyer, Thomson-CSF, was majority owned by the government of France.

After the asset purchase agreement was signed, Thomson met repeatedly with DSS to discuss appropriate national security corporate governance. Designing missiles required LTV to access communications security (COMSEC) information and other categories of sensitive information,¹⁷⁷ and Thomson knew that national security corporate governance would be required in order to maintain the subsidiary’s clearance and contracts. However, Thomson expected, given the severability of the proscribed data

174. Allison Transmission Holdings, Inc., Amendment No. 8 to Registration Statement (Form S-1) (Mar. 12, 2012) (disclosing barriers to removing an Outside Director).

175. Thomas C. Hayes, *LTV Corp. Files for Bankruptcy; Debt is \$4 Billion*, N.Y. TIMES, July 18, 1986, at D4.

176. Better still, the buyer’s bid came paired with a very attractive offer from an allied firm willing to buy the aircraft division. *In re Chateaugay Corp.*, 186 B.R. 561, 573 (Bankr. S.D.N.Y. 1995), *order aff’d*, 198 B.R. 848 (S.D.N.Y. 1996), *aff’d*, 108 F.3d 1369 (2d Cir. 1997).

177. *Id.* at 569.

from the rest of the project, and given the close ties between France and America—NATO allies—that a special security agreement (SSA) would suffice. That is, Thomson expected and was willing to accept a factionalizing governance mitigation in which it would elect only a few inside directors despite owning all the shares. However, DSS pushed for the use of a proxy agreement to completely insulate the company from French influence, allowing Thomson zero directors.

Thomson thought that game was not worth the candle. It wished to have some say in the compensation and retention of the missiles division's CEO, and it wanted the right to approve budgets, and mergers and acquisitions.¹⁷⁸

Thomson backed out of the deal, and LTV had to scramble for other suitors. The next highest offer came from Marietta & Lockheed, which jointly offered only \$385 million, despite the bankruptcy judge's repeated urging that they raise the bid.¹⁷⁹ National security corporate governance drove at least a \$65 million wedge—about 15 percent of the division's entire value—between what the most interested buyer would have paid and what the estate actually received.¹⁸⁰

While the scale and timing of Thomson's disappointment may be unusual, it is not unusual for parties to agree that national security corporate governance is a key deal term. Merger and acquisition agreements frequently discuss FOCI mitigation, committing the parties to seek one sort of national security corporate governance and scuttling the deal if DSS demands more.¹⁸¹ Cancelled deals represent lower returns to selling shareholders and lost chances for the customer to enjoy efficient production.

178. *Id.* at 573. Note that even the most severe national security corporate governance ordinarily affords the shareholder veto power over mergers and acquisitions (M&A). Perhaps Thomson wished to have the right to *initiate* M&A for its subsidiary, or perhaps it was not satisfied with the degree of veto power then available.

179. Matthew D. Riven, *The Attempted Takeover of LTV by Thomson: Should the United States Regulate Inward Investment by Foreign State-Owned Enterprises?*, 7 EMORY INT'L L. REV. 759, 761 (1993).

180. The difference is even starker if a reverse-breakup fee is considered. Thomson had promised \$20 million to LTV in the event that Thomson failed to close on the deal (plus any legal fees and minus whatever chance those legal fees helped Thomson to avoid the breakup fee). Thomson should have been willing to pay \$20 million more than others even if national security corporate governance destroyed all synergies of the merger. That means the wedge was closer to \$85 million, or 22 percent of the total deal value, and the cost difference between a factionalizing mitigation and an insulating mitigation must have appeared to exceed 6 percent of the deal value.

Of course, this high difference in price can also be a sign that Thomson had illicit motives in the purchase. If it planned to share U.S. military secrets with France or others, it might have been willing to pay more than others on that basis.

181. *See, e.g.*, Glob. Def. & Nat'l Sec. Holdings, LLC, Stock Purchase Agreement § 6.7(d) (2015), <https://perma.cc/5KJE-GKD9>.

Countless other bids are surely never made because the bidder knows what problems they will face.¹⁸²

Parties' decisions to abandon acquisitions if confronted with burdensome national security corporate governance is both a social cost, and a cause of other costs. Like any barrier to the market for corporate control, national security corporate governance gives extra slack to managers.¹⁸³ There are indications that companies sometimes hoist the flag of endangered security clearance defensively, in order to frustrate hostile acquisitions. For example, one of the world's largest ink and dye producers attempted to keep a Japanese purchaser at bay by citing concern for mounting FOCI mitigation burdens.¹⁸⁴ Another fiduciary duty lawsuit recently alleged that management had *preferred* a white-knight foreign purchaser because they liked the idea of an absentee owner, who could not take an active role in management and who could not readily fire the existing managers.¹⁸⁵

182. Cf. Robert T. Miller, *Inefficient Results in the Market for Corporate Control: Highest Bidders, Highest-Value Users, and Socially Optimal Owners*, 39 J. CORP. L. 71, 123 (2013); Paul Connell & Tian Huang, Note, *An Empirical Analysis of CFIUS: Examining Foreign Investment Regulation in the United States*, 39 YALE J. INT'L L. 131 (2014). W. Robert Shearer, Comment, *The Exon-Florio Amendment: Protectionist Legislation Susceptible to Abuse*, 30 HOUS. L. REV. 1729, 1735 (1993) ("While Exon-Florio ostensibly serves the legitimate purpose of helping to protect U.S. national security, its vague parameters and elastic provisions create a potent protectionist weapon that virtually invites abuse."); Christopher S. Kulander, *Intruder Alert! Running the Regulatory Gauntlet To Purchase, Own, and Operate American Energy and Mineral Assets by Foreign Entities*, 46 TEX. TECH L. REV. 995 (2014); Jim Mendenhall, *United States: Executive Authority to Divest Acquisitions Under the Exon-Florio Amendment—The Mamco Divestiture*, 32 HARV. INT'L L.J. 227, 286, 290–93 (1991); Margaret L. Merrill, *Overcoming CFIUS Jitters: A Practical Guide for Understanding the Committee on Foreign Investment in the United States*, 30 QUINNIAC L. REV. 1 (2011); Jose E. Alvarez, *Political Protectionism and United States International Investment Obligations in Conflict: The Hazards of Exon-Florio*, 30 VA. J. INT'L L. 1, 149–50 (1989).

183. On the better known defensive uses of CFIUS, see generally ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS § 11.04 (7th ed. 2015). See also Merrill, *supra* note 182, at 37.

184. Sun Chem. Corp. v. Dainippon Ink & Chems., Inc., 635 F. Supp. 1417, 1422 (S.D.N.Y. 1986) ("Sun contends that any increase in Dainippon's stock ownership above the 4.9% it now holds would cause the loss of Kollman's classified military instrumentation business . . ."); see also Amy Butler Washington et al., *Balancing Act*, AVIATION WK. & SPACE TECH., Oct. 1, 2012, at 32 ("BAE Systems executives believe any threat from the merger to its Special Security Agreement (SSA) with the U.S. government would be a "deal breaker," says an industry official close to the talks. Each SSA is tailored to the specific business of a particular company.")

185. Scheidt v. DRS Techs., Inc., 36 A.3d 1082, 1090 (N.J. Super. Ct. App. Div. 2012). The court rejected plaintiff's argument, concluding that NISPOM actually requires Outside Directors have no prior involvement with the company, and so the foreign purchaser would be *bad* for the incumbents. See *id.* at 1091 n.10. It is true that the current board could probably not retain its job, but the current executives could probably serve as managers still, and could avoid serious scrutiny, since all governance would break down in the company. Insofar as board members were also executives, they would indeed have self-serving reasons to seek an appropriate foreign buyer.

2. Shareholder-Centrism

It is generally agreed that shareholders are the appropriate object of managerial concern, and that they are properly regarded as the sole “owners” to whom directors owe duties and are electorally accountable.¹⁸⁶ There are good economic reasons for this perspective. Shareholders are risk bearers and residual claimants;¹⁸⁷ it is particularly hard for them to completely protect themselves by clear contract terms alone since literally every business choice affects them.¹⁸⁸ Furthermore, their capital is locked in forever.¹⁸⁹ That means that they cannot protect themselves by breaking off business ties if exploited as can, say, employees.¹⁹⁰ Finally, equity investors are also a relatively homogeneous group, mostly united in their goal of absolute financial return, which lowers their relative “cost of ownership.”¹⁹¹

In factionalized firms, control is shared between the shareholders and the customer, because the mitigation agreement grants board seats both to the

186. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law* 10 (Ctr. for Law, Econ. & Bus., Discussion Paper No. 280, 2000), http://www.law.harvard.edu/programs/olin_center/papers/pdf/280.pdf (“as a consequence of both logic and experience, there is convergence on a consensus that the best means to this end—the pursuit of aggregate social welfare—is to make corporate managers strongly accountable to shareholder interests”); *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). *But see* Randall S. Thomas & Paul H. Edelman, *The Theory and Practice of Corporate Voting at U.S. Public Companies*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 459 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (problematizing ownership).

187. FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 68 (1991). They also happen to be good risk bearers because they can diversify their risks. It is easier to own shares in 1,000 companies than to shop at 1,000 co-op grocery stores or to work at 1,000 labor-owned factories.

188. *E.g.*, Williamson, *supra* note 12 (arguing against directorial representation for other constituencies). Although no one can predict the future, shareholders face the hardest challenges in telling managers up front how they would want the company run; they need to have some power to continue to direct the managers toward good projects in a changing world. *But see* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Sepe, *supra* note 12; Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 440 (1986). Each of these authors argues that other parties face incomplete contracts and residual claims, undermining the notion of “ownership.” Edelman and Thomas attempt to strike a balance between the orthodox position and these critics by arguing that only equity investors care about share price, and that share price is influenced by all factors. Thomas & Edelman, *supra* note 186.

189. Capital lock-in is one of the great contributions of modern corporate law. *See generally* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976) (discussing the liability of shareholders compared to creditors).

190. *See e.g.*, Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990) (arguing that control rights are located at the point most subject to inefficient hold up).

191. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996). Other patrons of the firm, such as employees and customers, have conflicting goals and may waste resources fighting to secure their goals.

investor and to government representatives. When either the shareholder or the government expends efforts to lobby the board to take a certain decision, those lobbying efforts are potentially wasteful.

While the cost of politics drops when firms become fully insulated, other costs grow. Proxy holders representing the government-customer now control a firm that they do not own, and they may opt to expropriate assets from the investor or impose inefficient behaviors that it would never have been willing to buy through a clear *ex ante* deal. For example, government representatives might cause the company to marginally increase the quality of a product or the security surrounding the production at a riotously large cost, since the government enjoys the benefit without directly paying the cost. Or the board might cause the company to break off profitable business with another nation in order to trivially improve security for the government. The shareholders, in contrast, will be understandably reluctant to accept residual claims if they have little influence over their sign and magnitude, and they may account for all of this *ex ante* in the price that they quote the government.

3. Unity

Governance orthodoxy and corporate law have generally favored a version of directorial unity: the board *as a whole* should be accountable to the shareholders *as a whole*,¹⁹² rather than some narrower constituency.¹⁹³

192. Directorial role can be likened to representative role. See Andrew Verstein, *Trustee or Delegate? Understanding Representation To Illuminate Shareholder Governance and Regulatory Change*, 9 EUR. CO. & FIN. L. REV. 74 (2012). The constituency director model is akin to a Madisonian delegate and the unity model is akin to the Burkean trustee.

193. David M. Morris et al., *Designated Directors and Designating Investors: Early Planning is Key*, CORP. GOVERNANCE ADVISOR, May/June 2008, at 5 (“Under New York and Delaware law, designated directors (also known as ‘representative’ or ‘constituency’ directors) have the same fiduciary duties as other directors to the corporations on whose board they serve.”). See also *Williamson v. Cox Commc’ns, Inc.*, No. Civ.A. 1663-N, 2006 WL 1586375, at *4 n.49 (Del. Ch. June 5, 2006) (“As directors . . . the individual defendants owed fiduciary duties to the Company.”); 1 R. FRANKLIN BALOTTI & JOSEPH A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS*, § 4.16 [E][2] (3d ed. 2003 & Supp. 2008) (“[T]he duties of directors designated by large stockholders are clear: under Weinberger, they still owe the corporation and its shareholders an uncompromising duty of loyalty.”); 1 EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW*, § 141.2.1.7 (5th ed. 2006) (“[T]he law does not recognize a special duty on the part of directors elected by a special class to the class electing them. Rather, the law demands directors’ fidelity toward the corporation and all its shareholders.”); cf. *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) (“[I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director.”), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *In re Trados Inc. S’holder Litig.*, Civil Action No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

Divisions among directors can raise the cost of consensus in what is intended to be a collegial and collaborative decision, since some directors may be affiliation-bound to support only certain lines of inquiry.

One place unity makes a difference is in terms of information flows. If some directors smuggle secrets to their patrons while concealing from the board some salient information gleaned from those same patrons, other directors may be disinclined to speak freely in the no longer honest and candid boardroom.¹⁹⁴ Thus the law typically recognizes that each “director has independent fiduciary duties to the corporation and all of its shareholders, which duties are usually understood to include a duty to maintain the confidences of the corporation.”¹⁹⁵ A director cannot disclose corporate information to just the shareholder patron who nominated her, nor are they to deprive the company of salient information derived from that patron.¹⁹⁶ The board may divide into committees, and individual board members may opt to leave the room when conflicted as to a particular transaction, but directors themselves are not arranged into classes, some of whom are systematically uninformed.¹⁹⁷

Factional mitigation agreements explicitly define classes of constituency directors – those who represent the shareholder, and those who represent the

Some have discussed unity as unrealistic. Stephen M. Bainbridge, *Reforming LIBOR: Wheatley Versus the Alternatives*, 9 N.Y.U. J.L. & BUS. 789 (2013). See also Janet E. Kerr, *The Financial Meltdown of 2008 and the Government's Intervention: Much Needed Relief or Major Erosion of American Corporate Law? The Continuing Story of Bank of America, Citigroup, and General Motors*, 85 ST. JOHN'S L. REV. 49, 92 (2011) (“[C]onstituency directors’ or ‘representative directors’ . . . may feel a responsibility to serve the constituency that helped them obtain their position.”); cf. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 287–90 (2003) (investigating a sample of 119 startups, finding venture capitalist investors get a seat on the board of directors in almost half of startups and board control in about 25 percent).

Others have attacked unity as inefficient. *E.g.*, Sepe, *supra* note 12, at 312; see also Martin Gelter & Genevieve Helleringer, *Lift Not the Painted Veil! To Whom Are Directors’ Duties Really Owed?*, 2015 U. ILL. L. REV. 1069 (2015).

194. See Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246 (2017) (discussing tensions related to information sharing).

195. See ABA COMMITTEE ON CORP. LAWS, *CORPORATE DIRECTOR'S GUIDEBOOK* 26–27 (5th ed. 2007).

196. Morris et al., *supra* note 193 (“In connection with an issue before the board directors have a duty to bring all of their knowledge and skill to bear. This includes a duty to disclose all material information known to the director relevant to the issue before the board.”); ABA COMMITTEE ON CORP. LAWS, *supra* note 195, at 21.

197. AM. LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* §3.03(a) (2017) (“Every director has the right . . . to inspect and copy all books, records, and documents of every kind, and to inspect the physical properties, of the corporation and of its subsidiaries, domestic or foreign, at any reasonable time, in person or by any attorney or other agent.”); *Kalisman v. Friedman*, C.A. No. 8447-VCL, 2013 WL 1668205, at *3 (Del. Ch. Apr. 17, 2013) (directors’ access to corporate information “essentially unfettered in nature”); *Kortum v. Webasto Sunroofs, Inc.*, 769 A.2d 113, 118 (Del. Ch. 2000) (director’s request for information presumed valid).

government. These divisions are supplemented by differences in the powers and information held by the different classes. Inside directors are not permitted access to any sensitive information. This is so even if the shareholder is willing to nominate trusted former statesmen already cleared to handle the nation's secrets. As a result, national security corporate governance ensures information blockages and asymmetries within the board.

There are also differences in information outflows. The GSC, composed of the Outside Directors and cleared officers, meets at least annually with DSS to provide extensive disclosure about the company's compliance and any plans that could influence compliance. This may increase the risk of company secrets being leaked to competitors, or might make boardroom conversations less candid. Most mitigation agreements substantially curtail directorial unity, plausibly leading to inefficiency.

Theory and anecdote suggest that national security corporate governance frustrates efficient governance systems. Someone bears the cost, and it may be the government.¹⁹⁸ Is there a systematic way that the government can determine whether the national security benefits of national security corporate governance are worth the cost? The answer will depend in part on how much these agreements improve security, the subject of the next section.

B. National Security

How well does national security corporate governance do in improving security? The answer is far from certain. There are some good signs in terms of security compliance at affected firms, but there are also ample examples of security lapses. It is impossible to conclude that national security corporate governance is useless, but it is equally impossible to decide that the government is getting its money's worth from the program.

On the positive side, DSS reports that complying companies have similar inspection results as compared to other government contractors, even though they presumably face greater risks.¹⁹⁹ However, it is unclear how much of this success results from FOCI's governance mitigations, and how much results from operational changes or other forms of oversight. Most FOCI firms are observed much more closely than similarly situated

198. *Infra* note 260 and accompanying text.

199. *Compare* DEF. SEC. SERV., *supra* note 162 (finding 17 percent of U.S. defense industry facilities were "commendable" in their compliance with federal guidelines for fiscal year 2012), *with* FOIA Response, *supra* note 8, at encl. 2 (reporting 19.05 percent "commendable" for FOCI companies in fiscal year 2014).

domestic firms and have numerous meetings with Government Security Committees and annual inspections. It is possible that close government scrutiny of covered firms, and not governance modification, is doing the work. A selection bias may also be at work: national security corporate governance may be cheapest to firms that – for whatever other reason – already have robust security commitments. We would expect those firms to have performed well even if national security corporate governance were a placebo.

And compliance is often less than perfect.²⁰⁰ One lesson from the corporate governance literature is that formal insulation from shareholder control may not be sufficient to actually constrain shareholder control.²⁰¹ In many cases, the gravitational pull toward shareholder interests is inexorable, and directors may find themselves in their investors’ sway – no matter how strongly admonished to disregard such influence, and no matter how many barriers are put into place.²⁰² If some shareholders use this influence to extract secrets, then the results will be worrisome.

Outside Directors may be difficult to remove, but the foreign investor gets to nominate the initial batch of directors or proxy holders, and they are presumably adept at vetting candidates for their responsiveness to the investors’ objectives. Nor can a director costlessly abandon her patron once actually installed on the board. Many directors would happily serve on *several* boards, collecting several sets of fees as welcome retirement income. In the incestuous world of intelligence work, directors could quickly develop a reputation for being uncooperative and miss out on nominations to lucrative future gigs.

Sometimes, investors may tighten the reins over directors by implementing compensation policies that are actually at odds with national security corporate governance procedures. For example, a Government Accountability Office (GAO) report—pointedly titled “DOD Cannot Ensure Its Oversight of Contractors under Foreign Influence Is Sufficient”—found one proxy holder running a consulting company that does

200. See U.S. DEP’T OF DEF., BIENNIAL REPORT TO CONGRESS ON IMPROVING INDUSTRIAL SECURITY (2011) (finding that 1.7 percent of its FOCI companies deserved a “marginal” or “unsatisfactory” security ranking, compared to 0.7 percent of non-FOCI companies).

201. E.W. Thomas, *The Role of Nominee Directors and the Liability of Their Appointors*, in CORPORATE GOVERNANCE AND THE DUTIES OF COMPANY DIRECTORS 148, 150 (Ian Ramsay ed., 1997) (describing “[l]oyalty inspired by selection, and confirmed by the confidence which the appointors repose in their nominees”).

202. See Gilson & Milhaupt, *supra* note 46, at 1365–66 (describing techniques by which foreign investors can influence a company, even once stripped of voting rights).

substantial business with the foreign investor.²⁰³ Another company hired one proxy holder as its CEO, paying him an executive salary almost six times as large as his stipend as a proxy holder. Although in violation of the proxy agreement, DSS did not immediately notice the conflict. The GAO noted that even “[a]fter DSS became aware of this relationship . . . the individual has remained as a proxy holder.”²⁰⁴

One key mechanism implemented to ensure Outside Directors’ devotion to national security, the military and government pedigree, can sometimes serve to endanger national security. The cultures of military and intelligence work may incline current and former government officials to place outsized trust in former government officials. The parent company will often also employ a bevy of respected flag officers. Thus, even if the directors of the contractor subsidiary are formally independent of the parent, their social and learned orientations may lead them to excessively defer to the influence of the parent. Likewise, DSS officials may themselves be drawn to trust former DSS and DOD agents now ensconced as directors of FOCI firms.

Similarly, Outside Directors, those chosen in connection with DSS, are all outsiders to the company. None are past or present employees or investors in the firm. Of course, this professional independence is intended to instill independence of judgment. But research on “independent directors” in traditional public companies has given mixed results even in ordinary companies with no connection to national security corporate governance.²⁰⁵ Lacking firsthand knowledge of the company, Outside Directors may be slow to discover latent security risks or contradict management’s assurances. Thus, their counterbalancing force could be quite weak. And if the managers identify with the foreign investor, the Outside Directors may end up echoing the very perspectives they were meant to check.

Many Outside Directors do not enter the board with a professional background one would predict would be useful in checking management. Though most are former government officials, some enter with a

203. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-681, INDUSTRIAL SECURITY: DOD CANNOT ENSURE ITS OVERSIGHT OF CONTRACTORS UNDER FOREIGN INFLUENCE IS SUFFICIENT (2005), <http://www.gao.gov/new.items/d05681.pdf>.

204. U.S. GEN. ACCOUNTING OFFICE, GAO/NSIAD-96-94, DEFENSE INDUSTRIAL SECURITY: WEAKNESSES IN U.S. SECURITY ARRANGEMENTS WITH FOREIGN-OWNED DEFENSE CONTRACTORS (1996), <http://www.gao.gov/assets/160/155356.pdf>. There is little public information about security lapses, and so it is not possible to learn whether lapses result from incompetence, corruption, concerted effort, or good-faith screw-ups.

205. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529–33 (2005) (reviewing empirical studies showing limitations on Outside Director effectiveness).

background in corporate security services; succeeding in that career path involves helping executives to minimize the burdens of national security corporate governance, and may dispose the Outside Director to facilitating the management's vision for the company rather than the government's.

All this would be less worrisome if DSS could effectively monitor and evaluate subject firms, but its ability to do so has been repeatedly questioned. In 2005, the GAO wrote a report critical of DSS's ability to ensure compliance.²⁰⁶ As of 2011, DSS claims to be in full compliance with the GAO's recommendations,²⁰⁷ though it would be wrong to end the story there. That same year, DSS's director told his staff, "We have been remiss in our fundamental oversight responsibilities to the Department and the U.S. Government," and that it was still necessary to "understand [the] culture of failed leadership, lack of accountability and failure to communicate."²⁰⁸ As recently as June of 2014, the DOD inspector general reported that DOD currently has "a cumbersome and inefficient process to verify, track, and manage relevant contractor documentation."²⁰⁹ DOD had no central database for Form 254 (a critical document describing the classification level for a contract) and relevant documentation, and so it could not share database access with other government offices.

Not only *could* DSS sometimes miss important compliance breaches under these circumstances, it appears to have done so on some occasions. One high-profile event concerned development of the F-35 Joint Strike Fighter. Beset by delays and cost overruns, the project's cost may reach \$200 million per plane,²¹⁰ so it would be a shame if the security of the "the most expensive weapons system ever developed,"²¹¹ were compromised by early and unauthorized foreign control over crucial steps in design and production. Yet, this is what some fear has already occurred. One major vendor to the project, BAE, operated under a national security corporate

206. U.S. GEN. ACCOUNTING OFFICE, *supra* note 48.

207. Schwellenbach, *supra* note 19.

208. Nick Schwellenbach, *DSS Director: Defense Security Service "Remiss" in "Fundamental Oversight Responsibilities,"* PROJECT ON GOV'T OVERSIGHT BLOG (Feb. 23, 2011), <https://perma.cc/RXD4-CV7J> (alteration in original).

209. INSPECTOR GEN., U.S. DEP'T OF DEF., REP. NO. DODIG-2014-080, ASSESSMENT OF DoD PROCESSES IN SUPPORT OF COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) DETERMINATIONS AND FOREIGN OWNERSHIP, CONTROL, OR INFLUENCE (FOCI) MITIGATION (2014), <https://fas.org/sgp/othergov/dod/cfius.pdf>.

210. The present monetary estimate to build the 2,457 planes is \$400 billion, up \$200 billion from three years ago. Christian Davenport, *Air Force Grounds 15 F-35 Joint Strike Fighters Because of 'Peeling and Crumbling' Insulation*, WASH. POST (Sept. 16, 2016), <https://perma.cc/2EN7-WUMG>. After construction is done, maintenance and operation costs will add another \$1 trillion, raising the per-plane cost to almost \$600 million. Adam Ciralsky, *Will It Fly?*, VANITY FAIR (Sept. 16, 2013, 12:00 AM), <https://perma.cc/8XU9-PQ4A>.

211. Ciralsky, *supra* note 210.

governance regime that required frequent and detailed disclosures to DSS. Instead, BAE withheld security reports from the U.S. government *for two years*, by falsely asserting that the audit reports were somehow “privileged.”²¹²

Even if national security corporate governance were implemented without any problems, we may still worry that it is sometimes used where stronger measures, such as terminating a contractor, should actually be required. Suppose that a contractor takes on an utterly unacceptable foreign investor, such that sober analysis would suggest that the contractor can no longer be trusted with vital secrets. Still, defense officials have already built a relationship with the contractor or determined that the contractor provides the best product, so it is understandable that they might embrace national security corporate governance as a way to preserve the status quo.²¹³

The GAO found just that phenomenon: “Security officials from the military services told us that their contracting officers are often reluctant to terminate ongoing contracts and therefore tend to propose National Interest Determinations to retain the contractor's services, without always attempting to find other U.S.-owned suppliers.”²¹⁴ Just as officials may demand national security corporate governance without proper regard for costs to the contractor, they may accept national security corporate governance even when national security corporate governance cannot succeed. This is similar to the alien property Custodian's decision to keep potentially traitorous directors on the boards of companies deemed important to the war.²¹⁵

With any large program, occasional lapses must be expected, so it is not possible to conclude that DSS fails more than other agencies. Nor, given the information available, is it possible to conclude that national security corporate governance's failures are too costly or readily preventable. However, there are reasons to reject a story that national security corporate governance's costs result in a decisively safer contracting program.

C. Government Independence and Integrity

Government power over enterprise always permits a degree of rent-seeking (or, in ordinary language, “corruption”), and lucrative government

212. Dana Hedgpeth, *Security of F-35 Jet Secrets Questioned*, WASH. POST, May 2, 2008, <https://perma.cc/3SGR-7Y75>.

213. Cf. Merton J. Peck & Frederick M. Scherer, *The Weapons Acquisition Process: An Economic Analysis*, 71 J. Pol. Econ. 302 (1963) (explaining that ex post accountability in the defense sector is hampered by a desire to preserve ex ante robust competition).

214. See H. Comm. on Armed Servs., *supra* note 107.

215. See *supra* notes 66–74 and accompanying text.

contracts tempt businesses to cultivate government decision makers.²¹⁶ Contemporary national security corporate governance is no different. The national security corporate governance regime arose in the vacuum left by the problematic alien property Custodian regime, and so we must be sensitive to it potentially facing similar temptations.²¹⁷

The Outside Directors of FOCI firms tend to be retired military officers and intelligence officers. Many are former officials at DSS.²¹⁸ Much of the potential inefficiency in national security corporate governance amounts to pressure to hire and retain candidates acceptable to the government. Some view the FOCI program as a retirement subsidy, from industry to client, for officials whose careers involved industry oversight and procurement. Outside Director roles are “highly sought after.”²¹⁹ Most pay a modest five-figure stipend,²²⁰ though some directorships may pay \$200,000,²²¹ and celebrity Outside Directors may have commanded far more.²²² The work commitment of board membership is quite modest in many cases, at least for the best organized of Outside Directors.²²³ As a result, it is quite common for an Outside Director to serve on several boards, with some serving on ten or more boards.

A long literature establishes the business prospects firms enjoy by hiring government officials.²²⁴ The hire can be quid-pro-quo corruption, the tactical hire of an official with the skills and relationships necessary to lobby former colleagues, or simply a demonstration of commitment and solidarity

216. Several prominent participants in the DSS program of national security corporate governance are also prominent violators of the Foreign Corrupt Practices Act, having paid large fines to settle charges that they bribed foreign governments in exchange for contracts or privileges. *See, e.g.*, Roger M. Witten et al., *Siemens Agrees to Record-Setting \$800 Million in FCPA Penalties*, WILMERHALE (Dec. 22, 2008), <https://perma.cc/TJ6H-N4JY>; Press Release, Dep’t of Justice, BAE Systems PLC Pleads Guilty and Ordered To Pay \$400 Million Criminal Fine (Mar. 1, 2010), <https://perma.cc/3LPT-K7RC>.

217. *See supra* Section I.B.

218. For example, one recent Director of DSS now serves on three boards.

219. Interview with former DSS official (Aug 19, 2015).

220. Interview with national security governance consultant (July 14, 2015). *See also* U.S. GEN. ACCOUNTING OFFICE, *supra* note 204.

221. Interview with former DSS official (June 25, 2015).

222. Michael Chertoff, former Secretary of Homeland Security, serves as chairman of the board of BAE Systems, where his compensation is likely quite high. Press Release, BAE Systems, The Honorable Michael Chertoff Elected Chairman of BAE Systems, Inc. Board of Directors (Apr. 18, 2012), <https://perma.cc/5Q3H-7PX2>.

223. A 1996 GAO report discussed a director being paid \$50,000 for eight days’ work per year. U.S. GEN. ACCOUNTING OFFICE, *supra* note 204, at 39.

224. Mehmet I. Canayaz, Jose V. Martinez & Han N. Ozsoylev, *Is the Revolving Door of Washington a Back Door to Excess Corporate Returns?* 3 (Econ. Research Forum, Working Paper No. 1507, 2015) (finding 7.43 percent better return to firms that will soon hire a government official); Mara Faccio, *Politically Connected Firms*, 96 AM. ECON. REV. 369 (2006).

with the bureaucracy.²²⁵ On this interpretation, national security corporate governance may be localized on foreign-owned firms precisely because they may lack the understanding and incentives to play the hiring game correctly.²²⁶

Given the disparity between private-sector salaries versus those available in civil and military service, and given the sums of money with which government actors are entrusted, it would be surprising if there were no mechanisms by which they can capture rents. In this respect DSS national security corporate governance appointments resemble another area of remunerated corporate oversight, provided by former government officials: corporate board monitorships.²²⁷ As Brandon Garrett and others have documented, large corporations are rarely convicted of crimes.²²⁸ Instead, culpable firms make promises, such as to hire a trusted outsider to watch over the company for a few years. Like a contractor appointing an Outside Director to mitigate foreign influence, these defendants hire a “monitor” to mitigate criminal influence – the key difference is that corporate compliance monitors are installed after law breaking, while Outside Directors are installed before any form of law breaking.²²⁹

225. Even without the requirement of FOCI mitigation, many firms might be wise to hire similar officials, for similar corporate jobs, with similar job security. And many in fact do so. National security corporate governance is arguably an intensification of choices companies would make even without mandate.

226. There is not always a direct feedback between hiring an official and being awarded a lucrative contract. Nor, from the perspective of the contracting agent, is there a direct link between awarding the contract and the firm hiring more former bureaucrats. Fully domestic firms are repeat players with reason to invest in long-term reputations for being appreciative and generous, but foreign entrants may have difficulty assuring their clients that they will reciprocate with appropriate hiring. A foreign firm might never hire government officials, or employ them only for the duration of a single project, especially if they return their focus to the primary market. This risk is even higher because so many firms find the American version of the revolving-door confusing and different from domestic practices.

Under this interpretation, the lack of business credentials and unparalleled job security of the FOCI boards is a feature, not a bug. It allows the foreign firm to render credible its participation in the domestic norms of reciprocity. Foreign firms are forced to do what domestic firms would do naturally – reward bureaucrats for favorable treatment in obtaining and servicing contracts.

For this thought, I thank Itai Feigenbau, lecturer from Tel Aviv University.

227. There are, of course, important differences between FOCI mitigation & national security corporate governance and monitorships. The latter is used for culpable firms, whereas a FOCI firm’s only crime is one of national or investor origin. But there are similarities too. Both are motivated by the worry that external regulation alone may fail to secure compliance with the law by a high-risk firm. Both are semi-contractual governance changes that can be quite inconvenient if the government’s representative takes an active role.

228. *Supra* note 16.

229. Interestingly, the preemptive installation of inside directors allows them to serve compliance functions unavailable to monitors, such as the gatekeeper function. *Cf.* Root, *supra* note 16, at 526 (arguing that monitors are unable to lend reputational capital, to certify that a corporation is compliant, because they arrive too late at the firm). *See also* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006) (describing the gatekeeper function). By arriving before

A corporate compliance monitor will tend to be a former prosecutor – often a friend of the prosecutor negotiating the agreement.²³⁰ For example, then-U.S. Attorney Chris Christie famously demanded that a defendant company hire former Attorney General John Ashcroft to its board as a monitor and pay him at least \$1.5 million per month.²³¹

Concerns about cozy corporate monitorships led to Congressional hearings and a policy memorandum by the Acting Deputy Attorney General. The result was a professionalizing of the monitor selection process. Now, the relevant prosecutors “may not make, accept, or veto the selection of monitor candidates unilaterally.”²³² Instead, monitor candidates are considered by a standing ad hoc committee within the Department of Justice²³³ and approved by the Office of the Deputy Attorney General.²³⁴ Where practical, a pool of three acceptable monitors should be submitted by the government to the corporation.²³⁵

Relative to contemporary monitorship practices, national security corporate governance suffers from a less open process. DSS retains veto power over candidates, there is little transparency, and there are few professionalizing checks, such as a standing committee, to limit the whims of a particular official.

It is understandable that DSS agents might be chosen less publicly than DOJ monitors. Moreover, DSS denies that it ever proposes a particular candidate; the company is tasked with finding acceptable directors and proxy holders. Nevertheless, we should be cognizant of the risks inherent in opacity.

wrongdoing, Outside Directors can certify to the government that the corporation is compliant on pain of losing their own sterling reputation. An interesting suggestion is that corporate monitors might be installed before any wrongdoing in order to assure constituents of their good faith compliance.

230. *Morford Memo Morphed: Who Picks the Corporate Monitors?*, CORP. CRIME REP. (Jan. 1 2013, 11:33 AM), <https://perma.cc/ML6H-CUT3> (“This ensures that the monitor comes from the boys club,” said one monitor who was briefed on the matter by high ranking Criminal Division officials but who asked not to be identified. In FCPA cases where Main Justice alums in DC firms represent most of the companies under investigation, they recommend each other for the monitorships.”). *But see* Veronica Root, *Modern-Day Monitorships*, 33 YALE J. ON REG 109 (2016) (describing the many varieties of monitorships).

231. Philip Shenon, *Ashcroft Deal Brings Scrutiny in Justice Dept.*, N.Y. TIMES, Jan. 10, 2008, at A1, <http://www.nytimes.com/2008/01/10/washington/10justice.html>.

232. U.S. DEP’T OF JUSTICE, U.S. ATTORNEY’S MANUAL, CRIMINAL RESOURCES MANUAL § 163 (2008), <https://www.justice.gov/usam/criminal-resource-manual-163-selection-and-use-monitors>.

233. “Each United States Attorney’s Office and Department component shall create a standing or *ad hoc* committee (‘Committee’) of prosecutors to consider the selection or veto, as appropriate, of monitor candidates. The Committee should, at a minimum, include the office ethics advisor, the Criminal Chief of the United States Attorney’s Office or relevant Section Chief of the Department component, and at least one other experienced prosecutor.” *Id.*

234. *Id.*

235. *Morford Memo Morphed*, *supra* note 230.

IV. NATIONAL SECURITY CORPORATE GOVERNANCE'S LESSONS

With some handle now on the operation of national security corporate governance as well as its plausible costs and benefits, this Part seeks to place national security corporate governance into broader context. First, it notes tendency of scholars and policymakers to downplay the corporate governance implications of their prescriptions and to press national security over competing priorities, neglecting the complex relationship between these areas. Second, it looks again at the national security corporate governance regime to draw some tentative conclusions about how it could better achieve its ends in light of the discussion. Third, it asks whether national security corporate governance and like techniques could sometimes be useful in non-security contexts, such as addressing financial risk. Finally, it examines whether national security corporate governance has something to say about shareholder primacy, codetermination, staggered boards and other changes to orthodox American corporate governance.

A. How to Balance Security and Governance?

The national security corporate governance regime privileges national security without much concern for its impact on corporate governance and efficiency. This is not a unique phenomenon. Without constant vigilance, national security concerns have a tendency to supplant other values,²³⁶ such as civil liberties,²³⁷ representative government,²³⁸ and transparency.²³⁹

This general tendency may be even stronger when it is only corporate governance at stake on the other side. Government officials and scholars

236. Even the scale or likelihood of the national security threat may become irrelevant. See generally, RON SUSKIND, *THE ONE PERCENT DOCTRINE: DEEP INSIDE AMERICA'S PURSUIT OF ITS ENEMIES SINCE 9/11* 62 (2006) (Vice President Dick Cheney said, "If there's a one percent chance that Pakistani scientists are helping al Qaeda build or develop a nuclear weapon, we have to treat it as a certainty in terms of our response."). Yet many of us would consider a one percent chance of certain threats to be insufficient to jettison all other values.

237. See Francis Cardinal George, *Civil Liberties vs. National Security: The Enduring Tension*, 19 NOTRE DAME J.L. ETHICS & PUB. POL'Y 219 (2005).

238. Marcus G. Raskin, *Democracy Versus the National Security State*, 40 LAW & CONTEMP. PROBS. 189, 220 (1976).

239. Pieter D. Wezeman & Siemon T. Wezeman, *Balancing Transparency and National Security*, STOCKHOLM INT'L PEACE RES. INST. (Jan. 29, 2014), <https://perma.cc/YER5-XS8G>; Patricia L. Bellia, *WikiLeaks and the Institutional Framework for National Security Disclosures*, 121 YALE L. J. 1448 (2012). See also Dianne Feinstein, Commentary, *Prosecute Assange Under the Espionage Act*, WALL. ST. J. (Dec. 7, 2010, 12:01 AM), <https://www.wsj.com/articles/SB10001424052748703989004575653280626335258>.

alike tend to overlook corporate law niceties,²⁴⁰ particularly when crafting defense and investment policy.²⁴¹ Why?

One possibility is that corporate law problems are less salient than national security problems. It is a well-known finding of behavioral economics literature that individuals tend to overweigh the importance of low-probability catastrophes, such as terrorism.²⁴² By contrast, the harms of bad governance often appear slowly, and on a company's balance sheet. It is hard to imagine a less salient problem, given widespread financial illiteracy.

Another possible explanation is the general willingness of policymakers, and some scholars, to impose burdens on corporations.²⁴³ Someone pays for ineffective corporate governance, but it is not self-evident who or how much.²⁴⁴ Tax scholars have long noted that the corporate tax is attractive to lawmakers because no one really knows who ultimately pays it.²⁴⁵

240. E.g., Yair Listokin argues in a forthcoming article that when corporate law conflicts with systemic risk regulation, corporate law should succumb every time. He would suspend the rights and protections normally accorded to shareholders whenever managers or the government see a major systemic risk problem. As he writes, "During financial crises, the normal conventions of corporate law do not apply." Yair J. Listokin & Inho Andrew Mun, *Rethinking Corporate Law During a Financial Crisis*, HARV. BUS. L. REV. (forthcoming 2018) (on file with author).

241. See, e.g., Gilson & Milhaupt, *supra* note 46. Professors Gilson and Milhaupt proposed a "minimalist" approach to defanging sovereign wealth funds—bar them from voting their shares. Despite the article's many virtues, Gilson and Milhaupt do not ask whether this proposal might pose efficiency costs by undermining accountability systems. Due to their expertise and substantial ownership, institutional investors play an important role in disciplining management. Eliminating some institutional investors from oversight should weaken corporate governance and performance. It is not sufficient to say that voting rights return to a subsequent domestic purchaser of shares. *Id.* The costs of poor governance are borne as long and until that transfer takes place. *Id.* Of course, many institutional investors are quite passive in exercising their rights, and even large institutions rarely own enough to make sweeping changes. By contrast, the FOCI context tends to arise when the foreign investor owns a substantial stake.

242. Cass R. Sunstein, *Probability Neglect: Emotions, Worst Cases, and Law*, 112 YALE L. J. 61 (2002).

243. It is perhaps fitting that Michael Oxley, the author of the eponymous Sarbanes-Oxley Act, which extensively federalized corporate governance, now serves on a FOCI board as a proxy holder. See Steve Lindquist, *Industrial Policy and Programs*, DSS ACCESS (Def. Security Serv., Washington, D.C.), 2012, at 8, <https://perma.cc/247A-WH24>.

244. One might argue that similar thinking has led to the use of corporate disclosure regulation to regulate other contentious social issues, such as executive pay and human rights abuses in foreign countries.

245. Compare, e.g., MIHIR A. DESAI, C. FRITZ FOLEY & JAMES R. HINES, JR., *LABOR AND CAPITAL SHARES OF THE CORPORATE TAX BURDEN: INTERNATIONAL EVIDENCE* (2008) (workers and investors share the tax), and Matthew H. Jensen & Aparna Mathur, *Corporate Tax Burden on Labor: Theory and Empirical Evidence*, 131 TAX NOTES 1083 (2011), <https://perma.cc/4AP4-SPBL> (arguing that 50 percent or more of the tax falls on workers), with ROSANNE ALTSHULER, BENJAMIN HARRIS & ERIC TODER, *CAPITAL INCOME TAXATION AND PROGRESSIVITY IN A GLOBAL ECONOMY* (2010), <https://perma.cc/2A5A-33EG> (arguing that the tax mostly falls on workers), and Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat'l Bureau of Econ. Research, Working Paper No. 11787, 2006) (describing conditions under which investors bear much of the cost).

Corporate law scholars have likewise noted this tendency in federal regulation of corporations. Lawmakers may underestimate the cost of mandating corporate governance rules²⁴⁶ or they may simply not care about the costs.²⁴⁷ This tendency makes it unsurprising that governance modifications might be tolerated for the promise of security gains, even without a sense of the costs.

Of course, the most important reason that we disregard corporate law is probably just the sense that national security is much more compelling. “Salus populi suprema lex esto.”²⁴⁸ National security promises freedom from fear and injury, and it addresses existential threats to the nation. By contrast, corporate law’s promises depend upon the maintenance of national and international order. Moreover, corporate law’s blessings are instrumental. When it works well, it tends to enhance shareholder welfare, which is only contingently linked to the general welfare.²⁴⁹ Shareholders may prosper when towering monopolies choke off competition,²⁵⁰ procure favorable regulation by lobbying²⁵¹ or bribery,²⁵² deal roughly with workers and the environment,²⁵³ and take excessive risks at the expense of creditors or society as a whole.²⁵⁴

And yet, corporate law supports effective and efficient enterprises, which are crucial to America’s admixture of public and private defense

246. SEC. & EXCH. COMM’N, FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION 39 (2006) (underestimating the cost of section 404 of the Sarbanes-Oxley Act by an order of magnitude). See Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?* 26 YALE J. ON REG. 229, 239–54 (2009) (summarizing post-enactment cost assessments of the Sarbanes-Oxley Act).

247. See, e.g., Romano, *supra* note 205 (noting the lack of concern for, or knowledge of, the cost of regulatory intervention in corporate governance).

248. This notion, meaning roughly that the safety of the people must be the supreme law, finds wide support among a diverse set of political philosophers. See, e.g., MARCUS TULLIUS CICERO, DE LEGIBUS 466–67 (Clinton W. Keyes trans., Harvard Univ. Press 1929); JOHN LOCKE, SECOND TREATISE ON GOVERNMENT (1690); THOMAS HOBBES, LEVIATHAN (1651); BARUCH SPINOZA, THEOLOGICAL-POLITICAL TREATISE (1670).

249. Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 57 ARIZ. L. REV. 85, 101 (2015); Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165, 187 (1988) (arguing that bargaining behavior in the corporate takeover context are a deadweight loss from a societal perspective).

250. *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 560–66 (1933) (Brandeis, J., dissenting in part).

251. *Citizens United v. Fed. Election Comm’n*, 558 U.S. 310, 355–356 (2010); Elizabeth Pollman, *Citizens Not United: The Lack of Stockholder Voluntariness in Corporate Political Speech*, 119 YALE L.J. ONLINE 53 (2009).

252. *Foreign Corrupt Practices Act: An Overview*, U.S. DEP’T OF JUST., <https://perma.cc/4K3H-F2H4> (last visited Oct. 4, 2017).

253. Judd F. Snierson, *The Sustainable Corporation and Shareholder Profits*, 46 WAKE FOREST L. REV. 541, 548–556 (2011).

254. Richard Ridyard, *Toward a Bank Shareholder-Oriented Model: Using Double Liability to Mitigate Excessive Risk-Taking*, 2 U.C. LONDON J.L. & JURIS. 141, 147–49 (2013) (explaining managerial incentives for risk taking).

procurement. If national security is advanced in ways that displace governance best practices, the government will find fewer or more expensive partners. Just as corporate law presupposes adequate national security, the American approach to national security presupposes adequate corporate law for contractors.

The dynamic and complex relationship between these values problematizes any simple hierarchy of importance and renders baseless the claim that national security should always trump corporate law. In fact, national security's relationship to corporate law is contingent and complex. Study of national security corporate governance suggests that practicable security policy requires both regulation of and solicitude toward private ordering.

Recognizing that national security corporate governance likely has some place in a strategy of national defense, but that we may have a tendency to underweight the damage done to governance, the following two Sections contemplate ways to meld the two spheres in a more effective and nuanced manner.

B. When To Pursue Security Through Governance?

First, the *actual* use of FOCI mitigation and national security corporate governance should probably be narrow. The cost of national security corporate governance may be quite high and the security actually achieved is sometimes questionable.²⁵⁵ Moreover, national security corporate governance provides an excuse to avoid the painful, but sometimes necessary, cutting of ties to an unacceptably risky contractor.²⁵⁶

Narrowing the scope is also suggested by the changing character of security risks.²⁵⁷ Less and less do information leaks come from executives passing envelopes to foreign owners—instead, they are unintentional breaches caused by cyber-attacks.²⁵⁸ Every day, American firms face a barrage of phishing, malware, and other cyber espionage. Cyber thieves do not solely target foreign-owned firms, nor does insulating or factionalizing the board prevent hackers or phishing scams. Focusing too greatly on national security corporate governance may distract attention from the real and urgent threat to all contracting firms.

255. See *supra* Part III.A–B.

256. Schwellenbach, *supra* note 208 and accompanying text.

257. See *supra* note 30 and accompanying text.

258. See DEF. SEC. SERV., *supra* note 31, at 27.

In many cases, the government would do better to make a genuinely risk-based assessment.²⁵⁹ Some “foreign” firms have a long history of compliance and probably can comply with security laws of general application. Others are sufficiently risky that FOCI mitigation provides unjustified comfort—it is better to do without some contractors if they cannot be trusted.

Whether restricting the use of national security corporate governance for foreign firms or increasing its application for some domestic firms or foreign non-contractors, it is the government’s responsibility to take stock of the costs it likely imposes. This is true even though national security corporate governance is mostly voluntary and so firms may decline (or divest) foreign investment if they would rather not comply with national security corporate governance. One might be tempted to impose national security corporate governance widely and let firms opt out if they find it too costly.

The reason that the government must consider the cost of the program is that it likely bears it. Many government contracts are formally or functionally cost-plus contracts. Only in a world of fantastic waste would cost play no part in pricing. If the government requests a strange governance structure, the government is likely to see part of the cost of the structure reflected in the size of the bill charged or quality of goods rendered, so the government must thoughtfully predict whether this security is worth the cost, on the front end, as it does with other product features.²⁶⁰

Even if the contract is not cost-plus, use of national security corporate governance is often rewarded by preferential bidding status. National security corporate governance can help contractors to qualify as small businesses (despite having massive parent companies) due to their substantial independence.²⁶¹ Dubbing a contractor worthy of national

259. It is expected that the new versions of the NISPOM will increasingly adopt a risk-based approach.

260. Sometimes the government can involuntarily impose national security corporate governance. For example, a company might invest large sums of money in project-specific assets, only to be told during the project that security needs have changed, and the project is now too sensitive to be handled by foreigners. To continue on the project, the contractor will have to accept FOCI migration. Sometimes, a company is even told that they will require the most severe insulating mitigation. In these cases, the government *ex post* expropriates additional security and externalizes the cost onto the contractor. Insofar as the government *does not* directly bear the cost of national security corporate governance, it sets a more problematic chain in motion. If it does this widely and without restraint, contractors will be understandably reluctant to deal with the government on any project and will charge more accordingly. A reputation for judicious use of national security corporate governance only in cases where it actually pays its way makes the government a better contracting partner throughout.

261. Kyung M. Song, Foreign Workers for U.S. Jobs a Rarity at Boeing, THE SEATTLE TIMES (May 4, 2013, 8:00 AM), <https://perma.cc/5FDL-FK67>.

security corporate governance is also a decision to disqualify many of its competitors for a project, or allow the contractor to seize projects intended to support genuinely small contractors. Again, the government must decide whether extra security justifies reduced competition among bidders.

Second, while the *actual* use of national security corporate governance should narrow, the *potential* scope for national security corporate governance should probably grow. National security corporate governance is used where firms pose special security threats in large part because their shareholders may have geopolitical motives or see profits in excessive risk, but those criteria are not limited to foreign firms. National security corporate governance should be potentially available even in cases with entirely American shareholders, so long as the incentives are such that shareholders might tolerate treasonous geopolitics in the search for profits. Some domestic contractors employ many foreign nationals, source large parts of their supply chain abroad, and do an increasing amount of business overseas.

For example, Boeing does half of its engineering work in Russia and other nations,²⁶² will make fighter jets in India,²⁶³ sells 70 percent of its commercial aircraft outside of the United States,²⁶⁴ and has billions of dollars worth of military sales.²⁶⁵ Overall, Boeing made more than half of its revenue from non-U.S. sales.²⁶⁶ Arguably, Boeing faces greater risks of foreign influence and pressure than a Maryland company that happens to have a few Canadians or Cayman Island hedge funds among its shareholders. Yet, Boeing is not even potentially subject to the FOCI regime. At least in theory, DSS should be able to use national security corporate governance and other tools to manage information security risks at nominally domestic firms like Boeing.

Likewise, the potential scope of national security corporate governance should also be widened in light of its second goal, industrial readiness.²⁶⁷ Insofar as national security corporate governance helps prepare for managerial changes after expropriation, it should be potentially available at any firm that would be realistically expropriated at wartime. Presumably

262. *Id.*

263. Vikram Chandra, *What Boeing May 'Make In India': Fighter Plane, Choppers*, NDTV (Oct. 16, 2015, 3:40 PM), <https://perma.cc/X6WA-67NF>.

264. *See Close Relationships with Global Stakeholders are Key*, BOEING INT'L, <https://perma.cc/3ED2-3Y9C> (last visited Oct. 17, 2017).

265. Clay Dillow, *U.S. Companies are Making a Killing on Foreign Military Sales*, FORTUNE (May 11, 2015), <http://fortune.com/2015/05/11/foreign-military-sales/>.

266. BOEING, LEADING AHEAD: THE BOEING COMPANY 2014 ANNUAL REPORT 12 (2015), <https://perma.cc/8LCM-PC6S> (stating "non-U.S. customers accounted for approximately 58% of [its] revenue").

267. *See supra* part I.B.

wartime expropriation strategies would cover more than just foreign-owned military contractors.²⁶⁸ Perhaps, as in the past, many foreign-owned industrial facilities would be expropriated, or perhaps the Pentagon keeps (or could keep) a more detailed list. In either case, transition planning remains a valuable, if covert, objective of national security corporate governance, and that should be reflected in the potential jurisdiction of the program.

C. How Should We Govern for Security?

Cost-sensitivity also means that when national security corporate governance is used, agreements should be drafted with sensitivity to the unique situation of the complying company. At present, DSS prefers to use the same few templates for all national security corporate governance, with as few modifications as possible, in order to ease its monitoring burden. While this is understandable, a greater investment in staffing, to allow more nuanced national security corporate governance plans, would likely pay dividends. If these templates are calibrated to deal well with some companies, they may be overly strict for some and overly lax for others. In many cases, a bespoke agreement might better achieve security and efficiency goals than an off-the-rack agreement.

Another option is openness to incentive pay.²⁶⁹ While much of national security corporate governance seeks to sunder directors and shareholders, directorial shareholding may sometimes reduce both inefficiency and geopolitically motivated risk. A firm that shares secrets with a rogue nation will be fined and excluded from future government contracts—hardly attractive for a director holding unvested stock.²⁷⁰ While it is notoriously challenging to implement sensible incentive compensation programs,

268. The actual content of the list, as well as the conditions for conclusion and the publicity of its membership, is both important and beyond the scope of the Article.

269. Professor Charles Elson and others have long argued that directors should be compensated not with cash or stock options, but with stock. Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 859 (2003) (issuing a "call for truly independent, equity-owning directors as the solution to the governance conundrum raised by Enron and other corporate debacles"); Charles M. Elson, *Executive Overcompensation-A Board-Based Solution*, 34 B.C. L. REV. 937, 944 (1993) (proposing that "corporations . . . pay their directors their annual fees in restricted company stock"); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 371 (2009); Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance*, 14 J. CORP. FIN. 257, 266-67 (2008) (stating that board ownership of shares correlates to company performance).

270. Even when it is economically rational to risk upsetting American clients, the benefits will often accrue to the parent company or an overseas subsidiary. A director of the U.S. subsidiary, which obtains all of its business from federal agencies, will have an incentive to protect the subsidiary even in those cases, so long as her stock is subsidiary stock. As a practical matter, many subsidiaries will not have their own stock, however.

particularly at private companies and subsidiaries,²⁷¹ it is no indictment that incentive compensation is presently rare among Outside Directors and proxyholders. Contractors under FOCI are principally concerned with DSS's approval, without which they cannot do business. Conservatism is rational in such a context. However, some contractors may be willing to experiment with incentive pay if DSS preemptively signals openness to the effort.

D. Should We Pursue Other Values through Governance?

Progressive legal scholars have long wished the boardroom to welcome values other than shareholder wellbeing. They have lamented America's unwillingness to try arrangements such as Germany's scheme of mandatory codetermination, in which workers elect almost half the board of the company. National security corporate governance reminds us that we occasionally try such things in America too,²⁷² and we could go considerably further.

National security corporate governance also suggests altogether new ways to deemphasize shareholder wealth maximization, for those so inclined. Beyond positive steps to *empowering* neglected constituencies, we can take negative steps to *disempower* shareholders. Recall that almost a quarter of the companies subject to national security corporate governance have *only* national-security oriented directors. If we wish to protect workers, we do not have to imagine co-determination, the regime of approximate sharing between capital and labor.²⁷³ Instead, we can actually replace the whole board with a slate of labor-backed representatives. If shareholders agitate for dividends rather than systemic risk-reducing cushion, we can anesthetize ordinary board functions, insulating existing directors from elections and exempting them from state law fiduciary duties.²⁷⁴

271. Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 715 (2011).

272. American states increasingly permit the incorporation of firms with an explicit, board-level mandate to pursue non-profit-maximizing social goals. *See generally*, Ofer Eldar, *The Role of Social Enterprise and Hybrid Organizations*, 2017 COLUM. BUS. L. REV. 92 (2017).

273. *See* Steven L. Schwarcz, *Rethinking Corporate Governance for a Bondholder Financed, Systemically Risky World*, 58 WM. & MARY L. REV. 1335, 1365 (2017) (discussing co-determination).

274. *See* Dept. of Transp. v. Ass'n of Am. R.R., 135 S. Ct. 1225 (2015) (describing the case of Amtrak, a company owned by private shareholders and statutorily required to seek profits, whose board is not selected by common stockholders and is entrusted with several non-profit goals); *see also*, Jon D. Michaels, *An Enduring, Evolving Separation of Powers*, 115 COLUM. L. REV. 515, 588 n.331 (2015). The government also selects board members Fannie Mae and Freddie Mac, as well as the Chairman of the Federal Reserve. *See supra* notes 227–235 and accompanying text.

We had better be serious though. As corporate traditionalists have predicted, these are costly steps in terms of efficiency and they may tend to enrich managers and bureaucrats along the way. Many of us care about workers, the environment, and other causes enough to support external regulation, but not enough to dismantle the orthodox system of governing enterprise.²⁷⁵ Such reluctance may be read as a lack of concern for the causes. National security may be the rare test case for non-corporate values and structures displacing the regnant private ordering precisely because we are unequivocal about its importance.

Are there other areas of widespread concern, where national security corporate governance could guide our thinking about new strategies for achieving public goals? If there is a non-security area where national security corporate governance-like strategies may be most attractive, it is in systemic financial risk.

Warren Buffet called swaps “Financial Weapons of Mass Destruction,” and perhaps the metaphor can be explored.²⁷⁶ Like national security, systemic financial risk entails asymmetric risks with terrific public costs. Also, financial firms may tolerate or seek great risks at their shareholders’ implicit urging. Investors in large firms may find it individually rational (though collectively irrational) for managers to make speculative bets, write swaps that they cannot satisfy, and retain little or no capital.

Kristin Johnson has proposed that boards of directors of some financial institutions be required to add a monitor, charged with protecting against systemic risk.²⁷⁷ Professor Johnson suggests that the monitor would attend board meetings but not have the power to vote.²⁷⁸ Going even further, Professor Steven Schwarcz argues that bondholders ought to get a voting minority position on corporate boards, both in recognition of the vulnerability of this important creditor class and in order to reduce arguably excessive risk taking.²⁷⁹

275. Hansmann & Kraakman, *supra* note 186.

276. Lucinda Shen, *Warren Buffet Just Unloaded \$195 Million Worth of These Weapons of Mass Destruction*, FORTUNE (Aug. 8, 2016), <http://fortune.com/2016/08/08/mass-destruction-buffett-derivatives/>.

277. Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 241 (2013). Other articles have urged the imposition of a public-regarding duty on directors of systemically important firms, though without necessarily altering the composition of the board itself. See e.g., Robert C. Hockett, *Are Bank Fiduciaries Special?* 68 ALA. L. REV. 1071 (2017); Saule T. Omarova, *Bank Governance and Systemic Stability: The “Golden Share” Approach*, 68 ALA. L. REV. 1029 (2017); Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1 (2016).

278. Johnson, *supra* note 277.

279. Schwarcz, *supra* note 273, at 1345, 1363–66 (advocating for bondholder representation on boards).

Perhaps such arrangements would reduce systemic risk, but so far neither proposal has garnered significant support. Such cases become stronger when likened to national security corporate governance for financial risks. While both Johnson's and Schwarcz's proposals are ambitious, neither is unprecedented. We are already in the business of installing constituency directors with an eye to non-shareholder value.

We can also consider the case for non-shareholder directors in light of succession planning. Dodd-Frank calls for systemically important firms to engage in explicit succession planning, crafting "living wills." These plans have been criticized on various fronts. It is difficult to craft a realistic plan for winding up one's enterprise, much less to make that plan dynamic, public, and credible. Worse yet, honest succession plans (or honest reactions to them from regulators) could spark a panic. Could implicit succession planning be a better approach?

In the 2008 financial crisis, the government came to control numerous firms, such as AIG and GM. The government had to call the shots for these companies with the immediate goal of keeping the economy operational. This is not unlike wartime expropriation of crucial industrial infrastructure.

Many problems occurred as a result of government control over these firms. One controversial decision was to authorize large bonuses at firms that had only recently gotten bailouts.²⁸⁰ The bonuses were justified on the theory that they were necessary to retain top talent—talent, which may have recently helped cause the crisis but now, due to their own culpability in the toxic assets, had the only hope of understanding and unraveling it. There was, in short, a dearth of experienced and loyal employees, and the government had to pick between operational effectiveness and trustworthiness. Far better if several members of the board, representing the public interest, stood ready to take the reins at a time of national crisis. Monitors of the sort Johnson describes could serve this function. Recognizing that a financial crisis creates expropriation scenarios akin to those of wartime makes more plausible the use of wartime preparations and solutions.²⁸¹

280. Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After \$170 Billion Bailout*, N.Y. TIMES (Mar. 14, 2009), <http://www.nytimes.com/2009/03/15/business/15AIG.html>; Matt Taibbi, *Secrets and Lies of the Bailout*, ROLLING STONE, Jan. 4, 2013, <http://www.rollingstone.com/politics/news/secret-and-lies-of-the-bailout-20130104>.

281. While this section has discussed monitors for financial risk, the line quickly blurs between this novel use and the traditional national security purpose of national security corporate governance. In August 2008, a teetering Lehman Brothers once explored a fire sale to Korean investors. *The Story of How Lehman's Last-Minute Korean Rescue Fell Apart*, WALL ST. J.: DEAL J. (Sept. 16, 2008, 10:46 AM), <http://blogs.wsj.com/deals/2008/09/16/the-story-of-how-lehmans-last-minute-korean-rescue-fell-apart/>. As David Zaring notes, this transaction would have been subject to CFIUS review. Zaring, *supra* note 103. Such review could not possibly have concluded under the bank's short fuse. If Lehman were

We can also think of it as a sort of expropriation when creditors seize control over a company, as they do through the bankruptcy process when a firm is insolvent. Perhaps the presence on the board of creditor representatives long before insolvency is broached would help ease the transition into and out of bankruptcy. Thus, the succession planning and expropriation lens provides another argument in support of creditor representation on boards.²⁸²

CONCLUSION

Corporate law and national security law envision fundamentally different forms of coordination. Corporate law supports private ordering and accountability, particularly of managers to shareholders, in pursuit of profits and efficiency. National security law provides for the common defense, even if it means tolerating a measure of secrecy, coercion and bureaucracy.

Both bodies of law govern distinct spheres of activity, and so there is seldom any need to reconcile their dissonant logics. We are untroubled that corporate directors in Delaware operate with completely different constraints than CIA agents in Kabul. Nevertheless, questions at the borderland of corporate law and national security law may call forth multiple and conflicting answers, raising challenging questions of interaction and priority.

Defense contractors travel that borderland. Private companies provide personnel for armed combat,²⁸³ transport captives for extraordinary rendition²⁸⁴ and conduct interrogations themselves.²⁸⁵ They build the navy's

already subject to a form of national security corporate governance, a fast track CFIUS approval might have been available. *See supra* notes 101–07.

282. Schwarcz, *supra* note 273.

283. David Barstow et al., *Security Companies: Shadow Soldiers in Iraq*, N.Y. TIMES, Apr. 19, 2004, at A1; Renae Merle, *DynCorp Took Part in Chalabi Raid*, WASH. POST, June 4, 2004, at A17. *See also* Laura A. Dickinson, *Government for Hire: Privatizing Foreign Affairs and the Problem of Accountability Under International Law*, 47 WM. & MARY 135, 149 (2005) (stating that the ratio of contractor to non-contractor increased by a factor of ten between the Gulf War and the war in Iraq). *See generally* Jon D. Michaels, *Beyond Accountability: The Constitutional, Democratic, and Strategic Problems with Privatizing War*, 82 WASH. U. L.Q. 1001 (2004).

284. Stephen Braun, *Court Case Reveals Details of Secret Flights*, SAN DIEGO UNION-TRIB (Sept. 1, 2011, 12:03 AM), <http://www.sandiegouniontribune.com/sdut-court-case-reveals-details-of-secret-flights-2011sep01-story.html>.

285. Hunter Stuart, *How We Outsourced CIA Torture and Why It Matters*, HUFFINGTON POST (Dec. 16, 2014, 12:46 PM), http://www.huffingtonpost.com/2014/12/12/outsourcengtorture_n_6317236.html.

missiles²⁸⁶ and write the NSA's data gathering software.²⁸⁷ Contractors are participants in national security, but they are also corporations subject to corporate law.

What is the relationship between corporate law and national security in that domain? Corporate law supports manager accountability to shareholders. If this improves the effectiveness of defense contracting firms, then it may permit the government to buy better defense capacity on the same budget. Conversely, shareholders may push for direct or immediate gains, even if it endangers America.²⁸⁸

National security corporate governance modifies governance and operation structures. It creates opportunities for wasteful management to exploit shareholders, and it tempts government officials to favor foreign firms in the hopes of lucrative retirement jobs on the boards of FOCI firms.

Yet, it does arguably solve problems. It reduces the risks inherent in contracting with foreign-influenced enterprises. More interestingly and subtly, it provides a channel for increased government influence and a preparatory field for possible wartime industrial efficiency. The arrangement looks more favorable when such tail risks are considered. National security corporate governance has a secret ambition as a succession-planning tool, allowing the government to better control captured assets in times of emergency.

Whatever its merits or costs, national security corporate governance has eluded careful study. Military contractors are situated at the intersection of security and governance, public and private, safety and efficiency. They encompass both, and national security corporate governance is one vision of how to reconcile them. It is rarely appropriate to balance two values by ignoring the importance of one, and national security corporate governance proves that point again. At the same time, national security corporate governance reminds us that debates about the form of corporate governance, whether it should encompass or exclude non-shareholder priorities, need not be conducted in hypothetical terms, since there are cases to consider in the military contractor space.

286. Richard Krushnic & Jonathan Alan King, *Meet the Private Corporations Building Our Nuclear Arsenal*, THE NATION (Sept. 22, 2015), <https://perma.cc/RC3M-GUXP>.

287. James Bamford, *The NSA Is Building the Country's Biggest Spy Center (Watch What You Say)*, WIRED (Mar. 15, 2012, 7:24 PM), http://www.wired.com/2012/03/ff_nsadatacenter/.

288. Scholars have also identified other possible risks, such as governmental actors using privatization as a means to gain power and freedom from political, legal or constitutional restraints. Laura A. Dickinson, *Outsourcing Covert Activities*, 5 J. NAT'L SEC. L. & POL'Y 521, 522 (2012) (describing how use of contractors avoids oversight); Jon D. Michaels, *Privatization's Pretensions*, 77 U. CHI. L. REV. 717, 722 (2010). *Contra* Alexander Volokh, *Privatization and the Law and Economics of Political Advocacy*, 60 STAN. L. REV. 1197 (2008) (arguing that privatization does not pose special risks of corporate influence).

Ultimately, national security corporate governance is a study in the tension between security and governance, and in how our law manages that complex relationship. When the subject is national security, all explanations are underdetermined. Too much is classified or hidden to objectively assess national security corporate governance for its own sake or as a window into other potentialities. But, the stakes are also too high not to draw what conclusions we can.