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DOMESTIC PARTNER EMPLOYEE BENEFIT FOR SAME-SEX AND OPPOSITE PARTNERS IN THE ERA OF SAME-SEX MARRIAGE: THE MASSACHUSETTS EXPERIENCE

by JAMES ANGELINI* AND JASON PETERSON**

INTRODUCTION

This article examines the quandary employers face with respect to domestic partnership benefits (DPBs) in gay marriage states. In 2004, activists celebrated as Massachusetts became the first state to legalize gay marriage.[1] Leading up to the Massachusetts Supreme Judicial Court's landmark holding in *Goodridge v. Department of Public Health*,[2] many employers had voluntarily offered DPBs to the same-sex partners of their employees. *Goodridge* and gay marriage turned the discriminatory argument on its head. Namely, would those employers continue to offer benefits to employees in same-sex relationships, often to the exclusion of employees in opposite-sex relationships, when both same-sex and opposite-sex couples could legally marry?

Since 2004, four additional states have legalized gay marriage and employers in each of those states must now resolve the same dilemma.[3] The Massachusetts experience, therefore, provides a useful roadmap to predict employer reaction. This article will first summarize the current

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1 *Same-Sex Marriage, Civil Unions and Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated September 2010), http://www.ncsl.org/ default. aspx? tabid=16430.

2 798 N.E.2d 941 (Mass. 2003).

3 *Same-Sex Marriage, Civil Unions and Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated September 2010), http://www.ncsl.org/ default.aspx?tabid=16430.

state of domestic partnership policies including pertinent historical, financial, tax, and the myriad legal obstacles. Second, through an empirical survey this article will suggest that Massachusetts employers have surprisingly extended their DPBs policies. Finally, this article will conclude by discussing the generalizability of our findings to the states and other research limitations.

EVOLUTION OF DOMESTIC PARTNERSHIPS

Employers typically offer fringe benefits to employees and their families, including legal spouses.[4] Examples include health insurance, tuition payments, life insurance, flexible spending accounts, and health savings accounts.[5] Some employers offer these benefits to same-sex and, to a lesser degree, opposite-sex domestic partners.[6] The main advantage and motivation of employers extending benefits to domestic partners is to attract and retain the most qualified employees.[7] Employers also offer DPBs because they may feel it is the right thing to do and not offering such benefits is often viewed as discriminatory.[8] The disadvantage of offering domestic partner benefits is mainly cost and perhaps legal issues as discussed in this article.

History

The history of domestic partnerships is relatively short. Commentators generally credit Tom Brougham with establishing the term in 1979.[9] Mr. Brougham was instrumental in helping to establish the first municipal DPBs offered to government employees in 1985.[10] The first publicly traded company to offer benefits to domestic partners was Lotus, in 1991[11] and the first private employer to offer benefits to domestic partners was the Village Voice in 1982.[12] There has since been dramatic growth in the

[4] *Domestic Partner Benefits: Facts and Background*, EMPLOYEE BENEFIT RESEARCH INSTITUTE, 1 (Feb 2009), http://www.ebri.org/pdf/publications/facts/0209fact.pdf.

[5] *Id.*

[6] *Id.*

[7] *Id. See also* Maria O'Brien et al., *Same Sex Marriage and its Implications for Employee Benefits: Proceedings of the 2005 Meeting of the Association of American Law Schools Sections on Employee Benefits, and Sexual Orientation and Gender Identity Issues*, 9 EMP. RTS. & EMP. POL'Y J. 499 (2005).

[8] *See Domestic Partner Benefits: Facts and Background*, *supra* note 4.

[9] Leonard Traiman, *A Brief History of Domestic Partnerships*, GAY & LESBIAN REV., July-Aug., 2008, at 1, http://www.equalitywithoutmarriage.org/G&LR%20July-Aug%202008.pdf.

[10] *Id.* at 3.

[11] Branford Duncan, M.D. & James Lock, M.D., P.D., *Offering Domestic Partnership Health Benefits: An Economic Concern?* 5 JOURNAL OF GAY AND LESBIAN MEDICAL ASS'N, No. 3 (2001), at 97.

[12] *Id.*; *Domestic Partnerships*, GLBTQ, http://www.glbtq.com/social-sciences/domestic_

number of private, public and government employers offering DPBs to their employees. Approximately one-third of all employers[13] and one-half of large employers[14] now provide benefits to same-sex partners of employees. Among the Fortune 100 businesses, eighty percent offer such benefits, as do seventy-five percent of the largest law firms.[15] Notwithstanding the financial meltdown, many employers have continued to offer DPBs even while curtailing other benefits.[16]

Definition

There is no universal definition of "domestic partnership" in either the Internal Revenue Code or under federal law."[17] In fact, under federal law, the Defense of Marriage Act (DOMA) makes it clear that same-sex couples may not marry and are not spouses.[18] Further, thirty states have amended their state constitutions to define marriage as a union between one man and one woman.[19] The Commonwealth of Massachusetts, however, has successfully challenged the constitutionality of DOMA and more challenges are likely.[20]

Table 1 analyzes which states have domestic partnership laws, civil unions or same-sex marriage. Five states including Massachusetts,

partnerships.html (last visited Aug. 7, 2010).

[13] 2008 SOCIETY FOR HUMAN RESOURCE MANAGEMENT, June 1, 2008, http://moss07.shrm.org/Research/SurveyFindings/Documents/08-0335_BenefitsSR_FINAL_.pdf.

[14] *2008 Employer Benefits Health Survey*, KAISER FAMILY FOUNDATION & HUMAN RESEARCH AND EDUCATIONAL TRUST, Sep. 24, 2008, http://ehbs.kff.org/pdf/7790.pdf.

[15] *State of the Workplace 2007-2008*, HUMAN RIGHTS CAMPAIGN FOUNDATION, at 9, http://www.hrc.org/documents/HRC_Foundation_State_of_the_Workplace_2007-2008.pdf.

[16] *More Coverage for Domestic Partners*, BUSINESS WEEK, Sept. 28, 2009, at 68.

[17] Toni Lester, *Adam and Steve vs. Adam and Eve: Will the New Supreme Court Grant Gays the Right to Marry*?, 14 AM. U.J. GENDER SOC. POL'Y & L. 253, 262, (2006). Generally, however, the two types of domestic partnership arise either when a state or municipality acknowledges the status of the couple or when the couples assert that they are in a relationship for the purposes of acquiring work related benefits. *Id.*

[18] Defense of Marriage Act, 1 U.S.C. §7 (2006). However, President Obama has extended benefits to same-sex partners of federal employees, but not to opposite-sex partners. *See Obama Extends Benefits For Gay Federal Workers*, BOSTON GLOBE, June 3, 2010. http://www.boston.com/news/nation/articles/2010/06/03/obama_extends_benefits_for_gay_federal_workers/.

[19] Tiffany C. Graham, *Exploring the Impact of the Marriage Amendments: Can Public Employers Offer Domestic Partner Benefits to their Gay and Lesbian Employees*, 17 VA. J. SOC. POL'Y & L. 83, 84 (2009). Depending upon the expansiveness of the constitutional amendment, same-sex marriage opponents have successfully challenged the offering of domestic partnership benefits. *Nat'l Pride at Work, Inc. v. Governor of Mich.*, 732 N.W.2d 139, 151 (Mich. Ct. App. 2007). *See also* Melissa B. Neely, Note, *Indiana Proposed Defense of Marriage Amendment: What Will it Do and Why is it Needed?*, 41 IND. L. REV. 245, 254-55 (2008).

[20] *Massachusetts v. United States Dep't of Health and Human Serv.*, No. 1:09-11156-JLT, 2010 U.S. Dist. LEXIS 67927 (D. Mass. July 8, 2010).

Connecticut, Iowa, New Hampshire, and Vermont, and the District of Columbia have legalized same-sex marriage.[21] New Jersey is the only state recognizing civil unions.[22] Twelve states have a domestic partnership law or a near equivalent.[23] Eight of those twelve states include all opposite-sex couples in the definition and two include only opposite-sex couples that meet specific criteria such as age.[24] All states with domestic partnership laws require state employers to extend benefits.[25]

Table 1
State Domestic Partnership Laws

State	Domestic Partnership Law?	Do Domestic PartnershipLaws Include Opposite-Sex Domestic Partnerships?	Is Same Sex Marriage Legal?	Civil Unions?
AL	N	NA	N	N
AK	Y[7]	N	N	N
AZ	N	NA	N	N
AR	N	NA	N	N
CA	Y	Y[2]	N[1]	N
CO	N[5]	NA	N	N
CT	N	NA	Y	N
DE	N	NA	N	N
DC	Y	Y	Y	N

[21] For Massachusetts *see infra* note 61. For Connecticut see *Kerrigan v. Commissioner of Pub. Health*, 957 A.2d 407 (Conn. 2008. For Iowa *see Varum v. Brien*, WL 874044 (Iowa 2009). On April 7, 2009, Vermont legalized same-sex marriage by legislation (Bill H275). On June 3, 2009 New Hampshire legalized same-sex marriage by legislation (Bill HB 73). On December 18, 2009 the District of Columbia legalized same-sex marriage by legislation (Bill 18-482). On August 4, 2010, the United States District Court for the Northern District of California overturned California's Proposition 8 that banned same-sex marriage. *Perry v. Schwarzenegger*, No. C 09-2292 VRW, 2010 U.S. Dist. LEXIS 78817 (N.D. Cal. Aug. 4, 2010). A federal appeals court, however, has extended a stay on same-sex marriages until the court hears the case in December, 2010. Jessie McKinley, *Appeals Court Extends Stay on Allowing Gay Marriage*, N.Y. TIMES, Aug. 17, 2010, at 12.

[22] *See* Christine Nelson, *Civil Unions & Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated January 2010), http://www.ncsl.org/default.aspx?tabid=4244.

[23] *See Same-Sex Marriage, Civil Unions and Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated September 2010), http://www.ncsl.org/default.aspx?tabid=16430.

[24] *See* Christine Nelson, *Civil Unions & Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated January 2010), http://www.ncsl.org/default.aspx?tabid=4244.

[25] *See States Offering Benefits for Same-Sex Partners of State Employees*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last visited December 2010), http://www.ncsl.org/default.aspx?tabid=16315.

State	Domestic Partnership Law?	Do Domestic PartnershipLaws Include Opposite-Sex Domestic Partnerships?	Is Same Sex Marriage Legal?	Civil Unions?
FL	N	NA	N	N
GA	N	NA	N	N
HI	Y	N[4]	N	N
ID	N	NA	N	N
IL	N	NA	N	N
IN	N	NA	N	N
IA	N	NA	Y	N
KS	N	NA	N	N
KY	N	NA	N	N
LA	N	NA	N	N
ME	Y	Y	N	N
MD	Y	Y	N	N
MA	N	NA	N	N
MI	N	NA	N	N
MN	N	NA	N	N
MS	N	NA	N	N
MO	N	NA	N	N
MT	N	NA	N	N
NE	N	NA	N	N
NV	Y	Y	N	N
NH	N	NA	Y	N
NJ	Y	Y[6]	N	Y
NM	N	NA	N	N
NY	N	NA	N	N
NC	N	NA	N	N
ND	N	NA	N	N
OH	N	NA	N	N
OK	N	NA	N	N
OR	Y	N	N	N
PA	N	NA	N	N
RI	N	NA	N	N
SC	N	NA	N	N
SD	N	NA	N	N
TN	N	NA	N	N
TX	N	NA	N	N
UT	N	NA	N	N
VT	N	NA	N	N
VA	N	NA	N	N
WA	Y	Y[3]	N	N
WV	N	NA	N	N
WI	Y	Y	N	N
WY	N	NA	N	N

Notes:

[1]On May 15, 2008 the California Supreme Ct. ruled that same-sex couples should have the right to marry. A ballot initiative (Proposition 8) subsequently banned same-sex marriage on Nov. 4, 2008. On August 4, 2010 the Ninth District Court ruled that Proposition 8 is unconstitutional, but stayed new same-sex marriages pending an appeal. Same-sex marriages that occurred from June 16, 2008 to November 4, 2008 are valid.

[2]California recognizes domestic partnerships for opposite-sex couples only when one partner is at least 62 years old and both are qualified to collect Social Security.
[3]Washington recognizes domestic partnerships for opposite-sex couples only when one partner is at least 62 years old.
[4]Hawaii allows domestic partnership to any couple that cannot legally marry. That would include same-sex couples but also opposite-sex couples prohibited from marrying because they are blood relatives, such as a mother and son.
[5]Colorado does allow "designated beneficiary agreements" which confer some of the same rights as domestic partnerships.
[6]New Jersey recognizes domestic partnerships for opposite-sex couples only when one partner is at least 62 years old.
[7]Alaska has a limited domestic partnership law for state employees only, based on a Alaska Supreme Court ruling (Alaska CLU v. State of Alaska). It does not apply to private employers.
NA = Not applicable
Source: Author analysis of state laws. National Conference of State Legislatures, "Same Sex Marriage, Civil Unions and Domestic Partnerships", April 2010, at:

States that acknowledge domestic partnerships have defined a domestic partner in varying ways. Two examples are illustrative. California defines domestic partners as, ". . . two adults who have chosen to share one another's lives in an intimate and committed relationship of mutual caring."[26] Couples must register as a domestic partnership and registering provides certain benefits and consequences for federal and state taxes in the area of benefits taxation, community property, income allocation, offers in compromise, and other issues.[27] Only same-sex couples and some opposite-sex couples in California may register as domestic partners and only if they 1) share a common residence (they don't have to have joint ownership nor must the residence be their only residence); 2) neither partner is married or in a domestic partnership with another person that has not been terminated, dissolved or annulled; 3) the two persons are not related by blood in a way that would prevent them from marrying in California; and 4) both persons are at least 18 year of age.[28] Furthermore, both persons must be of the same sex.[29] Opposite-sex partners qualify only if one partner is 62 years of age or older and if both partners qualify to collect Social Security.[30] Also, both must be capable of legal consent.[31]

[26] CAL. FAM. CODE § 297(a) (2004).
[27] CAL. FAM. CODE § 297(b) (2004).
[28] *Id.* § 297(b)(1)-(4).
[29] *Id.* § 297(b)(5)(A).
[30] *Id.* § 297(b)(5)(B).
[31] *Id.* § 297(b)(6).

Oregon defines domestic partner as "an individual joined in a domestic partnership" and "domestic partnership" as "a civil contract entered into in person between two individuals of the same sex who are at least 18 years of age, who are otherwise capable and at least one of whom is a resident of Oregon."[32] It also means

> a person in a relationship with an employee, each of whom: 1) Is under no legal disability to marry the other person, but for the fact that each is of the same sex; 2) Desires a relationship of marriage under Oregon law and would enter into marriage with the other person, and only with the other person, if Oregon law permitted it; 3) Is committed to the care and support of the other person; 4) Is responsible for the needs of the other person; 5) Is responsible for financial obligations to others equivalent to such financial obligations that arise within a marriage recognized under Oregon law; and 6) Is not married and has no similar commitment and responsibility relative to any other individual.[33]

Other states have slightly different definitions and some, such as Hawaii, allow domestic partnerships between blood relatives, such as a single mother and her adult son.[34] Most definitions include ambiguous language that would be difficult to substantiate if challenged, such as California's definition requiring couples to live in ". . . an intimate committed relationship of mutual caring."[35]

Over fifty percent of Fortune 500 companies offer benefits for domestic partners and several states require employers to offer DPBs if they offer benefits to spouses.[36] Employers that offer benefits to domestic partners create their own definition. A typical definition is an individual who is: (1) in an exclusive committed relationship (defined to be living with the eligible employee for at least three consecutive years immediately prior to the effective date of the extension of the Plan coverage); (2) jointly responsible for common welfare (with shared financial obligations; (3) neither married to anyone else nor a domestic partner of anyone else; (4) not related by blood; and (5) over the age of 18.[37]

Proposed language in the Domestic Partnership Benefits and Obligations Act of 2003 provides an example of an attempt at a Federal definition.[38] This legislation, which did not pass, pertained to Federal

32 OR. REV. STAT. § 150-316.007-(B)(1)(c) (2003).

33 OR. REV. STAT. § 150-316.007-(B)(5)(a)-(f) (2003).

34 HAW. REV. STAT. § 572C-2 (2006). Hawaii has a "reciprocal beneficiary" law that provides limited rights to same-sex couples, similar to domestic partnership laws. *Id.*

35 *See supra* note 26 and accompanying text.

36 *See State of the Workplace 2007-2008*, *supra* note 15, at 1.

37 I.R.S. Priv. Ltr. Rul., 9431017 (May 4, 1994).

38 Domestic Partnerships and Obligations Act of 2003, S. 1252, 108th Cong. (2003).

employees only and required filing an affidavit of eligibility.[39] The affidavit attested that the employee and the domestic partner of the employee:

> (1) are each other's sole domestic partner and intend to remain so indefinitely;
> (2) have a common residence, and intend to continue the arrangement;
> (3) are at least 18 years of age and mentally competent to consent to contract;
> (4) share responsibility for a significant measure of each other's common welfare and financial obligations;
> (5) are not married to or domestic partners with anyone else;
> (6) understand that willful falsification of information within the affidavit may lead to disciplinary action and the recovery of the cost of benefits received related to such falsification; and
> (7)(A) are same-sex domestic partners, and not related in a way that, if the 2 were of opposite sex, would prohibit legal marriage in the State in which they reside; or
> (B) are opposite-sex domestic partners, and are not related in a way that would prohibit legal marriage in the State in which they reside.[40]

Although the state and employer definitions are similar, clearly a uniform definition of domestic partnership is required. Such a definition could be relied upon by both public and private employers and would be useful for state tax purposes.[41]

Cost of Providing Domestic Partnership Benefits

An accurate and current estimate of providing DPBs is difficult to find. This is especially true when opposite-sex partners are included. A 2005 survey found that sixty-four percent of employers reported that providing domestic partner benefits increased total benefit costs by less than one percent and eighty-eight percent of employers reported an increase of less than two percent.[42] A 2004 study concluded that the average small business (0-19 employees) will incur no noticeable increase in costs and larger businesses (over 500 employees) will incur no more than $25,000 in total cost increases.[43]

However, the age of these studies as well as the fact that the studies did not include employers that cover opposite-sex employees, create

[39] Domestic Partnerships and Obligations Act of 2003, S. 1252, 108th Cong., § 2(b). (2003).

[40] Domestic Partnerships and Obligations Act of 2003, S.1252, § 2(b), 108th Cong. (2003).

[41] Arriving at a definition provides fertile material for future research and study.

[42] *Domestic Partner Benefits: Cost and Utilization*, HUMAN RIGHTS CAMPAIGN, http://www.hrc.org/issues/workplace/benefits/domestic_partner_benefit_costs.htm (last visited Aug. 7, 2010).

[43] M.V. LEE BADGETT & GARY GATES, THE BUSINESS COST IMPACT OF MARRIAGE FOR SAME-SEX COUPLE 2 (2004), http://www.hrc.org/documents/businesscost.pdf (2004).

doubt as to their current reliability. Same-sex cohabitating couples are a much smaller population than opposite-sex cohabitating couples.[44] An examination of the 2000 U.S. Census estimates that the population of opposite-sex households is over eight times larger than the number of same-sex households.[45] Furthermore, the increasing propensity of opposite-sex couples to live together without marrying increases the domestic partner population and creates the potential for larger increases in benefit costs in the future, if opposite-sex partners are covered.[46]

Given these trends and the likelihood that more states will legalize same-sex marriage, it is the subject of our research to see whether or not employers will extend domestic partner benefits to opposite-sex partners or eliminate them for all domestic partners, and how same-sex marriage and legal issues influence their decision in states where marriage is legal, particularly in Massachusetts.

Taxation of Employee Benefits to Domestic Partners

The Federal taxation of employee fringe benefits is well settled. Many types of fringe benefits are deductible by the employer and excluded from the employee's income.[47] Many of these benefits are excludable not only for the employee but also for the employee's spouse and tax dependents.[48] The IRS has ruled that benefits provided to either same-sex or opposite-sex domestic partners, and dependents of domestic partners are taxable to the employee.[49] This is because the federal definition of a spouse requires legal marriage and defines it as

[44] U.S. Census Bureau, CENSUS 2000 SPECIAL REPORTS, MARRIED-COUPLE AND UNMARRIED PARTNER HOUSEHOLDS: 2000 1 (Feb. 2003), http://www.census.gov/prod/2003pubs/censr-5.pdf.

[45] *Id*. Out of 5.5 million couples that were living together in 2000, 4.9 million were opposite-sex and 594,000 were same-sex. U.S. CENSUS BUREAU, CENSUS 2000 SPECIAL REPORTS, MARRIED-COUPLE AND UNMARRIED PARTNER HOUSEHOLDS: 2000, 3 (Feb. 2003), http://www.census.gov/prod/2003pubs/censr-5.pdf. The total has increased from 3.2 million in 1990 and is surely larger in 2010. *Id*. at 1.

[46] Sharon Jayson, *Census Reports More Unmarried Couples Living Together*, USA TODAY, July 28, 2008, http://www.usatoday.com/news/nation/census/2008-07-28-cohabitation-census_N.htm.

[47] *See generally* I.R.C. §§ 74, 79, 85, 86, 102, 104, 105, 106, 117, 119, 125, 127, 129, 131, 132, 137, 7702.

[48] *Id.*

[49] I.R.S. Priv. Ltr. Rul., 9717018 (Jan. 22, 1997); Priv. Ltr. Rul., 9850011 (Sep. 10, 1998). *But see* Tax Equity for Health Plan Beneficiaries, S. 1153, H.R. 2625, 111th Cong. (2009). The bill would amend the Internal Revenue Code to exclude accident and health plan benefits extended to eligible domestic partners from an employee's gross income. *Id.* The bill was referred to the Committee on Finance on May 21, 2009 and remains in committee as of this writing. S. *1153: Tax Equity for Health [plan beneficiaries Act of 2009*, GOVTRACK.US, (last viewed December 2010), http://www.govtrack.us/congress/bill.xpd?bill=s111-1153.

only between a man and a woman, even if some states allow same-sex marriage.[50] If local law allows same-sex marriage the spouse would not be a recognized spouse for federal tax purposes.

The only way an employee can exclude benefits paid on behalf of a domestic partner is if the domestic partner is the employee's dependent as defined by §152 of the I.R.C. To qualify as a dependent, the domestic partner must be considered a *qualifying relative*.[51] This requires the employee to provide more than fifty percent of the domestic partner's support[52] and the domestic partner cannot have gross income greater than the exemption amount (currently $3,650).[53] Furthermore, the domestic partner must be a U.S. citizen, resident or national, or a resident of Canada or Mexico.[54] The domestic partner must also be a member of the employee's household[55] for the entire taxable year, unless this violates local laws against cohabitation.[56] Therefore, in states that do not allow cohabitation, the domestic partner could not qualify as a dependent because he or she would fail the relationship test.[57] In that case the benefits would be taxable to the employee.

State taxation of employee fringe benefits varies by state. Generally, state laws follow federal laws for opposite-sex spouses.[58] However, state laws vary considerably as to the state taxation of benefits offered to domestic partners. States with same-sex marriage (MA, CT, IA, VT, NH and DC) do not tax the benefits for same-sex spouses and usually don't tax benefits paid on behalf of opposite-sex spouses. However, they may tax benefits paid to domestic partners, either same-sex or opposite-sex. Table 2 summarizes these rules for Federal and Massachusetts taxation.

[50] *See supra* note 18 and accompanying text.
[51] I.R.C. § 152(a)(2) (2010).
[52] I.R.C. § 152(d)(1)(C) (2010).
[53] *Id.* § 152(d)(1)(B).
[54] I.R.C. § 152(b)(3)(A) (2010).
[55] I.R.C. § 152(d)(2)(H) (2010).
[56] I.R.C. § 152(f)(3) (2010).
[57] As of this writing only seven states have laws against cohabitation.
[58] *See* Heather Abrigo, *The Unintended Consequence of Providing Employee Benefits for Domestic Partners*, 15 J. OF PENSION BENEFITS 18, 20 (2007).

Table 2

Taxation of Fringe Benefits

	Domestic Partners (1)	**Married - Same-Sex**	**Married - Opposite Sex**
Federal Tax Law	Taxable	Taxable	Not Taxable
Massachusetts Tax Law	Taxable	Not Taxable	Not Taxable

(1) Same or Opposite Sex

Gay Marriage

The advent of DPBs largely predates the legalization of gay marriage. Employers offer DPBs for several reasons, which include maintaining market competitiveness for qualified employees and because of perceived fairness.[59] Many employers felt it was discriminatory to offer benefits to legally married opposite-sex spouses of employees but not to unmarried same or opposite-sex domestic partners.[60] However, the legalization of gay marriage meant that all employees could marry and therefore the discrimination was possibly lessened or eliminated in those states. Thus, in 2003, when the Massachusetts Supreme Judicial Court in *Goodridge*, held that it was unconstitutional for the state to deny marriage licenses to seven same-sex couples, employers had to rethink DPBs.[61]

While Massachusetts employers have faced this dilemma for over seven years, employers in four other states are just beginning to consider their DPBs policies. Five years post-*Goodridge*, four additional states successfully legalized gay marriage. In 2009, the Supreme Court of Connecticut held that merely permitting same-sex couples to enter civil unions while denying the full right of marriage was

[59] *See Domestic Partner Benefits: Facts and Background*, *supra* note 4.
[60] Id.
[61] *Goodridge v. Department of Public Health*, 798 N.E.2d 941, 969 (Mass. 2003).

unconstitutional.[62] In April 2009, Iowa's Supreme Court held that a state statute that limited marriage licenses to opposite couples was unconstitutional.[63] Weeks later, Vermont became the first state to legislate gay marriage absent a court ruling.[64] New Hampshire's legislature quickly followed suit when it legalized gay marriage months later.[65]

Public sentiment toward gay marriage is changing and evolving, which is evidenced by the increasing number of states that either have, or are moving toward, legalizing gay marriage through court rulings, legislative action, or popular vote. A 2009 study found that while only forty-two percent of Americans supported gay marriage, the percentage represented the highest level since polling began in 2004.[66] Further, Gallup polls conducted between 1996 and 2006 found a strong increase in public opinion favoring gay marriage.[67] Based on these studies, polls, and previously discussed court rulings, acceptance of gay marriage is increasing throughout the United States.

The Legal Argument

On its face, the unlawful discrimination argument appears rational for the unmarried employee who is in an opposite-sex relationship and whose partner does not qualify for benefits when that same partner would if the employee was in a same-sex relationship.[68] The advent of gay marriage has bolstered this argument: why should an unmarried employee in a same-sex relationship be eligible for benefits when the employee and partner could marry and qualify in the same manner as opposite-sex couples?[69] Not surprisingly, the legal remedy is evolving

[62] *Kerrigan v. Commissioner of Public Health*, 957 A.2d 407, 482 (Conn. 2008). New effective legislation would legalize gay marriage as well. 2009 Conn. Pub. Acts 13.

[63] Varnum v. Brien, 763 N.W.2d 862, 907 (Iowa 2009).

[64] 15 V.S.A. § 8. The Vermont legislature overturned Governor Jim Douglas's veto. Keith B. Richburg, *Vermont Legislature Legalizes Gay Marriage*, WASHINGTON POST, April 7, 2009.

[65] Abby Goodnough, *New Hampshire Legalizes Same-Sex Marriage*, NEW YORK TIMES, June 3, 2009.

[66] http://www.cbsnews.com/8301-503544_162-4972643-503544.html

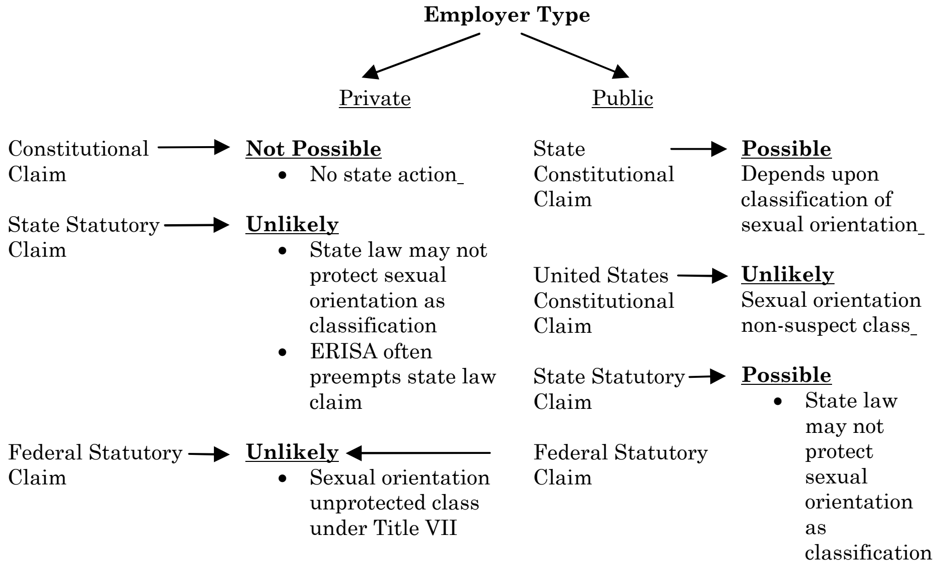
[67] *Same-sex Marriages and Civil Unions*, RELIGIOUSTOLERANCE.ORG, (last visited Dec. 2010), http://www.religioustolerance.org/hom_marp.htm.

[68] *See e.g. Irizarry v. Board of Education of the City of Chicago*, 251 F.3d 604 (7th Cir. 2001); *Foray v. Bell Atl.*, 56 F. Supp. 2d 327 (S.D.N.Y. 1999).

[69] *See Partners Healthcare Sys., Inc. v. Sullivan*, 497 F. Supp. 2d 29, 31-32 (D. Mass. 2007). *But see* Bindu Kolli, Comment, *In Love and in Jeopardy: Why Legal Recognition of Same-Sex Unions Does Not End the Need for Domestic Partner Benefit Programs*, 10 U. PA. J. BUS. & EMP. L. 225 (2007) (citing lack of protection from employment discrimination based on sexual orientation as reason to maintain domestic partnership benefits); DOMESTIC PARTNERSHIP BENEFITS STILL MATTER IN THE AGE OF EQUAL MARRIAGE:

and complex. As discussed *infra*, state action requirements, constitutional classification of sexual orientation, ERISA, and Title VII largely negate the likelihood of a successful lawsuit. Flowchart 1 summarizes the legal considerations:

Flowchart 1



The aggrieved employee and partner might look first to protection pursuant to the Equal Protection clause under the Fourteenth Amendment of the United States Constitution.[70] Of course, the first hurdle is that the employer must be a state actor and thus private sector employees receive little constitutional protection.[71] Further, even in situations in which there is state action, because most courts have held that opposite-sex couples are a non-suspect class, the public employer must merely demonstrate that the employer's disparate policy is rationally related to a legitimate government interest.[72] For example, in

MARRIAGE DOES NOT MEAN INSTANT EQUALITY FOR LESBIAN AND GAY EMPLOYEES, GAY & LESBIAN ADVOCATES & DEFENDERS 1 (Nov. 2009) (citing ongoing job prospects and legal uncertainty as reasons to maintain same-sex domestic partnership benefits).

[70] "[N]o state shall . . . deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. Amend. XIV, § 1.

[71] *See Moose Lodge No. 107 v. Irvis*, 407 U.S. 163 (1972) (holding no protection pursuant to Fourteenth Amendment where private nightclub denied service to African American).

[72] *See* Irizarry, 251 F.3d at 610. Outside the realm of opposite-sex couples, courts have generally held that sexual orientation is a non-suspect classification. *Romer v. Evans*, 517

Irizarry v. Board of Education of the City of Chicago, in 2001, the Seventh Circuit Court of Appeals held that the Chicago Board of Education had properly identified both the cost of extending domestic partnership benefits beyond same sex partners, and the desire to attract homosexual teachers as a rational basis for its unequal policy.[73]

While still mandating state action, protection pursuant to state constitutions is more permissive because the United States Constitution provides a mere floor in terms of protecting individual rights.[74] In some instances, state courts have held that sexual orientation is a suspect classification thereby requiring the state to satisfy a heightened scrutiny.[75] This was the case in *Tanner v. Oregon Health Sciences University*, in which an Oregon university denied health and life insurance benefits to unmarried same-sex couples.[76] Three lesbian employees sued the university notwithstanding the fact that the university treated same-sex and opposite-sex unmarried couples exactly the same.[77] In holding that the university violated the Oregon Constitution, the court noted that "[s]exual orientation, like gender, race, alienage, and religious affiliation is widely regarded as defining a distinct, socially recognized group of citizens, and certainly it is beyond

U.S. 620 (1996) (analyzing amendment to Colorado constitution prohibiting state or local protection of gays and lesbians under rational basis pursuant to United States Constitution); *Lawrence v. Texas*, 539 U.S. 558, 574 (2003) (using rational basis standard in analyzing constitutionality of Texas sodomy law).

[73] Irizarry, 251 F.3d at 610. Of note, it appears that the court may have held differently, had Illinois permitted gay marriage. *Id.* at 611.

[74] *Kerrigan v. Commissioner of Public Health*, 957 A.2d 407, 420 (Conn. 2008).

[75] *See Tanner v. Oregon Health Sciences Univ.*, 971 P.2d 435, 447 (Ore. 1998) (holding unmarried homosexual couples as suspect classification under Oregon Constitution). *See also* Kerrigan, 957 A.2d at 431-32 (holding same-sex couples subjected to intermediate scrutiny under Connecticut Constitution because quasi-suspect class). *But see Conway v. Deane*, 932 A.2d 571, 629 (Ma. 2007) (analyzing state law denying marriage licenses to same-sex couples under rational basis because same-sex couples non-suspect class pursuant to Maryland constitution); *Andersen v. King County*, 138 P.3d 963, 981 (Wash. 2006) (holding same-sex couples non-suspect class under Washington Constitution); *Alaska Civil Liberties Union v. Alaska*, 122 P.3d 781,789 (Alaska 2005) (subjecting same-sex couple to minimum scrutiny under Alaska constitution); *Goodridge v. Dept. of Public Health*, 798 N.E.2d 941, 961 (Mass. 2003) (holding denial of marriage licenses to same-sex couple unconstitutional under mere rational basis review pursuant to Massachusetts constitution); *Snetsinger v. Montana Univ. Sys.*, 104 P.3d 445 (Mont. 2003) (holding same-sex couples entitled mere rational review under Montana Constitution).

[76] Tanner, 971 P.2d at 437-38.

[77] *Id.* at 438. Even a neutral policy, like the one in *Tanner*, may violate the equal protection clause if has a disparate impact on a class. *Conaway v. Deane*, 932 A.2d 571, 559-560 (Md. 2007).

dispute that homosexuals in our society have been and continue to be the subject of adverse social and political stereotyping and prejudice."[78]

In other instances, state courts have found that while sexual orientation does not receive heightened scrutiny, the employer's policy was not rationally related to a legitimate government interest thereby failing the permissive rational basis test.[79] For example in *Snetsinger v. Montana University System*, the university permitted opposite-sex domestic couples to obtain benefits while not allowing the same for couples of the same sex.[80] The appellate court held that the trial court had erred when it concluded that the university's policies classified eligibility by marital status and not by sexual orientation.[81] The court further held that the policy was not rationally related to the goal of administrative efficiency because there were other means to obtain that efficiency.[82] Table 3 outlines the constitutional classifications in gay marriage states.

Table 3

State	Classification	Means	Citation
Massachusetts	Non-Suspect	Rational Basis	*Goodridge v. Dept. of Public Health*, 798 N.E.2d 941, 961 (Mass. 2003)
Connecticut	Quasi-suspect	Intermediate Scrutiny	*Kerrigan v. Commissioner of Public Health*, 957 A.2d 407, 431-32 (Conn. 2008).
Vermont	Heightened	Reasonably Related	*Baker v. State*, 744 A.2d 864, 885-86 (Vermont 1999)

[78] *Id.* at 447. Of note, the court in *Tanner* applied a suspect classification analysis when interpreting the privileges or immunities clause and not to the equal protection clause. *Id.* at 444. "No law shall be passed granting to any citizen or class of citizens privileges or immunities, which, upon the same terms, shall not equally belong to all citizens." OR. CONST. ART. I, § 20.

[79] *Alaska Civil Liberties Union v. State*, 122 P.3d, 781, 789 (Alaska 2005); *Snetsinger v. Montana University System*, 104 P.3d, 445, 450 Mont. 2004).

[80] Snetsinger, 104 P.3d at 451.

[81] *Id.* at 450. Montana had defined marriage as between one man and one woman. Mont. Code Ann. 26-1-602 (2009).

[82] Snetsinger, 104 P.3d at 452.

State	Classification	Means	Citation
New Hampshire	Non-suspect	Rational Basis	*Opinion of the Justices*, 525 A.2d 1095, 1099-1100 (N.H. 1987)
Iowa	Quasi-suspect	Intermediate Scrutiny	*Varnum v. Brien*, 763 N.W.2d 862 (Iowa 2009)
California[83]	Suspect	Strict Scrutiny	*In re Marriage Cases*, 183 P.3d 384, 441-42 (Calif. 2008)

Absent state action, state and federal anti-discrimination laws provide the primary remedy to private sector employees and their partners. In the majority of states, however, anti-discrimination laws fail to protect against discrimination based on sexual orientation.[84] The laws in the five gay marriage states and California, however, do protect against employment discrimination based upon sexual orientation. Table 4 outlines the pertinent statutes in gay marriage states.

Table 4

State	Statute
Massachusetts	MASS. GEN LAWS ch. 151B, §§ 3-4
Connecticut	CONN. GEN. STAT. § 46a - 81c-m
Vermont	VT. STAT. ANN. tit. 21, § 495; VT. STAT. ANN. tit. 9, § 4503; VT. STAT. ANN. tit. 8, §§ 10403, 4724; VT. STAT. ANN. tit. 3, § 963
New Hampshire	N.H REV. STAT. ANN. §§ 21-I:42, 354-A:2, A:6
Iowa	IOWA CODE *§ 216.2(14)*
California[85]	CAL. GOV'T CODE § 12920; CAL. CIV. CODE § 51

Even when state law protects employees from discrimination on the basis of sexual orientation, the Employment Retirement Income Security Act (ERISA) almost always preempts the state law when the discrimination results in an employer denying an employee benefits.[86]

[83] *See supra* note 21.
[84] Human Rights Campaign Website (last visited Aug. 17, 2010), http://www.hrc.org/laws_and_elections/enda.asp. It is legal under the laws of twenty-nine states to discriminate on the basis of sexual orientation. *Id.*
[85] *See supra* note 21.
[86] 29 U.S.C. § 1144(a) (2006). ERISA provides that "[it] shall supersede any and all

This generally takes its form in two ways. First, in a gay marriage state such as Massachusetts, an employer may decline to offer benefits to a same-sex spouse.[87] ERISA preempts *Goodridge* when federal law governs a private employer's benefit program and DOMA permits an employer to deny benefits because of the limited definition of marriage.[88]

Second, and more on point with this article, ERISA preempts the discriminatory state law claim of an employee in an opposite-sex relationship whose employer has denied the opposite-sex partner benefits.[89] In *Partners Healthcare System v. Sullivan*, the hospital conglomerate sued the Massachusetts Commission Against Discrimination (MCAD) after it failed to dismiss a hospital employee's claim.[90] The employee, whose opposite-sex partner was denied employee benefits, asserted that the hospital's policy violated Massachusetts antidiscrimination laws.[91] One of the issues before the court was whether ERISA preempted a general state law.[92] Consistent with several district courts, the Federal District Court for the District of Massachusetts held that "any state law which directly controls who an ERISA plan may specify as a beneficiary is potentially preempted."[93]

As a result, Title VII of the Civil Rights Act generally remains the sole remedy of the employee's preempted state law claim. A successful Title VII claim requires that the plaintiff show both that he is within a protected class and that his employer treated him differently from those outside the protected class.[94] Title VII, however, expressly limits the

State laws insofar as they may now or hereafter relate to any employee benefit plan . . . ." *Id*. Government plans and church plans are exempt from ERISA. *Id.* § 1003(b).

[87] HEALTH LAW ADVOCATES, SAME-SEX SPOUSAL HEALTH BENEFITS, IN MASSACHUSETTS AFTER *GOODRIDGE*, GLAD 1 (June 2009); Kimberly Blanton, *Same-Sex Retirement Benefits Lag Only 35% of Mass. Firms Say They'll Extend Offerings*, BOSTON GLOBE, Dec. 29, 2004, at D1.

[88] *See* HEALTH LAW ADVOCATES, *supra* note 87, at 1. Self-insured plans are exempt from state insurance laws and are therefore preempted by ERISA. *Id.* at 2. Moreover, the plan must clearly exclude same-sex spouses. *Id.*

[89] 29 U.S.C § 1144(a) (2009).

[90] *Partners Healthcare Sys. v. Sullivan*, 497 F. Supp. 2d 29, 31 (D. Mass. 2007).

[91] *Id.* at 32. Discrimination under Massachusetts law may arise when an employer discriminates on the basis of sexual orientation. MASS. GEN. LAWS ch. 151B § 4.

[92] 497 F. Supp 2d at 34-35.

[93] *Id.* at 37. *See also Air Transport Ass'n of America v. City and County of San Francisc*o, 992 F. Supp. 1149, 1173 (N.D. Cal. 1998) (noting ERISA preempts employee pension benefit plan and employee welfare benefit plan). *But see* Joel M. Nolan, Note, *Chipping at the Iceberg: How Massachusetts Anti-discrimination Law Can Survive ERISA Preemption and Mandate the Extension of Employee Benefits to All Married Spouses Without Regard to Sexual Orientation*, 42 NEW ENG. L. REV. 109, 138-39 (2007) (proposing District Court in Partners employed too broad of interpretation of connection between Massachusetts anti-discrimination laws and ERISA).

[94] *Humenny v. Genex Corp.*, 390 F. 3d 901, 906 (6th Cir. 2004).

protected class based on an "individual's race, color, religion, sex, or national origin."[95] Therefore, for example, a male employee who has an opposite-sex partner struggles to show that his employer treated him differently from a similarly situated female employee who has a qualifying same-sex partner.[96] This is particularly true in non-gay marriage states, because same sex partners do not have the option to marry and thus the two employees are not similarly situated.[97] In gay marriage states, however, the employee may argue that he is similarly situated because both employees have the option to marry.[98]

In 1989, the United States Supreme Court carved out an exception under Title VII for employment discrimination based upon sexual stereotyping.[99] This type of claim arose in the context of a lesbian employee claiming that her employer discriminated against her because she was not feminine enough in the workplace.[100] Employees have had little success in shaping their claims based on this theory.[101] In *Partners*, MCAD broadened this argument to include claims for "associational sex discrimination" in which an employer discriminated against an employee based on the sex of person with whom the employee chose to associate.[102] The court rejected this theory and limited recovery to discrimination based on the "characteristics that were readily demonstrable in the workplace, such as the plaintiff's manner of walking and talking at work, as well as her work attire and her hairstyle."[103] The record did not support that the heterosexual male living with a female domestic partner had been discriminated against because of "any stereotypical sex characteristic demonstrated in the workplace."[104]

Legislators have responded to the lack of protection afforded same sex couples within Title VII through the introduction of legislation that would outlaw discrimination in the workplace based on sexual orientation.[105] In June 2009, Representative Barney Frank introduced

[95] 42 U.S.C. § 2000e-22(a)(1).

[96] Foray, 56 F. Supp. 2d at 329-330.

[97] *Id.* at 330.

[98] *Id. See also* Partners Healthcare Sys., 497 F.Supp.2d at 38 (recognizing soundness of argument).

[99] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).

[100] *Id.* at 250.

[101] *See Vickers v. Fairfield Medical Center*, 453 F.3d 757, 759 (6th Cir. 2006) In *Vickers*, an employee claimed that he was discriminated against based upon either the real or perceived assumptions about his sexual practices as a homosexual male. *Id.* at 763. *See also Higgins v. New Balance Athletic Shoe, Inc.*, 194 F.3d 252, 260-61 (1st Cir. 1999) (affirming summary judgment on behalf of employer on impermissible stereotyping claim).

[102] Partners Healthcare Sys., 497 F. Supp 2d at 38-39.

[103] *Id.* at 39 (quoting Vickers, 453 F.3d at 763.

[104] Partners Healthcare Sys., 497 F. Supp 2d at 39.

[105] *See supra* note 95 and accompanying text.

the Employment Non-Discrimination Act of 2009 in the House and in August 2009, Senator Jeff Merkley introduced the same bill in the Senate.[106] Congress has failed on several occasions since 1994 to pass the bill, and the current bill remains in committee.[107] The Employment Non-Discrimination Act does not require an employer "to treat an unmarried couple in the same manner as the [employer] treats a married couple for purposes of employee benefits."[108] It further fails to protect against disparate impact claims or those claims in which the employer institutes a facially neutral policy that impacts a protected class.[109] Neither clause would have much impact in gay marriage states, because the employer would have to limit its policy to either same-sex or opposite-sex domestic partners in order for it to have any effect.

THE SURVEY

This article provides empirical evidence of the effect of same-sex marriage on employer policies regarding DPBs. The survey examines changes in DPBs as a result of the legalization of same-sex marriage on May 17, 2004.[110] Our sample consisted of 158 companies that responded to a survey conducted in partnership with the Northeast Human Resource Association.[111]

Of the 158 companies that responded to the survey, sixty-five percent of the companies were for-profit, twenty-eight percent were non-profit, two percent were state government and one percent was federal government employers. Three percent were other types of organizations, such as local government.

Table 5 summarizes the results of the survey.

[106] H.R. 3017, 111th Cong. (2009); S. 1584 111th Cong. (2009).

[107] Matthew Barker, Comment, *Employment Law – Anti-Discrimination – Heading Toward Federal Protection for Sexual Orientation Discrimination*, 32 U. ARK. LITTLE ROCK L. REV. 111, 129 (2009).

[108] H.R. 3017, 111th Cong. § 8(b) (2009); S. 1584 111th Cong. § 8(b) (2009).

[109] *Id.* § 8(a)(1). *See also supra* note 77 and accompanying text. The Act only applies to employers that have fifteen or more employees. *Id.* § 3(4)(A).

[110] *See supra* note 61 and accompanying text.

[111] The Northeast Human Resource Association (NEHRA) has a membership base of nearly 3,000 human resource professionals, representing large and small companies in all industries in the New England area. The survey, which was co-authored by the authors and NEHRA staff, was conducted from July 29, 2010 to August 12, 2010. For more information visit www.nehra.com.

Table 5	
Summary of 2010 Survey Results	
(Numbers in parentheses indicate number of respondents)	
Prior to Goodrich did you offer DPB?	
Yes **(A)**	57% (87)
No	43% (66)
(A) If Yes did you offer them to:	
same - sex partners only	33% (29)
Both same and opposite - sex partners	67% (59)
Did you change your DPB policy?	
Yes **(B)**	31% (47)
No	69% (106)
(B) If Yes how did you change your policy?	
Extended to same - sex	22% (10)
Extended to opposite - sex	2% (1)
Extended to both	32% (15)
Ended DPB for all **(C)**	19% (9)
Some other change	25% (12)
(C) In what way did you end DPBs?	
Ended DPBs to same-sex partners	67% (6)
Ended DPBs to opposite-sex partners	11% (1)
Ended DPBs for both	22% (2)
Are you considering changing your DPB policy?	
Yes **(D)**	10% (15)
No	90% (132)
(D) If you are changing your DPB policy, how is it changing?	
Extend to same-sex	7% (1)
Extend to opposite - sex	13% (2)
Extend to both	40% (6)
End benefits to both	20% (3)
Some other change	20% (3)

Fifty-seven percent of the respondents already offered DPBs of some kind (same-sex or opposite-sex) before *Goodridge*.[112] Forty-seven companies reported that they changed their DPBs after *Goodridge*. Of these, twenty-six extended DPBs not previously offered. Of the twenty-six that extended benefits, ten extended them to same-sex domestic partners, one company extended them to opposite-sex partners and fifteen extended them to both. Nine ended DPB for all domestic partners. Twelve unaccounted companies remain that changed their DPB policy in some way. If these twelve companies did in fact change their DPBs in some way, but neither extended new benefits nor ended existing benefits wholesale, it can be reasonably assumed that they offered DPBs of some kind prior to *Goodridge* and that in response to *Goodridge* they modified the DPBs in some way but did not end them completely. If this is so, it can further be logically assumed that these twelve companies offered DPBs of some kind before and after *Goodridge*. Therefore, the number of companies that offered DPBs after *Goodridge* is 113 (twenty-six extended DPBs plus eighty-seven companies who previously offered DPBs). Prior to *Goodridge*, fifty-seven percent of companies surveyed offered DPBs, while after *Goodridge*, seventy-four percent of companies surveyed offered DPBs. This indicates that the response to *Goodridge* was an increase of seventeen percent in the number of companies offering domestic partner benefits of some kind, which is unexpected.

Further analysis of the responses indicates that of the fifty-seven percent of companies that offered DPBs prior to *Goodridge*, thirty-three percent offered them only to same-sex partners and sixty-seven percent offered them to both same-sex and opposite-sex partners. Of the forty-seven companies that changed their DPBs in some way post-*Goodridge*, fifty-five percent (twenty-six companies) extended DPBs vs. nineteen percent percent (nine companies) which ended them. For the nine companies that ended DPBs, six (sixty-seven percent) ended them for same-sex partners; one ended them for opposite-sex partners and two ended them for both. For companies that changed their DPB policy by extending benefits not previously offered, thirty-eight percent offered them to same-sex partners, four percent offered them to opposite-sex and fifty-eight percent offered them to both. The trend seems to be to extend DPBs rather than to end DPBs, as a result of *Goodridge*. This trend specifically seems to favor same-sex DPBs over opposite-sex DPBs alone and the extension of DPBs to both opposite-sex and same-sex couples is greater than either individually.

[112] Although 158 companies responded to the survey only 153 answered the question about offering DPBs prior to *Goodridge*.

This response, extending DPBs to same-sex partners either alone or in conjunction with opposite-sex partners as a response to *Goodridge,* is surprising. *Goodridge* granted legality to same-sex *marriages*.[113] Same-sex domestic partnerships were legally unchanged by the ruling.[114] Yet the response in the business community seems to have been an expansion of domestic partnership benefits across the board and especially for same-sex partners. Though it might seem that the ruling made the same-sex DPB obsolete, it seemed to have the opposite affect. Perhaps the advent of legal gay marriage is linked to same-sex domestic partnership benefits in the minds of business people? Significantly, "fairness" was sighted as the number one most important reason (seventy-two percent of companies) for extending benefits for those who changed their policies after the ruling. "Fairness" was also sighted as the number one reason (seventy-eight percent) for the much smaller number of companies that ended their previously offered DPBs.

As a response to the legalization of same-sex marriage, "fairness" is a logical reason for eliminating DPBs rather than extending them. Offering DPBs to those who do not have the option of marrying, as in the case of same-sex couples, is fair. As has been stated previously, expanding DPBs to either orientation is an incongruous response to *Goodridge,* especially when "fairness" is given as the reason. Logically, one would think that the justification of offering DPBs to same-sex partners should be eliminated once they are allowed to marry. It seems even less fair to offer or extend DPBs to same-sex partners over opposite-sex partners even though both can marry. However, some have argued that even though same-sex couples can marry in some states inequities persist because they cannot marry in all states and the marriage is not recognized by federal law. Therefore, fairness may still be an important issue for employers.[115] Though public perception was not offered as a reason for changing policies in the study, it would be interesting to know if fairness meant the perception of fairness by the general public or merely a sense of fairness by the employer. Additionally, the second and third reasons cited for extending benefits were liability and competiveness. Cost, liability, and tax issues were of greater concern to the small number of companies ending benefits.

As the DPBs increased in scope and availability there seemed to be a decrease in the importance placed on marriage as a prerequisite for benefits. Most of the companies (sixty-nine percent) did not require proof of marriage in order for spouses to receive benefits.

[113] Goodridge, 798 N.E.2d at 969.

[114] *Id.*

[115] *See Domestic Partnership Benefits Still Matter In the Age of Equal Marriage*, GLAD, Nov. 2009, http://www.glad.org/uploads/docs/publications/dp-benefits-post-goodridge.pdf.

Very few companies have different policies with regard to employees working or living outside of Massachusetts. Apparently, companies offering DPBs offer them to all employees regardless of where they are or whether they can marry legally in the state they live in.

Looking to the future only ten percent of the companies indicated they were considering changing the DPB policy in some way (fifteen companies). Of these fifteen companies the largest number (6) were extending benefits to both same-sex and opposite-sex couples. Only three were ending benefits to both. Therefore, it seems that most of the companies that were going to change in response to *Goodridge* had already done so at the time of this survey.

SUMMARY

Five states and the District of Columbia allow same-sex couples to marry. Certainly, more states will follow suit.[116] In those states that allow same-sex marriage, such as Massachusetts, the question arises as to whether it is discriminatory for employers to deny benefits to opposite-sex domestic couples while continuing to provide benefits to same-sex domestic couples.

Before same-sex marriage was allowed it could be argued that same-sex domestic couples could not legally marry and therefore it was fair to provide benefits. Now that same-sex couples can marry in some states, such as in Massachusetts, it appears discriminatory to extend benefits to same-sex couples, who do not wish to marry, while denying benefits to opposite-sex couples who do not wish to marry. Employers in these states may be subject to lawsuits for continuing this practice. These employers have two options. They can extend benefits to opposite-sex domestic couples or end benefits for all domestic couples. Extending benefits to opposite-sex domestic couples is potentially very expensive because of the increasing number of couples cohabitating and the much larger opposite-sex domestic partner population. However, ending benefits for same-sex and opposite-sex domestic couples will have negative effects on the employer's ability to recruit the best employees and may have negative publicity effects.[117] Ending benefits for all couples could force some same-sex couples to marry despite unique negative effects of marriage not applicable to opposite-sex couples.[118]

[116] *Same-Sex Marriage, Civil Unions and Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated September 2010), http://www.ncsl.org/default.aspx?tabid=16430.

[117] *See e.g.* Thomas Coleman, *Boston Globe Takes a Wrong Turn on Employee Benefits*, UNMARRIED IN AMERICA, July 10, 2006, http://www.unmarriedamerica.org/column-one/7-10-06-boston-globe.htm.

[118] *Supra* note 117.

The survey data indicate that the response of employers to legal same-sex marriage is to expand benefits, rather than to end them, to both same-sex and opposite-sex domestic partners, but more so to same-sex partners. This response is unexpected and the potential liability from opposite-sex couples seems to be ignored in favor of perceived increases in fairness, perhaps due to the fact that same-sex state marriages are not recognized federally and that DPBs are now offered to opposite-sex domestic partners in many companies. These results may not be generalizable to other states that have or will legalize same-sex marriage. The political ideology of the state most likely affects employer policies and the results from Massachusetts may not be duplicated in more conservative areas of the country. This paper is useful for employers reviewing their domestic partner benefits policy in all states but especially in states where legalization of same-sex marriage is a strong possibility. It is also useful for employers with multi-state operations. Since Massachusetts was the first state to legalize same-sex marriage[119] the domestic partner policies of Massachusetts employers should be of interest to all.

[119] *Same-Sex Marriage, Civil Unions and Domestic Partnerships*, NATIONAL CONFERENCE OF STATE LEGISLATURES (last updated September 2010), http://www.ncsl.org/default.aspx?tabid=16430.

EXECUTIVE COMPENSATION: THE IMPACT OF DERIVATIVE LAWSUITS AND REGULATIONS AFTER *DISNEY*

by SUSAN C. ATHERTON*

I. INTRODUCTION

Always controversial, but more so in our current economic downturn, the substantial compensation packages of U.S. corporate executives have become the central focus of regulators' efforts to increase disclosure and accountability through enforcement and legislation. This phenomenon has dominated U.S. securities regulations and legislation, particularly as a result of securities fraud and breach of fiduciary duties in severance and retirement arrangements.[1] Further, recent House Committee hearings identified compensation practices at large financial institutions as one factor among many contributing to the onset of the financial crisis in 2007.[2] Corporations' concentration on producing high short-term profits resulted in generous bonus payments without regard to long-term risks, thus intensifying excessive risk-taking.[3] Consequently, the large compensation payments and bonuses while corporations

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1 John W. Moka III, 2010 a Record Year for Securities Litigation: An Advisen Quarterly Report – 2010 Review (January 2011).

2 Martin Neil Bailey, Executive Compensation Oversight After the Dodd-Frank Wall Street Reform and Consumer Protection Act, Brookings (March 1, 2011, 3:07PM), http://brookings.edu/testimony/2010/0924_executive_compensation. (Testimony before the House Financial Services Committee to outline a safer compensation structure for financial institutions.)

3 *Id.*

announced record losses heightened regulators' and shareholders' awareness of the need for increased director risk oversight and vigilance in approving compensation.

The outrage over the high severance package of Disney's CEO Michael Ovitz perhaps marked the most intense shareholder resentment since the Enron and WorldCom scandals.[4] Shareholders' derivative claims to recover investment losses based on breaches of fiduciary duty, fraud, corporate waste and unjust enrichment increased.[5] Also, despite an increase in compliance and regulations, shareholders and regulators may have been even more disappointed in the Delaware Court's 2006 *Disney* decision reaffirming that directors who act in good faith and exercise due care will not be held liable for breaches of fiduciary duties nor be exposed to personal liability for their compensation decisions.[6] The *Disney* decision suggests that compensation cases and state statutes enacted after it will continue to provide liberal protections for the personal liability of directors and officers, and that shareholders will most likely achieve limited success in derivative suits. [7]

After describing the compensation debate and outlining the steps of a derivative lawsuit, this paper explores relevant case law to assess the adequacy of shareholder remedies in recent claims of excessive executive compensation. In today's environment, derivative case law and current regulations may demonstrate that a door has been opened to erode some of directors' personal liability protections despite the courts' reaffirmation of protections with *Disney*.[8]

II. THE COMPENSATION DEBATE

It may be useful to focus on the relationship between what appears to be a shift in the balance between the courts and regulators, and between director primacy and shareholder power. While state law regulates corporations' compensation decisions that constitute gross negligence, waste, or bad faith as well as the directors' decision-making process, federal law focuses primarily on disclosure of certain compensation arrangements; i.e. incentive-based. Furthermore, state and federal courts review only the process by which the compensation arrangement is made, not the actual arrangement. This may result in unintended

[4] Moka, *supra* note 1.

[5] *Id.*

[6] *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd.* 906 A.2d 27 (Del. 2006).

[7] Kurt A. Mayr, II, Note, *Indemnification of Directors and Officers: The "Double Whammy" of Mandatory Indemnification Under Delaware Law in Waltuch v. Conticommodity Services, Inc.*, 42 Vill. L. Rev. 223, 230 (1997).

[8] Telman, *supra* note 6.

consequences, wherein directors' behavior is adverse to shareholder interests, but shareholders are unable to effect changes.

From a practitioner viewpoint, compensation is an accounting expense item, and might be considered distinguishable from corporate entrepreneurial decisions that constitute business risk, such as new innovations, mergers and acquisitions, new product and market development, or entry into global markets. But there are numerous issues underlying the compensation debate. Was the compensation arrangement made in good faith? Should compensation be linked to risk? If the value of the package is materially adverse, what result? Will compensation disclosure provide sufficient information under varying possibilities?

Numerous courts have recognized the need to shield directors from liability for the risky ventures necessary for commercial development.[9] Scholars and courts have expressed concern that qualified businesspeople would refuse to serve on boards if their risk decisions were not protected or, even if they agreed to serve, individual members would become risk averse and investors would suffer.[10] Without a standard for personal liability, directors might engage in more risky commercial ventures utilizing shareholders' funds without adequate risk of personal liability.[11] Current state and federal law thus places risk for directors' decision-making on the shareholder through liberal protections and indemnification.[12] Shareholders' concern today is that they bear the risk of investment losses because of poor financial decisions in the subprime mortgage market and excessive compensation awards, yet as taxpayers must also bear the financial risk of bailing out the very same institutions that created the problem. The resulting "double whammy" suggests that a review of the doctrine of director primacy as unfettered risk-taking might result in legislation or court decisions that erode some of directors' personal liability protections. [13]

Implementation of new legislation with accompanying enforcement may result in a shift in the balance toward a slight increase in shareholder power. However, the regulatory focus on disclosure without prescribing a process leaves responsible director behavior to the vagaries of the market or to private litigation and the protections of the business judgment rule. Without a process to evaluate compensation "risk," very little will change. Some hope was provided by a series of Securities and

[9] D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation,* 81 Tul. L. Rev. 829, 844 (2007).

[10] *Id.* at 845-846.

[11] *Id.* at 846.

[12] Mayr, *supra* note 7, at 223.

[13] *Id.*

Exchange Commission ("SEC") promulgations beginning in 2006. Federal regulations such as The Dodd-Frank Wall Street Reform and Consumer Protection Act ("The Dodd-Frank Act") of 2010 included mechanisms for enforcement of risk oversight and curtailment of some of the protections associated with compensation decisions because of factors identified as contributing to the economic and financial crisis.[14] The apparent conflict between the courts' affirmation of personal liability protections and the regulatory mandate to enforce director oversight for risk and reduce director protections may not provide additional success in derivative actions to recover shareholder losses on behalf of corporations.

III. THE PROCEDURAL NATURE OF THE DERIVATIVE LAWSUIT

Normally, shareholders objecting to compensation decisions sue the individual board members.[15] The decision to initiate or pursue a lawsuit on behalf of a corporation is based on the principle of director primacy, that directors, rather than shareholders, manage the business and affairs of the corporation.[16] A derivative action is a lawsuit brought by a shareholder against a director or officer of the corporation for mismanagement or breach of fiduciary duty, on behalf of the corporation, to enforce a claim belonging to the corporation.[17] Recovery generally goes to the corporation, and as the shareholders' return is often dwarfed by the expense of bringing the suit. Derivative suits are increasingly limited by procedural and substantive restrictions imposed to prevent perceived abuses generated by such suits. [18]

As directors (or other fiduciaries) of corporations or associations have duties to the investors and the corporation to act in good faith and with loyalty, due care and complete candor, the restrictions imposed by the procedural posture of derivative cases is noteworthy. Almost universally, plaintiff shareholders allege a breach of fiduciary duties by directors and officers, along with claims of corporate waste and unjust enrichment. The Delaware courts exercise extreme care and fairness in analyzing plaintiffs' claims beginning with satisfaction of the demand requirement. If the suit proceeds, the court carefully reviews allegations of breaches of fiduciary duties and the business judgment rule, which

[14] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

[15] Jennifer S. Martin, Article: *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation,* 32 Del. J. Corp. L. 481, 493 (2007).

[16] Del. CODE ANN. Tit. 8 § 141(a) (2005).

[17] Martin, *supra* note 15, at 495.

[18] Robert B. Thompson and Randall S. Thomas, Article: *The Public and Private Faces of Derivative Lawsuits,* 57 Vand. L. Rev. 1747, 1758 (2004).

are inseparable. Claims of waste and unjust enrichment are then analyzed under Delaware corporation law. These steps in derivative litigation are briefly described below.

A. The Demand Requirement

Following from Delaware corporation law, in order to cause the corporation to pursue litigation, a shareholder must either: (1) make a pre-suit demand by presenting the allegations to the corporation's directors, requesting that they bring suit, and showing that they wrongfully refused to do so, or (2) plead facts showing that demand upon the board would have been futile.[19] The purpose of the demand requirement is not to insulate defendants from liability; rather, the demand requirement and the strict requirements of factual particularity under Rule 23.1 exist to preserve the primacy of board decision-making regarding legal claims belonging to the corporation.[20] Where a plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the board would have been futile.[21] The pre-suit demand requirement is required under Delaware law if shareholders seek to recoup damages to the corporation for breaches of fiduciary duties, waste, or unjust enrichment.[22] One of two factors are sufficient to determine whether a demand is excused on the basis of demand futility:

> (1) "under the particularized facts alleged, a reasonable doubt is created that […] the directors are disinterested and independent;" or
>
> (2) "the pleading creates a reasonable doubt 'that the challenged transaction was otherwise the product of a valid exercise of business judgment.' "[23]

Assuming that the demand requirement is met, the court continues to review the allegations for breaches of fiduciary duties.

B. Fiduciary Duties of Directors and Officers

Historically, the fiduciary duties required by directors and officers of a corporation encompass the duty of care, loyalty and to act in good

[19] Del. Ch. Ct. R. 23.1(a).

[20] *Id.*

[21] *Id.*

[22] *In re* Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106, 120 (Del. Ch., Feb. 24, 2009) (citing *Aronson v. Lewis*, 473 A.2d at 814).

[23] *Id.* (citing *Brehm v. Eisner*, 746 A2d 244, 256) Under Delaware law as clearly articulated in *Brehm*, these prongs are in the disjunctive. Therefore, if either prong is satisfied, demand is excused.

faith, described briefly below. The court reviews the facts to determine whether those duties have been met.

The Duty of Care:

The duty of care "requires that directors of a Delaware corporation 'use that amount of care which ordinarily careful and prudent men would use in similar circumstances'..."[24] The duty of care concerns directors' decision-making *process*, not the substance of their decisions.[25] The standard in Delaware for determining whether a director has breached his duty of care is gross negligence.[26] A board's informed decision will withstand a duty of care challenge unless its substance cannot be "attributed to any rational business purpose."[27]

The Duty of Loyalty:

"[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[28] The Delaware Supreme Court recently clarified in *Stone v. Ritter* that the "duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith."[29] Alleged breaches of the duty of loyalty are generally scrutinized by courts under the entire fairness standard of review.[30]

The Duty to Act in Good Faith:

"Good faith has been said to require an "honesty of purpose" and a genuine care for the fiduciary's constituents..."[31] The *Disney* court found it easier to define bad faith, which can take different forms with varying degrees of culpability.[32] A director acts in "subjective bad faith" when his actions are "motivated by an actual intent to do harm" to the

[24] Thomas A. Eubler, *Shareholder Policy Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law,* Del. J. Corp. L., 203 (2008) (quoting *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd.* 906 A.2d 27 (Del. 2006).

[25] *Id.*

[26] *Id.* at 203 (citing *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985)).

[27] *Id.* (citing *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 747 (Del. Ch. 2005) (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

[28] *Id.* at 204 (citing *Cede & Co. v. Technicolor,* 634 A.2d 345 (Del. 1993)).

[29] *Id.* (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).

[30] *Id.* (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)).

[31] *Id.* at 204.

[32] *Id.*

corporation.[33] An "intentional dereliction of duty" or "a conscious disregard for one's responsibilities" also are "legally appropriate, although not . . . exclusive definition[s] of fiduciary bad faith."[34]

C. The Business Judgment Rule

In *Aronson v. Lewis*, the Delaware Supreme Court described the business judgment rule as an evidentiary presumption favoring directors, and characterized as:

> "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decisions to establish facts rebutting the presumption."[35]

In general, the court does not separate claims of breach of fiduciary duty from its review of the business judgment rule in evaluating the directors' process for making its compensation decisions. The business judgment rule presumes that directors act in good faith in making business decisions in the best interest of the company. Plaintiffs must overcome the presumption of a good faith business judgment but may only do that by proving a breach of one of the duties, or acts of fraud, bad faith or self-dealing.[36] Thus, the business judgment rule liberally protects directors unless plaintiffs can prove that the directors and officers committed fraud, acted in bad faith, or put their interests ahead of the interests of the corporation.

IV. THE *DISNEY* DECISION AND ITS FOUNDATIONS

Two earlier shareholder derivative suits furnished a foundation for the *Disney* decision and the Delaware courts' standards for establishing personal liability of directors and officers for damages caused by breaches of fiduciary duty. Shareholder plaintiffs in *Smith v. Van Gorkom*[37] and *Caremark*[38] alleged claims other than excessive compensation. However, these cases established exculpatory and indemnification standards that liberally protected directors from shareholder challenges. As only a small number of derivative suits claiming excessive compensation based on allegations of the breach of

[33] *In re* Walt Disney, *supra* note 6, at 55.
[34] *Id.* at 56-57.
[35] Telman, *supra* note 8, at 833-834.
[36] *In re* Viacom Inc. Shareholder Derivative Litig., 2006 N.Y. Misc. LEXIS 2981 (N.Y. 2006).
[37] *Smith v. Van Gorkom*, 486 A.2d 858 (1985).
[38] *In re* Caremark, *supra*.

fiduciary duty, corporate waste and unjust enrichment are successful in the absence of fraud, bad faith or self-dealing, plaintiffs must show a breach of the duty of loyalty or good faith. In *Smith v. Van Gorkom,* a foundation was laid for the standards of duty of care and the duty to act in good faith that are reflected in the *Disney* decision and current standards espoused by the Delaware courts and corporation laws.[39] In contrast, *Caremark* allowed exculpatory language in cases claiming director liability for risk oversight by limiting director liability for breaches of the duty of care but also provided an opening for a new line of legal investigation regarding director risk oversight.[40] Furthermore, claims alleging director liability for risk oversight become more important after *Disney*, raising questions about both the process and substance of compensation arrangements.

A. Smith v. Van Gorkom *and* Caremark

In *Smith v. Van Gorkom*, the Delaware Supreme Court held individual directors liable for breaching their duties of care when they approved a merger transaction after only two hours of deliberation without reading the merger agreement or engaging in any sale-appropriate preparations.[41] In response, Delaware amended its Corporation Law to permit corporations to stipulate in their bylaws that directors will not be liable for damages for beach of the duty of care.[42] The courts acted swiftly to limit the scope of plaintiff derivative suits challenging director oversight solely to a breach of the duty of loyalty. Thus, exculpatory language in Delaware corporate law limited director liability only to instances involving a breach of the duty of good faith or loyalty while simultaneously eliminating liability for a breach arising under the duty of care.[43] This distinction is later noted in *Disney* but has great implications for regulators as the duty of care is not clarified or expanded to support new legislation or enforcement.[44] It follows from *Smith v. Van Gorkom* that directors cannot be held liable regardless of fault or resulting harm and shareholders must endeavor to prove a breach of the duty of loyalty in the face of these limitations if they wish to recover damages on behalf of the corporation.[45] It also follows that shareholders alleging a duty of care claim would require a lower

[39] *Smith v. Van Gorkom, supra* note 37.

[40] *In re Caremark*, *supra* note 38.

[41] Telman, *supra note 8,* at 847 (citing *Smith v. Van Gorkom*, 488A.2d 858 (Del. 1985)

[42] *Id.* at 848.

[43] Anne Tucker Nees, Article: *Who's the Boss? Unmasking Oversight Liability within the Corporate Power Puzzle,* 35 Del. J. Corp. L. 199, 216, 217 (2010).

[44] *In re* Walt Disney, *supra*.

[45] Nees, *supra* note 43, at 219.

showing of fault for failed oversight while a duty of loyalty claim requires a higher standard of proof that a director took, or failed to take, a certain action in bad faith or with a conscious disregard of a duty.[46] Thus, the courts hold shareholders to a higher standard with regard to breaches of loyalty and good faith claims.

The 1996 landmark *Caremark* decision focused on the issue of board oversight.[47] The court found that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[48] Shareholders alleged that the members of Caremark International's board of directors breached their fiduciary duty of care to Caremark when employees violated federal and state laws and regulations applicable to health care providers, thus violating a duty to be active monitors of corporate performance.[49] The basic rule under *Caremark* for assessing whether board oversight of risk management satisfies the directors' fiduciary duties is that directors can only be liable for a failure of board oversight where there is "sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists."[50] The Delaware courts have made clear that they will not impose liability under a *Caremark* theory unless the directors intentionally failed to implement any reporting or information system or controls or, having implemented such a system, intentionally refused to monitor the system or act on warnings it provided,[51] and thus laid the foundation for the duty of good faith in *Disney*.

In *Caremark*, the court stated clearly that director liability for a breach of the duty to exercise appropriate attention arises in two contexts: "to follow *from a board decision* that results in a loss because that decision was ill advised or "negligent" or "from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss."[52] Most important, the court stated that "compliance with a director's duty of care can never appropriately be judicially determined by reference to the *content of the board decision* . . ."[53] In other words, the *Caremark* court clarified its role to review the process and not the substance of compensation

[46] *Id.*
[47] *In re* Caremark, *supra* note 38.
[48] *Id.* at 5.
[49] *Id.* at 1.
[50] *See* Hillary A. Sale, *Monitoring* Caremark's *Good Faith*, 32 Del. J. Corp. L. 719 (2007); *In re* Caremark, 698 A.2d at 971.
[51] 698 A.2d at 972.
[52] *Id.* at 3.
[53] *Id.* at 3-4.

packages. Little has changed since *Caremark* as both the courts and regulators today focus on reviewing the process for compensation decisions and not the substance of compensation arrangements and negotiation. This conceivably permits directors unfettered discretion in making compensation arrangements that may be adverse to shareholders.

B. In re The Walt Disney Company Derivative Litigation

Long awaited and followed, the Delaware Supreme Court's decision in the shareholder derivative litigation against the Walt Disney directors has influenced subsequent cases and regulatory proposals. The Delaware Supreme Court in 2006 affirmed the Chancery Court's finding that Disney directors did not breach their fiduciary duties or commit waste in the 1995 hiring and 1996 termination of Michael Ovitz as President of the Walt Disney Company with a $130 million severance package.[54] It is noteworthy that the Chancery Court acknowledged that the derivative challenges occurred ten years earlier, before the Enron and WorldCom debacles, and the law does not require corporate fiduciaries to meet current standards of ideal corporate governance, or penalize them for failing to comply with aspirational best practices.[55] Rather, corporate "fiduciaries who act faithfully and honestly on behalf of those whose interests they represent are indeed granted wide latitude in their efforts to maximize shareholders' investment."[56] We may opine from this statement that today's debate over executive compensation is reflected in the court's emphasis that while "the best practices of corporate governance include compliance with fiduciary duties. . . . [C]ompliance . . . however, is not always enough to meet or to satisfy what is expected by best practices of corporate governance."[57] This statement is perceptive and farsighted, perhaps signaling the early stages of the need to realign the balance between director primacy and shareholder power by making changes in corporate governance structure that are closer to the ideal.

In *Disney*, the Delaware Supreme Court affirmed the boundaries and use of the business judgment rule presumption that directors act in good faith in making business decisions in the best interests of the company and its shareholders.[58] Plaintiffs may overcome the business judgment presumption only by proving a breach of one of the duties: fraud, bad faith or self-dealing. Where plaintiffs cannot overcome the presumption

[54] *In re* Walt Disney, *supra* note 6.
[55] *Id.*
[56] *Id.* at 698.
[57] *Id.* at 745.
[58] *Id.* at 747.

of a good faith business judgment, they may still try to demonstrate waste by showing that directors acted in bad faith or with gross negligence.[59] In its opinion, the Delaware Supreme Court recognized that "the duty to act in good faith ... to date is not a well-developed area of [Delaware's] corporate fiduciary law."[60] The Court identified two categories of fiduciary behavior that constitute bad faith, which is more than gross negligence: (i) conduct that is motivated by an actual intent to harm and (ii) intentional dereliction of duty, a conscious disregard of one's responsibilities.[61] Such conduct is neither exculpable nor indemnifiable.

> [T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense . . . or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.[62]

In acknowledging the increased recognition of the duty of good faith in the current corporate law environment, the Supreme Court determined that "some conceptual guidance to the corporate community [about the nature of good faith] may be helpful."[63] However, the Supreme Court flatly rejected the notion, advanced by plaintiffs, that lack of good faith could be equated with gross negligence, which is the standard for finding a violation of the fiduciary duty of care.[64] This statement provokes inquiry – if directors are afforded liberal protections for violations of the duty of care as well as for violations of the duty to act in good faith, corporate directors and officers could be granted almost unlimited power to utilize shareholder investments in a manner that is substantially adverse to shareholder interests, without regard to fault or resulting harm. Requiring directors and officers to exercise due care and act in good faith provides consistency and stability in the judicial system as well as in the marketplace.

While the *Disney* decision reassures boards of directors of continued protections from personal liability for their risky business decisions if

[59] *In re* Walt Disney, *supra*.
[60] *Id*. at 63.
[61] *Id*. at 64.
[62] *Id*. at 67.
[63] *Id*. at 64.
[64] *Id*. at 65.

they exercise due care and act in good faith, it does not address the issue of why the shareholder should bear the investment risk *as well as* the risk of directors' decisions with limited remedies for redress. [65] Continued recognition of the business judgment rule can ensure that corporate decision-making and innovation is not unduly stifled by the threat of litigation, but the Rule does not equate the duty of care with the duties of loyalty and to act in good faith.[66] In reality, the duty of care implies a due diligence that goes beyond putting information and reporting systems in place and failing to monitor such systems. Thus, due diligence with regard to compensation risk implies a duty to understand the impact of the arrangement on an accounting basis since such expenses affect the corporation's net profits and thus return on shareholder investment on both the long- and short-term. Perhaps taking compensation decisions out of risk oversight and disclosing the impact on revenue would allow shareholder challenges on the basis of accounting fraud or misconduct rather than in a derivative action.

V. DERIVATIVE CASES AFTER *DISNEY*

A. In re Viacom

In *In re Viacom,* shareholders brought a derivative action against Viacom, its directors, and certain officers, alleging breach of fiduciary duties and unjust enrichment when directors awarded three officers \$159 million in compensation in one year while recording \$17.5 billion in losses.[67] Defendants challenged plaintiffs' lawsuit asserting that plaintiffs filed prior to making a demand on the Viacom board of directors and failed to show demand futility or state a claim for breach of fiduciary duty or unjust enrichment.[68] Under Delaware Rule 23.1, plaintiffs in a derivative action must make a demand upon the board of directors prior to the commencement of legal proceedings.[69]

Where plaintiffs established that one of the directors had a long-standing close business and personal relationship with the CEO and that the director is "controlled by another," the board is considered to lack independence.[70] The court found that plaintiffs met the first prong of the test for demand futility: (1) "under the particularized facts alleged, a reasonable doubt is created that [...] the directors are

[65] *In re* Walt Disney, *supra* note 54.
[66] Telman, *supra* note 92.
[67] *In re* Viacom, *supra* note 36.
[68] *Id*. at 8.
[69] *Id* at 8-9 (citing Del. Ch. Ct. R. 23.1).
[70] *Id*. at 9.

disinterested and independent."[71] By establishing a lack of director independence, the court held that the compensation process was unfair and showed a breach of the duty of loyalty where directors allegedly favored the CEO's interest over that of shareholders.[72] The business judgment rule will not shield directors' decisions in cases where extraneous influences such as an interested director may affect those decisions, so that the director cannot maintain that the challenged transaction was otherwise the product of a valid exercise of business judgment.[73]

In reviewing motions to dismiss, the court applied the "entire fairness" two-prong test (fair dealing and fair price) to the compensation package although this test is generally used to assess the fairness of a merger to shareholders.[74] The court relied on *Disney* to dismiss defendants' challenge of the claim for breach of the duty of good faith noting that the "intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate standard for determining whether fiduciaries have acted in good faith."[75]

Finally, the *Viacom* court found that plaintiffs adequately stated a claim for unjust enrichment finding that enrichment of the executives resulted in the unjust impoverishment of Viacom which occurred through the distribution of allegedly excessive compensation and an alleged loss of $17.5 billion in 2004.[76] Pursuant to Delaware law:

> [u]njust enrichment is the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity or good conscience. The elements of unjust enrichment are: (1) an enrichment; (2) an impoverishment; (3) a relation between the enrichment and impoverishment; (4) the absence of justification; and (5) the absence of a remedy provided by law.[77]

In reviewing the impact of the *Disney* decision, it appears that claims of unjust enrichment and waste, if they survive the demand requirement and claims for breach of the duty of good faith, are adequate remedies for shareholders, as we observe in the *Citigroup* decision.[78]

[71] *Id.*
[72] *Id.* at 17-18.
[73] *Id.* at 22.
[74] *Id.* at 18.
[75] *Id.* (citing *In re* Walt Disney, 907 A.2d 693, 2005 Del. Ch. LEXIS 113 (Del. Ch. 2005)).
[76] *Id.* at 24.
[77] *Id*. (Citing *Jackson v. Kennedy*, 741 A.2d 377, 393 (1999)).
[78] *In re* Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106, 120, 2009 Del. Ch. LEXIS 25 (Del. Ch. 2009).

B. In re Citigroup

The primary claim in *In re Citigroup* is the allegation of a breach of fiduciary duty by not properly monitoring and managing business risks that Citigroup faced from subprime mortgages and securities and by ignoring alleged "red flags" that indicated deteriorating conditions in the subprime and credit markets.[79] Plaintiffs argued that the directors are liable for damages arising from a failure to "make a good faith" attempt to follow procedures put in place or failing to ensure adequate and proper corporate information and reporting systems existed that would enable directors to be fully informed regarding Citigroup's risk to the subprime mortgage market.[80] The Court, in dismissing this claim, reaffirmed that plaintiffs face an "extremely high burden" in claiming director liability for a failure to monitor business risk and that a "sustained or systemic failure" to exercise oversight is needed to establish the lack of good faith that is a necessary condition to liability.[81]

All claims against Citigroup directors were dismissed except the allegation of waste in approving a multi-million dollar payment and benefit package for CEO Charles Prince who retired in November 2007 and is considered responsible for Citigroup's problems.[82] Plaintiffs based their claim on director failure to monitor *business risk* in contrast to the typical *Caremark* claim of liability for damages arising from a failure to properly monitor or oversee employee misconduct for violations of law.[83] The Court reaffirmed the *Caremark* standard but denied the claim for a failure to monitor *business risk* noting that the discretion granted directors and managers allows them to maximize long-term shareholder value by taking risks without fear of being personally liable if the company experiences losses.[84] However, the court refused to dismiss the claim of waste for director approval of compensation for retiring CEO Charles Prince. Although the directors of a Delaware corporation have authority and broad discretion to make executive compensation decisions, it is also well settled that this discretion is not unlimited.[85]

The standard used by the Court to evaluate waste is whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any

[79] *Id.* at 111.
[80] *Id.* at 124-125.
[81] *Id.*
[82] *Id.* at 112.
[83] *Id.*
[84] *Id.* at 139.
[85] *Id.* at 138.

reasonable person might be willing to trade."[86] The Delaware Court held that "there is an outer limit . . . at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."[87] The compensation was determined to constitute waste given the enormous losses and met the "so one sided" standard given Prince's agreements of non-competition, non-solicitation, and release of claims, suggesting that Prince's exchange was so little that it lacked consideration.[88] Thus, this case suggests that Delaware courts consider an expansion of the theory of risk oversight in situations where a "sustained or systemic failure" to exercise oversight in the market is characterized by: (1) payment of substantial executive compensation and (2) either: (a) a period of sustained and serious losses under the executive's office or (b) the exchange of consideration by the executive to be so inadequate as to constitute a lack thereof. In such situations, directors may be liable for a lack of good faith or gross negligence and thus breach the duty of care.

C. American International Group (AIG)

Claims based on alleged fraud and illegalities at *American International Group* (AIG) survived a motion to dismiss partly on the theory that the defendants had "consciously failed to monitor or oversee the company's internal controls."[89] The court noted that AIG executives and inside directors were allegedly "directly knowledgeable of and involved in much of the wrongdoing," rather than independent, non-executive directors, and the court relied on the distinction between business decisions and matters of corporate fraud and violations of law.[90] Both *Citigroup* and *AIG* derivative suits reflect the difficulty of showing a breach of fiduciary duty for failure to exercise oversight. Additionally, directors are not required to undertake extraordinary efforts to uncover non-compliance within the company provided a monitoring system is in place.[91] However, by extending the *Caremark* standard, in situations where defendants consciously failed to monitor or oversee internal controls, even if those controls exist and are adequate, the compensation decision could be challenged under the duty of care (gross negligence standard) or the failure of directors to act in good faith. Alternatively, if directors knowingly ignore "red flags," compensation decisions under these situations that result in damages to shareholder

[86] *Id.* (citing Brehm at 262-263).
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.* at 34.
[91] *Id.*

investments could result in claims of breach of fiduciary duties or claims of unjust enrichment. Shareholders may find such claims are more successful and allow recovery of compensation that adversely impacted shareholder investments.

VI. REGULATION AND LEGISLATION OF COMPENSATION

The debate regarding executive compensation packages may be rooted in concerns related to economic stability, best practices of corporate governance, and increasing shareholder power. However, the regulatory and legislative environment chose to focus on disclosure to provide investors with a clearer, more complete picture of compensation to executive officers and directors. As a result, Congress enacted significant legislation with executive compensation provisions and beginning in July 2006, the Securities and Exchange Commission (SEC) adopted revisions to its rules concerning disclosure of executive compensation, requiring companies to provide investors with details about executives' stock-option grants and programs.[92] Companies were also required to prepare a principles-based Compensation Discussion and Analysis section in their proxy statements, annual reports and registration statements.[93] Critics of the amendments suggest that although the objective of the changes was to more closely conform to the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123R where compensation is shown as earned during a particular reporting period (i.e., monthly or quarterly), this may not provide a completely accurate picture of actual *annual* executive compensation.[94]

Congressional proposals were also made to limit executive compensation and the amount of deferred compensation for tax purposes. These limits are found in The Housing and Economic Recovery Act of 2008 and the Emergency Economic Stabilization Act of 2008.[95] Additionally, The American Recovery and Reinvestment Act of 2009 restricted executive compensation paid by companies during the period in which any obligation arising from financial assistance provided under the Troubled Assets Relief Program (TARP) remained outstanding.[96] Further limits included requirements for the Secretary of

[92] Michael V. Seitzinger, Cong. Research Serv. RS22583, Executive Compensation: SEC Regulations and Congressional Proposals (2009) (citing 71 Fed. Reg. 78,33, 78,393 (September 8, 2006)).

[93] Michael V. Seitzinger and Carol A. Pettit, Cong. Research Serv. R40540, Executive Compensation Limits in Selected Federal Laws (2009) (citing 71 Fed. Reg. 53,158 (September 8, 2006), amending 17 C.F.R. Parts 228, 229, 232, 239, 240, 245, 249, and 274)).

[94] Seitzinger, *supra* note 90 at 1 (citing 71 Fed. Reg. 53,158, 53,164 (September 8, 2006)).

[95] *Id.* at 5-6.

[96] *Id.* at 10.

the Treasury to develop appropriate standards for executive compensation, establishment of Corporate Board Compensation Committees to review employee compensation plans and permitting shareholders of a TARP recipient a separate nonbinding vote to approve compensation at annual meetings.[97] Bills have been submitted to recover bonuses made to American International Group (AIG) employees and executives.[98] The Corporate and Financial Institution Compensation Fairness Act of 2009 included requirements for say-on-pay, independent compensation committees, incentive-based compensation disclosure, and compensation standards for financial institutions.[99]

Paralleling Congressional acts, the SEC in 2010 proposed amendments to its rules relating to shareholder approval of executive compensation and "golden parachute" compensation arrangements.[100] These amendments were put in place to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) relating to shareholder approval of executive compensation and "golden parachute" arrangements.[101] The Dodd-Frank Act sought to align risk management with executive pay as a general manner and created new requirements for shareholder non-binding votes to be included in proxy statements for a company's first annual meeting occurring on or after January 21, 2011.[102]

To maintain consistency with the compensation requirements in the Dodd-Frank Act, the SEC amendments require a non-binding shareholder vote to approve compensation (say-on-pay) not less than once in every three years, and require disclosure of any compensation related to shareholder "approval of an acquisition, merger, consolidation, or proposed sale or other disposition of . . . the assets of an issuer . . . any type of compensation (whether present, deferred, or contingent)..."[103] An important facet of the SEC amendments is the statement that 'None of these shareholder votes is binding on an issuer or its board of directors or is to be construed "as overruling a decision by such issuer or board of directors."'[104] Also, the SEC specifically stated that shareholder votes do not "create or imply any change to the fiduciary duties of such issuer or board of directors" nor do they "create or imply any additional fiduciary

[97] *Id*.

[98] *Id*. at 11.

[99] Seitzinger, *supra* note 90 (citing H.R. 3269, 111th Cong. (2009)).

[100] Seitzinger, *supra* note 91 (citing 75 Fed. Reg. 66,590, 66,591 (October 28, 2010)).

[101] Dodd-Frank, supra note 13. Section 951 of the SEC proposal amends the Securities and Exchange Act of 1934 by adding Section 14A.

[102] *Id.* at 123.

[103] 75 Fed. Reg. 66,591 (October 28, 2010).

[104] 75 Fed. Reg. Exchange Act, Section 14A(c)(1).)

duties for such issuer or board of directors.'"[105] The SEC added a requirement regarding the issuer's compensation policies and practices as they relate to risk management and risk-taking incentives noting that, to the extent that risk considerations are a material aspect of the compensation policies or decisions for named executives, the corporation must include these risk considerations in its Compensation Discussion and Analysis.[106]

While the Dodd-Frank Act and SEC amendments seek to increase shareholder participation in corporate compensation decisions, the Dodd-Frank Act focused on the stability of the financial industry. Questions regarding the impact of executive compensation on the stock value of a company, the role of the board in monitoring risk, and whether the courts or the regulators should monitor compensation and associated risk are still to be answered. Shareholders will continue to challenge compensation decisions that harm shareholder value. While the SEC amendments do not change or add new corporate fiduciary duties, they do link compensation disclosure to risk, requiring disclosure that is "materially adverse" to be disclosed. Specifically, the SEC requires a company to disclose: (1) the extent of the board's role in risk oversight of the company; and (2) the effect that the board's risk oversight function has on its leadership structure.[107]

Although the fiduciary duty of care includes a well-established responsibility of directors to monitor potential risks facing the company, identifying business risk, assessing their impact, and managing risk may be complex and financially burdensome. The role and expectations of directors in monitoring and evaluating risk have expanded substantially due to greater scrutiny of business in general, yet the alignment of risk with the fiduciary duty of care has not been clarified or expanded so that legal remedies may attach. The need for risk oversight regulation and corporate governance reforms is more apparent because of the financial crisis, yet drastic change may be needed to avert a similar future event. The Dodd-Frank Act may succeed in curtailing some of the factors that led to the current situation as its purpose is to promote stability in financial institutions and to limit risk that may create instability in the financial system.[108] Working in mutual cooperation, Dodd-Frank requires the SEC to enforce disclosure by prohibiting the listing of any security of an issuer that does not comply with the requirements of Section 953, Executive Compensation Disclosures, to disclose the "structure of all incentive-based

[105] *Id.* Section 14A(c)(3).)
[106] *Id.*
[107] *Id.*
[108] Dodd-Frank, *supra* note 13 at 1903.

compensation . . . sufficient to determine excessive compensation, fees, or benefits; or could lead to material financial loss."[109] Federal regulators must jointly prescribe regulations that prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement that is determined to encourage inappropriate risks.[110] Moreover, issuers of securities who prepare accounting restatements due to material noncompliance under securities laws will be required to recover compensation from any current or former executive officer of the issuer. [111] Recovery of excess compensation may provide additional remedies to shareholders on behalf of the corporation.

VII. CONCLUSION

While regulators and legislators are making progress in promulgating rules for executive compensation disclosure, shareholders continue to have limited roles in establishing compensation packages or in challenging directors' decisions after mandated disclosure. The recent executive compensation litigation does not affect shareholder remedies in any material manner. The legislation provides little incentive for corporations to alter their compensation decision-making process absent a change in fiduciary duties or the standard of review.

However, *Gantler v Stephens* opens the door for courts to monitor executive compensation by inquiring whether officers fulfilled their fiduciary duties when negotiating their own compensation agreements.[112] The Delaware Chancery Court has already held that corporate officers are bound by their fiduciary duty of loyalty to negotiate their employment contracts in an arm's-length adversarial manner.[113] If they instead try to manipulate the negotiation process, the officers open themselves up to shareholder lawsuits that invite judicial

[109] *Id.*

[110] *Id.* at 1905.

[111] Telman, *supra* note 8. Dodd-Frank provides Section 952(b)(2) Recovery of Funds for issuers of securities who submit restatements that may have had a "material adverse" effect on a corporation and thus might flag undue risk taking.

[112] *Id.* at 23. The court held that the same fiduciary duties that apply to directors of a corporation also apply to its officers, although the Delaware statutory liability shield does not extend to persons other than directors. . . .The court also implicitly rejected self-serving language in disclosure documents designed to support what the court apparently viewed as a suspect internal decision process. While the court did nothing to undercut the law surrounding the business judgment defense . . . it once again made clear that merely asserting the exercise of business judgment will not protect a board or management from allegations that they breached their fiduciary duties if the complaining party can demonstrate that the board's decision either was not made as part of a good faith pursuit of a legitimate corporate interest or was not taken with due deliberation-in the court's words, "advisedly."

[113] *In re* Walt Disney, supra note 55.

scrutiny of compensation negotiations and the result of those negotiations, the compensation agreements. Despite the argument that shareholder litigation has a limited effect on excessive executive compensation, the courts are reluctant to limit directors' personal liability for such decisions and may not be able to judge the desirability of compensation packages and policies.[114]

The *Gantler* court explicitly extended fiduciary duties to corporate officers.[115] Rather than eroding the fiduciary standards affirmed in *Disney,*[116] *Gantler v. Stephens* may create a presumption of officer fiduciary duty in the negotiation of the hiring and compensation decision (as well as in firing or termination decisions) and the duty of due care.[117] Thus, an executive whose compensation is being considered has fiduciary obligations that require him to place the corporation's interests above his/her own, prior to accepting a position. Disclosure of material facts to directors about the value of the compensation being considered would support the directors' duty to exercise reasonable diligence and to be fully informed about the impact of the compensation. Further, the executive who is a beneficiary of their decision has a positive duty to disclose material information. Best practices would suggest that compensation committee members understand the amounts an executive would receive, under different circumstances that could arise, so that a reasonable decision would be made. A negative impact of a compensation decision would clearly show evidence of the lack of appropriate director attention to internal reporting mechanisms.

A potential legal strategy is to expand the duty of care requirement for directors in making compensation decisions that may have a material adverse effect on the company while increasing directors' risk management procedures and risk oversight roles through legislation and enforcement. Expanding the duty of care would allow courts to determine the extent that risk arising from a company's compensation policies are reasonably likely to have a "material adverse effect" on the company leading to shareholder challenges based on breach of the duty of care in addition to challenges of breach of fiduciary duty, corporate waste, or unjust enrichment. A "materially adverse" claim that compensation decisions violate the "duty of care" requirement may improve plaintiff success in fiduciary duty claims.

[114] Randall S. Thomas and Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 Minn. L. Rev. (2011).

[115] *Gantler v. Stephens*, 965 A.2d 695, 35 (Del. 2009), http://www.jdsupra.com/post/documentViewer.aspx?fid=816fb148-68c5-410f-9548-45857776304.pdf

[116] *Id.*

[117] *Id.*

Alternatively, directors should bear some of the risk for compensation decisions. Directors maintain that the primary objective of compensation is to utilize it as a mechanism for recruiting and retaining executive talent, not related to performance or decisions impacting innovation or risk-taking. It is well-established that executive compensation packages comprise salary as well as items such as stock options, retirement packages, or payouts for termination with or without fault. By removing some of the compensation elements from protections afforded by the business judgment rule and strengthening the requirements for the duties of due care and good faith, directors may be more likely to exercise reasonable diligence in the compensation negotiation. Shareholder derivative litigation challenges on compensation would then fall under fraud, bad faith or self-dealing by directors and/or the officer negotiating compensation. Evidence of bad faith would be provided through SEC enforcement of the accounting and financial statement requirements for compensation disclosure. Thus the substance as well as the process for compensation decision-making would become more transparent and provide accountability to shareholders.

FACEBOOK GOT ME FIRED: LEGAL AND MANAGEMENT ISSUES FOR SOCIAL NETWORKING AND THE BLOGOSPHERE

by KABRINA KREBEL CHANG*

I. INTRODUCTION

Ashley Johnson was a server at Brixx Pizza in North Carolina. A couple sat at one of her tables for three hours, keeping Ms. Johnson at work long after her shift. When the couple left just a $5.00 tip, Ms. Johnson vented about them on her Facebook page, calling them cheap and mentioning Brixx by name. A few days later, Ms. Johnson was fired. According to Brixx, she violated company policy by disparaging customers and criticizing the restaurant.[1] What used to be discussed in a closed office or over a drink after work is now discussed online, and in many cases in a manner that creates a permanent record, a record that an employer can view and one on which employment decisions can depend.

Ms. Johnson is not the first person to be fired for her social networking posts. Kevin Colvin, an intern at Anglo Irish Bank's North American office, emailed his supervisor explaining that due to a "family emergency" he would not be at work for the last several days of October. When a Facebook photo of Mr. Colvin surfaced showing him in a fairy costume at a Halloween party during his absence from work, Mr. Colvin

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[1] *Brixx Pizza Fires Waitress Ashley Johnson for Complaining about tip on Facebook*, HUFFINGTON POST (May 17, 2010), http://www.huffingtonpost.com/2010/05/17/brixx-pizza-fires-waitres_n_578847.html.

was fired.[2] Similarly, Dan Leone, a Philadelphia Eagles parking attendant, was fired after six years with the Eagles organization when he posted on his Facebook profile that he was "devastated about Dawkins signing with Denver … Dam Eagles R Retarted [sic] !!"[3]

These employers are in the minority of businesses proactively addressing the explosive use of social media. Yet, according to the most recent data, 72% of young adults ages 18-29 and 40% of adults 30 or older use social networking sites.[4] In 2009 over one quarter of adult Internet users made a visit to a social networking site.[5] Among adults 18 and older, 73% have a Facebook profile, 48% have a profile on MySpace, and 14% use LinkedIn.[6] Blogs, or web logs, began gaining in popularity in 1999 and by 2004 became mainstream forums for discussion, criticism, and commentary.[7] Blogging among adults over 30 has increased, from 7% of online adults in 2006 to 11% in 2009.[8] Fourteen percent of online adults have created their own webpage and just over a quarter posted comments online on a news group, website, blog or photo site.[9] But businesses have been slow to recognize this trend and its consequences. According to the Employment Law Alliance, of the 1,000 adults they surveyed, 5% said they maintained a blog, and 16% said they posted work-related comments. However, only 15% reported that their employer had specific policies on work-related blogging.[10] Among those employees who work for a company with blogging policies, 62% say the policies prohibit posting any employer-related material on a blog, and 60% say the policies discourage employees from criticizing or making negative comments about the employer.[11] According to a Society for Human Resource Management

[2] Owen Thomas, *Bank intern busted by Facebook,* GAWKER (Nov. 12, 2007, 5:06 PM), http://valleywag.gawker.com/321802/bank-intern-busted-by-facebook.

[3] Helen A.S. Popkin, *Twitter gets you fired in 140 characters or less*, MSNBC.COM (Mar. 23, 2009), www.msnbc.com/id/29796962/from/ET/print/1/displaymode/1098.

[4] Amanda Lenhart et al., *Social Media & Mobile Internet Use Among Teens and Young Adults*, PEWINTERNET (Feb. 3, 2010), http://pewinternet.org/Reports/2010/Social-Media-and-Young-Adults.aspx.

[5] *Id.*

[6] *Id.*

[7] Blood, Rebecca, *Weblogs: A History and Perspective,* REBECCA'S POCKET BLOG (Sept. 7, 2000), http://www.rebeccablood.net/essays/weblog_history.html.

[8] *Id.*

[9] *Id.*

[10] Press Release, Employment Law Alliance, Blogging and the American Workplace- As Work-Related Web Logs Proliferate, New National Survey Finds Few Employers are Prepared for the Impact (Feb. 6, 2006), http://fm.employmentlawalliance.com/ela/FMPro?-DB=ela_articles.fp5&-format_article.html.

[11] *Id.*

study, a full 85% of employers do not yet have written policies describing appropriate employee blogging material.[12]

So is it legal to fire someone based on their post on a social networking site or a blog? This article will examine the laws and issues courts focus on when deciding employer/employee conflicts involving social networking and blogging. It will describe cases where employees have been fired or otherwise disciplined for their personal use of social networking sites and blogs. This paper will also examine the business reasons why employers are interested in their employees' personal use of social networking sites and how courts balance the competing interests between employers and employees. Lastly, the potential for liability to third parties when employers do not take enough action to prevent employees' personal use of social networking and the Internet will be considered.

II. EMPLOYEE FREEDOM OF SPEECH RIGHTS UNDER THE STORED COMMUNICATIONS ACT

A. The SCA

In an effort to address emerging media and communications technology, Congress passed the Electronic Communications Privacy Act (ECPA) in 1986. The ECPA was created to extend the coverage of the federal Wiretap Act.[13] The Wiretap Act covered communications that could be heard by the human ear and in-person communications. The Wiretap Act did not account for the development of new technologies such as emails, pagers, blogs and social networking as means of communication.[14] The ECPA prohibits the intentional interception of emails and generally allows an employer to monitor emails sent and received on its servers. The Stored Communications Act (SCA), which is part of the broader ECPA, prohibits "intentionally access[ing] without authorization a facility through which an electronic communication service is provided…and thereby obtain[ing]…access to a wire or electronic communication while it is in electronic storage in such system."[15]

[12] Amy Joyce, *Blogged Out of a Job: Few Firms Have Rules but Posters Be Warned*, WASHINGTON POST, Feb. 19, 2006, (citing a survey by the Society for Human Resource Management).

[13] 18 U.S.C. §§ 2510-2522.

[14] Orin S. Kerr, *A User's Guide to the Stored Communications Act, and a Legislator's Guide to Amending It*, 72 GEO. WASH. L. REV. 1208 (2003-2004), *available at* http://ssrn.com/abstract=421860.

[15] 18 U.S.C.A §2701 (a)(1) (West).

B. Pietrylo v. Hillstone Restaurant Group[16]

When it comes to employers viewing their employees' personal social networking pages, what is authorized access? For example, is it authorized access when your supervisor asks to use your MySpace password to look at the MySpace page of another employee? The court in *Pietrylo v. Hillstone* addressed that issue.[17] Brian Pietrylo, who worked at Houston's, a Hillstone Restaurant Group restaurant, created a group on MySpace.com called the "Spec-Tator." According to Pietrylo, the purpose of the group was to "vent about any BS we deal with [at] work without any outside eyes spying in on us. This group is entirely private and can only be joined by invitation."[18] Pietrylo invited past and present Houston's employees to join the group. Once a member accepted the invitation to join the group, the member could access the Spec-Tator site whenever they wanted to read or add new postings.[19]

Pietrylo invited Karen St. Jean, a greeter at Houston's, to join the group. While dining at the home of TiJean Rodriguez, a Houston's manager, St. Jean accessed the group on Rodriguez's computer using her MySpace account and showed Rodriguez the Spec-Tator site.[20] Later, Robert Anton, another Houston's manager, asked St. Jean for her password to access the Spec-Tator site. Although St. Jean stated that she never felt directly threatened with any adverse employment action, she felt compelled to provide her password to members of management because they were her superiors, and if she did not give them her password she "knew that something was going to happen."[21] Anton used St. Jean's password, gained access to the Spec-Tator site and printed copies of its contents. Anton then discussed the contents of the Spec-Tator site with other members of senior management including Robert Marano, regional supervisor of operations, and with human resources at Hillstone.[22]

Some posts on the Spec-Tator site included sexual remarks about management and customers, jokes about some of the specifications that Houston's had established for customer service and quality, references to violence and illegal drug use, and a copy of the new wine test that was to be given to the employees. Pietrylo claimed the remarks were just jokes; however, management did not find them funny. Management was

[16] 2009 U.S. Dist. LEXIS 88702 (D.N.J Sept. 25, 2009).

[17] *Id.*

[18] Pietrylo v. Hillstone Rest. Grp., 2008 U.S. Dist. LEXIS 108834, at *2 (D.N.J. July 24, 2008).

[19] *Id.*

[20] *Id.*

[21] *Id.* at *11.

[22] *Id.* at *3.

concerned that the content of the site contradicted Houston's four core values: professionalism, positive mental attitude, aim to please approach, and teamwork. Pietrylo was therefore terminated.[23]

Pietrylo sued Hillstone claiming a violation of the SCA, wrongful termination in violation of public policy, and invasion of privacy.[24] The jury found that Hillstone had not invaded Pietrylo's privacy; however, there was a violation of the SCA because Hillstone's access to the Spec-Tator site was not authorized. Hillstone claimed that their access was authorized because St. Jean, an authorized user of the group, showed Rodriguez the site on her own, and voluntarily gave her password to Anton and Marano, albeit indirectly through Rodriguez. Thus they claimed that St. Jean authorized Anton, Marano, and other management to access the Spec-Tator site.[25] The court thought differently. Houston's managers accessed the Spec-Tator site several times, and not by accident. Based on this, the court determined that Anton and Marano knew that they were not authorized to access the Spec-Tator site, accessing the site through a MySpace page that was not their own. Managers continued to gain access to the site through St. Jean's account even after realizing that St. Jean had reservations about having provided her account information. The court pointed out that certainly Houston's had a right to protect its employees from harassment and to protect the core values of its company; however, their methods for achieving such goals were not legal.[26]

C. Employer Policies Toward Employee Online Communications

Interestingly, in contrast to the *Pietrylo* case, some companies embrace online expression and openly encourage employees to take to the Internet and communicate via blogs. For example, Jonathan Schwartz of Sun Microsystems, J.W. Marriott, Jr. of Marriott International, and Michael Critelli of Pitney Bowes all write official blogs.[27] Sun Microsystems provides space for employees to blog (blogs.sun.com).[28] As of March, 2011 there were 157 million blogs,[29] including corporate-sponsored blogs and "unofficial blogs," that is, blogs created by employees, without the consent, approval, or frequently

[23] *Id*. at *4-5.

[24] *Id.*

[25] *Id*. at *2.

[26] *Id.*

[27] Brad Stone and Matt Richtel, *The Hand that Controls the Sock Puppet Could Get Slapped*, N.Y. TIMES, July 16, 2007, *available at* http://www.nytimes.com/2007/07/16/technology/16blog.html.

[28] Tom Zeller, *When the Blogger Blogs, Can the Employer Intervene?,* N.Y. TIMES, Apr. 18, 2005, *available at* http://nytimes.com/2005/-4/18/technology/18blog.html.

[29] BLOG PULSE, http://www.BlogPulse.com.

without the knowledge of their employer. But this practice has its risks as well. From 1999-2006, John Mackey, CEO of Whole Foods, famously posted comments on a Yahoo Financial chat board using a pseudonym. His comments routinely touted Whole Foods and sometimes criticized rival Wild Oats. The postings and Mackey's identity were revealed in a footnote of a court filing by the FTC, which tried to stop the acquisition of Wild Oats by Whole Foods.[30] Mackey later apologized to Whole Foods shareholders for his "error in judgment" after the SEC announced it was opening an investigation into his online postings.[31]

Whether they encourage or frown upon employee blogging, the fact is very few companies have formal policies regarding employees' blogging activity. According to the most recent American Management Association Survey, only 20 percent of respondents had a policy regulating employees' postings to personal blogs.[32] Moreover, there is very little case law addressing the issue of employees posting on their personal blogs. *Yoder v. University of Louisville*[33] is one case worth considering. It does not strictly address the employer-employee relationship. However, many of the issues the court addressed in this case--professional code of conduct, protecting confidential information--are the types of interests that businesses claim they are seeking to protect by limiting employee conduct online. Yoder was dismissed as a student from the University of Louisville School of Nursing (SON) because of a blog she posted on her MySpace page. The blog post, "How I Witnessed the Miracle of Life,"[34] was based on Yoder's experience with

[30] Andrew Martin, *Whole Foods Executive Used Alias*, N.Y. TIMES, July 12, 2007, *available at* http://www.nytimes.com/2007/07/12/business/12foods.html.

[31] Associated Press, *SEC, Whole Foods' Board to Review Chief's Online Postings*, WASHINGTON POST, July 18, 2007, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/07/17/AR2007071701862.html.

[32] Philip L. Gordon and Katherine Cooper Franklin, *Blogging and the Workplace*, CORPORATE COUNSEL (Aug. 9, 2006), http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp.

[33] 2009 U.S. Dist. LEXIS 67241 (W.D. Ky. Aug. 3, 2009).

[34] *Id.* The Blog post read as follows:

> As part of my mother-baby clinical (99% of the time clinicals are a waste of my time) I was assigned to find a pregnant mother and follow her around. I didn't look far. If you have ever worked a 12-hour shift in the hospital, you'd know that 50% of females there are at various stages of pregnancy. People say that there's something in the water. I say it's the shift - basically, she works 3 days and has 4 days to do everything else, including getting knocked up. That's how I got surprised with my own Creep - I was working nights in the ER. Never thought I'd have one, but there ya go. If your wife is infertile, send her to work at the hospital, she'll come back with triplets.
>
> Anyway, I found my mom fairly easy - I just came to work and confronted one of the ladies. Good thing that it was her third pregnancy - and she had no problem with me being stuck to her like a tick to an ass, so I cordially invited myself to observe the

glorious moment of The Popping.

****

Last Friday I armed myself with a camera, and journeyed to the assigned hospital, where I met my wonderful lady, getting ready to pop. Since it was her third kid, everyone expected her to shoot it out within 30 minutes. She was already getting induced by elephantine dose of Oxytocin (Mmmm, Oxytocin!)

I took my camera, put it on "Rec" and assumed the position.

45 minutes later, no baby.

1 hour 30 minutes later, no baby.

The anesthesiologist comes in and sets up my girl with an epidural. Having it done is one thing; watching someone else getting it done is another. The doc took out this teeny needle first and numbed her up. Then she took out this huge-ass 10 inch needle and jammed it into her spine!

I was watching the whole thing, with my face changing expressions like Louis De Funes'. But I guess everything went fine, because my 'mom' was back into position in no time, waiting for the Creep to show up.

3 hours later, no baby.

I'm looking at the mother with sheer disdain, she looks at me with sheer anger, but still - no baby.

I've got to go to work this evening, and I'm starting to cuss. I haven't slept in 36 hours, so I went to my car, got my blanket, kicked the nervous spouse out of the recliner, and went to sleep.

4 hours later she starts to throw up. I jump up, and turn my camera on again, assuming the position of a greyhound, right in between her legs.

... no baby.

5 hours.

6 hours.

7 hours.

My eyes are starting to feel like they're filled with sand, and my heart is starting to palpitate. The momma is throwing up, the daddy's stomach is growling and he's starting to bitch like a 14-year-old school girl in the mall.

8 hours later, the nurse comes in, checks the momma, and says, "ok, we're ready to push".

FINALLY!!! I turn my camera on again. Two more nurses, and a woman doctor come in. They put my momma into a position of American Eagle, prop her up with pillows, and shine bright light at the cooch.

an obstetric patient whom she was assigned to follow through the birthing process as part of her course work. The blog was posted on Yoder's MySpace page on February 2, 2009[35] and described, among other things, the newborn baby as "a wrinkly bluish creature, all Picasso-like and weird, ugly as hell, covered in god knows what, screeching and waving its tentacles in the air."[36] Yoder also characterized the father while he was awaiting the delivery as "starting to bitch like a 14-year-old school girl in the mall."[37]

Shortly after the blog was posted, a nursing student informed instructor Glenda Adams that students were discussing the post. On February 25, 2009 Adams contacted SON Associate Dean Ermalynn Kiehl and explained that she was concerned Yoder had revealed confidential patient information about the mother and baby. Kiehl reviewed the blog and contacted SON Dean Marcia Hern. On February 26, Kiehl and Hern reviewed the blog and agreed that it violated the SON Honor Code, the childbearing course's Confidentiality Agreement, the course consent form signed by the birth mother, and in general the standards of the nursing profession.[38] Yoder was dismissed from the SON because her blog postings "regarding patient activities and identification as a University of Louisville School of Nursing student"[39] violated the nursing Honor Code. The letter did not reference the Confidentiality Agreement. Yoder sued the University, Kiehl and Hern,

The momma's family is sitting in the corner, shaking all over, with the two younger brothers of the baby, the in-laws, and the bitching spouse.

At last my girl gave one big push, and immediately out came a wrinkly bluish creature, all Picasso-like and weird, ugly as hell, covered in god knows what, screeching and waving its tentacles in the air.

15 minutes later it turned into a cute pink itty bitty little baby girl. Mom was forgotten, the whole squacking family surrounded the new Creep; she was crowned with a pink cap, wrapped into a blanket and finally shut up with a teat.

I came to work, overwhelmed with emotions and new knowledge and experience. I sat down, looked around and once again proved that women are FREAKING STUPID and don't learn from their past mistakes.

I said: "I want another baby!!"

The End.

[35] *Id*. at *2.
[36] *Id*. at *6-7.
[37] *Id*. at *5.
[38] *Id*. at *7.
[39] *Id*. at *10.

claiming that they violated her First Amendment right to free speech by dismissing her based on her blog.[40]

The court did not need to reach the constitutional issues because they decided the case on narrower grounds. The court found that, as a whole, Yoder's blog did not contain information that could possibly lead to the discovery of the birth mother's identity; therefore, the blog did not violate the Honor Code or the Confidentiality Agreement.[41] In addressing the crudeness of the blog as a violation of the professionalism requirement of the Honor Code, the court agreed with the University that the blog was vulgar, distasteful, and objectionable in parts. However, this did not make the blog unprofessional; the blog was seen as entirely non-professional, that is, written by a person not acting as a representative of the School of Nursing or nursing in general.[42] Yoder's blog was her crude attempt to be funny describing an anonymous prolonged labor and delivery, written without any defined audience and posted on a personal MySpace page. Although Yoder's observations on women, children, motherhood and the birthing process may have been crude, the blog did not violate the professionalism provision of the Code because it was not created or used in any professional context. The Court held that if the SON wanted the professionalism provision to apply at all times and in all contexts, it would have to give fair notice.[43]

III. SOCIAL NETWORKING AND THE NLRA

Clearly, the definitions in this field are in transition. According to the National Labor Relations Board (NLRB), if employees are talking together about working conditions, prohibiting that conversation could be a violation of the National Labor Relations Act (NLRA). In November 2010, the NLRB filed its first suit involving an employee termination based on social media issues. Dawnmarie Souza worked for the ambulance service American Medical Response of Connecticut (AMR). Ms. Souza had to prepare a response to a customer's complaint about her work and she requested representation from her union.[44] When her request was denied, Ms. Souza took to her Facebook page and posted negative comments about her supervisor, calling him, among other vulgarities, a "scumbag." [45] Some of Ms. Souza's co-workers supported her through their comments to her post: "I'm sorry hon! Chin up!"[46]

[40] *Id.*
[41] *Id*. at *16.
[42] *Id*. at *18.
[43] *Id*. at *19.
[44] Press Release, National Labor Relations Board, Office of the General Counsel, Complaint Alleges Connecticut company illegally fired employee over Facebook comments (Nov. 2, 2010), *at* http://www.nlrb.gov/shared_files/Press%20Releases/2010/R-2794.pdf.
[45] Sara Yin, *Connecticut Woman Fired Over Face book Rant*, PCMAG.COM (Nov. 11, 2010),

In December 2010, AMR fired Ms. Souza for violating the company's Internet policy which prohibits employees from posting anything about the company without permission. AMR also claimed that Ms. Souza was fired because of "multiple, serious complaints about her behavior."[47] The NLRB saw it differently. "You are allowed to talk about your supervisor with your co-workers…[t]he only difference in this case is she did it on Facebook and did it on her own time and on her own computer." [48] Are the posts on Ms. Souza's Facebook page the concerted activity of co-workers? Or are they disloyal? Concerted activity is protected under the NLRA, while disloyalty is not.[49] The NLRB claims that employees discussing conditions at work, as in Ms. Souza's case, are engaging in concerted activity.[50] However, if the comments are defamatory and not supported by facts, the conduct may be considered disloyal.[51] The court unfortunately did not rule on this case because the parties settled on February 8, 2011.[52]

But the rules are evolving. In 2002, the Ninth Circuit addressed a similar issue in *Konop v. Hawaiian Airlines.*[53] Konop, a pilot for Hawaiian Airlines, created and maintained a website of comments critical of his employers and the incumbent union, the Air Line Pilots Association (ALPA). Konop opposed certain concessions sought from the union and, because ALPA supported those concessions, Konop encouraged employees to consider alternative union representations. [54] Konop created a list of people, mostly pilots, who were eligible to access the site including pilots Gene Wong and James Gardner. He controlled access to his site by requiring a user name and password. Once a user entered the name of an eligible person, the user created their own username and password and submitted that information to the site. By submitting the information, the user was accepting the terms and conditions of use for the site, which prohibited any member of Hawaiian

http://www.pcmag.com/article2/0,2817,2372465,00.asp.

[46] *Id.*

[47] *Id.*

[48] Steven Greenhouse*, Company Accused of Firing Over Facebook Post*, N.Y. TIMES, Nov. 8, 2010, *available at* http://www.nytimes.com/2010/11/09/business/09facebook.html.

[49] Endicott Interconnect Technologies v. NLRB, 453 F.3d 532 (D.C. Cir. 2006).

[50] David Alim-Young, *NLRB Weighs in on Social Networking- "The Facebook Complaint,"* NLRB INSIGHT (Feb. 8, 2011), http://www.nlrbinsight.com/2011/02/nlrb-weighs-in-on-social-networking-the-facebook-complaint/.

[51] *Id.*

[52] Julianne Pepitone, *Facebook firing test case settled out of court*, CNNMONEY.COM (Feb. 8, 2011), http://money.cnn.com/2011/02/08/technology/facebook_firing_settlement/ index.htm.

[53] 302 F.3d 868 (9th Cir. Cal. 2002).

[54] *Id.* at 872.

Airlines management from viewing the website and prohibited users from disclosing the contents of the website to anyone else.[55]

In December 1995, Hawaiian vice president James Davis asked Wong for permission to use Wong's name to access Konop's website. Davis claimed that he was concerned about untruthful allegations Konop might be posting. Wong agreed. Wong had not previously logged into the website to create an account, thus when Davis logged in he presumably used Wong's name, created a password and clicked "submit" indicating acceptance of the terms and conditions.[56]

Later that day, Reno Morella, ALPA chairman, contacted Konop and told him Bruce Nobles, president of Hawaiian, was upset by Konop's website remarks, particularly his accusations that Nobles was suspected of fraud. Konop believed that Nobles was threatening to sue him for defamation based on the posted statements. Davis continued to monitor the website using Wong's name and also obtained permission from Gardner to use his name to access the site. Konop claims that through April 1996 Davis logged in over twenty times as Wong and that Gardner or Davis logged in at least fourteen times as Gardner.[57]

Konop sued alleging violations of the federal Wiretap Act and the SCA based on Hawaiian's unauthorized access to his site, and also alleging violations of the Railway Labor Act (RLA) for interfering with his organizing efforts. In sorting this out, the court recognized that the Wiretap Act and the ECPA were inadequate to address the modern forms and uses of communication like Konop's secure website.[58] While the legislative history of the ECPA suggests that Congress wanted to protect electronic communications that are designed to be private, such as email and private electronic bulletin boards, the nature of the Internet is such that it is nearly impossible to verify the true identity of users, like the users of Konop's site.[59] Again, it is clear that both company policy and laws are in transition, evolving in an effort to respond to new uses, situations, and circumstances.

So is a private site like Konop's an "electronic communication" that can be intercepted in violation of the Wiretap Act? The court said it was.[60] In order for Konop's website to be an "electronic communication" it must be a "transfer of sign, signals…data or intelligence of any nature transmitted…by wire, radio, electromagnetic…system."[61] And website

[55] *Id*. at 873.
[56] *Id*. at 874.
[57] *Id*.
[58] *Id*.
[59] *Id*. at 875.
[60] *Id*. at 879.
[61] *Id*. at 876.

owners like Konop do transmit electronic documents to servers where the documents are stored. If a user wants to view the website, they request the server to transmit a copy of the document to the user's computer. Once a user accesses a website, information is in fact transferred from the website owner to the user via one of the specified mediums. [62] The Wiretap Act prohibits "interception" of electronic communications.[63] "Intercept" applies to acquisition of an electronic communication contemporaneous with its delivery.[64] In this case, the court concluded that electronic communications in storage had less protection than other forms of communication.[65] Thus for Konop's website to be "intercepted" in violation of the Wiretap Act, it had to have been accessed during transmission, not while in electronic storage.[66] As a result, the Court determined that Davis' accessing of the site was not an interception as defined by the Wiretap Act because the communication was in storage at the time of access.[67] In reaching this conclusion, the court is consistent with the less burdensome procedures of the SCA.[68]

The SCA prohibits intentional access to a wire or electronic communication while it is in electronic storage without authorization.[69] However, conduct authorized by a user is not a violation. According to the SCA, a user of the service can authorize third-party access to the electronic communication.[70] Although Wong and Gardner had the authority to authorize Davis' conduct because they were eligible users of Konop's site, the court did not find any evidence that Wong ever actually used Konop's site.[71] It was unclear when or if Gardner had ever used the site. The trial court assumed Wong and Gardner were users merely because they were eligible to access the site. This approach reads the "user" requirement out of the law. Because neither Wong nor Gardner were users of Konop's website at the time they authorized Davis to view it, Davis' access was unauthorized.[72]

The next issue the court confronted, and the issue most similar to the recent NLRA complaint, was whether Davis' unauthorized access to Konop's site and subsequent release of the contents of the site to a rival

[62] *Id.* at 876.
[63] *Id.* at 877.
[64] *Id.*
[65] *Id.*
[66] *Id.* at 878.
[67] *Id.* at 879.
[68] *Id.*
[69] *Id.* at 880.
[70] *Id.*
[71] *Id.*
[72] *Id.*

union leader violated the Railway Labor Act by interfering with a protected activity. According to Hawaiian, Konop forfeited any protection because the contents of his site contained malicious, defamatory, and insulting material.[73] The RLA protects even false and defamatory statements unless the statements are made with actual malice (knowing the statements are false or acting with a reckless disregard for the truth).[74] The court considered Konop's statements "rhetorical hyperbole" and therefore without actual malice.[75] Of course, employers in general are prohibited from surveillance of union activities. But the fact that Davis' access did not actually limit Konop's organizing efforts was seen as irrelevant. The appropriate issue was whether the conduct had the tendency to chill protected activities. If so the surveillance was seen as objectionable.[76]

IV. POTENTIAL FOR THIRD PARTY LIABILITY

Slowly, courts are beginning to make inroads in addressing employee social networking and employment decisions based on this new form of communication. However, as employee social networking and Internet use increase, so too may an employer's liability for such use. Similar to the conflict between employees and employers for use of social networking, the legal status of employer liability for injury to third parties based on an employee's use of the internet or social networking is in flux. For example, in *Blakey v. Continental Airlines,*[77] Blakey, a pilot for Continental, included in her complaint for sexual harassment against her employer comments posted on the Crew Member Forum (the Forum).[78] The Forum is an online virtual community for the crew members to exchange ideas and information. The Forum was accessible to all Continental pilots through internet service provider Compuserve, and Continental management was not allowed to post or reply to messages posted on the Forum.[79]

In deciding whether the Forum was sufficiently integrated into Continental's workplace, the court determined that there was no difference between the Forum and an actual bulletin board used exclusively by the pilots and crew of that airline.[80] The fact that the electronic bulletin board was not physically located at work was not

[73] *Id.* at 883.
[74] *Id.*
[75] *Id.*
[76] *Id.* at 884.
[77] 751 A.2d 538 (N.J. 2000).
[78] *Id.* at 457.
[79] *Id.* at 544.
[80] *Id.* at 459.

decisive.[81] Because the Forum is considered a workplace setting, liability rests on whether Blakey gave notice to Continental of the harassment by her co-workers.[82]

In a similar case in Pennsylvania, an association of 2,300 black police officers sued the Philadelphia Police Department for allowing officers to post racist and offensive content on Domelights.com, a website devoted to law enforcement.[83] The complaint alleged that white officers post and moderate the forum while on duty and on department computers, thereby creating a hostile environment.[84] The court in Pennsylvania has yet to decide this case.

There is some existing case law that can provide insight into where employers stand in terms of liability. For example, in *Doe v. XYC Corp.,*[85] a mother brought suit on behalf of her 10 year-old daughter against XYC Corp., the employer of the girl's step-father. The employee sent images of his step-daughter to child pornography sites, and had viewed child pornography on the Internet from his work computer and over XYC's internet system.[86] Other employees were aware he had viewed pornography at work and did nothing about it other than tell him to stop. When the man was arrested on child pornography charges, evidence of pornography was found on his computer and the mother sued for injury to her daughter. [87]

The court found that XYC was on notice of the employee's behavior because co-workers had complained and the company had monitored his Internet use. Based on this notice, XYC had a duty to exercise control over the employee, given the clear risk of harm to others. Such exercise of control would include internal discipline including termination, and reporting his conduct to law enforcement.[88]

Although this case deals with the very serious issue of child pornography, there are many lessons for management. For example, if employers are on notice of criminal conduct of their employees while using the Internet, the employer may have a duty to report that employee to law enforcement, or at least internally discipline that employee. This duty assumes monitoring Internet use by the employer. Secondly, an employer may be liable if they could have known that the

[81] I*d.* at 449.
[82] *Id*. at 552.
[83] Dan Stamm, *Domelights.com Shuts Down Amidst Lawsuit*, NBC PHILADELPHIA (July 24, 2009), http://www.nbcphiladelphia.com/news/local/Domelights-Shuts-Down-Amidst-Lawsuit.html.
[84] *Id.*
[85] 887 A.2d 1156 (Super. Ct. App. Div. N.J. 2005).
[86] *Id*. at 1160.
[87] *Id*. at 1161.
[88] *Id.* at 1167-1168.

employee was using the computer and Internet to engage in unlawful activities that cause harm to third parties. In her complaint, the mother stressed, among other things, that XYC is liable for the harm to her daughter because their failure to act allowed the employee to continue to secretly tape his step-daughter at home. The trial court found that XYC had no duty to control their employee's conduct at home. However, the appellate court noted that Plaintiff's counsel did not address this issue on appeal, and therefore that issue was not part of their decision.[89]

V. CONCLUSION

The court in *Konop* admitted that the few laws that apply to social networking and blogging are too complicated and inadequate to "address [these] modern forms of communication."[90] One common denominator is authorized access. The cases in this article illustrate primarily the access issues, that is, did the employer gain authorized access to the employee's personal communications? In *Yoder*[91], where authorized access was not an issue, the court never decided whether Yoder's posts could be used against her at school, just that her posts did not violate the sections of the Honor Code and Confidentiality Agreement as alleged by the school.[92]

Social networking is here to stay, and companies have embraced it as the latest marketing channel, networking vehicle, and job forum. Employers have a vested interest in what anyone, particularly their employees, say about the company on social networking sites. But where does that leave employees and their employers? Based on the courts' treatment of the few cases they have seen, employers are free to use posts against their employees, provided access to those posts was authorized. However, just because an employer has the legal right to take action does not mean they should. Although over thirty states have laws that restrict what an employer can do with an employee's legal off-duty conduct,[93] no developed body of case law deals with this issue and many issues are yet to be settled, such as the potential for employer liability to third parties. By drafting well-thought out Internet and social media policies and training their employees on such policies, employers may avoid many of the potential risks. As with the development of biotechnology patent law and intellectual property and copyright violation on the Web, employers and employees will only

[89] *Id.* at 1164.
[90] *Konop,* 302 F.3d at 874.
[91] 2009 U.S. Dist. LEXIS 67241.
[92] *Id.*
[93] Judy Greenwald, *Getting Burned*, BUSINESSINSURANCE.COM (July 19, 2009), http://www.businessinsurance.com/apps/pbcs.dll/article?AID=/20090719/ISSUE01/30719.

achieve some amount of predictability as courts decide these matters, case by case. And that will take time.

FITTING THE JIGSAW PIECES TOGETHER TO DEFINE THE SCOPE OF THE TAX SHELTER EXCEPTION TO THE SECTION 7525 PRIVILEGE

by JENNIFER L. CHAPMAN*

INTRODUCTION

In today's global business environment, business persons increasingly rely upon attorneys, certified public accountants, and other professionals to plan and execute transactions. Unfortunately, it is not uncommon for these carefully arranged transactions to lead to litigation. Therefore, it is vitally important for all parties involved in a transaction to understand the basic evidentiary privileges that will apply in most business litigation. When one enters the tax arena, those privileges become more complex due to the addition of the § 7525 privilege, which applies to "federally authorized tax practitioners."[1] Though often equated to the attorney-client privilege, the § 7525 privilege encompasses a unique set of people and an equally unique area of litigation. As such, § 7525 contains its own nuances and exceptions, which have been variously interpreted by the courts.

The case law interpreting the § 7525 privilege is muddled at times and has confounded even the most experienced jurists and attorneys. While much of the law surrounding the privilege has become more settled in recent years, questions still circle around the scope of the major exception to the § 7525 privilege, namely the tax shelter

* Assistant Professor of Legal Studies & Accounting, Georgia Gwinnett College aware of and, more importantly, understand, the nuances of the privilege and its exceptions.

[1] I.R.C. §7525(a)(3)(A).

exception. The instances when the tax shelter exception should apply may well be as varied as the transactions which may give rise to the claim that a tax shelter existed. The definition of a communication covered by the privilege is less than clear. Moreover, whether that tax shelter was promoted by a practitioner continues to be an area permeated with uncertainty. A better understanding by business executives of the § 7525 privilege, as well as the tax shelter exception to that privilege, will improve the way in which business is done and, moreover, will ensure that all parties involved in tax litigation are

Section 7525 has been discussed and analyzed numerous times in academic journals[2] following a string of high profile court decisions.[3] However, the tax shelter exception to the privilege has not been defined in a complete and helpful manner and has received little attention in the greater § 7525 discussion. The purpose of this article is to explore the relevant Internal Revenue Code sections along with existing case law, to define the known scope of the tax shelter exception to the § 7525 privilege, and to offer suggestions for clarifying the role and scope of the exception. Part I outlines the history of § 7525 and its interaction with related sections of the Internal Revenue Code dealing with tax shelters. Part II analyzes the current scope of the tax shelter exception based on existing case law addressing the exception. Part III contains a detailed analysis of how courts have begun to define the scope of the exception and offers suggestions to complete the picture so that all involved understand the true scope of the tax shelter exception. Part IV concludes with an overview of the current state of the law surrounding the tax shelter exception to § 7525 as well as a summary of the author's suggestions for improving understanding of that exception.

[2] *See, e.g.,* Tracy Hamilton, *Work Product Privilege: The Future of Tax Accrual Work Paper Discovery in the Eleventh Circuit After* Textron, 27 GA. ST. U.L. REV. 729 (Spring 2011); Henry J. Lischer, Jr., *Work Product Immunity for Attorney-Created Tax Accrual Workpapers?: The Aftermath of United States v. Textron*, 10 FLA. TAX REV. 503 (2011); Jacob A. Kling, *Comment: Tax Cases Make Bad Work Product Law: The Discoverability of Litigation Risk Assessments After* United States v. Textron, 119 YALE L.J. 1715 (May 2010); William H. Volz and Theresa Ellis, *An Attorney-Client Privilege for Embattled Tax Practitioners: A Legislative Response to Uncertain Legal Counsel,* 38 HOFSTRA L. REV. 213 (2009); Claudine Pease-Wingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of* United States v. Textron, 8 HOUS. BUS. & TAX L.J. 337 (2008).

[3] *See, e.g.,* United States v. Textron, Inc., 577 F.3d 21 (1st Cir. 2009) (en banc); Valero Energy Corp. v. United States, 569 F.3d 626, 628 (7th Cir. 2009); BDO Seidman, LLP v. United States, 492 F.3d 496, 822-28 (7th Cir. 2007) (discussing the scope of the § 7525 privilege).

I. THE TAX SHELTER EXCEPTION AND RELATED INTERNAL REVENUE CODE PROVISIONS

Congress has a long history of trying to curtail the use of tax shelters by taxpayers trying to evade the federal income tax. The tax shelter exception to § 7525 may be the latest attack on tax shelters' appeal to taxpayers, but it is heavily reliant on earlier provisions of the Internal Revenue Code ("the Code"). Several of these provisions inform the tax shelter exception and give additional insight into the scope of that exception. Therefore, Part I outlines the interaction of these sections and explores the intended scope of the tax shelter exception in light of these related provisions before turning to the courts' interpretation of § 7525(b).

A. Section 7525

Section 7525 of the Code was enacted in 1998,[4] partially in response to the accounting profession's growing interaction with attorneys in litigation matters. In particular, as the line between "accounting advice" and "legal advice" blurred, accountants sought protection for themselves and for their clients, particularly in light of the Supreme Court's holding in *Upjohn v. Arthur Andersen* several years earlier that there is no federal accountant client privilege.[5] Congress responded with § 7525,[6] which grants the following privilege to communications between taxpayers and federally authorized tax practitioners:

> With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.[7]

Thus, certified public accountants and others defined as "federally authorized tax practitioners"[8] gained some degree of protection in

[4] Pub. L. 105-206, § 3411(a), 112 Stat. 685 (1998).

[5] United States v. Arthur Young & Co., 465 U.S. 805, 817 (1984) ("[N]o confidential accountant-client privilege exists under federal law.").

[6] Pub. L. 105-206, § 3411(a), 112 Stat. 685 (1998). Section 7525 was amended in 2004. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004). Except where indicated, this article focuses exclusively on the current language of that section.

[7] I.R.C. § 7525(a) (2011).

[8] *See* § 7525(a)(3)(A) (defining "federally authorized tax practitioner" as any individual authorized to practice before the Internal Revenue Service and subject to regulation under section 330 of title 31, United States Code).

noncriminal tax matters before the Internal Revenue Service as well as in federal court.[9]

However, the § 7525 privilege, like all evidentiary privileges, is not unlimited. The primary exception to the privilege can be found in the Internal Revenue Code itself. Section 7525(b) specifies that the privilege:

> shall not apply to any written communication which is between a federally authorized tax practitioner and any person, any director, officer employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person, and in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii).[10]

Under this definition, the tax shelter exception to the § 7525 privilege clearly comes into play only if there is a qualifying written communication[11] that is in connection with the promotion of a tax shelter.[12]

B. Code Provisions Addressing Abusive Tax Shelters

By basing the definition of a "tax shelter" in § 7525 upon § 6662(d)(2)(C)(ii), Congress implicitly tied the tax shelter exception to a host of other provisions in the Code which, like the tax shelter exception itself, strive to limit or eliminate the use of tax shelter transactions. A review of several of those provisions helps one's understanding of the types of transactions targeted by § 7525(b).

1. Section 6662:

Section 6662 generally provides for a series of accuracy related underpayment and understatement penalties.[13] Importantly, a reduction in the § 6662(d) penalty for a substantial understatement of tax does not apply in a transaction that is deemed a tax shelter.[14] Section 6662(d)(2)(C)(ii) defines "tax shelter" broadly as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income

[9] § 7525(a)(2)(A) to (B).

[10] § 7525(b) (internal citations omitted).

[11] § 7525(b).

[12] § 7525(b)(2).

[13] *See generally* I.R.C. § 6662 (outlining penalties which may apply where a taxpayer underpays or understates its federal income tax liability).

[14] *See* § 6662(d)(2)(B) (providing for a reduction in the substantial understatement penalty where the taxpayer relied on substantial authority or there is adequate disclosure and a reasonable basis for the tax treatment pursued by the taxpayer).

tax."[15] The explicit reference to this definition in § 7525's tax shelter exception makes clear that qualifying communications related to any and all such transactions will not be privileged. As such, the tax shelter exception stands ready to target abusive or evasive transactions. However, communications related to transactions that simply minimize a taxpayers' income tax liability will continue to enjoy the privilege.

2. Sections 6694, 6700 and 7408:

Section 6662's broad definition of "tax shelter" carries over to various other provisions throughout the Code. Three of these provisions, in particular, help inform the intended scope of the § 7525 tax shelter exception. Section 6694 assesses an understatement penalty against tax return preparers.[16] This penalty is similar to and related to the substantial understatement penalty imposed upon taxpayers in § 6662. As one might expect, § 6694 limits a preparer's ability to avoid this penalty where a position is taken on a return that involves, or may involve, a tax shelter.[17] Generally, a position that is supported by substantial authority will not result in the imposition of the § 6694 penalty.[18] However, if any position is with respect to a tax shelter,[19] then the IRS will impose the penalty against the preparer unless the preparer reasonably believed that the disputed position would "more likely than not be sustained on its merits."[20] In other words, the preparer bears a substantially higher burden in order to avoid the § 6694 penalty where a tax shelter transaction is involved.[21]

Sections 6700 and 7408 comprise the remaining members of the trio of Code provisions which most squarely address the intended scope of the tax shelter exception to § 7525. First, § 6700 imposes a penalty upon any person who promotes a tax shelter.[22] This penalty, unlike §§ 6694 and 7525, is not limited to federally authorized tax practitioners.[23] In addition, it does not explicitly adopt the definition of "tax shelter" found

[15] § 6662(d)(2)(C)(ii).

[16] I.R.C. § 6694(a).

[17] § 6694(a)(2)(C).

[18] § 6694(a)(2). *See* Treas. Reg. § 1.6662-4(d) (defining and listing examples of sources which constitute "substantial authority" under the Internal Revenue Code).

[19] As in § 7525, a "tax shelter" under § 6694 includes any transaction defined in § 6662(d)(2)(C)(ii). § 6694(a)(2)(C).

[20] § 6694(a)(2)(C).

[21] Section 6694 contains an overarching "reasonable cause exception" which allows a preparer to avoid a penalty where there is reasonable cause for the understatement, provided the preparer acted in good faith. § 6694(a)(3). Given the high standard for avoiding the penalty under the general rule for tax shelters, this provision may be the more reliable road to travel if a tax preparer can show good faith.

[22] I.R.C. § 6700.

[23] § 6700(a) (imposing the penalty on "any person").

in § 6662(d)(2)(C)(ii). Rather, § 6700(a)(1)(A) states that the penalty will be imposed upon any person who organizes (or assists in organizing) or participates in any fashion in the sale of any interest in (1) "a partnership or other entity;"[24] (2) "any investment plan or arrangement;"[25] or (3) "any other plan or arrangement"[26] and "makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)" certain statements.[27] In particular, both the sale and any covered statement must be in regard to the "allowability of a deduction or credit," the exclusion from income, or any other tax benefit that is known to be false or which the person has reason to know is false or fraudulent or to be a gross valuation overstatement as to a material matter.[28]

This extended definition of the circumstances under which the § 6700 penalty can be imposed is interesting in relation to the tax shelter exception to § 7525 for one simple reason: the title of § 6700 is "Promoting Abusive Tax Shelters."[29] While "promotion" does not find its way into the text of § 6700, this provision should be consulted when examining the definition of "promotion" in § 7525. Specifically, § 7525(b)(2) provides that the § 7525 privilege does not apply to certain written communications "in connection with the *promotion* of . . . any tax shelter."[30] Therefore, absent additional, contrary guidance elsewhere in the Code, the provisions of § 6700 should be consulted in regard to the definition of "promotion" under § 7525.[31] This interaction gains traction from the fact that the transactions prohibited in § 6700(a)(1)(A) are identical to the transactions contained within the § 6662(d)(2)(C)(ii) definition of a "tax shelter" referred to in § 7525(b)(2).[32]

Similarly, § 7408 provides that the United States can file a civil action to enjoin any person engaging in certain, specified conduct.[33] Of particular importance to the current discussion, any action or inaction which is subject to a penalty under § 6700 can be enjoined under this

[24] § 6700(a)(1)(A)(i).
[25] § 6700(a)(1)(A)(ii).
[26] § 6700(a)(1)(A)(iii).
[27] § 6700(a).
[28] § 6700(a)(2)(A), (B).
[29] § 6700.
[30] I.R.C. § 7525(b)(2) (emphasis added).
[31] *See infra* text accompanying notes 115-16 (suggesting that § 6700 offers a source of guidance for the scope of the tax shelter exception).
[32] *Compare* § 6662(d)(2)(C)(ii) (defining a "tax shelter" broadly to include any partnership, other entity, investment plan, or any other plan or arrangement with a significant purpose of income tax avoidance or evasion) *with* § 6700(a)(1)(A) (offering a virtually identical definition of "tax shelter").
[33] I.R.C. § 7408(a).

provision.[34] In other words, not only can the Internal Revenue Service impose a monetary penalty for promoting an abusive tax shelter under § 6700, but the Secretary has the power to enjoin the same conduct. Again, for purposes of the § 7525 tax shelter exception, the title of § 7408 proves informative. That section is aimed at "Actions to Enjoin Specified Conduct Related to Tax Shelters and Reportable Transactions."[35] In a sense, § 7408 reasserts the definition of "tax shelter" within the Internal Revenue Code and the importance the Internal Revenue Service places upon regulating such transactions.

II. THE COURTS' TREATMENT OF THE TAX SHELTER EXCEPTION TO § 7525

Given the extensive treatment of tax shelters in the Internal Revenue Code and Regulations, it should come as no surprise that many taxpayers' attempts to engage in transactions classified as tax shelters often end up in the courtroom. Once a transaction gives rise to litigation, a whole new set of rules, specifically the rules underlying the various evidentiary privileges, come into play. Tax litigation, in particular, often results in an alphabet soup of privilege claims – attorney-client privilege, work product doctrine, and, of course, the § 7525 privilege. Due to the often confusing interplay among these privileges, the courts have struggled at times to define where one privilege begins and another ends, much less to develop guidelines for when the various exceptions to these privileges permit the admission of otherwise inadmissible evidence. Section 7525's tax shelter exception has proved troublesome, as its contours have never been fully developed.

Part II includes a detailed look at a series of recent decisions which have involved the tax shelter exception. This discussion centers on the various approaches by the courts and the extent of overlap between those approaches. As discussed in the paragraphs that follow, the cases to-date involving the tax shelter exception have failed to clearly define the scope of that exception, with some relying on the interaction with other Code sections or the legislative history, while others pay no heed to either. Each court, to varying degrees, has developed its own method of analysis. As a result, litigants and professionals are left with a puzzle to piece together.

[34] § 7408(c)(2).
[35] § 7408.

A. BDO Seidman: The Seventh Circuit's Approach

1. Background:

The Seventh Circuit took its first look at the tax shelter exception to the § 7525 privilege in *United States v. BDO Seidman.*[36] The Internal Revenue Service sought to enforce an administrative summons against BDO Seidman, LLP, a large, second-tier public accounting firm.[37] The summonses were a part of a compliance investigation into whether the accounting firm had promoted and then failed to disclose potentially abusive tax shelters.[38] When BDO refused to comply with the summonses, the IRS petitioned the United States District Court for the Northern District of Illinois for enforcement of the summonses.[39]

In the years leading up to the enforcement action, the IRS became aware that BDO Seidman was marketing various tax planning opportunities which the IRS came to believe were abusive tax shelters.[40] As such, the IRS commenced a compliance investigation and, as part of that investigation, sought a large number of documents from BDO related to these transactions.[41] When BDO notified its clients that it intended to produce documents that would reveal the clients' identities to the Internal Revenue Service, these clients intervened in the enforcement action.[42] The intervenors argued that the documents were, *inter alia*, protected by the § 7525 privilege.[43] The IRS responded that the tax shelter exception should apply to overcome that privilege or, alternatively, that the crime-fraud exception applied.[44] The district court refused to find that either exception applied simply because the IRS characterized the transactions as "cookie cutter tax shelters."[45] Moreover, the district court added that whether or not the intervenors or BDO engaged in tax shelters was the ultimate question in the IRS'

[36] 492 F.3d 806, 814. This case has endured a long journey through the courts. This discussion will focus only on the July 2, 2007, opinion by the Seventh Circuit.

[37] *Id.* at 809.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.* at 810. The district court first denied the motion to intervene, and the Seventh Circuit affirmed that denial. *Id.* However, the IRS and the intervenors later filed a joint motion in which the IRS consented to the intervention, thereby allowing the privilege issues to remain in the case. *Id.*

[43] *Id.* at 810.

[44] *Id.* at 809. Interestingly, the district court treated the crime-fraud exception as applying to both the § 7525 privilege and the attorney-client privilege, indicating that, at least in this sense, the two privileges were co-equal. *Id.* at 810.

[45] *Id.* at 810.

investigation and refused to find the tax shelter exception applied for that reason.[46] The court, instead, analyzed the totality of the circumstances to determine whether the crime-fraud exception applied to each individual document.[47] The IRS appealed the court's ruling on the tax shelter exception.[48]

2. Seventh Circuit's Analysis:

On appeal, the Seventh Circuit engaged in an extensive analysis of the tax shelter exception to the § 7525 privilege.[49] The Court first noted that, in order for the exception to apply, the underlying communication must otherwise fall within the § 7525 privilege.[50] As such, the burden of proving the exception applied rests with the "opponent of the privilege" – the IRS.[51] The Court then turned to the scope of the tax shelter exception itself. First, the Court found that, under the clear language of the statute, the exception applied to *any* tax shelter, not just corporate tax shelters, even under the pre-2004 version of the Code.[52] Next, the Court reasoned that, since § 7525(b) is unambiguous, there is no need to look to the legislative history of the section to determine the scope of the exception.[53] The Court then found that the provision applied to all

[46] *Id.* at 810-11 (noting the district court's refusal to rule on whether BDO or the intervenors were engaged in tax shelters because that was the "ultimate issue" in the underlying investigation).

[47] *Id.* at 811-12. The district court engaged in an eight factor analysis, noting that these factors had to be evaluated in light of the totality of the circumstances for each document. *Id.*

[48] *Id.* at 808.

[49] *See id.* at 822-28 (analyzing the scope of the tax shelter exception to § 7525). Note that the pre-2004 version of § 7525 applied in this case. *See supra* note 4 (noting that § 7525 was amended by the American Jobs Creation Act of 2004). Before the 2004 Amendments, § 7525(b) was limited to corporate taxpayers and a more narrow set of written communications, reading:

> (b) Section not to apply to communications regarding corporate tax shelters. The privilege under subsection (a) shall not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii)).

§ 7525(b) (2000) (current version at I.R.C. § 7525(b) (2011). The cross-reference to § 6662(d)(2)(C)(iii) also reflects a pre-2004 version of that Code section. *See BDO Seidman*, 492 F.3d at 823, n.13.

[50] *BDO Seidman*, 492 F.3d at 822 ("The fact that the privilege does not apply to the class of communications described in subsection (b) presupposes the existence of an otherwise applicable privilege.")

[51] *Id.* (citing Wright & Graham, 24 Federal Practice & Procedure § 5507, at 571).

[52] *Id.* at 823 (quoting § 7525 and emphasizing its explicit applicability to *any* tax shelter).

[53] *Id.* at 824. Interestingly, the Seventh Circuit took the time to describe how the

taxpayers, rejecting the intervenors' assertion that such a broad reading of the tax shelter exception would swallow the privilege.[54] On the other hand, the existence of the exception, in the Court's view, does not destroy the basic privilege that applies to communications of any sort between an individual taxpayer and his or her practitioner.[55] Under this analysis, the Seventh Circuit vacated and remanded the district court's ruling as to the tax shelter exception.[56]

In summary, the Seventh Circuit based its analysis of the scope of the tax shelter exception on the plain language of the statute. Thus, it found that the exception applies to all taxpayers and any tax shelter. Furthermore, according to the court, the tax shelter exception does not require a showing of crime or fraud. All that is required is a written communication between the taxpayer and a corporate agent regarding a transaction which falls within the definition of a tax shelter. The burden of meeting this proof requirement rests with the government. The Court summarized the IRS' burden of proof as follows:

> [T]he IRS must bring forward evidence that: (1) the communication relates to a tax shelter, as defined by §6662(d)(2)(C)(ii); (2) the communication was made by a director, shareholder, officer, or employee, agent, or representative of the corporation; and (3) the communication was made in connection with the promotion of the direct or indirect participation of the corporation in such tax shelter.[57]

In other words, the Seventh Circuit takes an expansive view of the tax shelter exception. Provided the IRS can produce evidence meeting the three prongs of the test set forth above, it will have met its burden, and the tax shelter exception will apply.

B. Countryside Limited Partnership*: The Tax Court's Approach*

The Tax Court approaches this topic somewhat differently. Most recently, the Tax Court addressed the scope of the tax shelter exception

legislative history simply added to the confusion over the scope of the exception. *Id.* Moreover, practitioners have remained confused over the scope of the exception since § 7525 was adopted in 1998. *See, e.g.,* James Beaver, *Two Courts Address Tax Shelter Exception to Tax Practitioner Privilege*, 40 TAX ADVISER 558 (August 1, 2009) (outlining the practical implications of the *Valero* and *Countryside* cases); Sheryl Stratton, *Accounting-Client Privilege: Unclear from the Start*, 80 TAX NOTES 7 (July 1998) (criticizing § 7525 and discussing its inherent ambiguities).

[54] *See id.* at 828 (rejecting the intervenors' arguments that § 7525 applied only to corporate taxpayers and only to the income tax).

[55] *See id.* at 827 ("because the tax shelter exception applies only when the written communication relates to the corporation's direct or indirect participation in a particular type of tax shelter [it] will not affect any otherwise privileged communication . . . .").

[56] *Id.* at 828.

[57] *Id.*

in its brief opinion in *Countryside Limited Partnership v. Commissioner*.[58] As discussed below, the Tax Court adopted a slightly different analysis of the tax shelter exception than the Seventh Circuit applied in the *BDO Seidman* case. In particular, the Tax Court appears to focus more on the taxpayer's relationship with the federally authorized tax practitioner and to place a greater value on the legislative history behind § 7525(b).

Mr. Arthurs Winn was a partner in Countryside Limited Partnership.[59] After the partnership became involved in a federal income tax case, the Internal Revenue Service sought to discover a series of documents, related both to the partnership's business and that of the partners, including Mr. Winn.[60] Specifically, the Service sought a series of "Estate Planning Meeting Minutes" related to meetings between Mr. Winn and his certified public accountant, Mr. Egan.[61] The minutes chronicled the communications, some of which were confidential, between Mr. Egan, the taxpayers' attorneys, Mr. Winn, and the partnership.[62] In addition, the Service sought two pages of handwritten notes made by a member of the partnership related to confidential communications that occurred during a meeting between Mr. Egan and the taxpayers, among others.[63]

Mr. Winn objected to the motion to compel production of these documents, claiming they were protected under the § 7525 privilege.[64] The Service responded that the § 7525 privilege did not apply, because the documents constituted written communications promoting illegal tax shelters.[65] Thus, the Tax Court had the opportunity to address the tax shelter exception head on. In analyzing the exception, the Tax Court focused its attention on two key aspects of the tax shelter exception: (1) what constitutes a written communication; and (2) what constitutes promotion. Ultimately, the Tax Court found that the tax shelter exception did not apply to the documents at issue.[66]

[58] 132 T.C. 347 (2009).

[59] *See id.* at 348 (noting Mr. Winn was a participating partner in Countryside, LP).

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id*

[64] *Id.* Other documents sought by the IRS were found to be protected by the attorney-client privilege and were not a subject of the Tax Court's opinion. *See id.* (noting that "[w]e have resolved by order all issues" regarding the privilege claims).

[65] *Id.* at 349-50 (outlining the position of the IRS as to the documents at issue).

[66] *See id.* at 355 (denying the motions).

First, the court analyzed the meaning of "written communication."[67] In particular, the court focused on the notes taken by another member of the partnership during a meeting between the partners and their advisors.[68] These notes were not a verbatim record of the meeting, but rather a series of notes of the most important topics discussed.[69] Moreover, the notes were retained by the member of the partnership who made them.[70] Because § 7525(b) applies only to written communications, the Tax Court had to decide whether the mere act of taking notes constituted a communication.[71] The IRS took the position that the notes were a written record of oral communications involving a tax shelter and therefore constituted written communications, while the taxpayers, of course, took the opposite view.[72] The court found in favor of the taxpayer and ruled the notes were privileged.[73]

In reaching this conclusion, the Tax Court took a very pragmatic approach. Its analysis revolved around the simple question of whether or not the notes themselves were communicated to anyone other than the member who took them in a manner that would destroy the privilege protecting them.[74] Because the member who made the notes never transformed them into a written communication to anyone else, the court reasoned, there was no written communication.[75] Rather, the only communications between the federally authorized tax practitioner and the member were oral communications.[76] Oral communications are clearly outside the tax shelter exception, so the notes were privileged.[77]

Next, the Tax Court engaged in an analysis of the meaning of "promotion" under § 7525(b) to determine whether the minutes of the various estate planning meetings were protected. In its discussion of this aspect of the tax shelter exception, the Tax Court found that the nature of the relationship between a taxpayer and his or her federally authorized tax practitioner is a key factor in determining whether the practitioner's actions constituted promotion.[78] Mr. Winn and Mr. Egan

[67] *Id. at* 350-51. As discussed previously, § 7525(b) applies only to written communications. *See supra* text accompanying notes 8-10 (discussing the tax shelter exception in § 7525(b)).
[68] *Id.* at 351.
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.* at 352.

had a long-standing accountant-client relationship, with Mr. Egan doing work for various businesses controlled by the Winn family as well as individual family members and trusts.[79] At the time of the action against the partnership, Mr. Egan had been working with the Winns for over twenty years.[80] He was paid based on a combination of fixed fees and hourly rates and had no stake in the outcome of the transactions questioned by the Service.[81] Moreover, as with many other transactions, Mr. Egan helped Mr. Winn evaluate alternatives to the transactions at issue in the litigation.[82] And, in formulating his advice in the questioned transactions, he did not rely on "any generic prototypes, descriptive materials, or files maintained by [the accounting firm]."[83]

Against this backdrop, the court found that Mr. Egan's activities did not meet the definition of "promotion."[84] That term is not defined in § 7525 itself, so the court first noted that a common definition meaning included "'[e]ncouragement of the progress, growth, or acceptance of something; furtherance' and 'advertising; publicity.'"[85] After noting that the courts that had addressed the issue had reached different responses, the Tax Court, unlike the Seventh Circuit, found the tax shelter exception provision ambiguous and therefore relied on the legislative history for assistance.[86] Noting that § 7525(b) was first discussed in a conference on a Senate amendment to a House bill, the Tax Court quoted the conference report: "The Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly the Conferees do not anticipate that the tax shelter exception will adversely affect such routine relationships."[87] Thus, the Tax Court took the position that, where an ongoing relationship existed between a client and a federally authorized tax practitioner, that relationship would mitigate a finding that the practitioner had engaged in "promotion." However, "[t]here may be a point at which [a practitioner's] actions cross the line, and will no longer be encompassed within the routine relationship . . . and will

[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *See id.* at 354-55 (analyzing the facts in light of the legislative history of § 7525 and concluding that the accountant did not promote a tax shelter).
[85] *Id.* at 353 (quoting The American Heritage Dictionary of the English Language 1402 (4th ed. 2000)).
[86] *Id.* (citing United States v. Textron, Inc., 507 F. Supp. 2d 138, 148 (D.R.I. 2007) (the term applies to the peddling of prepackaged tax shelters) and Valero Energy Corp. v. United States, No. 06 C 6730 (N.D. Ill. Aug. 26, 2008) (corrected memorandum opinion and order) (the term applies "to a person who organizes or assists in organizing a tax shelter")).
[87] *Id.* (quoting H.Conf. Rep. 105-399, at 269 (1998), 1998-3 C.B. 747, 1023).

amount to tax shelter promotion."[88] Since Mr. Egan had not crossed that line, the relationship was sufficient for the Tax Court to find that no promotion had occurred. Thus, the minutes were protected by the § 7525 privilege and were not subject to the tax shelter exception.

The *BDO Seidman* and *Countryside Limited Partnership* cases illustrate the differences between the approaches taken by the Seventh Circuit and the Tax Court, respectively. The Seventh Circuit focuses more heavily on the language of the statute itself, having found its meaning clear and unambiguous. As such, the Seventh Circuit largely ignored the legislative history of the statute and developed its three-part test directly from the language of § 7525, while the Tax Court relied heavily on the statute's history to clarify the statutory language, finding it ambiguous and open to interpretation depending on the underlying facts. Thus, taxpayers involved in litigation in the Seventh Circuit face a relatively straight-forward test, while those going to the Tax Court face a more fluid and fact intensive test for application of the exception.

C. District Court Decisions: Arthur Andersen *and* KPMG

Given their position on the front line, the district courts have no doubt borne the brunt of grappling with the scope and meaning of the § 7525(b) exception since its enactment. The published trial court opinions dealing with the tax shelter exception contain a variety of approaches to analyzing the exception, with some adopting part or all of the Seventh Circuit or Tax Court views and others developing their own methods of analysis. However, as discussed in this section, some common themes have begun to emerge. As such, a brief review of the pertinent published opinions in two of the more prominent, recent cases, *United States v. Arthur Andersen, LLP*[89] and *Doe v. KMPG, LLP*,[90] should prove helpful in exploring the contours of the tax shelter exception.

1. United States v. Arthur Andersen, LLP*:*

In its August 15, 2003, opinion, the District Court of the Northern District of Illinois held that the identities of an accounting firm's clients who might have participated in illegal tax shelters were not privileged and had to be revealed to the government in its case against the accounting firm.[91] Here, the Internal Revenue Service had issued a series of administrative summonses to Arthur Andersen, seeking information about certain transactions that were being investigated as

[88] *Id.* at 354.
[89] No. 02-C-6790, 2003 U.S. Dist. LEXIS 14228 (N.D. Ill. August 15, 2003).
[90] 325 F. Supp. 2d 746 (N.D. Tex. 2004).
[91] Arthur Andersen, 2003 U.S. Dist. LEXIS 14228, at *21.

potential tax shelters.[92] The purpose of the government's action was to determine whether Andersen had illegally promoted tax shelters to its clients.[93] Some time later, Andersen notified some of its clients about the summons and told the clients that it was going to reveal each client's identity unless a client notified Andersen that the client wished to assert a privilege with respect to the information sought.[94] Forty former clients notified Andersen they wished to assert such a privilege.[95] Following a series of motions, hearings, and other legal wrangling, the district court issued its ruling on the identity privilege.

Following the process suggested and the reasoning dictated by the *BDO Seidman* litigation, the court reviewed a series of documents *in camera* before ruling on the government's motion to compel.[96] The court then looked at the *BDO Seidman* opinion itself, and determined that the language was so broad that the Seventh Circuit effectively precluded the existence of an identity privilege under § 7525.[97] Though the court engaged in the factual finding exercises prescribed by the *BDO Seidman* case, the court noted that "the language at the end of the *BDO* opinion sweeps very broadly, dipping into legislative intent and other IRS policy considerations, and does not explicitly base its holdings on the specific facts. . . ."[98] This determination proved fatal to the intervenors' identity privilege claims. Unlike the clients in the *BDO Seidman* litigation, Andersen's clients had each received individual advice and had engaged in transactions that were specifically tailored to their own goals, Andersen did not prepare tax returns for the clients, the clients received engagement letters specifying the transactions were not covered by §§ 6111 and 6112, and the clients intended to assert the § 7525 privilege as to many of the documents involved.[99] Because the court found that the Seventh Circuit's rejection of an identity privilege was so broad, none of these facts could influence the district court's decision on the matter.[100]

[92] *Id.* at *3.

[93] *Id.*

[94] *Id.* at *3-4.

[95] *Id.* at *4.

[96] *See id.* at *7-8 (describing the process the district court engaged in to review the documents in question to determine if the tax shelter exception applied).

[97] *Id.* at *20.

[98] *Id.* at *16.

[99] *Id.* at *13-15.

[100] *See id.* at *20 ("[I]t appears that the Seventh Circuit intended . . . to pronounce a generally applicable prohibition on the assertion of the identity privilege . . . that does not seem altered by differing factual scenarios."). *Cf.* Shane Jasmine Young, *Note: Pierce the Privilege or Give 'Em Shelter? The Applicability of Privilege in Tax Shelter Cases*, 5 NEV. L.J. 767 (advocating for the abolition of both the § 7525 privilege and the identity privilege in tax shelter cases).

In other words, the district court interpreted the *BDO Seidman* decision to mean that no identity privilege exists under § 7525.

2. Doe v. KPMG, LLP*:*

Like the *Arthur Andersen* litigation, *Doe v. KPMG, LLP*, involved an administrative summons seeking information from the accounting firm about some of its clients, including those clients' names and certain documents relating to suspected tax shelter transactions.[101] After KPMG notified the clients of the summons, the clients filed a case in the District Court of the Northern District of Texas seeking injunctive and declaratory relief.[102] The parties entered into a stipulated and agreed upon order under which KPMG agreed not to disclose the clients' identities or any documents related to the transactions to the Internal Revenue Service.[103] The plaintiffs filed a motion for summary judgment based upon that order.[104] The IRS then moved to intervene and filed a motion to dismiss the case.[105] Thus, the district court was faced with the scope of the § 7525 privilege and, in particular, the existence of and scope of any identity privilege.

First, the *KPMG* court explicitly states that clients' identities are not subject to the § 7525 privilege for the simple reason that identities are not "communications" except when revealing a client's identity would, in and of itself, reveal an underlying confidential communication.[106] Moreover, the court continued, the clients' motives for participating in tax shelters is obvious – tax savings.[107] Therefore, a practitioner reveals nothing to the Internal Revenues Service regarding the clients' motivation by revealing a client's identification. Finally, the court notes that the clients could have no reasonable expectation that KPMG would keep their identities confidential, given the various tax laws which applied to the transactions at issue and required the practitioner to disclose various pieces of information about tax shelter transactions.[108]

[101] 325 F. Supp. 2d 746, 748 (N.D. Tex. 2004).
[102] *Id.* at 749.
[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *See id.* at 752-53 (analogizing the protection of clients' identities under § 7525 with the protection afforded clients' identities under the attorney-client privilege and noting the Seventh Circuit rejected a similar claim in the *BDO Seidman* litigation). *See also* United States v. BDO Seidman, 377 F.3d 802, 812 (7th Cir. 2003) (concluding that no confidential communication results from the disclosure of a taxpayer's identity in response to an administrative summons).
[107] *See id.* at 753 ("'virtually any taxpayer who seeks tax advice . . . is looking for ways to minimize his taxes'") (quoting U.S.'s Mot. to Dismiss at 5).
[108] *See id.* at 753-54 (discussing the disclosure requirements contained in Notice 2000-44 and §§ 6111 and 6112 of the Code).

Based on the above reasoning, the court found that no identity privilege existed to protect KPMG's clients. Unlike the Northern District of Illinois, however, the *KPMG* court centered its holding around §§ 6111 and 6112 as well as the relevant facts before it. In addition, the court relied heavily on the ties between the § 7525 privilege and the attorney-client privilege. Therefore, while both district courts relied heavily on the Seventh Circuit's analysis of the § 7525 privilege in the *BDO Seidman* litigation, each court interpreted that analysis differently, although reaching substantially similar results. The courts' failure to consistently apply existing precedent adds to the current atmosphere of uncertainty. Therefore, a synopsis of those points on which the courts and the Code offer sufficient guidance should prove helpful. Where no sufficient guidance can be found, suggestions are made based upon existing legal principles.

III. LEGISLATIVE ANALYSIS

When Congress enacted § 7525, it recognized the need to exempt from the privilege certain communications regarding transactions involving abusive tax shelters. In doing so, Congress acted in accord with an established practice of disfavoring tax evasion. Moreover, the exception makes sense in view of the larger relationship between the § 7525 privilege and the attorney-client privilege, as the latter has its own crime-fraud exception. Unfortunately, Congress failed to give practitioners, taxpayers, and the courts a clear definition of the types of communications and transactions which should fall within the exception. The courts, litigants, and professionals who deal with tax transactions continue to deal with the ramifications of this lack of precision.

As always when conducting any analysis, it is easiest to begin with the known quantities. First, the Code is clear that the tax shelter exception applies only to written communications.[109] Given the inherent difficulties that would arise from policing oral communications, this limitation is more than sensible. Only with written communications will the parties have a record of the communication. Second, § 7525(b) clearly limits the exception to transactions defined as tax shelters under § 6662(d)(2)(C)(ii).[110] By doing so, Congress effectively coordinated two of the key provisions dealing with tax shelters, suggesting that those provisions and others containing similar language must be read in tandem. Specifically, the reference to § 6662(d)(2)(C)(ii) ensures that §

[109] I.R.C. § 7525(b). *See supra* text accompanying notes 8-10 (discussing the § 7525(b) tax shelter exception).

[110] § 7525(b). *See supra* text accompanying notes 8-10 (discussing the § 7525(b) tax shelter exception).

7525(b) mirrors other sections of the Code, including §§ 6111 and 6112, bringing case precedent under those provisions into play as well. With such extensive interplay among the various Code provisions and such an ample body of case law dealing with what constitutes a tax shelter under the Code, the definition of "tax shelter" in § 7525(b) is fairly certain. Finally, the Code itself defines "federally authorized tax practitioner."[111] Because only written communications with a federally authorized tax practitioner could potentially fall within the tax shelter exception, this definition helps flesh out the communications which are and are not covered. In addition, the inclusion of this definition further develops the ties between § 7525 and the attorney-client privilege by explicitly stating the professionals whose work could fall within the privilege.

Aside from these few certainties, the scope of the tax shelter exception remains muddled. In particular, the questions of what is a "communication" and what is "promotion" have been answered in varying manners by the courts.[112] First, the definition of "communication" should be easily agreed upon. The courts appear in agreement after the *BDO Seidman* litigation that the mere identity of the taxpayers involved in purported tax shelters should not be protected by the § 7525 privilege. In essence, the identity of a taxpayer cannot be seen as a "communication," much less one to which the tax shelter exception should apply for several reasons. As a starting point, the courts have recognized that the mere identity of the taxpayers involved reveals nothing regarding the substance of the transaction itself, except in the rare case where revealing the taxpayer's identity would require the release of an underlying, privileged communication.[113] More to the point, the Code requires accounting firms and other practitioners to reveal the identities of clients who have engaged in certain listed transactions.[114] As a result, clients should have no expectation that their identities will remain confidential. In addition, the term "communication" has an accepted, common definition which has been

[111] *See* § 7525(a)(3)(A) ("The term 'federally authorized tax practitioner' means any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code.").

[112] *See supra* Part II.C. (discussing two district court decisions dealing with the definition of "promotion" and "communication").

[113] *See, e.g.,* Doe v. KPMG, LLP, 325 F. Supp. 2d 746, 752-53 (N.D. Tex. 2004) (analogizing the protection of clients' identities under § 7525 with the protection afforded clients' identities under the attorney-client privilege and noting the Seventh Circuit rejected a similar claim in the *BDO Seidman* litigation). *See also* United States v. BDO Seidman, 377 F.3d 802, 812 (7th Cir. 2003) (concluding that no confidential communication results from the disclosure of a taxpayer's identity in response to an administrative summons).

[114] I.R.C. §§ 6111, 6112.

well-developed in case law dealing with the attorney-client privilege.[115] According to this definition, a communication requires the transfer of information related to the tax shelter transaction from one person to another. Thus, as is clear from the *Countryside, LP* case,[116] notes that are less than a direct transcription of an oral communications or notes which are never communicated to another party should not be covered by the tax shelter exception. The rationale is very simple – they were never communicated.

By piecing together the existing case law, then, a clear picture of what should be included as "communications" under the tax shelter exception emerges. That term should apply only to information regarding the facts or circumstances of the underlying tax shelter transaction. It should not apply to the taxpayers' identities absent proof that a given taxpayer's identity in and of itself would reveal an otherwise privileged communication, and the burden of proving that situation should rest squarely on the practitioner or client claiming the privilege. In addition, in order for the exception to apply to a document, the content of that document must have been transferred from one person to another. In a sense, this requirement is analogous to the publication requirement in a defamation case. Just as there can be no publication absent a third party hearing or reading otherwise defamatory comments, there can be no communication if a document that might otherwise fall within the tax shelter exception remains in the possession of its creator.

Next, the problem of when a practitioner is engaged in the "promotion" of a tax shelter remains unclear. Again, the courts and the Code have given us the puzzle pieces to fit together. These pieces, subject to a few clarifications, can be put together in such a fashion as to provide an acceptable level of clarity. First, § 6700 of the Code, entitled "Promoting Abusive Tax Shelters," should be brought into the discussion of what "promotion" means. Though the section fails to define "promotion," the provision does provide some guidance. Specifically, § 6700(a)(1)(A) imposes a penalty on any person who organizes (or assists in organizing) or participates in any fashion in the sale of any interest in a tax shelter or "makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)" a statement related to certain tax effects where the statement is known or should be known to be false or fraudulent.[117] These specifics provide helpful hints as to what Congress contemplated when it required "promotion" of a tax

115 *See supra* Part II.C.
116 *See supra* Part II.B.
117 § 6700(a)(2)(A), (B).

shelter before the tax shelter would apply. Moreover, § 6700 appears to track certain components of the legislative history of § 7525.[118]

The current case law either directly or indirectly follows the lead set in § 6700. For example, the sale or advertisement of packaged or canned proposed transactions to all clients or the general public appears to be a universally accepted example of "promotion" of a tax shelter. Few would argue with this rule, and it reflects the general ideas contained in § 6700. By selling a one-size-fits-all transaction that clearly seeks to minimize or eliminate negative tax effects, practitioners are actively promoting the transaction. On the other hand, where practitioners meet with individual clients and develop tax planning techniques tailored to address the particular needs of that client, whether "promotion" occurs is less certain. When faced with this situation, the Tax Court opted to develop a sort of facts and circumstances test.[119] Such a test, if clearly delineated, would go far toward clearing up the present confusion over the definition of "promotion." Based on § 6700 and the Tax Court's reasoning, key factors should include: the length of the relationship between the practitioner and the client, the types of work performed by the practitioner on the client's behalf, the method used to calculate the practitioner's fees, and other facts relevant to the question of whether the practitioner stood to benefit if the taxpayer engaged in a suggested transaction.

Where a practitioner suggests a transaction to a long-time client as part of an ongoing relationship, that suggestion looks less like "promotion" and more like ordinary tax advice which should be covered by the § 7525 privilege. This conclusion is bolstered where the practitioner regularly provides tax planning advice to the client, regardless of whether the practitioner also prepares a client's tax return, and offers the client alternative transaction structures, particularly where the other alternatives lack the characteristics of a tax shelter.[120] Finally, where a practitioner is paid on an hourly basis or on any other basis which does not tie his or her fee to the tax savings to the client, there is less of an argument for the existence of a tax shelter. Fees that

[118] *See supra* text accompanying notes 81-85 (discussing legislative history of § 7525 and congressional intent as to the definition of "promotion"). *Cf.* § 6700(a)(2)(A), (B) (detailing the actions prohibited by that provision).

[119] *See supra* Part II.B.

[120] Tax return preparation is an accounting function and clearly outside the § 7525 privilege. *See, e.g.,* H.R. CONF. REP. NO. 105-599, at 267 (1998) (noting that, in keeping with the common law, neither the attorney-client privilege nor the § 7525 privilege will "apply to communications and documents generated in the course of preparing [a tax] return."). Therefore, whether a tax return is prepared should have little or no bearing on the application of the tax shelter exception.

are tied to tax savings appear more in the vein of commissions and, as such, are more indicative of "promotion."

Thus, on the question of "promotion," pre-packaged transactions with the primary purpose of minimizing or avoiding the income tax should be deemed tax shelters, absent proof to the contrary from the practitioner involved. On the other hand, the existence of an ongoing relationship between the practitioner and the client and fees that are hourly or calculated without regard to tax savings should weigh against a finding of "promotion." Therefore, if the courts wish to adopt a bright-line rule, the sale or advertisement of pre-packaged programs or transactions could be deemed "promotion" *per se*. However, such a rule could open up the possibility that taxpayers and practitioners could take steps to avoid the rule by structuring transactions so as to establish facts supporting the existence of an ongoing relationship between the parties and suggesting that the transactions were tailored to the client's needs. Therefore, the courts should follow the lead of the Tax Court and adopt the factors suggested above to apply, particularly in cases other than where a pre-packaged program or transaction is at issue. This approach would coincide with the legislative history of § 7525 and with the general guidance contained in § 6700. Analyzing the relevant factors will lead to a consistent definition of "promotion" for purposes of the tax shelter exception.

IV. CONCLUSION

In conclusion, while the scope of the § 7525 privilege has become more certain in recent years, the courts, taxpayers, and tax practitioners continue to struggle with the tax shelter exception to the privilege. The current case law and various Code sections dealing with tax shelters form a few of the pieces of the definition of a "tax shelter." However, while the Code expressly limits the exception to written communications and mandates that a federally authorized tax practitioner, as that term is defined in the Code, must be a party to the communication, the definitions of "communication" and of "promotion" remain murky, due to an absence of guidance in the Code and varying treatments by the courts. This article suggests that "communications" should include only the transfer of otherwise confidential information between persons. Similarly, the term "promotion" should include all sales or advertisement of pre-packaged avoidance or evasion transactions as well as individualized transactions that meet certain factors tending to indicate that a practitioner is actively engaged in selling or benefitting from a tax shelter transaction. By adopting a universally accepted definition for both of these terms, all involved in a tax case will have a better understanding of how the rules apply. Moreover, these definitions will serve to complete the puzzle that is the tax shelter exception.

REPRODUCTION AND DISTRIBUTION OF COPYRIGHTED MATERIALS FOR USE AS EXHIBITS IN A JUDICIAL PROCEEDING: FAIR USE OR FOUL PLAY?

by WILLIAM E. GREENSPAN*

I. INTRODUCTION

Assume Tom White, an assistant professor at State University, has been submitting an original paper each year for the past five years to the North Atlantic Regional Business Law Association (NARBLA). Even though each paper appears to meet NARBLA guidelines and format, the NARBLA Board of Editors consistently rejects the papers for publication in the Business Law Review, giving various reasons such as lack of the requisite scholarly contribution, research quality, topic interest, and/or writing quality.

Further, assume Tom has applied for promotion from the rank of assistant professor to associate professor at State University. After reviewing the candidate's self-evaluation for promotion, the recommendation from the reappointment and promotion committee, and the dean's appraisal, the provost denies Tom's request for promotion. The provost explains in a promotion-rejection letter that Tom has excellent teaching evaluations. He has performed significant service to the university and the community. However, Tom has not demonstrated a continuing record of research and publication.

Consequently, Tom sues NARBLA and the NARBLA Board for Editors for damages, claiming dubious theories of recovery such as

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breach of contract and intentional infliction of emotional distress. Tom makes copies of several recent articles in the Business Law Review for use in the district court proceedings. He intends to demonstrate his papers are of the same, if not better quality, than those accepted for publication in the Business Law Review. The district court judge grants the defendants' motion for summary judgment, explaining that in the absence of any direct proof of discrimination, the court will not substitute its opinion for that of the NARBLA Board of Editors concerning the qualifications of a paper for publication.

Subsequently, NARBLA and the authors of the articles copied for the Business Law Review sue Tom for copyright infringement, claiming Tom copied and distributed copyrighted materials without permission from the copyright owners. Tom raises a "fair use" defense. Now the court has to decide the issue of to what extent a defendant may successfully assert a fair use defense in a copyright infringement case when the defendant copies and distributes copyrighted materials, without permission from the copyright owners, for use in a judicial proceeding.

This paper will (1) review relevant statutory law and legislative history as it relates to copyright infringement and "fair use," (2) discuss cases addressing "fair use" as it applies to the use of copyrighted materials in judicial proceedings, and (3) make recommendations for those considering using copyrighted materials in a judicial proceeding.

II. RELEVANT LAW

The United States Constitution gives Congress the power "To promote the progress of Science… by securing for limited Times to Authors… the exclusive Right to their… Writings."[1] In exercise of this power Congress "crafted a comprehensive statutory scheme governing the existence and scope of copyright protection for original works of authorship fixed in any tangible medium of expression."[2] The United States Supreme Court has noted the "immediate effect of our copyright law is to secure a fair return for the author's creative labor. But the ultimate aim is, by this incentive, to stimulate artistic creativity for the general public good."[3] Copyright law creates a balance between "the interest of authors… in the control and exploitation of their writings… on the one hand, and society's competing interest in the free flow of ideas [and] information on the other hand."[4]

[1] U.S Const., Art I, § 8, cl. 8.
[2] Reed Elsevier, Inc. v. Munchnick, 130 S.Ct. 1237, 1241.
[3] Twentieth Century Music Corporation v. Aiken, 211 U.S. 151, 156 (1975).
[4] Sony Corp. v. Universal City Studios, 464 U.S. 417, 429-30 (1984).

A. Requirements, Exclusive Rights, Subject Matter, Remedies

The Copyright Act[5] gives one who creates an original[6] work of authorship[7] in any tangible medium of expression[8] six exclusive rights, including the rights to reproduce[9] and distribute[10] copies of the work. The subject matter of a copyright includes eight categories, three of which are literary works,[11] pictorial works,[12] and motion pictures.[13] Any person who violates any of the exclusive rights of the copyright owner is liable for copyright infringement,[14] and may be liable for statutory damages as little as $200 per violation for innocent infringement, up to a maximum of $150,000 per violation for willful infringement of a registered work.[15]

Consistent with the ultimate aim to stimulate artistic creativity for the general public good, the Copyright Act places several exemptions or

[5] 17 U.S.C. §§ 101 *et. seq.* (2010).

[6] "Original" as the term is used in copyright "means only that the work was independently created by the author (as opposed to copied from other works), and that it possesses at least some minimal degree of creativity." Feist Publications, Inc. v. Rural Tel. Serv. Co. 499 U.S. 340, 345 (1991). *See,* Kelley v. Chicago Park Dist., Nos. 08-3701, 08-3712, 2011 WL 501161 (7th Cir. Feb. 15, 2011) (holding a wildflower garden lacked the necessary originality for copyright protection); Sater Design Collection, Inc. v. Waccamaw Const., Inc., No. 4:08-cv-4133-TLW-SVH, 2011 WL 666146 (D.S.C. Feb. 14, 2011) (noting the issuance of a certificate of registration by the United States Copyright Office constitutes prima facie evidence of the validity of an original architectural work).

[7] *See* Urantia Foundation v. Maaherra, 114 F.3d 955 (9th Cir. 1997) (observing that a book consisting of revelations received from non-human spiritual beings was copyrightable because the authors of the book selected, coordinated, and arranged the revelations in such a way that it was an original work of authorship created by human beings).

[8] 17 U.S.C. § 102 (a) (2010).

[9] *Id.* at § 106 (1) (2010).

[10] *Id.* at § 106 (3) (2010).

[11] *Id.* at § 102 (a) (1) (2010). "Literary works" are works, other than audiovisual works, expressed in numbers, or other verbal or numerical symbols or indicia, regardless of the nature of the material objects, such as books, periodicals, manuscripts, phonorecords, films, tapes, disks, or cards, in which they are embodied. 17 U.S.C. § 101 (2010).

[12] *Id.* at §102 (a) (5).

[13] *Id.* at § 102 (a) (6). "Audiovisual works" are works that consist of a series of related images which are intrinsically intended to be shown by the use of machines or devices such as projectors, viewers, or electronic equipment, together with accompanying sounds, if any, regardless of the nature of the material objects, such as films or tapes, in which the works are embodied. 17 U.S.C. § 101 (2010).

[14] *Id.* at § 501 (2010).

[15] *Id.* at § 504 (2010). Other remedies may include an injunction to restrain the infringer from continuing violations, the impoundment and destruction of all reproductions of the work made in violation of the owner's rights, a recover of actual damages and any additional profits of the infringer (in lieu of statutory damages), and an allowance for costs and a reasonable attorney's fee in the discretion of the court to the prevailing party. 17 U.S.C. §§ 502-504 (2010).

limitations on the exclusive rights of a copyright owner.[16] Perhaps the most well known limitation is the "fair use doctrine."[17]

B. The Fair Use Doctrine

In 1710, the English Parliament established an author's copyright with the Statute of Anne.[18] Subsequently, judges in the United States recognized as common law that fair use of unauthorized reproduction of copyrighted material would not infringe any of the author's exclusive rights.[19]

In an early Massachusetts case[20] Justice Story had to decide whether in Rev. Charles W. Upham's book, "The Life of Washington," the copying of 319 letters written by George Washington constituted fair use. Recognizing it was difficult to "lay down any general principles applicable to all cases,"[21] Justice Story observed the question of piracy necessitates looking to "the nature, extent, and value of the materials thus used; the objects of each work; and the degree to which each writer may be fairly presumed to have resorted to the same common sources of information, or to have exercised the same common diligence in the selection and arrangement of the materials."[22] Since the letters constituted the most important part of the book with the intention to supersede the use of Washington's letters, rather than to give a fair and reasonable criticism of the letters, Justice Story found the use of the letters was not a fair use.[23] The criteria Justice Story used in this case were largely adopted by Congress when it first codified the fair use doctrine in Section 107 of the 1976 Copyright Act.[24]

The legislative history indicates the fair use bill endorsed the common law of fair use, and recognized, especially during a period of rapid technological change, "the courts must be free to adapt the doctrine to particular situations on a case-by-case basis. Section 107 was intended to restate the present judicial doctrine of fair use, not to change, narrow, or enlarge it in any way."[25]

Section 107, as codified, permits the fair use of a copyrighted work, including reproduction in copies, for purposes such as criticism,

[16] *Id.* at §§ 107-122 (2010).
[17] *Id.* at § 107 (2010).
[18] Act for the Encouragement of Learning, 1709, 8 Anne, ch. 19.
[19] *See,* Pierre N. Leval, *Toward a Fair Use Standard,* 103 HARV. L. REV. 1105 (1990).
[20] Folsom v. Marsh, 9 F. Cas. 342 (C.C.D.Mass. 1841).
[21] *Id.* at 344.
[22] *Id.*
[23] *Id.* at 345.
[24] 17 U.S.C. § 107 (2010).
[25] H.R.Rep. No. 1476. 94th Cong., 2d Sess. 169, *reprinted in* 1976 U.S. Code & Admin. News 5659, 5680.

comment, news reporting, teaching, scholarship, or research. In determining whether use of a work is fair use, a court should consider four factors: "(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the market for or value of the copyrighted work."[26]

The United States Supreme Court has observed these factors are not to be treated in isolation; "all are to be explored, and the results weighed together, in light of the purposes of copyright,"[27] on a case-by-case analysis, the relevant factors being "illustrative and not limitative."[28] The fourth factor – the effect of the use upon the market for or value of the copyright work - is the single most important element in a fair use analysis.[29] A review of some of the most recent cases regarding fair use reveals such cases can rarely be sorted into four neat factors. Each case is unique. "The cases take on an individual narrative logic,"[30] covering a wide range of scenarios.[31] This paper focuses on one scenario – reproduction and distribution of copyrighted materials for use as exhibits in a judicial proceeding. Under what circumstances is such use a fair use?

[26] 17 U.S.C. § 107 (2010).

[27] Campbell v. Acuff-Rose Music, Inc., 510 U.S 569, 577-78 (1994).

[28] *Id.*

[29] Harper & Row Publishers, Inc. v. Nation Enterprises, 471 U.S. 539, 566 (1985) (finding publication of a short of a book by President Ford was not fair use).

[30] Lorie Graham, Stephen McJohn, *Thirty-Two Short Stories About Intellectual Property,* 3 HASTINGS SCI. & TECH. L.J. 1, 13 (2011).

[31] *See, e.g.,* Gaylord v. United States, 595 F. 3d 1364 (Fed. Cir 2010) (holding when the U.S. Postal Service copied a stamp bearing the image of a copyrighted statue of the Korean War Veterans Memorial, there was no fair use); A.V. v. iParadigms, 562 F.3d 630 (4th Cir. 2009) (deciding iParadigms had a good fair use defense when it used its Turnitin online plagiarism detection service to copy student papers because the use was transformative); WPIX, Inc. v. ivi, Inc., No. 10 Civ. 7415 (NRB), 2011 WL 607111 (S.D.N.Y. Feb. 22, 2011) (rejecting a fair use defense, granting an injunction to preliminarily enjoin defendants from streaming plaintiffs' copyrighted television programming over the internet without plaintiff's consent); Society of the Holy Transformation Monastery, Inc. v. Archbishop Gregory of Denver, Colorado, 685 F.Supp.2d 217 (D.Mass. 2010) (stating even though the copying of Greek religious texts was not commercial, there was no fair use because the copying was not transformative).

III. REPRODUCTION AND DISTRIBUTION OF COPYRIGHTED MATERIALS FOR USE AS EXHIBITS IN A JUDICIAL PROCEEDING IS FAIR USE

There are few cases on point on the issue of fair use in the context of using copyrighted materials as evidentiary submissions in judicial proceedings. With one exception, courts deciding the issue have favored fair use. The rationale is demonstrated in the following cases.

A. The Anti-Feminist Case

In *Hollander v. Swindells-Donovan,*[32] the story began in 2006 when Den Hollander wrote, registered for a copyright, and published on his website six essays conveying his anti-feminist world view.[33] In 2007 Hollander, individually and on behalf of similarly situated men, sued several New York City nightclub operators and promoters, claiming that "Ladies Night" promotions, whereby women were charged discounted admission, constituted sex discrimination in violation of the Fourteenth Amendment Equal Protection Clause.[34] Hollander made a motion to disqualify District Judge Miriam Cederbaum, claiming she was biased and prejudiced toward men.[35] Deborah Swindells-Donovan (Donovan), counsel for one of the defendant nightclubs, obtained copies of Hollander's essays and introduced the essays in court to demonstrate that Hollander was trying to disqualify Judge Cederbaum, not because Judge Cederbaum was biased, but because she was a woman. Judge Cederbaum denied Hollander's motion and subsequently in 2008 dismissed the case because the nightclubs' offering reduced-price admission to females did not constitute state action.[36]

The story continues. After Judge Cederbaum dismissed Hollander's case, Hollander then instituted a lawsuit against Donovan, claiming that when Donovan reproduced and distributed Hollander's essays for use as exhibits in the case against the nightclubs, Donovan committed copyright infringement. In defense, Donovan claimed fair use.[37] Both parties moved for summary judgment. Thus the issue before the court was whether Donovan's evidentiary submissions of Hollander's essays in the case against the nightclubs constituted fair use as a matter of law.[38]

[32] No: 08-CV-4045 (FB) (LB), 2010 WL 844588 (E.D.N.Y. Mar. 11, 2010).

[33] *Id.* at *1.

[34] Hollander v. Copacabana Nightclub, 580 F.Supp.2d 335 (S.D.N.Y. 2008), *aff'd,* 624 F.3d 30 (2nd Cir. 2010), *cert. denied,* 131 S.Ct. 914 (2011).

[35] *Hollander,* 580 F.Supp.2d 335, at 343.

[36] *Id.*

[37] *Hollander,* 2010 WL 844588 at *1.

[38] *Id.* at *2.

Block, Senior District Judge, reviewing the fair use factors, noted Donovan admitted reproducing the essays. The essays were creative works, and the copying was substantial. However, the copying was made only as "evidence of the workings of Hollander's mind," not to produce a comparable work or to use the essays for their expressive content.[39] More importantly, the submissions of Hollander's essays did not adversely affect the use upon the market for or value of the copyrighted work.[40]

Hollander is an example in which not all of the four fair use factors favor fair use. However the fourth factor trumps the other three.

B. The Child Custody Case

Consider *Bond v. Blum*[41] in which William Slavin and his wife, Alyson, were divorced and involved in a child custody suit over their three children. Meanwhile, Alyson married William Bond who wrote a manuscript describing how when he was 17 years old he murdered his father. Bond registered for a copyright on the manuscript – *Self-Portrait of a Patricide: How I Got Away with Murder* – and unsuccessfully made several attempts to get it published. Alyson's father, Kenneth Blum, Sr., was able to obtain a copy of the transcript and to make a copy for William Slavin who attempted to introduce the manuscript in the child custody proceeding to establish that the home of Alyson and William Bond would not be an appropriate place for the three children.[42]

Bond brought an action against Blum, William Slavin, and others who had copies of the manuscript asking the court to issue a preliminary injunction, prohibiting the defendants from using the manuscript for any purpose, and demanding the defendants return all existing copies.[43] Bond claimed use of the manuscript in the child custody proceeding would constitute copyright infringement. The defendants claimed fair use. On the issue of fair use, the district court granted the injunction, noting even though the manuscript was copied in its entirety, the use as an exhibit in the child custody proceeding would have no detrimental effect on the potential market for the copyrighted manuscript, and could "in a perverse way," actually increase the market value for the manuscript.[44]

The court of appeals affirmed, agreeing with the defendants that since use of the manuscript in the child custody case was non-

[39] *Id.* at *4.
[40] *Id.*
[41] 317 F.3d 385 (4th Cir. 2003), *cert. denied,* 450 U.S. 820 (2003).
[42] 317 F.3d at 390.
[43] *Id.* at 391.
[44] *Id.* at 392.

commercial, this was not an interest the copyright law was designed to protect. More importantly, noting the fourth factor was undoubtedly the single most important factor of fair use, the effect of the defendants' use on the potential market for the value of the copyrighted work was absolutely zero.[45]

Bond illustrates that a court will be willing to apply fair use to a scenario that does not undermine any right conferred by the Copyright Act. By applying the fair use doctrine, the court did not deny William Bond the privilege of continuing to try to commercially exploit his manuscript.

C. The Adult Movies Nuisance Abatement Case

Turning to *Jartech, Inc. v. Clancy,*[46] Jartech, Inc. and Mooks, Inc. were entities controlled by James and Artie Mitchell who produced, distributed and displayed adult movies. The Santa Ana (California) City Council hired an attorney, James Clancy, as special counsel to the city for drafting, adopting, and implementing a public nuisance ordinance designed to rid the city of its adult movie theatres.[47] In preparation for proving the adult movie theatres were a nuisance, Clancy arranged for an agent of the Council to enter one of the theatres owned by the Mitchells, and to secretly take photographs every few seconds of the visual screen images while running a tape recorder that recorded the entire soundtrack. Then Clancy had the photographs reproduced in small print, fifty per page, with script from the tape recordings printed under each photo.[48] The City Council used this evidence to declare the adult theatres were a nuisance. Consequently, the City Attorney revoked the Mitchells' licenses and permits.[49]

The Mitchells then filed suit on behalf of their theatres against Clancy and other Council members for copyright infringement of five copyrighted motion pictures. In defense, the defendants claimed, among other things, fair use.[50] The court of appeals affirmed the district court's finding that the copying was in the safe harbor of fair use. The purpose of the copying was not commercial or for subsequent use or enjoyment. Instead, the copying was to be used in a nuisance abatement proceeding. The copying of the screen images was abbreviated. The Council's use of the evidence was not commercially exploitive of the Mitchells' market.[51]

[45] *Id.* at 396-97.
[46] 666 F.2d 403 (9th Cir. 1982).
[47] *Id.* at 404.
[48] *Id.* at 405.
[49] *Id.*
[50] *Id.*
[51] *Id*. at 407.

This case demonstrates that it is irrelevant whether the party claiming fair use in a judicial proceeding is a private party or a public entity. What matters most when considering fair use is the fourth fair use factor: the effect of the use upon the potential market for or value of the copyrighted work.

D. The Website Copying for Unrelated Litigation Case

Finally, in favor of fair use, in *Shell v. Devries,*[52] Suzanne Shell was the author and copyright owner of an internet website named *www.profane-justice.org.* Jolene Devries and Anna Hall Owen, without permission from Shell, copied ten pages from Shell's website onto their computers. The purpose of the copying was to use the pages as evidence in unrelated litigation as an exhibit to a motion for attorney fees.[53] Shell sued Devries and Owen for copyright infringement.

The court of appeals agreed with the decision of the district court that the copying constituted fair use. The purpose of the copying did not reproduce the work for its intrinsic purpose. The website showed a time line for events leading up to a lawsuit.[54] The nature of the copyrighted work was factual, rather than fictional, simply a chronology of events. Although the copying may have been substantial, the use of the materials for an exhibit to a motion for attorney's fees in no way impacted the marketability of Shell's materials.[55]

Shell confirms that reproducing copyrighted materials for use in judicial proceedings does not disqualify a fair use defense just because the materials are used in non-related litigation. Nor, summarizing these cases finding fair use of copyrighted materials used as exhibits in judicial proceedings, does it matter whether the party claiming fair use is public or private. Courts have declined to use a "per se" rule for fair use. Instead, each unique scenario is analyzed according to the four fair use factors. The fourth factor is the most important, outweighing the other factors. As long as the use in a judicial proceeding of a copyrighted work is not a substitute for the content of the copied work, or used for a commercial purpose, courts are likely to find fair use.[56]

[52] No. 07-1086, 2007 WL 4269047 (9th Cir. Dec. 6, 2007), *cert. denied,* 553 U.S. 1036 (2008).

[53] 2007 WL 4269047 at *1.

[54] *Id.*

[55] *Id.*

[56] *See, e.g.,* Religious Technology Center v. Wollersheim, 971 F.2d 364 (9th Cir. 1992) (providing copyrighted religious scriptures to expert witnesses for the purpose of preparing their testimony in state tort litigation constituted fair use); Kulik Photography v. Cochran, 975 F.Supp. 812 (E.D.Va. 1997) (using a copyrighted photograph in a courtroom in defense of O.J. Simpson was fair use, especially since the trial judge had already admitted the photograph into evidence).

IV. REPRODUCTION AND DISTRIBUTION OF COPYRIGHTED MATERIALS FOR USE AS EXHIBITS IN A JUDICIAL PROCEEDING IS NOT FAIR USE

There is one scenario where a court declined to allow a fair use defense for a copyrighted exhibit used in a judicial proceeding. In *Images Audio Visual Productions, Inc. v. Perini Bldg. Co., Inc.,*[57] the Saginaw Chippewa Tribe of Michigan hired Perini Building Company to build the Soaring Eagle Casino and Resort complex in Mount Pleasant, Michigan. In order to maintain an evidentiary record of the construction progress in case a dispute arose during or after construction, Perini hired Robert Rentschler, a commercial photographer who was the sole owner of Image Audio Visual Productions, to take aerial photos of the construction site at regular intervals during the progress of the construction.[58]

During the next year and a half, Rentschler flew over the construction site 47 times taking color photographs of the construction site, after which Perini selected and paid for 305 of the images.[59] Two years after Perini began construction on the project, the Tribe became dissatisfied with the work and terminated Perini, claiming defective work and construction delays. According to the terms of the contract between Perini and the Tribe, the dispute went to arbitration.[60]

In preparation for the arbitration proceedings, Perini asked Rentschler to make six sets of photocopies of the construction photos so Perini could distribute the copies to three arbitrators, the witnesses, and the counsel for each party. Unfortunately, they could not agree on the price.[61] So Perini took the original photos to a local copyshop, Copy Corps, which made color copies at a cost of $1.00 per copy as opposed to the $10.50 per print, or $43.50 per negative, that Rentschler quoted.[62]

When Rentschler learned of this, he warned Perini the photographs were copyrighted. Rentschler asked Perini to comply with the Copyright Act and pay damages to Rentschler. When Perini refused, Rentschler sued Perini for copyright infringement. In defense, Perini claimed fair use.[63]

The district court reviewed the four fair use factors in great detail. For the first factor, the purpose and character of the use, the court found this factor did not favor fair use. The purpose for the photos, the reason

[57] 91 F.Supp.2d 1075 (E.D.Mich. 2000).
[58] *Id.* at 1077.
[59] *Id.* at 1078.
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.* at 1078-79.

why Rentschler made the photos, was for use in a judicial (or semi-judicial) proceeding. When Perini made copies of the photos, it was for the same purpose, not a transformative or different purpose. Perini's intended purpose was to supplant one of the Rentschler's commercially valuable rights – to make copies of the photos. Perini made an intrinsic use of Rentschler's photographs, that is for the same purpose as Rentschler intended – to use as demonstrative evidence of the construction work Perini performed at the Soaring Eagle project. [64]

Moving on to the second factor, the nature of the copyrighted work, the court found the photos were more creative than factual or functional. These were not simply photographs taken by an amateur. Perini chose to hire a professional commercial photographer who could capture the various stages of the project in a way far superior to other forms of evidence such as documentary records of his progress or testimony of employees who worked at the site. This factor did not favor fair use.[65]

Turning to the third factor, the amount and substantiality of the portion used, the court noted Perini reproduced Rentschler's photos in their entirety. Perini copied 287 of the 305 photos. He made color photocopies, near-exact replicas of the original works. Both parties admitted this factor did not favor fair use.[66]

Finally, examining the all-important fourth factor, the effect on the potential market, the court found this factor did not favor fair use. The reason why the photographs were made was because both Perini and Rentschler contemplated there would be litigation, which was the principal market for the photos. When Perini made unauthorized copies of the photographs, he entirely eliminated that market. The court commented that if a copyrighted work is made specifically for the purpose of litigation, and if the copyrighted work could be copied without getting permission from the copyright holder, then there would cease to be any viable marketplace for the copyrighted works.[67]

All four factors weighed against fair use. In sum, this case recognized that generally use of copyrighted materials in a judicial or quasi-judicial proceeding is fair use unless the use of a copyrighted work is a substitute for the content of the copied work, was copied for its intrinsic or intended purpose, and does not serve any transformative or further purpose. The fourth fair use factor, the effect on the market, weighs most heavily in a fair use analysis.[68]

[64] *Id.* at 1081-84.
[65] *Id.* at 1084-85.
[66] *Id.* at 1085.
[67] *Id.* at 1085-86.
[68] *See, e.g.,* Ross v. Miller's Rexall Drugs, Inc., Civ.A. No. D-68840, 1990 WL 314290 (Ga.Super. 314290) (Oct. 10, 1990) (noting it was not fair use to make copies of photographs

V. RECOMMENDATIONS FOR THOSE CONSIDERING USING COPYRIGHTED MATERIALS IN JUDICIAL PROCEEDINGS

Prior to reproducing and distributing copyrighted materials for use as an exhibit in a judicial proceeding, a litigant should consider the following:

1. Ask the copyright owner for permission to copy the materials. In some instances the copyright owner may be willing to give permission without asking for a royalty, such as when one believes use of the materials in a judicial proceeding would generate publicity, enhancing the potential market for or value of the copyrighted work.
2. Make sure the documents are necessary or essential for the prosecution or defense of the lawsuit, and there is no acceptable substitute, such as testimony of expert witnesses or other non-copyrighted materials.[69]
3. If a litigant should decide to use copyrighted materials in a judicial proceeding, give the author credit or attribution for the work.
4. Do not use the copyrighted materials beyond the confines of the lawsuit, such as to write a book or produce a movie using passages from the copyrighted work.[70]
5. Be prepared to use fair use as a defense if the copyright owner sues for infringement of copyright.

Turning to the introduction to this paper where Assistant Professor, Tom White, sues NARBLA, copying articles from the Business Law Review for use as exhibits in his lawsuit, and then NARBLA sues Tom White for copyright infringement for reproducing and distributing copyrighted articles, Tom will successfully raise a fair use defense. He will not be liable to NARBLA for copyright infringement, because even though the works copied are creative and the copying is substantial (he copied articles in their entirety), the copying was for a non-commercial purpose and was transformative, for a purpose other than its intrinsic purpose, to supplant or substitute the potential market for or value of the articles. If anything, the publicity the lawsuit generates may enhance the market value of the articles. Thus in NARBLA's lawsuit against Tom White, Tom wins that battle. But in Tom's lawsuit against

produced by a non-party certified Professional Evidence Photographer who formed a business for the purpose of providing photographic evidence to trial lawyers for use in litigation; the copying of the negatives would be a complete usurpation of the copyright owner's work, far beyond anything contemplated by fair use).

[69] *See,* Steven D. Smit, "*Make a Copy for the File:" Copyright Infringement by Attorneys,* 46 BAYLOR L. REV. 1, 42 (suggesting it is rather easy to demonstrate that copies of a document are necessary to effectively and efficiently engage in litigation as long as the documents are relevant to the issues in the lawsuit).

[70] *Id.* at 46-47 (giving an example whereby an unpublished diary used as an exhibit in a lawsuit is later used to write a book for some commercial purpose).

NARBLA, for questionable theories of breach of contract and intentional infliction of emotional distress, Tom loses that war.

VI. CONCLUSION

A litigant preparing exhibits for a judicial proceeding should try to avoid using copyrighted materials without permission from the copyright owners. Even if a copyright owner refuses to give permission or asks for an unreasonable royalty for use of the copyrighted works, a litigant may still use the works as an exhibit in a judicial proceeding if the works are necessary or essential to prosecute or defend the case, the use is non-commercial, the use is transformative rather than intrinsic, and the use does not have an adverse effect upon the potential market for or value of the copyrighted work. The exclusive rights of a copyright owner are not unlimited. One of the limitations is the "fair use" doctrine.

THE DIAMOND IS THE CRYSTALLINE REVELATOR[1]

by CHET HICKOX* AND GINA DI GRANDI**

INTRODUCTION

Long engagements give people the opportunity to find out each other's character before marriage, which is never advisable.[2] In matters that are as emotionally charged as love, marriage, and the legal issues involved in unwinding any property interests that may have arisen during those engagements, the American legal system has a storied and amusing history. Until the 1930s, litigation for the emotional damages for broken hearts was referred to as "heartbalm suits". Today, these causes of action[3] have largely been replaced with disputes over premarital gifts, predominately diamond engagement rings. This article will review the history of litigation arising from broken engagements and examine the present trends in this field.

BACKGROUND

For three centuries, individuals injured by the their fiancé's breaking of the engagement have looked to breach of promise to marry as a basis of recovery.

[1] Thomas Holley Chivers, EONCHS OF RUBY, Preface (Arno Press 1972) (1851).

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[2] Ernest Oscar Wilde, *The Importance of Being Ernest* 238 (Crescent Books 1995) (1895).

[3] Rebecca Tushnet, Note, RULES OF ENGAGEMENT, 107 YALE L.J. 2583, 2586 (1998).

Originating in Europe**,** these breach of promise suits soon found their way to the American legal system.[4] Although these suits appear contractual in nature due to the apparent importance given to the elements of offer and acceptance, punitive damages were often awarded.[5] As if to show the severity of these damages, many courts also described them as just retribution[6] or vindictive[7] damages. Since punitive damages are seldom awarded in contract law, their presence in these causes of action add an element that is tortious in nature.[8] Because both compensatory and punitive damages were available to the plaintiff, substantially always the woman,[9] courts had to determine whether or not there were factors present that would justify the breach of the engagement contract.[10] If no justification existed, then factors in aggravation or mitigation could be introduced. Both the timing and the character of the factors were important. The analysis described in *Butler v. Eschleman*[11] elucidates this:

> 1st, if the woman was of bad character at the time of contract, and that was unknown to the defendant, the verdict ought to be in his favor. 2d, if the plaintiff after the promise, had prostituted her person to any person other than the defendant, she thereby discharged the

[4] *See* Brian L. Kruckenburg, Comment, *"I Don't": Determining Ownership of the Engagement Ring When the Engagement Terminates,* 37 WASHBURN L.J. 425, 428 (1998). *Citing* 1 Homer H. Clark, Jr., *The Law of Domestic Relations in the United States* § 1.1 (2d ed. 1987).

[5] Bukowski v. Kuznia, 186 N.W. 311 (Minn. 1922).

[6] Johnson v. Caulkins, 1 Johns. Cas. 116, 119 (N. Y. 1799).

[7] Johnson v. Jenkins, 24 N.Y. 252, 253 (1862).

[8] Shore v. Farmer, 522 S.E.2d 73, 76 (N.C. 1999).

[9] For rare examples of a male plaintiff sued for breach of promise, *See e.g.,* Baddely v. Mortlock 1 Holt, 151; 171 English Reports 195 (1816). The female, defendant, refused to marry the plaintiff after he was unable or unwilling to explain to her satisfaction dishonesty in pecuniary matters and perjury; *see also* Salens v.Tubbs No. 06-2194, UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT, 08a0540n.06; 292 Fed. Appx. 438; 2008 U.S. App. LEXIS 19012; 2008 FED App. 0540N (6th Cir.), September 3, 2008, Filed, NOT RECOMMENDED FOR FULL-TEXT PUBLICATION. SIXTH CIRCUIT RULE 28(g) The parties, Church from England and Tubbs from Michigan, met on the Internet in the fall of 1999. *Id.* After a short relationship they became engaged in March 2000. *Id.* In June, 2000 Tubbs ended the engagement because she discovered, again on the Internet, that her fiancé demonstrated "bizarre and abnormal behavior" and that he led a "risqué lifestyle as a cross[-]dresser and bi-sexual." *Id.* Following Church's death in July 2000, his estate filed suit and was awarded the return of his personal property, title to a house that Tubbs had purchased in Michigan in both names using only his funds, and the value of a $7000 engagement ring that she had thrown into the Elk Creek River. *Id.*

[10] "If a man…deliberately promises to marry a woman…and she reciprocated the promise,… and afterwards he refuses to ratify the agreement thereby made, he is liable to her for damages for breach of contract, unless he can show good legal cause why he should be exonerated from the fulfillment of his promises." Clark v. Reese, 35 Cal 89 (1868).

[11] 18 Ill. 44 (1856).

> defendant. 3d, if her conduct was improperly indelicate, although not criminal, it ought to be considered in mitigation of damages. And 4th, if such were her conduct after the promise, it was proper, in the same view, for consideration of the jury.[12]

The justification that the woman was of bad character could be proven by showing either that the woman was unchaste or that she "obtained the promise through fraud"[13] or was insane or diseased[14], or "malformed or impotent"[15] or that she was related to the defendant in one of the ways forbidden by the book of Leviticus.[16] Of these seven justifications, the most common indication of bad character was that the prospective bride was unchaste, and if the prospective groom lacked knowledge of this condition, he had the legal justification to terminate the engagement.[17] However, if the defendant had knowledge of the plaintiff's condition prior to the offer of marriage, the justification to terminate did not exist. In *Johnson v. Travis*[18] the court charged the jury that if it, "found the contract of marriage to have been entered into, and that at that time the defendant knew that plaintiff had been an unchaste woman, and was the mother of two bastard children, and that the defendant broke the contract … their verdict would be for the plaintiff."[19] Even if the woman was chaste until the engagement, but then committed fornication with a man other than her fiancé after the engagement, the prospective husband would also be justified in breaking the contract.[20] While unchastity was generally permitted as a defense to

[12] *Id* at 45, *quoting* Boynton v. Kellogg, 3 Mass. 189 (1807).

[13] "The defendant, being a designing and crafty woman, induced the plaintiff, by ardent professions of love and affection, to visit her at her home in Bourbon County. He became very much enamored of her, and visited her frequently. She, designing to defraud him of his property, falsely represented that she was wealthy, falsely professed great love and affection for him, and promised to marry him." Douthitt v. Applegate, 6 P. 575, 577 (Kan. 1885). *See also* Mack v. White, 218 P.2d 76, 78 (Cal. 1950).

[14] Shackleford v. Hamilton, 19 S.W. 5 (Ky. 1892). In Minnesota, the marriage of epileptic persons was also prohibited by statute. MINN. G.S., § 7090 (1913).

[15] McKane v. Howard, 95 N.E. 642, 643 (N.Y. 1911).

[16] Marriage was "prohibited by the laws of God, which have been commonly understood as the prohibitions declared by verses from 6 to 18, inclusive, of the eighteenth chapter of Leviticus. The marriage of cousins of the first degree was not prohibited by those laws, and the most distant relation in consanguinity therein stated was that of uncle and niece or aunt and nephew." Arado v. Arado, 117 N.E. 816, 817 (Ill. 1917). *See also* Harrison v. Cage, 1 Ld. Raym. 386 (1698).

[17] "[I]f the plaintiff was guilty of unchastity before the defendant's promise to her, and did not inform him and he did not know of it until after action brought, the verdict must be for him." Colburn v. Marble, 196 Mass. 367, 383 (1907).

[18] 22 N.W. 624 (Minn. 1885).

[19] *Id*.

[20] "The court instructed the jury, that, if the plaintiff, after a mutual engagement of marriage between her and the defendant, committed the crime of fornication with any other

breach of promise, if the defendant participated in the unchaste behavior the defense was not allowed. "No one should be permitted to take advantage of his own wrong, to defend himself from responsibility by alleging evils and mischiefs of which he is the author."[21]

If no factor existed for the defendant to be excused from his promise, the parties could present factors in aggravation or mitigation. A plaintiff's damages were "enhanced by such facts and circumstances as aggravated the injury itself. Circumstances under which the offense is committed, or the wrong is done, may increase the real injury by adding to the indignity and contumely, increasing the mental agony, and bringing public disgrace and consequent loss of reputation."[22] For instance in "a case of breach of promise, accompanied with a seduction, the injury is infinitely greater than where there is only a breach of promise. When there is a seduction, there is a total loss of character, and all hopes of future happiness and usefulness are blighted, and certain degradation and future misery, if not crime, are its consequences."[23] Seduction[24] could be further aggravated by a resulting pregnancy since "[T]his, in itself, would degrade her in the eyes of the public."[25]

Mutually consensual intercourse, also called criminal intercourse, would hold both parties equally at fault. By contrast, seduction, or carnal intercourse, is the result of the defendant's coercion and therefore makes him more culpable. In support of special damages, the court in

man, the defendant would be thereby absolved from such engagement; that, after he obtained a knowledge of the misconduct, it was optional with him whether to break off, or to continue the contract; that, subsequently to the knowledge of such misconduct, he might enter into such a contract with the plaintiff; and that, if he waived the misconduct, or entered into the contract after he had knowledge of it, he would be bound by the contract." Snowman v. Wardwell, 32 Me. 275 (1850).

[21] Butler v. Eschleman, 18 Ill. 44, 46 (1856).

[22] Johnson v. Jenkins, 24 N.Y. 252, 253 (1862).

[23] Fidler v. McKinley, 21 Ill. 308, 313 (1859).

[24] Seduction was considered particularly heinous due to the perception of the genders. "[I]n order to repress the libidinous advances of the male sex, under dishonest and seductive assurances of marriage. Considering the character of the two sexes distinctly marked out by nature, little doubt can remain. The modest and retiring character of the female sex in general, excludes the idea of seduction. Unsolicited, they are unobtrusive, and their chastity, so essential to the happiness of society, secure. For a man to court a young woman of good character, secure her attachment and her confidence, thus to break down the fences and remove the guards of virtue, a successful incursion follows almost of course, if he be without principles of honor. According to the usual feelings of humanity, such base and covert advances in the path of seduction, too frequently meet with but feeble opposition. Consequences, so naturally flowing from dishonest practices, from whence injury arises, ought in the nature of things to be taken into account, when estimating a compensation for such injury." Conn v. Wilson, 2 Tenn. 233, 234 (Tenn. 1814).

[25] Boynton v. Kellogg, 3 Mass. 189, 191 (1807).

Fleetford v. Barnett[26] permitted the plaintiff to show that "by sundry and divers means, and by inducements to partake in wine and other stimulants and intoxication beverages and by the promise of marriage, the defendant persuaded the plaintiff to have carnal intercourse with him, whereby he debauched and carnally knew her, and she became sick and pregnant."[27]

Other factors in aggravation would be the method and manner in which the breach occurred.[28] If the defendant broke the engagement without justification but in a respectful and kind manner, punitive damages would not be incurred.[29] However, if the defendant should exhibit willfulness and malice,[30] by breaking the engagement "wantonly, recklessly and unjustifiably"[31] and making "slanderous statements concerning the plaintiff"[32] to justify his breach, then the jury would be justified in awarding punitive damages.

Likewise, the financial and social position of the defendant and "what rights and privileges she (the plaintiff) would have acquired, pecuniarily and socially"[33] were factors that a jury could consider. In breach of contract to marry cases, courts referred to these damages as aggravated, but they appear compensatory since they didn't reflect on the bad or good character of the defendant. However, since a wife would acquire all the "advantages of (the husband's) wealth and station"[34] a jilted betrothed should receive a share of that wealth.

While the defendant's character was a factor in aggravation, the plaintiff's character could be a factor in mitigation; "the jury might justly and with good sense find that the mental suffering or loss of character of a licentious or bad woman was less than that of a virtuous and good woman."[35] While it may seem irrational, not only was the woman's conduct during the engagement considered, but her conduct subsequent to the breaking of the promise was relevant in the determination of damages. "Profane cursing and swearing "[36] and "threats to take the life

[26] 52 P. 293 (Colo.1898).

[27] *Id.* at 294.

[28] "It is always competent, for the purpose of enhancing the damages, to prove the motives that actuated the defendant," Thorn V. Knapp, 42 N.Y. 474, 478. (1870).

[29] Johnson v. Jenkins, 24 N.Y. 252, 254 (1862).

[30] Roberts v. Druillard, 82 N.W. 49, 50 (Mich. 1900).

[31] *Id.* at 49.

[32] *Id.*

[33] Johnson v. Travis, 22 N.W. 624, 625 (Minn. 1885).

[34] Kelly v. Renfro, 9 Ala. 325, 329 (1846).

[35] McKane V. Howard, 95 N.E. 642, 644-645 (N. Y. 1911).

[36] Berry v. Bakeman, 44 Me. 164, 166 (1857).

of a human being,"[37] "evince grossness"[38] and "may well be regarded as the fruit of feelings of a highly malicious character."[39]

Antiheartbalm Statutes

By the early 20th Century, women began to be accused of using the courts as an instrument for blackmail and extortion[40] in which they would use the threat of publicity to force a settlement.[41] Beginning in the 1930s, legislatures across the United States responded to this emotional cry for compensation with a wave of antiheartbalm statutes abolishing breach of promise to marry suits.[42] Legislatures began banning heartbalm suits claiming they were attempts by women to link money with love.[43] Antiheartbalm legislation was designed to preserve the sphere of intimate human relations free from the intrusion of commodification and a market valuation of love.[44] Feminist author Dorothy Dumbar Bromley said that breach of promise inappropriately "put a contract to marry on the same footing as a bargain for a horse or a bale of hay."[45] The marital relationship that exists between a man and a woman is not capable of being measured in monetary terms.[46] In 1935, seven states passed antiheartbalm statutes.[47] As of 1997, 21 states had antiheartbalm statutes.[48] Additionally, several states have judicially abolished breach of promise to marry suits.[49]

Engagement Rings: Their History and Symbolism

Today, most lawsuits involve attempts to recover property given as prenuptial gifts in contemplation of marriage. These gifts almost always involve engagement rings[50] and sometimes include other property,

[37] *Id.*

[38] *Id.*

[39] *Id.* at 167.

[40] Adam D. Glassman, *I Do! or Do I? A Practical Guide to Love Courtship and Heartbreak in New York* 12 BUFF. WOMEN'S L.J. 47, 55. (2003-2004). *citing* Goldstein v. Rosenthal 56, N.Y.S. 2d 503, 504 (Civil Ct., City of N.Y. Bronx County 1968) "Breach of promise suits were used by avaricious young women to mulct young men who were both wealthy and rather susceptible to feminine wiles." *Id.*

[41] Prosser and Keeton, *On the Law of Torts* (West 5th ed. 1984) § 124 at 929.

[42] Rebecca Tushnet, Note, *Rules of Engagement*, 107 YALE L.J. 2583, 2586 (1998).

[43] *Id*. at 2588 n.25.

[44] *Id*. at 2590.

[45] *Id.* at 2589 n.27.

[46] *Id*. at 2588.

[47] Alabama, Illinois, Indiana, Michigan, Massachusetts, New York and Pennsylvania.

[48] *See* Kruckenberg *supra* note 4, at 425 n.31.

[49] *See, e.g.,* Gilbert v. Barkes, 987 S.W.2d 772, 777 (Ky. 1999); Jackson v. Brown, 904 P.2d 685 (Utah 1995).

[50] "In the absence of a contrary expression of intent, it is logical that engagement rings

which may have been conditional gifts in contemplation of marriage.[51] The gift of rings has been a symbol of betrothal for at least 2000 years.[52] In the 3rd century, the Roman poet Macrobius explained that there was a nerve, the Vena Amoris, which connected the fourth finger and the heart, and "because of this nerve the newly betrothed places the ring on this finger of his spouse as though it were a representation of the heart."[53] In 860 A.D., Pope Nicolas I endorsed the practice of giving gold engagement rings to demonstrate the future groom's wealth.[54] Three centuries later in 1215, Pope Innocent III expanded on the requirement of gold rings to include those made of silver and iron.[55] Probably, the first diamond engagement ring was given to Mary of Burgundy by Archduke Maximillian of Austria in 1477.[56] At the time, diamonds were believed to possess magical powers concerning love, purity and fidelity.[57]

should be considered, by their very nature, conditional gifts given in contemplation of marriage. Once it is established that a ring is an engagement ring, it is a conditional gift. Other types of property may be shown to be conditional gifts given in contemplation of marriage, but such a classification would require specific evidence." Heiman v. Parrish, 942 P.2d 631, 634 (Kan. 1997), "In our culture, the ring is generally placed on one of the fingers, in others, it may be attached to other positions of the anatomy. . . . It is a universal symbol of deep seated sexual and social ramifications, a seminal area of research for behavioral scientists. Is it any wonder that it presents such complicated problems for mere lawyers?'" Goldstein v. Rosenthal, 288 N.Y.S. 503, 504 (1968).

[51] *See, e.g.,* Piccininni v. Hajus, 429 A.2d 886, 887 (Conn. 1980) ($40,000 in home improvements); Crowell v. Danforth, 609 A.2d 654, 655 (Conn. 1992). ($63,760.66 a down payment on a condominium); Aronow v. Silver, 538 A.2d 85, 853, 354 (N.J. 1987) (Joint stock purchased with husband's funds, held in wife's name); Cooper v. Smith, 800 N.E.2d 372, 374 (Ohio 2003) (horse, a tanning bed, and hard wood flooring for the perspective bride's mother's kitchen).

[52] George Frederick Kunz, *Rings for the Finger*, 199 (Dover Press 1973).

[53] Macrobius, Saturnalia, Book vii Verse 13, translated and edited by Robert A. Kaster (Harvard University Press 2011).

[54] John Reilly Beard, *Bingham's 'Antiquities of the Christian Church,' vii. 250, The Peoples Dictionary of the Bible*. 399-400 (Simpkin, Marshall 1848). "Pope Nicolas I decreed gold rings the standard for betrothal. The ability to procure such a ring was solid evidence that the suitor had the financial resources to support his future wife and be a good provider." www.cash4gold.com/sell/sell-gold/evolution-of-engagement-rings (last visited 28-March-2011).

[55] Pope Innocent III assembled the Fourth Lateran Council in 1215 because of the results from the Third and Fourth Crusades. Among the canons he put into order was Canon 51 which forbids clandestine marriages from taking place. He wanted a longer time to pass before a couple could be married after a betrothal took place. In order for the status of the relationship to be recognized a ring was given to the future bride. Traditionally plain rings of gold, iron or silver were used. www.engagementringpro.com/engagement-ring-history.php (last visited 28-March-2011).

[56] *See* Kunz *supra* note 52, at 199, *quoting Jahrbuch der Kunsthistorischen Sammlungen des allerghöchsten Kaiserhauses*, vol. I, Pt. II, p. xxi, Wien, 1883.

[57] R.S. Peale, *Peale's Popular Compendium of Useful Knowledge, Science History Biography and Industrial Statistics,* 330 (Peale, 1890).

In the 1870s, Tiffany and Co. invented the solitaire mount that consisted of a "six prong platinum or gold setting holding up a luminous diamond."[58] During the 20th century, De Beers made the diamond engagement ring de rigueur through its 1947 advertising campaign, "A Diamond is Forever,"[59] and by its practice of loaning diamonds to movie stars to wear in movies such as *Gentlemen Prefer Blondes*[60] in which Marilyn Monroe famously sang "Diamonds Are a Girl's Best Friend."

THREE MODERN APPROACHES

Many states permit recovery for antenuptial gifts made in contemplation of marriage finding that they do not fall under the blanket of antiheartbalm legislation and are thus actionable.[61] For example, in *Pavlicic v. Vogtsberger*[62] the Supreme Court of Pennsylvania allowed a 75-year-old man to recover the value of a house, a car, various pieces of jewelry and a saloon that he purchased for his 26-year-old fiancée when she deserted him to marry a man her own age. That court refused to let an antiheartbalm statute perpetuate "fraud by adventurers and adventuresses in the realm of heartland"[63] holding that "breach of any contract which is not the actual contract for marriage itself, no matter how closely associated with the proposed marriage, is actionable."[64]

Recovery for engagement rings has moved away from tort law to property and contract based suits. Most states recognize engagement rings as conditional gifts[65] while a few regard them as unconditional gifts.[66] The condition is inherent in the nature and symbolism of the engagement ring, so if the marriage does not occur, the ownership of the ring does not vest.[67] In conditional gift states, the courts either take a

[58] Anne Ward, *Rings, Through the Ages* 198 (Rozzilo International 1981).

[59] *See With this Ring*, American Radio Works, http//:americanradioworks.publicradio.org/features/diamonds/full.html (Last visited 11-April-2011) "In 1947, a maiden lady copywriter at N. W. Ayers, Frances Gerety, created the most durable slogan in history: "A diamond is forever."

[60] David Ewen, *The Story of America's Musical Theater* 216 (Chilton Book 1968).

[61] Margaret F. Brinig, *Rings and Promises*, 6 J.L ECON. & ORG. 203, 206 (1990).

[62] 136 A.2d 127 (Pa. 1957).

[63] *Id*. at 130.

[64] *Id*. at 132.

[65] Adam D. Glassman, *I Do! Or Do I? A Practical Guide to Love, Courtship, and Heartbreak in New York—or—Who Gets the Ring Back Following a Broken Engagement* 12 BUFF. WOMEN'S L. J. 47 (2003) citing *Restatement of the Law, Restitution § 58* comment b.

[66] Pavlicic v. Vogtsberger 136 A.2d 127 (Pa. 1957).

[67] Barbara Frazier, *"But I Can't Marry You": Who is Entitled to the Engagement Ring When the Conditional Performance Falls Short of the Altar?,* 17 J. AM. ACAD. MATRIMONIAL LAW 419, 422. (2001).

fault-based or no-fault-based approach to the broken engagement when determining who is entitled to the ring.

Conditional Gift

A minority of jurisdictions decline to imply the conditional nature of the engagement ring and require an express condition for the marriage to take place before the donee's right to the ring vests.[68] In these jurisdictions, the donor must demonstrate that the "parties understand the engagement ring is conditional in nature."[69] Kansas refuses to imply the conditional nature of the engagement ring and requires proof by a preponderance of the evidence that the ring was given in the contemplation of marriage, before it will recognize that a ring is an engagement ring.[70]

Fault-based Approach to Conditional Gift

Many states use a fault-based theory of recovery for antenuptial gifts. In California, if the donee breaks the engagement the donor is entitled to keep the ring.[71] Generally, if there is a mutual agreement to terminate the engagement, the donor is entitled to the ring.[72] But, if the donor breaks the engagement, the donee is entitled to keep it.[73] Courts reason that antenuptial gifts should go to the party who is not at fault, because no person should be able to take advantage of his or her own fault.[74]

However determining which party is at fault for the termination of the engagement may be difficult.[75] "The breach of a marriage contract may be shown by any words or conduct although there is neither verbal

[68] Coconis v. Christakis, 435 N.E.2d 100, 102 (Ohio 1981); Fowler v. Perry 830 N.E. 97, 105 (Ind. 2005).

[69] *See e. g.,* In re: Diana Carol Stoltz, 283 B.R. 842; 2002 Bankr. LEXIS 1272 (Md. 2002).

[70] Heiman v. Parrish, 942 P.2d 631, 635 (Kan. 1997).

[71] Priebe v. Sinclair 202 P.2d 577 (Cal. 1949).

[72] The condition is implied that if both parties abandon the projected marriage, the sole cause of the gift, it (the ring) should be returned, Mate v. Abraham, 62 A.2d 754, 755 (N.J. County Ct. 1948).

[73] "The donee should keep the ring only if the donor unjustifiably breaks the engagement." Spinnell v. Quigley, 785 P.2d 1149 (Wash. 1990).

[74] *Id.* at 1149-50.

[75] What is fault or the unjustifiable calling off of an engagement? By way of illustration, should courts be asked to determine which of the following grounds for breaking an engagement is fault or justified? (1) The parties have nothing in common; (2) one party cannot stand prospective in-laws; (3) a minor child of one of the parties is hostile to and will not accept the other party; (4) an adult child of one of the parties will not accept the other party; (5) the parties' pets do not get along; (6) a party was too hasty in proposing or accepting the proposal; (7) the engagement was a rebound situation which is now regretted; (8) one party has untidy habits that irritate the other; or (9) the parties have religious differences. The list could be endless. Heiman v. Parrish, 942 P.2d 631, 635 (Kan. 1997).

nor written refusal to marry."[76] A breach may also be found by the termination of intimate communications and visits without explanation,[77] or by a "dishonorable proposal, …for her to become his mistress, instead of his wife."[78]

No-fault Approach to Conditional Gift

The modern trend in the United States has been to shift away from fault-based engagements, eliminating the proof of any element of fault[79] except in cases of fraud, in extremely gross and rare situations.[80] Many jurisdictions recognize that couples rarely breakup because only one party is to blame, while the other remains completely blameless.[81] "[T]he engagement period is one where each party should be free to reexamine his or her commitment to the other and be sure he or she desires the commitment to marry the other. If the promise to wed were rashly or improvidently made, public policy would be better served if the engagement promise to wed would be broken."[82] Further, allowing the litigation of fault only prolongs the period of time until the couple can get over the broken engagement and get on with their lives. This also may "encourage every disappointed donee to resist the return of engagement gifts by blaming the donor for the breakup of the

[76] In Coconis v. Christakis, the parties, college students, became engaged in August, 1980. 435 N.E.2d 100, 102 (Ohio 1981). They returned to their respective schools, he in Saskatchewan and she in Ohio, the following month. From October 6, 1980, until the end of the school year they didn't communicate at which time he requested the return of the ring. *Id.* The court held that "it would not be incumbent upon defendant to continue with preparations for a wedding under circumstances in which she could reasonably perceive plaintiff's lack of interest in attending." *Id.* He was held to have terminated the engagement by his failure to either communicate with her or to return her telephone calls. *Id.*

[77] Bowes v. Sly, 152 P. 17, 18 (Kan. 1915).

[78] Campbell v. Arbuckle, 4 N.Y.S. 29, 30 (1889).

[79] "The court noted that although the practice of determining possession of an engagement ring based on fault is the majority rule, it preferred the modern trend towards no-fault. Likening broken engagements to broken marriages." Heiman v. Parrish, 942 P.2d 631, 635 (Kan. 1997).

[80] *Id.* at 637.

[81] "What fact justifies the breaking of an engagement? The absence of a sense of humor? Differing musical tastes? Differing political views? The painfully-learned fact is that marriages are made on earth, not in heaven. They must be approached with intelligent care and should not happen without a decent assurance of success. When either party lacks that assurance, for whatever reason, the engagement should be broken. No justification is needed. Either party may act. Fault, impossible to fix, does not count. *Albanese* is correct in saying: "It does not matter who broke the engagement. A person may have the best reasons in the world for so doing. The important thing is that the gift was conditional and the condition was not fulfilled."" Aronow v. Silver, 538 A.2d 851, 853-854 (N.J. 1987) *quoting in part* Albanese v. Indelicato, 51 A.2d 110, (N.J. 1947).

[82] Heiman v. Parrish, 942 P.2d 631, 638 (Kan. 1997).

contemplated marriage, thereby promoting dramatic courtroom accusations and counter-accusations of fault."[83] A final inherent risk of applying fault-based theory to antenuptial agreements is that each party may attempt to drive the other to break the engagement[84]

An exception to the no-fault rule occurs if either party to an engagement is married to another at the time of engagement. It seems to be irrelevant whether the married party is the prospective bride[85] or groom.[86] Courts have approached this in several different ways. Some courts have held "an agreement to marry under such circumstances is void as against public policy… and it is not saved or rendered valid by the fact that the married individual contemplated divorce and that the agreement was conditioned on procurement of the divorce."[87] Other courts view the return of a ring as an equitable remedy and have applied the doctrine of unclean hands.[88]

Unconditional Gift

The Restatement of the Law: Restitution suggests that engagement rings are not conditional and therefore non-recoverable unless there is evidence that the donee fraudulently entered into the relationship for the purpose of obtaining gifts and subsequently terminates the relationship.[89] The Restatement Restitution reads:

> A person who has conferred a benefit upon another, manifesting that he does not expect compensation therefore, is not entitled to restitution merely because his expectation that an existing relation will continue or that a future relation will come into existence is not realized, unless conferring of the benefit is conditioned thereon.[90]

[83] Gaden v. Gaden, 272 N.E.2d 471, 476 (N.Y. 1971).

[84] *See* Tushnet *supra* note 3, at 2595 n. 62. "Courts enforcing general contract law have dealt with this issue under the doctrine of anticipatory breach. One problem with fault rules is that parties can manipulate who is at fault, particularly when legal fault requires some formal act. In nonengagement relationships, parties may jockey with each other, attempting to find an excuse for ending the relationship." *See* Larry T. Garvin, *Adequate Assurance of Performance: Of Risk, Duress, and Cognition*, 69 U. COLO. L. REV. 71, 105-07 (1998).

[85] Lowe v. Quinn, 267 N.E.2d 251 (N.Y. 1971).

[86] Cooper v. Smith, 800 N.E.2d 372 (Ohio 2003).

[87] Lowe v. Quinn, 267 N.E.2d 251, 252 (N.Y. 1971).

[88] "The deliberate attempt to take another man's wife from him, and entering into an engagement with her to marry at a time when she could not lawfully marry, and giving a ring to further such an unlawful engagement is a defiance of public policy and constitutes the rankest sort of unclean hands. The doors of equity are closed to the petitioner and deny him any relief whatsoever." Morgan v. Wright, 133 S.E.2d 341, 343 (Ga. 1963).

[89] RESTATEMENT OF RESTITUTION § 58 cmt. c.

[90] *Id.*

North Dakota and Montana recognize an engagement ring as a gift without an implied or express condition attached to it.[91] In *Albinger v. Harris*[92] the court refused to void the gift of an engagement ring given with donative intent and voluntary delivery and acceptance, merely because the giver experienced a change of heart.[93] In Montana no gift is revocable after acceptance except a gift in view of death.[94] Although the courts recognize an engagement as a contract to marry, the Montana statute barring heartbalm actions, maked such contracts unenforceable.[95] Thus when an engagement ring is given in consideration for the promise to marry, recovery of the ring is barred by the abolition of the breach of promise actions.[96]

North Dakota also recognize an engagement ring as an unconditional gift.[97] At least when purchased with joint assets, North Dakota and Montana define a gift as "a transfer of personal property made voluntarily and without consideration."[98] In *Kohler*,[99] the Supreme Court of North Dakota permitted the recipient of the engagement ring to keep it regardless of the fact that both parties had made installment payments on the ring.[100]

The Supreme Court of Montana held that if engagement rings were treated as conditional gifts and women were not able to retain them, it would carve "an exception in the state's gift law for the benefit of predominately male plaintiff"[101] creating possible gender bias In *Albinger v. Harris* the court reasoned that:

> "While antenuptial traditions vary by class, ethnicity, age and inclination, women often still assume the bulk of pre-wedding costs, such as non-returnable wedding gowns, moving costs, or non-refundable deposits for caterers, entertainment or reception halls. Consequently, the statutory "anti-heart balm" bar continues to have a disparate impact on women. If this Court were to fashion a special exception for engagement ring actions under gift law theories, we would perpetuate the gender bias attendant upon the Legislature's decision to remove from our courts all actions for breach of antenuptial promises."[102]

[91] MONT. CODE ANN., §27-1-722.
[92] 48 P.3d 711 (Mt. 2002).
[93] *Id*. at 719.
[94] MONT. CODE ANN., §70-3-203 (2010).
[95] *Id.* § 27-1-722.
[96] *Id.* § 27-1-602.
[97] Kohler v. Flynn 493 N.W.2d 647, 649 (N.D. 1992) *citing* N.D. CENT. CODE 47-11-06 (2010).
[98] MONT. CODE ANN., § 70-3-101 (2010), N.D. CENT. CODE, § 47-11-06 (2010).
[99] 493 N.W.2d 647 (N.D. 1992).
[100] *Id.* at 650.
[101] Albinger v. Harris 48 P.3d 711, 725 (Mt. 2002).
[102] *Id*. at 720.

The unconditional gift approach to prenuptial gifts does not completely bar the gift giver from recovering the gift. While it seems unlikely, the parties could at the time of engagement choose to contract for the return of the ring to the donor in the event that the engagement fails. This is similar to what is done with pre-nuptial agreements.

While all three commonly used approaches have merit, both the no-fault and the unconditional gift approaches have the advantage of providing the parties a bright line rule as to who is entitled to the engagement ring if the marriage fails to occur. In reality parties to engagement seldom choose the locus of their marriage proposals and acceptances based on state law. If these rules were a determinative factor, brides would make Glacier National Park a much more popular engagement site since Montana is the likeliest state for the woman to keep the "ice."[103]

[103] Robert E. Rains, To *Rhyme or Not to Rhyme: An Appraisal*, 16 CARDOZO STUD. L. & LIT. 1, 3 (2004).

THE BUREAU OF CONSUMER FINANCIAL PROTECTION: REGULATION, DEREGULATION, AND REREGULATION

by RICHARD J. HUNTER, JR.*, JOHN SHANNON** AND MARK BLODGETT***

I. INTRODUCTION

At the end of the first decade of the twenty-first century, a debate continues to rage between those who favor increased government regulation and those who continue to champion a lessened role for government in both business and society. This clash of ideas and philosophies will no doubt play and important part of the challenges to our political, economic, and legal systems in the future. The confluence of recent events has caused a renewed interest in questions concerning regulation of business on the federal level and the proper role of the federal government in the U.S. economy. How these issues and others which will no doubt arise in the future are resolved may offer a glimpse at whether the "regulation conundrum" is resolved in favor of more or less governmental regulation of significant aspects of our American economy. This conundrum can be seen in the debate that swirled around the passage of the *Consumer Financial Protection Act of 2010* and the creation of the *Bureau of Consumer Financial Protection* (accomplished in Title X of the Act) in the spring and summer of 2010.

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II. AN OVERVIEW OF DODD-FRANK

The *Dodd–Frank Wall Street Reform and Consumer Financial Protection Act* [1] [CFPA] is a federal statute that was signed into law by President Barack Obama on July 21, 2010. The Act was the product of the financial regulatory reform agenda proposed by the Obama administration in the wake of the near financial collapse in the economy experienced in late 2008 through 2009.

The reform legislation was initially proposed on December 2, 2009, in the House of Representatives by Congressman Barney Frank of Massachusetts, and in the United States Senate in the Banking Committee by Chairman Chris Dodd of Connecticut. The Act is considered to be the most sweeping change to financial regulation in the United States since the Great Depression.[2] As Professor Charles Whitehead of Cornell University noted:

> Our present system of financial regulation was born of the Great Depression - during the 1930s, for banks, securities firms, and thrifts, and during the 1940s, for investment advisors and mutual funds. Federal regulation divided intermediaries into separate categories, based on the businesses they conducted at the time, largely in order to address perceived abuses leading up to the economic collapse of the late 1920s. The Glass-Steagall Act, for example, created a clear regulatory divide between commercial and investment banking. Twenty years later, the Bank Holding Company Act extended that separation by walling off banks from the underwriting of insurance products.[3]

Because of the weaknesses in the regulatory regime, Congressional action was required. The CFPA represents a dramatic shift in the financial regulatory environment that had significantly trended toward *deregulation* during *both* the Reagan[4] and Clinton[5] administrations.

[1] Pub. L. 111-203, H.R. 4173 (2010) [hereinafter H.R. 4173].

[2] The legislative history of the Act includes the following highlights:

- Introduced in the House as "The Wall Street Reform and Consumer Protection Act of 2009" (H.R. 4173) by Barney Frank (D–MA) on December 2, 2009;
- Committee consideration by the Financial Services Committee;
- Passed the House on December 11, 2009 by a vote of 223–202;
- Passed the Senate with amendment on May 20, 2010 by a vote of 59-39;
- Reported by the joint conference committee on June 29, 2010; agreed to by the House on June 30, 2010 (237-192) and by the Senate on July 15, 2010 (60-39);
- Signed into law by President Barack Obama on July 21, 2010.

[3] Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U.L. REV. 1, 16-17 (2010).

[4] *See, e.g.*, Thomas O. McGarity, *Regulation and Litigation: Complementary Tools for Environmental Protection*, 30 COLUM. J. ENVTL. L 371, 386 (2005) (discussing the "anti-regulatory years of the Reagan Administration" with regard to environmental issues); Daniel T. Deacon, *Deregulation Through Nonenforcement*, 85 N.Y.U.L. REV. 795 (2010);

Proponents and opponents of the legislation agree that the Act will impact a wide swath of federal financial regulatory agencies and will affect almost every aspect of the nation's financial services industry.

The Act is divided into sixteen individual titles. As an indication of the scope of the legislation, the law firm of Skadden Arps has conducted an exhaustive study of the legislation and has reported that the Act will require federal regulators to create, at a minimum, 243 rules, conduct 67 studies, and issue 22 periodic reports.[6]

The stated aim of the legislation is:

> To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail," to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.[7]

The CFPA expressly prohibits a "covered person or service provider" from: (i) engaging in unfair, deceptive, or abusive acts or practices,[8] or knowingly or recklessly providing substantial assistance to a covered person or service provider in violation of the CFPA's Unfair and Deceptive Acts and Practices [UDAP] provisions or rules; (ii) offering or providing to a consumer a financial product or service not in conformity with federal consumer financial law; or (iii) failing to permit access to or copying of records, establishing or maintaining records, or making reports or providing information to the Bureau.[9]

The Act greatly impacts the existing regulatory structure. It creates a host of new agencies, and merges, eliminates, and sunsets others in an effort to streamline the regulatory process, to increase oversight of specific institutions regarded as a systemic risk, to amend the seminal Federal Reserve Act,[10] and to promote transparency and affect other

Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260, 1263-66 (2006) (explaining Reagan Administration's use of Office of Management and Budget (OMB) and Office of Information and Regulatory Affairs (OIRA) to pursue deregulatory agenda).

[5] Colloquium: *The Fifth Annual Robert C. Byrd Conference on the Administrative Process: The First Year of Clinton / Gore: Reinventing Government or Refining Reagan / Bush Initiatives?* 8 ADMIN. L.J. AM. U. 23 (1994).

[6] Skadden, *The Dodd-Frank Act: Significant Impact on Public Companies,* July 21, 2010, http://www.skadden.com/eimages/The_Dodd-Frank_Act_Significant_Impact_on_Public_Companies.pdf (last visited Aug. 17, 2010).

[7] H.R. 4173, Statement of Purpose.

[8] *See, e.g.*, Carolyn L. Carter, *Consumer Protection in the States: A 50-State Report on Unfair and Deceptive Acts and Practices*, Feb. 2009, www.consumerlaw.org, *at* http://www.nclc.org/images/pdf/udap/report_50_states.pdf (last visited Aug. 26, 2010).

[9] H.R. 4173 § 1036.

[10] The Federal Reserve Act of 1913, 12 U.S.C. § 221 (2000), Pub L. No. 63-43, ch. 6, § 13, 38 Stat. 251, 263 (codified as amended at 12 U.S.C. § 343 (2006)).

important regulatory changes. As noted by the Act's sponsors, the Act has a variety of purposes. The Act establishes rigorous standards and modes of supervision to protect the economy in general, and in particular, American consumers, investors and businesses; ends taxpayer funded "bailouts" of financial institutions;[11] provides for an advanced warning system on the stability of the economy; creates rules on executive compensation and corporate governance; and eliminates the loopholes that led to the economic recession and near financial meltdown.[12] The agencies created under *Dodd-Frank* are either granted explicit new powers over a particular aspect of financial regulation, or power that is transferred from an existing agency.[13] All of the new agencies that are created under the legislation, and some existing agencies that are not currently required to do so, are now compelled to report to Congress on an annual (or biannual) basis, to present the results of current operations and plans, and to lay out expectations and future goals. For example, the law firm of Foley and Lardner reports that the Act includes new reporting requirements for the Bureau and other related agencies. The Bureau is required to conduct a study, not later than one year after the designated transfer date of authority, in order to identify any practices which may be considered as "unfair, deceptive, or abusive" in connection with a reverse mortgage transaction. Further, the Act requires that the Director and the Secretary of Education, in consultation with the Commissioner of the Federal Trade Commission, and the Attorney General, submit a report to select Congressional and Senatorial committees on private education loans and private educational lenders. The new Bureau will also be required to conduct a study on the "nature, range, and size" of variations between the credit scores sold to creditors and those sold to consumers by consumer reporting agencies. The Director is also required to review all relevant federal laws and administrative regulations to the use of exchange facilitators (a person who, for a fee, facilitates an exchange of "like- kind" property) for consumer transactions, and to submit a report

[11] For a balanced discussion of the question of bailouts for institutions deemed "too big to fail," see *The Bailout Bill?* www.factcheck.org/2010/04/the-bailouitbill. *See also* Cornelius Hurley, *Paying the Price for Too Big to Fail*, 4 ENTREPREN. BUS. L.J. 349 (2010).

[12] Senate Committee on Banking, Housing, and Urban Affairs, *Summary: Restoring America's Financial Security* (2010), *available at* http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf (last visited Sept. 28, 2010).

[13] The institutions affected by the changes found in the CFPA include many of the regulatory agencies involved in monitoring the financial system: the Federal Deposit Insurance Corporation (FDIC), the U.S. Securities and Exchange Commission (SEC), the Federal Reserve, and the Securities Investor Protection Corporation (SIPC). The CFPA also provides for the final elimination of the Office of Thrift Supervision that had been created in 1989 to deal with another financial crisis.

to Congress describing its recommendations for legislation to ensure the appropriate protection of consumers who use exchange facilitators.[14]

Three new agencies created include the Financial Stability Oversight Council,[15] the Office of Financial Research,[16] and the Bureau of

[14] *See* Christi A. Adams, *The Consumer Financial Protection Act- Understanding Titles F through H*, http://www.cfslbulletin.com/tags/doddfrank-act, Nov. 8, 2010.

[15] The Council is specifically tasked with "identifying risks to the financial stability of the United States, promoting market discipline, and responding to emerging threats to the stability of the United States financial markets." At a minimum, the Council is required to meet on a quarterly basis. There are three specific purposes that have been assigned to the Council:

1. Identify the risks to the financial stability of the United States from both financial and non-financial organizations;
2. Promote market discipline, by eliminating expectations that the Government will shield them from losses in the event of failure (i.e., ending "too big to fail"); and
3. Respond to emerging threats to the stability of the U.S. financial system.

H.R. 4173 § 112(a)(1).

The Financial Stability Oversight Council has ten *voting members*:

1. Secretary of the Treasury (who chairs the Council);
2. Chairman of the Federal Reserve;
3. Comptroller of the Currency;
4. Director of the Bureau of Consumer Financial Protection;
5. Chairperson of the SEC;
6. Chairperson of the FDIC;
7. Chairperson of the CFTC;
8. Director of the Federal Housing Finance Agency;
9. Chairman of the National Credit Union Administration Board; and
10. An independent member (with insurance expertise), appointed by the President, with the advice and consent of the Senate, for a term of 6 years.

There are five *non-voting advisory members* who may go into the equivalent of executive session when discussing confidential supervisory information:

1. Director of the Office of Financial Research (part of the Treasury Department and established in this Act) who is the Council's executive director;
2. Director of the Federal Insurance Office (part of the Treasury Department and established in this Act);
3. A state insurance commissioner, to be designated by a selection process determined by the state insurance commissioners (2-year term);
4. A state banking supervisor, to be designated by a selection process determined by the state banking supervisors (2-year term); and
5. A state securities commissioner (or officer performing like function) to be designated by a selection process determined by such state security commissioners (2-year term).

H.R. 4173 § 111.

[16] The Office of Financial Research was established as a department within the Treasury. The Office is tasked with providing "administrative, technical, budget analysis and other support services to the Council and its affiliated agencies." H.R. 4173 § 152(a). The Director of the Office of Financial Research is appointed for a six-year term. As an

Consumer Financial Protection[17]—the object of this study. Interestingly, while the Act impacts all federal financial regulatory agencies, it eliminates one (the Office of Thrift Supervision)[18] and creates two new regulatory bodies—the Financial Stability Oversight Council and the Office of Financial Research, both of which are described in detail above.

III. TITLE X[19]

Title X is commonly referred to as the *Consumer Financial Protection Act of 2010.* Title X establishes within the Federal Reserve System a new Bureau of Consumer Financial Protection.[20] Creation of the Bureau

indication of scope of the authority of the Director, the Director has subpoena power and may require from any financial institution (bank or non-bank) any data needed to carry out the functions of the office. This may be the most important aspect of the creation of the Office. H.R. 4173 § 152(f).

[17] H.R. 4173 § 1001.

[18] The Office of Thrift Supervision (OTS) was organized in 1989 to deal with the savings and loan crisis of the 1980's. The OTS also expanded its oversight to companies that were not banks. However, some of the of the most notable failures under OTS supervision during the financial crisis of 2008-2009 includes American International Group (AIG), Washington Mutual, and IndyMac—leading to a general critique of its operations and oversight practices. *See* Patricia McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure,* 41 CONN. L. REV. 1327 (2009) (concerning Wachovia Mortgage, FSB, and Countrywide Bank and noting that by December 31, 2008, thrifts totaling $335 billion in assets had failed under the watch of the OTS in the previous sixteen months).

[19] H.R. 4173 § 1001.

[20] The "enumerated consumer laws" encompass almost all federal laws that regulate the activities of consumer financial product and service providers, including the following:

- The Alternative Mortgage Transaction Parity Act of 1982, Pub. L. No. 97-320, 96 Stat. 1545 (codified at 12 U.S.C. § 3003)a(3));
- The Consumer Leasing Act, 15 U.S.C. § 1667 (2000);
- The Electronic Fund Transfer Act, 15 U.S.C. § 1693 (1994);
- The Equal Credit Opportunity Act, 15 U.S.C. § 1691 (1996);
- The Fair Credit Billing Act, 15 U.S.C. § 1666 (1988);
- The Fair Credit Reporting Act (portions), 15 U.S.C. § 1681 (1999);
- The Homeowners' Protection Act, 12 U.S.C. § 4901 (2000);
- The Fair Debt Collection Practices Act, 15 U.S.C. § 1692 (1999);
- The Federal Deposit Insurance Act (portions), 12 U.S.C. § 1813 (1994);
- The Gramm-Leach-Bliley Act (portions), Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12, 15, 16 and 18 U.S.C.) (repealing Glass-Steagall Act of 1933, Pub. L. No. 73-66, 48 Stat. 162);
- The Home Mortgage Disclosure Act, 12 U.S.C. § 2801 (2000);
- The Home Ownership and Equity Protection Act, Pub. L. No. 103-325, § 151, 108 Stat. 2190 (1994) (codified as amended in scattered sections of 15 U.S.C.);
- The Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 (2000);
- The S.A.F.E. [Secure and Fair Enforcement] Mortgage Licensing Act, 12 U.S.C. § 5101 (2008);

reflects the belief of many in Congress that federal agencies failed to effectively supervise the consumer lending activities of both banks and non-banks.[21] The newly created Bureau has been given broad regulatory and enforcement powers, including the power to prohibit the use of arbitration agreements[22] regarding future disputes between consumers and "covered persons" under the Act.[23]

IV. PURPOSE AND NATURE OF THE BUREAU

The Bureau of Consumer Financial Protection was established in order to regulate consumer financial products and services, enforce compliance with federal consumer financial laws, and ensure that markets for such products and services are "fair, transparent and competitive."[24] The Act created a number of units and offices, such as

- The Truth in Lending Act, 15 U.S.C. § 1601 (2000);
- The Truth in Savings Act, 12 U.S.C. § 4301 (1994);
- Section 626 of the Omnibus Appropriations Act, Pub. L. No. 111-8 § 626(a), 123 Stat. 524, 677 (2009); and
- The Interstate Land Sales Full Disclosure Act, 15 U.S.C. § 1701 (1982).

H.R. 1473 § 1002(12).

[21] A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or was not previously supervised by a national or international banking regulatory agency. NBFIs are important because they facilitate bank-related financial services, such as investments, risk pooling, contractual savings, and market brokering. *See, e.g.*, Jeffrey Carmichael & Michael Pomerleano, *Development and Regulation of Non-Bank Financial Institutions* (World Bank Publications, 2002), at 12.
Examples of an NBFI include insurance firms, pawn shops, cashier's check issuers, check cashing locations, currency exchanges, and microloan organizations. For a comprehensive historical study of NBFIs, see, e.g., Coopers & Lybrand, *Non-Bank Financial Instruments: A Study of Five Sectors* (Feb. 28, 1997), www.fincen.gov/news_room/rp/reports/html/cooply.html.

[22] *See* Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802 (noting that the *McMahon* court had upheld an arbitration agreement in the customer/broker settling principally because it had assurance that the customer's rights would be adequately protected and that customer/broker claims are generally arbitrated upon a finding by the SEC that they are protective of investors). *See also* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

[23] *See, e.g.*, Mark J. Astarita, *From Start to Finish, A Walkthrough of the Process*, http://www.seclaw.com/arbover.html (last visited Aug. 19, 2010): "Although arbitration and mediation have existed as dispute resolution mechanisms for well over 200 years, it was not until the decision of the United States Supreme Court in *Shearson/American Express v. MacMahon,* 482 U.S. 220 (1987) that arbitration became the most widely used means of resolving disputes in the securities industry." For a critique of the mandatory nature of the practice, see Seth E. Lipner, *Should Securities Arbitration Be Mandatory*? http://www.forbes.com/2009/06/29/lipner-mandatory-arbitration-intelligent-investing-consumer.html (last visited Aug. 20, 2010).

[24] For a series of insightful articles on the Bureau, see, e.g., Stephanie C. Robinson, *Analysis of Consumer Financial Protection Agency Legislation: Top Ten Issues*, Mortgage Banking & Consumer Financial Products Alert, Oct. 26, 2009, *available at*

the Office of Fair Lending and Equal Opportunity and the Office of Financial Education, which will be responsible for researching and analyzing markets in consumer financial products and services, monitoring equal access to credit, and analyzing consumer behavior. The Bureau is also charged with monitoring consumer complaints through a single database maintained by the federal government.

The Bureau is an independent agency[25] that was established within the Federal Reserve. The Bureau will be headed by a director who is appointed by the President, with the advice and consent of the Senate, for a term of five years. The Bureau is subject to financial audit by the Government Accountability Office or GAO, and must report to the Senate Banking Committee and the House Financial Services Committee on a bi-annual basis.

The Bureau is separated into five units:

- Research,
- Community Affairs,
- Complaint Tracking and Collection,
- Office of Fair Lending and Equal Opportunity, and
- Office of Financial Literacy.

Within the Bureau, a new Consumer Advisory Board will assist the Bureau by informing it of emerging market trends. The Consumer Advisory Board is appointed by the Director of the Bureau, with at least six members recommended by regional "Fed" Presidents.

A. Scope of Bureau Authority

The Bureau monitors compliance of "covered persons" [described below] with regulations and federal laws relating to "consumer financial products and services." A "consumer financial product or service" is any

http://www.klgates.com/newsstand/ Detail.aspx?publication=5986); Melanie H. Brody, Steven M. Kaplan, David L. Beam & Stephanie C. Robinson, *Million Dollar Baby: The Consumer Financial Protection Agency Act of 2009,* Mortgage Banking & Consumer Financial Products Alert, July 27, 2009, *available at* http://www.klgates.com/newsstand/ Detail.aspx?publication=5816); Melanie H. Brody & Stephanie C. Robinson, *Singularity of Purpose: Is Looking Out for Consumers Too Narrow a Mission?*, Mortgage Banking Alert, June 25, 2009, *available at* http://www.klgates.com/newsstand/ Detail.aspx?publication=5735); Melanie H. Brody & Stephanie C. Robinson, *Fifty Ways to Need a Lawyer: Congress Proposes to Establish Financial Services Watchdog Agency*, Mortgage Banking & Consumer Credit Alert, Apr. 15, 2009, *available at* http://www.klgates.com/newsstand/ Detail.aspx?publication=5547).

[25] An independent agency is an agency of the United States government that is created by an act of Congress and is independent of the executive departments. Some examples of well-known independent agencies include: the EPA, FEMA, the CIA, the ICC (terminated in 1995), NASA, the NLRB, NSF, U.S. Postal Service, the FCC, Social Security Administration, the FTC, GSA, the SBA, and the SEC.

"financial product or service" defined in the Act when it is offered or provided for use by consumers primarily for personal, family, or household purposes. "Consumer" means an individual or an agent, trustee, or representative acting on behalf of an individual. Financial products and services include the following:

- extending credit, which would include first- and subordinate-lien, open-end and closed-end, residential mortgage loans;
- acquiring, purchasing, selling, brokering, or servicing loans or other extensions of credit (but not solely extending commercial credit to an originator of consumer credit);
- leasing or brokering leases equivalent to purchase finance arrangements under certain conditions;
- providing real estate settlement services, other than insurance or electronic conduit services;
- performing appraisals of real estate or personal property;
- deposit-taking, money transmitting, or money services;
- selling, providing, or issuing stored value in any electronic format if the seller exercises substantial control over terms and conditions of the stored value;
- check cashing, check collection, and check guaranty services;
- financial data processing and transmission services;
- providing financial advisory services, including providing credit counseling to consumers and providing services to assist a consumer with debt management or debt settlement, with modifying loans, or with avoiding foreclosure (but excluding persons regulated by the SEC or a state securities commission);
- collecting, analyzing, maintaining, or providing consumer report information or other account information for use in connection with any decision regarding the offering or provision of a consumer financial product or service, with certain exceptions;
- debt collection related to a consumer financial product or service; and
- such other product or service as defined by Bureau regulation if the Bureau finds the product or service is entered into or conducted as a subterfuge or with a purpose to evade any federal consumer financial law, or if it is permissible for a bank or a financial holding company to offer or provide it under federal law or regulation and has or is likely to have a material impact on consumers;[26] but does not include the business of insurance or electronic conduit services.[27]

[26] H.R. 4173 §§ 1002(4), 1002(5), 1002(15).

[27] Electronic conduit services means the provision of electronic data transmission, routing, intermediate or transient storage, or connections to a telecommunications system or network, *except* where the person: (i) selects or modifies the content of the electronic data; (ii) transmits, routes, stores, or provides connections for electronic data, including financial data, in a manner that such financial data is differentiated from other types of data of the same form that such person transmits, routes or stores, or with respect to which, provides connections; or is a payee, payor, correspondent, or similar party to a payment transaction with a consumer. H.R. 4173 § 1002(11).

B. "Covered Parties," "Related Parties" and "Exclusions"[28]

The Act provides that a "covered person" generally is any person engaged in offering or providing a consumer financial product or service; the term also includes any affiliate of such person which acts as a service provider for such person.

The Act defines "service provider" as a person that provides a material service to a covered person in connection with the offering or provision by the covered person of a consumer financial product or service. Service providers include: (i) a person that participates in designing, operating, or maintaining the consumer financial product or service; and (ii) a person who processes related transactions (other than unknowingly or incidentally and in a manner in which the data is undifferentiated from other types of data the person transmits or processes). The term does *not* include a person who merely offers or provides ministerial support services or advertising space.

"Related persons" also are "covered persons" under the Act. The term, "related persons," is defined, but only with respect to a covered person that is *not* a bank holding company, credit union, or depository institution, as:

- directors, officers, employees with managerial responsibility, controlling shareholders of, or agents for, the covered person;
- shareholders, consultants, joint venture partners, and any other person as determined by the Bureau who materially participates in the conduct of the affairs of the covered person; and
- independent contractors (including attorneys, appraisers, or accountants) who knowingly or recklessly participate in any violation of law or regulation, or breach of a fiduciary duty.

What persons and activities are not covered?[29] General exclusions from the definition of "covered persons" are made for certain classes and entities.

The Act specifically exempts certain entities to the extent they are not engaging in financial activities. Except to the extent that a person otherwise engages in offering or providing a consumer financial product or service, or is otherwise subject to any enumerated consumer law or

[28] H.R. 4173 §§ 1002(6), 1002(26)(A), 1002(26)(B), 1002(25)(A), (B), 1002(25)(C).

[29] H.R. 4173 §§ 1027, 1002(3), 1002(15)(C), 1027(m), 1002(15)(C), 1027(a), 1027(a)(2), 1027(b), 1027(c), 1027(d), 1027(e), 1027(e)(2), 1027(f), 1027(g), 1027(h), (i), 1027(j), 1027(k), 1027(l). The exclusion for the activity of an attorney engaged in the practice of law does not apply where a financial product or service: (i) is not offered or provided as part of or incidental to the practice of law, occurring exclusively within the scope of the attorney-client relationship; or (ii) is otherwise offered or provided by the attorney in question with respect to any consumer who is not receiving legal advice or services from the attorney in connection with the financial product or service.

any law for which authorities will be transferred to the Bureau, the following *generally* are not subject to the Act:

- persons engaged in the business of insurance, which includes reinsurance;
- providers of electronic conduit services;
- merchants, retailers, and sellers of non-financial goods or services;
- real estate licensees and registrants;
- manufactured home retailers and modular home retailers;
- accountants and tax preparers;
- lawyers;
- persons regulated by a state insurance regulator;
- employee benefit and compensation plans and certain other arrangements under the Internal Revenue Code of 1986;
- persons regulated by the SEC or a state securities commission;
- persons regulated by the CFTC;[30]
- persons regulated by the Farm Credit Administration;
- people engaged in the solicitation or making of charitable contributions; and
- auto dealers predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing or motor vehicles, or both.[31]

V. POWERS OF THE BUREAU

What enforcement powers will the bureau have? The Bureau will have the power to:

- issue civil investigative demands and file a petition to a court for their enforcement;
- conduct joint investigations, including joint fair lending investigations with the Department of Housing and Urban Development [HUD] and/or the Department of Justice [DOJ];
- issue subpoenas;
- conduct hearings and adjudication proceedings and issue cease-and-desist orders; and

[30] For an explanation of the CFTC or Commodity Futures Trading Commission, see www.cftc.gov (last accessed April 4, 2011).

[31] H.R. 4173 § 1029(a). This exclusion for auto dealers was one of the more controversial and debated provisions of the Act. The Act will not apply to a person that (i) provides consumers with any services related to residential or commercial mortgages or self-financing transactions involving real property; (ii) operates a line of business that involves the extension of retail credit or retail leases involving motor vehicles, and in which (a) the extension of retail credit or retail leases is provided directly to consumers; and (b) the contract governing such extension of retail credit or retail leases is not routinely assigned to an unaffiliated third party finance or leasing source; or (iii) offers or provides a consumer financial product or service not involving or related to the sale, financing, leasing, rental, repair, refurbishment, maintenance, or other servicing of motor vehicles, motor vehicle parts, or any related or ancillary product or service. H.R. 4173 § 1029(b). Furthermore, the Federal Trade Commission is authorized to prescribe rules under sections 5 and 18(a)(1)(B) of the Federal Trade Commission Act of 1914, 15 U.S.C. §§ 41-58, 38 Stat. 717 (1914), with respect to an auto dealer, and the Act preserves the authorities of other agencies over motor vehicle dealers. *See* H.R. 4173 § 1029(c), (d).

- commence civil actions.[32]

The scope of the Bureau's powers came into sharp focus during the general debate on passage of the Act. Generally, the authority to prescribe rules and to issue orders previously vested in various federal agencies and offices—including the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Office of Thrift Supervision [OTS], the FDIC and, to a limited extent, the Federal Trade Commission [FTC]—are transferred to the Bureau under the Act. The transfer of "consumer financial protection functions" (which encompass both rulemaking authority and the power to examine covered persons) must be accomplished during the second 180-day period following enactment of the Act.

The Bureau is granted a wide range of administrative authority and is empowered to investigate and respond to complaints related to consumer financial products and services, monitor markets for such products and services in order to identify consumer risks, supervise covered persons, enforce federal consumer financial law, and issue and implement rules, orders, and guidance regarding federal consumer financial law.

Civil actions against covered persons in order to enforce and seek penalties and relief for violations of federal consumer financial law may also be brought by the Bureau. Such actions must be brought within three years *following discovery of the violation* giving rise to the action, and the relief sought may include:[33]

- rescission or reformation of contracts;
- refunds of money or return of real property;
- restitution;
- disgorgement of compensation for unjust enrichment;
- monetary damages;
- limits on activities or functions of the person;
- public notification of the violation, including costs for notification; and
- civil money penalties of up to $5,000 per day, up to $25,000 per day for a reckless violation, or up to $1 million per day for a knowing violation.

The Bureau is also permitted to consider *mitigating* factors in order to reduce any penalties assessed or relief granted.[34] It should also be noted

[32] H.R. 4173 §§ 1052(a); 1052(b); 1052(c); 1052(e); 1053, 1054.

[33] H.R. 4173 § 1054(g).

[34] K&L Gates, an international law firm comprised of more than 2,000 lawyers, reported that the CFPA is silent with respect to *private rights of action*. An earlier version of the legislation that was approved in the House of Representatives on December 11, 2009, had included specific language stating that the CFPA does not create a private right of action, but also does not negate any private right of action arising under the enumerated consumer laws or authorities transferred under subtitles F or H of the Act. *See Consumer Financial*

that litigation costs may be recovered in actions brought by the Bureau, a state attorney general, or a state regulator to enforce any federal consumer financial law.[35] The Bureau also must refer any person to the Attorney General of the United States if the Bureau obtains evidence that the person has engaged in criminal conduct.[36] The Act also contains important whistleblower protection provisions.[37]

A. Review of Bureau Regulations

Critics complained that the Bureau might become too powerful or might exercise too great a role in the providing of core financial services to American consumers. In an attempt to provide a realistic check upon the powers of the Bureau, the Financial Stability Oversight Council is empowered to set aside any final regulation, or provision thereof, promulgated by the Bureau if it determines that it "would put the safety and soundness of the United States banking system or the stability of the financial system of the United Sates at risk."[38] The Bureau is required to coordinate its activities with federal regulators and state bank regulatory authorities in the conduct of its activities under the Act so as to reduce the burden of compliance shouldered by covered persons in relation to potentially duplicative requirements. In a mark of reciprocity, any reports and information collected by other federal and state regulatory authorities must be made available to the Bureau, with due consideration for concerns relating to confidentiality. In addition, periodic reports to the Bureau and any examinations conducted by the Bureau are permitted so that the Bureau may assess compliance, obtain information, and both detect and assess consumer risks. The Bureau may also require that "covered persons" file reports or written answers in response to consumer complaints.

On the other side of the regulatory equation, the Act requires that "covered persons" make information available to consumers—including information related to the consumer financial product or service

Protection Agency Act of 2009, Title X of the *Wall Street Reform and Consumer Protection Act of 2009*, H.R. 4173, 111th Cong. § 4508 (2009). Melanie H. Brody and Stephanie C. Robinson of K&L Gates opine that "Presumably, the availability of private rights of action under the enumerated consumer laws remains unchanged, and no new private right of action is created under CFPA." *See* Melanie H. Brody & Stephanie C. Robinson, *Consumer Financial Services Industry, Meet Your New Regulator: Financial Services Reform Act*, July 7, 2010, *www.klgates.com*/news*stand/Detail.aspx?publication=6527*

[35] H.R. 4173 § 1055(b).

[36] H.R. 4173 § 1056.

[37] H.R. 4173 § 1057.

[38] *See, e.g.*, Michael P. Carlson & Jennifer D. Miernicki, *Bureau of Consumer Financial Protection*, July 15, 2010, www.faegre.com/showarticle.aspx?Show=11695.

provided to such consumer and supporting written documentation maintained by in the ordinary course of the covered person's business.

B. Issues Relating to Preemption

An important issue relating to *preemption* is raised by the Act. The Act reduces the ability of a federally chartered institution, a bank, and a thrift operating a subsidiary to rely upon federal preemption of state consumer financial laws to prevent suits by state authorities. Any state laws *inconsistent* with the Act are expressly preempted, and the Act further clarifies that state consumer financial laws that have a discriminatory effect on or significantly interfere with the exercise of powers by a national bank are also preempted, although any preemption determination[39] may be made by regulation or order of the Office of the

[39] Preemption arises because of the Constitution's Supremacy Clause. U.S. CONST. art. VI. There are four aspects of the preemption debate; that is, whether a specific state regulation would or would not be preempted:

1. Congress may intend to "occupy the field" in a given area because federal regulations may be so pervasive or the federal interest so dominant, as in federal labor legislation or in nuclear waste disposal. *See, e.g.,* Silkwood v. Kerr-McGee Corp., 464 U.S. 238 (1984).
2. Where a state law or statute conflicts with a federal rule. *See, e.g.*, JOHN E. NOWAK, RONALD D. ROTONDO & J. NELSON YOUNG, CONSTITUTIONAL LAW 267 (1978); Aetna Health Inc. v. Davila, 542 U.S. 200, 204 (2004) (holding that the Employee Retirement Income Security Act's limitations on state-based claims by patients against insurers effectively preempt claims pursuant to state law); Gade v. Nat'l Solid Waster Mgt. Ass'n, 505 U.S. 88, 99 (1992) (declaring that the Occupational Health and Safety Act (OHSA) preempts state occupational and safety standards unless they receive federal approval); Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 300 (1988) (ruling that the federal Natural Gas Act preempts state statute purporting to regulate issuance of long-term securities by natural gas pipeline companies); Michigan Canners & Freezers Ass'n v. Agricultural Mktg. & Bargaining Bd., 467 U.S. 461, 478 (1984) (holding state agricultural marketing statute preempted by federal Agricultural Fair Practices Act).
3. Where a state law or statute stands as an "obstacle" to the accomplishment and execution of the purposes of Congress. *See, e.g.*, Geier v. American Honda Motor Co., Inc., 529 U.S. 861, 899 (2000) (concluding that "no airbag" design defect claims were preempted by Department of Transportation vehicle safety standards); United States v. Locke, 529 U.S. 89, 109 (2000) preempting state regulations relating to the design, construction and operation of oil tankers); Michigan Canners & Freezers Ass'n v. Agricultural Marketing & Bargaining Board, 467 U.S. 461, 478 (1984) (holding that federal Agricultural Fair Prices Act preempted Michigan Agricultural Marketing and Bargaining Act to the extent that state requirements conflicted with federal regulatory scheme relating to the marketing of agricultural products).
4. When federal regulations are so pervasive that that they leave no room for state regulations. *See*, *e.g.*, Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 300 (1988) (holding that state laws regulating the issuance of securities by natural gas

Comptroller of the Currency [OCC] only on a case-by-case basis. To the extent a state law affords *greater* protections to consumers, such state law would *not* be deemed inconsistent and is therefore not preempted.

Interestingly, in recognition of the unique nature of the federal-state partnership in combating unfair or deceptive practices impacting on consumers, the Bureau can be compelled to promulgate a rule if a majority of states enact a resolution which supports the implementation or revision of consumer protection regulations. Civil actions by state attorneys general and regulators to enforce the Act and Bureau rules are permitted within certain prescribed limits and with notice to the Bureau.

The Act also clarifies that although state authorities may not exercise *visitorial powers* (i.e., conduct examinations, inspect books and records, enforce compliance with appropriate federal and state legislation, and otherwise supervise activities authorized by federal banking laws)[40] with respect to national banks, this restriction does not prohibit enforcement of a subpoena against a national bank or federal thrift in connection with the enforcement of a non-preempted state fair lending law, thus codifying the holding of the United States Supreme Court in *Cuomo v. Clearing House Ass'n, L.L.C.*[41]

pipeline companies was preempted by Natural Gas Act which also regulated the issuance of such securities). Or,

5. Where it would be a physical impossibility to comply with both federal and state law. *See* Richard C. Ausness, *The Impact of Wyeth v. Levine on FDA Regulation of Prescription Drugs*, 65 FOOD DRUG L.J. 247, 248 (2010).

[40] *See* 12 C.F.R. § 7.4000 (2009).

[41] 129 S.Ct. 2710 (2009) (partially invalidating a regulation issued by the Comptroller of the Currency that insulates national banks from attempts by state officials to inappropriately exercise regulatory or "visitorial powers" over OCC-chartered institutions and upholding the issuance of an injunction by the lower courts precluding the New York Attorney General from enforcing his demands for documents on the grounds that he lacked the "visitorial power" to enforce an administrative subpoena issued outside of ongoing litigation). *See also* 69 Fed. Reg. 1904 (Jan. 13, 2004) (preemption regulation) and 69 Fed. Reg. 1895 (Jan. 13, 2004) (visitorial powers regulation). In 2005, the New York State Attorney General, Andrew Cuomo, began investigating possible racial discrimination in the real estate lending practices of several national banks. The Attorney General requested that the implicated banks turn over certain non-public information to aid the investigation. The Clearing House Association (CHA), a consortium of national banks including several involved in the investigation, filed a lawsuit in a New York federal district court to prevent the Attorney General from continuing his investigation. The CHA argued that the Office of the Comptroller of the Currency (OCC), the federal agency charged with overseeing national banks, was appropriately responsible for regulating the banks' compliance with activities that fall under the National Bank Act (NBA) and therefore precluded state officials like the Attorney General from doing so. In response, the Attorney General argued that the Federal Housing Act (FHA) provided an exception to the OCC's sole stewardship of the NBA and therefore authorized his investigation. The district court granted the CHA's

VI. Additional Studies

The Act provides for the commissioning of additional studies and consideration of regulatory amendments in areas such as remittance transfers, fees and payment cards, compilation of recommendations regarding Fannie Mae and Freddie Mac, and reverse mortgage transactions.

A. Remittance Transfers

The Electronic Funds Transfer Act (EFTA) is amended to include provisions governing certain "remittance transfers"—electronic (i.e., relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities) transfers of funds by remittance transfer providers, requested by senders located in the states and to a designated recipient. These provisions include a requirement that remittance transfer providers disclose to senders the amount of currency to be received by the recipient, the amount of transfer, fees to be charged, exchange rates, and certain other information. This

request for an injunction and stopped the Attorney General's investigation.

On appeal, the U.S. Court of Appeals for the Second Circuit sustained the injunction against the Attorney General's investigation, but used the decision in a separate case, filed by the OCC and utilizing different arguments, to do so. The court of appeals held that the district court lacked jurisdiction to decide the FHA claim. It reasoned that since the Attorney General had not yet filed any lawsuits against the banks under investigation, the issue of whether the FHA provided an exception to the enforcement of the NBA was not ripe for adjudication.

On appeal to the United States Supreme Court, Court considered the following question: Are state officials precluded from regulating and enforcing banking activities governed by the National Bank Act and the Office of the Comptroller of the Currency's regulations? The Supreme Court held that the OCC's interpretation of the NBA that precluded state officials from regulating and enforcing banking activities was not reasonable. With Justice Antonin G. Scalia writing for the majority and joined by Justices John Paul Stevens, David H. Souter, Ruth Bader Ginsburg, and Stephen G. Breyer, the Court distinguished between a state's "visitorial powers" – its supervisory powers – and its enforcement powers. The Court stated that the NBA only prevented a state from exercising its visitorial powers over banks. Therefore, the Court reasoned that a state was not precluded from exercising its ordinary powers to enforce state laws. In essence, *Cuomo v. Clearing House Association, L. L. C.*, the Court determined that a federal banking regulation did not preempt the ability of states to enforce their own fair-lending laws. The Court determined that while the Office of the Comptroller of the Currency is the sole regulator of national banks, it doesn't have the authority under the National Bank Act to pre-empt state law enforcement against national banks. The case is interesting because of the Justices who composed the majority—Justice Scalia was joined by Justices Stevens, Breyer, Ginsberg, and Souter in an unusually constituted 5-4 decision. The opinion was authored by Justice Scalia.

provision may hold significant international implications for nations which rely on remittances in providing national liquidity.[42]

B. Fees and Payment Cards

The EFTA is further amended to provide the Board with the power to regulate "interchange transaction fees" of issuers with assets greater than $10 billion, in order to keep such fees reasonable and proportional to the costs incurred by the issuer. The regulations will not apply to debit cards and general-use prepaid cards issued in connection with a governmental payment program or prepaid, reloadable cards redeemable at unaffiliated merchants, service providers, or ATMs. The EFTA is also amended to regulate "network fees" to ensure such fees are not used to compensate issuers for electronic debit transactions, to circumvent the provisions of the EFTA or impose restrictions on the number of payment card networks or routing directions which may be used in the processing of electronic debit transactions.

C. Compilation of Recommendations Regarding Fannie Mae and Freddie Mac

The Secretary of the Treasury is required to study options related to ending the controversial conservatorship of *Fannie Mae* and *Freddie Mac*. The Secretary will provide recommendations regarding the feasibility and taxpayer costs related to the wind-down, privatization, consolidation, or dissolution of these entities. It appears that both Democrats and Republicans are committed to winding down these agencies.

D. Reverse Mortgage Transactions

Within one year following the transfer date designated under the Act, the Bureau is required to study and determine appropriate restrictions on reverse mortgage transactions with due consideration to the objectives of the Act. This provision will have significant impact on this type of transaction that specifically impacts on American seniors.

[42] *See, e.g.*, Jesus Canas, Roberto Coronado & Pia M. Orrenius, *Explaining the Increases in Remittances to Mexico*, July/Aug. 2007, www.dallasfed.org/research/swe/2007/swe0704b.cfm. *The authors note that* "Mexicans living in the United States sent a record $23.1 billion back home in 2006, putting remittances third after oil and maquiladora exports as a foreign-exchange generator for Mexico (*Chart 1*). Over the last decade or so, inflation-adjusted remittances have grown at an average annual rate of 15.6 percent. Since 2000, the rate has risen to 20.4 percent."

VII. CONCLUSION

Considering the fact that the Congress spent the better part of 2010 in massive partisan gridlock, the fact that a Bureau of such power and import could be created is in itself amazing! The transfer of functions, responsibilities and key regulatory personnel from a host of federal agencies previously responsible for supervising consumer credit laws, and the broad authorization by the Congress to the Bureau of new rulemaking powers, may result in the creation of an administrative agency that may be an effective and efficient advocate for American consumers. Also considering the current regulatory conundrum—regulation, deregulation, re-regulation—whether the Bureau will be able to use these powers and specific administrative and statutory authorities in a manner that will be effective, understandable, transparent and evenhanded will determine not only the success of the Bureau but also the course of regulation in the foreseeable future.

CONFUSION FROM THE TAX COURT: THE AMBIGUOUS MEDICAL EXPENSE DEDUCITON

by DAVID S. KISTLER*

INTRODUCTION

A new issue has arisen in Court over the question of the deductibility of Sexual Reassignment Surgery (SRS) and other similarly related procedures. In the O'Donnabhain case this issue was heard before the Tax Court sitting en banc. Unfortunately, the judgment gave the taxpayer a somewhat hollow victory. The taxpayer did win as SRS was acknowledged as a legitimate medical deduction, but several serious concerns with the decision remain. First, the panel of judges was deeply divided over the issue with nothing less than six supplementary opinions that either concurred or dissented in part or in whole to the majority opinion. Second, the majority of judges gave a bifurcated opinion on what constituted an appropriate medical deduction verses a personal expenditure on the issue of Gender Identity Disorder (GID). Third, the IRS has vowed to appeal the decision. The objective of this study is to examine the court's judgment and expose the shortcomings of the decision handed down.

HISTORY

R. G. O'Donnabhain was born a male. He was mentally and physically discontented with his sex and decided to seek guidance on a physical transformation to the female sex. He went through a series of psychological tests and examinations and then a series of physical

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changes to become a female. At this point in time she (O'Donnabhain is now referred to in the female person) deducted the medical expenses associated with this conversion on her income tax. The Internal Revenue Service (IRS) originally approved the deduction and then turned around and denied the deduction.

Taxpayer filed suit in federal Tax Court. Tax Court sat en banc to hear this case as it was an issue of first impression.

Over a six-year period O'Donnabhain went through numerous procedures and requirements to finally have SRS. She started psychotherapy sessions in 1996 with Dr. Ellaborn, a psychotherapist. Dr. Ellaborn diagnosed the patient with severe GID less then a year later. In 1997 taxpayer started taking feminizing hormones and continued this for approximately four years through 2001. Also in 1997 she commenced electrolysis in order to remove unwanted body hair and continued such treatments for approximately eight years into 2005. Plastic surgery was conducted several times in 2000 to feminize her facial features which included a facelift, a tracheal shave (cutting the voice box to produce a more feminine sound), Botox treatments (prescription medicine that is injected into muscles and, for example, used to eliminate frown lines), and rhinoplasty (nose reshaping). In that same year she began the minimum of a one year pre-SRS requirement of living full time as a female. Before SRS, the taxpayer went to another psychologist for a second recommendation. This is a standard recommendation procedure required by the Benjamin standards. Dr. A. Coleman, a licensed psychotherapist, concurred in the opinion for the need of SRS. Dr. Meltzer, a surgeon, examined taxpayer as a candidate for SRS. He then gave a formal recommendation that she was physically fit for surgery. SRS surgery and breast augmentation (enlargement) was completed in 2001. In 2002 further surgery was performed for adjustment to her genitals and to eliminate scar tissue. Facial surgery was continued in 2005 in order to achieve a more feminine appearance.

The taxpayer also instituted other non-medical but significant changes. She legally changed her name and had the gender designation switched on her driver's license. She requested approval from her employer to appear at her place of work dressed as a female and was granted said request.

The IRS specially denied the deduction for hormone therapy, sexual reassignment surgery, and the breast augmentation surgery.[1] The position taken by the IRS was that: 1) the three procedures undertaken by the taxpayer were cosmetic surgery, 2) that GID under §213 is not a

[1] *O'Donnabhain v. Comm'r*, 134 T.C. 4, 3 (2010).

disease, 3) the three procedures undertaken by the taxpayer did not treat GID, and 4) that the taxpayer was incorrectly diagnosed. All of the above positions were disputed by the taxpayer. This position of the IRS has caused considerably protest from those dealing with GID. "The IRS's decision to classify O'Donnabhain's sex reassignment surgery as cosmetic 'sparked outrage' from experts who specialize in GID."[2] For example, Marshall Forstein, an associate professor of psychiatry from Harvard Medical School stated that "it seems the IRS is now in the business of practicing medicine without a license."[3]

STANDARDS FOR REVIEW

The standard medical reference book used for mental problems is considered the Diagnostic and Statistical Manual of Mental Disorders (4th ed. 2000) (DSM Manual) which is published by the American Psychiatric Association. The DSM Manual is the bible for psychiatric practitioners. When an individual desires to have a sex change the psychiatric profession generally refers to this condition as GID. The condition of GID can be segregated into mild, moderate, or severe.[4] To be diagnosed with GID the following conditions must be shown to exist in an individual:

> (1) A strong and persistent desire to be, or belief that he or she is, the other sex; (2) persistent discomfort with his or her anatomical sex, including a preoccupation with getting rid of primary or secondary sex characteristics; (3) an absence of any physical intersex (hermaphroditic) condition; and (4) clinically significant distress or impairment in social, occupational, or other important areas of functioning as a result of the discomfort arising from the perceived incongruence between anatomical sex and perceived gender identity.[5]

Psychiatric professionals who are confronted with a case of severe GID generally follow a strict path consisting of a "triadic" treatment (referred to as the Benjamin standards of care) which is:

> (1) hormonal sex reassignment; i.e., the administration of cross-gender hormones to effect changes in physical appearance to more closely resemble the opposite sex; (2) the "real-life" experience (wherein the individual undertakes a trail period of living full time in society as a member of the opposite sex); and (3) sex reassignment surgery [SRS],

[2] Wikipedia.org, *O'Donnabhain v. Commissioner*, http://en.wikipedia.org/wiki/O'Donnabhain_v._Commissioner (last visited March 22, 2010)

[3] *Id.*

[4] American Psychiatric Association, Diagnostic and Statistical Manual of Mental Disorders (4th ed. 2000) at 2.

[5] *Id.* at 581.

> consisting of genital sex reassignment and/or nongential sex reassignment.[6]

For a transgender individual this 'real-life" experience period is considered adequate only if it is carried out for at least one full calendar year. In this period the person under consideration for SRS must dress full time in the normal apparel of the opposite sex and conduct oneself as a member of the opposite sex. This includes all activities, whether for pleasure or work.

Legal standards that the court examined included §213 of the Internal Revenue Code (IRC) and §1.213 of the Internal Revenue Regulations (Regulations). The general rule allows a deduction for medical expenses. An exception exists for cosmetic surgery, because this is considered a personal nondeductible expenditure. However, there is an exemption to the cosmetic surgery exception.

Under §213(a) a deduction for medical care is allowed (the general rule). Medical care is defined under §213(d) (1) (A) as expenses that

> Includes the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

A very similar definition is given in §1.213-1(e) (1) (i). However, §1.213-1(e) (1) (ii) further explains the meaning of 'structure or function of the body' by stating that "operations or treatments affecting any portion of the body" fall under this terminology. In addition, §1.213-1(e) (1) (ii) states that the deductions are 'strictly' confined to "expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness."

The exception for medical expenses is §213(d) (9) (A) where cosmetic surgery is clearly stated as not falling under medical care (the exception to the general rule). However, this section further states that cosmetic surgery could be included under certain situations (the exception to the cosmetic surgery rule starts with the word 'unless'). The text of the section reads:

> The term 'medical care' does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality [i.e., from birth], a personal injury . . . , or disfiguring disease.

Under the Regulations, cosmetic surgery is not defined or mentioned. However, cosmetic surgery is defined under §213(d) (9) (B) as:

[6] *O'Donnabhain,* 134 T.C. at 8.

> Any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.

EXPERTS

Tax Court put great value on the testimony of the expert witnesses. Taxpayer provided one expert, Dr. Brown. IRS provided two experts, Dr. Schmidt and Dr. Dietz. Dr. Dietz was presented only for the question of whether someone diagnosed with transsexualism has a disease or illness.[7]

Dr. Brown is a ". . . licensed physician, board certified in adult psychiatry"[8] He also "participated in the development of the Benjamin standards of care."[9] Dr. Brown's additional credentials include the fact that he has reviewed nearly 500 patients regarding the diagnosing of GID, published numerous peer-reviewed papers in various medical journals, and has written chapters for several books on GID.[10]

The viewpoint of Dr. Brown is that "there is a general agreement in mainstream psychiatry that GID is a legitimate mental disorder."[11] He stated that it is "important to the mental health of a male with severe GID to be able to 'pass' convincingly in public as a female."[12] Dr. Brown opinioned that SRS was necessary in severe cases because there was a "lack of any other known effective treatment."[13]

Dr. Schmidt is also "a licensed physician, board certified in psychiatry."[14] He was not been directly involved in the treatment of GID patients "since the mid-1980's."[15] He claimed to have " 'participated in the publication' of several peer-reviewed journal articles about GID"[16] However, he was not the author listed on any of these articles nor did he write any book chapters on the subject. Nor was the term 'participated' explained.

Dr. Schmidt questions the validity of GID in that it "remains the subject of debate within the psychiatric profession."[17] His own viewpoint was "undecided" on the issue of whether GID has validity. Interestingly, within a year prior to this tax case, Dr. Schmidt "provided a diagnosis of

[7] *Id.* at 20.
[8] *Id.* at 14.
[9] *Id.*
[10] *Id.*
[11] *Id.* at 15.
[12] *Id.*
[13] *Id.* at 16.
[14] *Id.* at 17.
[15] *Id.*
[16] *Id.*
[17] *Id.* at 18.

GID as an expert witness in a U.S. District Court." He also stated that GID does require treatment.[18] Perhaps the most profound statement that Dr. Schmidt made was when he stated that GID " 'will tear you apart psychologically' " if not treated.[19] However, he also states that such "procedures are elective and not medically necessary."[20] Dr. Schmidt attempted to lower the status of the Benjamin standards of care when he called them "merely guidelines rather than true standards of care."[21] A comment made by Dr. Schmidt appears to benefit the taxpayer's position rather than the IRS position when he stated "that once a genetic male with GID makes the decision to transition to a female identity, everything that reinforces the identity is helpful for psychological well-being."[22] Although Dr. Schmidt gives the opinion that no scientific proof exists to relate GID to a physically abnormality, he states "that there is some evidence that GID may have a neurological cause."[23]

Dr. Dietz is also "a licensed physician and board certified in psychiatry."[24] His writings consist of approximately 100 articles in peer-reviewed professional publications, journals, and book chapters on the subjects of sex, criminal and antisocial behavior.[25] He wrote no specific publication on the subject of GID.

In the opinion of Dr. Dietz, GID is merely a mental disorder and not a disease or illness. This conclusion is based on his belief that GID does not "arise from a pathological process within the body."[26] However, he also states that for something to be classified as a disease "it is not necessary that this process be fully known or understood."[27] Dr. Dietz does not equate mental disorders with diseases. Several 'mental diseases' when analyzed under Dr. Dietz definition give mixed results. However, the line between mental diseases and physical problems is not clear-cut. "Panic disorder and obsessive-compulsive disorders are now understood to have an organic basis" but . . . [this was discovered] within the last decade or so."[28] He stated that bulimina (i.e., binge eating) would not be a disease but that anorexia is uncertain as to its definition.

[18] *Id.*
[19] *Id.*
[20] *Id.* at 20.
[21] *Id.* at 18.
[22] *Id.* at 19.
[23] *Id.* at 20.
[24] *Id.*
[25] *Id.*
[26] *Id.* at 21.
[27] *Id.*
[28] *Id.* at 22.

Post-traumatic stress disorder does not fall under disease according to his definition.[29]

DECISION

Findings of fact include that the taxpayer was born a normal physical male, that she experienced anxiety regarding her male gender role in life, and that this discomfort intensified in as she became older.[30] Tax Court stated that "she felt that she was a female trapped in a male body."[31] All experts testified that patients who did not have an appropriate treatment for GID resorted to autocastration, autopenectomy, and even suicide.[32] Senate Finance Committee report at the time of including the cosmetic surgery exception included language that stated "procedures such as hair removal electrolysis, hair transplants, liposuction, and facelift operations generally are not deductible."[33] Electrolysis expenses were not challenged by the IRS.[34]

Several stipulations were agreed upon by both parties: 1) for a person within the framework of GID, "transsexualism represents the most extreme form of gender dysphoria,"[35] 2) anyone suffering from GID has a dissatisfaction with their physical sex and expected gender role in society,[36] 3) gender hormones had a positive psychological effect,[37] 4) feminizing hormones were a drug under §213,[38] and 5) hormone treatment, SRS surgery, and breast augmentation all met the definition of what is medical care under the IRC.[39]

Tax Court made three holdings: 1) Taxpayer's GID ". . . is a 'disease' within the meaning of §213(d)(1)(A);"[40] 2) Taxpayer's ". . . hormone therapy and sex reassignment surgery . . . "[41] were medical procedures for the treatment of said disease and therefore, did not fall under the umbra of cosmetic surgery; 3) Taxpayer's breast enlargement surgery was done for improving her appearance and did not meaningfully promote any bodily functions. Thus, breast augmentation surgery in

29 *Id.*
30 *Id.* at 3.
31 *Id.*
32 *Id.* at 16 Dr. Brown; at 18 Dr. Schmidt.
33 *Id.* note 27 at 29.
34 *Id.* note 13 at 10.
35 *Id.* note 8 at 7.
36 *Id.*
37 *Id.* note 9 at 7.
38 *Id.* at 23.
39 *Id.* at 100.
40 *Id.* at 2.
41 *Id.*

this situation was cosmetic surgery.[42] Great reliance was made upon testimony of the experts regarding these three holdings.

The IRS cites Dr. Dietz and gives his opinion that a 'disease' must be something associated with a pathological process. Tax Court gave a various array of factors to find fault with this reasoning: 1) Citing the Finance Committee report, which has summarized the meaning of disease in the Regulations, Tax Court found that the term " 'disease' as used in the statute as synonymous with 'a physical or mental defect or illness;' "[43] 2) Tax Court also stated that "it has also long been settled that 'disease' as used in §213 can extend to mental disorders."[44] Several cases dating back to the 1960's were cited as support for this conclusion. It should also be noted that §213 (d) (9), which is about cosmetic surgery, does not include the term 'physical' in any of its definitions; 3) The DSM manual "which all three experts agree is the primary diagnostic tool of American psychiatry;"[45] 4) Numerous medical publications that "recognize GID or transsexualism and treatments for the condition;"[46] 5) The prevailing view is that GID diagnosis is valid and "Dr. Schmidt's own professed misgivings about the diagnosis are not persuasive;"[47] 6) That "GID is a serious, psychologically debilitating condition."[48] Dr. Schmidt testimony that not resolving the GID conflict within a person "will tear you apart psychologically" helped to substantiate the seriousness of the disease; 7) Several courts including "seven of the U.S. Courts of Appeals . . . concluded that severe GID or transsexualism constitutes a 'serious medical need.' "[49] The U.S. Supreme Court also holds this belief.[50] These cases dealt with inmates requesting GID treatment.[51]

Regarding definitions of a term, the Tax Court stated that the "use of expert testimony to establish the meaning of a statutory term is generally improper."[52] This question was not for the respondent to attempt to answer because it was a question of law. The interpretation

[42] *Id.*
[43] *Id.* at 25.
[44] *Id.* at 26.
[45] *Id.* at 41.
[46] *Id.* note 38 at 42.
[47] *Id.* at 43.
[48] *Id.*
[49] *Id.* at 45.
[50] *Id.* note 40 at 46 (citing Farmer v. Brennan, 511 U.S. 825, 829 (1994)).
[51] See *De'Lonta v. Angelone*, 330 F.3d 630, 634 (4th Cir. 2003); *Allard v. Gomez*, 9 Fed. Appx. 793, 794 (9th Cir. 2001); and *Cuoco v. Moritsugu*, 222 F.3d 99 (2nd. Cir. 2000).
[52] *Id.* at 35.

of the word 'disease' by respondent was found to be meritless as it was "flatly contradicted by nearly half century of caselaw."[53]

Whether or not the taxpayer was correctly diagnosed with the GID disorder was questioned by the IRS based upon Dr. Schmidt's testimony that other conditions had not been ruled out. Tax Court found that taxpayer's "GID diagnosis is substantially supported by the record."[54] Of the "three witnesses who supported petitioner's GID diagnosis,"[55] all three interviewed petitioner. However, Dr. Schmidt did no interview with petitioner and his testimony was given "considerably less weight."[56]

In regards to specific expenditures that are claimed for a medical expense deduction, the Tax Court stated that a 'but for' test must be applied if the disbursements have a dual purpose of personal benefit as well as medical benefit. In this test it must be proven "that the expenditures were an essential element of the treatment and that they would not have otherwise been incurred for nonmedical reasons."[57]

Since the taxpayer was relieved of the physical and mental suffering of GID, hormone therapy and SRS constituted a treatment under §213. The Tax Court equated treatment of disease with relief in either a physical or emotional setting.[58] The Benjamin standards were cited as recommending these treatments as being "widely accepted in the psychiatric profession."[59] One U.S. Court of Appeals and two of the highest state courts have held that in cases "of severe GID, sex reassignment surgery is the only known effective treatment."[60] These cases had different fact patterns. One case dealt with a prisoner,[61] another with an employee,[62] and the third with Medicaid.[63] All the cases came to the same conclusion in that psychotherapy in itself was ineffective as a treatment when dealing with GID. Also, "the undisputed evidence is that administration of feminizing hormones to genetic male GID sufferers produces a psychological calming effect in addition to physical changes."[64]

Breast enlargement, however, was found to be cosmetic surgery. Tax Court stated "that petitioner has failed to show that her breast

[53] *Id.* at 37.
[54] *Id.* at 47.
[55] *Id.* at 48.
[56] *Id.*
[57] *Id.* at 27 (citing Jacobs v. Commissioner, 62 Y.C. 813, 819 (1974)).
[58] *Id.* at 50 (citing Starrett v. Commissioner, 41 T.C. 881).
[59] *Id.* at 50.
[60] *Id.* at 55.
[61] *Maggert V. Hanks*, 131 F.3d 670, 671.
[62] *Sommers v. Iowa Civil Rights Commn.*, 337 N.W.2d 470, 473 (Iowa 1983).
[63] *Doe v. Minn. Dept. of Pub. Welfare*, 257 N.W.2d 816, 819 (Minn. 1977).
[64] *Id.* at 58.

augmentation surgery"[65] treated GID. Dr. Coleman and Dr. Meltzer appear to have concluded that taxpayer's breast enlargement was sufficient. Dr. Coleman stated that the taxpayer "appears to have significant breast development."[66] Dr. Meltzer observed that taxpayer's breast were "approximately B cup breasts with a very nice shape."[67] Dr. Ellaborn made no statement regarding the breast size of the taxpayer. "No documentation concerning petitioner's comfort level with her breasts"[68] was provided. Finally, "petitioner conceded in her testimony that she had "a fair amount of breast development."[69]

ANALYSIS

This paper does not dispute the findings by the Tax Court that GID is a disease and that hormone therapy and SRS are treatments for GID. However, the denial of breast augmentation as a medical expense is hereby disputed. The majority opinion stated that breast size was adequate due to the testimony of several doctors and lack of documentation of a need for such a procedure. These arguments supported the denial of breast augmentation as a medical deduction. This author believes that the reasoning of the Tax Court is deficient when applied to breast augmentation. Even Judge Halpern, in a concurring opinion, took issue with the thought of examining the size of taxpayer's breast when he stated: "I find superfluous and potentially misleading"[70] this reasoning of the majority regarding breast augmentation.

The Question of Disease

Dr. Schmidt testimony has several faults with it. He contradicts himself when stating that GID diagnosis within the psychiatric profession is still the subject of debate and 1) yet he provided a GID diagnosis in a court room not more than year before this case went to trial and 2) states that GID does require treatment. How can the expert state that GID is a subject open to debate and that he holds no view point, but still give a GID diagnosis and admit to treatment of such a condition? In addition to the above, "the majority also criticizes Dr. Schmidt for citing a religious publication."[71] The IRS attempted to pass this non-peer reviewed article by the court as medical evidence.

[65] *Id.* at 61.
[66] *Id.* at 12.
[67] *Id.*
[68] *Id.* at 62.
[69] *Id.* note 51 at 62.
[70] *Id.* at 70.
[71] *Id.* at 93.

Dr. Dietz states that GID is not a disease or an illness due to the fact that no pathological reason can be associated with GID. He does admit that it is a mental disorder. The problem is that Dr. Dietz also states that for something to be classified as a disease, the mental profession need not understand the process. These statements appear to conflict with each other. It should go without proof that mental disorders are not fully known or understood.

Even the Benjamin Standards of care for GID were attacked. Siding with Dr. Schmidt, several of the judges viewed these standards as 'mere guidelines' and not generally accepted standards. However, no where does this opposition find any other type of generally acceptable standards for the treatment of GID. Judge Holmes even states that these standards are "not as well-based on scientific evidence" as other psychiatric treatments."[72] However, no supporting evidence is provided by Judge Holmes regarding this statement. It is quite amazing that he makes such a statement when he states in his concurring opinion that "I profess no expertise in weighing the merits of . . . the competing theories on"[73] GID.

The Question of Deduction

Dr. Brown clearly stated that it is important, not merely convenient, for the transgendered male to female patient "to 'pass' convincingly in public as female."[74] This standard was used for the deductibility of facial surgery, SRS, and hormone therapy.[75] The masculine body features had to be removed and replaced with female features to make a complete conversion. A question remains as to why this standard was not applied to breast augmentation.

Although disputing the breast augmentation surgery as a deduction, Judge Gustafson goes even further. He attempts to insert a new standard for the medical deduction. When determining whether a deduction is allowed he refers only to a 1934 court case. This new standard allows the expenditure "only as there is clear provision therefore can any particular deduction be allowed."[76] The term 'clear provision' is not defined in any manner. However, §213 would appear to meet this standard as it unequivocally states that a deduction for medical expenditures is allowed.

Although the Senate Finance Committee report clearly stated that certain procedures (in particular electrolysis and facelift) were generally

[72] *Id.* at 87.
[73] *Id.* at 85.
[74] *Id.* at 15.
[75] *Id.* note 52 at 63.
[76] *Id.* at 122.

not deductible, this was only the general rule and did not include exceptions. It should be noted that "the IRS's settled opinion that procedures as diverse as abortion . . ., vasectomies, and face lifts . . . qualify as 'medical care' because they affect a structure or function of the body."[77] In §1.213-1 (e) (1) (ii) it is clearly stated that if the expenditure is primarily for medicare it is deductible. Breast augmentation would then fall under this classification from the Regulations.

The dissent make the argument that breast augmentation as well as SRS are mere improvements and thus not deductible. Judge Gustafson declares that "SRS drastically terminates a male patient's functioning sexuality."[78] However, he then states that "SRS did not change petitioner into a 'function[ing]' female."[79] Sadly, he gives no definition of a 'functioning female.' It can be noted that some naturally born females can not function in the normal sense of a female in that they can not have children through birth. It would appear that Judge Gustafson is asking for a standard that not even God grants.

The Question of Breast Augmentation

IRS expert Dr. Schmidt stated that 'everything' [within reason] which helps the patient to transform is helpful for the mental well-being of the patient. Therefore, if the transgender male to female patient thinks that a breast cup size of C is acceptable, then such a size should be created for the patient. This is because the determination is not made by law or by the physician, but by the patient's own belief. Keep in mind that GID is considered a mental disorder by the DSM manual and not a physical ailment.

A dispute arose over the meaning of §213 (d) (9) (B). This section of the IRC has two prongs: Improving appearance and a) bodily function or b) preventing or treating an illness or disease. Judge Foley wanted to exam the current case only from the perspective of 'improving appearance' and 'bodily function.' He felt that this alone was sufficient to deny the expenditure. What he failed to exam was that the second prong dealt with treating an illness. Since this occurred, the expenditure was not a cosmetic surgery item. One can not simply take the first part of this code section and make an opinion without examining the second part. Due to "the sparse legislative history accompanying the enactment of §213 (d) (9)"[80] the court is primarily limited to the language of the statute.

[77] *Id.* at 101.
[78] *Id.* note 4 at 123.
[79] *Id.*
[80] *Id.* at 115.

Another item regarding terminology of §213 (d) (9) (B) is that the first prong talks about 'improving appearance.' The typical female has breast enlargement surgery to improve her appearance and therefore, the expenditure is cosmetic surgery. Taxpayer had this type of surgery performed not to improve her appearance, but to change it. That is a totally different reason. Since the change was due to a mental illness, it should be a deductible medical expense. Change means transformation or alteration. Improvement means to make greater or to enhance. Taxpayer, IRS, and the court overlooked the meaning of these words.

There are a large number of factors that indicate that breast augmentation is only one facet of the transition required for transgendered male to female patients. Dr. Brown pointed out "the social stigma (including rejection by family and employment discrimination) and the pain and complications typically associated with such [GID] surgery."[81] Not pointed out is the enormous time spent in the conversion, the effort of undertaking the transition in physical alterations and adoption of a new lifestyle, and the expenses of all the above treatments and other necessary items (including an entire new wardrobe).

The Tax Court noted that medical care was to be defined in a broad and comprehensive manner as per *Stringham v. Commissioner*.[82] Taken individually the procedure of breast augmentation could be defined as a personal expenditure for self improvement. However, the breast enlargement was simply a part of a much larger picture. There was a failure to exam the procedures undertaken by the taxpayer in totality.

Dr. Meltzer only compared taxpayer's breasts with other transsexual males and not with a typical female or an ideal female.[83] The current socially accepted perfect female in regards to breast size is displayed in magazines such as the swimsuit issue of *Sport Illustrated* or *Playboy*. One could also examine advertisements in such catalogs or online stores such as *Victoria Secrets* or *Frederic's of Hollywood*. Generally, there are no A or B cup breasted females shown in these magazines. Considering the fact that many females have breast enlargement, a satisfactory breast size would appear to be at least a C cup.

Another argument is whether the breast augmentation treated the disease or was merely beneficial to the taxpayer for personal reasons. The general rule is stated by Judge Holmes in that "breast surgery is likely one of the commonest types of cosmetic surgery."[84] However, Dr. Meltzer "testified that the primary purpose of the breast surgery was

[81] *Id.* at 16.
[82] *Id.* at. 24 (citing Stringham v. Commissioner, 12 T.C. 580, 583-584 (1949)).
[83] *O'Donnabhain,* 134 T.C. 4 at 62.
[84] *Id.* at 103.

not to improve petitioner's appearance"[85] but to convert a male into a female. The primary reason taxpayer sought breast augmentation was to make the conversion to a female. Otherwise there was no need or desire for the surgery. Even Judge Holmes states that "the key question under §213(d) (1) is whether the treatment is therapeutic to the individual involved."[86] Nowhere is there a requirement for documentation of a medical necessity.

CONCLUSION

A substantial disagreement arose over the deductibility of hormone therapy, SRS, and breast augmentation. Several of the judges were clearly at hostile ends with each other. Attitudes about personal preferences and preconceived notions were evident in some concurring and dissenting opinions. For example, from Judge Gustafson's dissent he has been accused as demonstrating "a thinly veiled hostility toward her [the taxpayer], arising from what appear to be his preconceived notions about transgender individuals."[87] This negative attitude is supported by other statements he made. In his dissent Judge Gustafson stated that the taxpayer received the listed medical procedures "with their [the doctors] encouragement."[88] This gives the reader the idea that the doctors persuaded or swayed the taxpayer to go through with the numerous medical and nonmedical procedures that she undertook. He also refused to accept that the taxpayer actually changed sexes when he stated that "this convention does not reflect a conclusion that petitioner's sex has changed."[89] I am unaware of any more of a drastic change that could convince someone that a real change from male to female has taken place then when SRS and breast surgery have been performed. Judge Gustafson called "the surgical procedures involve in this case are startling."[90] With transgender issues such as GID and SRS in the news, how can anyone call these procedures 'startling'? Also, it is estimated that "1,000 to 2,000 Americans a year . . . undergo sex-change operations."[91]

This paper exams the Tax Court's decision and the reasoning behind the bifurcated decision and hopefully provides insight for further reasoning. The major contribution to legal literature from this article is

[85] *Id.* at 70.

[86] *Id.* at 90.

[87] Anthony C. Infanti, *Dissecting O'Donnabhain,* TAX ANAYLSIS, 1405 (March 15, 2010).

[88] *O'Donnabhain,* 134 T.C. at 119.

[89] *Id* at 119.

[90] *Id.* at 120.

[91] Anthony Faiola, *Woman Suing IRS Over Sex-Change Tax Claims*, Wash. Post, Oct. 1, 2007, Suburban Edition at A03,

the analysis of an issue of first impression. Several new ideas regarding the issue of deductibility have been presented. The GID and the SRS medical deductions are a new question in the laws of taxation. However, even with Tax Court sitting en banc, an opinion was issued which appears will be challenged in the near future. Anthony C. Infanti, professor of law from the University of Pittsburgh's School of Law stated that "it seems as if Judge Gale [majority opinion] is anticipating scrutiny either on appeal or from the public on this sensitive issue." [92] Neither party to the litigation had the issue resolved in their favor. Even the Tax Court had deeply divided opinions on the subject. Professor Infanti felt that the taxpayer won a hollow victory in "a sharply divided Tax Court."[93]

One final note is that there is considerable danger in this opinion that the legal system could be drafted into a 'culture war' between two sides over the question of GID and SRS.[94] Unfortunately, there will always be at least two sides to an issue and the court will be required to render an opinion. Therefore, the legal system must attempt to provide standards for analysis of such items as the deductibility of GID and SRS. The question that remains is whether Tax Court established standards or merely entered the dispute and confused the issues?

[92] Anthony C. Infanti, *Dissecting O'Donnabhain,* TAX ANAYLSIS, 1404 (March 15, 2010).

[93] *Id.* at 1403.

[94] *O'Donnabhain,* 134 T.C. at 82.

DOMESTIC VIOLENCE AND THE WORKPLACE: A NEW CONNECTICUT LAW JOINS THE DEBATE

by CHRISTOPHER L. LEVESQUE* AND
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INTRODUCTION

Domestic violence is a widespread problem with serious economic and social consequences. However, it rarely receives broad public attention. Contributing to the recognition problem are the various labels attributed to the conduct – domestic violence, domestic abuse, family violence, intimate partner abuse, among others – along with a corresponding array of slightly varying definitions,[1] some highlighting a pattern of persistent, controlling behavior, [2] and others more specifically focusing on an abusive action between two people in a close relationship.[3] Distinctions in terminology aside, the underlying consequences remain the same. The pervasiveness and depth of domestic violence is profound and poses significant costs to our nation's families, communities and businesses.

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1 NAT'L CTR. FOR INJURY PREVENTION AND CONTROL, COST OF INTIMATE PARTNER VIOLENCE AGAINST WOMEN IN THE UNITED STATES 46-47 (2003), *available at* www.cdc.gov/violenceprevention/pdf/IPVBook-a.pdf (noting need for standardized definitions so as to aid data collection and analysis) [hereinafter COST OF VIOLENCE].

2 *What is Battering*, NAT'L COAL. AGAINST DOMESTIC VIOLENCE, http://www.ncadv.org/learn/TheProblem.php (last visited Feb. 21, 2011).

3 *Understanding Intimate Partner Violence*, CENTER FOR DISEASE CONTROL AND PREVENTION (2006), *available at* www.cdc.gov/ncipc/dvp/ipv_factsheet.pdf.

Domestic violence can occur to anyone, cutting across every potentially relevant demographic -- gender, race, age, religion, geography, and socioeconomic status.[4] Indeed, no group is immune from the direct or indirect effects of domestic abuse. [5] Nevertheless, this type of conduct disproportionately victimizes women, who represent an estimated 85% of the abused population.[6] In terms of absolute numbers, every year it is estimated that 5.3 million women suffer some form of domestic abuse,[7] and 4.8 million women endure physical assaults and rapes by an intimate partner.[8] Even as a percentage of the United States population, these figures are quite distressing. The tangible effects are similarly devastating, as domestic violence can tear families apart and shatter intimate relationships, while the frequently accompanying feelings of embarrassment, humiliation, rationalization, denial, and stigma underscore the insidiousness of such abuse.[9]

This article examines the impact of domestic violence on the private workplace. While most acts of domestic violence occur in the home, the effect of such violence can impede or even prevent employees from performing their jobs.[10] The article focuses specifically on the recent innovation in Connecticut law, the rather awkwardly named, "An Act Concerning the Recommendations of the Speaker of the House of Representatives' Task Force on Domestic Violence" (DVA).[11]

In addition to reviewing the DVA and its development, this article also reflects insights from a number of experts in the field who helped make this new law a reality. Part I examines the individual and societal harms of domestic violence and its impact on the workplace. Part II reviews the pre-DVA legal environment and highlights the limited and

[4] *What is Battering*, *supra* note 2.

[5] COST OF VIOLENCE, *supra* note 1, at 20.

[6] *Domestic Violence Facts*, NAT'L CTR. FOR INJURY PREVENTION AND CONTROL, www.ncadv.org/files/DomesticViolenceFactSheet(National).pdf (last visited Feb. 21, 2011).

[7] PATRICIA TJADEN & NANCY THOENNES, NAT'L INST. OF JUSTICE, EXTENT, NATURE, AND CONSEQUENCES OF INTIMATE PARTNER VIOLENCE iii (2000), *available at* http://www.ncjrs.gov/pdffiles1/nij/181867.pdf. *See also* Marcy L. Karin, *Changing Federal Statutory Proposals to Address Domestic Violence at Work*, 74 BROOK. L. REV. 377, 377 (2009) ("Over five million acts of domestic violence are committed every year. The prevalence of these acts makes domestic violence the leading cause of injury to women.").

[8] COST OF VIOLENCE, *supra* note 1, at 1.

[9] Interview with Erika Tindill & Linda Blozie, Members of the Conn. Coal. Against Domestic Violence, in E. Htfd, Conn. (Jan. 11, 2011) [hereinafter Tindill & Blozie].

[10] *Id.*

[11] Act effective Oct. 1, 2010, 2010 Conn. Acts 144 (providing protections for domestic violence victims) [hereinafter DVA]; Tindill & Blozie, *supra* note 9. While this is not the first state law passed impacting domestic violence in the workplace, *e.g.,* COLO. REV. STAT. § 24-34-402.7 (2009); D.C. CODE §§ 32-131.01, 32-131.02 (2001), it is the newest state law innovation.

scattered relief available for domestic violence victims in the workplace. Part III discusses the development of the DVA and the evaluation of various alternative methods of regulation. Part IV examines and evaluates the final product and its impact on employers, employees, and the workplace overall.

I. THE ENDURING PROBLEM OF DOMESTIC VIOLENCE

A. Individual and Societal Burdens

Domestic violence has long been understood to place a tremendous burden on individuals, society and the workplace. Yet, as with most significant interpersonal issues, cultural shifts and distinctions can influence both the prevalence and awareness of the problem and the dynamics necessary to address it. Domestic abuse and sexual harassment certainly mean quite different things today than they did thirty or forty years ago. Regardless of the increased recognition of the problems and causes of domestic violence, this conduct likely will continue to occur and present challenges for the directly and indirectly affected alike.

The overall consequences of domestic violence are significant, with one source estimating that 25% of the women in the United States have experienced domestic violence in their lifetimes.[12] Another study pegs the figure even higher, with nearly one-third of women reporting being abused by a male significant other at some point in their life.[13] Not surprisingly, in the face of such large figures, no major category of people truly is immune, with the incidence and effects of domestic violence cutting broadly across racial and other demographic lines.[14] Even confining the analysis to domestic violence victimization of adult women, such numbers would allow few employers to escape having the issue touch members of their workforces.

Though staggering, even these numbers fail to convey the full depth of domestic violence and its effects on the individual victims, their families, and society. Domestic violence is primal by nature, involving an assault on one's person and identity from those expected to furnish the most intimate and basic sources of support and protection – the members of one's own family. As a result, the implications for the

[12] *Domestic Violence Statistics*, DOMESTIC VIOLENCE RES. CTR., http://www.dvrc-or.org/domestic/violence/resources/C61/#dom (last visited Feb. 21, 2011).

[13] KAREN S. COLLINS ET AL., HEALTH CONCERNS ACROSS A WOMAN'S LIFESPAN: THE COMMONWEALTH FUND 1998 SURVEY OF WOMEN'S HEALTH 6 (1999).

[14] *Id.* at 7.

individual can be quite profound – implicating matters of intimacy, security, self-worth, and general mental health.[15]

The resulting coping mechanisms may complicate matters further. Domestic violence sufferers often fail to consider themselves victims, even in the face of severe abuse.[16] Instead, possibly due to the breakdown of fundamental support systems in their lives, abused women often place the blame on themselves.[17] They tend to deny the conduct and harbor feelings of embarrassment and shame.[18] However, not all of these second order effects are internalized. The stigma and injuries associated with domestic violence can manifest themselves outwardly, and interventions by others, no matter how well intentioned, can serve to escalate the harm.[19] These interveners can include friends, family, colleagues, authority figures, and employers.[20]

Not surprisingly, something as powerful as domestic violence exacts a marked toll on victims, who often need time and a variety of resources to overcome its effects.[21] By the time some victims acknowledge their circumstances, second order consequences, such as compromises in employment stability may have set in.[22] Productive steps may include reaching out for support to family, friends, fellow employees, and even the employer -- as well as seeking direct protections from authority figures such as the police and courts.[23]

The characteristics and policies of employers can also influence the dynamics associated with domestic violence. Employers that are unsympathetic to domestic violence issues can force victims to sacrifice treatment or judicial intervention in exchange for retaining employment.[24] Domestic violence is therefore in some fashion a workplace issue. Given the costs, challenges and uncertainties involved with replacing productive employees and addressing potential issues of morale in a workforce, recognition of the issue and the development of well-informed employer polices tend to make good business sense.

[15] Elissa Stone, Comment, *How the Family and Medical Leave Act Can Offer Protection to Domestic Violence Victims in the Workplace*, 44 U.S.F. L. REV. 729, 752 (2010); Tindill & Blozie, *supra* note 9.

[16] Tindill & Blozie, *supra* note 9.

[17] *Id.*

[18] *Id.*

[19] *See* Stone, *supra* note 15, at 734; Tindill & Blozie, *supra* note 9.

[20] *Id.*

[21] Tindill & Blozie, *supra* note 9.

[22] Jennifer E. Swanberg, T.K. Logan & Caroline Macke, *Intimate Partner Violence, Employment, and the Workplace: Consequences and Future Directions*, 6 TRAUMA, VIOLENCE & ABUSE 286, 304 (2005).

[23] Tindill & Blozie, *supra* note 9.

[24] *Id.*

B. Impact of Domestic Violence on the Workplace

The harms of domestic violence do not stop at the workplace door. Yet at first glance, it would seem that employers have little role to play. Managers generally do not perpetrate domestic violence and cannot pass laws, punish abusers or provide therapy or other forms of treatment. However, the effects of domestic abuse on the workplace are quite significant and employers should care about its occurrence.

Employment represents a major element of one's identity, and certainly does so for victims of domestic violence.[25] It represents control, independence, and furnishes the economic means for someone to extricate herself from an abusive environment.[26] Support and stability in the workplace therefore can contribute significantly to an individual's ability to overcome effects of domestic violence.[27]

Domestic violence can affect the workplace and employer in a number of direct ways. First, abused workers often perform at a substandard or compromised level.[28] An employee's morale can suffer due to the inability to control her life circumstances and to perform the basic functions of her job, causing a downward, self-reinforcing spiral.[29] Strong feelings of vulnerability, fear, and insecurity further can disrupt an employee's focus at work.[30] Additionally, physical symptoms of violence and abuse obviously can compromise one's ability to perform, as can matters like problems sleeping and relaxing.[31] Abused employees are also likely to experience high levels of absenteeism, arrive late to work, and depart early.[32]

The damage can quickly transcend the individual employee, with fellow workers readily able to discern whether an employer is treating a

[25] Telephone interview with Deborah McKenna, Partner, Emmet & Glander (Feb. 2, 2011).

[26] *Id.*

[27] *Id. See also* Swanberg, Logan & Macke, *supra* note 22, at 304.

[28] *Domestic Violence and Employees*, SAFEHORIZONS.ORG, www.safehorizons.org/safework/dv_andemployees.htm (last visited Feb. 21, 2011).

[29] Tindill & Blozie, *supra* note 9.

[30] *Domestic Violence and Employees*, SAFEHORIZONS.ORG, www.safehorizons.org/safework/dv_andemployees.htm (last visited Feb. 21, 2011) (noting that 64% of domestic violence victims say their ability to work is affected by the violence, 68% of employees of Fortune 1500 companies say that domestic violence has had a harmful effect on the physical safety of employees, and 80% of employees of Fortune 1500 companies witness the negative impact that domestic violence has on employee productivity).

[31] COST OF VIOLENCE, *supra* note 1, at 45.

[32] *See, e.g.,* Margaret E. Johnson, *Redefining Harm, Reimagining Remedies, and Reclaiming Domestic Violence Law*, 42 U.C. DAVIS L. REV. 1107, 1155 n.213 (2009) (noting study reporting employment productivity and absenteeism losses to domestic violence); Stone, *supra* note 15, at 731.

victim-employee with respect and support.[33] As a domestic violence victim's sufferings further are recognized, it can influence the attitudes and performance of the other employees.[34] Workmates can become distracted by the sufferings of others, take time away from productive elements to assist and support, and develop feelings of sympathy, empathy, concern, for the victim and perhaps even frustration at the employer.[35]

Domestic violence can also implicate matters of safety and security, with direct consequences in the workplace in the forms of stalking, threats and outright physical violence.[36] Half a million women are stalked annually by an intimate partner, which has clear implications for the workplace given the amount of time an individual spends there and the ease with which an abuser can locate the victim's employment site.[37] Abusers also frequently call victims at work in order to threaten them and interrupt their ability to perform – a characteristic form of attempted control.[38] Indeed, of abused women within the workforce, roughly 74% report harassment at work.[39] A 2004 survey conducted by the Society for Human Resource Management stated that 11% of employer members reported violence from a girlfriend or boyfriend to an employee, and similar percentages from spouses or ex-spouses.[40]

Observed at a macro level, the workplace consequences of domestic violence are considerable. One source reports that health related costs for domestic violence issues exceed $5.8 billion annually -- $4.1 billion in direct health care costs and another $1.8 billion in loss of productivity or wages.[41] Employers may also have to pay workers' compensation to domestic violence victims who are injured by a partner while at work or if the injury arose out of the employment context.[42]

[33] CAEPV, LIZ CLAIBORNE & SAFE HORIZON, CORPORATE LEADERS AND AMERICA'S WORKFORCE ON DOMESTIC VIOLENCE: AWARENESS, ATTITUDES, AND ACTION (2007) (Some 71% of employees saying that more should be done about domestic violence and 80% witnessing the impact of domestic violence on productivity).

[34] *Domestic Violence and Corporations*, SAFEHORIZONS.ORG, *www.safehorizons.org/*safework/dv_andemployees.htm (last visited Feb. 21, 2011).

[35] *See id.*

[36] Stone, *supra* note 15, at 731-33.

[37] TJADEN & THOENNES, *supra* note 7, at iii.

[38] COST OF VIOLENCE, *supra* note 1, at 14.

[39] *Effects in the Workplace*, EMPLOYERS AGAINST DOMESTIC VIOLENCE, http://www.employersagainstdomesticviolence.org/effects.html (last visited Feb. 21, 2011).

[40] John E. Matejkovic, *Which Suit Would you Like? The Employer's Dilemma in Dealing with Domestic Violence*, 33 CAP U. L. REV. 309, 311 (2004) (citing Workplace Violence Survey, Society for Human Resource Management (2004)).

[41] Stone, *supra* note 15, at 732-33.

[42] Jesse Bode Brown, *The Costs of Domestic Violence in the Employment Arena: A Call for Legal Reform and Community-Based Education Initiatives*, 16 VA. J. SOC. POL'Y & L. 1, 35-

This is particularly relevant given that employers generally serve as the ultimate payer or arranger of healthcare costs for employees. These problems are becoming increasingly well recognized, with one report noting that roughly 47% of senior executives polled believe that domestic violence affects productivity, and 66% consider it a major societal concern.[43] Perhaps even more revealing, 78% of surveyed human resources personnel identified domestic abuse as a critical workplace issue.[44]

Facilitating appropriate treatment and furnishing a supportive environment for victims of domestic violence makes good business sense. Well-intentioned, productive employees are generally a firm's most valuable resource, and the recruitment, training and development of an employee is a time-consuming, expensive affair. One source estimates that it costs 150% of a given position's salary to replace an employee, while other commentators peg the total cost of replacement at anywhere from 30% to 250% of a role's annual compensation.[45]

Additionally, domestic violence can affect an employer through the lens of public perception. Employee victims with physical symptoms like bruises and broken limbs, as well as behavioral evidences of abuse may come in contact with potential customers and others who happen to visit a workplace. Bearing witness to such symptoms can be quite discomforting, and signs of abuse may reflect directly upon the employer, leaving others with the impression that the employer is callous and uncaring.

Inefficiencies in the legal system also can exact a cost on the employer if an employed victim of domestic violence seeks judicial intervention. Delays and uncertainties in court processes can manifest themselves in declines in productivity due to unforeseen absences and potential violent episodes. Domestic violence victims frequently must reach out for restraining orders and protective orders, as well as renew them in court in order to escape or avoid their abusers. Such a process can be very time consuming, particularly in light of the relatively limited protection that such efforts often render.[46]

36 (2008).

[43] MARGI LAIRD MCCUE, DOMESTIC VIOLENCE: A REFERENCE HANDBOOK 175 (2d ed. 2008).

[44] *Domestic Violence and Corporations*, SAFEHORIZONS.ORG, *www.safehorizons.org/* safework/dv_andemployees.htm (last visited Feb. 21, 2011).

[45] One source estimates that it costs 150% of a given position's salary to replace an employee, while other commentators peg the all-in cost at anywhere from 30% to 250% of a role's annual compensation.

[46] *See* Carolyn D. Schwarz, *Unified Family Courts*, 42 FAM. CT. REV. 304, 304 (2004) ("[V]ictims of domestic violence . . . are often involved in a multitude of proceedings in different courts that stem from a single incident or pattern of domestic abuse, leading to a

Stigma and self-denial often make these actions a difficult step for domestic violence victims under the best of circumstances.[47] The consequences are dramatic, however, with homicide constituting the second leading cause of workplace death for women.[48] Not all such violence can be prevented, of course, but an employer's understanding and assistance in facilitating contact for domestic abuse victims with authorities may well forestall some of it.

Most employers want to do the right thing, but it is not always easy given the need to balance the interests of the business, its employees and its customers.[49] These difficulties are amplified in the case of entrepreneurial ventures, where the distinctions between management and the employee base often are blurred, everyone's contributions are vital almost all of the time, and interdependency among members of the team is critical.

II. THE PRE-DVA LEGAL ENVIRONMENT

Prior to the DVA, Connecticut law provided various support for domestic violence victims, including potential leave from their employment. However, the interplay of the relevant schemes and legal principles left a measure of uncertainty for many domestic violence victims and afforded little, if any, protection for others.

The most prominent employment law that could provide assistance is the federal Family and Medical Leave Act (FMLA). Connecticut workers can take up to twelve weeks of unpaid leave to address serious health conditions of their own or of family members, or for events involving the birth or adoption of a child.[50] While the amount of leave is expansive, for the private sector, the FMLA limits its application to companies with more than fifty employees, and to workers who have already logged more than 1250 hours with the employer.[51] The FMLA further defines a serious health condition as one that requires inpatient care or continuing treatment by a healthcare provider.[52]

time-consuming, confusing, and overwhelming process."); TJADEN & THOENNES, *supra* note 7, at 53, *available at* http://www.ncjrs.gov/pdffiles1/nij/181867.pdf (reporting that roughly half of the protective orders granted due to physical assault violated, roughly two-thirds violated where granted due to stalking or rape).

[47] Tindill & Blozie, *supra* note 9.

[48] Stefanie L. Steines, Note, *Parking-Lot Laws: An Assault on Private-Property Rights and Workplace Safety*, 93 IOWA L. REV. 1171, 1173 (2008) ("Workplace homicides are the . . . second-leading cause of deaths among women in the workplace.").

[49] Tindill & Blozie, *supra* note 9.

[50] Family and Medical Leave Act, 29 U.S.C. § 2612 (2006).

[51] *Id.* § 2611(2)(A).

[52] *Id.* § 2611(11).

The federal FMLA has only limited application in the domestic violence context. Given the pre-meditated and controlling nature of domestic violence, its crippling effects may often fail to manifest themselves in the acute form of injury likely to lead to such care or treatment.[53] Employees of small businesses and newly hired workers are excluded altogether, and the FMLA does not extend its reach to the non-medical consequences of domestic abuse.[54] As a result, the FMLA currently falls short in the context of domestic violence. Attempts have been made through the years to amend the FMLA in a manner to broaden its protection to cover domestic violence and related circumstances, but nothing concrete has come of those efforts.[55]

Another federal law, the Occupational Safety and Health Act (OSHA), also operates in a way that can afford protections to domestic abuse suffering employees, but its application is even less effective than the federal FMLA in most circumstances.[56] OSHA requires employers to maintain a safe and healthy workplace for its employees, free of recognized dangers and to develop a workplace violence prevention program.[57] While a stalker posing threat to an employee during work hours ostensibly could trigger OSHA, the act bears little relevance to the internalized trauma and consequences of domestic violence. Moreover, OSHA is silent on matters occurring away from the worksite, where the vast majority of domestic violence episodes occur. It also lacks stringent enforcement mechanisms – no private right of action is available, and the agency seems ill equipped to prosecute matters efficiently.[58]

Other state laws also provide a possible remedy. Like a number of its sister states, Connecticut has developed an analogue to the federal

[53] *See* Marjorie Conner Makar, *Domestic Violence: Why the Florida Legislature Must do More to Protect the "Silent" Victims*, 72 FLA. B.J. 10, 16 (1998) ("While acute injuries may be the most obvious manifestation of domestic violence, it is often the long-term medical and psychological consequences of battering that are most debilitating over time.").

[54] 29 U.S.C. § 2611 (2006).

[55] *E.g.,* Michael Z. Green, *Unpaid Furloughs and Four-Day Work Weeks: Employer Sympathy or a Call for Collective Employee Action?*, 42 CONN. L. REV. 1139, 1173 (2010). Green specifically mentions the Domestic Violence Leave Act, which was proposed to extend FMLA coverage to leave related to domestic violence. *Id.* (citing Domestic Violence Leave Act, H.R. 2515, 111th Cong. (2009)).

[56] *See* Occupational Safety and Health Act, 29 U.S.C. § 654 (2006).

[57] *Id.*

[58] *E.g.,* Lynn Rhinehart, *Workers at Risk: The Unfulfilled Promise of the Occupational Safety and Health Act*, 111 W. VA. L. REV. 117, 122-23 (2008) (noting weaknesses in OSHA enforcement powers); Katherine V.W. Stone, *Legal Protections for Atypical Employees: Employment Law for Workers without Workplaces and Employees without Employers,* 27 BERKELEY J. EMP. & LAB. L. 251, 260 (2006) ("There is no private right of action under OSHA.").

FMLA, extending protection beyond the federal act's boundaries.[59] The Connecticut Family and Medical Leave Act (CTFMLA) retains the basic conditions meriting leave of the federal act, expanding its coverage most notably to cover organ donor and related procedures, and extends the basic leave period to sixteen weeks.[60] Connecticut also limits the application of its law to employers with more than seventy-five employees, compared to the FMLA fifty-employee threshold.[61] However, Connecticut requires fewer hours of employment service for coverage to apply to a particular employee – 1000 versus the FMLA's 1250.[62] Most relevant for this article, the CTFMLA does not address domestic violence in a manner beyond the at-best tangential coverage contemplated in the federal act.

It is clear that relatively little protection thus existed for victims of domestic violence regarding their interactions with their employer. Both federal law and state law have failed to provide sustained protections from employer discretion.

With both federal and state statutory protections unavailing, the last remaining source of protection was through the common law. In Connecticut there is only a single reported case addressing the issue of an employer's obligation in regards to domestic violence: the recent case of *Gillies v. The Stonington Free Library*.[63] In *Gillies*, a library employee allegedly suffered a significant course of abuse from her ex-husband over a term of many years. According to the complaint, this abuse resulted in highly visible physical bruising.[64] For a time, the library allegedly "accommodated" Ms. Gillies, first by shielding her from the public and having her work remotely, then by instructing her to stay away from the library facility.[65] The library ultimately decided to terminate Ms. Gillies' employment, prompting Ms. Gillies to bring suit claiming, among other things, that the library fired her due to her status as a victim of domestic violence in contravention of public policy.[66] The defendant

[59] *E.g.,* Darrell R. VanDeusen, *The Maryland Flexible Leave Act: Is it Really that Simple?*, 40 U. BALT. L.F. 59, 73-75 (2009); Jane Waldfogel, *The Impact of the Family and Medical Leave Act*, 18 J. POL'Y ANALYSIS & MGMT. 281 (1999) (empirically examining impact of state FMLA laws).

[60] CONN. GEN. STAT. § 31-51*ll* (2010).

[61] § 31-51*kk*.

[62] *Id.*

[63] No. CV09-5011135-S (Conn. Super. Ct. filed Mar. 27, 2009). *See also* Bernard Jacques, *Domestic Violence Comes to Work*, CONN. LAW., Mar. 2010, at 28, 32-33 (summarizing the decision).

[64] Complaint at ¶ 24, Gillies v. Stonington Free Library, Inc., No. CV09-5011135-S (Conn. Super. Ct. filed Mar. 27, 2009).

[65] *Id.* at ¶¶ 29-37.

[66] *Id.* at ¶ 43.

brought a motion to strike the claim.[67] The court ruled that terminating a victim of domestic violence because she is a victim of that violence could potentially amount to a violation of public policy.[68] The facts and legal principles attendant to the *Gillies* case inspired one of her lawyers, Deborah McKenna, to help push for a legislative solution.[69]

III. DEVELOPMENT OF THE DVA AND THE CONSIDERATION OF ALTERNATIVES

The development of new domestic violence legislation rested with a bipartisan legislative task force (Task Force) that would formulate Connecticut's response to the consequences of domestic abuse.[70] The Task Force was headed by State Representative Mae Flexer, and its efforts came on the heels of a failed bill, modeled after a relevant New York City ordinance,[71] that sought to extend protected class status under Connecticut's employment discrimination to victims of domestic violence.[72]

The Task Force was faced with a host of options when deciding how Connecticut should tackle the question of domestic violence. In terms of the status quo, the pendency of the *Gillies* case and its underlying, public policy-based legal theories, taken together with the leave protections afforded to victims in connection with criminal matters and the availability of leave through the federal and state FMLAs, furnished at least some level of protection for victims of domestic violence. As evidenced by the DVA, the Task Force ultimately decided that more protections were needed.

A. Development of Protections through Existing Case Law

Starting with the common law principles, the public policy underpinnings of *Gillies* afforded little practical protection for current and future domestic violence victims. Such common law-based rights take considerable time to develop from the perspectives of reach, scope, consistency and reliability. Should subsequent appellate courts accept Ms. Gillies' public policy theory, developing a reliable, clear and

[67] Memorandum in Support of Motion to Strike, Gillies v. Stonington Free Library, Inc., No. CV09-5011135-S (Conn. Super. Ct. June 4, 2009).

[68] *Gillies*, No. CV09-5011135-S, slip op. (Conn. Super. Ct. Aug. 26, 2009); Jacques, *supra* note 62, at 32.

[69] McKenna, *supra* note 25.

[70] *See Domestic Violence*, HOUSE DEMOCRATS OF CONNECTICUT, http://www.housedems.ct.gov/DV/ (last visited Mar. 3, 2011).

[71] N.Y., N.Y., ADMIN. CODE § 8-107.1 (2006).

[72] Shortly preceding the work of the Task Force, the General Assembly's Labor and Public Employees Committee had developed H.B. 5284, 2010 Gen. Assemb., Feb. Sess. (Conn. 2010), *available at* http://www.cga.ct.gov/2010/TOB/H/2010HB-05284-R00-HB.htm.

integrated protection for domestic violence victims on such a basis would be extremely difficult.

A single case rarely leads to anything approaching settled law given the vagaries of litigation processes. The fact-specific circumstances of each case, the handling and disposition by the trial courts, issues raised on appeal, the effectiveness of the advocacy on both sides, the tendency toward settlement of claims, and many other factors can influence the development of the law. It is a rather long road to anything approaching *stare decisis*, with the result often a rather narrow, focused proposition compared to a fully developed legislative solution. Relying upon this approach likely did not seem like a wise course of action to the Task Force in the face of potential alternatives.

B. Domestic Violence Victims as Members of a Protected Class

Notwithstanding the fate of Raised House Bill No. 5284, the Task Force could have chosen to expand the scope of people constituting members of a protected class to include victims of domestic violence.[73] Such a classification could have deepened protection for domestic violence victims by obligating employers to justify certain employment terminations on grounds other than one's victim status, and also raised public awareness of the issue. Nevertheless, there are more efficient and less controversial ways of getting to the same, and indeed, broader notions of protection. As with a reliance on a common law solution, a protected class designation alone would furnish little guidance to employees and employers on a day-to-day basis. Employees and employers alike would still need to wait for the relatively inefficient mechanism of court determinations to help shape the law and establish the particulars of what actions and justifications were appropriate. Identification of particular rights and categories of leave within a statutory scheme seems like a far more pointed solution.

There are other downsides to the protected class approach, even if it were included as part of a more comprehensive legislative package. The protected class designation in Connecticut is currently limited to members of classes defined by immutable characteristics, such as race and gender.[74] Extending such a protective framework to domestic abuse

[73] *See* H.B. 5284, 2010 Gen. Assemb., Feb. Sess. (Conn. 2010). Other states have administered such blanket protections. *See* Karin, *supra* note 7, at 395 ("Three jurisdictions—Illinois, New York City, and Westchester County—specifically prohibit all forms of employment discrimination against employees because they are or are perceived to be victims of domestic violence."). According to Karin, these jurisdictions also require employers to grant reasonable accommodations to employees while at work. *Id.* (citing Reynolds v. Fraser, 781 N.Y.S.2d 885, 887-88, 891 (N.Y. Sup. Ct. 2004)).

[74] *See* CONN. GEN. STAT. § 46a-60 (2001).

victims could inspire a degree of resentment among members of currently protected classes. Not that those class members would object to the notion of protecting women from abuse, but the permanence aspect common to presently protected class groups is simply missing. Such a step could also be interpreted to suggest willingness by the legislature to continue opening the door of protected class status to other similarly deserving groups. That alone could lead to unnecessary noise and vitriol and distract attention from the task at hand – protecting domestic violence victims.

C. Amendment of the CTFMLA

The CTFMLA historically served as the principal statutory regime offering protection to domestic abuse victims in the employment context. The then (and still) current CTFMLA provided a clear measure of protection for a potentially large number of domestic abuse sufferers. Consistent with its basic terms and focus, the CTFMLA would mandate potential leave for employees whose domestic violence suffering resulted in a serious medical condition.[75] Given the severe, potentially debilitating nature of domestic violence, on at least a conceptual level, the CTFMLA therefore could furnish broad-based protection for at least some victims of domestic abuse. Unfortunately, the CTFMLA presumably leaves even more categories of such victims with little or no protection.[76] It affords no protection for employees of small businesses (those with fewer than 75 workers),[77] and excludes workers with less than half a year's full-time tenure or the equivalent from its protections.[78] Domestic abuse also can affect victims without rising to the level of a serious medical condition as set forth in the CTFMLA. Moreover, not all forms of leave and protection relevant to domestic violence victims are confined to matters involving healthcare.

Instead, the focus should be on helping victims address the devastating realties of domestic violence. The relevant matters pertaining to leave for domestic violence victims, such as seeking protective orders, undergoing counseling at victim services organizations, and relocating one's residence, seem to fit best outside of a medical leave statutory framework. Finally, the CTFMLA does not provide an aggrieved employee with direct recourse to the courts. Instead, an individual must file an application with the state's department of labor and participate in an administrative process.[79]

[75] CONN. GEN. STAT. § 31-51*ll*.
[76] CONN. GEN. STAT. § 31-51*kk* (2010).
[77] § 31-51*kk*
[78] *Id.*
[79] § 31-51*pp*.

Such a process may work well for general leave determinations involving medical conditions, but may not extend as effectively to the rather broad array of matters relating to domestic violence.

D. Pressure to Reform the FMLA

While beyond the reach of the Connecticut legislature, the notion of expanding the federal FMLA or bringing political pressure to do so also merits consideration. Indeed, attempts to amend the FMLA in significant substantive respects have occurred throughout the years, including extending it to cover domestic violence.[80]

The prospect of elevating the public consciousness of the issue of domestic violence, giving it an air of legitimacy by aligning it with a broad-based, enduring federal legislative scheme, is quite appealing. Federal coverage could serve to harmonize the treatment of the issue through the development of a uniform, nationwide set of definitions and thereby alleviate the noise created by having a multitude of jurisdictions developing their own frameworks. That much of the employment-related elements of domestic violence laws relate to the concept of leave further supports having an amended FMLA serve as the potential appropriate vehicle. Indeed, one recent commentator has set out a well-reasoned case for such an extension of the federal FMLA.[81]

There are some practical downsides to such an extension, however. First, as with the CTFMLA, the federal FMLA is a fairly specific legislative vehicle aimed at matters with, at best, a modest overlap with the concept of domestic violence. As such, it may not fit well with the unique factual considerations and legal issues incident to domestic violence. Second, from an administrative standpoint, the reformulation or significant expansion of the federal FMLA could cause conflict with the various state FMLAs that sprang from the federal act. Since the federal FMLA became effective, a number of states have developed their own FMLA analogues. Distinctions between the federal and various state acts are already sufficiently confusing for employees, employers and others. Introduction of federal FMLA-based leave protection for domestic leave victims in the face of both existing state FMLA laws and domestic violence legislation might therefore serve to complicate matters for employers, rather than simplify them.

Given the drawbacks of these various alternatives, the Task Force established an independent DVA that provided a variety of protections

[80] Aaron L. Agenbroad, *Federal and State Legislative and Regulatory Agenda: What's Cooking and What's on the Horizon?*, 839 PLI LIT. 135, 145 (2010) (citing Balancing Act of 2009 (H.R. 3047), and the similarity of the attempt to amend the federal FMLA to the Domestic Violence Act, H.R. 2515).

[81] *See generally* Stone, *supra* note 15.

specifically targeted to domestic violence. These protections are to be integrated in various sections of the Connecticut General Statutes. The following section describes the resulting DVA and evaluates its impact on employers and employees.

IV. THE NEW CONNECTICUT DVA: DESCRIPTION AND EVALUATION

A. Contours of the DVA

What ultimately became the DVA began its final developmental phase as Substitute House Bill 5497 (sHB5497), and featured dozens of legislative co-sponsors.[82] As the bill approached final form, the architects of sHB5497 narrowed its ambitions somewhat, but left most of the original proposal intact, including provisions relating to employment leave.[83] Notably, the legislature refined elements of the bill in ways material to Connecticut businesses, particularly regarding the definition of "employer" (based on the number of employees), and the quantity of leave afforded by the DVA to domestic violence victims.[84] The original bill extended the reach of the proposed act to all employers and provided for an unlimited (that is, unspecified) amount of leave time.[85] Later amendments set the definition of employer as those employing three or more people, and fixed the amount of leave available annually to a set period of twelve days.[86]

The resulting DVA, signed by the governor into law effective October 1, 2010, integrated a number of key elements into the Connecticut General Statutes. First, the DVA sought to streamline judicial processes related to domestic violence. Toward that end, the DVA expands the scope of documents a court can consider in reviewing a petition for relief from physical abuse, allows the court to consider the conduct of an offender in other jurisdictions, permits the availability of protective orders during probationary periods, and fortifies the rigor of the persistent offender law in domestic violence cases.[87] Second, the DVA created an electronic monitoring program for domestic violence

[82] *See* JUDICIARY COMM., BILL STATUS REPORT FOR SUBSTITUTE FOR RAISED H.B. NO. 5497, Feb. Sess. (Conn. 2010), *available at* http://www.cga.ct.gov/asp/cgabillstatus/CGABSPrint.asp?selBillType=Bill&bill_num=HB05497&whichyear=2010.

[83] Interview with Mae M. Flexer, Democratic Representative, 44th Dist. Conn., in Htfd., Conn. (Dec. 7, 2010).

[84] *Id.*; *see also* H.B. 5497, 2010 GEN. ASSEMB., Feb. Sess. § 14(b) (Conn. 2010) (as introduced by Comm. on Judiciary), *available at* http://www.cga.ct.gov/2010/TOB/H/2010HB-05497-R00-HB.htm.

[85] Flexer, *supra* note 83; H.B. 5497, 2010 GEN. ASSEMB., Feb. Sess. § 14(a)(1) (Conn. 2010).

[86] DVA, *supra* note 10, § 15(a)(1).

[87] DVA, *supra* note 10, § 1.

offenders.[88] This provision allows for the judicial branch to establish a pilot program for monitoring perpetrators of domestic violence. Third, the DVA encourages, but does not require, the establishment of three special court dockets for domestic violence matters.[89]

The fourth key element, most relevant to this discussion of domestic violence and the workplace, protects employees from employment consequences (such as termination and other punitive steps) as a result of their status as domestic violence victims.[90] The DVA further accomplishes this goal by providing victims of domestic abuse with twelve days of unpaid time off per calendar year from work.[91] The leave can be used for a broad spectrum of purposes in relation to domestic violence, including medical care and counseling, participation in a civil or criminal proceeding, relocation of one's residence, and to obtain assistance from a victim services organization.[92] While the leave cannot affect other forms of leave available under other state or federal law, it can take the form of compensatory or vacation time, personal days and other employer furnished paid time off.[93]

In the interests of preventing fraud and abuse, the DVA allows employers to require (not more than) seven days' notice, where practicable, and the submission of police or court records or a signed statement from a relevant service provider to verify the appropriate nature of the leave.[94] Contrary to other applicable Connecticut and federal laws, availability of leave under the DVA does not require that an employee satisfy a tenure or term of service requirement.[95] Finally, violations of the DVA's provisions, including improper denial of leave, can lead to a direct civil action, which a domestic violence victim must file within 180 days.[96]

The DVA offers some inherent advantages over many of the alternatives discussed earlier by virtue of its maintaining a focus on domestic violence by protecting individuals due to their status as victims and furnishing modest opportunities for leave to address matters peculiar to that status. The DVA also furthers criminal proceedings statutes and seems to avoid the problems inherent with shoehorning leave provisions into the CTFMLA or other existing statutory regime. The most important impacts, however, may fall upon the employees who

[88] *Id.* § 3.
[89] *Id.* § 13.
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] DVA, *supra* note 10, § 13.
[94] *Id.* § 15.
[95] *Id.*
[96] *Id.*

benefit from the DVA and the employers who must follow its requirements.

B. Strengths of the DVA

The DVA in its current form has much to offer. Employees benefit from the DVA because it applies to all but the smallest of employers. Whereas the DVA defines employer as any person engaged in business with three or more employees, both the CTFMLA and the FMLA have considerably higher employee-number thresholds.[97]

The DVA also addresses domestic violence broadly. The required leave may be used not only for immediate medical care related to domestic violence, but for longer-term psychological or other counseling related to the victim's injuries, as well.[98] The DVA recognizes the potential need for medical and victim services, attendance at relevant legal proceedings, and relocation of one's residence in order to avoid the abuse, while furnishing crisp definitions of the types of leave afforded.[99] As a result, it empowers victims to get the help they need while securing their right to stay employed, provide for themselves and their families, and take advantage of the economic means to escape abuse. Special dockets and administrative efficiencies furnished by the DVA may further assist victims in reducing the amount of leave necessary.[100]

Moreover, the DVA takes the needs of employers expressly into consideration. If leave is foreseeable, such as a planned medical appointment, the DVA enables employers to require as much as one week's advance notice before the leave begins.[101] The notice must also disclose the intended purpose of the leave.[102] This enables the employer better to manage potential disruptions in the workplace that might arise from the employee's temporary departure.

Furthermore, employers have tools available to certify the validity of the leave and minimize abuse or fraud through the DVA. An employer has the right to request a signed written statement from the employee confirming that the leave is for a purpose authorized under the DVA.[103] An employer also may request official records related to the domestic violence episode, or signed statements from appropriate government officials.[104]

[97] *Id.* § 15(a)(1).
[98] *Id.* § 15(b).
[99] DVA, *supra* note 10, § 15(b)
[100] Tindill & Blozie, *supra* note 9.
[101] DVA, *supra* note 10, § 15(c).
[102] *Id.*
[103] *Id.* § 15(d).
[104] *Id.*

More generally, by allowing employees to seek the assistance they need, the DVA may help curb some measure of unplanned absenteeism and productivity drain currently borne by employers. The DVA may lead to a safer workplace through the tightened court processes and provisions of leave allowing victims to secure protection. All of this, in turn, can help with workplace morale and empower employers to follow their better instincts. Most employers probably want to do the right thing by their employees in the face of something as potentially devastating as domestic violence, and such an act can furnish the pathway for fair, balanced treatment of a workforce and the needs of a domestic abuse victim. That the DVA is fairly clear and explicit also helps with administration. The terminology is clear, so employers can understand its implications, and the DVA's consistency with the criminal leave statute provisions may make it susceptible to relatively easy adoption into existing employer policies.

C. Limitations of the DVA

The DVA is not without problems. Some problems may be resolved as courts refine and interpret the language of the DVA in litigation. Other issues may need to be resolved through later statutory reforms.

One of the significant challenges of the DVA is the time given for permitted leave. The 12-day annual unpaid leave period does not coincide with other periods of leave in related employment statutes. The DVA states that provided leave does not impact any other leave under state or federal law. The result may be a stacking effect of DVA leave and FMLA leave for the same or closely related occurrences. Other than the three-employee minimum coverage size, the annual leave period is also not sensitive to the resources and limitations the employer has to accommodate such leave. The cumulative impact of DVA leave, FMLA leave, and other protections on employers could be both significant and burdensome.

Regarding the burden on small and entrepreneurial businesses, Connecticut might have chosen to include a reasonable accommodations feature to the leave portions of the DVA. Under such a balancing provision, the employer could weigh an employee's request and need for leave against the needs of the business in order to avoid potentially devastating effects that the proposed leave might cause.

While a balancing-of-needs mechanism may have modest application for most businesses most of the time, it might be a crucial circumstance for a very small business at a critical time. Entrepreneurial businesses, in particular, enjoy relatively little margin for error. The elevated interdependencies among complementary-skilled team members and typically austere budgets make it extremely difficult for a new firm to account for the unplanned absence of an employee. Unlike other businesses of even a similar small size, an entrepreneurial firm may not have had the opportunity to develop redundant skill sets and other prophylactic mechanisms to absorb an unplanned leave event. Moreover, even if sufficient capital somehow existed (highly unlikely, in many cases), the often frenzied pace of operations in such a firm complicates matters greatly, and may eliminate options available to other small businesses, such as contracting with temporary service firms to backfill a role. A higher minimum employee size would enable small businesses to avoid the significant burden the DVA might impose.

Finally, the 180-day period for an employee to bring an action alleging a violation of the law by the employer may be too short.[105] This period is the same as that given employees who want to file discrimination claims under Title VII of the Civil Rights Act of 1964.[106] However, for someone struggling through relentless domestic violence that also may have been improperly terminated for taking permissible leave to escape the abuse, finding the wherewithal to look into filing a potential civil action within such a narrow period may prove difficult. Given the relative clarity of the DVA's provisions, it would not work an undue hardship on a violating employer to face a longer statute of limitations provision more in line with typical actions in contract and tort.

CONCLUSION

Domestic violence is a crippling problem for far too many people. Victims of domestic violence may feel isolated and unable to avail themselves of criminal legal protections. Such abuse can have devastating consequences for an individual's self-esteem and overall mental health.

Domestic violence not only impacts the victim, but also the victim's employer. Domestic violence has a material impact on employee productivity. Employees may miss work because of such violence or becomes less productive due to the mental stress placed upon them because of the abuse. Although employers rarely participate in domestic violence, the effect of such violence can be felt acutely in the workplace.

The DVA represents an important remedy to domestic violence victims in relation to their employers. It establishes objective standards by which employers and employees can mutually resolve domestic violence problems. While requiring the availability of twelve days leave per year, it also ensures that the employer can receive sufficient documentation about the problem and receive notice about leave

[105] *Id.* § 14(c).
[106] 42 U.S.C. § 2000e-5(e)(1) (2006).

whenever possible. Ideally, an employee suffering from domestic violence should be able to avail herself of necessary state resources without fear of employment discharge. The employer should have the opportunity to work with the employee to minimize disruptions to business operations as much as possible.

The DVA is not perfect. Some language remains unclear and perhaps it is inevitable that litigation will occur over interpretation of the new statute. However, from the perspective of the employee who is regularly subjected to violence or the threat of violence at home, the DVA represents an important innovation in protection from the economic consequences of this odious behavior.

STATE RESTRAINTS ON PRESCRIPTION RECORDS: "CONSTITUTIONAL FLU" OR LEGITIMATE REMEDY?

by CARTER MANNY*

I. INTRODUCTION

According to Harvard Law School Professor Laurence Tribe, "constitutional flu" afflicted Northern New England when the states of New Hampshire, Maine and Vermont enacted statutes[1] in 2006 and 2007 limiting the dissemination and use of prescription information collected from pharmacies for the purpose of marketing drugs.[2] Since the 1990s, pharmacies have been selling prescription records to data mining companies that assemble reports which identify each doctor's history of prescribing specific pharmaceuticals.[3] The reports are sold to

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1 N.H. REV. STAT. ANN. § 318:47-f, 22 ME. REV. STAT. ANN. § 1711-E and 18 VT. STAT. ANN. § 4631.

2 *See* Laurence H. Tribe, *The Fatal First Amendment Flaw in Prescription Restraint Statutes, available at* http://www.wlf.org/publishing/publication_detail.asp?id=2125 (visited Mar. 2, 2011). Professor Tribe states in the article that he is a "non-litigating consultant" to IMS Health, a data mining company that has challenged the constitutionality of the statutes.

3 *See e.g.,* Gwen McLean, *Access: Restricted Selling pharmaceuticals under the Physician Data Restriction Program*, *available at* http://www.modernmedicine. com/modernmedicine/ article/ articleDetail.jsp? id=401674&sk= &date = &page ID=2 (visited Mar. 22, 2011)(Ms. McLean states that prior to the mid-1990s, sales representatives for drug companies did not have access to prescribing history data for each physician. Gwen McLean is a managing editor of Informa Training Partners, an organization which provides training for salespeople in the pharmaceutical industry. *See* Gwen McLean, *Formula for success: Using ethical pharmacology to support your message*, *available at* http://pharmrep.findpharma. com/pharmrep/article/articleDetail.jsp?id= 114600&search String=formula%2520 for%2520

drug companies for use by their sales representatives to increase their effectiveness in persuading physicians to prescribe specific products. Critics of pharmaceutical data mining contend that it invades medical privacy, increases the use of inappropriate pharmaceuticals and drives up health care costs through excessive use of expensive brand-name drugs rather than lower-priced alternatives.[4]

Data mining companies challenged each statute under the First Amendment of the U.S. Constitution as a violation of their rights of free speech.[5] The challenges were successful in federal district courts in New Hampshire[6] and Maine,[7] but failed in the First Circuit Court of Appeals which upheld both laws.[8] The Vermont statute was upheld at the federal district court level,[9] but was invalidated by the Second Circuit Court of Appeals.[10] With a split between the circuits, in early 2011 the U.S. Supreme Court granted *certiorari*[11] to the case from Vermont. The case presents an opportunity for the Supreme Court to develop First Amendment jurisprudence with respect to laws which protect information from commercial exploitation. This article examines First Amendment issues regarding the three states' statutes as of March, 2011, prior to the U.S. Supreme Court's decision in the case from Vermont.

success (visited Mar. 22, 2011)).

[4] *See, e.g.*, David Orentlicher, *Prescription Data Mining and the Protection of Patients' Interests*, 38 J. L. MED. & ETHICS 74 (2010).

[5] IMS Health, Inc., and Source Healthcare Analytics, Inc. challenged all three statutes. Verispan, LLC, was named as a plaintiff in the challenges to the Maine and Vermont statutes. All three companies mine medical data. *See* IMS Health Inc. v. Ayotte, 490 F.Supp. 2d 163 (D. N.H. 2007), *rev'd*, 550 F. 3d 42 (1st Cir. 2008), *cert. denied,* 129 S. Ct. 2864 (2009): IMS Health Inc. v. Rowe, 532 F.Supp. 2d 153 (D. Me. 2007), *rev'd sub nom.* IMS. Health v. Mills*,* 616 F. 3d 7 (1st Cir. 2010), *petition for cert. pending sub nom.* IMS Health Inc. v. Schneider*,* No. 10-984 (filed Jan. 28, 2011). IMS Health Inc. v. Sorrell, 631 F. Supp. 2d 434 (D. Vt. 2009), *rev'd,* 630 F. 3d 263 (2d Cir. 2010), *cert. granted,* 562 U.S. ___ (U.S. Jan. 7, 2011), *available at* http://www.supremecourt.gov/orders/ courtorders/ 010711zr.pdf (visited Mar. 23, 2011).

[6] IMS Health Inc. v. Ayotte, 490 F.Supp. 2d 163 (D. N.H. 2007), *rev'd*, 550 F. 3d 42 (1st Cir. 2008), *cert. denied,* 129 S. Ct. 2864 (2009).

[7] IMS Health Inc. v. Rowe, 532 F.Supp. 2d 153 (D. Me. 2007), *rev'd sub nom.* IMS. Health v. Mills*,* 616 F. 3d 7 (1st Cir. 2010), *petition for cert. pending sub nom.* IMS Health Inc. v. Schneider*,* No. 10-984 (filed Jan. 28, 2011).

[8] Ayotte v. IMS Health Inc., 550 F. 3d 42 (1st Cir. 2008) *cert. denied,* 129 S. Ct. 2864 (2009); IMS Health Inc. v. Mills, 616 F. 3d 7 (1st Cir. 2010), *petition for cert. pending sub nom.* IMS Health Inc. v. Schneider*,* No. 10-984 (filed Jan. 28, 2011).

[9] IMS Health Inc. v. Sorrell, 631 F. Supp. 2d 434 (D. Vt. 2009), *rev'd,* 630 F. 3d 263 (2d Cir. 2010).

[10] IMS Health Inc. v. Sorrell, 630 F. 3d 263 (2d Cir. 2010).

[11] IMS Health Inc. v. Sorrell, 630 F. 3d 263 (2d Cir. 2010), *cert. granted,* 562 U.S. ___ (U.S. Jan. 7, 2011), *available at* http://www.supremecourt.gov/orders/courtorders/ 010711zr.pdf (visited Mar. 23, 2011).

II. DATA MINING AND MARKETING OF PHARMACEUTICALS

The pharmaceutical industry employs approximately 90,000 sales representatives, known as "detailers," who market prescription drugs in the United States largely by means of face-to-face meetings with physicians.[12] In the pharmaceutical industry, the marketing activities are known as "detailing."[13] During 2000, the industry spent approximately $4 billion dollars on promotional activities aimed at the approximately 1.5 million medical professionals who have authority to prescribe drugs in the United States.[14] On average, a primary care doctor interacts with twenty-eight pharmaceutical sales people per week, while a specialist interacts with fourteen.[15]

For various reasons, including insurance reimbursement, pharmacies accumulate data about prescriptions they have filled.[16] Although drug companies lack direct access to this information, it has become available through data mining companies who purchase it from pharmacies.[17] Before data are transferred, the pharmacies use encryption software to conceal the identities of patients.[18] The data miners process the data to create a detailed record of each physician's prescribing history and sell that information to pharmaceutical companies.[19] Sales of prescriber-identifiable data are big business. A leading medical data mining company, IMS Health, had revenue of $1.5 billion from sales of prescriber-identifiable data in 2005.[20]

Armed with precise information about a doctor's prescribing practices, a sales representative is able to use various tactics for promoting sales of her company's products. She can put more effort into targeting physicians who regularly prescribe competing drugs, doctors who prescribing large quantities for particular conditions and physicians who have a history of prescribing drugs that have just come onto the market.[21] Some doctors are offended by sales people who challenge them with the doctor's own prescribing history.[22] Despite evidence that

[12] *See, e.g.,* Stephanie Saul, *Doctors Object as Drug Makers Learn Who's Prescribing What*, NY TIMES, May 4, 2006 at A1.

[13] *Id.*

[14] *See, e.g., Ayotte,* 550 F.3d at 46.

[15] *See, e.g., Id.* at 47; *Mills*, 616 F.3d at 32.

[16] *See, e.g., Mills,* 616 F.3d at 15.

[17] *See, e.g. Id.* at 15.

[18] *See, e.g. Id.* at 16.

[19] *See, e.g. Ayotte*, 550 F.3d at 45.

[20] See, e.g., *Mills*, 615 F.3d at 45.

[21] *See Id.* at 47.

[22] *See, e.g.*, Puneet Manchanda & Elizabeth Honka, *The Effects and Role of Direct-to-Physician Marketing in the Pharmaceutical Industry: An Integrative Review*, 5 YALE J. HEALTH POL'Y & ETHICS 785, 788-91 (2005).

physicians generally have negative views about pharmaceutical sales representatives, and feel that they are not influenced by the promotional activities, there is also evidence that the marketing efforts are successful in causing doctors to prescribe the drugs the sales people are promoting.[23]

III. COMPARISON OF THE THREE STATUTES

The New Hampshire, Maine and Vermont statutes are similar in how they tailor their restrictions. First, each statute limits the scope of data to include only information that identifies the prescriber.[24] Secondly, each statute bans only transfers or uses for commercial or marketing purposes.[25] Consequently, information about prescriptions which does not identify prescribers or which will not be used for marketing is not restricted. The statutes differ in the role prescribers play in activating or waiving the restrictions on use of their prescribing histories. In Maine, the restrictions apply only if the prescriber "opts in" to the protection by filing with the board of licensure.[26] The New Hampshire and Vermont statutes provide restrictions automatically, but the Vermont law explicitly allows a prescriber to "opt out" of the protection

[23] *See, e.g.*, Orentlicher, *supra* note 4, at 75-76.

[24] The New Hampshire statute uses the phrase "prescriber-identifiable data." N.H. REV. STAT. ANN. § 318:47-f. The Maine statute uses the phrase "information that identifies a prescriber." 22 ME. REV. STAT. ANN. § 1711-E(2-A). The Vermont statute uses the phrase "prescriber-identifiable information." 18 VT. STAT. ANN. § 4631(a).

[25] The New Hampshire statutory ban is for transfers or uses "for any commercial purpose," and explicitly excepts the purposes of "pharmacy reimbursement; formulary compliance; care management; utilization review by a health care provider, the patient's insurance provider or the agent of either; health care research; or as otherwise provided by law." N.H. REV. STAT. ANN. § 318:47-f. The Maine statute bans transfers or uses "for any marketing purposes." 22 ME. REV. STAT. ANN. § 1711-E(2-A). The Maine statute defines marketing to include "any of the following activities undertaken . . . related to the transfer of prescription drugs from the producer or seller to the consumer or buyer: (1) Advertising, publicizing, promoting or selling . . .; (2) Activities, undertaken for the purpose of influencing the market share of a prescription drug or the prescribing patterns of a prescriber, a detailing visit or a personal appearance; (3) Activities undertaken to evaluate or improve the effectiveness of a professional detailing sales force; or (4) A brochure, media advertisement, or announcement, poster or free sample of a prescription drug." 22 ME. REV. STAT. ANN. § 1711-E(1)(F-1). The Vermont statute bans transfers or uses "for marketing or promoting a prescription drug" and explicitly excepts the purposes of "pharmacy reimbursement; prescription drug formulary compliance; patient care management; utilization review by a health care professional, the patient's health insurer, or the agent of either; health care research; dispensing prescription medications; the transmission of prescription data from prescriber to pharmacy; care management; educational communications provided to a patient, including treatment options, recall or safety notices, or clinical trials; and for certain law enforcement purposes as otherwise authorized by law." 18 VT. STAT. ANN. § 4631(e)(1)-(7).

[26] 22 ME. REV. STAT. ANN. § 1711-E(4-A).

by giving his or her consent on a licensing application or renewal form filed in accordance with a program established by the Department of Health and the Office of Professional Regulation.[27] The New Hampshire statute is silent on a prescriber's ability to waive the restrictions.[28] Violations of the New Hampshire and Maine statutes are deemed to be unfair trade practices under both states' laws.[29] A violation of the Vermont statute is deemed to be a violation of the Vermont Consumer Fraud Act.[30]

IV. DO THE STATUTES REGULATE SPEECH OR CONDUCT?

The judges in the First Circuit's decision in the case involving the New Hampshire statute were divided over the issue of whether it regulated speech or conduct. The majority considered the precise nature of the restriction the statute places on the plaintiffs, the data mining companies. The court reasoned that the law limits only "the ability of data miners to aggregate, compile and transfer information destined for narrowly defined commercial ends."[31] In the majority's view, the statute restricts the conduct, rather than the speech, of the plaintiff data miners because information here has become a commodity.[32] The majority reasoned that the plaintiffs were asking the court "to rule that because their product is information instead of, say, beef jerky, any regulation constitutes a restriction of speech."[33] The majority acknowledged that although speech is affected by the statute, it consists primarily of communications between pharmaceutical sales representatives and doctors, none of whom are plaintiffs in the case.[34] The majority concluded that because the statute regulates conduct rather than speech, the First Amendment does not apply, and the statute is economic regulation subject to review only under a rational basis standard.[35]

In a separate opinion in which Judge Kermit Lipez concurred in part and dissented in part, he disagreed with the First Circuit majority's characterization of the regulated activity as "conduct," and then focused

[27] 18 VT. STAT. ANN. § 4631(c)(1).

[28] N.H. REV. STAT. ANN. § 318:47-f.

[29] N.H. REV. STAT. ANN. § 318:47-f; 22 ME. REV. STAT. ANN. § 1711-E(3).

[30] 18 VT. STAT. ANN. § 4631(f).

[31] *Ayotte*, 550 F. 3d at 52.

[32] *Id.* *See* Neil M. Richards, *Reconciling Data Privacy and the First Amendment*, 52 UCLA L. REV. 1149, 1194 (2005) (concluding that restrictions on use of consumer data to target advertisements were "not a regulation of speech at all, but rather a regulation of information use – the business activity of deciding to whom to market products.")

[33] *Id.* at 53.

[34] *Id.*

[35] *Id.* at 54.

on one of the desired outcomes of the Maine Legislature as being the modification of marketing messages communicated by sales representatives to doctors.[36] He analyzed the facts as including three separate commercial activities: (1) the transfer of information to data miners, (2) the transfer of the information in aggregated form from the data miners to the pharmaceutical companies, and (3) the use of the information by pharmaceutical sales representatives in their marketing activities directed at doctors. The statute indirectly restricts the marketing messages in the third transaction by imposing restrictions in the first two. Because the Legislature's purposes are linked to the third transaction, Judge Lipez concluded that an assessment of the statute's effect must be focused on the third transaction between the sales representative and the doctor.[37] Accordingly, he reasoned, the regulated activity must be analyzed as speech.

The three judges in the Second Circuit's decision involving the Vermont statute were also divided on whether the statute regulated conduct or speech, with the majority finding that speech was involved.[38] The Second Circuit majority rejected the First Circuit's reasoning by focusing on the Vermont Legislature's intention to correct the massive imbalance in information presented by pharmaceutical sales representatives to doctors and concluded that the statute is "aimed at influencing the supply of information, a core First Amendment concern."[39] The majority also expressed concern that "the obscure distinction between speech and 'information assets' is an insufficient basis for giving the government leeway to 'level the playing' field subject only to rational basis review."[40]

Judge Debra Ann Livingston's carefully reasoned dissent in the Second Circuit's decision involving the Vermont statute reached the same conclusion as the majority in the First Circuit's case from New Hampshire: that "conduct" rather than "speech" is being regulated. She attacked the Second Circuit's majority opinion in the Vermont case as lacking any discussion of how the data mining companies' activities can be deemed to advance the values served by the First Amendment.[41] She characterized the statute as operating as a "permissible restriction on *access* to information," an activity which does not involve the First

[36] *Id*. at 80 (Lipez, J. concurring in part and dissenting in part).

[37] *Id*. at 80 – 81. Judge Lipez cites Boos v. Barry, 485 U.S. 312 (1988) (noting that "[r]egulations that focus on the direct impact of speech on its audience" must be viewed as speech-based for purposes of First Amendment analysis.)

[38] *Sorrell*, 630 F. 3d at 272.

[39] *Id*.

[40] *Id*.

[41] *Id*. at 288.

Amendment.[42] Moreover, she observed that sales representatives do not refer to prescription histories in their conversations with doctors, but use that information to identify doctors most likely to prescribe particular types of drugs, so that sales pitches may be effectively directed at them.[43] The information is also used by pharmaceutical companies to monitor the effectiveness of the marketing practices and to compensate sales people based on the success of their efforts.[44] Judge Livingston criticized the majority for failing to provide any authority for the proposition that the First Amendment protects methods for identifying an audience. She also stated that even if the statute has some effect on the manner in which sales representatives tailor their messages, that effect is a very "thin reed" on which to hang a finding that the Vermont statute restricts speech rather than conduct.[45]

Attempting to categorize the activity regulated by the statutes as "speech" or "conduct" is problematic because elements of both are present in the series of events. Furthermore, the restrictions on use and transfer of prescriber-identifiable information would not have been imposed unless pharmaceutical sales representatives had been using the information to tailor the messages they direct at physicians. Judge Livingston's analysis does not take into account the fact that although the drug companies direct their sales people not to tell doctors that they know the doctor's prescription history, some sales representatives disregard that instruction and confront physicians with the information.[46] Moreover, complaints about the use of prescription history data to pressure prescribers were brought to the attention of the state legislatures before the prescription restraint laws were enacted.[47] Washington University Law Professor Neil Richards suggests an alternative to the "speech" versus "conduct" analysis would be to assume that an activity regulated is "speech" and then focus on what level of protection it should receive under the First Amendment.[48] He argues that there currently are a number of laws regulating "unprotected speech" that should be subject only to scrutiny under a rational basis standard, as well as other laws whose regulations of speech are subject

[42] *Id*. at 289.
[43] *Id*.
[44] *Id*.
[45] *Id*.
[46] *See, e.g.*, Saul, *supra* note 12 (stating that "drug representatives are told not to share the prescribing details with doctors, some nonetheless have confronted doctors with the data").
[47] *See, e.g., Ayotte*, 490 F. Supp. 2d at 173 (summarizing testimony at hearings before committees of the New Hampshire Legislature).
[48] *See* Richards, *supra* note 32, at 1170.

to intermediate scrutiny or strict scrutiny.[49] Although the First and Second Circuits did not explicitly follow Professor Richards' approach, all the judges who characterized the activity regulated by the prescription restraint laws as "conduct," provided an alternative basis for their conclusions by evaluating the statutes under the well-established standards for commercial speech under the First Amendment. Accordingly, the question of whether the activity regulated is "speech" or "conduct" is not crucial in deciding whether the prescription restraint laws are permissible under the First Amendment.

V. IS THE REGULATION OF COMMERCIAL SPEECH PERMISSIBLE?

Although the majority of the judges deciding the First Circuit case initially determined that the activity regulated by the New Hampshire statute was "conduct," they provided an alternative analysis under the First Amendment by also characterizing the regulated activities (the acquisition, manipulation and sale of prescriber-identifiable data) as commercial speech, reasoning that those transactions "at most embody 'expression related solely to the economic speaker and its audience.'"[50] Judge Lipez concurred with the majority, thus making clear that if the New Hampshire statute regulates speech, the First Circuit unanimously viewed that speech as being commercial speech. In a separate case, the First Circuit took the same approach by concluding that if the activity regulated by the Maine statute is speech, it is commercial speech.[51] Similarly, the Second Circuit majority concluded that the Vermont statute restricted commercial speech,[52] while Judge Livingston's dissent followed a similar path as was taken by the First Circuit majority: the regulated activity is first characterized as "conduct," and then as commercial speech.[53] Accordingly, all the opinions analyzed the prescription restraint statutes using the standards for First Amendment analysis of commercial speech developed by the U.S. Supreme Court in *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York*.[54] The analysis for permissible regulation of truthful commercial speech in *Central Hudson* is (1) whether the state has a

[49] *Id*. at 1171 (Professor Richards list examples of laws not perceived to regulate protected speech as including laws involving fraud, criminal threats, conspiracies, the solicitation of criminal acts, securities, antitrust, labor organizing, copyrights, trademarks, sexual harassment, torts and the regulation of professions.)

[50] *Ayotte*, 550 F. 3d at 54, quoting *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York*, 447 U.S. 557, 561 (1980).

[51] *Mills*, 616 F.3d at 19.

[52] *Sorrell*, 630 F.3d at 272-75.

[53] *Sorrell*, 630 F.3d at 286-90.

[54] 447 U.S. 557 (1980).

substantial interest, (2) whether the regulation sufficiently advances that interest, and (3) whether the regulation is sufficiently narrow.[55]

A. Does the State Have a Substantial Interest?

The legislatures in New Hampshire, Maine and Vermont provided similar justifications for passing the prescription restraint statutes: (1) protection of medical privacy, (2) protection of patient health and (3) cost containment.[56] In the First Circuit case from New Hampshire, the majority did not address the first two reasons but focused on cost containment as clearly constituting a substantial interest.[57] In his separate opinion, Justice Lipez agreed that cost containment was a substantial interest, and found that protection of patient health was a substantial interest as well, but rejected protection of medical privacy as a substantial interest, reasoning that the statute only protected the doctor's history of prescribing drugs.[58] In the First Circuit case from Maine, the majority focused only on privacy as a justification and found that Maine has a substantial interest in protecting doctors from unwanted solicitations from pharmaceutical sales representatives.[59] The majority did not focus on the cost containment justification. In a separate opinion, Judge Lipez again found cost containment, but not privacy, to be a substantial interest.[60] In the Second Circuit case from Vermont, the majority found that protection of patient health and cost containment, but not medical privacy, were substantial interests.[61] In the dissent, Judge Livingston found that medical privacy, as well as patient health and cost containment, were all substantial interests.[62] The unanimity of support among the judges of both circuits for the determination that cost containment is a substantial interest reflects the strength of the evidence presented by the states in all three cases. Although evidence presented in support of the other two justifications for the prescription restraint laws was not as strong, it is not necessary for a state to have more than one "substantial interest" to satisfy the first part of the *Central Hudson* standard for commercial speech.

B. Does the Regulation Advance a Substantial Interest?

In the First Circuit case from New Hampshire, the majority found that while there were studies showing that pharmaceutical sales

[55] *Central Hudson*, 447 U.S. at 564.
[56] *Ayotte*, 550 F.3d at 55; *Mills*, 616 F.3d at 17; *Sorrell*, 630 F.3d at 275.
[57] *Ayotte*, 550 F.3d at 55.
[58] *Id.* at 85.
[59] *Mills*, 616 F.3d at 21.
[60] *Mills*, 616 F.3d at 37.
[61] *Sorrell*, 630 F.3d at 276.
[62] *Sorrell*, 630 F.3d at 290.

practices substantially increase the rate at which doctors prescribe brand-name drugs, the evidence in support of the proposition that the sales practices become more successful when the sales people have access to a doctor's prescription history was "less formidable."[63] However, plaintiff data miners did not deny that prescription histories make marketing practices less efficacious, and the record contained "substantial evidence that, in several instances, [sales representatives] armed with prescribing histories encouraged the overzealous prescription of more costly brand-name drugs regardless of both the public health consequences and the probable outcome of a sensible cost/benefit analysis."[64] The majority concluded that there was a sufficient legislative record so deference should be given to the legislature's judgment that restraining the use of prescription histories advances the state's interests.[65]

Judge Lipez's opinion in the case from New Hampshire focused on testimony of doctors explaining how sales representatives use knowledge of a physician's prescription history to persuade doctors to switch from other drugs to the products the sales people are promoting.[66] Judge Lipez also emphasized testimony regarding a "counter-detailing" experience at Harvard Medical School, in which presentations of scientifically sound factual information by pharmacists to doctors reduced the number of inappropriate prescription choices by physicians.[67] He also mentioned results from academic studies indicating that physician-specific marketing by pharmaceutical sales representatives leads to more prescriptions of brand-name drugs, often with no additional patient benefit, but with increased patient costs.[68] Judge Lipez also cited the testimony of a sales representative explaining how knowledge of a physician's prescription history enabled the salesperson to engage in "almost a cat and mouse game" when he got a doctor to state an objection to his company's drug so he could "shift those objections or doubts and downplay or negate them altogether."[69] Another sales representative's similar tactic is contained in a newspaper article included in the New Hampshire statute's legislative history recounting that the sales representative "told of his understanding that, if he learned that a doctor was prescribing a competitor's product, his

[63] *Ayotte*, 550 F.3d at 57.
[64] *Id*. at 58.
[65] *Id*. at 58 – 59.
[66] *Id*. at 90 -91 (Lipez, J. concurring in part and dissenting in part).
[67] *Id*. at 91.
[68] *Id*.
[69] *Id*. at 90 (Lipez, J. concurring in part and dissenting in part)(quoting testimony of Mr. Shahram Ahari.)

presentation should focus on undermining the product."[70] Judge Lipez criticized the trial court for holding the State of New Hampshire to a higher standard of proof than is required by U.S. Supreme Court precedent in commercial speech cases, and noted that it is unrealistic to expect the State to produce empirical evidence showing the extent of the influence of prescriber-identifiable data on physician decision-making when New Hampshire's statute was the first of its kind in the U.S. and had been in effect for less than a year when the trial was held.[71] Based upon his thorough analysis, Judge Lipez concluded that the First Circuit should defer to the New Hampshire legislature's judgment and find that there was a sufficient showing that the statute advanced the state's substantial interest in cost containment.[72]

In the First Circuit case from Maine, the majority opinion devoted only a paragraph to the issue of whether the statute advanced a substantial interest.[73] The majority focused on evidence showing that Maine doctors have identified the use of their prescribing histories as "a singularly objectionable practice."[74] The opinion stated that "both record evidence and common sense" support the conclusion that the harms are real and will be alleviated by the Maine statute "to a material degree."[75] Judge Lipez's concurring opinion is also concise on this issue, mentioning little more than that the record establishes a plausible cause and effect relationship between targeted marketing and higher drug prices.[76]

In the Second Circuit case from Vermont, the majority concluded that the statute did not sufficiently advance the state's interests in cost containment and public health because the method selected was too indirect.[77] It viewed the process of (1) banning the transfer of prescriber-identifiable information from data miners to pharmaceutical companies, causing (2) less effective marketing of brand-name drugs that are more expensive than generic alternatives, leading to (3) fewer prescriptions of brand-name drugs, thereby (4) reducing health care costs and protecting public health by minimizing prescription for more expensive or less tested medications, as being too indirect to meet the

[70] *Ayotte,* 550 F.3d at 91 (Lipez, J. concurring in part and dissenting in part)(quoting Liz Kowalczyk, *Drug Companies' Secret Reports Outrage Doctors*, BOSTON GLOBE, May 25, 2003 at A1.)

[71] *Ayotte,* 550 F.3d at 92-93 (Lipez, J. concurring in part and dissenting in part).

[72] *Id*. at 96.

[73] *Mills*, 616 F.3d at 22.

[74] *Id*.

[75] *Id*.

[76] *Id*. at 37.

[77] *Sorrell*, 630 F.3d at 277 – 79.

standard of advancing the state's interests.[78] The majority then characterized the statute as an attempt by the state to "place its thumb on the scales of the marketplace of ideas" by taking out "some truthful information that the state thinks could be used too effectively."[79]

Judge Livingston's dissent in the Second Circuit case from Vermont concluded that the statute directly advanced all of the state's interests and cited not only the evidence produced at the trial but the reasoning in Judge Lipez's concurring opinion in the First Circuit's case involving the statute from New Hampshire.[80] She also deftly challenged the majority's logic by pointing out that the chain-of-events reasoning they attacked as being too indirect to advance a substantial interest, was the same reasoning they had used to conclude that the Vermont statute implicated the First Amendment.[81] Judge Livingston, like Judge Lipez in the First Circuit, believes that courts should defer to legislatures in this area.[82]

When combined, the majority opinions by the First Circuit in the cases from New Hampshire, Judge Livingston's dissent in the Second Circuit case from Vermont, and especially Judge Lipez's thorough analysis in his separate opinion in the First Circuit's case from New Hampshire, provide ample analysis in support of the conclusion that the prescription restraint statutes meet the requirement of advancing one or more substantial interests. These opinions correctly apply the appropriate legal standard and provide adequate justification for judicial deference to the reasoned judgments of the state legislatures. The majority opinion in the Second Circuit's case from Vermont places too great a burden on the State to show that the Vermont statute advances a substantial interest.

C. Is the Regulation Sufficiently Narrow?

In the First Circuit case from New Hampshire, the majority noted that the question posed by the last part of the *Central Hudson* standard, whether a regulation is no more extensive than necessary to serve the state's interest,[83] has been refined by the U.S. Supreme Court in later cases to include a determination of whether the restriction is in reasonable proportion to the interest served[84] and whether the state could achieve its interest in a manner that does not restrict speech or

[78] *Id*. at 277.
[79] *Id*.
[80] *Id*. at 293 (Livingston, J. dissenting)
[81] *Id*. at 294
[82] *Id*. at 292
[83] *Central Hudson*, 447 U.S. at 564.
[84] Edenfield v. Fane, 500 U.S. 761, 767 (1993).

restricts less speech.[85] The majority evaluated three alternatives to the New Hampshire statute raised by the plaintiffs and considered by the trial court: (1) a ban on gifts from sales representatives to doctors, (2) a program to educate physicians on the benefits of prescribing generic drugs as much as possible, and (3) modification of New Hampshire's Medicaid program so that expensive brand-name drugs for which substitutes exist would be dispensed only if a physician consulted with a pharmacist.[86] The majority noted that the New Hampshire Legislature found that gift-giving was pernicious only when it occurred within the context of a high-intensity sales pitch made possible by the sales person's knowledge of a doctor's prescribing history.[87] Moreover, the majority saw that an unintended consequence of a gift ban would be to cut off the flow of free samples of drugs which doctors typically give to their indigent patients.[88] With respect to an education campaign, also known as "counter-speech," the majority considered that it would be economically unrealistic for states to be able to commit sufficient resources to deal with the pharmaceutical industry's annual four billion dollar "marketing juggernaut" promoting their products.[89] The majority stated that it is "not a ground for striking down a commercial speech regulation that some counter-information campaign, regardless of the cost, might restore equilibrium to the marketplace of ideas."[90] Finally, the majority rejected the modification of the Medicaid program as a realistic alternative by noting that although inserting a laborious step into the decision-making process may prompt doctors to prescribe more generic drugs, the modification will do nothing to correct or eliminate the distorting factors previously introduced by sales representatives into the doctor's prescribing practices.[91] Accordingly, the majority concluded that neither the plaintiff data miners nor the trial court had identified an alternative to the New Hampshire statute that would achieve the state's interests without restricting speech.[92]

Judge Lipez's concurring opinion in the case from New Hampshire noted that the last part of the *Central Hudson* standard has been described in a later U.S. Supreme Court decision as meaning that the state is not required to employ the least restrictive means but must show narrow tailoring of the regulation to the asserted interest, "a fit

[85] Thompson v. Western States Medical Center, 536 U.S. 357, 371 (2002).
[86] *Ayotte*, 550 F.3d at 59 – 60.
[87] *Id*. at 59.
[88] *Id*.
[89] *Id*. at 60.
[90] *Id*. at 60 (citing *Posadas de Puerto Rico Associates v. Tourism Co. of Puerto Rico*, 478 U.S. 328, 344 (1986)).
[91] *Ayotte*, 550 F.3d at 60.
[92] *Id*.

that is not necessarily perfect, but reasonable."[93] He documented criticism of the "reasonable fit" language and the intermediate scrutiny standard for commercial speech in subsequent U.S. Supreme Court opinions.[94] Judge Lipez then cited several articles in which scholars have observed that intermediate scrutiny under *Central Hudson* appears to be moving toward a strict scrutiny standard.[95] In support of his conclusion that the narrow tailoring standard of *Central Hudson* has been satisfied, he noted that the only message proscribed by the New Hampshire statute is one that "incorporates awareness of the doctor's prescribing practices."[96]

In the First Circuit case from Maine, the majority opinion noted that the Maine statute's mechanism requiring physicians to opt-in to confidentiality protection is a "less restrictive means" of vindicating their interest in not having their prescription histories used by sales representatives.[97] The majority then refered to its prior opinion in the case from New Hampshire to reject as ineffective the alternatives of banning free samples, educating doctors and implementing formulary controls.[98] In his concurring opinion, Judge Lipez also relied on his analysis in the prior case from New Hampshire to conclude that the Maine statute meets the last part of the *Central Hudson* standard.[99] He criticized the trial court for seeming to assume that the alternatives it has considered would be just as effective as the statute in advancing the state's interest in cost containment.[100] Judge Lipez emphasized that the evidence in both the New Hampshire and Maine cases supported the

[93] *Id.* at 96 (Lipez, J. concurring and dissenting)(quoting *Board of Trustees of State University of New York v. Fox*, 492 U.S. 469, 480 (1989)).

[94] *Ayotte*, 550 F.3d at 96 (Lipez, J. concurring and dissenting)(citing Thompson v. Western States Medical Center, 535 U.S. 357, 367-68 (2002); Lorillard Tobacco Co. v Reilly, 533 U.S. 525 (2001); Greater New Orleans Broadcasting Association v. U.S., 527 U.S. 173, 184 (1999)).

[95] *Id.* at 97 (Lipez, J. concurring and dissenting)(citing Troy L. Booher, *Scrutinizing Commercial Speech*, 15 GEO. MASON U. CIV. RTS. L. J. 69, 77 (2004); R. Michael Hoefges, *Regulating Professional Services Advertising: Current Constitutional Parameters and Issues Under the First Amendment Commercial Speech Doctrine*, 24 CARDOZO ARTS & ENT. L. J. 953, 989 (2007); Emily Erickson, *Disfavored Advertising: Telemarketing, Junk Faxes and the Commercial Speech Doctrine*, 11 COMM. L. & POL'Y 589, 602 (2006); Elizabeth Spring, *Sales Versus Safety: The Loss of Balance in the Commercial Speech Standard in Thompson v. Western States Medical Center*, 37 U.C. DAVIS L. REV. 1389, 1404 (2004)).

[96] *Ayotte*, 550 F.3d at 97 (Lipez, J. concurring and dissenting).

[97] *Mills*, 616 F.3d at 22.

[98] *Id.* at 22 – 23.

[99] *Mills*, 616 F.3d at 37 (Lipez, J. concurring and dissenting).

[100] *Id.*

view that despite the expertise of medical professionals, sales representatives are able to influence prescribing decisions.[101]

In the Second Circuit case from Vermont, the majority applied the same "reasonable fit" standard mentioned by Judge Lipez in the First Circuit case from New Hampshire, but in a highly restrictive way to conclude that the "fit" between the Vermont statute and the state's interest is poor.[102] The majority pointed out that the statute applies to all brand name prescription drugs regardless of a drug's efficacy or whether it has a generic alternative.[103] Because the court characterized the state's interest as the regulation of new and allegedly insufficiently tested drugs in cases where there are cheaper generic alternatives available, it concluded that the state should limit its measures to those drugs alone.[104] The majority stated that there is no need for the court to consider what level of deference it should give to the Vermont Legislature because the Legislature has not narrowed the scope of the statutory restraint to prescription drugs for which there are generic alternatives and drugs whose efficacy is in question. The majority then characterized the statute as a "categorical ban."[105]

The majority in the Second Circuit case also considered alternatives to the statute's restriction on physician-identifiable data. They reasoned that the State could wait to determine the effectiveness of its newly funded "counter-speech" program, which includes "academic detailing"[106] and sample generic vouchers.[107] Although there was expert testimony that it was not realistic for the State of Vermont to spend the same amount of money on counter-speech as the pharmaceutical industry spends on marketing, the majority characterized the testimony as falling "far short of demonstrating that the alternatives would be inadequate." The majority also raised the possibility that the State of Vermont could require that generic drugs be used as a first course of action, absent a doctor's determination to the contrary, for Medicare patients.[108] The majority concluded that the State has not met its burden of

[101] *Id.*
[102] *Sorrell*, 630 F.3d at 279.
[103] *Id.*
[104] *Id.*
[105] *Id.* at 281
[106] "Academic detailing" is a presentation to a physician of scientifically sound factual information about a drug by a qualified expert in the field who has no financial interest in the sale of the drug. It can be part of an outreach program affiliated with a teaching hospital or medical school. *See, e.g.,* Steven B. Soumerai and Jerry Avorn, *Principles of Educational Outreach ("Academic Detailing") to Improve Clinical Decision Making*, 263 J. AM. MED. ASSN. 549 (1990).
[107] *Sorrell*, 630 F.3d at 280.
[108] *Id.*

demonstrating why these alternatives, either alone or in combination, would not be sufficient to achieve the government's interests.[109]

Judge Livingston's dissent in the Second Circuit case characterized the statute's restriction on speech as both "minimal and indirect" because the statute only limits the message sales representatives convey by preventing them from "tailoring" the message based on a doctor's prescription history.[110] She repeated her conclusion that the State has a substantial interest in medical privacy, as well as in public health and cost containment accepted by the majority.[111] She reasoned that none of the alternatives suggested by the majority would address all three state interests because none would further the protection of medical privacy.[112] Judge Livingston concluded by asserting that the majority does not perform a proportionality analysis at all but "converts the 'reasonable proportionality' standard into a far more aggressive form of inquiry which, in effect, if not form, bears striking resemblance to strict scrutiny.[113]

With respect to the last part of the *Central Hudson* standard, the judges on the First Circuit and Judge Livingston from the Second Circuit take a similar approach and apply the standard with flexibility and deference to legislative determinations. They view the statutory restraints on speech as being indirect and minimal by restricting only those messages which incorporate "awareness of a doctor's prescribing practices."[114] They provide well-reasoned explanations why alternatives to the prescription restraint statutes are ineffective, unrealistic or both. In contrast, while the majority opinion in the Second Circuit case acknowledged that the last part of the *Central Hudson* standard has some flexibility, it applied the standard in a highly rigid way. The majority characterized the Vermont statute as being a poor fit with the state's interests because it did not narrow the targeted drugs in the narrowest possible way. The majority's dismissal of the adequacy of the State's evidence as to the feasibility of alternatives is surprising, considering the strength not only of the evidence but the strength of the First Circuit's reasoning regarding similar alternatives. Underlying the approach taken by the majority in the Second Circuit case seems to be an assumption that the last part of the *Central Hudson* standard requires the state to adopt the narrowest possible restraint.

109 *Id.*
110 *Sorrell*, 630 F.3d at 295 (Livingston, J. dissenting).
111 *Id.* at 296.
112 *Id.*
113 *Id.*
114 *Ayotte*, 550 F.3d at 97 (Lipez, J. concurring and dissenting).

VI. CONCLUSION

Aside from its awkward analysis of the New Hampshire and Maine prescription restraint statutes as regulating "conduct" rather than "speech," the First Circuit's analysis of First Amendment issues is correct. In his separate opinion, Judge Lipez presents a thorough and thoughtful explanation of why the New Hampshire and Maine statutes meet the standards for commercial speech originally set forth in *Central Hudson*. He applies those standards in a way that recognizes that legislatures are entitled to some leeway when crafting information restraints that further strong public interests. In contrast, the majority opinion in the Second Circuit case from Vermont seems to be based on an assumption that commercial speech is sacrosanct and cannot be limited directly or even indirectly, unless a legislature imposes the narrowest possible restraint. Judge Livingston's dissent correctly points out many of the weaknesses in the majority opinion which result from this flawed assumption. If the U.S. Supreme Court follows the overly-restrictive application of the *Central Hudson* standard in the majority opinion in the Second Circuit's case from Vermont, the crippling effect on legislative ability to protect information in databases from harmful commercial exploitation may be far worse than the "flu" alleged by Professor Tribe.

VICIOUS CYCLE: HOW LAWYERS PERPETUATE DELAWARE'S DOMINANCE AND INDETERMINACY

by ROBERT MILLER*

INTRODUCTION

This article addresses the impact of Delaware's lawyers and judges, as well as out-of-state lawyers who specialize in Delaware law (hereinafter "Delaware specialists"), on Delaware's ability to win the race for incorporations in spite of its indeterminate law. Delaware specialists shepherd out-of-state incorporations into Delaware. Delaware's lawyers and judges create indeterminate law benefiting all three groups. The indeterminacy of Delaware fiduciary duty law and director exculpation highlights some of the results of Delaware's indeterminacy. However, stockholder initiation of state of incorporation changes (hereinafter "stockholder initiation") could break the cycle. If the states or the federal government require shareholder initiation, corporations may choose to incorporate in states with more determinate law. As a result, states could try to maximize corporate migration and new incorporations by engaging in a "limited race to certainty". Such a race refers to a state propagating determinative corporate law rules, supported by state politicians and the state bar, to lure corporations to incorporate in that state. Although other states could engage in a limited race to certainty, Georgia's high annual franchise tax enlarges its potential benefits compared to other states.

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Delaware's lawyers and judges, together with Delaware specialists, all benefit from Delaware's indeterminate law, while Delaware specialists supply a steady flow of out-of-state incorporations. Delaware judges benefit because they are less constrained by indeterminate precedent so they can pronounce more equitable judgments. Delaware lawyers benefit from the increased litigation and accompanying fees derived from the indeterminate law. Delaware specialists benefit from the demand for their knowledge of Delaware law which is scarce due to its complexity and indeterminacy. Lawyers control incorporation decisions and when Delaware specialists control Initial Public Offerings (IPOs) and reincorporation decisions they will create continual demand for their knowledge by incorporating in Delaware. Without directors and lawyers searching for the most determinate law, Delaware lawyers and judges are free to perpetuate indeterminate law and reap the accompanying rents.

Delaware has long been viewed as the winner of the race for predictability and stability (hereinafter, the "race for certainty"),[1] but its indeterminate fiduciary duties and exculpation standards betray such a belief. Considerable controversy surrounds the contours of Delaware's fiduciary duties and even their exact number.[2] Recent cases may have placed good faith as a sub-duty of the duty of loyalty, but questions regarding the actual contents of good faith were simply shifted to the duty of loyalty.[3] The change-in-control duties are also very indeterminate as subsequent cases have only made the original uncertain standards even less concrete.[4] Because exculpation is a function of how a fiduciary duty claim is defined, the indeterminacy of Delaware's fiduciary duties directly impacts exculpation standards. Moreover, significant overlap among §102(b)(7)'s exceptions to exculpation cloud the scope of exculpation.[5] Neither the Delaware courts nor its legislature have made either the duty regime or the exculpation standards more determinate. Why should they? The same lawyers and

[1] Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* I J.L. ECON. & ORG. 225, 240-41 (1985).

[2] *See* William J. Carney & George B. Shepherd, *Symposium: The Mystery of Success of Delaware Law: The Mystery of Delaware Law's Continuing Success,* 2009 U. ILL. L. REV. 1, 14 (2009) (citing Paul T. Schnell, *From the Editor – M&A at Year's End, M&A Law*. 3-4 (Glasser Legal Works, Jan. 2005) ("The law governing the responsibilities of directors has become so muddled that, incredibly, one can't get a consistent answer to the most basic corporate law question of how many fiduciary duties directors have – if you ask Delaware lawyers, the answer can range from two to five!")).

[3] *See* Stone v. Ritter*,* 911 A.2d 362, 364 (Del. 2006) (*en banc*).

[4] *Compare* Blasius Indus, Inc. v. Atlas Corp.*,* 564 A.2d 651, 658-63 (Del. Ch. 1988) *with* Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del Ch. 2000).

[5] Del. Code Ann. Tit. 8, §102(b)(7) (2011). *See infra* note 121 and text accompanying.

judges obtain rents from indeterminacy which do not adversely affect Delaware's rate of out-of-state incorporations.

One possible cure for this perpetual cycle is stockholder initiation. If stockholders can initiate changes, then analysis of the state of incorporation will shift from the monopoly of corporate counsel, probably Delaware specialists, to other lawyers or even investment banks who could suggest changing the state of incorporation to a state with more determinate law. Furthermore, if stockholders begin to initiate changes, directors will reconsider their state of incorporation to preempt stockholder initiation.

Stockholder initiation could open the door for Georgia to wage a limited race to certainty against Delaware. Georgia's limited race would only require enacting determinate corporate law rules instead of an impossible assault on Delaware's already formidable infrastructure. Many states will not participate in such a race because they do not make sufficient sums from the franchise taxes on corporations who do not transact business within their borders. Other states face independent legal barriers which make them objectively unattractive for incorporation.[6] However, Georgia's annual franchise tax structure would allow it to generate greater revenue from out-of-state corporations relocating to Georgia, even if they do not transact business within Georgia's borders, than all other states except Delaware.[7] Additionally, Georgia's corporate bar would benefit from the increased corporate workload and two of its more distinguished members, William Carney and George Shepherd, strongly influence the Georgia Corporate Code and are highly critical of Delaware's indeterminate duty scheme.[8]

In Part I, this article outlines the race for incorporations and why this article focuses on the race for certainty rather than its more famous counterparts, the "race to the bottom theory" (hereinafter the "race to the bottom") or the "race to the top theory" (hereinafter the "race to the top") . Part II profiles the cycle of indeterminate law and Delaware incorporations perpetuated by Delaware lawyers, Delaware judges and Delaware specialists. Part III profiles Delaware's indeterminate fiduciary duty scheme and focuses on the duty to monitor and change-in-control duties. It concludes by considering the obstinacy of Delaware lawyers and judges in rejecting changes to make Delaware's law more determinate. Part IV considers the indeterminacy of Delaware's

[6] *See* N.Y. BUS. CORP. LAW 630 (McKinney 2002) (provides for unlimited wage claims against the ten largest stockholders of a corporation).

[7] *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 689 tbl.1 (2002).

[8] *See* Carney & Shepherd, *supra* note 2 (criticizing the indeterminacy of Delaware corporate law).

exculpation statute, §102(b)(7). Part V considers the possibility of stockholder initiation to break the stranglehold of Delaware specialists on incorporation decisions. Part VI considers the limitations of a possible challenge and why Georgia, and other states, could challenge Delaware.

I. RACING FOR INCORPORATIONS

Corporate law scholars have long chronicled the competition amongst states for corporate charters.[9] States compete for benefits flowing from corporate charters, including tax revenue and indirect benefits such as jobs and legal fees.[10] Three prevalent theories, or "races," encapsulate the modern views of state charter competition. The race to the top holds that market forces align director and stockholder incentives and so directors will choose states whose corporate laws maximize stockholder value.[11] The race to the bottom claims that states adopt corporate laws that favor directors' interests because directors make reincorporation decisions.[12] The third possibility is race for certainty whereby stability and predictability of legal rules drive directors' incorporation decisions.[13] The normative implications of the race to the bottom versus the race to the top are uncertain. However, certainty is crucial to both directors and stockholders because it decreases transaction costs and litigation. The obstinacy and rent seeking of Delaware's lawyers and judiciary inhibits its ability to win the race for certainty.

The efficiency of the market for corporate charters is not constrained by the easy, low cost incorporation process. Incorporation is predicated upon neither the domiciliary or residence of the founder nor the entity she endeavors to incorporate.[14] States only require that founders file a certificate of incorporation and pay a fee to the secretary of state.[15] States also impose annual franchise taxes in the form of a flat tax, a function of the amount of business done by the corporation in state, or a combination of the two options.[16] Although aggregated corporate fees

[9] *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663, 665-66 (1974).

[10] *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency,* 15 DEL. J. CORP. L. 885, 888 (1990). (In Delaware, corporate franchise taxes and fees accounted for approximately 20% of general fund revenues in 1990.).

[11] *See, e.g.,* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law,* 26 J.L. & ECON. 395, 398 (1983); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law,* 76 NW. U. L. REV. 913, 919-20 (1982)

[12] Cary, *supra* note 9, at 665-66.

[13] Romano, *supra* note 1, at 240-4.

[14] *See generally* 8 Del. C., § 101(a) (1953).

[15] *See generally* 8 Del. C., § 101(a) (1953).

[16] Kahan & Kamar, *supra* note 7, at 688.

and taxes can substantially benefit a state like Delaware,[17] individual taxes and fees are not sufficient to significantly affect an individual corporation's search for the optimal state of incorporation. Additionally, undercutting all other states' prices is not a simple solution because differences in the quality of law, services and network benefits are significantly more important.[18]

The race to the bottom focuses on states' incentive to enact corporate laws protecting directors. The board of directors controls incorporation because it can initiate changes in the state of incorporation subject to stockholder approval.[19] Accordingly, states should cater to directors.[20] Race to the bottom proponents argue that market discipline is lax and managers can take advantage of states providing lenient liability rules and takeover defenses to the detriment of stockholders.[21] Therefore, states will compete by creating more lenient corporate governance rules.

The race to the top holds that state competition for corporate charters will stimulate corporate laws enhancing stockholder value.[22] A security's price reflects the market's judgment of all publicly available information, including a corporation's state of incorporation.[23] If a corporation is not incorporated in the optimal state, investors will price the corporation's stock lower than they would have, but for the suboptimal reincorporation. A lower share price hurts directors in multiple ways. First, it reduces directors' compensation because directors are compensated in stock or its derivatives.[24] Additionally, having a lower share price will increase the corporation's cost of capital, leading to greater vulnerability for hostile takeovers and bankruptcy.[25] Because stockholder and director incentives are aligned, firms will

[17] *Id.* at 688-94 (2002) (illustrating the large amount of corporate fees and taxes generated by Delaware).

[18] Lucien A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 591 (2002).

[19] Lucien A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1460 (1992) [hereinafter Bebchuk, *Federalism*]. Bebchuk notes that stockholder approval provides little restraint on directors' reincorporation decisions because information asymmetries, collective action and distorted choices aid director's proposals. *Id.*

[20] JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 61 (Princeton Univ. Press 2008).

[21] Cary, *supra* note 9, at 705.

[22] Bebchuk, *Federalism, supra* note 19, at 1496-99 (1992).

[23] WILLIAM CARNEY, CORPORATE FINANCE: PRINCIPALS AND PRACTICE, 98-99 (Foundation Press, 2005). This is known as the semi-strong form of the Efficient Capital Markets Hypothesis (ECMH). *Id.*

[24] *Id.*

[25] Stephen M. Bainbridge, *Response to Increasing Stockholder Power: Director Primacy and Stockholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006).

migrate to states whose laws maximize stockholder value.[26] Hence, according to the race to the top, states will compete by creating value-maximizing corporate governance rules.[27]

Discerning the race to the bottom with the race to the top is impossible without knowledge of stockholder preferences. All state statutes require stockholder approval of limitation to director liability.[28] Yet, according to Brown and Gopalan, there are no documented cases of stockholders blocking an amendment.[29] Additionally, all of the Fortune 100 companies, except one, have an exculpation provision.[30] The provisions were identical in providing waiver to the fullest extent of state law.[31] This evidence may suggest low market discipline which would favor the race to the bottom. However, stockholders may want greater protection for directors to promote risk-taking. Without knowing stockholders' preferences, it is difficult to discern whether the race to the top actually differs from the race to the bottom.

A third possibility, the race for certainty, is the focus of this paper because its merits are more obvious than the other two races. The race for certainty holds that a state's ability to lure corporations is contingent upon the predictability and stability of its corporate law because greater certainty lowers transaction and litigation costs for both a corporation and its directors.[32] Certainty is important throughout a corporation's lifecycle but when a corporation considers a major transaction, the importance is magnified.[33] Major transactions breed litigation, and a corporation will benefit from incorporating in a state with more determinate fiduciary duty law. Predicting the appearance of new rules enacted ex-post is difficult but a corporation can minimize uncertainty by choosing a state where such rules are less likely to appear.[34]

II. WHY IS DELAWARE SO INDETERMINATE?

Delaware judges and Delaware lawyers create corporate law and have strong incentives to ensure its indeterminacy. Delaware specialists

[26] Bebchuk, *Federalism, supra* note 19, at 1496-99 (1992).

[27] *Id.*

[28] John F. Olson et al., *Indemnification and Insurance Current Through the December 2009 Update*, DIR. & OFF. LIAB § 1:20 (2009).

[29] *See* J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285 (2009).

[30] *Id.*

[31] *Id.* at 310.

[32] Romano, *supra* note 1, at 273-79.

[33] Carney & Shepherd, *supra* note 2, at 11.

[34] *Id.* at 17. *But see* Romano, *supra* note 1, at 250 (arguing that firms will relocate to Delaware when they are about to engage in a transaction that increase the chances of litigation).

benefit from Delaware's indeterminate law and supply a continual stream of Delaware incorporations. The stream of new incorporations controlled by Delaware specialists allows Delaware's judges and lawyers to produce indeterminate law without losing corporations. Indeterminate law provides rent-seeking opportunities for both lawyers and judges. Indeterminacy increases litigation, which directly benefits lawyers through increased fees. Ex-post duties and fact-specific standards benefit judges by facilitating more equitable judgments less constrained by precedent. Delaware lawyers and judges also directly create the supply of indeterminate law. Lawyers help produce indeterminate standards because of the large overlap between members of the Delaware state bar and members of the Delaware legislature.[35] Judges interpret the statutes indeterminately.[36] Delaware specialists benefit from Delaware's indeterminacy and promote Delaware incorporations. Knowledge of Delaware's law is very valuable because it is complex and constantly in flux. However, the value of the knowledge is a function of the demand for the knowledge. Because Delaware specialists control IPOs and incorporation decisions, they can funnel incorporations to Delaware to insure continual demand for their knowledge.

Lawyers

Delaware's lawyers benefit from Delaware's indeterminacy because it provides greater fees for their work on behalf of Delaware corporations, and it may even increase the number of Delaware incorporations. Both advisory fees and litigation fees are increased by indeterminate legal rules. Therefore, the Delaware bar will not face internal divisions over a tradeoff between advisory and litigation interests.[37] Indeterminacy may help bring corporations and their legal work to Delaware through network benefits.[38] Network benefits accrue when a firm uses the same law as other firms, thereby decreasing transaction costs.[39] Delaware's indeterminacy makes it incompatible with other states' law so Delaware corporations form a "Delaware-only network."[40] The large number of Delaware corporations makes joining this network desirable.

Previous commentators have noted that the bar should be wary of too much uncertainty because it might "kill the proverbial golden goose" and

[35] Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 506 (1987).

[36] *Id.*

[37] *Id.* at 504.

[38] Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1911 (1998).

[39] *Id.*

[40] *Id.*

force Delaware firms to reincorporate elsewhere.[41] Therefore, the bar should seek an equilibrium level of indeterminacy where "the marginal increase in bar revenues from litigation equals the marginal losses in revenues due to reduced incentives to incorporate in Delaware."[42] Nonetheless, Delaware lawyers benefit from indeterminacy up to the point that marginal returns become negative. Delaware lawyers can control the level of indeterminacy through the large overlap between the Delaware state bar and the state legislature.[43]

Judges

Delaware judges' incentives may be aligned with Delaware lawyers' in maximizing litigation. William Cary posited that the close relationship between the Delaware judiciary and bar results from shared experiences representing Delaware corporations.[44] As a result, a pernicious golden rule[45] – how the judges would want to be treated if they were lawyers – may incentivize Delaware judges to maximize fees for their former colleagues.[46] Macey and Miller dismiss Cary's cynical analysis but still come to the same conclusion.[47] They posit that the judiciary creates rules increasing litigation because Delaware judges believe that greater exposure to the judicial system aids Delaware corporations.[48] Indeterminate law grants judges greater discretion and allows for more equitable decisions. More equitable decisions create non-pecuniary rewards for judges including "a belief in better serving society."[49] Because Delaware Chancery Courts have limited jurisdiction, their dockets are not congested.[50] Therefore, a larger caseload creates more opportunities for judges to hone their corporate expertise through analytically challenging cases, another non-pecuniary benefit.[51]

[41] Macey & Miller, *supra* note 35, at 505.

[42] *Id.*

[43] *Id.* at 506; *see also* Earnest L. Folk, *Reflections of a Corporate Law Draftsman,* 42 CONN. B.J. 409, 411 (1968) (noting that the 1968 Delaware Corporate Law Revision Committee "consisted chiefly of pro-management corporation attorneys").

[44] Cary, *supra* note 2, at 691.

[45] In another application of the pernicious golden rule, Hill and McDonald examined the relationship between directors and managers. *See* Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith and Structural Bias*, 32 J. CORP. L. 833, 853 (2007) [hereinafter Hill & McDonnell, *Disney*].

[46] *See* Cary, *supra* note 2, at 691.

[47] *See* Macey & Miller, *supra* note 35, at 502.

[48] *Id.*

[49] Kamar, *supra* note 38, at 1941.

[50] The Chancery Courts do not have jurisdiction over criminal or tort matters. Medek v. Medek, 2008 WL 4261017 (Del. Ch., Sept. 10, 2008) (describing in detail the limited scope of its subject matter jurisdiction).

[51] *Id.*

Delaware further amplifies these rewards because in Delaware, judges operate as the fact-finders, not juries.[52]

Specialists

Indeterminate law benefits Delaware specialists because it increases the value of their scarce skills and may even help replenish their human capital. The incompatibility of Delaware law with the Model Business Corporations Act, or other states' law, increases the value of Delaware specialists if there is sufficient demand for knowledge of Delaware law. Lawyers benefit from having their expertise centered in one jurisdiction because their human capital depreciates at a slower rate.[53] Even though Delaware's indeterminacy may partially mitigate this advantage, hourly fee lawyers may still benefit because they can bill clients for the time of researching problems that also sustains their human capital.[54]

Delaware specialists' direct control of demand for Delaware law through control of incorporation decisions minimizes the corporate migration resulting from Delaware's indeterminacy. A corporation's legal counsel handles the paperwork and logistics of incorporation and exercises substantial influence over incorporation decision itself.[55] The division of work between a lawyer and client creates a classic agency relationship because a client is dependent upon the lawyer's decision and possesses minimal ability to monitor the lawyer's work. [56] Hence, a lawyer may choose the optimal state of reincorporation for his future billable hours, as opposed to the optimal state for the corporation. Jon Coates' article explaining variation amongst takeover defenses provides indirect evidence of lawyers' rent seeking through their control of incorporation decisions.[57] Coates found that the location of the corporation did not correlate with differences in takeover defenses.[58] Instead, the location of the law firm who guided the IPO correlated with the differences between takeover defenses. For instance, Silicon Valley

[52] William M. Lafferty & W. Leighton Lord III, *Towards a Relaxed Summary Judgment Standard for the Delaware Chancery: A New Weapon Against Strike Suits*, 15 DEL. J. CORP. L. 921, 931 (1990). However unlikely, the Chancery Court may use a jury trial. Del. Code Ann. tit. 10 § 369 (2011) ("[w]hen matters of fact, proper to be tried by a jury, arise … the Court of Chancery may order such facts to trial ….").

[53] Romano, *supra* note 1, at 275.

[54] Macey & Miller, *supra* note 35, at 486.

[55] Romano, *supra* note 1, at 275. Romano's survey found the overwhelming majority of firms who changed their state of incorporation stated that the move had been suggested by legal counsel. *Id.*

[56] John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1310-11 (2001).

[57] *Id.* at 1383.

[58] *Id.* at 1379.

law firms, no matter the location of their clients, used fewer defenses.[59] According to Coates, the law firm's decision to adopt defenses, whether predicated upon knowledge of defenses or personal beliefs, predominates instead of the jurisdictional effects.[60] These findings can be analogized to the reincorporation decision as well because Delaware specialists, no matter their location, will shepherd corporations into Delaware.

III. FIDUCIARY DUTIES

This part considers the results of Delaware's indeterminate director duties and its obstinacy in failing clarify them. Although there are many examples of indeterminacy, this article focuses on how *In re Caremark International Inc. Derivative Litigation*[61] and *Stone v. Ritter*[62] illustrate the indeterminacy of the duty of directors to monitor corporate operations (hereinafter "duty to monitor") and the contents of the duty of good faith. Additionally, indeterminacy surrounds Delaware's change-in-control duties which govern directors' standards of liability when they use defensive tactics to combat a takeover, sale or merger of their corporation.[63] *Unocal v. Mesa Petroleum*,[64] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*.[65] and *Blasius Industries, Inc. v. Atlas Corp.*[66] set forth the three best known duties for directors in change-in-control situations.[67] Unlike other legal standards whose later applications clarified them, even after subsequent applications, *Unocal*, *Revlon* and *Blasius* remain extremely indeterminate.[68] Neither Delaware's courts, nor its legislature, have created a spectrum or other framework encompassing all of the fiduciary duties which would make liability more predictable. Considering the benefits its lawyers and judges derive from indeterminacy, their resistance is unsurprising.

Overview

Fiduciary duties constrain directors' actions by punishing directors for actions not in the stockholders' best interests.[69] Delaware's duties breed immense amounts of litigation because they are not only

[59] *Id.*
[60] *Id.*
[61] *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).
[62] Stone v. Ritter, 911 A.2d 362 (2006) (*en banc*).
[63] Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 1980 (2009).
[64] Unocal v. Mesa Petroleum, 493 A.2d 946 (Del. 1985).
[65] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
[66] Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).
[67] Barzuza, *supra* note 63, at 1974.
[68] *See* Carney & Shepherd, *supra* note 2.
[69] *See* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92 (1991).

indeterminate but many are created ex-post.[70] Cyclically, the possible imposition of new duties stimulates complaints while possible personal liability flowing from a new duty encourages settlement. The settlements then stimulate further complaints.

Although the Business Judgment Rule (hereinafter "BJR") protects directors, they still must run the corporation for the benefit of the stockholders. The BJR provides directors and other managers with judicial deference as long as their actions are in good faith and not fraudulent.[71] Breaches of fiduciary duties fall outside the BJR's protection. The traditional director duties in Delaware are the duty of care and the duty of loyalty. The duty of loyalty calls for directors to place the interests of a corporation above a director's personal interests or the interests of any stockholder or officer.[72] Classic breaches of the duty of loyalty stem from a director appearing on both sides of the transaction.[73] The duty of care requires that directors consider all relevant information available prior to making a business decision.[74] In *Smith v. Van Gorkum,* the classic duty of care case, the directors of TransUnion breached their duty of care because they approved a merger too quickly, without considering expert advice.[75] Change-in-control duties are categorized as neither the duty of care nor duty loyalty breaches but breaches of these duties also fall outside the protection of the BJR. Over time, the Delaware Courts enunciated several change-in-control duties outside of the duties of care and loyalty but stricter than the BJR. The most famous examples are *Unocal, Revlon* and *Blasius*.[76] Change-in-control situations, or situations involving the breakup of corporate entities, breed litigation, irrespective of the level of legal determinacy. However, indeterminate law exacerbates the problem.

Caremark & Stone

A *Caremark* claim alleges that directors have insufficiently informed themselves of the decisions of officers and other employees, resulting in a corporate loss. Officers and employees make most corporate decisions while only the most important decisions must be authorized by the board including mergers, executive compensation and distributions to

[70] *See infra* note 121 and accompanying text.
[71] *See, e.g.,* Shlensky v. Wrigley, 237 N.E.2d 776, 779-80 (Ill. App. Ct. 1st Dist. 1968) (illustrates the low threshold of the requirement that directors have some legitimate business reason for their actions).
[72] Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).
[73] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993).
[74] Smith v. Van Gorkum, 488 A.2d 858, 872 (Del. 1985).
[75] *See id.* at 874-880.
[76] Barzuza, *supra* note 63, at 1974.

stockholders.[77] *Caremark* embodies this reality by pronouncing a board's duty to create adequate information gathering and reporting systems that convey information to directors in a timely manner, instead of direct liability for officers' decisions.[78] Hence, when directors have no knowledge of unlawful employee actions and make good faith efforts to remain informed through the creation of a monitoring system, they will not be held liable for failing to monitor the employee's actions.[79]A *Caremark* claim was categorized under the duty of care.[80] However, because the court noted that the claim also required actions in bad faith, questions arose regarding the existence of a third duty, a duty of good faith and its contents.[81]

In *Stone*, the Delaware Supreme Court, re-categorized the duty to monitor and the duty of good faith under the duty of loyalty and ended the debate about a third duty. Seizing on the distinction of bad faith conduct noted by *Caremark*, the court found that the duty to monitor required bad faith conduct but in a significant departure from *Caremark*, "the duty violated by [bad faith] conduct is the duty of loyalty." [82] *Stone* characterized the duty of good faith as a subcategory of the duty of loyalty.[83] Therefore, the duty of good faith cannot provide an independent basis for liability like the duty of care or the duty of loyalty.[84] Following *Stone*, if plaintiffs allege a breach of the duty of good faith, then the complaint sounds in the duty of loyalty.

Stone settled the debate over the number of fiduciary duties in Delaware but it did not clarify the duty of good faith within the duty of loyalty. *Stone* described failures to act in good faith occurring "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[85] However, *Stone* left the door wide open for further permutations because "[t]here may be other examples of bad faith yet to be proven or alleged."[86] The greater

[77] *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 968 (Del. Ch. 1996). These are the decisions that fall within the *Van Gorkum*/duty to be informed prong of the duty of care.

[78] *Id.* at 970.

[79] *Id.*

[80] *Id.*

[81] *See, e.g., In re* Walt Disney Co. Deriv Litig., 906 A.2d 27 (Del. 2006), Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

[82] Stone v. Ritter, 911 A.2d 362, 370 (2006) (*en banc*).

[83] *Id.*

[84] *Id.*

[85] *Id.* (citing *In re* Walt Disney Co. Deriv Litig., 906 A.2d 27 (Del. 2006)).

[86] *Id.*

problem of the uncertainty surrounding the contents of the duty of good faith was simply shifted to the duty of loyalty which had previously only covered conflict of interest cases.[87]

Change-in-Control Duties

The fiduciary standard of *Unocal* imposes duties on directors using antitakeover devices but questions regarding its application and viability make it an indeterminate standard. The *Unocal* standard requires directors to prove the need for a takeover defense through a two-step process of first showing a legitimate threat of takeover and second, if such a threat exists, showing that the antitakeover measures enacted are reasonable in comparison to the threat.[88] *Unocal* originated from concerns that directors use unnecessarily strong takeover defenses to stifle attempted hostile takeovers in order to protect their jobs at the expense of stockholder value.[89] Although a worthy goal, *Unocal* defined neither "legitimate threat" nor "reasonable in comparison."[90] In an effort to crystallize the standard, subsequent Chancery Court decisions distinguished coercive from non-coercive bids.[91] However, the Delaware Supreme Court later stated that such decisions applied the *Unocal* standard too restrictively.[92] Although commentators may disagree on the vitality of *Unocal*,[93] its standard is no clearer than first articulated.[94]

Similar questions surround the *Revlon* duty after subsequent decisions watered-down its duties.[95] *Revlon* originated from concerns that directors would solicit and choose a friendly buyer, or "white knight," and block a larger hostile buyer's bid because the white knight would provide the directors with individual benefits such as retention, consulting contracts or severance.[96] The *Revlon* duty requires that once

[87] Andrew D. Appleby & Matthew D. Montaigne, *Three's Company: Stone v. Ritter and the Improper Characterization of Good Faith in the Fiduciary Duty 'Triad,'* 62 ARK. L. REV. 431 (2009).

[88] Unocal v. Mesa Petroleum, 493 A.2d 946, 954-55 (Del. 1985).

[89] *Id.*

[90] Kamar, *supra* note 38, at 1916.

[91] *See id.* at 1915 (citing Grand Metro. Pub. Ltd. v. Pillsbury Co. 558 A.2d 1049, 1058 (Del. Ch. 1988) and City Capital Assocs. v. Interco, Inc. 551A.2d 787, 796-98 (Del. Ch. 1988)).

[92] Unitrin, Inc., v. American Gen. Corp.*,* 651 A.2d 1361 (Del. 1995); Paramount Commc'ns v. Time, Inc., 571 A.2d 1140 (Del. 1989). *See* Paul L. Regan, *What's Left of Unocal?,* 26 DEL. J. CORP. L. 947 (2001).

[93] *Compare id, with* Barzuza, *supra* note 63, at 1985.

[94] Kamar, *supra* note 38, at 1916.

[95] Carney & Shepherd, *supra* note 2.

[96] *See* Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1781-82 (2007); Hill & McDonnell, *Disney, supra* note 45, at 839.

a corporation is for sale, the board's duty is like an auctioneer who must actively pursue the best price for stockholders.[97] *Revlon's* ex-post nature strengthens the duty because the inquiry focuses on the actual effect of any blocking measure which hinders a sale, instead of the reasonableness of the board's decision at the time of enactment.[98] Instead of building on the strict ex-post standard, the Delaware Supreme Court in *Paramount Communications, Inc. v. QVC Network Inc.,* created a new ex-ante standard which judges directors on the procedure of their decision-making process as well as the reasonableness of their decision at the time it was made.[99] This complete about-face unnecessarily cast doubt upon *Revlon's* continued vitality. Commentators note that the board's decision in *QVC* was unreasonable from both ex-ante and ex-post perspectives.[100] Therefore, *QVC* could have used the *Revlon* standard or announced *Revlon's* demise and the creation of a new standard. Instead, two possible standards exist because no case has applied the easier standards of *QVC* where *Revlon's* would have previously applied.[101]

The *Blasius* standard is a third example of an originally indeterminate standard that subsequent decisions have made even murkier. *Blasius* provides a strict requirement of "compelling justification" when a board's "primary purpose" is the infringement of its stockholder proxy rights, even in good faith.[102] However, it is often difficult to decipher whether a target board's "primary purpose" is a legitimate delay of an election to allow more decision-making time or a denial of stockholders' franchise for self-serving reasons.[103] Similarly to *Unocal* and *Revlon*, later cases have not clarified the *Blasius* standard. In *Chesapeake Corp. v. Shore*, the Delaware Supreme Court stated that a single standard, the *Unocal* Standard,[104] would be preferable, but in the end the court applied the *Blasius* standard.[105] More recently, the *Blasius* standard has been further undermined when the modified *Unocal* reasonableness standard applied to a board's decision to

[97] *Id.* at 184.

[98] Thanos Panagopoulos, *Thinking Outside the Box: Analyzing Judicial Scrutiny of Deal Protection Devices in Delaware*, 3 BERKELEY BUS. L.J. 437, 449 (2006).

[99] Paramount Commc'ns, Inc. v. QVC Network Inc*.,* 637 A.2d 34, 45 (Del. 1993).

[100] Thanos Panagopoulos, *supra* note 98, at 451.

[101] *Id.* (no case has yet decided whether to apply *QVC* instead of *Revlon* where the deal protection measures were sufficient at the time they were imposed but a later offer made them unreasonable ex-post).

[102] Blasius Indus, Inc. v. Atlas Corp*.,* 564 A.2d 651, 658-63 (Del. Ch. 1988).

[103] Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del Ch. 2000).

[104] *Id.* at 323.

[105] *Id.* at 324.

postpone a stockholder meeting.[106] However, in the same case the court also applied the compelling justification standard of *Blasius*.[107] The correct standard to apply in actions against directors for restricting its stockholders' franchise is more indeterminate today than when *Blasius* was first announced.

Obstinacy

Hill and McDonnell suggest a single duty, the duty of loyalty, analyzed as a spectrum spanning from the inattention duty of care cases like *Van Gorkum* to traditional duty of loyalty cases.[108] Basically the greater the chances that the directors' decision will be based upon interests other than maximizing stockholder value, the closer the court should scrutinize the decision.[109] When considering the large intermediate portion of the spectrum, the amount of judicial scrutiny required would be a function of the degree to which the decision lacked good faith.[110]

Appleby and Montaigne contend that the duty of good faith should be the single overarching duty.[111] The duty of good faith is a director's duty to actively pursue the best interests of the corporation.[112] The further a director's alleged actions diverge from fulfilling the interests of stockholders, the stricter the judges should evaluate a director's decisions.[113] Either single duty framework would provide a clearer standard of conduct for directors.[114]

However, neither Delaware's Supreme Court nor its legislature has adopted Hill and McDonnell's or Appleby and Montaigne's frameworks even though it has shown a willingness to consider commentators' proposals. Without a single-duty framework, directors must contend with a multitude of case-specific categories[115] and be vigilant of, "new rules [which] have been announced with remarkable regularity."[116] Delaware courts usually do not provide notice that the new duty will be created which only exacerbates the indeterminacy problem.[117] In

[106] Mercier v. Inter-Tel (Del) Inc., 929 A.2d 786, 810 (Del. Ch. 2007).

[107] *See id.* at 819 (citing MM Co, Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003)).

[108] *Mercier,* 929 A.2d at 839.

[109] *Id.* at 858.

[110] Hill & McDonnell, *Stone, supra* note 96, at 1781-82.

[111] Appleby & Montaigne, *supra* note 87.

[112] *Id.* at 472.

[113] *Id.*

[114] *Id.*

[115] Carney & Shepherd, *supra* note 2, at 16-17.

[116] *Id.*

[117] Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 500 (2009). *But see* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (*en banc*) (noting the possibility of a duty to monitor in regard to red flags).

Desimone v. Barrows, Vice Chancellor Strine specifically addressed commentators' concerns regarding increased director liability under *Stone*.[118] Yet, *Desimone* did not adopt a one-duty framework. Unlike § 102(b)(7)'s quick enaction following *Van Gorkum*,[119] the Delaware General Assembly has not created a new provision for a one-duty framework.

Caremark, *Stone,* the change-in-control cases and the failure to use a single-duty framework all illustrate indeterminacy of Delaware's fiduciary duty law. However, the Delaware lawyers and judges who control the level of indeterminacy of Delaware law benefit from that same indeterminacy if corporations continue to incorporate in Delaware. Meanwhile, as long as Delaware specialists ensure the supply of incorporations, judges and lawyers are not incentivized to make Delaware's law more determinate.

IV. EXCULPATION

The uncertainty surrounding the standards for fiduciary duties in Delaware directly affects the standards for directors' exculpation. The uncertain parameters of § 102(b)(7) and judges' willingness to reformulate plaintiff's claims to survive summary judgment weaken director exculpation. Together, the indeterminate fiduciary duties and the uncertain exculpation standards provide further incentive for settlement. More settlements only incentivize more plaintiff claims and further litigation. Considering the benefits accrued by Delaware lawyers and judges from increased litigation, the continued uncertainty surrounding exculpation is unsurprising.

Overview

Exculpation statutes restrict potential director liability. Following the finding of liability for gross negligence, and the accompanying breach of the duty of care, against the TransUnion board in *Van Gorkum*,[120] the Delaware General Assembly enacted § 102(b)(7) to limit liability for directors and shield them from duty of care violations.[121] Subsequently, every state enacted similar provisions protecting directors,[122] and the

[118] Desimone v. Barrows, 922 A.2d 908, 936 n.92-93, 97 (Del. Ch. 2007).

[119] *See infra* note 12521 and accompanying text.

[120] Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985).

[121] 8 Del. C. § 102(b)(7) 2001.

[122] MARK A. SARGENT & DENNIS R. HONABACH, D & O LIABILITY HANDBOOK: LAW--SAMPLE DOCUMENTS--FORMS (Thompson West ed., 2006) (District of Columbia is the only exception).

vast majority of major public corporations have adopted these protections.[123]

Uncertainty of Delaware Exculpation

The confusion surrounding fiduciary duties in Delaware also affects exculpation. Enacted in response to *Van Gorkum*, § 102(b)(7) exculpates duty of care violations where a board or director is grossly negligent in becoming informed.[124] Section 102(b)(7) lists the exceptions to exculpation:

> (i)[f]or any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.[125]

Because the Delaware Code does not define or use "loyalty" anywhere besides § 102(b)(7), its parameters are uncertain.[126] Previously, this lack of definition would have been unproblematic as the common law duty of loyalty only encompassed self-dealing cases. But in the wake of *Stone*, the parameters of the duty of loyalty include the vaguely defined duty of good faith as well. Because the parameters of the duty of loyalty are uncertain, the parameters of exculpation are derivatively uncertain.

The Delaware legislature has not rewritten § 102(b)(7) even though its overlapping factors cause uncertainty. Section 102(b)(7) employs "good faith" as an exception to exculpation. Does this term apply to good faith conduct or the sub-duty of good faith?[127] "Good faith" should have some meaning beyond a sub-duty of the duty of loyalty considering the duty of loyalty is already mentioned as an exception.[128] This same quandary also surfaces when comparing "improper benefit" and the duty of loyalty. Judge (now Justice) Jacobs provided one implicit answer to the problems of interpreting § 102(b)(7) by stating that it "balkanizes the fiduciary duty of loyalty into various fragments, thereby creating unnecessary conceptual confusion."[129] Therefore, some of the subparts

[123] *See* Brown, Jr. & Gopalan, *supra* note 29.

[124] In the wake of the rising directors' liability insurance premiums following *Van Gorkum*, the Delaware legislature enacted § 102(b)(7). *See* Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkum*, 34 GA. L. REV. 477, 490 (2000).

[125] 8 Del. C. § 102(b)(7) (2001) (emphasis added).

[126] James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liabilty Limitation and Indemnification*, 43 BUS. LAW. 1207, 1212 (1988).

[127] *See* Dennis R. Honabach, Smith v. Van Gorkom*: Managerial Liability and Exculpatory Clauses—A Proposal to Fill the Gap of the Missing Officer Protection*, 45WASHBURN L.J. 307 (2006).

[128] *See* Olson, *supra* note 28.

[129] Emerald Partners v. Berlin, 2003 Del. Ch. LEXIS 42, 139 n.133 (Del. Ch. 2003),

may be meaningless.[130] However, the Delaware Supreme Court has not explicitly certified this implicit view.[131] Even after Judge Jacobs' criticism, the Delaware General Assembly has not changed §102(b)(7).

The defendant's burden of proving exculpation under § 102(b)(7), in conjunction with judicial reformulation of plaintiff complaints, creates more uncertainty for defendant directors seeking exculpation. Section 102(b)(7) is an affirmative defense so a director must prove his or her conduct falls within the parameters of the section, instead of its minefield of exceptions.[132] This burden is only lifted when plaintiffs solely allege duty of care violations because duty of care complaints are by definition dismissed under § 102(b)(7).[133] In *Ryan v. Lyondell Chemical Co*., the Chancery Court transformed a duty of care claim into a duty of loyalty claim.[134] Thankfully, the Delaware Supreme Court reversed.[135] Nonetheless, potential judicial reformulation of claims exacerbates the uncertainty surrounding even duty of care allegations under §102(b)(7).

Indeterminacy Squared

The combined effect of indeterminate duties and unsettled exculpation standards creates a recipe for increased litigation. Carney and Shepherd's newest work demonstrates these effects through statistical evidence.[136] From 1999 to 2000, the Delaware Chancery Courts handled 1280 corporate law complaints.[137] One thousand three, or 78%, of the complaints alleged breaches of fiduciary duties.[138] Carney and Shepherd commented that Delaware's courts possess a high reversal rate which only exacerbates the indeterminacy of Delaware law.[139]

reprinted in 28 DEL. J. CORP. L. 1027 (2003).

[130] *See* John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 120-25 (2004) (commenting on Judge Jacobs' statement and its possible implicit backing by the Delaware Supreme Court).

[131] *See id.*

[132] *Emerald Partners*, 2003 Del. Ch. LEXIS at 1224.

[133] *In re* General Motors Class H Stockholders Litig., 734 A.2d 611, 619 n.7 (Del. Ch. 1999).

[134] Ryan v. Lyondell Chem. Co., 2008 WL 2923427 *1 (July 29, 2008).

[135] *See* Ryan v. Lyondell Chem. Co., 970 A.2d 235 (2009).

[136] *See* Carney & Shepherd, *supra* note 2 (2009).

[137] Carney & Shepherd, *supra* note 2, at 45 (2009) (citing Robert Thompson & Randall Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1761 (2004)).

[138] *Id.* (these totals and percents only counted suits in Delaware, not suits in other states applying Delaware law using the internal affairs rule).

[139] Carney & Shepherd, *supra* note 2, at 15-17 (2009) (comparing Chief Justice Veasey's

When the complaint is not dismissed, plaintiffs are entitled to discovery which substantially increases settlement value of the plaintiff's complaint. The many sources of uncertainty, including the scope of fiduciary duties, the scope of exculpation and possible judicial reformation of complaints, hinder directors' ability to predict the dismissal of a plaintiff's complaint. Professor Bainbridge describes the effect of a plaintiff surviving summary judgment and being entitled to discovery as "a fishing expedition [where] the settlement value of such claims will go up."[140] Therefore, considering the potential of plaintiffs to survive summary judgment and their subsequent entitlement to discovery, directors will settle claims of even marginal value. Yet, the settlements only incentivize more claims and more litigation which again benefit Delaware's judges and lawyers.

Delaware lawyers and judges benefit from the increased litigation that accompanies Delaware's indeterminacy. Delaware specialists benefit because they are compensated through the renewal of their human capital and the increased fees generated by additional litigation. Hence, the Delaware specialists will continue incorporating their clients in Delaware. This cycle is self-perpetuating and unlikely to stop without external influences.

V. STOCKHOLDERS HOLD THE KEY

Modern corporate governance reform could break this cycle through stockholder initiation. Lucien Bebchuk's proposed corporate governance reforms encompass allowing the stockholders to initiate corporate charter amendments, including a change to the corporation's state of incorporation.[141] Stockholder initiation could facilitate corporate migration to states with more determinate law.[142] With brighter prospects for luring corporations with more determinate law, a state may engage in a limited race as profiled in Part VI.

Stockholder Control of Incorporation Decisions

Bebchuk's proposal allows stockholders to initiate and vote for changes to a corporation's state of incorporation. Bebchuk posits in a series of articles that stockholders should have greater power to remove boards of directors[143] and change the "rules-of-the-game decisions"

remarks of 25% reversal rate to the Carney and Shepherd's of 9/20 decisions or 45% for 2002, the last year that Veasey's comments applied.) *Id.*

[140] *See* STEPHEN BAINBRIDGE, CORPORATION LAW AND ECONOMICS 480 (Foundation Press 2001).

[141] *See* Lucian A. Bebchuk, *The Case for Increasing Stockholder Power*, 118 HARV. L. REV. 833, 837 (2005) [hereinafter Bebchuk, *Power*].

[142] *Id.* at 869.

[143] *See* Lucien A. Bebchuk, *The Myth of the Stockholder Franchise*, 93 VA. L. REV. 675, 677

including initiating changes to the corporate charter or a corporation's state of incorporation.[144] To further stimulate stockholder proposals, the corporation would reimburse stockholders' costs for proposals which pass a certain threshold of success.[145] Limiting reimbursement to "successful" proposals encourages reasonable proposals.[146] If stockholders can change the state of incorporation, then stockholders will be able to implement value-increasing changes for the corporation.[147]

If stockholders can decipher the optimal state for reincorporation and then change the state of incorporation, they could upset corporate counsel's self-serving choice. Bebchuk posits that incorporation decisions are less likely to be based upon inside information and stockholders will usually not suffer from a significant informational asymmetry.[148] Although stockholders face the collective action problem of actually deciphering the best state for incorporation, the reimbursement rule would lower costs and help overcome this barrier.[149] Even passive investors would support a sufficiently value-increasing change.[150] Realistically, changes may not occur often but the possibility of value-increasing changes is better than no possibility at all.[151]

Indirect Benefits

Even if changes occur infrequently, a reasonable threat of change could spur management to inquire about the state of incorporation. The primary benefit stockholder initiation is management altering their actions to avoid stockholder intervention.[152] If stockholders threaten to initiate a change to the state of incorporation, then management will initiate changes to the state of incorporation, or at least research the subject more diligently. If the research is done by a different legal

(2007) (noting that from 1996-2005 incumbent directors faced rival slates only 118 times and for large cap. companies the number decreased to only 24 cases.).

[144] *See* Bebchuk, *Power*, *supra* note 141.

[145] *Id.* at 874.

[146] *Id.*

[147] *Id.* at 867.

[148] Lucien A. Bebchuk, *Letting Stockholders Set the Rules*, 119 HARV. L. REV. 1784, 1793 (2006) [hereinafter Bebchuk, *Rules*]. Commentators disagree on stockholders' ability to assess a corporation's choice of state of incorporation. *Compare Id.* (rules-of the-game decisions, such as reincorporation decisions, should be in the realm of stockholders' proxy power) *with* Macey & Miller, *supra* note 35, at 486-87 ("Evaluating a lawyer's suggestion to relocate a firm to Delaware is particularly costly for stockholders.")

[149] *Id.* at 1798-99.

[150] Bebchuk, *Power*, *supra* note 141, at 867.

[151] Bebchuk, *Rules*, *supra* note 148, at 1799.

[152] Bebchuk, *Power*, *supra* note 141, at 878.

counsel or outside agency,[153] it could encourage directors to choose a state with more determinate law than Delaware.

If adopted nationally, stockholder initiation provides an opportunity for stockholders, either directly or by pressuring directors, to break the stranglehold of legal counsel on state incorporation decisions.[154] For instance, if a hedge fund initiates a change because it is weary of fiduciary duty suits or directors utilize a different law firm or investment bank to research state reincorporation options, then the state of incorporation decision may not be in the hands of Delaware specialists. Different counsel, who may not be wed to Delaware's law, could recommend incorporation elsewhere. Examples of such review could help persuade a state to launch a limited race to certainty against Delaware.

VI. MISSION POSSIBLE

Stockholder initiation could break the cycle of Delaware corporations only if another state attempts to steal incorporations away from Delaware through a limited race to certainty. A state cannot cost effectively match the Delaware's corporate infrastructure in a full race for incorporations. However, a limited race, involving the creation of more determinate fiduciary duty rules, could lure corporations from Delaware without the prohibitive costs of a full-scale challenge. Other roadblocks hinder even limited challengers including the short time horizons of politicians, low franchise tax revenues and laws that make a state objectively unattractive for incorporation.

Georgia represents a possible challenger because it could derive significant revenue from out-of-state corporations even if the incoming corporations do not transact any business in Georgia. Its bar might also support a challenge because two of its distinguished members, Shepherd and Carney, have previously attacked Delaware's indeterminate standards. Additionally, it is not hamstrung by laws which make it objectively unattractive to corporations.[155]

Georgia's potential for success hinges on a number of factors. First, the inherent lag of changing Delaware's common law rules creates a window of opportunity for Georgia even if Delaware courts react by creating more determinate rules. Second, Delaware's bar may be content

[153] Coates, *supra* note 56, at 1383-84 (2001) ("If lawyers cannot provide the complete package of products and services a client needs, non-lawyers will pick up the slack. Only tasks for which lawyers have a regulatory monopoly (such as litigation)" are immune from competition.).

[154] Bebchuk, *Power*, *supra* note 141, at 874-75 (National adoption may require federal intervention).

[155] *See* N.Y. BUS. CORP. LAW 630 (McKinney 2002).

with losing incorporations because the large gains from indeterminate law may offset their loss. Additionally, short-term profit maximizing may push the Delaware bar to support increased indeterminism even in the face of corporations fleeing Delaware.

Limitations on a Challenge

Delaware possesses undeniable advantages that make a full scale challenge impossible.[156] Delaware captures 85% of out-of-state incorporations.[157] Delaware possesses an unmatched corporate legal infrastructure including specialized courts and counsel.[158] Creating an equivalent infrastructure would be prohibitively expensive and even if a contender could upgrade sufficiently, Delaware could upgrade its own facilities in the interim.

A limited race to certainty presents challenges for a contender's politicians who have short time horizons and view a subsequent increase in franchise taxes as insignificant. Politicians only have limited time in office and reelection is their primary consideration.[159] Therefore, the long run benefits from incorporations may not accrue soon enough for a politician to care.[160] In the past, politicians' short time horizons have stopped some states' challenges to Delaware.[161] Politicians may view the gains from increased franchise tax revenue as insufficient in comparison to the efforts required to lure corporations.[162] Forty-five states charge a low flat tax and only generate significant revenue from corporations that do business in the state.[163] Without a significant overhaul of their franchise tax system, these states would gain little by attracting corporations who do not transact business in-state. For instance, if a state with a low flat tax like Maryland attracted 20% of the market for incorporations, it would only generate an additional $200,000 if the corporations did not transact business in Maryland.[164]

Other states suffer from specific laws that limit their attractiveness to corporations. One example is New York's imposition of unlimited liability for wage claims upon the ten largest stockholders in a

[156] *See* Bebchuk & Hamdani, *supra* note 11; Kahan & Kamar, *supra* note 7.

[157] Lucien A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 395 tbl. 5. (2003).

[158] Bebchuk & Hamdani, *supra* note 18, at 588.

[159] Kahan & Kamar, *supra* note 7, at 730.

[160] *Id.* at 729 (2002).

[161] *Id.* Illinois, the home to Trans Union, took far longer to enact an exculpation statute than most states because amendments to the Illinois Business Corporation Act failed after the savings and loan fiasco undermined directors' popularity with politicians. *Id* at 731-32.

[162] *Id.* at 688.

[163] *Id.*

[164] *Id.* at 689 tb.1.

corporation.[165] This law is widely viewed as a significant deterrence to incorporating in New York.[166] However, strong organized labor opposition has undercut all attempts to repeal the law.[167] Any state that wishes to challenge Delaware must overcome political and economic hurdles to mount such a challenge.

Georgia's Opportunity

Georgia can realistically mount a limited race to certainty against Delaware. Georgia's potential franchise tax revenues make a limited challenge worthwhile even without corporations doing business in-state. The costs of the challenge are very low and two prominent members of its bar, Carney and Shepherd, are very critical of Delaware's indeterminacy. Excepting Georgia and Delaware, the only states who use a franchise fee structure which taxes in-state corporations higher than out-of-state corporations are Nebraska, Rhode Island, Virginia, and West Virginia.[168] This paper focuses on Georgia because its franchise tax structure has greater potential to earn franchise taxes from corporations who do not transact business in Georgia.[169]

Due to its franchise tax scheme, Georgia could gain significant revenue from an influx of corporations. Unlike most states, Georgia charges a significant franchise tax even if the corporation does not conduct any business in-state.[170] If Georgia could draw 10% of U.S. corporations, a large improvement from its current 1.5% share, it would reap over $4 million in franchise tax revenue.[171] Georgia's politicians could gain meaningful revenue from attempting a limited race to certainty. Moreover, the legal business derived from increased in-state corporations would also increase Georgia's tax revenue.[172]

The Georgia bar probably would support Georgia's limited challenge. First, Georgia lawyers would reap increased fees from additional corporate legal work. Second, William Carney and George Shepherd, well known detractors of Delaware's indeterminate law scheme,[173] exert strong influence over Georgia corporate law and its code.[174]

165 N.Y. BUS. CORP. LAW 630 (McKinney 2002).
166 Kahan & Kamar, *supra* note 7, at 732 n.195 (citations omitted).
167 *See id.* at 732 n.196 (citations omitted).
168 *Id.* at 688 n. 36 and text accompanying.
169 *Id.* at 689.
170 *Id.* at 689 tb.1.
171 *Id.*
172 *Id.* at 698-99.
173 *See* Carney & Shepherd, *supra* note 2.
174 Carney helped draft the previous Georgia Business Code while Shepherd is drafting the next version.

Bebchuk and Hamdani argue that a quick reaction by the Delaware legislature could forestall an exodus of corporations and make any law-based challenge impossible.[175] States trying to rival Delaware face the stalking horse problem. The stalking horse problem allegedly occurs when another state creates superior corporate law and Delaware reacts quickly by enacting or proclaiming similar changes. Delaware's other advantages then allow it to keep most of its out-of-state incorporations.[176] However, the potency of the stalking horse problem may be exaggerated.

The Delaware judiciary would take a significant amount of time because appropriate cases would be necessary to pronounce rule changes. Delaware has heavily relied upon its courts to moderate and structure its indeterminate corporate code. Vice Chancellor Strine's call for aid is quite illustrative. "The General Assembly could contribute usefully to ending the balkanization of the duty of loyalty by rewriting § 102(b)(7) to make clear that its subparts all illustrate conduct that is disloyal."[177] Yet, it still took judicial intervention in *Stone* to clarify that the duty of good faith is a stand-alone duty.[178] Delaware's courts cannot rescue it *sua sponte* because, as Judge Lamb said in the wake of the *Lyondell* fiasco,[179] "the [Delaware] court[s] are not a regulatory or legislative body. We interpret on a fact-specific, case-by-case basis."[180] Therefore, creating a more determinate law through judicial decisions will be a long and uncertain process.

Delaware lawyers may be willing to lose some corporations without enacting more determinate law because the losses might be covered by gains through indeterminacy or short-termism may drive the Delaware bar to accept losses of corporations in return for the short-run gains. Delaware lawyers would prefer to lose some corporations if the marginal benefits of a higher level of indeterminacy covered the losses of the corporate migration.[181] Increased indeterminacy could yield increased legal fees until the corporations move elsewhere.[182] If the Delaware bar were dominated by senior lawyers with short time horizons, such a strategic decision would be rational.[183] Macey and Miller suggest that an unexpected increase in number of Delaware lawyers could also lead

175 Bebchuk & Hamdani, *supra* note 18, at 594-95.
176 *Id.* at 594.
177 Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).
178 *See supra* notes 82 & 83.
179 *See supra* notes 1344 & 1355.
180 Tina Chi, *'Ryan' Clarifies Director Duties, Says Delaware Judge*, 12 CORP. GOVENANCE REP. (BNA) 19 (Feb. 2, 2009).
181 *See supra* note 42.
182 Macey & Miller, *supra* note 35, at 505.
183 *Id.*

to short term profit maximization as lawyers try to increase litigation.[184] Analysis of the likelihood of these situations is beyond the scope of this article but they illustrate that the Delaware bar may be content to lose corporations to other states. Hence, the stalking horse problem may not be as inhibitory as once thought.

CONCLUSION

The current cycle of Delaware incorporations will continue even though Delaware law remains indeterminate unless an outside force intercedes. Whether implemented as a result of legislation or market pressure, stockholder initiation offers an opportunity to finally break the cycle. Other states, such as Georgia, would then have a better opportunity to mount successful limited challenge using more determinate law. Without intervention, the cycle will continue and Delaware's lawyers, judges and specialists will continue to reap the rewards of taxing corporations through Delaware's indeterminacy.

[184] *Id.*

BOARD OF TRUSTEES V. ROCHE MOLECULAR SYSTEMS, INC.: NEGOTIATING THE WEB OF COMPETING OWNERSHIP CLAIMS TO INVENTIONS ARISING FROM GOVERNMENT-FUNDED ACADEMIC-INDUSTRY COLLABORATION

by MARGO E. K. REDER*

I. INTRODUCTION

In *Board of Trustees v. Roche,*[1] the Supreme Court is poised to rule on the disposition of rights to inventions arising out of academic-industry collaborations funded in part by U.S. government research grants and thereby covered by the Bayh-Dole Act (BDA).[2] Central to this case is the contentious issue over multiple and inconsistent assignments of patent rights claimed by both Stanford University and Cetus, a biotech company[3] where crucial aspects of the invention were developed in its labs. This case speaks to collaborations between universities and businesses, in which employees and know-how flow freely between partners, financing for which is partly based on federal research grants. The ruling implicates public policy goals including: recent government policy initiatives supporting innovation and invention, academic entrepreneurship along with its associated economic and

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1 583 F.3d 832 (Fed. Cir. 2009), *vacating and remanding*, 583 F. Supp.2d 1016 (N.D. Cal. 2008).

2 2010 U.S. LEXIS 8553 (U.S. Nov. 1, 2010) (No. 09-1159).

3 Cetus, one of the first biotech companies, was a faculty start-up, spun-off from University of California at Berkeley based on inventions from its labs.

competitiveness consequences, and the continuing vitality of the historic doctrine that patent rights vest first with inventors.

Should the Court award rights to the university-contractor whose assignment is first in time though the language concededly lacks precision? Or should the Court award rights to the company whose assignment while second in time is clear as to intent and rights? What of the inventor, the presumed owner? How to construe the BDA, whose main purpose was to incent invention and innovation through commercialization of government-funded research? Its stunning success has had the effect of converting billions of taxpayer dollars for basic research into commercial applications, jobs, companies and wealth. While the BDA language focuses mainly on allocating and tiering rights of contractor-universities and the government, it lacks clarity as to the inventor's rights or partnering companies' rights for it does not explicitly repudiate American patent law.

This case significantly impacts universities that seek to commercialize their faculties' research into patentable inventions and highlights their risk exposure well in relation to collaborations with businesses that partner or share knowledge with universities. This exposes the tensions as to control or ownership of inventions inherent in collaborations between research universities and commercial entities and points to another thicket of complications for universities' faculty relationships. The Court will issue its opinion at the end of the Term and it will be the first time the Court has construed this aspect of the Bayh-Dole Act.

II. CASE BACKGROUND

A. The Invention

The patent rights in question claim methods for quantifying HIV in human blood samples and correlating those measurements to the therapeutic effectiveness of anti-retroviral drugs. The claimed methods use the polymerase chain reaction (PCR) to measure ribonucleic acid (RNA) from HIV in the blood plasma of patients.[4] The PCR exponentially amplifies the sample to show detectable levels of the nucleic acids. The three patents (5,968,730, the '730 patent; 6,503,705, the '705 patent; and 7,129,041, the '041 patent) derive from a parent application and share the same title, 'Polymerase Chain Reaction Assays for Monitoring Antiviral Therapy and Making Therapeutic Decisions in the Treatment of Acquired Immunodeficiency Syndrome.'[5] Three

[4] *See Board of Trustees*, 583 F.3d at 837.

[5] *Id.* at 836-37. The U.S. Patent and Trademark Office registration information: U.S. Patent No. 5,968,730 (Merigan, Katzenstein and Holodniy, inventors), issued on

Stanford researchers, Mark Holodniy, Thomas Merigan, and David Katzenstein, are named inventors on all three patents. A fourth inventor, Michael Kozal appears on just one of the patents.

The legal complications arose because one of the inventors signed multiple and inconsistent agreements defining his obligations to assign his invention rights. First, in 1988 when Mark Holodniy joined Merigan's lab at Stanford as a Research Fellow, he signed a Copyright and Patent Agreement (CPA) obligating him to assign any inventions to Stanford.[6] In the CPA, Holodniy acknowledges that Stanford enters into contracts or grants with third parties, including the government, and that he may "conceive or first actually reduce to practice" various inventions.[7] Specifically paragraph 2 provides: "*I agree to assign or confirm in writing* to Stanford and/or Sponsors, that right, title and interest in…such inventions as required by Contracts or Grants."[8]

October 19, 1999: 1. A method of evaluating the effectiveness of anti-HIV therapy of a patient comprising: (i) collecting a plasma sample from an HIV-infected patient who is being treated with an antiretroviral agent; (ii) amplifying the HIV-encoding nucleic acid in the plasma sample using HIV primers in about 30 cycles of PCR; and (iii) testing for the presence of HIV-encoding nucleic acid, in the product of the PCR; in which the absence of detectable HIV-encoding nucleic acid correlates positively with the conclusion that the antiretroviral agent is therapeutically effective.

U.S. Patent No. 6,503,705 (Kozal, Merigan, Katzenstein and Holodniy, inventors), issued on January 7, 2003: 1. A method of evaluating the effectiveness of anti-HIV therapy of an HIV-infected patient comprising: a) collecting statistically significant data useful for determining whether or not a decline in plasma HIV RNA copy numbers exists after initiating treatment of an HIV-infected patient with an antiretroviral agent by: (i) collecting more than one plasma sample from the HIV-infected patient at time intervals sufficient to ascertain the existence of a statistically significant decline in plasma HIV RNA copy numbers; (ii) amplifying the HIV-encoding nucleic acid in the plasma samples using HIV primers via PCR for about 30 cycles; (iii) measuring HIV RNA copy numbers using the products of the PCR of step (ii); (iv) comparing the HIV RNA copy numbers in the plasma samples collected during the treatment; and b) evaluating whether a statistically significant decline in plasma HIV RNA copy numbers exists in evaluating the effectiveness of anti-HIV therapy of a patient.

And U.S. Patent No. 7,129,041 (Merigan, Katzenstein and Holodniy, inventors), issued on October 31, 2006: 1. A method of evaluating the effectiveness of anti-HIV therapy of a patient comprising: correlating the presence or absence of detectable HIV-encoding nucleic acid in a plasma sample of an HIV infected patient with an absolute CD4 count, wherein the presence or absence of said detectable HIV-encoding nucleic acid is determined by (i) collecting a plasma samples from an HIV-infected patient who is being treated with an antiretroviral agent; (ii) amplifying HIV-encoding nucleic acid that may be present in the plasma sample using HIV primers via PCR and; (iii) testing for the presence of HIV-encoding nucleic acid sequence in the product of the PCR.

[6] *Board of Trustees*, 583 F.3d at 837.

[7] *Id.*

[8] *Id*. at 841.

Holodniy further promised in the CPA to "not enter into any agreement creating copyright or patent obligations in conflict with this agreement."[9]

Since Holodniy had no prior experience with PCR techniques, in 1989 he began regular visits to Cetus, a private company whose PCR work had matured by then. Merigan, Holodniy's supervisor at Stanford directed him to work with Cetus and himself executed a number of Materials Transfer Agreements with Cetus allocating some intellectual property rights.[10] Cetus Company Policy required all visitors to sign agreements. Accordingly Holodniy signed Cetus's "Visitor's Confidentiality Agreement" (VCA). The primary purpose of Cetus's VCA was to maintain confidentiality of all aspects of company operations. Though characterized by the company as a confidentiality agreement, additionally it featured an assignment clause that figures prominently into this litigation: specifically Holodniy agreed that "[I] will assign and *do hereby assign* to CETUS, my right, title, and interest in each of the ideas, inventions and improvements" devised as a consequence of his work with Cetus.[11] This purportedly effects a present transfer of future invention rights. This collaborative research yielded results: the research produced an assay that became the basis of the invention and further, Holodniy co-authored a paper with Cetus employees and subsequently returned to work further with Stanford colleagues on clinical studies that led to the patented invention.[12]

Also adding to the mix of issues, Stanford applied for and received government funding from the National Institutes of Health to conduct HIV research.[13] Federal funding is commonly sought to support research of small businesses and non-profits. Congress passed the Bayh-Dole Act (BDA) to promote research and development and to ensure that it obtains sufficient rights in federally funded inventions. The Act allows the Government to elect to take title to inventions, or the contractor universities, or inventors may elect title if the Government does not.[14] Should universities elect to take title to inventions, the Government nevertheless reserves "march-in" rights under certain conditions.[15]

[9] *Id*. at 843.
[10] *Id.*
[11] *Id*. at 842.
[12] *Id.* at 837.
[13] *Id*. at 838.
[14] *Id*. at 844. *See infra* Part II for a complete rendering of the statutory provisions.
[15] *Board of Trustees*, 583 F.3d at 844; *see also* 35 U.S.C. section 203 (2006).

B. Competing Claims of Ownership

In December 1991, Roche purchased Cetus, including its agreements with Stanford researchers through an Asset Purchase Agreement.[16] Thereafter, Roche began manufacturing HIV detection kits employing the RNA work.[17]

In May 1992, Stanford filed the parent application to which these patents claim priority.[18] (The '730 patent issued on Oct. 19, 1999; the '705 patent on Jan. 7, 2003; and the '041 patent on Oct. 31, 2006, after this litigation began.) Stanford is the assignee of all three patents.[19] In June 1992, Stanford filed an invention disclosure with the NIH.[20] In November 1994, Stanford formally notified the Government that it elected to retain title to the invention under the Bayh-Dole Act, confirming the grant of a "nonexclusive, nontransferable, irrevocable, paid-up license."[21]

In May 1995 Holodniy signed a second agreement with Stanford, this time executing an assignment of rights in the parent application to Stanford.[22] In April 2000, Mr. Luis Mejia a Senior Licensing Associate in Stanford's Office of Technology Licensing conducted a slide presentation at Roche that purported to establish Stanford's ownership of the HIV RNA invention, at which time he offered Roche a license to the patents.[23] This meeting put Roche on notice that Stanford claimed ownership of Holodniy's work, that Stanford patented the invention relating to the Holodniy-Cetus collaboration, that Stanford continued to file related patent applications, and that Stanford expected Roche to license the technology. Roche disputed this, claiming that it owns all of Holodniy's rights pursuant to the VCA signed in 1989.[24]

C. Litigation over Competing Claims

In 2005, Stanford filed suit in the United States District Court for the Northern District of California alleging that Roche's HIV detection kits infringed its patents.[25] Roche answered and counterclaimed arguing *inter alia*, that Stanford lacked standing to sue because Roche "possesses ownership, license, and/or shop rights to the patents through Roche's

[16] *Board of Trustees*, 583 F.3d at 837-88.
[17] *Id*. at 838.
[18] *Id*. at 842.
[19] *Id*. at 838.
[20] *Id*.
[21] *Id*.
[22] *Id*. at 842.
[23] *Id*. at 847.
[24] *Id*.
[25] *Id*. at 838.

acquisition of Cetus's PCR assets."[26] Roche pleaded its ownership theory in three forms: as a declaratory judgment counterclaim, an affirmative defense, and challenge to Stanford's standing to sue for infringement.[27] The parties cross-motioned for summary judgment on Roche's rights in the patents. The district court denied Roche's motion in full and granted Stanford's motion in part. After briefing and a hearing, the court construed several claim terms.[28] At this point, Roche moved for summary judgment on grounds that the asserted claims were invalid. The district court granted Roche's motion though based on its conclusion that the claims failed the non-obviousness requirement and the parties filed a cross-appeal.[29]

On appeal to the Court of Appeals for the Federal Circuit (CAFC), Stanford appealed the judgment of invalidity; Roche cross-appealed the judgment as to the parties' respective rights in the patents. The court first considered Roche's claims of ownership as a bar to Stanford's standing and began with a review of the chain of title to the invention. Conceding that interpreting contracts is normally a state law matter (the question here was whether the patent assignment clause created an automatic assignment or merely an obligation to assign), the court retained jurisdiction since the contracts were so closely linked to the patent case.[30]

The court of appeals initially ruled that the district court abused its discretion when it incorrectly declined to consider Roche's affirmative defense based on ownership of the invention.[31] Thereafter the court construed each agreement chronologically. It interpreted the 'I agree to assign' language of the 1988 Holodniy-Stanford agreement, "I agree to assign…right, title and interest…in such inventions…." to be merely a promise to assign rights in the future in contrast to an immediate transfer of any interest.[32] Relying on other cases as well as on Stanford's Administrative Guide that provided, "Unlike industry and many other universities, Stanford's invention rights policy allows all rights to remain with the inventor if possible," the court ruled that the 1988 agreement did not effect a transfer of the invention to Stanford.[33]

The court then considered the effect of the 1989 Holodniy-Cetus agreement (that Roche is a successor in interest to) that stated, "I will

[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Board of Trustees*, 563 F. Supp.2d 1016 (N.D. Cal. 2008).
[30] *Board of Trustees*, 583 F.3d at 841.
[31] *Id.* at 840.
[32] *Id.* at 841.
[33] *Id.* at 841-42.

assign and do hereby assign to CETUS, my right, title, and interest in each of the ideas, inventions…." and distinguished this language from that used in the 1988 Holodniy-Stanford agreement. Holding that the 1989 agreement effected a present transfer of Holodniy's future inventions to Cetus, at the moment it was signed, Cetus gained equitable title to Holodniy's future inventions.[34] (Once the invention is made and the patent is filed, legal title would be in the assignee.) While Stanford filed the patent application on May 1992, Holodniy had already conceived his contribution to the invention by then, with Cetus automatically gaining legal title before Stanford filed. Even though Holodniy purported to assign his rights to Stanford in 1995, he had no rights to assign according to the court's interpretation of the multiple contracts.[35]

The court rejected Stanford's attempt to overcome what it found was a defective chain of title as to the university. Stanford's assertion that it was an innocent, bona fide purchaser of Holodniy's rights did not resonate with the court because the university was on notice where, even though he was employed by them, they knew his PCR work at Cetus was directly related to the Stanford project, and the Materials Transfer Agreement highlights this point.[36] Stanford's second assertion – that Holodniy was an agent of the university and lacked authority to sign away valuable patent rights – was likewise rejected based on the court's conclusion that Holodniy signed away his, not Stanford's rights, as he was the inventor.[37]

Noting that since the federal government as another potential party-in-interest did not seek title to the invention, the court ruled that title vested in Holodniy since in its opinion, the original Holodniy-Stanford agreement was insufficiently definite on an assignment date and instead was better characterized as an indefinite obligation to assign potential future rights. Therefore Holodniy retained rights – until he transferred them to Cetus, more than six years before Stanford formally notified the Government of its election to retain title as provided by the Bayh-Dole Act.[38]

Finally as to Roche's counterclaim for a judgment of ownership of the three patents, the court ruled that challenge was time-barred by the statute of limitations and the district court correctly dismissed Roche's claim.[39] Stanford's inability to establish that it possessed Inventor

[34] *Id*. at 842.
[35] *Id.*
[36] *Id*. at 843-44.
[37] *Id.* at 844 (emphasis in original).
[38] *Id*.
[39] *Id*. at 846-47.

Holodniy's interest in the patents-in-suit defeated its right to assert its cause of action against Roche. While Roche's failure to timely seek a judgment of ownership defeated its counterclaim, this did not alter the fact that Stanford had no title, and therefore it lacked standing to assert claims of patent infringement against Roche.[40]

In considering competing claims of ownership, the CAFC recognized fundamentally that rights vested first in the inventor rather than in either of his employers. The court then crafted a bright line rule based on its interpretation of contract language and with reference to patent law precedent holding that patent rights to this federally funded research vested first in the inventor rather than the university contractor even though work had begun at Stanford University, and that these rights were effectively assigned to Cetus in priority to rights claimed by Stanford.[41] Under this construct, an inventor's present assignment of an invention trumps an inventor's promise to assign future, as-yet undiscovered inventions, considered by the court to be too remote for rights to vest. This opinion potentially undermines the goals for enacting the BDA. Moreover it greatly complicates technology transfer since it is exceedingly difficult to discover assignments as there is no uniformity to the language of rights transfers nor is there any central repository for recordation of these rights for all to see. Therefore it is not practically possible to effectively assess the assignments for validity or relevancy as to proposed deals and this leads to a great deal of uncertainty in the legal environment. The CAFC's decision altered the settled expectations of university contractors and significantly disrupted the present model under which contractors commercialized inventions based on basic research funded by the federal government.

The Supreme Court heard arguments in this case on February 28, 2011. Construing rights in this case is problematic and for this, the Court heard from the Deputy Solicitor General of the United States in addition to Petitioner and Respondent. In granting certiorari, the Court framed the question as, "whether a federal contractor university's statutory right under the Bayh-Dole Act, 35 U.S.C. sections 200-212, in inventions arising from federally funded research can be terminated unilaterally by an individual inventor through a separate agreement purporting to assign the inventor's rights to a third party."[42]

During Oral Arguments Mr. Donald Ayers representing Stanford asserted such rights could not be terminated unilaterally because the research was covered by the BDA and therefore the Stanford employee

[40] *Id*. at 848-49.
[41] *Id*. at 848.
[42] *See supra* note 2.

lacked the power to transfer title to the future invention.[43] He suggested that the cost of this free basic research money is a restricted right to inventions by the employee inventors - that individuals who participate in projects with BDA money have correspondingly limited rights subject to contractors' election to retain ownership. Chief Justice Roberts refuted this claim reminding counsel that title initially vests in inventors even if the work is done on behalf of an employer.[44] Further the Chief Justice suggested that Stanford and other such contractors could advance their own interests at the expense of those of the United States' while cloaking themselves as guardians or stewards of this public interest.[45]

The Deputy Solicitor General Mr. Malcolm Stewart appeared on behalf of the United States in support of Petitioners, acknowledging that while its interests are aligned with the contractor/Stanford's in the instant case, this may not be so in future similar cases.[46] Mr. Stewart's main points related to concerns over individual inventors' ability to retain title as this is prejudicial to advancing goals of the BDA. His proposed solution is to craft a rule in which federal BDA government funding of university contractors automatically takes precedence over contractual arrangements with commercial partners.[47]

Mr. Mark Fleming argued on behalf of Roche, focusing on the gaps in understanding of commonly accepted definitions of statutory language in the BDA. For example, the BDA does not explicitly state that it supersedes patent law, though its provisions are inconsistent with patent law.[48] The Justices had zeroed in on this as well during Respondent's arguments earlier.[49] For contractors electing to 'retain title' when they do not yet have it according to patent law, evidences a chasm in the parties' understanding, one that was overlooked by Congress, and is now left to the Court to interpret. Mr. Fleming repeatedly questioned whether this was even BDA-funded research[50] and further cautioned that should Stanford prevail, Roche, a good faith successor-in-interest, would be completely unprotected, and it is possibly more in the nature of a takings case.[51]

[43] Transcript of Oral Argument at 3, 9-10, Board of Trustees v. Roche, 2010 U.S. LEXIS 8553 (U.S. Nov. 1, 2010) (No. 09-1159).

[44] Transcript, *supra* at 12-13.

[45] *Id*. at 42.

[46] *Id.* at 17-18.

[47] *Id.* at 24.

[48] *Id.* at 27.

[49] *Id.* at 14-15, 36, 48.

[50] *Id.* at 54-55.

[51] *Id.* at 9-10, 54-55.

Petitioner Stanford University is seeking an expansive interpretation of the BDA, citing the overarching policy goals and public benefits accruing from the Act. Stanford however, needs to overcome two primary concerns. First, that its position effectively negates individual inventors' rights and it will have to convince the Court that the BDA's intent supersedes patent law governing vesting of title. Second, Stanford needs to overcome concerns about the obvious shortcomings in its assignments clauses, by convincing the Court that the BDAs intent supersedes contract principles too.

Respondent Roche Molecular Systems faces other perhaps more daunting hurdles, mainly related to public policy and technological progress. Roche needs to overcome concerns that should it prevail, a precedent is created in which a company may effectively privatize taxpayer-funded basic research and thereby limit technological development, or at least diffusion of it. Further, this potentially diminishes the government's rights and public benefits thereby frustrating all that the BDA was intended to foster, simply because of a contract outlining a different set of assignment rights the Federal Circuit construed to be better drafted.

It is unclear what direction the Justices are poised to take, though during Oral Arguments it appeared that Justices Breyer and Kennedy focused on the value of a broad recognition of rights created by the BDA. At one point Justice Breyer opined, "[if] the Federal Government paid for it, they should have the invention...[t]here is a statute here that really seems to assume, though not explicitly say, that the universities will have title - - that...an effort to assign by the employee in contravention of what this statute takes as its basic assumption, and a contract , is void as a matter of public policy, because the exclusive license is assumed...to be assigned to the university...."[52] On the other hand, Justices Ginsburg, Alito, Sotomayor and Kagan focused on the private contracts and assignments and this suggests a resistance to recognizing a broad interpretation of the BDA for expediency simply to reach a result for a contractor whose owns assignments were lacking in clarity.[53] Justice Scalia pointed out the problematic provisions concerning university-contractors' rights to elect to retain title, when there is no such accepted definition of this new language Congress crafted for the BDA, especially since it adds uncertainty over the disposition of rights.[54] Chief Justice Roberts observed that there are

[52] *Id.* at 29-30.

[53] *Id.* at 9, 36-37, 39, 45.

[54] *Id.* at 16-17; *compare id.* at 48 (Mr. Fleming takes exception to a reading that 'retain' means to automatically 'get' title as Stanford would have it) *with id.* at 57-58 (Mr. Ayers suggesting that 'retain' could only be construed in its common sense meaning in relation to

many entanglements contractors can find themselves in and they can possibly work around BDA restrictions with private companies, or even carve out special deals for superstar researchers, and thereby contravene the goals of the BDA.[55]

A dozen amicus curiae briefs were received by the Supreme Court for this case as well.[56] The circuit court opinion and the grant of certiorari triggered a great deal of uncertainty and speculation throughout university communities, start-ups, spin-outs, and even the more established biotech, life science labs that perform the critical work of translating basic research into commercial applications for goods and services.

III. LAW AND POLICY: THE BDA AND THE PRESENT BUSINESS ENVIRONMENT

A. The Bayh-Dole Act (BDA)

The University and Small Business Patent Procedures Act of 1980, better known as the Bayh-Dole Act (BDA), was passed in an effort to foster the development and diffusion of government-sponsored research.[57] Described as "possibly the most inspired piece of legislation to be enacted in America in the past half-century,"[58] and referred to as innovation's "golden goose." The BDA created an effective formula to translate basic research and reversed a legacy of underutilized government-owned research stalled or squandered for lack of a comprehensive or uniform government policy to leverage research for commercial applications. The BDA provides a series of incentives and unleashes the potential of these taxpayer-financed inventions by shifting intellectual property ownership rights away from the government and towards institutions amenable to taking a stewardship role in fostering marketable opportunities.

The BDA provides recipient universities (the contractors) of federal research funds the option of electing to retain rights to inventions created with the research grants.[59] The academic institutions then

Congress's goals of a permissive ownership environment with respect to university-contractors in order to advance technological developments and the public interest).

[55] *Id.* at 35.

[56] *See* SCOTUSblog, *available at* http://www.scotusblog.com/case-files/cases/board-of-trustees-of-the-leland-stanford-junior-university-v-roche-molecular-systems-inc/ (last visited June 21, 2011).

[57] 25 U.S.C. sections 200-212 (2006).

[58] Opinion, *Innovation's Golden Goose*, The Economist at 3 (2002).

[59] 35 U.S.C. sections 200-212 (2006). The Department of Commerce administers the program, and promulgated regulations, rights to inventions made by nonprofit organizations and small business firms under government grants, contracts, and

possess a bundle of rights with certain restrictions to commercialize, or license out these inventions to entities that can effectively commercialize the work. This academic-industry alliance, backed by government funding is a tremendously successful platform for all participants and provides significant benefits to the public just as the patent system is intended to function. The BDA dramatically changed the paradigm as between contracting universities and the government because heretofore the government retained title to federally sponsored research.

Congress devised this Act to promote collaboration between the academic and business sectors and as a way to commercialize the underutilized, even dormant basic research and patents owned by the government.[60] The General Accounting Office (GAO) found that prior to 1980 only five percent of patents on federally sponsored inventions were used.[61] Furthermore, there were twenty-six different federal agency policies on using results from such research.[62] Negotiating title and licensing rights to federally sponsored research was clearly a complicated endeavor. Without rational policies, businesses lacked incentives to exploit this technology by taking on such risk, and therefore potentially innovative research languished. By this time moreover, federal expenditures on research expanded from the modest funding of World War II era research projects[63] to reach $8 billion by 1980.[64]

B. Background on the pre-BDA environment:

To add valuable context to the BDA's importance, it is helpful to consider government-sponsored research policies before 1980. During World War II, the U.S. government initiated and funded a series of research projects, establishing the National Defense Resources Committee "to coordinate, supervise, and conduct scientific research on the problem underlying the development, production and use of mechanisms and devices of warfare."[65] Initial projects focused on

cooperative agreements, 37 C.F.R. sections 401.1-401.17 (2010).

[60] 35 U.S.C. section 200 (2006).

[61] *See* U.S. Gov't Accountability Office, GAO-09-742, Federal Research: Information on the Government's Right to Assert Ownership Control over Federally Funded Inventions 2 (2009).

[62] *Id*. at 4.

[63] MIT's Radiation Laboratory made substantial contributions to radar, anti-aircraft and other electronics, and Columbia University sponsored the Manhattan Project. Funding continued to rise even beyond the Cold War era. *See* Scott Shane, Academic Entrepreneurship 46-47 (2004).

[64] *The Bayh-Dole Act at 25*, BayhDole25, Inc., Apr. 17, 2006, at 2, available at http://bayhdolecentral.com/BayhDole25_WhitePaper.pdf (last visited June 21, 2011).

[65] *Id.* at 7.

challenges with urgent and sensitive military, defense, computing or medical requirements so complex that they exceeded the scope and resources of private entities. The Office of Scientific Research and Development replaced the NDRC in 1941 lead by MIT President Karl Compton and Dean of Engineering Vannevar Bush.[66] These government initiatives, most especially work on radar and the Manhattan Project were transforming achievements dramatically altering the course of the war.[67]

Dean Vannevar Bush's report to Congress in 1945, *Science: The Endless Frontier*, was visionary in that he linked "government support of basic science to the goal of stimulating the economy."[68] Government backing continued to build for basic research in the form of a number of new agencies, notably the National Science Foundation and National Institutes of Health, though many other existing institutions received government research support as well. Federal expenditures on research reached $8 billion by 1980[69] and the government held title to approximately 30,000 patents.

Yet, there were many distressing signs that such investments were yielding meager returns. The technology was not being transferred to the marketplace and the U.S. economy languished during the 1960's and 70's, lagging in science and other invention benchmarks. The government practiced and commercialized fewer than 5% of patents on inventions it sponsored.[70] Businesses that could possibly commercialize the subject inventions found that the transactional costs were too high. This was due to the fact that there was no central government office or mechanism for the transfer of rights to these inventions. Each agency it turns out developed its own particular procedures, set of rights as well as licensing and royalty schedules for inventions they sponsored, so that businesses had to in some instances, negotiate with multiple government organizations for receipt of varying rights to inventions that were interconnected. By 1980 there was a maze of 26 different sets of agency regulations with varying terms and levels of support covering the use of government-funded research by private companies.[71]

To remedy this stall Congress held extensive hearings on how to leverage inventions and harmonize the interests of businesses, inventors, universities and funding agencies. A "solid bipartisan consensus had formed that the federal government should at least try a

[66] *Id.* at 8.
[67] *Id.*
[68] *Id.* n.13
[69] *Id.* at 7-8.
[70] *Id.* at 25 & n.25; *see also* GAO Rep't, *supra* note 61, at App. III, p.21.
[71] *See The Bayh-Dole Act at 25, supra* note 64, at 19 & n.37.

new approach."[72] The BDA was signed into law by then-President Carter on Dec. 12, 1980.

C. The Bayh-Dole Act statutory provisions

The BDA acts as a catalyst to invention and diffusion of basic research through providing a framework for cooperation between the government, universities (the contractors), inventors, and businesses in recognition that inventions thrive in a collaborative ecosystem with the right supports. For this, the BDA legislation makes two significant improvements. First it establishes a policy for uniform grant contracts applicable to all funding agencies that speeds commercialization. Second, it re-allocates rights as between the parties reversing the presumption of title so that now contractors are first in right and may claim title to government-funded research, thus providing a superior incentive scheme for successful commercialization. The sections in more detail:

Section 200: This section states the goals of the legislation and evidences Congress's objectives including: to promote competition, commercialization and diffusion of basic research; to ensure that the government retains sufficient rights for itself as a means to protect the public against non-use or unreasonable use of inventions, while minimizing costs of program/agency administration.[73]

Section 201: This provision describes the contracting parties and defines subject inventions as those that comprise any invention (whether first conceived or reduced to practice) funded *in whole or in part* under a government funding agreement (emphasis added).[74]

Section 202. This section is covered in more detail due to its relevance and importance to the case-in-chief. Section 202 addresses ownership of inventions created with government funding. The provisions do not exactly square with the tiered structure of rights enunciated under the Patent Act and therein is the challenge as to whether these two legislative pronouncements can be read together.

Sub-section (a) attempts to allocate rights to inventions. The language specifically provides, "[e]ach...organization...may, within a reasonable time after disclosure [of the invention to the funding agency] elect to retain title to any subject invention."[75] It implies contractor-

[72] *Id.* at 19.
[73] 35 U.S.C. section 200 (2006).
[74] 35 U.SC. section 201 (2006). Through this provision the government evidenced its intent to capture 100% of the value of inventions for which any government money fund was given.
[75] 35 U.S.C. section 202 (2006).

organizations have a first option to claim title - and notably absent is mention of inventors' right and title to inventions in whom rights first vest under U.S. patent law.[76]

Sub-section (b) identifies conditions under which the government may exercise rights to the invention.[77]

Sub-section (c) outlines the provisions that are to be included in funding agreements, as well as the contractor's responsibility to disclose inventions, file patent applications, and so forth. Notably, notwithstanding the contractor's title to an invention, the government retains a residual right to a nonexclusive, nontransferable, irrevocable paid-up license to practice the invention.[78]

Sub-section (d) allocates rights as between the government, the contractors and inventors providing that if contractors "do not elect to retain title to a subject invention...the Federal agency may consider and after consultation with the contractor grant requests for retention of rights by the inventor...."[79]

Section 203 delineates conditions under which the government may require the contractor to grant rights to other, third parties (known as march-in rights).[80]

The Department of Commerce is charged with issuing regulations clarifying terms and other conditions for contractors working under contract with funding agencies.[81]

D. Commercialization: translating basic research into inventions for market-ready goods and services - the present business environment

By all benchmarks, the BDA is an overwhelming success. At its essence, the BDA is meant to encourage the translation of abstract or theoretical ideas into socially useful inventions. The BDA can be characterized as a meta-idea, so-named by economist Paul M. Romer, because these are "ideas about how to support the production and transmission of other ideas."[82] He wrote, "...the country that takes the

[76] *See* 35 U.S.C. sections 101, 115 (2006) (outlining rights of inventors to obtain patents in their inventions). The Supreme Court recognized this right as early as 1851 in *Gaylor v. Wilder*, 10 How. 477, 493 (1851), and further established that inventions are the personal property of the inventor in *United States v. Dubilier Condenser Corp.*, 289 U.S. 178, 188 (1933). This case recognized that the invention belongs to the employee initially and not the employer. *Id.* at 189.

[77] 35 U.S.C. section 202(b) (2006); *see also* 37 C.F.R. section 401.6 (2010).

[78] 35 U.S.C. section 202(c) (2006).

[79] 35 U.S.C. section 202(d) (2006). *See* Murray L. Elland, *The Role of the Individual Inventor in Pharmaceutical Patents*, 18 U. Balt. Intell. Prop. L.J. 1, 10-13 (2009).

[80] 35 U.S.C. section 203 (2006).

[81] *See* 37 C.F.R. sections 401.1 - 401.17 (2010).

[82] Concise Encyclopedia of Economics, Economic Growth at 5, by Paul M. Romer (David R. Henderson, ed., Dec. 2007).

lead in the twenty-first century will be the one that implements an innovation that more effectively supports the production of new ideas in the private sector."[83] To paraphrase the General Accounting Office (GAO), the BDA is good policy and good for the economy.[84] The GAO estimates that "federal support accounts for over half of the research conducted at colleges and universities"[85] now in the billions of dollars that are translated into commercialized inventions, responsible for the formation of thousands of companies, jobs, and economic growth.[86] Funding to agencies that will also ultimately fund other research is in the range of $147 billion in fiscal year 2010.[87]

Recipients (the contractors) of federal funding for research sign an agreement with the funding agency under the terms and conditions of the statute and federal regulations. Contractors have created licensing and technology transfer offices to manage the process that starts with the results from basic research and perhaps end with a product that produces revenue. An entire industry has been created out of the need to bridge the divide between idea and market. Technology transfer is the process of transferring a method, know-how, application, technology and so forth - to entities that are most able to commercialize it for use in products or services, thereby promoting progress and maximizing the social benefit of government funding. Technology transfer describes the process of entering into agreements and managing licensing for the technology. Each university must build a technology evaluation and licensing team to manage government agency funding agreements, disbursal of funds, disclosure reporting to funding agencies, patenting, and to determine whether to seek licensing opportunities or develop a business model by using the technology as a start-up, and so forth. A professional organization, the Association of University Technology Managers exists to represent members' interests and support academic technology transfer. For fiscal year 2009, the AUTM Summary highlights the following:

- 658 new commercial products introduced
- 5,328 total licenses and options executed
- 596 startup companies formed based on university technology
- 3,423 startups still operating as of the end of FY2009

[83] *Id.*
[84] *See* GAO Rep't, *supra* note 61, at App. III, p.21.
[85] *See* GAO Rep't, *supra* note 61, at 1.
[86] *See* Bayh-Dole 30, available at http://www.b-d30.org/ (last visited June 21, 2011).
[87] *See* John F. Sargent, Jr., Cong. Research Serv., R40710, Federal Research and Development Funding: FY2010 2 (2010).

20,309 disclosures received[88]

To appreciate the impact of Bayh-Dole on just one contractor, consider MIT by way of example. In fiscal year 2010, it made 530 invention disclosures to the government. It filed 184 patents. It granted over 50 licenses to companies to commercialize some of these patents. MIT was responsible for starting 16 companies, and its gross revenue exceeded $75 million.[89] The primary method that revenue is generated is from straight licensing fees in which universities license inventions directly to existing companies for them to produce and distribute.[90] More recently among universities there is a trend towards a more entrepreneurial approach that is at its essence a riskier strategy: spinning off start-up companies (such as was the case of Stanford and Google) based on university-owned inventions with backing from the venture capital community. In this approach, contractor-universities stand poised to benefit in two ways from the tech transfer: through its underlying equity stake in the company in addition to the potential revenue from licensing fees for the technology.

E. The Impact of this Case on the Bayh-Dole Act and Future Technological Developments Meant to Promote the Public Interest

This is an auspicious age for R&D as government support is increasing for academic-industry collaboration and entrepreneurship.[91] The BDA created a powerful platform for building out these relationships and the benefits clearly continue to accrue. The Supreme Court's interpretation on how to best balance rights to make private contracts with the public's interest in taxpayer-financed research will surely influence technological progress, risk-taking job creation and

[88] *See* the Association of University Technology Managers site, available at http://www.autm.net (last visited June 21, 2011).

[89] *See* the MIT Technology Licensing Office's statistics page, available at http://web.mit.edu/tlo/www/about/faq.html#a1 (last visited June 21, 2011).

[90] *See generally* Prof. David B. Lerner's blog, http://www.davidblerner.com/ (last visited May 8, 2011).

[91] President Barack H. Obama, State of the Union Address (Jan. 25, 2011) ("The first step in winning the future is encouraging American innovation. None of us can predict with certainty what the next big industry will be or where the new jobs will come from. Thirty years ago, we couldn't know that something called the Internet would lead to an economic revolution. What we can do — what America does better than anyone else — is spark the creativity and imagination of our people. We're the nation that put cars in driveways and computers in offices; the nation of Edison and the Wright brothers; of Google and Facebook. In America, innovation doesn't just change our lives. It is how we make our living."). Further, the President announced the Startup America Partnership initiative, with information is available at http://www.startupamericapartnership.org/ (last visited June 21, 2011).

economic growth. There are a number of considerations in this respect as the Court grapples with this challenge.

R&D is maximized and best accomplished through networks that result in partnering and collaborating:

To the extent R&D needs a cohort of skills, motivation and financing, it becomes clear that this is not a lone endeavor. There is in these fields a high mobility index. The case in chief is a striking example of this professional mobility. Recall that co-inventor Thomas Merigan had ties to both Stanford and Cetus.[92] During Merigan's tenure at Stanford, he joined the Cetus Board in 1979 and signed a number of consulting agreements with Cetus agreeing to share research and know-how.[93] The collaboration at issue in this case began in 1988 between Merigan and Cetus. When research fellow Mark Holodniy began working for Merigan at Stanford, Merigan arranged for him to spend time at a Cetus lab bench with full access to its assets in order to perfect needed scientific techniques for their Stanford-based lab research to advance.[94] The ease with which academic and industry professionals are able to move between workplaces is striking. There are low fences and an open-door policy among contacts in the clubby cohesive world of networked academics and professionals in highly specialized industries.

This type of collaboration will necessarily increase since in many respects the "easy work" is done. Further research suggests more complexity and reaching deeper into the nature of that scientific discipline (math, computer science, chemistry, biology and so forth). Scientists are attempting to extract more knowledge from smaller, more complex samples and in this process will more frequently need to collaborate beyond traditional borders of disciplines. Collaboration is a necessity for progress at this point in time.[95] For example, biotechnologists must work with nanotechnologists to develop the right scale for prototypes. Just one report title underscores this point, '*Convergence of Biotechnology, Information Technology, and*

[92] Board of Trustees v. Roche, 487 F. Supp. 2d 1099, 1099-1102 (N.D. Cal 2007) (noting that Merigan signed numerous consulting agreements with Cetus and served on its Scientific Advisory Board while employed by Stanford as a Professor of Medicine with a research focus on infectious diseases).

[93] *Id.* (noting that Merigan had a right "to use Cetus' proprietary materials and information in exchange for a non-exclusive, royalty-free license to Cetus for any intellectual property developed as a result of the" Materials Transfer Agreements between the parties).

[94] *Id.*

[95] *See* Carolyn Y. Johnson, *Collaboration: The Mother of Invention*, Boston Globe, May 8, 2001, at A1.

Nanotechnology: A NASA Perspective.'[96] The next article in this volume focuses on technology transfer, and so forth.[97] In a broad sense, one isolated company almost cannot invent alone in this increasingly complex inventing and regulatory environment.

Furthermore the amount of money needed between idea and marketplace make development so exceedingly expensive and therefore risky for just one company, that it has further accelerated the trend toward partnering.[98] In recognition of this complicated backdrop, strategic partnerships have developed. Intel is reportedly investing $100 million to create research centers on college campuses in its effort to create a hybrid business model in which its in-house researchers will collaborate more closely with academic peers.[99] Merck and Harvard Medical School signed an agreement to jointly advance research.[100] And more often than not, academic researchers with which industry collaborates will have antecedent government funding agreements for the same, or similar work - meaning that the university is a contractor under the Bayh-Dole Act and accordingly its requirements must be met, irrespective of the peripheral contracts or partnership with commercial entities.

This ever more complicated R&D-to-commercialization trend suggests that in a future with combinations and permutations of funding agencies, research teams, universities, business partners, grad students, fellows, and other possible inventors, the process of discerning, or even

[96] 10 Aerospace Technology Innovation 6 (July-Aug. 2002).

[97] *Technology Transfer: [NASA] Glenn Founds Biomedical Research Consortium*, 10 Aerospace Technology Innovation 7 (July-Aug. 2002).

[98] Cong. Budget Office, Pub. No. 2589, Study: Research and Development in the Pharmaceutical Industry 1-2 (Oct. 2006) (estimating that in 2006, the cost of developing "an innovative new drug [is] more than $800 million).

[99] *See* Isaac Gateno, *Intel invests $100m in University research*, Stanford Daily, Feb 3. 2011, available at http://www.stanforddaily.com/2011/02/03/intel-invests-100m-in-university-research/ (last visited May 8, 2011) (observing that "these centers will be based on a new model that allows for researchers from the tech giant to collaborate more closely with academics....[that] they all benefit from...."); Steve Lohr, *Intel Spreads Its University Research Bets*, N.Y. Times, Jan. 28, 2011, available at http://www.bits.blogs.nytimes.com/2011/01/28/intel-spreads-its-university-research-bets/ (last visited May 8, 2011) (reporting that each project involves a few Intel researchers with far-flung teams of university researchers in a model that mimics the National Science Foundation's approach).

[100] Maureen Martino, Press Release: *Harvard Medical School and Merck Announce Research Agreement*, FierceBiotech, Sept. 14, 2007, available at http://www.fiercebiotech.com (last visited June 21, 2011) (Harvard Medical School's Chief Technology Development Officer noted that this "represents an important new model to collaborate with an industry leader, as well as an essential means to provide our investigators with the resources required to advance their work and translate their research findings into what we hope will one day culminate in new therapeutic modalities that address important unmet medical needs").

granting title to ownership of technology will become fraught with more complex difficulties.[101] It will be a challenge to create a 'bright-line' rule defining rights ahead of time as projects and project members change. And as the project members change, so do the assignments and rights within those assignments. In the case-in-chief for example, recall that Merigan needed more expertise in one discreet area, and the project team changed right at this moment - the point at which Cetus became involved thus forming the basis for its claim of title to the invention at issue.

Due Diligence challenges - inventors' rights, assignments and strategic partnerships as stealth wild cards that create uncertainty in the business environment:

Another related aspect to sorting rights in academic-industry collaborations is the due diligence problem. There is a paper trail of agreements concerning different aspects of projects being performed in distributed locations without a central repository of documentation. Aspects of a project may be funded differently, interested parties are not always the same for each aspect, and therefore in such a laddered-out crazy quilt of funding and inventing, there are bound to be troublesome aspects. Behind the inconsistent assignment phenomenon is fact that language of assignments is highly variable since parties are drafting customized agreements in contract to standard-form agreements easily capable of uniform interpretation, nor have they recorded agreements for 'all the world' to recognize and evaluate. In one stark example (though not covered by the BDA), Dana Farber Cancer Institute and Novartis Pharmaceutical Corp. partnered on cancer studies and entered into a Collaborative Research Agreement. They agreed that in return for certain funding provided to Dana-Farber, Novartis would be entitled to certain rights to the resulting work. The case was filed as a Declaratory Judgment action by Dana-Farber seeking the court's help on an inconsistent assignment case.[102] Dana-Farber allegedly assigned the same rights to two competing entities: Novartis, as well as Gatekeeper Pharmaceuticals (a start-up by Dana Farber's own employees). It seems that assigning entities lack a clear understanding even of the fact that antecedent agreements exist. Neither the parties,

[101] *See* Adam J. Sibley & Rodney L. Sparks, *The Difficulty of Determining Joint Inventorship, Especially With Regard to Novel Chemical Compounds and Their Applications*, 8 Loy. Law & Tech. Ann. 44, 56-58 (2009) (describing the intricacies and difficulties associated with establishing inventorship under U.S. law).

[102] Dana-Farber Cancer Inst. v. Gatekeeper Pharmaceuticals, Inc., No. 1:10-cv-11613-DPW (D. Mass. filed Sept. 21, 2010).

nor the facts and subject matter of these cases lend themselves to simple or straightforward resolution.

This uncertain contracting environment is further complicated because of inventors' rights that are possibly still in force. Recall from Part II above, that the BDA statutory scheme neglects to explicitly address these rights and addresses just those rights as between the government and the university contractor. Note that BDA section 202(a) provides that contractors may 'elect to retain title' to the invention; and that under section 202(d) the BDA recognizes inventors' rights, in a limited way in that they are subject to a first right of refusal by the contractor.[103] This suggests that inventors' rights are inferior to university contractors' and the government's rights though this is not dispositive because the Patent law scheme has not been repudiated. Interestingly U.S. patent law differs from almost every other countries' patent law in this respect. The U.S. awards a patent to the first to invent that subject matter, while in other countries, a patent is awarded to the first inventor to file a patent application for that subject matter.[104] There is more clarity regarding title, and assignments are thereby rendered unnecessary. Harmonizing these two statutes should clearly be a priority. Resolving priority of inventorship rights cases with individuals who have not yet signed invention assignment agreements, or even for those who have, will increase tremendously for this case calls into question instances in which an assignment *has* been executed. Employee status is not always clear and questions will further arise since the employment relationship has evolved to encompass less formal arrangements, including: those who work for hire, or as consultants, temps, interns, or perform contract work, and so forth.

In this increasingly stratified employment construct, establishing priority of inventorship rights absent a clear unequivocal invention assignment agreement will be troublesome. "In general, under varying applicable state and federal laws where the university employs the individual in question, there is a presumption that the employee owns the...IP, even though it may have been created during the course of their employment."[105] This general rule is subject to the following caveats: (1)

[103] *See* Part II, *supra*.

[104] *See* U.N. World Intellectual Property Organization, Patent Cooperation Treaty (June 9, 1970), available at http://www.wipo.int/pct/en/texts/articles/atoc.htm (last visited June 21, 2011); *see, e.g.*, Cook Biotech, Inc. v. Edwards Lifesciences AG, High Court of Justice, Court of Appeal, London, U.K. [2020] EWCA Civ. 718 (Jun 28, 2010, available at http://www.eplawpatentblog.com/2010/June/Etherton%2020LJ%2020-Cook%2020v%2020Edwards%2020Approved%2020final%5B1%5D.pdf (last visited June 21, 2011); Robert H. Rines, *Some Areas of Basic Difference B etween United States Patent Law and the Rest of the World - and Why*, 28 IDEA J. of L. and Tech. 5-8 (1987).

[105] Raymond Millien, *Within a University Community, Who Owns Newly-Created IP?,*

in general, if the employee sign an invention assignment agreement with the employer, the employer owns the IP; (2) the IP is assumed to belong to the employer who hires the employee to invent in this field; and (3) if an explicit assignment does not exist, the employee owns the underlying invention, and the employer nevertheless concurrently holds shop rights to it - a non-exclusive, non-transferable royalty-free license to use the employee's invention.[106] This further reinforces the sense that reliance on assignment agreements is not necessarily a solid strategy for promoting an effective scheme of establishing or transferring rights.

IV. CREATING A RATIONAL PLATFORM FOR TECHNOLOGY DEVELOPMENT AND TRANSFER

The present interpretation of the BDA by the circuit court stands as an obstacle to the accomplishment of the full purpose and objectives Congress expressed when it enacted the BDA.[107] While its decision was understandable under these facts, the net effects are decidedly unfavorable. This decision promotes parties' private contracts over the public benefits; it promotes the notion that an individual employee's interests are never aligned with those of his or her employer; it presumes there is no relationship of trust or accountability for projects funded by taxpayer contributions, that the invention is just another property to be leveraged or sold; and it gives no consideration to that remaining dormant right: the government retains the right to march-in should the invention languish or be subject to misuse. This is not to say that contractor universities, such as Stanford in this case, are the most able stewards for leveraging basic research, but the formal first-party agreement between the government and the contractor confirms these points and values.

The Supreme Court has shown a great deal of interest in patents recently, especially since Chief Justice Roberts' tenure, demonstrating a willingness to re-consider precedent and thereby alter the patent landscape.[108] This apparent newfound interest in patent cases "perhaps

Washington D.C. Intellectual Property Attorney Blog, Jan. 28, 2011, available at http://dcipattorney.com/2011/01/within-a-university-community-who-owns-any-newly-created-ip/ (last visited June 21, 2011).

[106] Gerald Ferrera et al., CyberLaw Text & Cases 299-328 (2012).

[107] *See* Bayh-Dole Act at 25, *supra* note 64, at 22 ("Congress passed Bayh-Dole at a time of widespread concern over America's relative economic decline. Making it easier to commercialize successful academic research was intended to facilitate technology transfer so as to stimulate economic development. The Bayh-Dole structure made it far easier for universities to own the technology developed in their research facilities, and equally importantly, allowed researchers themselves to profit from successful commercialization of their research").

[108] Robert C. Scheinfeld & Parker H. Bagley, *The Roberts Supreme Court Takes on Patent*

stems from a recognition of the growing importance of intellectual property to the nation's information-based economy."[109] Inventing and innovating are the linchpins of the U.S. economy and our future - they represent the technology that forms the basis of company formation and job creation. For example, Google started from a government-funded research project that resulted in an algorithm that yielded better search results for a digital library collection. During this cycle of technology development and deployment with company and job formation, research suggests that newer companies add jobs faster than older established companies.[110] In this respect then, fostering start-ups generates more value to workers and the economy than for example, giving tax credits or other government support to older companies. These are the outcomes that deserve attention, recognition and support.

To best effectuate the goals of the BDA this means generating the most return and public benefit and there needs more clarity throughout the entire contracting process. For this to occur title to inventions must be more carefully defined and the disposition of rights must be more transparent, possibly through creating a system for recording assignments so as to avoid the problem of multiple inconsistent assignments. Further, other provisions should address: when

Cases, Vol. 236, No. 61, N.Y.L.J. Sept. 26, 2006, available at http://www.bakerbotts.com/files/Publication/42e73ea4-2eb0-4be6-bef9-c130d3817012/Presentation/PublicationAttachment/9113f414-c44b-4131-98c6-c43e546dc3b0/Scheinfeld%20NYLJ%20Article,%209-27-06.pdf (last visited June 21, 2011) (the Court has shown a "willingness to tackle sophisticated patent cases which promise to exert a long-lasting effect...."); *see also* Brian T. Yeh, Cong. Research Serv., No. 7-5700, An Overview of Recent U.S. Supreme Court Jurisprudence in Patent Law (Sept. 17, 2010) ("nine cases that have been decided since 2005: *Merck KGaA v. Integra Lifesciences I, Unitherm Food Systems v. Swift-Eckrich, Illinois Tool Works v. Independent Ink, eBay v. MercExchange, Laboratory Corporation of America Holdings v. Metabolite Labs., MedImmune v. Genentech, KSR International Co. v. Teleflex Inc., Microsoft v. AT&T, Quanta Computer, Inc. v. LG Electronics, Inc.,* and *Bilski v. Kappos.*"). Furthermore, three patent cases were considered during the 2010-2011 Term: the *Board of Trustees* case herein, *Microsoft v. i4i L.P.* 598 F.3d 831 (Fed. Cir.), *cert. granted,* 2010 U.S. LEXIS 9311 (U.S. Nov. 29, 2010) (No. 10-290) (Microsoft is challenging long-standing precedent requiring clear and convincing evidence to prove invalidity of a patent. Microsoft is arguing that this standard is too high a threshold), and *Global-Tech Appliances, Inc. v. SEB S.A.*, 594 F.3d 1360 (Fed. Cir.) *cert. granted,* 2010 U.S. LEXIS 8068 (U.S. Oct. 12, 2010) (No. 10-6) (the Court is considering the level of intent required for a finding of inducing infringement).

[109] *See* Yeh, *supra.*

[110] *See* John C. Haltiwanger, Ron S. Jarmin, Javier Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, Nat'l Bureau of Econ. Research, NBER Working Paper No. 16300 1-2 (Aug. 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1666157 (last visited June 21, 2011) ("startups contribute substantially to both gross and net job creation...the younger the companies are, the more jobs they create, regardless of their size").

employee's rights vest and terminate, what rights survive or extinguish upon assignment, and so forth. This could be most easily accomplished by the Secretary of Commerce who is vested with power to enact regulations for the BDA. If the conditions are ideal for a coherent and transparent system for the transfer of technology and rights, this will encourage more collaboration for the purpose of research and development and subsequent commercialization. It is critical to ensure that the government retains access to the technology, that contractors and their employees are recognized for their role, and that business partners may pursue access to this technology and know-how so that the technology develops and the public can reap the benefits of these contributions.

THE KU KLUX KLAN ACT AND THE INTRACORPORATE CONSPIRACY DOCTRINE

By PATRICIA QUINN ROBERTSON* AND JOHN F. ROBERTSON**

THE KU KLUX KLAN ACT

The Fourteenth Amendment to the United States Constitution is the longest and most complex of the three amendments ratified in the years following the Civil War. Section 1 of the Fourteenth Amendment reads as follows:

> All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the state wherein they reside. No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.[1]

Section 5 provides "[t]he Congress shall have power to enforce, by appropriate legislation, the provisions of this article."[2]

The Fourteenth Amendment was passed by Congress, but the southern states refused to ratify it. This refusal prompted part of the Military Reconstruction Act of 1867.[3] Ratification of the Fourteenth Amendment was one of the many requirements that a southern state

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[1] U.S. CONST. amend. XIV, § 1.
[2] U.S. CONST. amend. XIV, § 5.
[3] *United States Statutes at Large*, Vol. XIV, Chap. CLIII, 428-29.

had to meet before military oversight could end. These requirements are contained in Section 5 of the Military Reconstruction Act.[4]

Even though the Fourteenth and Fifteenth Amendments were eventually ratified, African-American citizens in the southern states were routinely denied their civil rights. This lead to a series of laws enacted under the provisions of Article 5 of the Fourteenth Amendment, and similar authority in the Fifteenth Amendment. These laws were designed to enforce the provisions of the new amendments. One of these was to become known as the Ku Klux Klan Act.[5] Only portions of the original Act remain part of the United States Code. Section 1 of the Act is now codified as 42 U.S.C. §1983, Section 2 is now 42 U.S.C. § 1985, and Section 6 is now codified as 42 U.S.C. §1986. In the codification process, Section 2 of the Act has been divided into three paragraphs. The first deals with preventing an officer from performing official duties, the second deals with witness or juror intimidation, and the third deals with conspiracies to deny persons or classes of persons their rights under the Fourteenth Amendment. The third paragraph also contains the remedies provision for all three parts of the Section. 42 U.S.C. § 1985(3) currently reads as follows:

> If two or more persons in any State or Territory conspire, or go in disguise on the highway or on the premises of another, for the purpose of depriving, either directly or indirectly, any person or class of persons of the equal protection of the laws, or of equal privileges and immunities under the laws, or for the purpose of preventing or hindering the constituted authorities of any State or Territory from giving or securing to all persons within such State or Territory the equal protection of the laws; or if two or more persons conspire to prevent by force, intimidation, or threat, any citizen who is lawfully entitled to vote, from giving his support or advocacy in a legal manner, toward or in favor of the election of any lawfully qualified person as an elector for President or Vice-President, or as a member of Congress of the United States; or to injure any citizen in person or property on account of such support or advocacy; in any case of conspiracy set forth in this section, if one or more persons engaged therein do, or cause to be done, any act in furtherance of the object of such conspiracy, whereby another is injured in his person or property, or deprived of having and exercising any right or privilege of a citizen of the United States, the party so injured or deprived may have an action for the recovery of damages, occasioned by such injury or deprivation, against any one or more of the conspirators.

[4] *Id.* at 429.

[5] *United States Statutes at Large*, Vol. XVII, Chap. XXII, 13-15. This Act is also known as the Enforcement Act of 1871 and as the Civil Rights Act of 1871.

Section 2 of the Act originally included criminal as well as civil sanctions.[6] The U.S. Supreme Court held that the criminal sanctions were unconstitutional in *United States v. Harris.*[7] The Supreme Court found no support in any of the post-Civil War amendments for a statute governing the actions of individuals. The Justices found that all these amendments were directed towards actions of the states.[8] The Supreme Court went on to issue several rulings in this time period that generally restricted the application of the Fourteenth Amendment.[9] These rulings held sway well into the next century. For example, the court found no cause of action under Section 1985(3) when a political meeting was broken up by private individuals in *Collins v. Hardyman*.[10]

One of the earliest cases to expand Section 1985(3) rights in particular was *Griffin v. Breckenridge*.[11] In this case, the plaintiffs were a group of African-Americans who were driving in an automobile when they were stopped by the defendants, held at gunpoint, and beaten. The Supreme Court found that Section 1958(3) did provide a remedy in this situation. Addressing two earlier issues, the Court found that it was able to separate the constitutional provisions of the Ku Klux Klan Act from the unconstitutional ones, and that the limiting language that once restricted the Act to state actions was not supported by the plain meaning of the statute or the interpretation of the Civil Rights statutes after *Collins*.[12]

THE INTRACORPORATE CONSPIRACY DOCTRINE

The Fifth Circuit formulated the intracorporate conspiracy doctrine almost sixty years ago in *Nelson Radio & Supply Co., Inc. v. Motorola, Inc.*.[13] In *Nelson Radio,* the plaintiff accused Motorola, Inc. and its

[6] *Id.* at 14.

[7] 106 U.S. 629 (1883). In this case, Harris and 19 other white men were charged with conspiracy after assaulting a group of African-Americans who were in the custody of a deputy sheriff. One of the men was killed in the attack. The United States Supreme Court reached a similar decision in Baldwin v. Franks, 120 U.S. 678 (1887). In Baldwin, a group of Chinese residents were chased out of the town of Nicolaus, California in violation of a treaty between the U.S. and China. The government made the argument that the criminal provisions of the Act, although earlier declared unconstitutional in Harris, still had merit when dealing with protecting rights under a federal treaty. The Supreme Court found that there was no way to separate any constitutional provisions of the statute from the unconstitutional ones.

[8] 106 U.S. 629.

[9] Wilson R. Huhn, *The Legacy of Slaughterhouse, Bradwell, and Cruikshank in Constitutional Interpretation,* 42 Akron L. Rev. 1051 (2009).

[10] 341 U.S. 651 (1951).

[11] 403 U.S. 88 (1971).

[12] 200 F.2d 911 (5th Cir. 1952).

[13] *Id.*

employees of engaging in a "conspiracy in restraint of trade" in violation of Section One of the Sherman Act.[14] However, the Fifth Circuit held that Motorola, Inc. was not liable for such a conspiracy because "[a] corporation cannot conspire with itself any more than a private individual can, and it is the general rule that the acts of the agent are the acts of the corporation."[15]

A corporation is generally viewed as a person under the law.[16] The Supreme Court of the United States has also determined that a corporation is a person for purposes of the Fourteenth Amendment.[17] Agency law tells us that corporate officers and employees are agents of the corporation. The basic theory of the intracorporate conspiracy doctrine is that a conspiracy requires two or more participants, and a corporation as a person is indistinguishable from its officers and employees.[18] A corporation is seemingly unable to conspire with its own officers and employees, as they are acting as its agents in the scope of their employment.

CIRCUITS HOLDING THAT THE INTRACORPORATE CONSPIRACY DOCTRINE BARS CLAIMS UNDER SECTION 1985

The U.S. Supreme Court has noted a split in Circuits about whether the intracorporate conspiracy doctrine applies to cases under Section 1985(3), but has not yet resolved that split.[19] Generally, the Second, Fourth, Fifth, Sixth, Seventh, Eighth and Eleventh Circuits have held that the intracorporate conspiracy doctrine bars claims under Section 1985(3), although some of these Circuits recognize that exceptions to this rule exist.[20] The exceptions that some Circuits have accepted provide that the intracorporate conspiracy doctrine will not bar a Section 1985(3) claim if: (a) the conspirators acted outside of their normal corporation duties or authority; (b) the conspirators had an

[14] *Id.*

[15] *Id.* at 914.

[16] *See* Trustees of Dartmouth College v. Woodward, 17 U.S. 518 (1819) (illustrating the corporation as an artificial person with the right to enter into a contract). *See also* United States v. Amedy, 24 U.S. 392 (1826) (stating "[t]hat corporations are, in law, for civil purposes, deemed persons, is unquestionable.")

[17] Santa Clara County v. Southern Pacific Railroad Co., 118 U.S. 394 (1886) (The actual conclusion about corporate personhood was apparently conveyed by the Chief Justice immediately prior to oral argument).

[18] *See Nelson Radio*, 200 F.2d 911 (5th Cir. 1952).

[19] Smithers v. City of Flint, 602 F.3d 758, 765 n.4 (6th Cir. 2010) (citing Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 775 n.24).

[20] *See, e.g.,* Buschi v. Kirven, 775 F.2d 1240 (4th Cir. 1985); Chambliss v. Foote, 562 F.2d 1015 (5th Cir. 1977); Johnson v. Hills & Dales General Hospital, 40 F.3d 837 (6th Cir. 1994); Garza v. City of Omaha, 814 F.2d 553 (8th Cir. 1987).

independent personal stake in the conspiracy; or (c) the conspiracy was criminal in nature.[21]

In the Second Circuit case of *Girard v. 94th St. & Fifth Ave. Corp,*[22] the plaintiff alleged a Section 1985(3) conspiracy by a corporation and its officers and directors to deprive her of her civil rights by allegedly denying her the right to receive a transfer of corporate stock and a proprietary lease in the corporation's building.[23] However, plaintiff's Section 1985(3) claim failed because the Court held that there could be no "conspiracy" among a corporate defendant and its officers and board of directors absent some activity of a personal nature by defendants.[24] The court stated that

> …simply joining corporate officers as defendants in their individual capacities is not enough to make them persons separate from the corporation in legal contemplation. The plaintiff must also allege that they acted other than in the normal course of their corporate duties. . . . 'It is not alleged that the individual defendants committed any act of a personal nature except in connection with the corporate affairs.'[25]

In *Hermann v. Moore,*[26] a tenured professor at Brooklyn Law School claimed that he was dismissed because of activism in support of African-Americans and other minorities.[27] The Second Circuit in *Hermann* explained that for a Section 1985(3) plaintiff to succeed, "there must be some racial, or perhaps otherwise class-based, invidiously discriminatory animus behind the conspirator's action."[28] The court in *Hermann* held that "there is no evidence that defendants dismissed plaintiff as a professor, or otherwise penalized him, because of his advocacy of Blacks or other minorities."[29] The *Hermann* opinion that "there is no conspiracy [under § 1985(3)] if the conspiratorial conduct challenged is essentially a single act by a single corporation acting exclusively through its own directors, officers, and employees, each acting within the scope of his employment" is still cited as the law in the Second Circuit.[30]

[21] *Id.* *See also* McAndrews v. Lockheed Martin Corp., 206 F.3d 1031, 1038 (11th Cir. 2000).

[22] 530 F.2d 66 (2d Cir. 1976).

[23] *Id.*

[24] *Id.*

[25] *Id.* at 72 (quoting Cole v. University of Hartford, 391 F. Supp. 888, 893 (D. Conn., 1975)).

[26] 576 F.2d 453 (2nd Cir. 1978).

[27] *Id.* *See also* Girard v. 94th Street & Fifth Avenue Corp., 530 F.2d 66, 70-72 (2nd Cir. 1976).

[28] *Hermann*, 576 F.2d at 457.

[29] *Id.*

[30] *Id.* at 459. *See, e.g.*, Straker v. New York City Transit Authority, 340 Fed. Appx. 675 (2nd Cir. 2009) (quoting *Hermann*, 576 F.2d at 459); Hartline v. Gallo, 546 F.3d 95 (2nd Cir.

However, the Second Circuit in *New York v. 11 Cornwell Co.,*[31] considered the case of a partnership allegedly formed by a group of neighbors to purchase property to prevent the Office of Mental Retardation and Developmental Disabilities (OMRDD) of New York from acquiring the property for a home for mentally retarded persons.[32] The plaintiff alleged that the seller of the property, the partnership and the partners were liable under Section 1985(3) for purchasing the property, placing it on the market for sale, but refusing to sell to the OMRDD.[33] Although the defendants argued that the intracorporate conspiracy doctrine would bar the plaintiff's recovery, the Second Circuit held that the intracorporate conspiracy doctrine does not apply to partnerships because "[a] corporation is a distinct and fictional legal entity; a partnership is not distinct from its members at all."[34] The court further held that recovery should not be barred against the partners and a partnership formed primarily for the purpose of the conspiracy.[35]

The Fourth Circuit has stated that there can be two exceptions to the doctrine: (a) the "generally recognized exception to the doctrine that a conspiracy may be found where the corporate agent 'has an independent personal stake in achieving the corporation's illegal objective;'" and (b) a conspiracy may "be found where the agent's acts were not authorized by the corporation."[36] For example, the Fourth Circuit in *Buschi v. Kirven*[37] considered claims by employees of a mental health hospital who alleged that they were dismissed because they complained about matters such as abuse of patients and racial discrimination in violation of Section 1985(3). [38] The Fourth Circuit in *Buschi* quoted the Fifth Circuit's opinion in an antitrust case as follows:

> It is basic in the law of conspiracy that you must have two persons or entities to have a conspiracy. A corporation cannot conspire with itself any more than a private individual can, and it is the general rule that the acts of the agent are the acts of the corporation.[39]

2008); Farbsten v. Hicksville Public Library, 254 Fed. Appx.50; (2nd Cir. 2007); Brown v. City of Syracuse, 197 Fed. Appx. 22 (2nd Cir. 2006).

[31] 695 F.2d 34 (2nd Cir. 1982).

[32] *Id.*

[33] *Id.*

[34] *Id.* at 41.

[35] *Id.*

[36] Bank Realty, Inc. v. Practical Management Technology, Inc., 1991 U.S. App. LEXIS 11793 at *12 (4th Cir. 1991). However, the intracorporate conspiracy doctrine barred the plaintiff's recovery under Section 1985(3) in that case because the plaintiff did not prove that the case fell under either of the two exceptions to the doctrine. *Id.*

[37] 775 F.2d 1240 (4th Cir. 1985).

[38] *Id.*

[39] Nelson Radio & Supply Co. v. Motorola, Inc., 200 F.2d 911 (5th Cir. 1952) (quoted in

The employees lost their conspiracy claim in the *Buschi* case.[40] The *Busch*i court did acknowledge that if an "officer has an independent personal stake in achieving the corporation's illegal objective" or if the "employees were dominated by personal motives or where their actions exceeded the bounds of their authority," the intracorporate conspiracy doctrine may not apply.[41] Courts in the Fourth Circuit continue to cite the intracorporate conspiracy doctrine as a bar to action.[42]

The Fifth Circuit has also adopted the intracorporate conspiracy doctrine to bar Section 1985(3) claims in *Chambliss v. Foote*.[43] In this case, a university instructor alleged that a university and its officials discriminated against her based upon her race, gender and religion and interfered with her civil rights and failed to grant her due process.[44] However, the Fifth Circuit held that the instructor's Section 1985(3) conspiracy case against the University of New Orleans and its officials failed because a "university and its officials are considered as constituting a single legal entity which cannot conspire with itself."[45] In a later case, the Fifth Circuit acknowledged the "personal purposes exception" to the doctrine of intracorporate conspiracy.[46]

The Sixth Circuit has adopted the intracorporate conspiracy doctrine, but acknowledges that there are exceptions to the doctrine.[47] In the 2008 case of *Amadasu v. Christ Hospital*,[48] the Sixth Circuit Court of Appeals held that the intracorporate conspiracy doctrine barred a claim by an employee of a hospital for civil rights violations.[49] The plaintiff sued numerous defendants, including the hospital, some hospital employees, and the hospital attorney, for employment discrimination due to age, race, national origin and disability, and retaliation based upon an earlier lawsuit filed by the plaintiff against the hospital.[50] The Sixth Circuit held that the intracorporate conspiracy doctrine barred the

Buschi, 775 F.2d at 1251).

[40] *Buschi,* 775 F.2d 1240

[41] *Id.* at 1252 (quoting Greenville Publishing, 496 F.2d 391, 399 (4th Cir. 1974) and Note, 13 Ga. L. Rev. at 608).

[42] *See, e.g.,* Groves v. City of Darlington, 2011 U.S. Dist. LEXIS 20867 (D.S.C. 2011); Nelson v. City of Crisfield, 2010 U.S. Dist. LEXIS 118360 (D. Md. 2010). *See also* American Chiropractic v. Trigon Healthcare, 367 F.3d 212 (4th Cir. 2004). In American Chiropractic, an antitrust case, the Fourth Circuit acknowledged the "independent personal stake" exception, but held that it did not apply in that case.

[43] Chambliss v. Foote, 421 F. Supp. 12 (E.D. La. 1976), *aff'd* 562 F.2d 1015 (5th Cir. 1977).

[44] *Id.*

[45] *Chambliss,* 421 F.Supp at 15.

[46] Benningfield v. City of Houston, 157 F.3d 369, 378 (5th Cir. 1998).

[47] Johnson v. Hill & Dales General Hospital, 40 F.3d 837 (6th Cir. 1994).

[48] 514 F.3d 504 (6th Cir. 2008).

[49] *Id.*

[50] *Id.*

plaintiff's claim, and the court stated that if "all of the defendants are members of the same collective entity, there are not two separate 'people' to form a conspiracy."[51] The Sixth Circuit also expanded the intracorporate conspiracy doctrine to bar recovery from the hospital's attorney who was not an employee of the hospital, but who "acted as their agent and was part of the collective entity when providing legal representation" in the earlier lawsuit.[52] The *Amadasu* court relied on an earlier Sixth Circuit case, *Hull v. Cuyahoga Valley Joint Vocations School District Board of Education,*[53] in which the Sixth Circuit held that three people (a superintendent, the executive director, and a school administrator) employed by the School Board, were not in a conspiracy because they were "all members of the same collective entity."[54] The Sixth Circuit adopted the scope of employment exception to the intracorporate conspiracy doctrine in *Johnson v. Hills & Dales General Hospital*,[55] holding that "when employees act outside the course of their employment, they and the corporation may form a conspiracy under 42 U.S.C. § 1985(3)."[56] The *Johnson* court recognized that there should not be immunity from suit under Section 1985(3) "where the actors coincidentally were employees of the same company."[57] The court "recognize[d] a distinction between collaborative acts done in pursuit of an employer's business and private acts done by persons who happen to work at the same place."[58] Further, the court stated that "[a] corporation formed for the purpose of depriving citizens of their civil rights would not be shielded by the intracorporate conspiracy doctrine."[59] The court held that "corporate actors might be beyond the

[51] *Id.* at 507 (quoting Hull v. Cuyahoga Valley Joint Vocational Sch. Dist. Bd. Of Educ., 926 F.2d 505, 510 (6th Cir. 1991)).

[52] *Id.* at 507 (citing Doherty v. American Motors Corp., 728 F.2d 334, 340 (6th Cir. 1984)).

[53] 926 F.2d 505 (6th Cir. 1991).

[54] *Id.* at 510 (relying on *Doherty*, 728 F.2d 334 (6th Cir. 1984)).

[55] 40 F.3d 837 (6th Cir. 1994). *See also* Al-Marayati v. The University of Toledo, 1998 U.S. App. LEXIS 9797 (6th Cir. 1997) (holding that "the University and various current and former employees of the University who acted within the scope of their legitimate authority" could not be co-conspirators).

[56] *Johnson,* 40 F.3d at 840-841 (6th Cir. 1994).The *Johnson* court held that the "outside the scope of employment" exception to the intracorporate immunity doctrine did not apply, even in the face of the following allegations: (a) "even if the employees lacked the necessary qualifications to prescribe proper medical treatment"; (b) "in addition to racial bias, the employees wished to have her assigned to another hospital so that they would not have to work so hard"; (c) "employee complaints contained rumors and falsehoods." *Id.* at 841.

[57] *Id.* at 840.

[58] *Id.*

[59] *Id.*

scope of their employment where the aim of the conspiracy exceeds the reach of legitimate corporate activity."[60]

In 1972, the Seventh Circuit in *Dombrowski v. Dowling*[61] reviewed an attorney's case against a real estate management company and its building manager under Section 1985(3), for allegedly refusing to rent office space to the attorney because of the racial composition of the attorney's usual clientele.[62] The Seventh Circuit held that "proof that a discriminatory business decision reflects the collective judgment of two or more executives of the same firm" is not sufficient to prove a "conspiracy" under Section 1985(3).[63] The *Dombrowski* Court held that:

> Agents of the Klan certainly could not carry out acts of violence with impunity simply because they were acting under orders from the Grand Dragon. But if the challenged conduct is essentially a single act of discrimination by a single business entity, the fact that two or more agents participated in the decision or in the act itself will normally not constitute the conspiracy contemplated by this statute.[64]

In 1990, the Seventh Circuit in *Travis v. Gary Community Mental Health Center*[65] addressed another Section 1985 case to hold that "it does not matter whether the corporate managers took multiple steps to carry out their plan; intra-corporate discussions are not 'conspiracies.'"[66] The *Travis* court also held that such discussions including outside lawyers for the corporation are also not conspiracies.[67] The Seventh Circuit again addressed the intracorporate conspiracy doctrine in *Hartman v. Trustees of Community College District No. 508, Cook County, Illinois*.[68] The *Hartman* court held that "if the challenged conduct is essentially a single act of discrimination by a single business entity, the fact that two or more agents participated in the decision or in the act itself will normally not constitute the conspiracy contemplated by [§ 1985(3)]."[69] However, the court also acknowledged that the "nature of the discriminatory activity may require that the doctrine be disregarded: Members of the Ku Klux Klan could not avoid liability by incorporating, for they would still be trying to organize (through persuasion or terror)

[60] *Id.*
[61] 459 F.2d 190 (7th Cir. 1972).
[62] *Id.*
[63] *Id.* at 196.
[64] *Id.*
[65] 921 F.2d 108 (7th Cir. 1990).
[66] *Id.* at 111.
[67] *Id.* *Travis* was a Section 1985(2) case, but the court held that "there was no sound basis for not applying the same approach to all of the various subsections of §1985." Wright v. Illinois Department of Children & Family Services, 40 F.3d 1492 (7th Cir. 1994).
[68] 4 F.3d 465 (7th Cir. 1993).
[69] *Hartman*, 4 F.3d at 470. *See also* Beese v. Todd, 35 Fed. Appx. 241 (7th Cir. 2002).

multiple centers of social or economic influence…."[70] The Seventh Circuit felt that "showing that corporate employees were motivated in part by personal bias" is not enough to make the activity actionable because such an interpretation would make the intracorporate conspiracy doctrine meaningless.[71] Also, in *Wright v. Illinois Department of Children and Family Services*,[72] the Seventh Circuit held that the intracorporate conspiracy doctrine would apply to Section 1985 claims against "individual members of a single governmental entity" because the defendants "can be said to constitute only a single 'center[] of social or economic influence.'"[73] The Seventh Circuit in *Wright* reiterated that "except in egregious circumstances, intra-entity discussions that result in discriminatory or retaliatory actions lie outside the scope of § 1985."[74]

In *Meyers v. Starke*,[75] the Eighth Circuit held that the intracorporate conspiracy doctrine barred action by a former state employee who sued three supervisors, alleging adverse employment action in violation of her First Amendment right to free speech at a hearing about the welfare of some children in custody of the state.[76] The court held that "the intracorporate conspiracy doctrine…allows corporate agents acting within the scope of their employment to be shielded from constituting a conspiracy under § 1985," and the court extended this protection to employees of a governmental body.[77] In *Cross v. General Motors Corp.*,[78] the Eighth Circuit also dismissed a claim by an employee of conspiracy to discriminate based upon race because "a corporation and its agents are a single person in the eyes of the law, and a corporation cannot conspire with itself."[79] The *Meyers* court went further to say that it is possible that Section 1985(3) might apply to a corporation if "individual defendants are named as well as the corporation, and those individuals acted outside the scope of their employment or for personal reasons."[80]

[70] *Hartman,* 4 F.3d at 470 (citing *Travis*, 921 F.2d at 110 (7th Cir. 1990)).

[71] *Hartman,* 4 F.3d at 470. *See also* Dombrowski v. Dowling, 459 F.2d 190, 196 (7th Cir. 1972).

[72] 40 F.3d 1492, 1508 (7th Cir. 1994).

[73] *Id*. (quoting *Dombrowski*, 459 F.2d at 196; *Travis,* 921 F.2d at 110).

[74] *Id.* at 1508-9.

[75] 420 F.3d 738 (8th Cir. 2005).

[76] *Id.*

[77] *Id.* at 742.

[78] 721 F.2d 1152 (8th Cir. 1983).

[79] *Id.* at 1156. *See also* Runs After v. United States, 766 F.2d 347, 354 (8th Cir. 1985); Baker v. Stuart Broadcasting Co., 505 F.2d 181, 183 (8th Cir. 1974).

[80] *Cross,* 721 F.2d at 1156 (citing Great American Savings and Loan Ass'n v. Novotny, 442 U.S. 366, 372 n. 11(1979); Stathos v. Bowden, 514 F.Supp. 1288, 1291-1293 (D. Mass. 1981); Dupree v. Hertz Corp., 419 F. Supp. 764, 766 (E.D. Pa. 1976); Coley v. M&M Mars, Inc., 461 F. Supp 1073, 1076-1077 (M.D. Ga. 1978); Rackin v. University of Pennsylvania, 386 F. Supp 992, 1005-1006 (E.D. Pa. 1974)).

In *Garza v. City of Omaha*,[81] the Eighth Circuit cited an exception to the intracorporate conspiracy doctrine as its reason for affirming the lower court's judgment in favor of a plaintiff employee on a Section 1985(3) claim.[82] The Eighth Circuit stated that "[w]hile it is true that a corporation cannot conspire with itself, an intracorporate conspiracy may be established where individual defendants are also named and those defendants act outside the scope of their employment for personal reasons."[83] Evidence indicated that the individual defendants in *Garza* participated in adverse employment actions to further their personal biases against the plaintiff who was Mexican.[84] The intracorporate conspiracy doctrine was once again applied by the Eighth Circuit in the 2010 opinion in *Sitzes v. City of West Memphis, Arkansas*.[85]

The Eleventh Circuit in *Dickerson v. Alachua County Commission,*[86] considered allegations that the employer county jail and its Caucasian employees conspired to demote African-American officers.[87] The Eleventh Circuit held that the County and its employees were unable to be conspirators under Section 1985(3) because the County and its employees are "a single legal entity" that "cannot conspire with itself."[88] In the 2007 case of *Holloman v. Jacksonville Housing Authority*,[89] the Eleventh Circuit used the intracorporate conspiracy doctrine to bar the Section 1985 claim of a tenant who was denied housing subsidies.[90] The tenant claimed a conspiracy to deny him equal protection of the laws.[91] The Eleventh Circuit dismissed the conspiracy claims based upon the intracorporate conspiracy doctrine.[92] However, the Eleventh Circuit has

[81] 814 F.2d 553 (8th Cir. 1987).

[82] *Id.*

[83] *Id.* at 556.

[84] *Id.*

[85] 606 F.3d 461 (8th Cir. 2010).

[86] 200 F.3d 761 (11th Cir. 2000).

[87] *Id.*

[88] *Id.* at 768. *See also* Denney v. City of Albany, 247 F.3d 1172 (11th Cir. 2001).

[89] 2007 U.S. App. LEXIS 1940 (11th Cir. 2007).

[90] *Id. See also* Grider v. City of Auburn, 618 F.3d 1240 (11th Cir. 2010) in which the intracorporate conspiracy doctrine barred the claim of bar owners against police officers under Section 1983 for malicious prosecution (citing McAndrew v. Lockheed Martin Corp., 206 F.3d 1031, 1036 (11th Cir. 2000) (en banc); Denney v. City of Albany, 247 F.3d 1172, 1190-91 (11th Cir. 2001); Rehberg v. Paulk, 611 F.3d 828, 2010 WL 2788199, at *19 (11th Cir. 2010); Dickerson v. Alachua Cnty. Comm'n, 200 F.3d 761, 767-68 (11th Cir. 2000); Chambliss v. Foote, 562 F.2d 1015 (5th Cir. 1977)).

[91] *Holloman,* 2007 U.S. App. LEXIS 1940.

[92] *Id. See also* Albra v. City of Fort Lauderdale, 232 Fed. Appx. 885 (11th Cir. 2007) in which the plaintiff's Section 1983 claim was barred by the intracorporate conspiracy doctrine.

also stated that the intracorporate conspiracy doctrine does not apply where defendants' alleged acts amount to a criminal conspiracy.[93]

CIRCUITS HOLDING THAT THE INTRACORPORATE CONSPIRACY DOCTRINE SHOULD BE MORE LIMITED FOR SECTION 1985 CLAIMS

The First, Third and Tenth Circuits indicate a more narrow interpretation of the intracorporate conspiracy doctrine in Section 1985(3) cases.[94]

The First Circuit indicated a more narrow interpretation of the intracorporate conspiracy doctrine in *Stathos v. Bowden*.[95] In *Stathos* the plaintiffs sued a governmental body and several of its Commissioners for sex discrimination and conspiracy under Section 1985(3).[96] The First Circuit held that "the boundaries of an 'intracorporate' exception to the §1985(3) conspiracy provision should be narrower than in antitrust."[97] The court explained that each business must set prices for its goods and services. Such price-setting serves a useful purpose, and such decisions may involve more than one person inside a business.[98] However, when two or more businesses join together to set prices, this may harm competition.[99] The Sherman Act is aimed at two or more businesses joining together to take an action such as price-setting.[100] "Where 'equal protection' is at issue, however, one cannot readily distinguish in terms of harm between the individual conduct of one enterprise and the joint conduct of several. Nor can one readily identify desirable social conduct as typically engaged in jointly by the officers of a single enterprise."[101] For this reason the *Stathos* court stated that "we do not see why [the boundaries of the intracorporate conspiracy exception to Section 1985(3)] should extend -- if at all -- beyond the ministerial acts of several executives needed to carry out a single discretionary decision."[102] The court in *Stathos*

[93] Odum v. Rayonier, Inc., 316 Fed. Appx. 855 (11th Cir. 2008). *See also* McAndrew v. Lockheed Martin Corp., 206 F.3d 1031 (11th Cir. 2000).

[94] *See, e.g.,* Stathos v. Bowden, 728 F.2d 15 (1st Cir. 1984); Novotny v. Great American Federal Savings & Loan Association, 584 F.2d 1235 (3rd Cir. 1978); Brever v. Rockwell International Corp., 848 F.2d 424 (1987).

[95] *Stathos,* 728 F.2d 15 (1st Cir. 1984).

[96] *Id.*

[97] *Id.* at 21.

[98] *Id.*

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.*

refused to apply the intracorporate exception because the activities of the defendants involved numerous acts over a period of time.[103]

The Third Circuit reversed the district court's dismissal of the employee's complaint for retaliatory discharge in *Novotny v. Great American Federal Savings & Loan Association*.[104] The employee claimed that his discharge was in retaliation for his support for women's equal employment rights.[105] The defendants included the employer, together with officers and board members.[106] The defendant officers and directors claimed that any actions were in their official capacities and, therefore, there could not be a conspiracy.[107] However, the *Novotny* court refused to "follow the line of cases adopting the rule that concerted action among corporate officers and directors cannot constitute a conspiracy under § 1985(3)."[108] The Third Circuit also held that activities arising from the relationship of attorney and client are not a conspiracy in *Heffernan v. Hunter*.[109] In addition, the Third Circuit held that "a section 1985(3) conspiracy between a corporation and one of its officers may be maintained if the officer is acting in a personal, as opposed to official, capacity, or if independent third parties are alleged to have joined the conspiracy" in *Robison v. Canterbury Village, Inc*..[110]

In *Brever v. Rockwell International Corp.*,[111] the Tenth Circuit considered a Section 1985(2) claim filed by whistleblowers against their former employer and co-workers.[112] The court noted that the corporation, acting through numerous employees, "allegedly engaged in a series of activities ranging from direct threats of harm and intentional bypass of required safety procedures to deliberate sabotage and sexually harassing body contact."[113] The defendants in that case attempted to

[103] *Id. See also* Irizarry v. Quiros, 722 F.2d 869, 872 (1st Cir.1983). However, the First Circuit dismissed a plaintiff law student's Section 1985(3) claim that the faculty of Harvard Law school gave lower grades to female students because the plaintiff failed to name individual faculty members as defendants. Rice v. President & Fellows of Harvard College, 663 F.2d 336, 338 (1st Cir. 1981). "The fatal defect in this claim is that she has sued only the President and Fellows of Harvard College, which is a single corporate entity and, therefore, unable to conspire with itself in violation of § 1985(3)." *Id.*

[104] 584 F.2d 1235 (3rd Cir. 1978).

[105] *Id.*

[106] *Id.*

[107] *Id.*

[108] *Id.* at 1259. However, the *Novotny* decision was vacated on other grounds. *Novotny*, 442 U.S. 366 (1979) (holding that "§ 1985(3) may not be invoked to redress violations of Title VII").

[109] 189 F.3d 405 (3rd Cir. 1999).

[110] 848 F.2d 424 (1987). However, the plaintiff in *Robison* failed to allege that defendant acted in any way other than in his official capacity as president of the corporation.

[111] 40 F.3d 1119 (10th Cir. 1994).

[112] *Id.*

[113] *Id.* at 1126.

raise the intracorporate conspiracy doctrine as a defense.[114] However, the court held that the intracorporate conspiracy doctrine should not apply to this circumstance.[115] The *Brever* court stated "the doctrine, designed to allow one corporation to take actions that two corporations could not agree to do, should not be construed to permit the same corporation and its employees to engage in civil rights violations."[116] The court further stated that even circuits that do apply the doctrine would not apply it here because "[c]ourts have recognized an exception where an officer or agent had 'an independent personal stake in achieving the corporation's illegal objective.'"[117]

As we near the sixtieth anniversary of the *Nelson Radio & Supply Co.* case, the intracorporate conspiracy doctrine continues to be raised by defendants in an attempt to bar claims under Section 1985.[118] The Ninth Circuit has not yet addressed this split, although recent cases in the Northern District of California indicate its agreement with the Tenth Circuit position.[119]

ANALYSIS OF THE INTRACORPORATE CONSPIRACY DOCTRINE IN SECTION 1985(3) CASES

The Circuit split continues about the intracorporate conspiracy doctrine and Section 1985(3).[120] As one court states, it is "not surprising that courts have reached disparate conclusions" about this important issue because:

[114] *Id.*

[115] *Id.*

[116] 40 F.3d 1119, 1127 (citing *Stathos*, 728 F.2d at 21).

[117] 40 F.3d 1119, 1127 (quoting *Buschi,* 775 F.2d at 1252).

[118] *See, e.g.,* Rashdan (Mohamed) v. Geissberger, 2011 U.S. Dist. LEXIS 3073 (N.D. Cal. 2011); Rivers v. County of Marin, 2010 U.S. Dist. LEXIS 1419 (N.D. Cal. 2010).

[119] *Id.* In the 2011 decision of *Rashdan* the Northern District of California decided a Section 1985(3) case against individual defendants who were instructors and administrators at a dental school. The plaintiff in *Rashdan* was an Egyptian-American female student at a dental school. She complained that one instructor called her work "Third World Dentistry," and another instructor called her "TW" (short for "Third World"). She also alleged that the school officials had tampered with her transcript and prevented her from obtaining her D.D.S. degree. *Rashdan,* 2011 U.S. Dist. LEXIS 3073 at 2. The Northern District of California noted that the Ninth Circuit had not addressed the Circuit split, but the court in *Rashdan* held that the intracorporate conspiracy doctrine did not bar the plaintiff's claim under Section 1985(3). However, the complaint was later dismissed. Rashdan v. Geissberger, 2011 U.S. Dist. LEXIS 4792 (N.D. Cal. 2011). Also, in the 2010 opinion in *Rivers*, 2010 U.S. Dist. LEXIS 1419, the Northern District of California dismissed the plaintiff's claims under §1985 based on the Equal Protection and Due Process Clauses due to lack of specificity. However, the court did acknowledge the Circuit split and noted that it agreed with the Tenth Circuit that the intracorporate conspiracy doctrine does not bar plaintiffs' claims in Section 1985 cases. *Id.*

[120] *Rivers*, 2010 U.S. Dist. LEXIS 1419 (N.D. Cal. 2010).

> Two rhetorical questions frame the dispute. (1) Why should action by a single employer be covered by § 1985 just because discussions among the firm's multiple agents precede decision? (2) Why should decisions taken by a plurality of actors be immune from check under § 1985 just because they take the trouble to incorporate? Which question you pose largely determines the outcome.[121]

The intracorporate conspiracy doctrine employs some familiar corporation and agency concepts to shield persons within a single corporation from Section 1985(3) liability. However, arguments against this doctrine are supported by other familiar corporation and agency concepts. In addition, the antitrust cases which were the initial source of the intracorporate conspiracy doctrine reveal some important differences between antitrust policy concerns and the policy concerns addressed by Section 1985(3) cases.122 For example, in an antitrust case, the U.S. Supreme Court stated that "[t]he officers of a single firm are not separate economic actors pursuing separate economic interests, so agreements among them do not suddenly bring together economic power that was previously pursuing divergent goals."123 Section 1985(3) does not address economic concerns about agreements in restraint of trade. Instead, Section 1985(3) addresses matters such as civil rights violations. The intracorporate conspiracy doctrine should be reexamined by the courts, because it may not be appropriate for Section 1985(3) conspiracies.

Legal characteristics of corporations and the laws of agency underpin the intracorporate conspiracy doctrine. Corporations cannot conduct activities without agents to act on their behalf. The laws of agency allow corporate officers to act as agents on behalf of the principle, the corporation. These officers, when acting on behalf of a fully disclosed principle, usually do not have personal liability for corporate actions.[124] The corporation is a form of business that permits unrestricted transferability of shares and some liability protection for its shareholders. These attributes have enabled many corporations to attract large amounts of capital. In addition, common law rules such as the "business judgment rule" have permitted corporate directors to make decisions and take some business risks without fear of personal liability

[121] *Travis*, 921 F.2d at 109.

[122] *See, e.g.,* Copperweld Corp. v. Independence Tube Corp, 467 U.S. 752 (1984).

[123] *Id. at 769.* "Coordination within a firm is as likely to result from an effort to compete as from an effort to stifle competition. In the marketplace, such coordination may be necessary if a business enterprise is to compete effectively." *Id.*

[124] *See, e.g.,* Treadwell v. J.D. Construction Co., 938 A.2d 794, 799 (Me. Sup. Jud. Ct. 2007) (holding "In order for an agent to avoid personal liability on a contract negotiated in his principal's behalf, he must disclose not only that he is an agent but also the identity of the principal.")

to the corporation or its shareholders, if the decisions are made without conflict of interest, with reasonable investigation and after determining that there is a rational basis for the decision in relation to the well-being of the corporation.[125] Judges are often hesitant to substitute their own business judgment for that of the directors of a corporation in those cases. [126] These characteristics of the corporation arguably serve a valuable purpose in society and the economy.

Admittedly, conspiracy in statutes "rarely … include[s] the garden-variety situation in which one who controls a corporation directs that corporation to do something. After all, a corporation can only act at the direction of whoever controls it, and we do not think of every corporate action as a 'conspiracy.'"[127] According to one case:

> Section 1985 descends from the Civil Rights Act of 1871 … The Radical Republicans in Congress wanted to put down the Invisible Empire, whose night riders were terrorizing the newly freed blacks and their white supporters. Congress was concerned not about unilateral action but about organized, almost society-wide resistance to emancipation and civil rights. Fear of violence (a theme running through the text of and debates on the 1871 act) could unite disparate centers of influence, closing opportunities to the freed men. Bigoted acts by a single firm, acting independently, pose risks of lesser caliber. [128]

Arguably, Congress was not thinking about corporations when it enacted Section 1985.

However, a conspiracy statute in the civil rights arena protects important rights. Therefore, summarily applying a "legal fiction" to decide these cases may not be appropriate without further examination of the legal fiction. Courts should determine whether the purpose of Section 1985(3) is served by eliminating conspirators' liability when they happen to be a part of a corporation.[129] For example, courts have concluded that the intracorporate conspiracy doctrine does not shield persons from liability in RICO cases.[130] In 2001, the U.S. Supreme Court held that a corporation and its employee/sole owner are two distinct entities for RICO purposes in *Kushner Promotions, Ltd. v. King*.[131]

[125] *See, e.g.,* Brehm v. Eisner, 906 A.2d 27 (Del. 2006).

[126] *See, e.g.,* Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. Ct. App. 1968) (holding that "Directors are elected for their business capabilities and judgment and the courts cannot require them to forego their judgment because of the decisions of directors of other companies. Courts may not decide these questions in the absence of a clear showing of dereliction of duty on the part of the specific directors.")

[127] In Re: Teleglobe Communications Corp. v. BCE Inc., 493 F.3d 345 (3rd Cir. 2007).

[128] *Travis*, 921 F.2d at 110.

[129] *See, e.g., Stathos,* 728 F.2d 15.

[130] *See In Re: Teleglobe*, 493 F.3d 345 (citing Ashland Oil, Inc. v. Arnett, 875 F.2d 1271, 1281 (7th Cir. 1989)).

[131] 533 U.S. 158 (2001)

Several circuits have stated that the intracorporate conspiracy doctrine does not apply to criminal cases.[132] In criminal conspiracy cases, "the action by an incorporated collection of individuals creates the 'group danger' at which conspiracy liability is aimed, and the view of the corporation as a single legal actor becomes a fiction without a purpose."[133] Therefore, courts should also look at Section 1985(3) carefully to determine whether the purpose of that statute is served by eliminating conspirators' liability when they are part of a corporation.

While the intracorporate conspiracy doctrine employs familiar concepts that are employed in many other contexts, courts should analyze these concepts very carefully in an area as important as civil rights. Important civil rights issues presented by the cases calls for a careful reexamination of the nature of a corporation and its relationship with its directors, officers and employees. This type of analysis is not new to the courts. For example, although shareholders are protected from personal liability in most corporate contexts, sometimes courts "pierce the corporate veil" to hold shareholders personally liable for corporate obligations when such shareholders dominate the corporation for an improper purpose.[134]

The Fifth Circuit explains that the intracorporate conspiracy doctrine, unlike traditional agency concepts, does not serve societal values by stating:

> The original purposes of the rule attributing agents' acts to a corporation were to enable corporations to act, permitting the pooling of resources to achieve social benefits and, in the case of tortious acts, to require a corporation to bear the costs of its business enterprise. But extension of the rule to preclude the possibility of intracorporate conspiracy does not serve either of these goals.[135]

Therefore, the intracorporate conspiracy doctrine may be a "fiction without a purpose" in the context of Section 1985(3).[136]

Courts who adopt the intracorporate conspiracy doctrine claim to rely upon the principle that employees, officers and directors are agents of a corporation, and a corporation cannot conspire with itself. However, courts generally hold persons, such as corporate employees, officers and directors personally liable for their own torts, while a corporation may also have direct or vicarious liability for those torts committed by its

[132] McAndrews v. Lockheed Martin Corp., 206 F.3d 1031, 1038 (2000)

[133] Dussouy v. Gulf Coast Investment Corp., 660 F.2d 594, 603 (5th Cir. 1981)

[134] *See, e.g.,* William Meade Fletcher, *1 Fletcher Cyclopedia of the Law of Private Corporations,* at 574-76 (cited in Hildreth v. Tidewater Equipment Co., 838 A.2d 1204 (Md. Ct. App. 2003)).

[135] *Dussouy*, 660 F.2d at 603.

[136] *Id.*

employees.[137] Decisions holding both the corporation and the individual employees liable for employee torts in the scope of employment are based on policy considerations, such as the fact that corporations benefit from the work done by the employees and corporations may be in a better position than the employees to compensate victims of the torts. Also, corporations, not the victim, have the most opportunity to control the employees, so that the corporation, not the victim, should bear the losses associated with the employees' torts.

Some analogies exist between the policy that holds employees, officers and directors personally liable for their own torts and a policy that holds such persons liable for conspiracy to deprive a person of civil rights. The policy that holds persons liable for their own torts makes sense because individuals should be deterred from committing torts, and should bear responsibility for their own torts. Therefore, if a person cannot "hide" behind a corporation to avoid liability for his or her tort, it seems logical that a person should not be able to "hide" behind a corporation to avoid liability for his or her own involvement in a conspiracy to deprive someone of the equal protection of the laws, or of equal privileges and immunities under the laws. Also, it is reasonable that a corporation should not be able to escape such liability for a conspiracy that happens inside the corporation's walls.

Proponents of the intracorporate conspiracy doctrine may argue that the exceptions adopted by some courts mitigate the arguments against the doctrine. One exception provides that if the conspirators acted outside of their normal corporation duties or authority, the intracorporate conspiracy doctrine will not bar recovery under Section 1985(3).[138] However, conspiring together to deprive someone of the equal protection or the laws, or of equal privileges and immunities under the laws seems equally wrong, whether done inside or outside the cloak of normal corporation duties or authority. Is it ever a proper corporate business purpose to discriminate against a protected class of persons? Should this group activity be excused, just because it was done in the context of a corporation? Another exception to the doctrine in some Circuits provides that if the conspirators had an independent personal stake in the conspiracy, then the intracorporate conspiracy will not bar recovery.[139] However, a determination of whether someone has an independent personal stake in the conspiracy and whether that is the

[137] *See, e.g.,* Millan v. Dean Witter Reynolds, Inc., 90 S.W.3d 760 (Tex. Ct. App. 2002).

[138] *See, e.g.,* Johnson v. Hills & Dales General Hospital 40 F.3d 837 (6th Cir. 1994); Al-Marayati v. The University of Toledo, 1998 U.S. App. LEXIS 9797 (6th Cir. 1997).

[139] *See, e.g.,* Bank Realty, Inc. v. Practical Management Technology, Inc., 1991 U.S. App. LEXIS 11793 at *12 (4th Cir. 1991).

sole or dominant motivating factor in the conspiracy seems difficult at best.

Conspiracies are deemed to be more serious than individual action due to the "group danger" problem.[140] Therefore, for example, a conspiracy by a group of people such as the Ku Klux Klan to prevent African-Americans from travelling and engaging in other constitutionally protected activity has been deemed to be more dangerous than actions by one individual acting alone to prevent African-Americans from engaging in such activity.[141] If a group meets and decides to deprive a protected group (such as African-American persons) of the equal protection of the laws, this is a conspiracy. If this is done in a partnership, it is actionable under Section 1985(3). Is such a group incorporates, should they be immune?[142] Is the group less dangerous if they work for the same corporation? For example, if a group of people (such as a board of directors) have the power to eliminate your job based upon your race, aren't they possibly more dangerous to you than a group of people outside of your employer's corporation?

The intracorporate conspiracy doctrine was developed in the context of antitrust law, but the policies underpinning antitrust law and the policies underpinning the Ku Klux Klan Act are different.[143] The U.S. Supreme Court in *Kushner Promotions, Ltd. V. King* stated in that case that the intracorporate conspiracy doctrine "turns on specific antitrust objectives."[144]

One court explained that "antitrust laws aim at preserving independent economic decisions, which supposes cooperation inside economic entities -- cooperation that cannot be called "conspiratorial" without defeating the foundation of competition."[145] Some argue that "[w]hen Congress drafted § 1985 it was understood that corporate employees acting to pursue the business of the firm could not be treated as conspirators. Courts looked past the individual acts to concentrate on the collective decision." [146] Also, a court has stated that "[p]enalizing 'coordinated conduct simply because a corporation delegated certain responsibilities to autonomous units might well discourage corporations from creating divisions with their presumed benefits.'"[147]

[140] *Dussouy*, 660 F.2d at 603.
[141] *Id.*
[142] *Novotny*, 584 F.2d 1235, 1257.
[143] *Stathos,* 728 F.2d 15.
[144] 533 U.S. 158, 166 (2001).
[145] *Travis*, 921 F.2d 108, 110.
[146] *Id.* (citing Dartmouth College v. Woodward*,* 17 U.S. 518 (1819)).
[147] American Chiropractic v. Trigon Healthcare, 367 F.3d 212, 225 (4th Cir. 2004) (quoting *Copperweld*, 467 U.S. at 771).

The Fifth Circuit has described the two rationales for the intracorporate conspiracy doctrine in antitrust cases as follows:

> [F]irst, agency principles attribute the acts of agents of a corporation to the corporation, so that all of their acts are considered to be those of a single legal actor, negating the multiplicity of actors necessary to conspiracy, and, second, applying the prohibition of combinations in restraint of trade contained in section 1 of the Sherman Act to activities by a single firm renders meaningless section 2, which prohibits monopolization and attempt to monopolize.[148]

While the first rationale expressed by the Fifth Circuit above could apply to Section 1985(3) cases, the second rationale does not. However, the first rationale, based upon a legal fiction, may not be justification enough for permitting the types of activity alleged in Section 1985(3) cases. Essentially, "[u]nlike antitrust conspiracies, which mainly are directed at the anticompetitive and collaborative efforts of businesses, the conspiracy in a § 1985(3) claim is focused on the discriminatory conduct of the individuals involved."[149]

The Third Circuit wrote eloquently about the distinction between antitrust and civil rights as follows:

> The considerations which shape this antitrust doctrine, rooted in the tension between the policy of preserving and fostering competition and the interest in not intermeddling unnecessarily in the internal entrepreneurial decisions of companies, do not lie parallel to the balance of concerns embodied in § 1985(3)….[W]hile courts have interpreted economic efficiencies and pro-competitive effects to constitute justifications for certain restraints of trade we discern no indication that similar defenses would protect a conjuration to deprive a minority of equal rights. … In the case of conspiracy among corporate officers, "conditions which constitute the essence of conspiracy rationales are present to the same extent as if the same persons combined their resources without incorporation."[150]

CONCLUSION

The U.S. Supreme Court has not been willing to speak to the Circuit split described in this paper. Although the majority of Circuit Courts of Appeals have allowed the intracorporate conspiracy doctrine as a defense to claims under 42 U.S.C. §1985(3), the defense should not be applied in these cases. The civil rights that the Fourteenth Amendment guarantees are significantly different from the economic rights that are

[148] *Dussouy,* 660 F.2d at 603 (citing *Nelson Radio*, 200 F.2d 911, 913-14).

[149] *Rashdan*, 2011 U.S. Dist. LEXIS 3073 at *19 (citing Griffin v. Breckenridge, 403 U.S. 88, 96, (1971)).

[150] *Novotny*, 584 F.2d 1235, 1258 n.121-122 (3rd Cir. 1978) (quoting *Developments in the Law - Criminal Conspiracy*, 72 Harv.L.Rev. 920, 952-53 (1959)).

protected by anti-trust laws The actions taken by a group of individuals to deny another his or her civil rights likely reflect the individual goals and biases of the participating individuals even if such actions further the economic interests of the corporate employer. In addition, the existing exceptions to the intracorporate conspiracy doctrine may require an evidentiary burden that many plaintiffs cannot meet. For these reasons, Congress should amend 42 U.S.C. § 1985(3) to eliminate the Circuit split. An accurate definition of "conspiracy" in the Act that conclusively removes the intracorporate conspiracy doctrine as a defense in Section 1985(3) cases would resolve the split.