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YOU'LL KNOW IT WHEN YOU SEE IT: FAIR USE AFTER *CARIOU*

by Liz Brown*

I. INTRODUCTION

In the wake of a 2012 ruling broadening the scope of copyright law's fair use defense, lawyers, artists and dealers face more uncertainty as to what kind of copying is legal. The Second Circuit's decision in *Cariou v. Prince*[1] has led to a new sense of unease, the exposure of a growing generation gap in the art business, and a dramatic reversal of the roles of artists and judges in evaluating works of art. This article examines the origin of the transformative use defense to copyright, its recent reformation, and its impact on both subsequent copyright rulings and the business of art.

Art, at the level involved in this case, is big business. Worldwide, the global art market was valued at approximately $64 billion in 2012.[2] Institutional investors are also turning to art as an investment vehicle.[3] As *Forbes* reported, the assets in art investment

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1 714 F.3d 694 (2d Cir. 2013) *cert. denied*, 134 S. Ct. 618 (2013).

2 *See, e.g.*, Kyle Chayka, *The Art Market was Worth $64 Billion in 2012*, HYPERALLERGIC (Jan. 2, 2013), http://hyperallergic.com/62911/the-art-market-was-worth-64-billion-in-2012/; *see also* Press Release, TEFAF Maastricht, TEFAF Art Market Report 2013 (Mar. 13, 2013), http://www.tefaf.com/DesktopDefault.aspx?tabid=15&tabindex=14&pressrelease=14879&presslanguage=.

3 *See* Kathryn Tully, *Are Investors Bullish on the Art Market?*, FORBES (Apr. 30, 2013, 7:13 PM), http://www.forbes.com/sites/kathryntully/2013/04/30/are-investors-bullish-on-the-art-market/.

funds worldwide rose 69% to $1.62 billion in 2012.[4] At the center of the modern art world is the rise of appropriation artists, such as Richard Prince, whose work is built on the works of other artists.[5] In *Cariou*, the Prince artworks at issue were marketed to A-list celebrities like Beyoncé, Tom Brady and Anna Wintour.[6] One series of these works sold at the Gagosian gallery for more than $10 million.[7] The *Cariou* decision held that Prince's unlicensed use of Patrick Cariou's photographs, with what many consider to be only minor modifications, was fair use rather than copyright infringement.

The *Cariou v. Prince* decision resolved issues that are critical to appropriation art, but the Second Circuit's ruling in that case—final now that the Supreme Court has denied certiorari—has troubling implications for the entire art market. By broadening the definition of "transformative," the Second Circuit's decision in *Cariou* may encourage other appropriation artists to use original images in ways that have never before been considered fair use. Without the revival or reaffirmation of limitations on how one artist can use another's work, many creative artists—and the businesses that rely on their work—are likely to suffer severe economic loss. The Supreme Court has noted that the fair use doctrine "permits and requires courts to avoid rigid application of the copyright statute when, on occasion, it would stifle the very creativity which the law is designed to foster."[8] In the wake of *Cariou*, however, it is now reasonable to ask whether the "creativity which the law is designed to foster" is meant to come from judges or artists.

II. THE ORIGINS OF THE TRANSFORMATIVE USE DEFENSE

In most cases, the Copyright Act prevents one person from taking and using another's protectable work without permission.[9] An accused copyright infringer can escape liability by showing that his use falls within the fair use exception, which allows for the use of copyrighted materials for certain limited purposes. The Copyright Act codifies the fair use defense in Section 107, setting out four factors for the court to consider in ruling on the defense:

[4] *Id.*

[5] *See, e.g.*, Randy Kennedy, *Apropos Appropriation*, N.Y. TIMES (Dec. 28, 2011), http://www.nytimes.com/2012/01/01/arts/design/richard-prince-lawsuit-focuses-on-limits-of-appropriation.html?pagewanted=all.

[6] Cariou v. Prince, 714 F.3d at 709.

[7] *Id.*

[8] Campbell v. Acuff-Rose Music, Inc., 510 U.S. 569, 577 (1994) (internal quotation marks omitted) (citing Stewart v. Abend, 495 U.S. 207, 236 (1990)).

[9] *See* 17 U.S.C. § 107 (1992).

> (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 potential market for or value of the copyrighted work.[10]

In an influential *Harvard Law Review* article, the Hon. Pierre Leval (then of the Southern District of New York) developed a theory of "transformative use," which elaborates on the first fair use factor.[11] According to Leval, in order to be transformative, a second work must add something new, with a further purpose or different character, altering the first work with new expression, meaning, or message.[12] A work's commercial qualities are less significant when the work is extremely transformative and parodic.[13]

The Supreme Court analyzed the fair use defense and adopted the doctrine of transformative use, citing Judge Leval's article, in its 1994 decision in *Campbell v. Acuff-Rose Music, Inc*.[14] In that case, the Court was asked to decide whether 2 Live Crew's song "Pretty Woman" infringed the copyright in Roy Orbison's song "Oh Pretty Woman."[15] In determining that the rap version was a parody, and therefore fair use, the Court noted that in evaluating a fair use defense, "[a]ll [of the four factors] are to be explored, and the results weighed together, in light of the purposes of copyright."[16]

III. THE DEVELOPMENT OF TRANSFORMATIVE USE IN *CARIOU V. PRINCE*

On November 12, 2013, the Supreme Court denied certiorari in *Cariou v. Prince*, letting stand a Second Circuit decision that has potentially dangerous repercussions for the art business.[17] *Cariou v. Prince* concerned an appropriation artist named Richard Prince, who created a series of artworks using the photographs of another artist, Patrick Cariou, as his base materials.[18] In 2000, Cariou published a book of his photographs of Jamaican Rastafarians called *Yes Rasta*.[19]

[10] *Id.*

[11] *See* Pierre N. Leval, Commentary, *Toward a Fair Use Standard*, 103 HARV. L. REV. 1105 (1990).

[12] *Id.* at 1111.

[13] Mattel, Inc. v. Walking Mountain Productions, 353 F.3d 792, 803 (9th Cir. 2003).

[14] 510 U.S. at 1171.

[15] *Id.* at 569.

[16] *Id.* at 578.

[17] Cariou v. Prince, 134 S. Ct. 618 (2013).

[18] Cariou v. Prince, 784 F. Supp. 2d 337, 343 (S.D.N.Y. 2011) *judgment rev'd in part, vacated in part*, 714 F.3d 694 (2d Cir. 2013).

[19] *Id.*

Cariou testified about the creative choices involved in composing his photographs, including the equipment, staging, and development techniques and processes involved.[20]

Prince bought copies of *Yes Rasta*, and incorporated some of the photographs in works displayed in St. Barth's in 2007-2008.[21] Prince ultimately completed a series of twenty-nine paintings in what he called the "Canal Zone" series, twenty-eight of which incorporated Cariou's *Yes Rasta* photographs.[22]

Prince had been a highly collectable and expensive artist for some time. His work had been the subject of major survey exhibitions at the Whitney Museum of American Art in New York, the San Francisco Museum of Modern Art, and the Serpentine Gallery in London, among other places.[23] In July 2008, a New York dealer had paid $8.4 million at auction for Prince's 2002 work, *Overseas Nurse*.[24]

The Gagosian Gallery, one of the most prominent art galleries in the United States, exhibited twenty-two of Prince's Canal Zone paintings in November and December 2008 at one of its Manhattan galleries.[25] The gallery sold eight of the paintings for a total of $10,480,000, 60% of which went to Prince.[26] Although another New York gallery had approached Cariou about exhibiting his work, that gallery withdrew its offer when it became aware of the Canal Zone exhibit.[27] Cariou sued Prince and Gagosian for copyright infringement.[28]

A. The District Court's Ruling for Cariou

The facts of the Cariou case were largely undisputed, and the District Court ruled on cross-motions for summary judgment.[29] In evaluating the first fair use factor, the purpose and character of Prince's use of Cariou's photographs, the court considered three sub-factors: commerciality, bad faith, and the extent to which Prince's art was "transformative."[30] The three factors are not given equal weight:

[20] *Id.*
[21] *Id.*
[22] *Id.* at 344.
[23] Gagosian Gallery, "Richard Prince: Cowboys, February 21 – April 6, 2013" (http://www.gagosian.com/exhibitions/richard-prince--february-21-2013)
[24] Carol Vogel, *Bacon is Again a Top Draw at Auction*, N.Y. TIMES (Jul. 2, 2008), http://www.nytimes.com/2008/07/02/arts/design/02auct.html
[25] *Id.*
[26] *Id.* at 350.
[27] Cariou v. Prince, 784 F. Supp. 2d at 344.
[28] Cariou v. Prince, 714 F.3d at 704.
[29] Cariou v. Prince, 784 F. Supp. 2d at 355.
[30] *Id.* at 347-51.

"the more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of fair use."[31]

In order to be transformative, the court noted, the new work should "comment on, relate to the historical context of, or critically refer back to the original works."[32] In light of that requirement, the court determined that Prince's works are transformative "only to the extent that they comment on the [Cariou] Photos."[33] Relying largely on Prince's own testimony that he didn't "really have a message" when making art, the court concluded that he "did not intend to comment on any aspects of the original works."[34] Accordingly, it found that "the transformative content of Prince's paintings is minimal at best."[35]

In doing so, the court revealed it held a negative view of Prince's artistry. For example, it quoted Prince's testimony that his message in collaging guitars onto Cariou's portraits of Rastafarian men had to do with the fact that men played guitars: "He's playing the guitar now, it looks like he's playing the guitar, it looks as if he's always played the guitar, that's what my message was."[36]

The other two components of the first fair use factor, commerciality and bad faith, also weighed against Prince. In light of the Gagosian Gallery's extensive marketing of the Canal Zone show and the sale prices of Prince's works, the court determined that the "Defendants' use and exploitation of the Photos was also substantially commercial."[37] Prince's failure even to seek a license from Cariou sealed the court's conclusion of bad faith.[38]

The court interpreted the second fair use factor, the nature of the copyrighted work, to be more restrictive where the work at issue is "expressive or creative," as opposed to "factual or informational."[39] Without further explanation, the court found that Cariou's photographs were "highly original," weighing against a finding of fair use.[40] The court quickly disposed of the third factor, the amount used, noting that Prince had appropriated the "central figures depicted in

[31] *Id.* at 348 (citing Campbell v. Acuff-Rose Music, Inc., 510 U.S. at 579).
[32] *Id.*
[33] *Id.* at 349.
[34] *Id.*
[35] *Id.* at 350.
[36] *Id.* at 349 (internal quotation marks omitted).
[37] *Id.* at 351.
[38] *Id.*
[39] *Id.* at 352 (citing Howard B. Abrams, The Law of Copyright, § 15:52 (2006)).
[40] *Id.*

portraits taken by Cariou" in most of the works at issue, weighing heavily against fair use.[41]

The analysis of the final factor, the effect on potential market, is perhaps the most interesting. The court rejected Prince's efforts to minimize the potential market for Cariou's works even though Cariou had not aggressively marketed them.[42] The potential market, the court noted, could be larger than the actual market for the original works.[43] An author is "entitled to protect his opportunity to sell his [works]"[44] and may be entitled to judgment even when he "has evidenced little if any interest in exploiting this market for derivative works."[45]

A New York gallery owner, Cristiane Celle, had offered to show Cariou's works, but later withdrew the offer in light of the Prince exhibit.[46] Celle testified that she cancelled the Cariou show because she "did not want to seem to be capitalizing on Prince's success and notoriety," fed by the Gagosian show.[47] She did not want to exhibit work which had been "done already" at another gallery.[48] Celle's cancellation supported the court's conclusion that the defendants usurped the market for Cariou's works.[49]

Fair use was not the only defense raised in the case. Prince and Gagosian also claimed that Cariou's photographs were not copyrightable because they were, as the court summarized it, "mere compilations of facts concerning Rastafarians and the Jamaican landscape, arranged with minimum creativity in a manner typical of their genre."[50] The District Court rejected that argument, citing "well over one hundred years" of precedent that portrait and landscape photographs can be copyrighted.[51]

The District Court may have gone a step too far by ordering the destruction of the infringing artworks. The severity of that order caught the attention of the art world. In its reversal, the Second Circuit described the lower court's order as granting "sweeping

[41] *Id*.
[42] *Id*. at 353.
[43] *Id*.
[44] *Id*. (citing J.D. Salinger v. Random House, Inc., 811 F.2d 90, 99 (2d Cir. 1987)).
[45] *Id*. (citing Castle Rock Entertainment, Inc. v. Carol Pub. Group, Inc., 150 F.3d 132, 145-46 (1998)).
[46] *Id*. at 344.
[47] *Id*.
[48] *Id*.
[49] *Id*. at 353.
[50] *Id*. at 346.
[51] *Id*.

injunctive relief."[52] It is possible that what was perceived as too severe a remedy led in part to the reaction and the reversal that followed.

B. The Second Circuit's Reversal In Favor of Prince

On appeal, Prince retained the firm of Boies, Schiller & Flexner.[53] Although the oral argument took place on May 21, 2012, the appellate decision did not issue until April 25, 2013, nearly a year later.[54] When it did issue, the Second Circuit's reversal sent shock waves through the art world.

Throughout the decision, the court assumed that Prince's work differed in an important way from Cariou's without explaining its rationale. For example, in describing Prince's use of the *Yes Rasta* photographs, the court noted, "Prince altered those photographs significantly by among other things painting 'lozenges' over their subjects' facial features and using only portions of some of the images."[55] In general, placing an oval cut out over part of a photo does not necessarily alter the photo significantly and the basis for the court's characterization of it as such is unclear. The court did interpret size differences as significant, however, noting that the *Yes Rasta* book measures "approximately 9.5" x 12"" while Prince's artworks are "several times that size."[56]

What troubled the Second Circuit most about the lower court's ruling, it seems, was the implication that a secondary work must "comment on the original or its author in order to be considered transformative."[57] In order to qualify as fair use, a secondary work could "serve[ ] some purpose other than those (criticism, comment, news reporting, teaching, scholarship and research) identified in the preamble to the [fair use] statute."[58] The secondary work only needs to "alter the original with new expression, meaning, or message."[59]

The court went on to declare that Prince's works passed the "new expression, meaning or message" test, noting that "Prince's composition, presentation, scale, color palette, and media are fundamentally different and new compared to the photographs, as is the expressive nature of Prince's work."[60] Rejecting Cariou's

[52] Cariou v. Prince, 714 F.3d at 704.
[53] *Id.* at 694.
[54] *Id.*
[55] *Id.* at 699.
[56] *Id.* at 700.
[57] *Id.* at 706.
[58] *Id.*
[59] *Id.* (internal quotation marks omitted) (citing Campbell, 510 U.S. at 579).
[60] *Id.*

arguments that Prince's own failure to identify any substantial message or purpose in his work were fatal to his fair use defense, the court stated that "[w]hat is critical is how the work in question appears to the reasonable observer."[61] The court found Prince's works so transformative that the fact that they were also commercial – another first-factor element - was, effectively, irrelevant.[62]

With regard to the effect of Prince's copying on the market for Cariou's work, the court found that Prince's copying did not usurp that market.[63] The bases for that conclusion were that (1) Celle did not cancel her plans to show Cariou's work "because it had already been done at Gagosian," (2) Cariou had "not aggressively marketed his work," and (3) wealthier people were more interested in Prince's work than Cariou's.[64]

The court's emphasis on the socioeconomic status of Prince collectors was striking. Observing that "Prince's artwork appeals to an entirely different type of collector than Cariou's," the court went on to note that Prince's works sold for millions of dollars.[65] It observed further that celebrities such as "Jay-Z and Beyoncé Knowles, artists Damien Hirst and Jeff Koons, professional football player Tom Brady, model Gisele Bundchen … and actors Robert DeNiro, Angelina Jolie and Brad Pitt" were invited to the Canal Zone opening dinner.[66]

After comparing the Prince and Cariou works, the court determined that twenty-five of the Prince works were protected by the fair use doctrine.[67] It remanded for consideration another five works to the district court, apparently deeming them too close to call.[68] In doing so, however, the court did not articulate any basis on which the district court could make such a determination. It is not clear why the appellate court believed the district court would be better able to determine whether the five remaining works were sufficiently transformative than the appellate court.

[61] *Id.* at 707.

[62] *See id.* at 708 ("[a]lthough there is no question that Prince's artworks are commercial, we do not place much significance on that fact due to the transformative nature of the work.").

[63] *See id.* at 709.

[64] *Id.*

[65] *Id.*

[66] *Id.* Although the ruling did not so specify, it is reasonable to infer from both the elite nature of the Gagosian Gallery and the price point for Prince's work that only the wealthiest collectors could afford to buy these pieces.

[67] *Id.* at 712.

[68] *Id.*

The Second Circuit's decision was not unanimous. Judge Wallace was uncomfortable in the role of art critic. Citing a cautionary note from the Supreme Court in the *Campbell* case that "it would be a dangerous undertaking for persons trained only to the law to constitute themselves final judges of the worth of a work, outside of the narrowest and most obvious limits,"[69] he wrote that "[i]t would be extremely uncomfortable for me to do so in my appellate capacity, let alone my limited art experience."[70]

C. Green Day: Fair Use in Rock Concerts

Cariou was not the only case to expand the fair use defense in 2013. In *Seltzer v. Green Day, Inc.*, the Ninth Circuit found that the rock band Green Day's use of Derek Seltzer's work in its concert backdrops was fair use.[71] Seltzer created an image called "Scream Icon," which he sold on stickers and posters.[72] Green Day used a version of "Scream Icon" in a video that ran during its concerts during a ten-city tour in 2009.[73] Seltzer sued Green Day for copyright infringement.[74]

Citing *Cariou* among other precedents and noting that "whether a work is transformative is a[n] often highly contentious topic," the Ninth Circuit ruled in Green Day's favor.[75] The court found that Green Day's use of "Scream Icon" amounted to new creative expression because it juxtaposed the original image with religious imagery: "With the spray-painted cross, in the context of a song about the hypocrisy of religion, surrounded by religious iconography, Staub's video backdrop using *Scream Icon* conveys 'new information, new aesthetics, new insights and understandings' that are plainly distinct from those of the original piece."[76] This, the court ruled, was transformative, and therefore the first fair use factor weighed in Green Day's favor.

Other factors weighed in Green Day's favor as well, including the potential for market impact. The court's phrasing of this factor, however, gives cause for concern. It noted that Seltzer's testimony about prior licensing of his imagery by another band "does not suffice to show that Green Day's use harmed any existing market or a

[69] *Id.* at 713 (citing Campbell, 510 U.S. at 582, quoting Bleistein v. Donaldson Lithographing Co., 188 U.S. 239, 251 (1903)).

[70] *Id.*

[71] Seltzer v. Green Day, Inc., 725 F.3d 1170 (9th Cir. 2013).

[72] *Id.* at 1173.

[73] *Id.* at 1174.

[74] *Id.* at 1175.

[75] *Id.* at 1176.

[76] *Id.* at 1177.

market that Seltzer was likely to develop."[77] The proper question, however, is not what market the original artist was "likely to develop" but instead what potential market existed for his work. By speculating about the artist's licensing plans, the Ninth Circuit Court of Appeals focused its inquiry on the actual market rather than the potential market, as the Copyright Act requires.[78]

The *Green Day* decision suggests that, after *Cariou*, circuit courts will continue to expand the scope of transformative use. In earlier cases, under similar circumstances, courts had rejected the fair use defense on similar facts. For example, in *Bouchet v. Baltimore Ravens Ltd. Partnership*, the designer of a logo later used in a professional football team's video sued the team for copyright infringement.[79] The Fourth Circuit Court of Appeals rejected the team's argument that the use of the logo was transformative, in part because it found that the logo in the video served the same purpose as the original: to symbolize the team.[80] Similarly, in *Monge v. Maya Magazines, Inc.*, two Latin American celebrities claimed that the pictures they took of their own wedding were stolen and published in a magazine.[81] The Ninth Circuit rejected the magazine's fair use argument, finding that the publication of the photos in a montage, with related text and articles, was only minimally transformative and could not save the magazine from a finding of copyright infringement.[82]

D. Guetta's Failure to Prove Fair Use

At the same time, California courts have reached the opposite conclusion to *Cariou* in similar cases. For example, the appropriation artist Thierry Guetta has lost two different copyright cases in three years, both stemming from his alteration of other people's photographs. In *Morris v. Guetta*, the Central District of California Appellate Court ruled that Guetta's adjustments to photographs of Sid Vicious taken by Dennis Morris constituted copyright infringement.[83] The court rejected Guetta's argument that appropriation art should be considered fair use *per se*: "[t]o permit one artist the right to use without consequence the original creative and copyrighted work of another artist simply because that artist wished

[77] *Id.* at 1179.
[78] *See* 17 U.S.C. § 107, *supra* note 9.
[79] 619 F.3d 301 (4th Cir. 2010).
[80] *See id.* at 310.
[81] 688 F.3d 1164 (9th Cir. 2012).
[82] *See id.* at 1174.
[83] Morris v. Guetta, No. 12-00684, 2013 WL 440127 (C.D. Cal. Feb. 4, 2013).

to create an alternate work would eviscerate any protection by the Copyright Act."[84]

Guetta also lost a copyright infringement case to Glen Friedman on similar facts in 2011.[85] In that case, Friedman sued Guetta for copyright infringement because Guetta created four works based on Friedman's photograph of the hip-hop group Run D.M.C. Guetta asserted the fair use defense, and lost. The court first rejected Guetta's claim that Friedman's photograph wasn't sufficiently original to merit copyright protection because there were many similar photographs of Run D.M.C. in the public domain. Friedman's creative decisions, the court noted, included "decisions about light and shadow, image clarity, depth of field, spatial relationships, and graininess" as well as selecting "the background and perspective of the Photograph[.] [A]ll of these particular artistic decisions commutatively result in the Photograph."[86] Noting that "originality" under copyright law requires only that the work be original to the creator and possess a minimal level of creativity, the court determined that Friedman's work was indeed original.

Moving on to consider the fair use defense, the court found that none of the four fair use factors weighed in Guetta's favor. It specifically rejected the claim that Guetta's adaptation of the photograph was "transformative" even though his work differed in some ways from Friedman's: "Although the statements made by those respective artworks and the mediums by which those respective statements were made differ, the use itself is not so distinct as to render Defendant's use a transformation of Plaintiff's copyright."[87] The court's standards for evaluating how much difference is necessary to render a second work "transformative" are not clear here, but they appear to be higher than the Second Circuit's standards in *Cariou*.

IV. THE CONSEQUENCES OF EXPANDING FAIR USE

The expansion of fair use illustrated by *Cariou* and its progeny raises several types of concerns: doctrinal, societal, and market-based. By blurring the line between transformative and derivative works, these decisions represent a significant shift in copyright law. The repercussions will affect the business relationships among

[84] *Id.* at *13 (quoting Friedman v. Guetta, No. CV 10–00014 DDP JCX, 2011 WL 3510890, at *7 (C.D.Cal. May 27, 2011)).

[85] Friedman v. Guetta, No. CV 10-00014 DDP JCX, 2011 WL 3510890 (C.D. Cal. May 27, 2011).

[86] *Id*. at *3.

[87] *Id*. at *6.

artists, dealers, and investors, and will shift the legal boundaries of creativity.

A. Doctrinal Impact

In the wake of *Cariou*, several observers have commented on the doctrinal shifts that the ruling represented.[88] Legal scholars were not the only critics of the opinion. Artists banded together to decry the *Cariou* ruling. When the Second Circuit remanded consideration of five works back to the district court, a coalition of professional associations and photographers filed a comprehensive amicus brief urging the court to reject the fair use defense as to those works.[89] The amici included the American Society of Media Photographers, Picture Archive Council of America, Professional Photographers of America, National Press Photographers Association, photographer Jeremy Sparig, Graphic Artists Guild, American Photographic Artists, and the American Society of Journalists and Authors.[90]

Perhaps the most troubling aspect of *Cariou* is the lack of guidance offered as to how much difference is necessary for a reasonable observer to determine that the use is transformative. A balancing test based on unclear factors is easy to get wrong. If adapting one artist's photographs by reprinting them in a different color and size and perhaps adding small decorative elements is fair use, then it is hard to imagine what kind of adaptive copying would not be permitted. Prince's adjustment of Cariou's photographs is comparable to someone reprinting an author's novel in a different font or color ink, or adding an illustration or two. Should the latter qualify as fair use?

A likely effect of this doctrinal vagueness is that whether one artist infringes the copyright of another will boil down to the aesthetic judgment of a particular judge or panel of judges. Subsequent decisions will therefore require lawyers and courts to parse the differences between copies of accused art works, which may not be widely available, in order to make their best guess as to what is "different enough" to pass legal muster.

[88] *See, e.g.*, Elizabeth Winkowski, *A Context-Sensitive Inquiry: The Interpretation of Meaning in Cases of Visual Appropriation Art*, 12 J. MARSHALL REV. INTELL. PROP. L. 746, 760 (2013); *Copyright Law - Fair Use - Second Circuit Holds That Appropriation Artwork Need Not Comment on the Original to Be Transformative. - Cariou v. Prince, 714 F.3d 694 (2d Cir. 2013)*, 127 HARV. L. REV. 1228, 1229 (2014).

[89] Brief for the American Photographic Artists et al. as Amici Curiae Supporting Plaintiff, Cariou v. Prince, No. 08 CIV 11327 (DAB) (S.D.N.Y.), http://blogs.nppa.org/advocacy/files/2013/12/Cariou-v-Pronce-Dist-Ct-Amicus-Brief-12-16-13.pdf [hereinafter Brief for the American Photographic Artists et al.].

[90] *Id.*

A related danger of recent case law is the increasingly blurry line between derivative and transformative use. According to the Copyright Act,

> A "derivative work" is a work based upon one or more preexisting works, such as a translation, musical arrangement, dramatization, fictionalization, motion picture version, sound recording, art reproduction, abridgment, condensation, or any other form in which a work may be recast, transformed, or adapted. A work consisting of editorial revisions, annotations, elaborations, or other modifications, which, as a whole, represent an original work of authorship, is a "derivative work."[91]

A transformative work, in contrast, is one that adds "something new, with a further purpose or different character, altering the first with new expression, meaning or message."[92]

The difference between derivative use and transformative use is getting harder to detect: "[i]f a court finds that defendants' use of an author's work is 'transformative' because it reaches new markets or makes the work available to a new audience, that finding could risk usurping the author's derivative work rights. Ultimately, those rights could hinge on a 'race to the market' for new and sometimes unanticipated uses."[93]

Arguably, that is what happened to Patrick Cariou. In his Canal Zone exhibit, Prince established a high-end market for what could be considered derivative works based on Cariou's photographs, usurping that market and foreclosing the possibility of a Cariou exhibit like the one Celle had planned.

Another point of concern is the court's apparent disregard for the accused infringer's subjective intent. Evaluating transformative use without reference to the allegedly infringing artist's intent makes little sense if the key question is whether there is a new "expression, meaning or message" in the secondary work.[94] While an artist's intent perhaps should not be viewed as dispositive, *Cariou* can be read to suggest that it is not even relevant. After all, in *Cariou*, Prince admitted that he had no transformative intent at all.[95] It is

[91] 17 U.S.C. § 101 (2010).

[92] *Campbell,* 510 U.S. at 579.

[93] *See* Fair Use: Hearing Before the Subcommittee on Courts, Intellectual Property, and the Internet of the H. Committee on the Judiciary, 113th Cong. 10 (2014) (statement of June M. Besek, Executive Director of the Kernochan Center for Law, Media and the Arts and Lecturer-in-Law, Columbia Law School), http://judiciary.house.gov/_cache/files/83d5bf33-9587-4908-849f-e63edc1b49f5/012814-testimony---besek.pdf [hereinafter, Statement of June M. Besek].

[94] *Campbell*, 510 U.S. at 579.

[95] *Cariou*, 784 F. Supp. 2d at 350.

hard to imagine that such an admission carries no weight at all in the determination of what is fair.

A further danger of the current slide toward finding that all appropriation is *per se* fair use may be a violation of the United States' obligations under the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) and other international treaties.[96] For example, the TRIPS agreement requires that signatories' copyright exceptions (for foreign works) meet a three-step test.[97] That test provides:

> Members shall confine limitations or exceptions to exclusive rights to certain special cases which do not conflict with a normal exploitation of the work and do not unreasonably prejudice the legitimate interests of the right holder.[98]

The first of the three steps requires that any exceptions to copyright protection be limited in scope, according to the World Trade Organization's dispute resolution panel.[99] "Normal exploitation" includes all ways in which the author would normally seek to exploit the work now or in the future.[100] In other words, an exception may not compromise a normal market for the work. The third step requires that the law protect authors from unreasonable loss of income.[101] Expanding the scope of transformative use as courts have begun to do may violate each of these three steps.

B. Commercial Impact

In order to appreciate the impact of *Cariou* on the art industry, it is important to understand the recent rise of appropriation as a means of making art.[102] Appropriation is a hot topic in the art world, and the extent to which borrowing source material is legal matters greatly to the profession given the increasing ubiquity of the practice. This is especially true for younger artists, whose attitude toward borrowing is significantly different from artists of earlier generations. As Stephen Frailey, the head of the undergraduate photography

[96] *See* Statement of June M. Besek, *supra* note 90, at 12-13.

[97] *Id.*

[98] Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, art. 13, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS 320 (1999), 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994).

[99] *See* Panel Report, *United States – Section 110(5) of the US Copyright* Act, WT/DS160/R (June 15, 2000), http://www.wto.org/english/tratop_e/dispu_e/1234da.pdf.

[100] *See* Statement of June M. Besek, *supra* note 90, at 12.

[101] *Id.*

[102] *See, e.g.*, Kennedy, *Apropos Appropriation*, *supra* note 5.

program at the School of Visual Arts in Manhattan, told the *New York Times*, "[t]hey feel that once an image goes into a shared digital space, it's just there for them to change, to elaborate on, to add to, to improve, to do whatever they want with it. They don't see this as a subversive act. They see the Internet as a collaborative community and everything on it as raw material."[103] This sense of freedom among young artists is mirrored in the general public by the success of apps such as Mixel, which facilitates the appropriation of images in new user-generated art.[104]

The expansion of fair use will affect more original artists as well. If the law permits appropriation artists like Prince to adapt materials without clear limits, it is easy to imagine that the sources such artists appropriate from may dry up for lack of commercial incentive.[105] That incentive is critical. Cariou's investment of time and trust-building in creating his photographs was significant. He spent "some six years" with the Rastafarians he documented in *Yes Rasta*, "gaining their trust and taking their portraits."[106] One could argue that time and effort was necessary for Cariou to develop the kind of relationships with his subjects that would permit him to take the portraits in the first place. The Second Circuit's decision undermines the importance of this kind of effort.

Lastly, the expansion of fair use as illustrated by *Cariou* threatens the existence of the photographic licensing market. That market, which serves as a conduit between photographers and the publications or other entities that want to license their work, can be sidestepped entirely if stealing photos is fair use.[107] Indeed, the fact that there is currently an operational licensing market that Prince could have accessed makes it more difficult to justify his unlicensed use of Cariou's photographs as fair.[108]

[103] *Id.*

[104] *See, e.g.*, MIXEL, mixel.cc (last visited Mar. 30, 2014).

[105] This is not to suggest that all artists have a profit motive—indeed, Patrick Cariou did not commercialize his art extensively—but the business of art requires compensation.

[106] Cariou v. Prince, 784 F. Supp. 2d at 343.

[107] *See, e.g.*, Brief for the American Photographic Artists et al., *supra* note 87, at 18.

[108] *See* Harper & Row Publishers, Inc. v. Nation Enterprises, 471 U.S. 539, 568 n. 9 (1985) ("[here] there is a fully functioning market that encourages the creation and dissemination of memoirs of public figures. In the economists' view, permitting 'fair use' to displace normal copyright channels disrupts the copyright market without a commensurate public benefit"); American Geophysical Union v. Texaco Inc., 60 F.3d 913, 931 (2d Cir. 1994) ("it is sensible that a particular unauthorized use should be considered 'more fair' when there is no ready market or means to pay for the use, while such an unauthorized use should be considered 'less fair' when there is a ready market or means to pay for the use").

C. Societal Impact

The *Cariou* case has important implications for the relationship between law and society as well. Prince's business approach, like that of many appropriation artists, also raises ethical concerns. Even if courts determine that his adaptation of Cariou's photographs was legal, was it ethical of him to use Cariou's images without attribution? If Prince can make headlines, and millions of dollars, from taking another artists' work, his success sends a message to younger artists that is not easily countered. It is difficult to expect art teachers to demand integrity of their students when the art world and/or the legal system discards its value.[109]

The issue is especially acute for younger artists, who have come of age in an era that lauds appropriation art as much as entirely original compositions. As noted in the preceding section, today's emerging artists see everything in common cultural space (including the media and the internet) as theirs for the taking, without the need for compensation or attribution. Copyright law, like all intellectual property law, must strike a balance between the protection of original creative work and the common interest in access. If case law undermines the importance of original work, as *Cariou* arguably does, what is the counterweight against free-for-all use of visual works that are not yet in the public domain? The future of the "public domain" as a concept may change as well.

V. THE FUTURE OF FAIR USE: NEXT STEPS IN COPYRIGHT LAW

Given the Supreme Court's denial of certiorari, *Cariou* will stand as precedent for the time being in the Second Circuit. Although it is possible that the Ninth Circuit could revisit the fair use doctrine if *Morris v. Guetta* is upheld on appeal, setting up a potential circuit split between the Second and Ninth Circuits, that possibility is mitigated somewhat by the expansive Ninth Circuit decision in *Green Day*.

Photographers' associations have started to investigate alternatives in their fight against courts' expansive interpretation of

[109] *Cariou* can also be viewed as an example of the imbalance of power in the legal system. While the identity of counsel is not generally considered relevant to the outcome of the case, it would be disingenuous to ignore the fact that Prince's appellate law firm was Boies, Schiller & Flexner LLP, one of the most expensive and prestigious law firms in the country. The dramatic reversal of the Second Circuit's opinion must have resulted from a significant legal effort by appellate counsel, some of which was described in a *New York Times* article on the increasing prevalence of appropriation art. *See* Kennedy, *Apropos Appropriation*, *supra* note 5.

fair use. In addition to submitting their amicus brief in *Cariou*, photographers are also considering lobbying Congress. Congress could, for example, amend the Copyright Act to clarify the distinction between derivative use and transformative use, which is not yet codified in the statute.[110] Another possible amendment to the Copyright Act would be the inclusion of compulsory licensing for artists who incorporate copyright-protected works of others into their work. The idea of such a licensing scheme was raised at least as early as 2002.[111]

The expansive interpretation of fair use is not deterring all copyright holders from asserting their rights, however. In late 2013, a toy manufacturer called GoldieBlox used the melody of the Beastie Boys' song "Girls" in an ad for its engineering kits marketed to girls without permission.[112] In the video advertising the toy, which went viral, Goldieblox rewrote the lyrics in a way that turned the original song's meaning on its head. It changed the words from "Girls/To do my dishes/Girls/To clean up my room" to "Girls/To build a spaceship/Girls/To code the new app."[113] When the Beastie Boys threatened to sue for copyright infringement, Goldieblox brought a claim for declaratory judgment that its ads fell within the fair use exception.[114] Within a week of filing its claim, however, Goldieblox withdrew both its motion and the offending ad, but the Beastie Boys filed a counter-suit.[115] Hours after reaching a final settlement in

[110] In fact, the Judiciary Committee held a hearing on the proper scope of the fair use defense on January 28, 2014. Scope of Fair Use: Hearing Before the Subcomm. on Courts, Intellectual Property and the Internet of the H. Comm. on the Judiciary, 113th Cong. (2014), http://judiciary.house.gov/index.cfm/2014/1/the-scope-of-fair-use.

[111] *See, e.g.*, Judith Bresler, *Begged, Borrowed or Stolen: Whose Art Is It, Anyway? An Alternative Solution of Fine Art Licensing*, 50 J. COPYRIGHT SOC'Y OF THE U.S.A. 15 (2002).

[112] GoldieBlox & Rube Goldberg, *The Princess Machine*, GOLDIEBLOX, http://www.goldieblox.com/pages/beastie-boys-rube-goldberg-machine (last visited Mar. 30, 2014).

[113] Jason Newman, *GoldieBlox Apologizes to Beasties: 'We Have Learned a Valuable Lesson,'* ROLLING STONE (Mar. 19, 2014, 12:31 am), http://www.rollingstone.com/music/news/goldieblox-apologizes-to-beasties-we-have-learned-a-valuable-lesson-20140319.

[114] Complaint, GoldieBlox, Inc. v. Island Def Jam Music Group, No. 3:13-cv-05428 (N.D. Cal. filed Nov. 11, 2013), http://www.scribd.com/doc/186402972/Beastie.

[115] Steve Knopper, *Beastie Boys Suing Toymaker for 'Girls' Use*, ROLLING STONE (Dec. 11, 2013 3:17 PM), http://www.rollingstone.com/music/news/beastie-boys-suing-toy-maker-for-girls-use-20131211. A provision in the will of the late Beastie Boy Adam Yauch's that "in no event may my image or name or any music or any artistic property created by me be used for advertising purposes" limited the likelihood that GoldieBlox could have secured a license in any event. Newman, *GoldieBlox Apologizes to Beasties: 'We Have Learned a Valuable Lesson,' supra* note 110.

March 2014, Goldieblox issued a public apology to the Beastie Boys.[116]

Indeed, despite the arguable narrowing of the fair use defense in *Cariou*, photographers continue to file copyright cases against appropriation artists for the unlicensed use of their work, even in the Second Circuit (which, of course, includes New York, arguably the art capital of the United States). Dance photographer Lois Greenfield, for example, filed suit against Jill Pankey in the Southern District of New York in late December 2013, alleging that Pankey infringed Greenfield's copyright by using her photographs as the apparent basis for a series of paintings.[117]

VI. CONCLUSION

The *Cariou* decision and other recent cases expanding the application of the fair use defense are cause for concern, not just in the multi-billion dollar global art market but for the preservation of the creative process in general. Copyright law, like all intellectual property law, seeks the right balance between rewarding the creators of new works and ensuring that those works can be used appropriately by the public. By allowing appropriation artists apparently unfettered access to copyrighted materials, judicial decisions like *Cariou* threaten the incentives of more original artists to create the sources on which appropriation art depends.

The doctrinal, commercial and societal effects of these cases will play out in the coming years. Courts will have many more opportunities to revisit and, hopefully, clarify the definition of transformative use in cases like *Greenfield v. Pankey*. Clearer guidelines from the courts, perhaps in connection with statutory amendments delineating what constitutes transformative use under Section 107, will benefit all creative producers. It is, overall, preferable for society when true unfettered creativity comes from artists and writers instead of finders of fact.

[116] Newman, *GoldieBlox Apologizes to Beasties: 'We Have Learned a Valuable Lesson,' supra* note 110.

[117] Complaint, Greenfield v. Pankey, No. 13 Civ. 9025 (PGG)(FM)(S.D.N.Y. filed Dec. 31, 2013).

COPYRIGHT IMPLICATIONS OF IMPORTING AND RESELLING FOREIGN EDITION TEXTBOOKS IN THE UNITED STATES: SUPREME COURT UPDATE ON FIVE LITTLE WORDS IN THE FIRST SALE DOCTRINE

by William E. Greenspan*

I. INTRODUCTION

Professor White orders the new edition of the Business Law text he will be using for the coming term. The text sells in the university bookstore for $260. Michelle, a student who will be taking Professor White's class next term, approaches Professor White and shows him a book she purchased on the Internet for $54. The layout, text, cases, diagrams, and case problems are exactly the same as the hard cover edition, except for the soft cover. On the cover of the book appear the words: "INTERNATIONAL EDITION: This book cannot be re-exported from the country to which it is sold by the publisher. The International Edition is not available in North America." Michelle asks Professor White several questions: Is it OK for me to use this book in class? Did I violate any copyright law when I purchased the book on the Internet? What if I buy several copies of the Foreign Edition and resell them at a profit to other students in the class?

The answers to these questions are of interest not only to book publishers and students, but also to libraries that buy and lend out books, stores that sell used books, and Internet companies such as Amazon and eBay.[1] The answers to Michelle's questions would

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further be of concern to any United States business that buys copyrighted foreign-made products, parts, or technology, including those in the business of reselling artwork, cars, personal appliances, cell phones, and computers.[2] Publishers and manufacturers desire to price their products keyed to local international markets, while retailers and consumers benefit when they can buy and resell copyrighted works at discount prices.

This paper will (1) identify relevant statutory law relating to the first sale doctrine and the unauthorized import sections of the Copyright Act of 1976 (as amended to date), (2) review how the United States Supreme Court has resolved the issue to date on to what extent one can legally import and resell copyrighted foreign edition textbooks (or other copyrighted foreign-made products) in the United States, and (3) make recommendations for United States copyright owners on how to protect their copyrights when marketing products abroad.

II. RELEVANT STATUTORY LAW

In the exercise of its constitutional power "To promote the progress of Science … by securing for limited Times to Authors … the exclusive Right to their … Writings …," Congress enacted the first copyright law of the United States in 1790.[3] Comprehensive revisions were made in 1831, 1870, and 1976.[4] Congress enacted several minor revisions since the 1976 revision. The philosophy behind U.S. copyright law is well expressed in leading U.S. Supreme Court cases. In *Twentieth Century Music v. Aiken*,[5] the Court observed: "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 initiative, to stimulate artistic creativity for the general public good."[6] As stated in *Sony Corp. v. Universal City Studios*, one purpose of copyright law is to create a balance between "the interest of authors … in the control and exploitation of their writings … on the one hand, and society's competing interests in the free flow of ideas [and]

[1] Kyle Watlington, *The First Sale Doctrine of the Copyright Act Applies to Copies of a Copyrighted Work Lawfully Manufactured and Purchased Abroad Which are Later Imported into the United States,* 15 TRANSACTIONS: TENN. J. BUS. L. 184, 185 (2013).

[2] Brett A. Shanks, *The First Sale Doctrine and Unauthorized Imports: Feeding an Out-of-Control Gray Market,* 53 WASHBURN L.J. 119, 132 (2013).

[3] U.S. CONST. Art. I, § 8, cl. 8.

[4] 17 U.S.C. §§ 101 *et. seq.* (2014).

[5] 422 U.S. 151 (1975).

[6] *Id.* at 156.

information on the other hand."[7] Consistent with this ultimate aim and purpose, copyright law gives a person who creates an original[8] work of authorship fixed in any tangible medium of expression six exclusive rights,[9] including the right to distribute copies, with limitations.[10] One of these limitations is known as the first sale doctrine.[11]

A. First Sale Doctrine

The first sale doctrine in copyright law was first expressed by the United States Supreme Court in *Bobbs-Merrill Co. v. Straus*.[12] Bobbs-Merill Company sold its copyrighted novel "The Castaway" to wholesalers with a conspicuous notice on each copy: "The price of this book at retail is one dollar net. No dealer is licensed to sell it at a less price, and a sale at a less price will be treated as an infringement of copyright."[13] When R.H. Macy & Company sold copies of the book at retail for eighty-nine cents a copy, Bobbs-Merill sued Isidor and Nathan Straus, partners trading as R.H. Macy & Company, to restrain the sale of the book at less than one dollar for each copy.[14]

The United States Supreme Court held there was no infringement of copyright.[15] Although recognizing the current copyright statute gave the copyright owner the "sole right to vend," the Court held copyright law did not give the copyright owner the right to place restrictions beyond the first sale of the novel.[16] The Court stated: "[O]ne who has sold a copyrighted article … has parted with all rights to control the sale of it. The purchaser of a book, once sold by

[7] 464 U.S. 417, 429-30 (1984).

[8] Feist Publications, Inc. v. Rural Telephone Service Co., Inc., 499 U.S. 340, 345 (1991) ("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."); Garcia v. Google, No. 12-57302, 2014 WL 747399 at *2 (9th Cir. Feb. 26, 2014) (deciding an actor's performance, when fixed, is copyrightable if it evinces some minimal degree of creativity no matter how crude, humble or obvious it may be."); Lyons v. American College of Veterinary Sports Medicine and Rehabilitation, Inc., Civil Action No. 11-12192-WGY, 2014 WL 644736 at *11 (D.Mass. Feb. 19, 2014) (holding bylaws and articles of incorporation for veterinarian organization did not meet the originality requirement, the *sine qua non* of copyright).

[9] 17 U.S.C. § 106 (2014).

[10] 17 U.S.C. §§ 107-122 (2014).

[11] 17 U.S.C. § 109(a) (2014).

[12] 210 U.S. 339 (1908).

[13] *Id.* at 341.

[14] *Id.*

[15] *Id.* at 350.

[16] *Id*.

authority of the owner of the copyright, may sell it again, although he could not publish a new edition of it."[17]

The most recent codification of the first sale doctrine as expressed in *Bobbs-Merrill*, is incorporated in sections 106(3) and 109(a) of the Copyright Act of 1976.[18] Section 106(3) gives the copyright owner exclusive distribution rights in one's copyrighted work.[19] Section 109(a), known as the first sale doctrine, places a limitation on the exclusive rights granted in section 106(3) by allowing a copyright owner the right to control only the first sale of a copyrighted work.[20]

Legislative history[21] explains the relationship between sections 106(3) and 109(a) by making it clear that once a copyright owner distributes a copy of one's work, all further rights of distribution cease with respect to that particular copy.[22] Thus one who owns a particular copy may further distribute that copy without permission from the copyright owner.[23] Later legislative history, explaining

[17] *Id.*

[18] 17 U.S.C. §§ 101 *et. seq.* (2014).

[19] Subject to sections 107 through 122, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following: … (3) to distribute copies … of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending…. 17 U.S.C. § 106(3) (2014).

[20] Notwithstanding the provisions of section 106(3), the owner of a particular copy … lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy…. 17 U.S.C. § 109(a). *See* Dawes-Lloyd v. Publish America, LLP, 441 Fed.Appx. 956 (3rd Cir. 2011), *cert. denied*, 132 S.Ct. 1568 (2012) (granting summary judgment for Publish America after Dawes terminated Publish America's license to sell Dawes's book, *A Child's Intuition*, and Publish America then sold the book rights to a foreign publishing company, especially since Dawes was not able to prove she registered a copyright in her book); Sturgis v. Target Corp., 630 F.Supp.2d 776 (E.Dist. Mich. 2009) (holding that once Sturgis permitted Authorhouse to publish and distribute his book, *Why Are Americans So Afraid?,* Sturgis had no control over Authorhouse selling copies of the book to Target which offered the book for sale on its website).

[21] Clause (3) of section 106 establishes the exclusive right of publication…. Under this provision the copyright owner would have the right to control the first public distribution of a copy … of his work, whether by sale, gift, loan, or some rental or lease arrangement. Likewise, any unauthorized public distribution of copies … that were unlawfully made would be an infringement. As section 109(a) makes clear, however, the copyright owner's rights under section 106(3) cease with respect to a particular copy … once he has parted possession with it…. H.R. Rep. No. 1476, 94th Cong., 2d Sess. 169*, reprinted in* 1976 U.S. Code Cong. & Adminin. News 5675-76.

[22] *Id.*

[23] Under this principle, … the copyright owner's exclusive right of public distribution would have no effect upon anyone who owns a particular copy … lawfully made under this title and who wishes to transfer it to someone else or to destroy it. *Id.* at 5693. *Also see*, John Horsfield-Bradbury*, "Making Available" as Distribution: File-Sharing and the Copyright Act,* 22 HARV. J.L. & TECH. 273 (2008) (explaining as the

section 109(a), distinguishes between the rights of the copyright owner versus the owner of a particular copy.[24]

For example, it is clearly legal under United States copyright law if at the end of an academic term one student, without permission from the copyright owner, sells, gives, or lends his lawfully owned textbook to another student.[25] The author owns the copyright in the book, while the student owns that particular copy of the book.[26] Considering the immediate effect, ultimate aim, and purpose of copyright law, the author has received his financial reward for the sale of that particular copy, while there is a free flow of information from one consumer to another.[27]

Application of the first sale doctrine becomes more complicated when one imports a copyrighted work into the United Sates without the copyright owner's permission. This requires a look at the unauthorized importation section of the Copyright Act of 1976.

B. Unauthorized Importation

Section 602(a) was added to the Copyright Act of 1976 in response to copyright owners seeking protection from unauthorized

legislative history of the Act summarizes, the two purposes of the distribution right independent of the reproduction right are (1) to ensure an author has "the right to control the first public distribution of an unauthorized copy … of his work," and (2) to protect against the "unauthorized public distribution of copies … that were unlawfully made," even if the distributor did not himself make the copies).

[24] The copyright owner has no right to control distribution (although reproduction and other rights are retained) of a copy … of a copyrighted work beyond the point of first sale of that copy, … whether to a wholesaler, retailer, or the ultimate consumer. The first sale doctrine distinguished between the copyright holder's exclusive rights in the intellectual property embodied in the copyright and the ownership rights in the material object itself. H.R. Rep. No. 987, 98th Cong. 2d Sess. 2*, reprinted in* 1984 U.S. Code Cong. & Admin. News 2898, 2899.

[25] 17 U.S.C. § 109(a) (2014).

[26] *Id.*

[27] Copyright owners have tried, often unsuccessfully, to evade the limitations of the first sale doctrine by claiming there was a licensing agreement rather than a sale. The first sale doctrine does not "extend to any person who has acquired possession of the copy … from the copyright owner by rental, lease, loan, or otherwise, without acquiring ownership of it." 17 U.S.C. § 109(d). *See,* International Equipment Trading, Ltd. v. AB SCIEX LLC, No. 13 C 1129, 2013 WL 4599903 (N.D.Ill. Aug. 29, 2013) at *6 (stating "if the copyright work is not sold, the copyright holder does not lose his right to control the distribution of that work. Thus, where a copyright holder only licensed and did not sell its copyrighted software, the first sale doctrine has no application as a matter of law."); UMG Recordings, Inc. v. Augusto, 558 F.Supp.2d 1055 (C.D. Cal. 2008) (holding the transfer of numerous songs on a CD to selected members of the public for personal use only for purposes of promoting and advertising the release of the new CD was a sale or gift, not a license, because title passed to the recipients who did not have to return the promotional CDs to UMG).

importation of copies.[28] The legislative history explaining the intention of Congress in enacting this section distinguishes between unauthorized "piratical" copies and unauthorized importation of copies lawfully made abroad. Section 602 makes both situations illegal.[29]

An example of a violation of section 602(a) would occur if a publisher in China, without permission from the copyright owner, makes copies of a United States copyrighted book. The publisher then attempts to import the copies into the United States. The United States Customs Service may prohibit importation of these piratical copies.[30] In this example, considering the immediate effect of copyright law, to secure a fair return for the author's creative labor, the author has not received his financial reward for the sale of these particular copies.[31]

Now consider what happens when a copyrighted work is produced in the United States and copies are sold to a foreign distributor who promises to resell the copies abroad. Violating this agreement, the distributor resells the copies to a United States distributor who resells to retailers in the United States. How do courts reconcile the first sale doctrine stated in section 109(a) with the unauthorized importation rule stated in section 602(a)?

[28] Importation into the United States, without the authority of the owner of copyright under this title, of copies … of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies … under section 106…. 17 U.S.C. § 602(a) (2014).

[29] Section 602 … deals with two separate situations: importation of "piratical" articles (that is copies … made without any authorization of the copyright owner), and unauthorized importation of copies … that were lawfully made. The general approach of section 602 is to make unauthorized importation an act of infringement in both cases…. Section 602(a) … states the general rule that unauthorized importation is an infringement merely if the copies … have been acquired outside the United States…. [A]ny unauthorized importer of copies … acquired abroad could be sued for damages and enjoined from making any use of them, even before any public distribution in this country has taken place. H.R. Rep. No. 1476, 94th Cong., 2d Sess. 169*, reprinted in* 1976 U.S. Code Cong. & Admin. News 5659, 5785-86.

[30] 17 U.S.C. § 603(c) (2014).

[31] Mary LaFrance, Wag the Dog: Using Incidental Intellectual Property Rights to Block Parallel Imports, 20 MICH. TELECOMM. & TECH. L. REV. 45, 68 (2013) (stating other examples that would violate § 602: "(1) copies made overseas, by a foreign publisher or printer, with the consent of the U.S. copyright owner and then imported before any sale takes place; (2) copies made overseas with the consent of the U.S. copyright owner and then delivered but not sold to a wholesaler that subsequently imports them; and (3) copies imported by a licensee, such as a film distributor that leases its prints, consignee or bailee." Stated otherwise, it would be a violation to import copies made overseas that have never been sold.).

C. Apparent Conflict between Sections 109 and 602(a)

The unauthorized importation rule in section 602(a) appears to conflict with the first sale doctrine in section 109(a). The first sale doctrine seems to permit conduct prohibited by section 602(a). The United States Supreme Court addressed this issue in *Quality King Distributors, Inc. v. L'anza Research Intern, Inc.*[32] The Court framed the issue as "whether the 'first sale' doctrine endorsed in § 109(a) is applicable to imported copies."[33]

Quality King involved "round trip" importation whereby L'anza manufactured hair care products in the United States with United States copyrighted labels. In one instance L'anza sold its products to a foreign distributor with the understanding that the products would be distributed in Malta, and possibly Libya. In violation of the agreement the distributor sold the products to Quality King Distributors who imported the goods back into the United States and resold the goods at discounted prices to retail stores in California.[34]

When L'anza brought suit against Quality King, the United States Supreme Court recognized (as stated by the court of appeals) that "it is unclear whether § 602(a) creates a right that is distinct from § 106(3) and therefore is not limited by § 109(a) (argument for L'anza), or alternatively, whether § 602(a) is merely an extension of § 106(3) and therefore is limited by § 109(a) (argument for Quality King)."[35] The Court chose the latter interpretation, holding in favor of Quality King, especially relying on the literal language of the relevant provisions of the copyright statute and the accompanying legislative history.[36]

Consequently, *Quality King* clearly stands for the rule of law that if a copyrighted product is produced in the United States and lawfully sold to a foreign distributor who, without permission from the copyright owner, imports the product back into the United States, current copyright law will not help the copyright owner to prevent the product from being imported into the United States.[37] However,

[32] 523 U.S. 135 (1998).

[33] *Id*. at 138.

[34] *Id.* at 138-39.

[35] L'anza Research Intern.v. Quality King Distributors, 98 F.3d 1109, 1113 (9th Cir. 1996).

[36] 523 U.S. at 153-54.

[37] See, Denbicare U.S.A. Inc. v. Toys "R" Us, Inc., 84 F.3d 1143, 1150 (9th Cir. 1996) (deciding the bankruptcy trustee's sale of diapers in the foreign trade zone, which is part of the United States, was a sale in the United States sufficient to bring § 109 into play).

Quality King did not decide if the result would be different if the goods were manufactured abroad, rather than in the United States.[38]

III. COPYRIGHTED PRODUCTS MANUFACTURED AND SOLD ABROAD

After *Quality King,* courts examined the relationship between the section 109(a) first sale doctrine and the section 602(a) importation rule when goods have been manufactured abroad. In *Omega S.A. v. Costco Wholesale Corp.*,[39] Omega manufactured watches in Switzerland that had a United States copyright for its "Omega Globe Design" on the underside of the watches. Costco Wholesale Corporation purchased the watches through a chain of buyers and sellers in the "gray market" and, without Omega's permission, imported the watches into the United States for resale.[40] When Omega sued Costco for copyright infringement, Costco asserted the *Quality King* first sale doctrine as an affirmative defense.[41]

The Ninth Circuit, affirming the district court, noted the first sale doctrine of section 109(a) limits section 602(a). However, the court recognized that for the first sale doctrine to apply to a case, the copy in question must be one "lawfully made under this title" (those five little words).[42] The phrase "lawfully made under this title" in section 109(a) grants first sale protection only to copies legally made and sold in the United States. For the first sale doctrine to apply as a defense to unauthorized importation, either the goods (1) must have been made in the United States, or (2) the goods must have been manufactured abroad and imported into the United States with authority or permission from the copyright owner.[43] Distinguishing this case from *Quality King,* the court observed that Omega manufactured its watches in Switzerland, and Costco sold the

[38] 523 U.S. at 154 (Ginsberg, J. concurring) (recognizing "we do not today resolve cases in which the allegedly infringing imports were manufactured abroad").

[39] 541 F.3d 982 (9th Cir. 2008).

[40] *Id.* at 984 (defining "Gray Market" goods, or "parallel imports," as genuine copyrighted goods, typically manufactured abroad, and purchased and imported into the United States by third parties without permission from the copyright owner). *See also*, Hillary A. Kewman, *Caveat Venditor: International Application of the First Sale Doctrine*, 23 SYRACUSE J. INT'L & COM. 161, 162 (1997) (explaining "parallel imports" are diverted from a foreign market, back into the United States, and are resold by an unauthorized party at a lower price who takes advantage of currency fluctuations or promotional and advertising campaigns paid for by the authorized distributors).

[41] 541 F.3d at 984.

[42] *Id.* at 985.

[43] *Id.* at 985-86.

watches without Omega's authority in the United States.[44] Thus Costco did not have a valid section 109(a) defense to Omega's claims.[45] No authorized sale occurred in the United States.[46]

Costco appealed the decision. The Supreme Court granted certiorari. After hearing oral arguments, an equally-divided Court issued a single-sentence opinion affirming the Ninth Circuit.[47]

Concerning the first sale doctrine and its relevance to importation of foreign textbook editions, consider *Pearson Educ., Inc. v. Liao*[48] in which the plaintiffs (Pearson Education, John Wiley & Sons, Cengage Learning, and McGraw Hill) alleged that defendants (Jun Liao and Zengshu Gu) purchased United States copyrighted educational textbooks that were both manufactured and intended for sale outside the United States (International Editions), and then, without the plaintiffs' permission, the defendants resold the textbooks within the United States on Internet bookselling sites (such as www.abebooks.com) using the name "Readmate."[49] Each of the textbooks was published in both a United States Edition and an International Edition.[50] The editions were substantially identical in content, but the International Editions were published using inferior ink, paper, and binding materials. The plaintiffs were able to prove that during the past three years prior to the commencement of this action, defendants sold in the United States at least one copy of an International Edition of 166 subject works.[51] When the plaintiffs sued the defendants for copyright infringement, the defendants claimed in defense that they were protected under the first sale doctrine.[52]

Recognizing that a copyright holder's exclusive right to sell copies is tempered by the *Quality King* first sale doctrine, the court noted the first sale doctrine does not protect persons who purchase copies of copyrighted works manufactured outside the United States, and then import them into the United States for resale without the copyright

[44] *Id.*

[45] *Id.*

[46] *See also,* Microsoft Corp. v. Big Boy Distribution LLC, 589 F.Supp.2d 1308 (S.D.Fla. 2008) (deciding Microsoft software manufactured and assembled in Ireland, and subsequently imported into the United States without permission or authorization from Microsoft, was not protected by the first sale doctrine).

[47] Costco Wholesale Corp. v. Omega, S.A., 131 S.Ct. 565 (Mem.) (2010).

[48] No. 07-Civ-2423 (SHS), 2008 WL 2073491 (S.D.N.Y. May 13, 2008) (not reported in F.Supp.2d).

[49] *Id.* at *1-2.

[50] *Id.*

[51] *Id.*

[52] *Id.*

owner's permission.[53] Stated otherwise, the first sale doctrine defense only applies to copies lawfully made under this title (the Copyright Act).[54] In this case, since the textbooks were manufactured abroad, and since the defendants imported the textbooks into the United States without the permission of the plaintiffs, the defendants were liable for copyright infringement. In addition to issuing injunctive relief, the court awarded the plaintiffs $750 for each of 166 infringing works for a total of $124,500 in damages.[55]

After *Quality King, Costco,* and lower court decisions (such as *Pearson Education*), it seemed pretty well settled that the first sale doctrine does not protect persons who purchase copies of copyrighted works manufactured outside the United States, and then import them into the United States for resale without the copyright owner's permission.[56] Those five little words in section 109(a) – "lawfully made under this title" – granted first sale protection only to copies legally made and sold in the United States, or goods manufactured abroad and imported into the United States with authority or permission from the copyright owner. Stated otherwise, the five word phrase – "lawfully made under this title" – imposed a geographical limitation, meaning the first sale doctrine only applies to copyrighted works made in the United States.[57] But, most recently, the United States Supreme Court revisited those five little words to decide whether to maintain a geographical limitation (within the United States) or, in the alternative, to read the phrase *non*-geographically, whereby the first sale doctrine shall apply to any copyrighted work created "in accordance with" United States law.[58]

IV. SUPREME COURT UPDATE ON FIVE LITTLE WORDS IN THE FIRST SALE DOCTRINE

On March 19, 2013, the United States Supreme Court issued an opinion in *Kirtsaeng v. John Wiley & Sons, Inc.*[59] John Wiley publishes two versions of some of its academic textbooks.[60] One

[53] *Id.* at *3-4.
[54] *Id.*
[55] *Id.*
[56] *See*, Diepiriye A. Anga, *Intellectual Property Without Borders? The Effect of Copyright Exhaustion on Global Commerce*, 10 B.Y.U. INT'L L. & MGMT. REV. 53 (2014).
[57] *Id.* at 57-58.
[58] Kirtsaeng v. John Wiley & Sons, Inc., 132 S.Ct. 1905 (Mem.) (2012) (granting petition for writ of certiorari to the United States Court of Appeals for the Second Circuit).
[59] 133 S.Ct. 1351 (2013).
[60] *Id.* at 1356.

version is sold in the United States while the other version is manufactured and sold by a Wiley subsidiary in other countries with the proviso that the foreign edition may not be exported out of those countries into the United States.[61] Supap Kirtsaeng, a citizen of Thailand, moved to the United States where he completed his undergraduate courses in mathematics at Cornell University, and then his Ph.D. at the University of Southern California.[62] While studying in the United States, Kirtsaeng had friends and family in Thailand buy copies of foreign edition English-language textbooks at Thai book shops where they were sold at low prices, and mail the textbooks to him in the United States.[63] Kirtsaeng then sold the books, reimbursed his family and friends, and kept the profits from the sales.[64]

Wiley brought an action for copyright infringement against Kirtsaeng for copyright infringement, claiming violations of Wiley's § 106(3) exclusive right to sell and distribute, as well as the illegal import provision in § 602(a).[65] In defense, Kirtsaeng claimed he was protected under the first sale doctrine in § 109(a) of the Copyright Act.[66] Following precedent in *Costco*, the Second Circuit agreed with the district court that the first sale doctrine does not apply to copies of United States copyrighted works manufactured abroad.[67] Kirtsaeng appealed and the Supreme Court granted certiorari.[68]

Justice Breyer, delivering the opinion of the Court, framed the issue. The Court had to decide whether those five little words in § 109(a) – "lawfully made under this title" – restrict the scope of the first sale doctrine in § 109(a).[69] Stated otherwise, does the "first sale" doctrine apply to protect a buyer or other lawful owner of a copy of a copyrighted work lawfully manufactured abroad? Can that buyer import that copy into the United States and sell it without the copyright owner's permission?[70]

In an exhaustive opinion, the Court abrogated *Costco*, ruling that the "first sale" doctrine applies to copies of a copyrighted work lawfully made abroad.[71] Wiley argued that the words in § 109(a) –

[61] *Id*.
[62] *Id*.
[63] *Id*.
[64] *Id*.
[65] *Id*. at 1357.
[66] *Id*.
[67] *Id*.
[68] *Id*.
[69] *Id*. at 1355.
[70] *Id*.
[71] *Id*. at 1355-56.

"lawfully made under this title" – impose a geographic limitation: the United States Copyright Act. Kirtsaeng regarded those five words as imposing a *non*-geographical limitation, meaning anywhere in the world provided it is "in accordance with" or "in compliance with" the United States Copyright Act.[72] Taking into account the language of § 109, its context, and the common law history of the "first sale" doctrine, the Court favored a *non*-geographical interpretation.[73]

There are winners and losers here. The losers are generally textbook publishers and authors, as well as other manufacturers of copyrighted goods manufactured abroad.[74] The winners include library associations, used-book dealers, technology companies, consumer-goods retailers, museums, and students.[75] For example, libraries and used book dealers will no longer have to obtain permission before circulating the large number of books in their collections that were printed overseas.[76] Technology companies will not have to obtain numerous permissions to import copyrighted software programs or packaging that go into a finished product, whether it be an automobile, microwave, calculator, mobile phone, tablet, or personal computer.[77] Retailers will not be subject to infringement suits for importing products with copyrighted packaging, logos, labels, and instructions.[78] Art museums can more easily display foreign-produced works by famous artists.[79] The Court explained its decision helped further basic constitutional copyright objectives to promote the progress of science and to stimulate artistic creativity for the general public good.[80]

V. RECOMMENDATIONS, STRATEGIES

As a consequence of *Kirtsaeng*, several purchasers of books legally manufactured abroad are no longer at risk for copyright infringement.[81] However, *Kirtsaeng* is a narrow decision in that it only applies to print publications. What can publishers of print editions do to minimize the effect of *Kirtsaeng*? One obvious solution is to make sure some of the text, cases, case examples, and case

[72] *Id.* at 1358.
[73] *Id.*
[74] *Id.* at 1364-67.
[75] *Id.*
[76] *Id.* at 1364-65.
[77] *Id.* at 1365.
[78] *Id.*
[79] *Id.*
[80] *Id.* at 1364.
[81] *See,* Pearson Educ., Inc. v. Kumar, 523 Fed. Appx. 16 (2nd Cir. 2013) (vacating district's court judgment as to plaintiff's copyright claim).

problems are different in the foreign editions, keyed to the interests of local markets, so the books would not be acceptable substitutes for classroom use in the United States. Another possibility is to reevaluate global pricing strategies and charge the same price for the books both domestically and abroad. However, that would not be practical since many consumers in foreign countries could not afford to pay United States prices.[82]

Another consequence of *Kirtsaeng* is there has been an increasing shift to digital content.[83] Typically, digital content is transferred by a license, not a sale.[84] To date, no court has held that the first sale doctrine applies to digital publications. Shortly after the Supreme Court's decision in *Kirtsaeng*, a New York district court issued a ruling that a digital music file, lawfully made and purchased, may not be resold by its owner through an online marketplace for digital music.[85] The owner is not protected by the first sale doctrine.[86] So another strategy for publishers is to vigorously promote online digital copies of textbooks with non-transferable licenses.

Returning to the introduction to this paper where Michelle asks her professor if she violated any copyright law when she purchased the International Edition on the Internet, the answer is clearly: No, she did not violate any copyright law provided the copy was legally made. In addition, Michelle asks if it is a violation of copyright law for her to buy several copies of a Foreign Edition and resell the copies

[82] See, Mitchell Ashkenaz, *Intellectual Property Law – Copyright Law – Applicability of "First Sale" Doctrine to Copies of Copyrighted Works Lawfully Produced Abroad*, 81 TENN. L. REV. 187, 209 (2013) (arguing textbooks, pharmaceuticals, and other goods intended to remain abroad would not be affordable at the prices they command in the United States).

[83] See, Ilaria Maggioni, *Where are We Going in High Tech? Kirtsaeng v. Wiley Incentivizes Digital Distribution*, 48 LES NOUVELLES 260, 261 (2013) (suggesting increased reliance on digital distribution may be viewed as an unintended consequence of *Kirtsaeng*).

[84] *Id.* Since digital works are traditionally brought to market under non-transferable personal-use licenses, not "sold," the first-sale doctrine so far has been held inapplicable to licensed digital works.

[85] Capitol Records LLC v. ReDigi, 934 F.Supp.2d 640, 648 (S.D.N.Y. 2013) (holding the unauthorized transfer of a digital music file over the Internet, where only one file exists before and after the transfer, constitutes illegal reproduction within the meaning of the Copyright Act); *but see*, Joshua J. Schroeder, *Bringing America Back to the Future: Reclaiming a Principle of Honesty in Property and IP Law*, 35, 41-47 HAMLINE J. PUB. L. & POL'Y 1 (2013) (advocating it would not be honest that corporations should have the right to charge American consumers more money for things they sell to foreigners at a much cheaper price; based on the public's underlying rights to foster free flowing knowledge and information, digital copies of copyrighted works sold online should have first sale limitations assigned to them).

[86] 934 F.Supp.2d at 648.

at a profit to other students in the class. The answer to that question is also: No, there is no violation of copyright law provided the copies were legally made.

VI. CONCLUSION

Unless and until Congress decides to amend the first sale doctrine to negate *Kirtsaeng* and revive *Costco*, or unless and until the Supreme Court abrogates its decision in *Kirtsaeng*, the law is well settled that once a legally-made copyrighted work has been sold by its owner anywhere in the world, any purchaser is free to resell that work, including by importing the work into the United States. Any student, in fact any person, is free to buy unlimited quantities of International Editions, import the textbooks into the United States, and resell those copies at a profit.

RECENT CONTROVERSY SURROUNDING THE EU – US SAFE HARBOR DATA PROTECTION REGIME

by Carter Manny*

I. INTRODUCTION

European data protection law provides comprehensive privacy protection for personal information.[1] Since 1998, the basic requirements are set forth in a Directive providing a framework for data protection, and national legislation implementing the Directive's provisions in the 28 Member States of the European Union.[2] In addition to regulating the use of personal information within Europe, the data protection system prohibits the transfer of personal information to a location anywhere outside of the 28 Member States, unless the transfer is to a country with an adequate level of privacy protection[3] or is permitted under an exception.[4] The broadest provision allows transfers to a country which has been found by the European Commission to ensure an "adequate level of protection" by means of its privacy law or of the privacy "commitments" it has

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[1] *See* Council Directive 95/46, 1995 O.J. (L281) 31 [hereinafter *Directive* or *Data Protection Directive*.]

[2] *See Id.*

[3] *See Id.* at Art. 25 (1) (providing that personal data may be transferred to a country that ensures an adequate level of protection).

[4] *See Directive, supra* note 1, at Art. 26 (1) (allowing transfers when the data subject has given consent, when necessary for the performance of certain contracts, when necessary for legally required on public interest grounds or in or to exercise or defend legal claims, when necessary to protect the vital interest of the data subject, or when made from a public register).

entered into as a result of negotiations between that country and the European Commission.[5] Only a few countries have been found to have sufficiently strict privacy laws to receive a general adequacy determination.[6] Organizations within those countries benefit enormously in that they can receive personal information freely from Europe. For example, a hotel chain with its headquarters in Canada can freely receive data from Europe about its European customers and employees, because Canadian law has been determined by the European Commission to provide adequate privacy protection according to European standards. Unlike Canada and Europe, however, privacy law in the United States consists of a patchwork of sector-specific federal and state legislation,[7] rather than a comprehensive system applying to all organizations. Accordingly, the U.S. could not expect to qualify for a general adequacy determination based upon its law. Consequently, the U.S. pursued the alternative way of obtaining a more narrowly-focused adequacy determination, by entering into negotiations with the European Commission to assemble a set of privacy commitments that could be adopted by U.S. companies.[8] The negotiations were successfully completed in 2000, resulting in an arrangement known as Safe Harbor.[9] The European Commission determined that privacy commitments made by U.S. organizations which joined Safe Harbor, combined with a system for enforcement of those commitments, would provide adequate protection for personal information which those organizations acquired from Europe.[10] Over 4000 U.S. organizations, large and

[5] *See Directive, supra* note 1, at Art. 25 (6) (providing that the Commission may find that a country ensures an adequate level of protection by reason of its domestic law or of the international commitments it has entered into).

[6] As of March 2014, only six countries (Switzerland, Canada, Argentina, Israel, Uruguay and New Zealand), the Principality of Andorra, and four dependencies (Guernsey, Jersey, the Isle of Man and the Faroe Islands) have been found by the Commission to provide adequate protection for personal data. *See* http://www.ec.europa.eu/justice/data-protection/document/international-transfers/adequacy/index_en.htm (visited Mar. 31, 2014).

[7] Examples of sector-specific U.S. federal statutes include the Fair Credit Reporting Act, 15 U.S.C. §§ 1681 – 1681v (2012) (credit reports); the Financial Services Modernization Act (also known as the Gramm-Leach-Bliley Act), 15 U.S.C. §§ 6801 – 6827 (2012) (financial information); and the Video Privacy Protection Act, 18 U.S.C. § 2710 (2012) (records of video rentals and sales).

[8] *See, e.g.,* Henry Farrell, *Negotiating Privacy Across Arenas: The EU – US "Safe Harbor" Discussions, available at* http://www.henryfarrell.net/privacy1.pdf (visited Mar. 31, 2014).

[9] *See Issuance of Safe Harbor Principles and Transmission to European Commission*, 65 Fed. Reg. 45,666 (2000)[hereinafter *Safe Harbor Principles*].

[10] See Commission Decision pursuant to Directive 95/46/EC of the European Parliament and of the Council on the adequacy of the protection provided by the safe harbor privacy principles and related frequently asked questions issued by the US

small, have joined Safe Harbor, making it an important way for commercially-important personal information to flow lawfully from countries in the EU to the U.S.[11]

Despite its growing number of participants, Safe Harbor has been criticized by privacy activists,[12] European data protection commissioners[13] and members of the EU Parliament.[14] Revelations during the summer of 2013 that the U.S. National Security Agency had obtained access to personal information of Europeans through Facebook, Google and other prominent Safe Harbor participants intensified that criticism.[15] In November 2013, the European Commission published a report listing areas of Safe Harbor needing improvement, and included reference to the Commission's authority to adapt, suspend or even revoke its approval of the Safe Harbor system.[16] In March 2014, the European Parliament went further by

Department of Commerce, 2000 O.J. (L215) 7 [hereinafter *Commission's Safe Harbor Decision*].

[11] *See* U.S. – EU Safe Harbor List, *available at* http://safeharbor.export.gov/list.aspx (visited Mar. 31, 2014). The list contains 4514 entries, but some organizations are noted as being "not current." Many large businesses are Safe Harbor participants, including Google, Facebook, Yahoo, Microsoft, Apple, Proctor & Gamble, Exxon-Mobil, Ford Motor Company, Chrysler, General Motors, General Mills, Genzyme, Georgia Pacific and Hewlett Packard.

[12] *See, e.g.*, John Oates, *Shortlist for Privacy "Oscars"Announced*, *available at* http://www.theregister.co.uk/ 2004/07/05privacy_awards (visited Mar. 31, 2014) (announcing a ceremony in July, 2004, during which mock awards would be issued by London-based Privacy International, a privacy advocacy organization, and mentioning that Safe Harbor was a contender for an award in the category of "Most Appalling Project.")

[13] *See, e.g.,* Peter Schaar, *Speech of 30 January 2009 on the occasion of Data Protection Day in Vienna*, *available at* http://www.bfdi.de/SharedDocs/Publikationen/EN/30012009_SpeechSchaarEuDSTagWien.pdf?_blob=publicationFile (visited Mar. 31, 2014)(in which the federal data protection commissioner of Germany noted some of the shortcomings of the Safe Harbor system.); Article 29 Data Protection Working Party, *Opinion 4/2000 on the level of protection provided by the "Safe Harbor Principles" Adopted on 16th May 2000, available at* http://www.ec.europe.eu/justice/policies/privacy/docs/wpdocs/2000/wp32en.pdf (visited Mar. 31, 2014.)

[14] *See, e.g., EU/US: MEPS Want Safe Harbour Data Protection Deal Renegotiated,* EUROPEAN REPORT, July10, 2000 at 1.

[15] *See, e.g.,* Glenn Greenwald, *As Europe erupts over US spying, NSA chief says government must stop media, available at* http://www.theguardian.com/commentisfree/2013/oct/25/Europe-erupts-nsa-spying-chief-government (visited Mar. 31, 2014); *Apple, Microsoft and Facebook targeted in Europe for NSA spying ties, available at* http://bgr.com/2013/06/26/apple-microsoft-facebook-nsa-prism (visited Mar. 31, 2014).

[16] *See Communication From the Commission to the European Parliament and the Council on the Functioning of the Safe Harbour from the Perspective of EU Citizens and Companies Established in the EU, available at* http://www.ec.europa.eu/justice/data-protection/files/com_2013_847_en.pdf (visited Jan. 16, 2014)[hereinafter *Commission's November 2013 Safe Harbor Report*].

voting to suspend Safe Harbor.[17] This article examines the controversy and considers what improvements should be made. It begins, however, with an overview of the Safe Harbor system.

II. OVERVIEW OF SAFE HARBOR

In general, Safe Harbor is a voluntary program which relies on self regulation and alternative dispute resolution supplemented by the possibility that violations will result in enforcement actions by U.S. administrative agencies.[18] An organization joins Safe Harbor by filing a self-certification letter with the U.S. Department of Commerce containing a commitment to adhere to a set of privacy principles adopted jointly by the European Commission and the Department of Commerce.[19] Not all organizations can join. Participation in Safe Harbor is limited to entities subject to the consumer protection jurisdiction of the Federal Trade Commission and Department of Transportation, both of which have authority to bring actions for unfair or deceptive practices.[20] Major sectors of U.S. business which are not eligible to join Safe Harbor include telecommunications providers, insurance companies and banks.[21]

A. Safe Harbor Privacy Principles

Safe Harbor participants must publicly declare that they comply with seven categories of privacy principles, which are: (1) notice, (2) choice, (3) onward transfer, (4) security, (5) data integrity, (6) access and (7) enforcement.[22] An organization can qualify by developing its own privacy policies or by joining a self-regulatory privacy program that adheres to the Safe Harbor principles.[23]

[17] *See, e.g., European Parliament threatens U.S. with end of pact on data protection, available at* http://www.upi.com/Top_News/World-News/2014/03/13/European-Parliament-threatens-US-with-end-od-pact-on-data-protection/UPI-28981394746376/ (visited Mar. 22, 2014).

[18] *See Safe Harbor Principles*, *supra* note 9.

[19] *See Frequently Asked Questions (FAQS) FAQ 6 – Self Certification, Safe Harbor Principles*, *supra* note 9, at 45669.

[20] *See Safe Harbor Principles, supra* note 9, Annex at 45668. Federal Trade Commission authority is provided in 15 U.S.C. § 45. Department of Transportation authority to take action against air carriers is provided in 49 U.S.C. § 41712.

[21] Businesses excluded from FTC jurisdiction under Section 5 of the FTC Act include banks, savings and loan institutions, Federal credit unions, and air carriers. *See* 15 U.S.C. § 45(a)(2). The insurance industry is considered to be outside the jurisdiction of the FTC to the extent it is regulated by state law as specified by the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et. seq.*

[22] *See Safe Harbor Principles, supra* note 9, at 45667.

[23] *See Id.* Privacy programs that comply with Safe Harbor include programs run by TRUSTe, BBBOnline and the Direct Marketing Association.

The principle of "notice" requires the organization to inform individuals of four things when they are first asked[24] to provide information: (a) the purposes for which the information is collected, (b) how to contact the organization, (c) the types of third parties to which it discloses information, and (d) the choices and means the organization offers the individual to limit the use and disclosure of the information.[25]

The principle of "choice" requires the organization to provide a "clear and conspicuous, readily available and affordable mechanism" to choose whether their information (a) is to be disclosed to third party, or (b) is to be used for a purpose that is incompatible with the purpose or purposes for which it was originally collected or subsequently authorized by the individual.[26]

The principle of "onward transfer" reinforces the first two principles by stating the obvious requirement that in order for the organization to disclose information to a third party, it must apply the notice and choice principles. The "onward transfer" provision also raises the possibility that the organization will be protected from liability for a third party's improper behavior if the third party is acting as the organization's agent to perform tasks on the organization's behalf if: (a) the agent has entered into a written agreement to provide privacy protection equivalent to relevant Safe Harbor Principles, or (b) the agent is a Safe Harbor participant, or (c) the agent is subject to the Directive (for example, a company in a Member State of the EU,) or (d) the agent is within another adequacy finding by the European Commission (for example, a company in Canada.)[27] Because there will be many situations not covered by the latter three instances, Safe Harbor participants will frequently want to enter into written agreements with agents containing privacy commitments equivalent to the Safe Harbor Principles. The Safe Harbor Agreement, however, is silent on the extent to which such agreements must be disclosed to individuals.

The principle of "security" requires reasonable precautions to protect personal information from loss, misuse, unauthorized access,

[24] Notice "must be provided in clear and conspicuous language when individuals are first asked to provide personal information to the organization or a soon thereafter as is practicable, but in any event before the organization uses such information for a purpose other than that for which it was originally collected or processed by the transferring organization or discloses it for the first time to a third party." *See Safe Harbor Principles, supra* note 9, at 45667.

[25] *See Safe Harbor Principles, supra* note 9, at 45667.

[26] *Id.*

[27] *See Safe Harbor Principles, supra* note 9, at 45668.

disclosure, alteration or destruction.[28] The principle of "data integrity" requires that information be relevant for the purposes for which it will be used, that it not be processed in a way that is incompatible with the purposes for which it was collected, and that the information be reliable, accurate, complete and current.[29]

The principle of "access" requires that individuals be able learn what information about them is held by an organization. Individuals also must be able to correct, amend or delete inaccurate information, except when (a) the burden or expense of providing access would be disproportionate to the risks to the individual's privacy in the case in question, or (b) when the rights of other persons would be violated.[30]

Finally, the principle of "enforcement" requires (a) enforcement by readily available and affordable independent mechanisms to resolve disputes and award damages when allowed by law or by "private sector initiatives," (b) follow up procedures for verifying that assertions about an organization's privacy practices are true and have been implemented, and (c) obligations to remedy problems with compliance, including rigorous sanctions for non-compliance.[31]

B. Other Safe Harbor Provisions

In addition to the Safe Harbor Privacy Principles, the Agreement contains a set of frequently asked questions ("FAQs,") with detailed explanations of how the Safe Harbor system should operate. The FAQs pertaining to the recent Safe Harbor controversy will be summarized as a prelude to the discussion of the controversy itself.

The FAQ on self-certification specifies the content of the annual self-certification letter which a Safe Harbor organization must send to the Department of Commerce.[32] One requirement is that the letter contain a description of the organization's privacy policy, including where the policy is available for viewing by the public, whether the organization verifies its privacy practices using "in-house" or third party verification, and the "independent recourse mechanism" used to resolve complaints. In addition, the organization's published privacy policy must contain a statement that the organization adheres to the Safe Harbor Principles.[33]

[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *See Frequently Asked Questions (FAQS) FAQ 6 – Self Certification, Safe Harbor Principles*, *supra* note 9, at 45669.
[33] *Id.*

The FAQ on verification provides an annual follow-up process for confirming that the organization's assertions about its privacy practices are true that the practices have been implemented in accordance with the Safe Harbor Principles.[34] Verification can be performed either by outside compliance review or by self-assessment. An outside review can be accomplished using various methods, including auditing and "technology tools."[35] A statement confirming that the review has been completed should be signed by the reviewer or a representative of the organization being reviewed.[36] The statement need not be made public, but must be made available when requested by an individual or as part of a compliance investigation.[37] The self-assessment provision lacks information about how the assessment should be conducted. It does, however, state the required conclusions for a successful self-assessment. Those requirements include: (a) confirmation that the organization's published privacy policy is accurate, comprehensive, prominently displayed, completely implemented and accessible, (b) that the privacy policy conforms to the Safe Harbor Principles, (c) that individuals are informed of any in-house arrangements for handling complaints and of the independent mechanisms through which they may pursue complaints, (d) that the organization has procedures for training employees about compliance requirements, and procedures for disciplining employees who fail to follow instructions, and (e) internal procedures for periodically conducting compliance reviews.[38] As was the case with an outside compliance review, the self-assessment is to be documented by a statement which need not be made public. The self-assessment statement is signed by a representative of the organization and must be made available when requested by an individual or as part of a compliance investigation.[39]

The FAQ on enforcement provides a list of acceptable dispute resolution mechanisms including those connected with privacy programs (for example TRUSTe and BBBOnline,) cooperation with European data protection authorities, and compliance with legal or regulatory supervisory authorities that provide for the handling of individual complaints and dispute resolution.[40] Sanctions need to be

[34] *See Frequently Asked Questions (FAQS) FAQ 7 – Verification*, *supra* note 9, at 45670.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *See Frequently Asked Questions (FAQS) FAQ 11 – Dispute Resolution and Enforcement*, *supra* note 9, at 45673.

rigorous enough to ensure compliance, and should include publicity for findings of non-compliance, deletion of data, injunctions and compensation for individuals for losses resulting from an organization's failure to comply.[41] If an organization persistently fails to comply with the Safe Harbor Principles, the Department of Commerce should be notified, and the Department shall include that information on its web site listing Safe Harbor organizations.[42] Failure by the organization to notify the Department of Commerce of the persistent failure to comply may be actionable under the False Statements Act.[43]

III. THE CONTROVERSY AND POSSIBLE IMPROVEMENTS TO THE SYSTEM

Safe Harbor has been criticized as containing safeguards that are too weak and an enforcement system that is overly reliant on self-regulation.[44] More specifically, the criticism tends to focus on three areas: (1) inadequate privacy policies of Safe Harbor participants, (2) problems with enforcement, and (3) issues involving "onward transfer" of personal information by Safe Harbor organizations to others. Each area of criticism is addressed below.

A. Privacy Policies

1. Insufficient Transparency:

A basic principle central to the Safe Harbor system is that an organization that fails to live up to its representation, is liable for an unfair or deceptive trade practice under Section 5 of the Federal Trade Commission Act. Safe Harbor requires a participating organization to make its privacy policy publicly available in

[41] *Id.*

[42] *See Frequently Asked Questions (FAQS) FAQ 11 – Dispute Resolution and Enforcement*, *supra* note 9, at 45674.

[43] *See Frequently Asked Questions (FAQS) FAQ 11 – Dispute Resolution and Enforcement*, *supra* note 9, at 45674; False Statements Act, 18 U.S.C. § 1001.

[44] *See, e.g.,* Peter Schaar, *Speech of 30 January 2009 on the occasion of Data Protection Day in Vienna*, *available at* http://www.bfdi.de/SharedDocs/Publikationen/EN/30012009_SpeechSchaarEuDSTagWien.pdf?_blob=publicationFile (visited Mar. 31, 2014)(in which the federal data protection commissioner of Germany noted some of the shortcomings of the Safe Harbor system.); Article 29 Data Protection Working Party, *Opinion 4/2000 on the level of protection provided by the "Safe Harbor Principles" Adopted on 16th May 2000, available at* http://www. ec.europe.eu/justice/policies/privacy/docs/wpdocs/2000/wp32en.pdf (visited Mar. 31, 2014.); *EU/US: MEPS Want Safe Harbour Data Protection Deal Renegotiated,* EUROPEAN REPORT, July10, 2000 at 1.

accordance with the principle of "notice,"[45] and specifies that failure to comply with the policy can be pursued as an unfair or deceptive practice.[46] The European Commission has identified instances in which privacy policies of Safe Harbor organizations are difficult to find.[47] In response to the criticism, the Department of Commerce has taken steps to improve the availability of privacy policies. These include allowing Safe Harbor organizations to upload their privacy policies to the Department of Commerce website and requiring those organizations post their privacy policies on their own websites.[48] Despite these improvements, the European Commission is justifiably concerned that some Safe Harbor organizations are not in compliance.[49]

2. Incomplete Implementation of Safe Harbor Principles:

In a report issued in 2004, the Commission found that a significant number of Safe Harbor organizations had not completely incorporated Safe Harbor principles into their privacy policies.[50] In some instances, organizations had failed to comply with the principle of "notice" because they had not adequately disclosed the purposes for which the data would be processed.[51] In addition, organizations failed to comply with the principle of "choice" by failing to disclose that individuals had the right to prevent disclosure of their information to third parties, or to prevent the use of the information for a purpose incompatible with the purposes for which the information was collected.[52] Some progress has been made since 2004 to improve compliance, most notably the Department of Commerce's commitment beginning in 2009 to evaluate the privacy policy of an organization during its initial self-certification and annual renewal of

[45] *See Frequently Asked Questions (FAQS) FAQ 6 – Self-certification*, *supra* note 9, at 45669.

[46] *See Frequently Asked Questions (FAQS) FAQ 11 – Dispute Resolution and Enforcement*, *supra* note 9, at 45673.

[47] *See Commission Staff Working Paper, available at* https://www.ed.europa.eu/justice/policies/privacy/docs/ adequacy/sec-2002-196_en.pdf (visited Mar. 31, 2014); *Commission Staff Working Document, available at* http://www.ec.europa.eu/justice/policies/privacy/docs/adequacy/sec-2004-1323_en.pdf (visited Mar. 31, 2014).

[48] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 6.

[49] See Future of Privacy Forum, *The US – EU Safe Harbor: An Analysis of the Framework's Effectiveness at Protecting Personal Privacy,* at 35, *available at* http://www.futureofprivacy.org/wp-content/uploads/FPF-Safe-Harbor-Report.pdf (visited Jan. 16, 2014)[hereinafter *FPF Report*].

[50] *See Commission Staff Working Document, at 8, available at* http://www.ec.europa.eu/justice/policies/privacy/docs/adequacy/sec-2004-1323_en.pdf (visited Mar. 31, 2014).

[51] *Id.*

[52] *Id.*

self-certification.[53] There is evidence, however, that the evaluation needs to be more rigorous. For example, there was an estimate in 2013 that the privacy policies of over thirty percent of organizations failed to comply with the "enforcement" principle because they lacked information about dispute resolution mechanisms.[54]

B. Dispute Resolution and Enforcement

1. Affordability of Dispute Resolution:

The process for resolving disputes involving individual claims against Safe Harbor organizations begins with an "independent recourse mechanism" specified in the organization's self-certification.[55] In many instances, the independent recourse mechanism will be a private body that provides alternative dispute resolution.[56] Although the Department of Commerce has been instrumental in getting several of the alternative dispute resolution providers to reduce their fees, two providers charge significant filing fees[57] which, in the opinion of the European Commission, is inconsistent with the Safe Harbor's requirement that dispute resolution be "affordable."[58]

2. Panel of European Data Protection Authorities:

Under the Safe Harbor's "enforcement" principle, an organization can satisfy its obligation to use an "independent recourse mechanism" for resolution of disputes by committing to cooperate with a panel of European Data Protection Authorities ("DPAs,") commonly referred to as the "DPA Panel."[59] The commitment to cooperate with DPAs is mandatory, however, for any organization receiving human resource

[53] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 7.

[54] *Id.* (quoting testimony by Chris Connolly of Galexia before the EU Parliament's LIBE Committee in Oct. 2013).

[55] *See Frequently Asked Questions (FAQS) FAQ 6 – Self Certification, Safe Harbor Principles*, *supra* note 9, at 45670.

[56] The most popular U.S. providers of dispute resolution are TRUSTe, BBBOnline, The International Center of Dispute Resolution operated by the American Arbitration Association, JAMS, the Direct Marketing Association and Privacy Trust. *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 13.

[57] The filing fees are: $200 by the International Center of Dispute Resolution operated by the American Arbitration Association, and $250 by Judicial Arbitration and Mediation Services ("JAMS.") *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 13, n. 47.

[58] The Safe Harbor principle of "enforcement" states that at a minimum an independent recourse mechanism must be "readily available and affordable." *See Safe Harbor Principles, supra* note 9, at 45668.

[59] *See Frequently Asked Questions (FAQS) FAQ 5 –The Role of Data Protection Authorities, supra* note 9, at 45669.

data from the EU.[60] The most popular independent recourse mechanism among Safe Harbor organizations is the DPA Panel.[61] Surprisingly, the DPA Panel has a low profile. The European Commission's web site contains a list of DPAs which comprise the panel,[62] a complaint form[63] and a three-page memo dated July 25, 2005,[64] in question and answer format. Although the Safe Harbor Principles states that the panel "will make public the results of its consideration of complaints submitted to it, if it sees fit,"[65] no evidence of such consideration is readily available online. According to the Commission, as of November 2013, the DPA Panel had received only four complaints, two in 2010 and two in 2013.[66] Even though the small number of complaints can be partially explained by lack of public awareness of the panel's existence, and by the fact that in many instances the panel has been designated to handle disputes limited to human resource data, it is also possible that the absence of large numbers of complaints indicates substantial compliance by Safe Harbor participants.

[60] *See Frequently Asked Questions (FAQS) FAQ 9 –Human Resource Data, supra* note 9, at 45672. With respect to human resource data, the Safe Harbor organization must "commit to cooperate in investigations by and to comply with the advice of competent EU authorities in such cases." If an organization wishes to transfer human resource data from a Member State where the DPA has not agreed to cooperate in this way, the provisions of FAQ 5 that describes the DPA Panel will apply. Accordingly, in some instances disputes involving human resource data will be handled by a single DPA and in other instances the dispute will be handled by the DPA Panel.

[61] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 13. The Future of Privacy Forum's research shows that approximately 1700 Safe Harbor organizations name DPAs as dispute resolution provider in some capacity. *See FPF Report*, *supra* note 49, at 22.

[62] Members of the DPA Panel are from Denmark, Germany, Finland, France, Ireland, Netherlands and the UK. *See Data Protection Panel, available at http://www.ec.europa.eu/justice/data-protection/document/international-transfers/adequacy/files/ussh/dp_panel_authorities_faq5_en.pdf (visited Mar. 16, 2014).*

[63] *See Data Protection Panel Standard Complaint Form, available at* http://www.ec.europa.eu/justice/data-protection/document/international-transfers/adequacy/files/ussh/complaint_form20130206_en.pdf (visited Mar. 16, 2014).

[64] *See Data Protection Panel, Questions and Answers, available at* http://www.ec.europa.eu/justice/policies/privacy/docs/adequacy/information_safe_harbor_en.pdf (visited Mar. 16, 2014).

[65] *See Frequently Asked Questions (FAQS) FAQ 5 –The Role of Data Protection Authorities, supra* note 9, at 45669.

[66] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 11.

3. Federal Trade Commission:

Although Safe Harbor began in 2000, the FTC did not bring its first enforcement action until 2009.[67] The cases fall into three broad categories: substantive violations of Safe Harbor Principles, false claims of Safe Harbor participation when an organization has never self-certified, and false claims of participation after a self-certification has lapsed.

a. Settlements Involving Substantive Violations of Safe Harbor Principles:

In 2011 and 2012, the Federal Trade Commission settled three cases involving deceptive practices in violation of Section 5 of the Federal Trade Commission Act, as well as substantive violations of Safe Harbor principles, by Google, Facebook and Myspace, in connection with social media operations. All three were self-certified Safe Harbor organizations at the time of the wrongdoing. Although the facts of the three cases are different, the terms of the settlements are similar.

The enforcement action against Google related to its social networking service, known as Google Buzz, which was launched in February, 2010.[68] Google Buzz allows users to share comments, photos, videos and other information through posts made, either publicly or privately, to individuals or groups of users.[69] Google used information from users who signed up to Google's web mail service, Gmail, to populate the Google Buzz social network, which resulted in previously private information becoming public.[70] The Gmail information which became public through Google Buzz included names and email contacts.[71] The FTC charged Google with falsely representing to Gmail users that it would use their information only for the purpose of providing them with web-based email, and would seek their consent before using their information for a purpose other than the purpose for which it was collected.[72] In addition, the FTC charged Google with deceiving users who signed up for Google Buzz by misrepresenting their ability to decline enrollment in certain

[67] *See FPF Report*, *supra* note 49, at 16.

[68] *See* Analysis of Proposed Consent Order to Aid Public Comment *In the Matter of Google Inc., File No. 1023136*, *available at* http://www.ftc.gov/sites/default/files/documents/cases/2011/03/110330googlebuzzanal.pdf (visited Mar. 23, 2014)[hereinafter *FTC Analysis of Google Consent Order*].

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] *Id.*

features, and by failing to disclose that certain information would become public by default.[73]

The enforcement action against Facebook involved changes in its privacy policy, and representations about privacy settings, deletion of photos, the sharing of information with advertisers and the operation of Facebook applications.[74] In December, 2009, Facebook changed its privacy policy so that certain information that users had previously designated as private became publicly available. In addition, the company told users that they could restrict access to certain information to a limited audience, when in fact the restrictions did not prevent the information from being shared with others. Facebook also stated that when a user deactivated an account, the user's photos and videos would be inaccessible to others. Contrary to that representation, access continued. The company stated that it would not share users' personal information with advertisers, yet that information was transferred to an advertiser when a user clicked on an ad. Finally, Facebook made representations about the operation of certain applications which were not accurate with respect to the level of security, and the amount of personal information used when an application was activated.

The action against Myspace involved its use of a unique number, called a "Friend ID" as part of the web address or "URL" of each user's profile page.[75] Knowledge of a user's Friend ID would allow access to the personal information of the user and the names of other users listed as their "friends." Myspace provided an advertiser with Friend ID of anyone who visited a Myspace page containing the advertiser's ad. Contrary to this practice, Myspace told users that (1) it would not share their personal information without first giving notice and obtaining consent, (2) its system did not allow advertisers access to users' personal information, and (3) information it shared with advertisers would be "anonymized."

All three cases focus primarily on the use of Section 5 of the Federal Trade Commission Act to pursue deceptive practices and include language mentioning that the practices also violate the defendant's commitments as a participant in Safe Harbor. In no

[73] *Id.*

[74] *See* Analysis of Proposed Consent Order to Aid Public Comment *In the matter of Facebook, Inc., File No.0923184, available at* http://www.ftc.gov/sites/default/files/documents/cases/2011/11/111129facebookanal.pdf (visited Mar. 23, 2014)[hereinafter *FTC Analysis of Facebook Consent Order].*

[75] *See* Analysis of Proposed Consent Order to Aid Public Comment *In the Matter of Myspace LLC, File No. 1023058, available at* http://www.ftc.gov/sites/default/files/documents/cases/2012/05/120508myspaceanal.pdf (visited Mar. 23, 2014)[hereinafter *FTC Analysis of Myspace Consent Order*].

instance is there any indication that the Safe Harbor violations had a substantial independent effect on the cases. The settlements of the cases are similar in most respects. Each company must adopt a comprehensive privacy program, must undergo a biennial compliance assessment by an independent privacy professional and must make certain information available to the FTC. The only mention of the Safe Harbor in the settlement agreements is a statement that each company shall not misrepresent its compliance with any privacy program, "including, but not limited to, the U.S. – EU Safe Harbor Framework." The duration of each settlement is twenty years. Considering the number of individuals affected by the deceptive practices, it is surprising that the settlements do not impose monetary penalties.[76]

b. Enforcement Pertaining to a False Claim of Self-Certification:

In 2009 the FTC brought a case against a California-based Internet marketer, Jaivin Karnani, for a number of deceptive practices including the use of websites ending in "co.uk" that misled British consumers into believing that the business was based in the United Kingdom.[77] The FTC alleged that a number of other deceptive practices had been committed including charging unexpected import duties, failing to comply with promised shipping dates, charging unreasonably high refund fees and failing to cooperate with consumers' cancellation requests.[78] Finally, the FTC alleged that Mr. Karnani's business falsely claimed to be a participant in the Safe Harbor.[79] The settlement order prohibited the defendant from engaging in a variety of practices, including misrepresentation of participation in any privacy program, but did not mention the Safe Harbor by name.[80] Although the settlement included a judgment for

[76] *See In re Google Inc.*, Agreement Containing Consent Order, File No. 1023136, *available at* www.ftc.gov/sites/default/files/documents/cases/2011/03/110330googlebuzza greeorder.pdf (visited Mar. 23, 2014); *In re Facebook Inc.*, Agreement Containing Consent Order, File No. 0923184, *available at* http://www.ftc.gov/sites/default/files/documents/cases/2011/1/111129facebookagree.pdf (visited Mar. 23, 2014); *In re Myspace LLC*, Agreement Containing Consent Order, File No. 1023058, *available at* http://www.ftc.gov/sites/default/files/documents/cases/2012/05/120508myspaceorder.pdf (visited Mar. 23, 2014).

[77] See FTC Settlement Bans Online U.S. Electronics Retailer From Deceiving Consumers with Foreign Website Names, *available at* http:www.ftc.gov/news-events/press-releases/2011/06/ftc-settlement-bans-online-us-electronics-retailer-deceiving (visited Mar. 26, 2014).

[78] *Id.*

[79] *Id.*

[80] *See* Stipulated Final Order for Injunctions and Other Equitable Relief, FTC v. Karnani, Civil No. CV 09-05276 DDP (Ex), U.S. Dist. Ct. Central Dist. Cal., (May 20, 2011), *available at* www.ftc.gov/sites/default/files/documents/cases/2011/06/110609 darnanistip.pdf (visited Mar. 26, 2014).

$500,000, the judgment was suspended, subject to the defendants' compliance with a list of provisions set forth in the order.[81]

c. Enforcement Pertaining to Lapsed Self-Certifications:

The FTC has brought enforcement actions against eighteen organizations for continuing to represent themselves as Safe Harbor organizations even though their annual self-certifications had lapsed.[82] The length of the periods of lapsed certification ranges from

[81] *Id.*

[82] *See* Agreement Containing Consent Order, *In re Directors Desk LLC,* FTC File No. 0923140, (Oct. 6, 2009) *available at* http://www.ftc.gov/sites/default/files/documents/cases/2009/10/091006directorsdeskagree.pdf (visited Mar. 24, 2014); Agreement Containing Consent Order, *In re Expatedge Partners LLC,* FTC File No. 0923138, (Oct. 6, 2009) *available at* http://www.ftc.gov/sites/default/files/documents/cases/2009/10/091006expated geagree.pdf (visited Mar. 24, 2014); Agreement Containing Consent Order, *In re Onyx Graphics Inc.,* FTC File No. 0923139, (Oct. 6, 2009) *available at* http://www.ftc.gov/sites/default/files/documents/cases/2009/10/091006onyxgraphics agree. pdf (visited Mar. 24, 2014); Agreement Containing Consent Order, *In re World Innovators Inc.,* FTC File No. 0923137, (Oct. 6, 2009) *available at* http://www.ftc.gov/sites/default/files/documents/ cases/2009/10/091006worldinnovatorsagree.pdf (visited Mar. 24, 2014); Agreement Containing Consent Order, *In re Progressive Gaitways LLC,* FTC File No. 0923141, (Oct. 6, 2009) *available at* http://www.ftc.gov/sites/default/files/documents/cases/2009/10/091006progaitway agree.pdf (visited Mar. 24, 2014); Agreement Containing Consent Order, *In re Collectify LLC,* FTC File No. 0923142, (Oct. 6, 2009) *available at* http://www.ftc.gov/sites/default/files/documents/cases/2009/10/091006collectifyagree.pdf (visited Mar. 24, 2014); Agreement Containing Consent Order, *In re Apperian Inc,* FTC File No. 1423017, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121apperianagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Atlanta Falcons Football Club LLC,* FTC File No. 1423018, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121atlantafalconsagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Baker Tilly Virchow Krause LLP,* FTC File No. 1423019, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121 bakertillyagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re BitTorrent Inc.,* FTC File No. 1423020, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121bittorrentagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Charles River Laboratories Intl. Inc.,* FTC File No. 1423022, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121charlesriveragree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re DataMotion Inc.,* FTC File No. 1423023, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121datamotionagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re DDC Laboratories Inc.,* FTC File No. 1423024, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121ddclaboratoriesagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Level 3 Communications LLC,* FTC File No. 1423028, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121 level3agree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re PDB Sports Ltd. (d/b/a Denver Broncos Football Club),* FTC File No. 1423025, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121denverbroncos agree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Reynolds Consumer Products Inc.,* FTC File No.

a few months[83] to over seven years.[84] Six of the cases were settled in 2009 and 2010. Settlements of the remaining twelve cases were proposed in early 2014. The settlements in 2009 and 2010, and the proposed settlements in 2014, contain the same set of provisions. Each organization is prohibited from misrepresenting its participation in any privacy program, including the Safe Harbor, and must submit a compliance report to the FTC. In addition, each is subject to monitoring by the FTC for a period of five years during which the organization must maintain and make available compliance documentation.[85] None of the settlements involved monetary penalties.[86]

C. Onward Transfer

1. Contracts With Agents:

Under the Safe Harbor principle of "onward transfer," a Safe Harbor organization often needs to enter into a written agreement with the agent receiving the data in order to obtain the agent's commitment to provide at least the same level of privacy protection contained in the Safe Harbor Principles (unless the agent is a member of Safe Harbor or otherwise covered by an adequacy decision.)[87] When the subcontractor will be processing the data on behalf of the transferor, there must be a written contract between the Safe Harbor transferor organization and the subcontractor, even when the subcontractor is also a Safe Harbor participant.[88] The

1423030, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121reynoldsagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Receivable Management Services Corporation,* FTC File No. 1423031, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121rmsagree.pdf (visited Feb. 6, 2014); Agreement Containing Consent Order, *In re Tennessee Football LLC,* FTC File No. 1423032, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121tennesseefootballagree.pdf (visited Feb. 6, 2014)[hereinafter *Sixteen FTC Settlements*].

[83] The shortest period of lapsed self-certification was for five months. *See* Agreement Containing Consent Order, *In re Level 3 Communications LLC,* FTC File No. 1423028, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121level3agree.pdf (visited Feb. 6, 2014).

[84] The longest period of lapsed self-certification was for seven years and two months. *See* Agreement Containing Consent Order, *In re Atlanta Falcons Football Club LLC,* FTC File No. 1423018, (Jan. 29, 2014) *available at* http://www.ftc.gov/sites/default/files/documents/cases/140121atlantafalconsagree.pdf (visited Feb. 6, 2014).

[85] *See Sixteen FTC Settlements, supra* note 82.

[86] *Id.*

[87] *See Safe Harbor Principles, supra* note 9, at 45668.

[88] *See Frequently Asked Questions (FAQS) FAQ 10 – Article 17 Contracts, supra* note 9, at 45673.

contract requirement in the Safe Harbor is similar to the Data Protection Directive's provision specifying that there be a contract between an organization providing data and a company hired to process that data.[89] The European Commission recommends that the use of subcontractors under the Safe Harbor be clarified by requiring that the Department of Commerce be notified of all subcontracts, and that privacy safeguards in those documents be made available to the public.[90]

2. Government Access to Data: the NSA controversy:

The most politically charged criticism of the Safe Harbor is that it has facilitated U.S. government access to the personal information of Europeans which has been transferred to large Safe Harbor organizations including Google, Facebook and others.[91] Defenders of Safe Harbor, however, point out that both Safe Harbor and the European Data Protection Directive contain provisions excluding privacy protection for data when used for national security or law enforcement purposes.[92] The European Commission, however, argues that because language in the Safe Harbor Principles states that they may be limited "to the extent necessary to meet national security, public interest, or law enforcement requirements,"[93] the limitation applies only when government access is "necessary and proportionate in a democratic society."[94] Furthermore, the Commission points out that large-scale access by intelligence services to data transferred to the U.S. in the commercial context was not forseeable at the time of the adoption of the Safe Harbor.[95] In other words, the Commission's conclusion is that U.S. government access to massive amounts of personal data held by some of the most prominent Safe Harbor participants goes beyond the scope of the Safe Harbor provision,

[89] *See Directive*, *supra* note 1, at Art. 17(3).

[90] The Commission has observed that many cloud computing service providers are Safe Harbor participants with good levels of compliance and that notes that the Commission's recommendations are largely directed at cloud providers who have not joined Safe Harbor. *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 15.

[91] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 15.

[92] The Directive states that it does not apply to processing operations concerning public security, state security, defense and the activities of the state in areas of criminal law. *See Directive, supra* note1, at Art. 3(2). The Safe Harbor Principles state that adherence to the Principles may be limited to the extent necessary to meet national security, public interest, or law enforcement requirements. *See Safe Harbor Principles, supra* note 9, at 45667.

[93] *See Safe Harbor Principles, supra* note 9, at 45667.

[94] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 15.

[95] *Id*.

because that access exceeds what is truly necessary for national security and law enforcement. Despite the severity of this violation of the Safe Harbor Principles, the Commission makes two modest recommendations. The first is that Safe Harbor organizations include information in their privacy policies noting that data they receive will be subject to government access for national security and law enforcement purposes.[96] The second is surprisingly restrained language noting the importance of using the Safe Harbor's national security exception only to the extent that it is "strictly necessary and proportionate."[97]

The Parliament of the European Union has taken a harder line against Safe Harbor. Following several months of investigation, which included public hearings, the Parliament's Committee on Civil Liberties, Justice and Home Affairs issued a report in February, 2014, on the effects of the U.S. National Security Agency's surveillance program on the rights of EU citizens.[98] The report criticized Safe Harbor organizations, including Google and Facebook, for enabling the surveillance by failing to encrypt information flowing between their data centers.[99] It also criticized the European Commission for failing to act to remedy deficiencies in Safe Harbor.[100] The report urged the Commission to suspend the Safe Harbor agreement immediately and called upon the data protection authorities in the EU Member States to suspend data flows to Safe Harbor organizations.[101] The following month, Parliament voted to suspend Safe Harbor.[102] However, under the Data Protection

[96] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 18. The Commission has commended Nokia for the following notice about government access to data in its privacy policy: "We may be obligated by mandatory law to disclose your personal data to certain authorities or other third parties, for example, to law enforcement agencies in the countries where we or third parties acting on our behalf operate." *See* European Commission, *Restoring Trust in EU-US data flows – Frequently Asked Questions* at 5, *available at* http://www.europa.eu/rapid/press-release_MEMO-13-1059_en.htm (visited Mar. 16, 2014).

[97] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 18.

[98] Committee on Civil Liberties, Justice and Home Affairs, *Report on the US NSA surveillance programme, surveillance bodies in various Member States and their impact on EU citizens'fundamental rights and on transatlantic cooperation in Justice and Home Affairs, available at* http://www.europarl.europa.eu/document/activities/cont/201403/20140305ATT80632/20140306ATT80632EN.pdf (visited Mar. 22, 2014).

[99] *Id*. at 26.

[100] *Id*.

[101] *Id*.

[102] *See, e.g.*, *European Parliament threatens U.S. with end of pact on data protection, available at* http://www.upi.com/Top_News/World-News/2014/03/13/European-Parliament-threatens-US-with-end-od-pact-on-data-protection/UPI-28981394746376/ (visited Mar. 22, 2014).

Directive, the European Commission is the body with sole authority to evaluate the adequacy of privacy commitments for international data transfers.[103] Furthermore, the Safe Harbor Principles imply that any decision to modify the Agreement can only be made by the Commission.[104] Consequently, the vote by Parliament has no formal effect on the status of Safe Harbor.

D. The Need for Improved Compliance

Despite the intensity of the criticism resulting from public disclosure of the National Security Agency's surveillance program, the Safe Harbor's greatest weakness is the perception that compliance is poor because enforcement is lax. One of the Commission's suggestions for improvement addresses this weakness very well by recommending that following a self-certification or annual renewal, a certain percentage of companies be subject to a compliance investigation focusing the company's substantive compliance with its privacy policy, as well on its adherence to the formalistic provisions of the Safe Harbor Principles.[105] A compliance investigation by an independent privacy professional is similar to an "outside compliance review" specified as one of the options for complying with the annual verification provision set forth in the Safe Harbor Principles.[106] It is also consistent with the requirement of a compliance assessment by an independent privacy professional imposed by the FTC as part of the settlements of substantive violations of Safe Harbor in the cases involving Google, Facebook and Myspace.[107] The Commission's recommendation does not deal with the question of who would bear the cost of compliance reviews, which is an important issue. One possibility would be to pass the cost along to all Safe Harbor participants through an annual fee which could be in proportion to the economic benefit it derives from its ability to receive personal information from Europe. The fee could be used by

[103] *See Directive* , *supra* note 1, at Art. 25

[104] *See Commission Decision of 26 July 2000 pursuant to Directive95/46/EC of the European Parliament and of the Council on the adequacy of the protection provided by the safe harbor privacy principles and related frequently asked questions issued by the US Department of Commerce*, 2000 O.J. (L215) 7, Art. 4 (1), which provides: "This Decision may be adapted at any time in the light of experience with its implementation and/or if the level of protection provided by the Principles and the FAQS is overtaken by the requirements of US legislation."

[105] *See Commission's November 2013 Safe Harbor Report, supra* note 16, at 18.

[106] *See Frequently Asked Questions (FAQS) FAQ 7 – Verification, supra* note 9, at 45670.

[107] *See In re Google Inc., In re Facebook Inc., In re Myspace LLC*, *supra* note 76, and accompanying text.

the Department of Commerce to hire additional staff who would serve as full-time compliance officers.

IV. CONCLUSION

Although Safe Harbor has become an important way for large and small U.S. organizations to obtain personal information from Europe in compliance with EU law, its survival is dependent upon the adoption of reforms that demonstrate that U.S. organizations are serious about their privacy commitments. There are also questions about how Safe Harbor might be affected by pending changes in European Law. In January, 2012, the European Commission released proposed privacy reform legislation, including a proposed regulation,[108] that would replace the current data protection framework in the European Union. Because the Proposed Regulation would repeal the 1995 Data Protection Directive,[109] questions have arisen as to the effect the new law would have on existing approvals of international data transfers by the Commission, including Safe Harbor. In the short run, the adoption of the Proposed Regulation will not disturb prior approvals, because it declares that such approvals shall "remain in force"[110] even though the Directive is repealed. In addition, the Proposed Regulation "is without prejudice to international agreements concluded between the Union and third countries regarding the transfer of personal data."[111] Over time, however, it is possible that the additional rights afforded European individuals under the Proposed Regulation will put pressure on the Commission to urge countries with adequacy determinations, including the U.S. with respect to Safe Harbor, to adopt data protection measures consistent with those additional rights. The implications for U.S. Safe Harbor organizations could be significant.

The controversy surrounding Safe Harbor, of course, has a political dimension. As a noted European privacy expert has noted, "Much of the criticism about Safe Harbor is about politics and economics rather than data protection – think NSA access to European Data, U.S. technological dominance, European competitiveness and other emotional issues. As a result, it is very difficult to perform an accurate and objective assessment of the effectiveness of the scheme

[108] EUR. PARL. DOC. (COM 2012) 11 (2012), *available at* http://ed.europa.eu/ justice/data-protection/document/ review2012/com_2012_11_en.pdf (visited 17 Mar. 2012) [hereinafter *Proposed Regulation*]. There are three parts to the Commission's Proposed Regulation: (1) an Explanatory Memorandum, (2) 139 Recitals, and (3) 91 Articles.

[109] *See Id.*, at Art. 88.

[110] *See Id.,* at Recital 134.

[111] *See Id.,* at Recital 79.

to protect data and privacy."[112] Despite the vote of the EU Parliament to suspend Safe Harbor, the Commission and others have signaled that they favor reform rather than repeal. For example, Peter Hustinx, the highly respected European Data Protection Supervisor, has told Parliament, "[W]e should not throw away Safe Harbour as such without investigating the scope for improvements. . . [I]t would be wise to keep all options open, and at the same time also explore all relevant possibilities for a constructive engagement."[113] Consequently, it is in the interest of officials of the U.S. Commerce Department and Federal Trade Commission, and Safe Harbor organizations, to support meaningful reforms that both improve compliance and justify support from the moderate forces in Europe.

[112] *See* Eduardo Ustaran, *An Honest Recap on Safe Harbor*, *available at* https://www.privacyassociation.org/privacy_perspectives/post/an_honest_recap_on_safe_harbor (visited Mar. 22, 2014).

[113] See Testimony of European Data Protection Supervisor Peter Hustinx at LIBE Committee Inquiry on electronic mass surveillance of EU citizens, Oct. 7, 2013, *available at* https://secure/edps.europa.eu/EDPSWEB/webdav/site/mySite/shared/Documents/EDPS/Publications/Speeshes/2013/13-10-07_Speech_LIBE_PH_E1 (visited Mar. 22, 2014).

FROM THE CORVAIR TO THE COBALT: CORPORATE SOCIAL RESPONSIBILITY LESSONS UNLEARNED

by David Missirian and Mystica Alexander*

I. INTRODUCTION

On Tuesday, March 25, 2014, the headline above-the-fold on page one of the New York Times read, "Carmaker Misled Grieving Family on a Lethal Flaw."[1] The carmaker in this instance is General Motors the flaw involved is a faulty ignition switch in the Chevy Cobalt which to date has been responsible for at least 26 deaths.[2] Adding to this tragedy is the fact that automaker may have been aware of this defect for as many as ten years without taking action.[3] GM's indifference and inaction, even after confirmation in May, 2009, from the data recorded in Cobalt black boxes that a "potentially fatal defect" existed and impacted hundreds of thousands of GM cars, is reminiscent of the automaker's seeming indifference to the potentially fatal risks posed by the Chevy Corvair in the 1960s.

The Corvair of the sixties was the brainchild of GM Vice President and engineer, Edward Cole, who wanted to provide the American car market with a smaller and lighter car with a rear engine.[4] Even

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[1] Hilary Stout, Bill Vlasic, Danielle Ivory, and Rebecca Ruiz, *Carmaker Misled Grieving Families on a Lethal Flaw*, N.Y. TIMES, Mar. 25, 2014, at A1.

[2] *Id.*

[3] *Id.*

[4] RALPH NADER, UNSAFE AT ANY SPEED – THE DESIGNED-IN DANGERS OF THE AMERICAN AUTOMOBILE 19 (1965).

during the design phase there was concern among the engineers that a rear-engine car which placed over 60 percent of its weight on the rear tires, such as the planned Corvair, presented safe-handling issues.[5] In fact, one of GM's best engineers had delivered a paper a few years before in which he explained that rear engine vehicles with a swing-axle suspension systems "could not handle safely in a wind, even at moderate speeds…"[6] For the engineering group, "[g]iven the goal of designing a much lighter vehicle [to seat six passengers] was no routine task. If these objectives could be achieved, the quest for profit maximization would have reached new frontiers.[7] While car design will necessarily involve some trade-off between price and style, the more important question is, "Who authorizes what compromises in engineering safety?"[8] Rather than incorporate technology that would correct the car's potential for swerving out of control, GM opted instead to place the burden on the car owners themselves and included at the end of the owner's manual a recommendation that a certain amount of tire pressure differential between the front and rear tires be maintained at all times to help ensure stability.[9] Many of the accidents involving these early Corvairs (1960-1963) were single vehicle collisions, such as the one that took the life of comedian Ernie Kovacs in 1962.[10] As hundreds of letters arrived at GM complaining of Corvairs out of control and as lawsuits began to pile up, GM maintained silence about its product and potential design flaws and in most cases simply denied responsibility and sought to place blame on the driver's negligence.[11] At last, GM authorized improvements to the 1964 Corvair and the engineers "did what they knew could and should be done" to improve vehicle stability.[12] "While [GM[may have finally lumbered into engineering improvements, it would have been corporate heresy for the proud industry leader to worry about the hundreds of thousands of Corvairs waiting for the law of averages to catch up with them on some S-curve or breezy straight-away. After all, those Corvairs were already sold."[13]

In 2014, General Motors once again finds itself embroiled in automotive controversy involving the Cobalt. There are questions of who knew what, and when, and was money the motivating factor.

[5] *Id.* at 21.
[6] *Id.* at 20.
[7] *Id.* at 20.
[8] *Id.* at 22.
[9] *Id.* at 23.
[10] *Id.* at 18.
[11] *Id.* at 10.
[12] *Id*. at 36-37.
[13] *Id*. at 37.

One of the victims of the car's faulty ignition switch was 29-year-old pediatric nurse, Brooke Melton, who died in an automobile crash in 2010 while driving her 2005 Chevrolet Cobalt. The car's ignition slipped into the accessory position three seconds before her car lost steering control, hydroplaned and was then struck by another vehicle.[14] The car had been taken to the dealership days before for precisely that problem and was returned to her as repaired.[15] The problem apparently experienced by Ms. Brooke was that due to an ignition switch defect.[16] Apparently, "General Motors knew in 2004, a decade before it issued a recall, that its Chevrolet Cobalt had an ignition switch that could inadvertently shut off the engine while driving, according to depositions in a civil lawsuit against GM."[17] "The stall also would cut off the driver's power steering and brakes, as well as safety systems such as airbags and anti-lock brakes."[18] At least one GM engineer while testing a new 2005 model car that went on sale in 2004 experienced precisely the problem experienced by Ms. Brooke.[19]

"Even though GM acknowledged the problem in the 2005 technical service bulletin — a type of routine notice from automakers to dealers about possible problems and fixes — the bulletin did not tell dealers to put the new key covers on the keys of new Cobalts before they were sold. The bulletin also did not tell dealers to alert buyers of the possibility that the key might move out of place and the engine might stall."[20] In Brooke Melton's civil suit, a programming engineer for the 2004 and 2005 Cobalt admitted that GM knew of the problem but "made a business decision not to fix this problem."[21] During the Milton trial a witness for the plaintiff estimated the cost of the fix to be $1.00.[22]

Adding to the egregiousness of GM's failure to act on a known defect, is GM's response to some of the families of the victims of the

[14] Gabe Gutierrez, Rich Gardella, Kevin Monahan and Talesha Reynold, *Parents Boiling with Anger After Daughter's Death*, NBC NEWS broadcast Mar. 14, 2014, *available at* http://www.nbcnews.com/storyline/gm-recall/parents-boiling-anger-after-daughters-death-gm-car-n52316.

[15] *Id.*

[16] *Id.*

[17] James R. Healey and Fred Meier, *Law Suit: GM Knew of Ignition Problem,* USA TODAY, Feb. 19, 2014, *available at* http://www.usatoday.com/story/money/cars/2014/02/18/gm-cobalt-g5-faulty-ignition-switches-recall-deaths-airbags/5582241/.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] Gutierrez, *supra* note 14.

[22] *Id.*

Cobalt. "In one case GM threatened to come after the family of an accident victim for reimbursement of legal fees if the family did not withdraw its lawsuit. In another instance, it dismissed a family with a terse, formulaic letter, saying there was no basis for claims."[23]

Thinking about GM's most recent actions and reflecting on the vast inroads that the field of business ethics has made in both the business community and academia over the past fifty years, one cannot help but wonder, "What has corporate America learned in all that time? Sadly, this paper concludes that the answer to this question is "not much." Part I considers the ethical underpinning of business decisions, both at the corporate and individual level. Part II then takes a closer look at the development of business ethics. Part III compares the economic and product liability climate of the 1960s and the present day to determine whether the climate of the particular time had any bearing on GM's decision-making with regard to the Covair and the Cobalt. Finally, the paper concludes that although great strides have been made in educating corporate America on the importance of business ethics, reality would indicate that perhaps the lure of profit remains the ultimate driver of business decisions.

II. ETHICAL THEORIES SHOULD PROVIDE THE UNDERPINNING FOR BUSINESS DECISIONS

One way to think about the decisions made by GM in the case of the early Corvairs and the Cobalt is to consider them through an ethical lens. In order to discuss business ethics and a business' ethical obligations, we need to first define "ethics" and understand its relationship to morality. Ethics can be thought of as, "a set of moral principles, or an area of study that deals with ideas about what is good and bad behavior."[24] Morality (as differentiated from morals) can be looked at as "conformity to ideals of right human conduct."[25] It is fair to say that most individuals try to do what is right or to act ethically most of the time. In fact "Amy Rees Anderson, the current managing partner and founder of ReesCapital and prior CEO of MediConnect Global, Inc., gave advice on her blog on how to be a successful person by stating, 'Do the right thing and let the consequences follow.'"[26] The guidance, meant to be inspirational,

[23] Stout, *supra* note 1.

[24] MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY, Eleventh Edition, *available at* http://www.merriam-webster.com/dictionary/.

[25] *Id.*

[26] Amy Rees Anderson, *Do the Right Thing*, Amy Rees Anderson Blog (August 20, 2012), http://www.amyreesanderson.com/blog/do-the-right-thing/.

leads us to the inevitable question of what exactly is the 'right' thing to do and in what context? Is doing the right thing always the same regardless of the circumstance? Is what is right and wrong for a CEO the same as what is right and wrong for a physician?

A. A Look at Some Commonly Referenced Ethical Theories

This question of what is right and wrong has puzzled philosophers for centuries. Though we need not review every ethical theory, it is helpful to look at the breadth of these theories and see how we might apply them to the questions outlined above. As a very general premise, most ethical theories can be divided into either a duty based system (deontology) or a consequence based system (teleology).[27] A duty based system proscribes conduct based on what ought to be done regardless of the consequences whereas a consequence based system proscribes conduct based on the outcome. Some ethical theories contain elements of both duty based systems and consequence based systems.[28] The natural law theorist St. Thomas Aquinas is viewed by some as one of these.[29]

St. Thomas Aquinas viewed law as "a rule or measure of human acts, whereby a person is induced to act or is restrained from acting."[30] It is in a sense something which circumscribes our conduct setting a boundary for us to follow. He also tied the idea of a law to one which was closely related to reason.[31] So for Aquinas, a law is a creation of reason, one whose essence is "an ordinance of reason."[32] Where might this reason begin? Aquinas would say in being or in the beginning of life. "Now as being is the first thing that falls under the apprehension simply, so good is the first thing that falls under the apprehension of the practical reason, which is directed to action: since every agent acts for an end under the aspect of good."[33] Aquinas felt that all reason was directed towards achieving good. "Good is to be

[27] GERALD R. FERRARA, MYSTICA M. ALEXANDER, WILLIAM P. WIGGINS, CHERYL KIRSCHNER AND JONATHAN DARROW, THE LEGAL AND ETHICAL ENVIRONMENT OF BUSINESS, (forthcoming March 2014)(manuscript at 47).

[28] Religious Studies Online, *Natural Law Theory*, http://www.rsrevision.com/Alevel/ethics/natural_law/.

[29] *Id.*

[30] *ST* Ia IIae 90.1, *cited in Thomas Aquinas: Moral Philosophy*, INTERNET ENCYCLOPEDIA OF PHILOSOPHY, http://www.iep.utm.edu/aq-moral/#H4 (last visited 3-28-2014).

[31] *Thomas Aquinas: Moral Philosophy*, INTERNET ENCYCLOPEDIA OF PHILOSOPHY, http://www.iep.utm.edu/aq-moral/#H4 (last visited 3-28-2014).

[32] William S. Brewbaker III, *Thomas Aquinas and the Metaphysics of Law*, 58 ALABAMA L. REV. 575, 585 (2007).

[33] *Id.* at 586.

done and evil is to be avoided."[34] For Aquinas this 'good' or natural state is one which originates from the eternal law.[35] The "eternal law" refers to God's providential ordering of all created things to their proper end.[36] So for him the natural law is one which is the result of reasoning stemming from our own inherent sense of what is good. This idea of the good is one which has been given to us by God.[37] The difficulty is that because humans are viewed as flawed in Aquinas's eyes, due to original sin, our perception of what is inherently inside of us can also sometimes be flawed.[38] Though he does believe that for the most part a person is driven to do that which would be good for society as a whole.[39] Had GM taken a natural law approach to resolving their ignition problem, they would have used their reasoning to discern what would be inherently good for society and acted accordingly. Their actions would have been guided by the good which dwelled within them towards protecting society as a whole ahead of their own personal gain.

Another theory which seeks to clarify right and wrong is Utilitarianism which is an outcome based theory. Originated by John Stuart Mill, Utilitarianism states that "actions are right in proportion as they tend to promote happiness; wrong as they tend to produce the reverse of happiness. By happiness is intended pleasure and the absence of pain; by unhappiness, pain and the privation of pleasure."[40] In this instance Mill makes a differentiation between higher pleasures and lower pleasures.[41] Those higher pleasures which Mills feels we should espouse to include those of mental, aesthetic and moral pleasures.[42] Additionally, Mill's theory includes both those actions which benefit society as a whole as well as those which benefit us individually. Mill's notion of humanity was that it was in our nature to be nurturing to society as a whole, and that by seeking happiness for our fellow man we too can obtain it for ourselves.[43] GM's decision of marginalizing the scope of the ignition problem and doing little to resolve it, put many people at risk. The consideration of only oneself and not the wellbeing of others flies

[34] *Thomas Aquinas: Moral Philosophy*, *supra* note 30.
[35] *Id.*
[36] *Id.*
[37] Brewbaker, *supra* note 32, at 581.
[38] *Id.* at 591, 610.
[39] *Id.* at 586.
[40] *John Stuart Mill (1806-1873)*, INTERNET ENCYCLOPEDIA OF PHILOSOPHY, http://www.iep.utm.edu/milljs/#SH2d (last visited 3-28-2014).
[41] *Id.*
[42] *Id.*
[43] *Id.*

directly in the face of Utilitarian theory. In this instance the only person whose good was maximized was GM's.

It is important to note when looking at Utilitarianism that in formulating the concept of maximizing utility or higher pleasures to achieve the good for self and society, we can still be in the dilemma of lacking specific guidelines to follow. What should one do if something is beneficial to oneself but not society? How large a piece of society should we look to for maximization? How do we balance quantity of happiness versus quality of happiness? These unresolved issues make application of Utilitarianism sometimes difficult.

In an effort to potentially add some clarity to the concept some philosophers took to incorporating religious ideals into Utilitarianism. These religious utilitarians looked to the Christian God to address a basic problem, namely how to harmonize the interests of individuals, who are motivated by their own happiness, with the interests of the society as a whole.[44] It could do this based on a theory that God's creation seeks to become good despite its shortcomings. We would also suggest that by melding biblical norms with utilitarianism the common man might find the application more understandable.

The last theory we will examine is that espoused by Immanuel Kant in his classic categorical imperative. "Act only on that maxim whereby thou canst at the same time will that it [your action] should become a universal law."[45] The basis of this theory is that one can determine appropriate action by taking that action and universalizing it. Or to put it another way, would you feel the action you are thinking about taking is appropriate or good if everyone were to do the same thing. The theory places us in a situation of evaluating the consequences of our actions not as they might apply to other abstract individuals whom we may have little feeling for but by redirecting the outcome to ourselves individually, whom we presumably care about. There does seem to be symmetry in his theory somewhat akin to the maxim of "do unto others as you would have them do unto you."[46] But as with the other theories, there are pitfalls and incongruities. For Kant, if a maxim cannot be universalized, it is not moral.

Some outcomes of Kant's system seem to be at odds with what we instinctively feel. For Kant, lying is something which is to be avoided, "as it was contrary to our moral dignity."[47] Yet if a person is

[44] *Id.*

[45] GERALD R. FERRARA ET AL., *supra* note 27 (manuscript at 50).

[46] *Luke* 6:31 (New International Version).

[47] Tim C. Mazur, *Lying*, ISSUES IN ETHICS, (v.6, n.1, Fall 1993), https://www.scu.edu/ethics/publications/iie/v6n1/lying.html.

at our door intent of killing our spouse inquiring if our spouse is at home, Kant would state that we must tell the truth, thereby jeopardizing our spouse's safety and potentially causing a greater wrong. Kant's methodology seems to lack an ability to easily compare the worth of outcomes. Is there a lesser of two evils in Kantian philosophy? Is a white lie, though a lie, a good thing if it keeps someone out of harm's way or spares someone's feelings? Once again GM's actions are not supported by ethical theory. It is hard to imagine how under Kantian philosophy it is a good thing if all auto manufacturers produce products which they are fairly certain will cause injury to their users. Kant would not have chosen the course of action taken by GM.

As can be seen by our review of several different ethical theories, each has its own potential criticism. Some systems, such as Kant's have internal contradictions. Is lying to be avoided even when the truth causes an undesirable result? Some theories lack clarity as a result of failing to define key terms. Such is the case for the utilitarian concept of "maximizing utility." Even the natural law theory espoused by St Thomas Aquinas relies on God, Whose existence and scope transcends our understanding, making its practical application one of faith. No one system answers all of the problems and contradictions clearly, at least from a human perspective. There is also great disagreement about which system is correct. Note that deciding which system is correct requires the use of a value system. This lack of overall clarity and consensus makes choosing a system to apply in the real world quite difficult.

B. Corporate Executives, Engineers, et. al. Have an Ethical Responsibility

The title of this section brings to mind an age old question from the book of Genesis, "Am I my brother's keeper?"[48] The simplicity of the question or potential declarative and its brevity might lead one to believe that the answer is fairly straightforward, but we will see that upon closer examination its' answer is far from simple and bears greatly on our present discussion. As a question it seems to ask, are we responsible for what happens to others. As a rhetorical question it also suggests that we need only concern ourselves with our own actions, and therefore need not worry about others. And yet, if we need only concern ourselves with our own action, does our failure to guide others to act ethically or to voice the unethical behavior of others mean that we are acting unethically?

[48] *Genesis* 4:9 (New International Version).

With this in mind, let us look at the role of various parties in automotive design, to evaluate their ethical obligation. In any given production process, there are various steps of production and design involving numerous people. Generally, product development goes through varying steps to achieve the final product. These steps generally are, to define the problem (or product), research the issue, specify the needed requirements, brainstorm possible solutions, develop and generate prototype solutions, test these solutions, evaluate the testing results, modify the prototype depending on results, and communicate results.[49] What initiates this process of the initial design or concept may be a single individual as was with the Ford Pinto[50] or many people who create a design brief.[51] After the design concept is created, it is the job of the engineer to formulate the solutions and create the prototype.[52]

> "In the making of the Corvair there was a breakdown in the flow of both authority and initiative. Initiative would have meant an appeal by the Corvair design engineers to top management to overrule the cost-cutters and stylists whose incursions had placed unsafe constraints on engineering choice."[53]

So the question becomes what is the ethical responsibility of an engineer who takes the design brief and creates the actual product? Many of us would instinctively say their obligation is to do their job reasonably, acting in an ethical fashion. That last requirement is an ethical judgment in and of itself. Richard T. De George states that, "no engineer can morally do what is immoral."[54] If commanded to do what he should not morally do, he must resist and refuse."[55] According to the National Society of Professional Engineers, (NSPE), "Engineers in the fulfillment of the professional duties shall hold paramount the safety, health and welfare of the public."[56] Under

[49] *The Engineering Design Process*, http://www.sciencebuddies.org/engineering-design-process/engineering-design-process-steps.shtml.

[50] A. Turner, *Ford Pinto*, A Blog of Science and Technological Studies (Jan. 30, 2014), http://arenrut.wordpress.com/tag/ford-pinto/.

[51] Automobile Design Process, http://www.dypdc.com/ugpad-automobile-design-process.php.

[52] *The Engineering Design Process, supra*, note 49**.**

[53] Nader, *supra* note 4.

[54] Richard T. De George, *Ethical Responsibilities of Engineers in Large Corporations: The Pinto Case,* BUSINESS AND PROFESSIONAL ETHICS JOURNAL vol. I, No.1 (1981), *reprinted in* THE FORD PINTO CASE: A STUDY IN APPLIED ETHICS, TECHNOLOGY AND SOCIETY, 179, 183 (Douglas Birsch and John H. Fielder eds., Albany: State Univ. of N.Y. Press 1994).

[55] *Id.*

[56] National Society of Professional Engineers, NSPE Code of Ethics for Engineers, *available at* http://www.nspe.org/resources/ethics/code-ethics.

NSPE rules of conduct, "If engineers' judgment is overruled under circumstances that endanger life or property, they shall notify their employer or client, and such other authority as may be appropriate."[57]

Therefore an engineer should not act immorally, nor commit an act or allow an act to be committed which would endanger the health, safety or welfare of the public. The difficulty of these directives is they fail to evaluate the cost of taking a given course of action. Nor do they recognize that product development and eventual production is not controlled by the engineer alone.[58] If an engineer sees a potential design or development problem, and reports this issue to his superiors who then report it to management in charge of production and management decides not to change the design is that an ethical lapse of the engineer? De George would say no. "He (the engineer) is responsible for bringing the facts to the attention of those who need them to make decisions…[A]n engineer cannot be expected and cannot have the responsibility to second-guess managerial decisions."[59] While having an engineer act morally, De George at the same time says, "we cannot reasonably expect engineers to be willing to sacrifice their jobs each day for principle."[60] The NSPE agrees with De George in part but seems to suggest that in certain circumstances more need be done. "If engineers' judgment is overruled under circumstances that endanger life or property, they shall notify their employer or client and such other authority as may be appropriate."[61] The code of ethics fails to elaborate of what, 'other authority' they are referring to.

Others such as Hart T. Mankin take De George to task for his position of limiting an engineer's responsibility. Mankin is stunned by De George's position on not placing one's job in jeopardy for principle. "Surely, if an engineer perceives his dilemma to be one of moral principle, can he do any less than sacrifice his job?"[62] He asks further why anyone would want to continue to work at a job where his moral principles are violated.[63] Mankin's view of an engineer's duty possesses the same somewhat myopic quality of De George. Both

[57] *Id.*
[58] Richard T. De George, *supra* note *54*, at 184.
[59] *Id.* at 183.
[60] *Id.* at 179.
[61] NSPE Code of Ethics for Engineers, *supra* note 56**.**
[62] Hart T. Mankin, *Commentary on "Ethical Responsibilities of Engineers in Large Corporations: The Pinto Case,"* BUSINESS AND PROFESSIONAL ETHICS JOURNAL vol. I, No.1, 15-17 (1981)*, reprinted in* THE FORD PINTO CASE A STUDY IN APPLIED ETHICS, BUSINESS, AND TECHNOLOGY, 195, (Douglas Birsch and John H. Fielder eds., Albany: State Univ. of N.Y. Press 1994).
[63] *Id.*

assign a duty and a requisite obligation to do an act, yet both fail to view their suggested actions in context of other potentially intervening consequences. Both men require actions which are ethically motivated yet neither suggest which ethical system to follow, thereby making it difficult to assess moral compliance. The NSPE desires engineers to go to "other authorities as may be appropriate"[64] when a safety issue is one which effects the public, yet they fail to state which authority one must go to nor do they address potential legal disclosure issues which an engineer might face when disclosing internal matters to an outside authority.

III. THE DEVELOPMENT OF THE CORPORATION'S SOCIAL CONSCIENCE AND ITS IMPACT ON BUSINESS DECISIONS

It is useful to reflect for a moment on the role of corporate America in society and how it has evolved since the country's early origins. The next logical step is to then review briefly whether this increased attention to business ethics has translated into more ethically sound business decisions.

A. A Historical Look at the Role of Business in Society

In the early period of the nation (pre-1776), Thomas McMahon tells us that religious obligations were the undercurrent of business activities, with wealth seen as a sign of divine favor and also imposing an obligation on merchants to serve the public good.[65] "Business men perceived their role as business persons as directly related to God."[66] After independence, the country journeyed on the road to the industrial revolution. By the late nineteenth century, the robber barons' influence was strong and "for them God was no longer in business in any real sense…Stewardship gave way to gaining power for personal use."[67] At this time there was no unified set of ethical principles to guide business decision-making.[68] Such was the course of business until the end of the 1950s and the early part of the 1960s. Around that time, the first serious effort was made to understand the relationship between business and society. In 1957 a comprehensive business ethics book, written by Herbert Johnston, was published.[69] Soon after, in 1963, *Business and Society* was

[64] NSPE Code of Ethics for Engineers, *supra* note 56.

[65] THOMAS MCMAHON, A BRIEF HISTORY OF AMERICAN BUSINESS ETHICS, A COMPANION TO BUSINESS ETHICS 342 (Frederick ed., 1999).

[66] *Id.* at 343.

[67] *Id.* at 344.

[68] *Id.* at 345.

[69] HERBERT JOHNSTON, BUSINESS ETHICS (1957).

written by Joseph McGuire.[70] This book is often considered "to mark the beginning of the formal study of business and society."[71] Also during this time frame Raymond C. Baumhart S.J., published an article in the Harvard Business Review which summarized the findings of 1,700 questionnaires completed by a broad range of business executives and managers and 100 face-to-face meetings with such individuals.[72] This study found that most industries, if not all, were engaging in some form of unethical behavior. Interestingly, Baumhart found "a tendency in every age group, company milieu, and management level for a man to accept the values of his superiors."[73] Baumhart's article was a catalyst spurring both business and government into action. The government created an agency to address unethical activity by business, colleges courses on business ethics were developed, and businesses began to develop training programs in ethics and formulate codes of ethics.[74]

The years between 1960 and 1970 are considered "years of sweeping social change that affected businesses and management."[75] "The long term effect of this social change has been a dramatic change in the 'rules of the game' by which business is expected to operate."[76] During this time "businesses executives began to talk about the social responsibilities of business, and to develop specific social programs in response to problems of a social, rather than economic, nature."[77] The 1970s also brought with it increased government regulation. In the 1970s "the automobile industry…was one of the largest and most embattled manufacturing enterprises…."[78] Around this time the Ford Pinto gas tank explosion cases brought a spotlight on automotive safety.[79] New government regulation oversight from the Environmental Protection Agency, the Occupational Safety and Health Administration, and the Consumer Product Safety Commission commenced during the 1970s.[80] But, did

[70] JOSEPH MCGUIRE, BUSINESS AND SOCIETY (McGraw-Hill, 1963).

[71] McMahon, *supra* note 65 at 346.

[72] Raymond Baumhart, S.J., *How Ethical are Businessmen?,* HARVARD BUSINESS REVIEW VOL. 39, ISSUE 4 (JULY/AUG 1961) 6-176.

[73] *Id.* at 156.

[74] McMahon, *supra* note 65 at 346-347.

[75] Rogene Buchholz and Sandra Rosenthal, SOCIAL RESPONSIBILITY AND BUSINESS ETHICS, A COMPANION TO BUSINESS ETHICS 303 (Frederick ed., 1999).

[76] *Id.*

[77] *Id.*

[78] Archie Carroll, Kenneth Liparito, James Post, and Patricia Werhaneeds, CORPORATE RESPONSIBILITY, THE AMERICAN EXPERIENCE 275 (Kenneth Goodpaster ed., Cambridge Univ. Press 2012).

[79] *Id.* at 276.

[80] *Id.*

this increased attention and public outcry for an increase in business ethics translate into a change in corporate decision making?

B. Practical Applications of the Increased Focus on the Social Responsibility of Business

"Business ethics as a movement refers to the development of structures internal to the corporation that help it and its employees act ethically, as opposed to structures that provide incentives to act unethically."[81] To address the increased public outcry for businesses to behave in an ethical manner, corporations turned to corporate ethics codes, ethics training programs, and a tip line or help line to encourage reporting of unethical actions. Methods for conveying the content of the ethical codes were developed and ethics training programs were introduced. When the Federal Sentencing Guidelines for Organizations were enacted in 1991 they provided a further impetus for corporations to develop ethics programs because such compliance programs, of which codes of ethics are a part, can potentially reduce the penalty imposed for an employee's unlawful actions.[82]

Codes of ethics reflect company ideals of behavior. But does adoption of a code of ethics ensure ethical behavior? One only has to look to the beautifully crafted 64 page Code of Ethics of the Enron Corporation[83] to know that the resounding answer to this question is "no." In fact, a survey administered to 150 business students found that corporate codes of conduct are not influential.[84] While corporate codes can vary in their focus, one study found that codes of conduct are not enough to promote ethical behavior of employees, believing that the codes' focus on things such as embezzlement and conflicts of interest, instead of corporate social responsibility issues such as selling unsafe products.[85] A look at GM's most recent statement of company values, *Winning with Integrity*, illustrates their point. GM admonished employees that it is important that the law and GM's policies be observed and so the GM culture is to be one which

[81] Richard T. De George, *A History of Business Ethics*, Markkula Center for Applied Ethics, Santa Clara University, February 19, 2005, *available at* http://www.scu.edu/ethics/practicing/focusareas/business/conference/presentations/business-ethics-history.html.

[82] *Note: The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2126-2127 (May, 2003).

[83] Enron's Code of Ethics is available at http://www.thesmokinggun.com/archive/0130061enron1.html

[84] Mary Anne Cleek and Sherry Lynn Leonard, *Can Corporate Codes of Ethics Influence Behavior?,* 17 JOURNAL OF BUSINESS ETHICS 619, 625 (1998).

[85] *Id.* at 623.

promotes the "prevention, resolution, and detection of misconduct." The code goes on to provide the following list of examples of misconduct: "fraud, theft, workplace violence, discrimination, harassment, misuse of company resources, conflicts of interest, information breaches, improper accounting controls or purchasing arrangements, and other unethical behavior."[86] Not listed are those items which directly impact social concerns such as production standards and consumer safety.

In addition, even if a company has implemented a code of ethics that requires consideration of a corporation's broader social responsibility and its commitment to the well-being of its customers, in reality, employees take their cues from the top and if management is not living by the code or is condoning unethical behaviors in favor of the increase bottom line (think Jeff Skilling and the tremendous pressure put on his subordinates to get results), then the code will not be a driver of business decision-making. "If the code is just a document that goes into a drawer or onto a shelf, it will not effectively encourage good conduct within the corporation. The same is true of any kind of training that the company undertakes … If the message is not continually reinforced, or (worse yet) if the message is undermined by management's actions, the real message to employees is that violations of the ethics code will not be taken seriously."[87]

One of the great strides made in the development of ethical corporate cultures has been the introduction of the corporate ethics officer. The role of the ethics officer varies between companies, but in general it is the ethics officer who will implement ethics training programs and monitor conduct.[88] However, a question remains whether the ethics officer is really in a position to take the actions necessary to ensure an ethical workplace. Ethics officers are both part of management and answerable to management.[89] Those who they evaluate are the same persons who hired them and evaluate them, causing a possible conflict of interest for the ethics officer that

[86] GENERAL MOTORS, WINNING WITH INTEGRITY, VALUES AND GUIDELINES FOR EMPLOYEE CONDUCT, (2011), *available at* http://www.gm.com/content/dam/gmcom/COMPANY/Investors/Corporate_Governance/PDFs/Winning_With_Integrity.pdf.

[87] Don Mayer, Daniel M. Warner, George J. Seidel and Jethro K. Lieberman, INTRODUCTION TO THE LAW OF PROPERTY, ESTATE PLANNING AND INSURANCE, 2.4 Corporations and Corporation Governance Ethics Codes (Edition 1, August 2012).

[88] W. Michael Hoffman, John Neill, and O. Scott Stovall, *An Investigation of Ethics Officer Independence,* JOURNAL OF BUSINESS ETHICS (Spring, 2007).

[89] Michael Hoffman, *Repositioning the Corporate Ethics Officer*, BUSINESS ETHICS QUARTERLY 744 (October, 2010).

could impact his or her objectivity.[90] The ethics officer's lack of status and authority within a company may undermine the officer's effectiveness."[91] Both the Department of Justice and the Federal Sentencing Guidelines have, therefore, called for a more independent status for the ethics officer as "part of the executive team with direct reporting responsibilities to the board or board committee."[92] This would alleviate any potential conflict of interest and would improve the ability of the ethic's officer to effectively oversee the actions of upper levels of management."[93] Such independence is essential in order to protect the interest of all constituencies, such as company employees, shareholders, and customers.[94]

Are codes of ethics and ethical training programs effective? "The answer is a qualified yes - as long as the program is not just a check the box exercise....There is also evidence that having a strong and well-implemented program drives a strong ethics culture in a company, which reduces ethics risk."[95] Still, corporate scandals involving major corporations that have taken all the appropriate actions to create an ethical corporate culture still occur. In the 1980s, GM, like other major corporations during this decade, adopted a Code of Ethics. In fact, GM used to produce their code in several small booklets, each covering a different aspect of the code and later consolidated these into one comprehensive code of conduct that was 120 pages long.[96] The code was later reduced in size and scope to the 19-page version GM uses today. The ethics office implements the company's training program which includes web-based interactive learning modules.[97] It appears then that at least in the past thirty years, General Motors has sought to implement business ethics into its corporate culture. How then, can we account for the similar underlying failures of ethical decision making involving both the Corvair and the Cobalt? Part III will consider whether economic concerns or product liability standards might account for this.

IV. THE CLIMATE OF THE SIXTIES AND THE EARLY

[90] *Id.*

[91] *Id.*

[92] Sheryl P. Hopkins, *How Effective are Ethics Codes and Programs?*, FINANCIAL EXECUTIVE (March, 2013).

[93] W. Michael Hoffman, John Neill, and O. Scott Stovall, *An Investigation of Ethics Officer Independence,* JOURNAL OF BUSINESS ETHICS (Spring, 2007).

[94] *Id.*

[95] *Id.*

[96] Andrew Singer, *As GM Struggles, Its Ethics and Compliance Office Motors On*, ETHIKOS AND CORPORATE CONDUCT QUARTERLY, available at http://www.singerpubs.com/ethikos/html/generalmotors.html.

[97] *Id.*

MILLENNIUM

Given that the ethical theories discussed thus far do not support the behavior of GM it is clear that there must have been some other externalities which caused them to make the choices they did. Our humanity strains to find a justification for why a company as large as GM would intentionally harm others without there being some great force to propel them down their chosen course. Could the economy with its stresses and strains on corporate success be the answer? Were there production issues or design solutions which were outside of the capability of GM?

A. The Economic Climate

"The beginning of the 1960's was characterized by economic expansion. From 1961 through 1965, U.S. private investment grew strongly."[98] Inflation which would not become an issue until the early seventies was in the first five years of the sixties roughly 1 to 2 percent.[99] With the advent of the Cuban missile crisis and the intensifying cold war, the stage was set for technological advancement.[100]

The auto industry at that time also had little to worry about from foreign auto makers. In 1958, the percentage of foreign imports purchased was just 8 percent[101] of total U.S. car sales. Though total cars produced in 1960 as part of the world consumption was down, they enjoyed an overall 45% market share.[102] It is interesting to note that from 1960 to 1965, Japan replaced France as the fourth largest producers of automobiles worldwide.[103] In the 1960s, GM averaged a 48.3% share of the U.S. car and truck market.[104] It seems unlikely that an economic need to beat out a competitor could account for GM's decisions to cut costs with the Corvair. "With a spectacular profit record and over 50% of the domestic automobile market, General Motors is least vulnerable to competitive pressures that might have

[98] John H. Makin, *The Present US Expansion Outshines the 1960s Expansion*, AEI ONLINE, Feb. 1, 2000, *available at* http://www.aei.org/article/economics/the-present-us-expansion-outshines-the-1960s-expansion/.

[99] *Id.*

[100] *Id.*

[101] THE HISTORY OF AMERICAN TECHNOLOGY; THE AUTOMOBILE INDUSTRY 1940-1959, http://web.bryant.edu/~ehu/h364/materials/cars/cars%20_60.htm.

[102] THE HISTORY OF AMERICAN TECHNOLOGY; THE AUTOMOBILE INDUSTRY SINCE 1960, http://web.bryant.edu/~ehu/h364/materials/cars/cars%20_90.htm.

[103] *Id.*

[104] Louis Woodhill, *General Motors is headed for Bankruptcy – Again,* FORBES, Aug. 15, 2012, *available at* http://www.forbes.com/sites/louiswoodhill/2012/08/15/general-motors-is-headed-for-bankruptcy-again/.

been the reason for cutting costs at the expense of Corvair safety. It is not commonly realized that General Motors' return on invested capital and its net income as a percentage of sales are about double those of its nearest competitor - the Ford Motor Company."[105] In addition to its failure to put safety ahead of economics in the design phase, GM also refused to issue a recall on the 1960-63 Corvairs, even though such action would not have represented a significant portion of corporate earnings. "But assuming that 750,000 cars have survived, the most money that such a recall would cost would be $25 million: equivalent to under a half-day's gross sales, or less than five days net profits (after tax).[106]

We next turn to the economic climate at the early years of the 21st century, the time when General Motors may have first become aware of the faulty ignition switch. In 2001 we as a nation were doing well. "In 2001, we had runaway wealth with house values expanding and 401(k)s growing, and we felt justified not saving as much, and we were still accumulating wealth. We were in an optimistic place and spending, and we were happy."[107] North American vehicle production hit a peak of 17.7 million vehicles, a high from 1961 to 2009.[108] 1999 was one of GM's most profitable years hitting a high of 6 billion dollars, with them (GM) remaining profitable through 2004.[109] "The data show that …in the last three months of 2004, the U.S. economy was expanding at a 3.8 percent annual rate.[110] Again, at the time it first became aware of the faulty ignition switch, the economic climate in which GM was operating was not unfavorable, and yet the company made a decision to ignore the auto defect and to fail to implement the necessary fix estimated at a cost of $1 per auto.

B. Product Liability

What we need to keep in mind is that whenever a manufacturer, such as General Motors, is producing a product with a potential

[105] NADER, *supra* note 4 at 41.

[106] *Id*. at 38.

[107] Catherine New, *Then and Now: How has the Economy changed since 9/11,* DAILY FINANCE (Sept. 11, 2011, 7:00 A.M), (*citing* Eric Malm, Professor of Economics, Cabrini College), http://www.dailyfinance.com/2011/09/11/then-and-now-how-the-economy-has-changed-since-9-11/.

[108] Joe Taschler, *Retrenched Auto Industry Zooms to Economic Health*, JOURNAL SENTINEL (January 11, 2014), http://www.jsonline.com/business/retrenched-auto-industry-zooms-to-economic-health-b99180259z1-239767861.html.

[109] Tom Kirshner, *GM Posts 4Q Net Profit as Comeback Continues*, LEGALNEWS.COM, (Feb. 25. 2011), http://www.legalnews.com/oakland/875144.

[110] *US Economy in 2004 Registers Highest Growth in Five Years,* VOICE OF AMERICA (Oct. 29, 2009), http://www.voanews.com/content/a-13-2005-02-25voa6567379827/274690.html.

defect, regardless of the size of the defect, they need to consider what legal liability they may face after it is sold to the general public. Depending on where they are sued within the United States, that legal liability may stem from simple negligence, in its various forms, to strict liability. Let us review briefly the differences and the potential impacts on GM's decision.

Injury standing alone does not establish negligence for which the law imposes liability, because the injury may be caused by act of God, of some other causality.[111] "The elements of negligence are a duty the defendant owes to the plaintiff, a breach of that duty by defendant, a causal connection between the breach and the plaintiff's injury, and actual injury".[112] "Every person in the conduct of his or her business has a duty to exercise ordinary care to prevent unreasonable foreseeable risks of harm to others and a duty to refrain from taking actions that might foreseeably cause harm to others."[113] "Where a situation suggests investigation and inspection in order that its dangers may fully appear, the duty to make such investigation and inspection is imposed by law. There is no excuse that one who has created a peril did not intend or expect, injury to result therefrom; every person is held to a knowledge of the natural and probable consequences of his or her acts."[114]

Without question, GM has a duty to make a reasonably safe automobile. The legal and ethical question for GM is whether they adequately investigated a problem and took appropriate actions to either remedy the problem or ameliorate its potential effect? "The test for tort liability is not whether the accident could have been avoided, but rather, whether it was foreseeable to a reasonable person in the defendant's position. The ultimate test of the existence of a duty to use due care is found in the foreseeability that harm may result if care is not exercised."[115] At the time GM designed and sold their first Corvairs, victims bringing a claim against the company under a negligence theory bore a heavy burden in making their case. For this reason historically to the early 1960s "products liabilities cases and recoveries were rare."[116] "It is a familiar story of how the judicial opinions of two American state court judges, Justice Roger Traynor of California and Justice John Francis of New Jersey, and

[111] 57A AM. JUR. 2D *Negligence* §71 (2004).
[112] *Id.*
[113] *Id.* at §123.
[114] *Id.*
[115] *Id.* at §124.
[116] University of Chicago, *Chapter 9 Product Liability*, available at http://www.uic.edu/classes/eecs/eecs491el/LectureText/ELChapter09.pdf

the torts scholarship of Dean William Prosser, culminated in the American Law Institute's ("ALI") adoption in 1965 of strict products liability in section 402A of the *Restatement (Second) of Torts* ("*Restatement Second*"). Section 402A caught on like wildfire in American state courts."[117]

When making decisions with regard to the Cobalt, GM had to keep in mind both negligence and the strict product liability standard. It appears that GM was aware of a problem with the ignition switch and even promulgated a fix of sorts which was sent out via a technical service bulletin to all dealerships.[118] What is also clear is that the technical service bulletin did not require notification of the problem to owners.[119] Under simple negligence theory what is their duty to warn of a potentially dangerous situation? "A person who controls an instrumentality or agency that he or she knows or should know to be dangerous and which creates a foreseeable peril to others has, if the danger is not obvious and apparent, a duty to give warning of the danger."[120] In our present situation, a difficulty faced is how can one say with reasonable certainty that this ignition movement is one, dangerous and two, causing a foreseeable peril? Is not every product the potential for injury if a part fails? Also, if the part was defective, would not every switch fail? Over 700,000 Cobalts have been recalled, not all 700,000 have had ignition failures I presume, therefore is not that proof of the switch not being a foreseeable risk?[121]

If we look at this from the perspective of strict liability, the most recent analysis is offered in the Restatement of Torts Third. "One of the most controversial aspects of the Third Restatement, however, is the apparent abandonment of the consumer expectation test [offered in the Second Restatement of Torts] in favor of a "risk-utility" test. The risk-utility test finds a product defective as designed only if the magnitude of the risk created by the design is greater than the utility of the product. Restatement (Third) of Torts: Products Liability sec. 2(b). Under the risk-utility test, the plaintiff need only show that the design of the product was the proximate cause of his injury, and the burden then shifts to the product manufacturer to demonstrate that the benefits of the particular design outweigh the risks."[122]

[117] Dominick Vetri, *Order Out of Chaos: Product Liability Design-Defect Law*, 40 Rich L. Rev. 1373 (May, 2009).

[118] James R. Healey and Fred Meier, *supra* note 17.

[119] *Id.*

[120] 57A AM. JUR. 2D *Negligence* §357 (2004).

[121] James R. Healey and Fred Meier, *supra* note 17.

[122] Heather M. Bessinger and Nathaniel Cade, Jr., *Whose afraid of the Restatement*

Under the more recent concept of Strict Liability as outlined above, GM need really only concern themselves with two things. First a nexus between their design and a person's injury and two that the design's failure, if one exist, is not outweighed by their benefit. Additionally the Third Restatement of Torts proposes a shift in our analytical focus, away from product design as a basis of liability to one of foreseeability and the creation of a reasonably safe product.[123] The Restatement of Torts Third, states, "that a product is defective in design when the foreseeable risks of harm posed by the product could not have been reduced or avoided by the adoption of a reasonable alternative design by the seller or other distributor or predecessor in the commercial chain of distribution and that the omission of the alternative design renders the product not reasonably safe."[124] For GM, under the new espoused strict liability concept, the issue is did they create a reasonably safe car, not, could they have designed a safer car? Product liability does not seem to be enough of a deterrent to prevent GM from repeating its pattern of behavior.

V. CONCLUSION

On March 28, 2014, GM posted the following press release on its website: "General Motors today said it will replace the ignition switch in all model years of its Chevrolet Cobalt, HHR, Pontiac G5, Solstice and Saturn Ion and Sky in the U.S. since faulty switches may have been used to repair the vehicles."[125] After all their years of indifference and inaction with regard to this defect, one can only say, "It's about time." The Corvair of the sixties and the Cobalt of the new millennium both represent a tragic disregard of ethical decision making. Sadly, despite fifty plus years of development in the field of business ethics, for GM it seems little has changed. As shown in this paper, the integration of ethics and the introduction of the ethics officer into the corporate structure were not enough to prevent profit-driven decisions. Nor does anything significant in economic climate in which GM made decisions with regard to these two vehicles or in the product liability environment of each era account for the carmaker's actions. It would be at least a small consolation if we could blame

(Third) of Torts?, WIS. L.J., September 17, 2010, *available at* http://wislawjournal.com/2010/09/17/whos-afraid-of-the-restatement-third-of-torts/.

[123] Daniel E. Cummins, Esq., *Product Liability Restatement Scorecard,* TORT TALK, Mar. 26, 2013, *available at* http://www.torttalk.com/2013/03/products-liability-restatement-scorecard.html.

[124] *Id.*

[125] General Motors to Secure Recalled Ignition Switches, http://media.gm.com/media/us/en/gm/news.html.html (last accessed March 29, 2014).

their lack of ethical conscience on something other than their greed. We collectively, would feel better if we knew that businesses only act this way when they are forced by economic catastrophe or by some unusual circumstance. But alas, there was no economic collapse, there was no miscommunication, there was no mistake. What we have was a cold, calculated decision to choose a path which placed peoples' lives at risk in return for improving GM's bottom line. Ethical compliance officers and codes of ethics will change little if businesses are not willing to let ethics compliance officers have the power to halt production and put ethics ahead of production. It is not enough merely to allow Jiminy Cricket to sit on our shoulder reminding us what we should do unless he has the power to change what we do.

CLASS ARBITRATIONS, A DRAFTING DILEMMA

by John F. Robertson*

I. INTRODUCTION

The Supreme Court of the United States has adjudicated several cases involving class arbitration in the past few years. Included in these cases were two cases that served to resolve two very different splits between the circuit courts of appeals. One of the issues involved when an arbitrator may commence a class arbitration, while the other issue was whether a party to a pre-dispute arbitration agreement may include a waiver of class action arbitration in the contract.

II. WHETHER THE FEDERAL ARBITRATION ACT ALLOWS CLASS ARBITRATION IF THE AGREEMENT IS SILENT

Pre-dispute arbitration agreements are unlikely to include a provision expressly authorizing class arbitration. The litigation surrounding class arbitration originally involved contracts that made no mention of class arbitration. Should this omission be read to imply that class arbitration was permitted, and, if so, is this a decision for the arbitrator or is it a gateway issue, similar to whether an arbitration agreement exists, that should be decided by the court? Section 4 of the Federal Arbitration Act (FAA) provides that a party may ask the federal courts "for an order directing that such arbitration proceed in the manner provided for in such agreement…the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the

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agreement."[1] The early cases differed on the meaning of the phrase "terms of the agreement" from Section 4. As explained below, the Supreme Court of the United States has visited this issue three times.

Champ v. Siegel Trading Company, Inc.[2]

A case that shows the early development of the theories involving class arbitration is the Seventh Circuit Court of Appeals' decision in *Champ v. Siegel Trading Company, Inc.* Esther Perera and Alvin Champ filed suit against Siegel Trading Company, Inc. and two individual defendants. Their claims were based on the Commodity Exchange Act, the Racketeer Influence and Corrupt Organizations Act, and the common law. The defendants moved to compel arbitration, and the district court granted this motion with respect to plaintiff Perera. Champ's claims were partially dismissed, but the district court did not compel arbitration for Mr. Champ. Ms. Perera asked to be certified as a class representative, a request that was originally granted. Upon the defendant's motion for reconsideration, the district court revoked its original order.[3] Ms. Perera filed an appeal with the Seventh Circuit Court of Appeals requesting that the district court's order be overturned. The Seventh Circuit found that it did not have jurisdiction over this question.[4] After Ms. Perera's appeal was dismissed, she settled her dispute with the defendants. At this point in the proceedings, Mal Yerasi and Stephen B. Geer intervene in the proceeding and attempt to appeal the district court's refusal to certify a class.[5]

The Seventh Circuit determined that there was now an appealable order, and allowed the appeal to move forward.[6] The Seventh Circuit understood the intervenors' position to be that "because an order compelling class arbitration would not contradict the terms of an agreement that is silent on the issue of class arbitration, such an order would still be "in accordance with" those terms."[7] The Seventh Circuit noted that there was no court of appeals decision addressing the issue, but that there were several cases addressing whether Federal Rule of Civil Procedure 42 allowed consolidation of

[1] 9 U.S.C. §4 (2012).
[2] 55 F.3d 269 (7th Cir. 1995).
[3] Perera v. Siegel Trading Company, Inc. 951 F.2d 780,781 (7th Cir. 1992).
[4] *Id.* at 784.
[5] 55 F.3d at 272.
[6] *Id.* at 274.
[7] *Id.*

arbitration proceedings.[8] The Seventh Circuit stated that the Second, Fifth, Sixth, Eighth, Ninth, and Eleventh Circuits had held that Rule 42 could not be applied to consolidate arbitration proceedings unless the parties specifically agreed to consolidation.[9] The Seventh Circuit applied this rationale to conclude that "Section 4 of the FAA forbids federal judges from ordering class arbitration where the parties' arbitration agreement is silent on the matter."[10]

The Seventh Circuit then considered the intervenors' argument that Federal Rule of Civil Procedure 23 authorized class arbitrations.[11] The Seventh Circuit held that then Federal Rule of Civil Procedure 81(a)(3)[12] only applied to judicial proceedings under the FAA.[13] Judge Rovner, in a concurrence, noted that corporations typically draft the arbitration agreements, and those parties are unlikely to include a class arbitration provision in their clauses.[14] Judge Rovner was not as concerned with the omission of a class

[8] Fed. R. Civ. P. 42 allows a court to consolidate actions that involve a common question of law or fact.

[9] 55 F. 3d at 274. The Seventh Circuit cited: Government of United Kingdom v. Boeing Co., 998 F.2d 68, 74 (2d Cir.1993); American Centennial Ins. v. National Cas. Co., 951 F.2d 107, 108 (6th Cir.1991); Baesler v. Continental Grain Co., 900 F.2d 1193, 1195 (8th Cir.1990); Protective Life Ins. Corp. v. Lincoln Nat'l Life Ins. Corp., 873 F.2d 281, 282 (11th Cir.1989) (per curiam); Del E. Webb Constr. v. Richardson Hosp. Auth., 823 F.2d 145, 150 (5th Cir.1987); Weyerhaeuser Co. v. Western Seas Shipping Co., 743 F.2d 635, 637 (9th Cir.), cert. denied, 469 U.S. 1061, 105 S.Ct. 544, 83 L.Ed.2d 431 (1984). *Id.* at 275. In a footnote, the Seventh Circuit pointed out that the First Circuit had authorized consolidated arbitration when state law specifically authorized it in New England Energy, Inc. v. Keystone Shipping Co., 855 F.2d 1, 5 (1st Cir.1988), cert. denied, 489 U.S. 1077, 109 S.Ct. 1527, 103 L.Ed.2d 832 (1989). *Id.*

[10] *Id.*

[11] Fed. R. Civ. P. 23 provides the guidelines for allowing a party to sue or be sued as a representative of a class of similarly situated parties.

[12] Current Fed. R. Civ. P. 81(a)(6) provides that the Federal Rules of Civil Procedure govern proceedings under several laws, including the FAA, to the extent that those laws do not provide other procedures. Rule 23 could only apply to the FAA if the FAA has no procedures of its own. At the time, Fed. R. Civ. P. 81(a)(3) read: "(a)(3) In proceedings under Title 9, U.S.C., relating to arbitration, or under the Act of May 20, 1926, ch. 347, § 9 (44 Stat. 585), U.S.C., Title 45, § 159, relating to boards of arbitration of railway labor disputes, these rules apply only to the extent that matters of procedure are not provided for in those statutes. These rules apply to proceedings to compel the giving of testimony or production of documents in accordance with a subpoena issued by an officer or agency of the United States under any statute of the United States except as otherwise provided by statute or by rules of the district court or by order of the court in the proceedings."

[13] 55 F.3d at 276.

[14] *Id.* at 278.

arbitration provision as she was with the absence of statutory authority to order class arbitration.[15]

While the Seventh Circuit found no room for class arbitration in the Federal Rules of Civil Procedure, state courts in at least one state did find an opportunity under state law. In *Southland Corporation v. Keating*,[16] the Supreme Court considered whether a state law could remove a claim from the scope of the FAA and whether a state court could require class arbitration. The Supreme Court ruled that the California statute at interest in this case violated the Supremacy Clause of the United States Constitution.[17] It also found that it lacked jurisdiction to resolve the class arbitration question.[18]

Green Tree Finance Corp. v. Bazzle[19]

The question of class arbitration first came to the Supreme Court of the United States in a case that resulted in a fractured decision.[20] In *Green Tree Finance Corp. v. Bazzle*, the South Carolina courts had allowed class certification in two similar cases involving the same lender. One set of plaintiffs, including Burt and Lynn Bazzle, had financed home improvements through Green Tree Finance Corp. (Green Tree); and, the other set, including Daniel Lackey, had financed the purchase of mobile homes from the same lender. South Carolina law required the lender to provide the borrowers with a form telling them of their rights to name their own legal counsel and

[15] *Id.*

[16] 465 U.S. 1, 104 S. Ct. 852, 79 L. Ed. 2d 1 (1984).

[17] *Id.* at 16.

[18] *Id.* at 9. Southland involved a case by franchisees against Southland Corporation, the franchisor of 7-Eleven convenience stores. Several plaintiffs filed suit against Southland in the mid-1970s. These suits were consolidated, and the plaintiffs asked for class certification while Southland asked the courts to compel arbitration. The trial court granted Southland's motion on all claims except those that arose under the California Franchise Investment Law, which the trial court and California Supreme court read to forbid arbitration requirements in regard to claims brought under the act. The California Court of Appeal took the opposite position on the Supremacy Clause issue, but both the California Court of Appeal and the California Supreme Court would require the trial court to certify a class. *Id.* at 4-6. The Supreme Court of the United States found that the parties intended for the forum to be the state courts of California. Southland did not raise the Supremacy Clause argument with regard to the possibility of the California courts allowing class certification, and the California Supreme Court did not rule on whether class arbitration under state law was preempted by the FAA. Accordingly, the Supreme Court found that it lacked jurisdiction over this question. *Id.* at 8.

[19] 539 U.S. 444, 123 S. Ct. 2402, 156 L. Ed. 2d 414 (U.S.S.C. 2003).

[20] Justices Breyer, Scalia, Souter and Ginsburg reached an agreement, Justice Stevens concurred in the judgment, and Chief Justice Rehnquist, Justice O'Connor and Justice Kennedy dissented.

insurance agent. The suits both alleged damages from the failure to provide the required form. Both loan agreements included an arbitration clause, and in both instances the cases were resolved by the same arbitrator who proceeded with a class arbitration.[21]

The Supreme Court of the United States considered two issues involving these cases. The first issue was whether the arbitration agreement was silent on class arbitration. The second issue was, if the contracts were silent, did the contracts then permit class arbitration? The court concluded that the arbitration clause gave the arbitrator great authority to interpret the contract.[22] Green Tree argued that the contract was not silent. Their position was that language in the arbitration agreement using the terms "us," "you," and "the buyer" meant that arbitration had to take place between Green Tree and a single, named customer.[23] The Court concluded that this was not obvious from reading the contract, and went on to conclude that the arbitration clause required the arbitrator to decide if the terms forbade class arbitration.[24] With respect to the second question, the Court said that this was also an issue of contract interpretation that should be decided by an arbitrator. The lower court record showed that the trial court ordered class arbitration in the Bazzle dispute. The Lackey dispute was less clear. The same arbitrator was engaged for both disputes and the relevant contract terms were identical. At the time that the arbitrator decided the Lackey dispute, the arbitrator was already aware of the trial court decision in *Bazzle*. The Court concluded that it was not clear the arbitrator had independently determined that the contracts permitted class arbitration, and remanded the case.[25]

Stolt-Nielsen S.A. v. AnimalFeeds International Corp.[26]

Stolt-Nielsen, a Norwegian shipping conglomerate, approached the U.S. Department of Justice under an amnesty program that protected the first company to come forward from anti-trust lawsuits.[27] They provided information about activities among three major shipping companies, and this information eventually led to lawsuits between

[21] *Id.* at 447. The awards against Green Tree exceeded $20 Million. *Id.*

[22] *Id.* at 451-52.

[23] *Id.* at 450.

[24] *Id.* at 451.

[25] *Id.* at 453-54.

[26] Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 130 S. Ct. 1758, 176 L. Ed. 2d 605 (2010).

[27] *See, e.g.* U.S. v. Stolt-Nielsen S.A., 524 F. Supp. 2d 609 (E.D. Pa., 2007). Amnesty was later withdrawn, and the Department of Justice indicted the company and two executives. http://www.justice.gov/atr/public/press_releases/2006/218199.htm.

customers and Stolt-Nielsen.[28] AnimalFeeds International Corp. (AnimalFeeds), the named plaintiff in the action, brought suit in the District Court for the Eastern District of Pennsylvania.[29] Several other suits had begun, and, in one suit, the Second Circuit determined that the claims were subject to arbitration.[30] The cases were centralized in the District Court for the District of Connecticut.[31] AnimalFeeds asked for class arbitration, and the parties agreed to submit the question to a panel of three arbitrators. The parties also stipulated that the arbitration agreement was silent with respect to class arbitration, and counsel for AnimalFeeds told the arbitration panel that silent means more than just an omission of references to class arbitration but a lack of an agreement on the issue.[32]

The arbitration panel determined that the arbitration clause allowed for class arbitration, but stayed the arbitration proceedings pending judicial review.[33] Judge Rakoff of the United States District Court for the Southern District of New York determined that the arbitration panel had made its decision in manifest disregard of the law. Manifest disregard of the law requires a showing "…both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit, and clearly applicable to the case."[34] The court found that the panel ignored an established rule of maritime law.[35] The Second Circuit Court of Appeals reversed the

[28] 559 U.S. at 667.

[29] *Id.*

[30] JLM Indus., Inc. v. Stolt-Nielsen SA, 387 F.3d 163, 183 (2d Cir. 2004).

[31] In re Parcel Tanker Shipping Servs. Antitrust Litig., 296 F. Supp. 2d 1370, 1371 (J.P.M.L. 2003).

[32] 559 U.S. at 669, citing App. To Pet. For Cert. 77a.

[33] 559 U.S. at 669.

[34] Stolt-Nielsen SA v. AnimalFeeds Int'l Corp., 435 F. Supp. 2d 382, 384 (S.D.N.Y. 2006) rev'd, 548 F.3d 85 (2d Cir. 2008) rev'd and remanded sub nom. Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 130 S. Ct. 1758, 176 L. Ed. 2d 605 (2010) and aff'd sub nom. Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 624 F.3d 157 (2d Cir. 2010) citing Halligan v. Piper Jaffray, Inc., 148 F.3d 197, 202 (2d Cir.1998).

[35] 435 F. Supp. at 386. The contracts all contained one of two standardized arbitration clauses that had been used for more than 30 years. The court stated that "…what Stolt presented was tantamount to an established rule of maritime law. For in the maritime area, more than perhaps any other, the interpretation of contracts-and especially charter party agreements-is very much dictated by custom and usage. See, e.g., Orvig's Dampskibselskab Aktieselskab v. Munson S.S. Line, 16 F.2d 957, 958 (2d Cir.1927); Schoonmaker-Conners Co. v. Lambert Transp. Co., 269 F. 583, 585 (2d Cir.1920); Samsun Corp. v. Khozestan Mashine Kar Co., 926 F.Supp. 436, 439 (S.D.N.Y.1996). Indeed, it could hardly be otherwise, for the international and transient nature of maritime commerce renders the development of binding rules of

district court decision, stating that the defendants had not cited any authority that there was an established rule of maritime law against class arbitration, nor had they shown anything in New York case law establishing a rule against class arbitration.[36]

The FAA provides rules for overturning an arbitration award. These are fairly limited, and include grounds such as corruption, fraud, partiality, misconduct on the part of the arbitrator, or where the arbitrator exceeded his or her power.[37] The Supreme Court of the United States concluded that the arbitration panel made a decision based on policy, and this exceeded the powers granted to the panel.[38] It went on to state that it appeared that the parties believed that the *Bazzle* decision requires an arbitrator to interpret the contract, but it did not need to revisit this question because the parties agreed to submit the issue to a panel of arbitrators.[39] The Court went on to discuss the lack of a rule from *Bazzle* for determining when class arbitration is permitted.[40] After a discussion of several cases, the Court stated: "…it follows that a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party agreed to do so."[41] The Court found that the arbitration panel imposed class arbitration on the parties in spite of evidence that the parties had not reached any agreement on this subject.[42]

Jock v. Sterling Jewelers, Inc.[43]

The Second Circuit Court of Appeals reconsidered some of these topics in *Jock v. Sterling Jewelers, Inc.* Sterling Jewelers involved an employment discrimination claim brought by a female employee of Sterling. Ms. Jock alleged that she, and other female employees, were paid less than male employees and were denied the same opportunities for advancement within the company.[44] The company's

custom absolutely necessary if the business is not to devolve into chaos." *Id.* at 385-86. In the alternative, the district court also found manifest disregard of the laws of New York, which the arbitration panel stated that they had applied under an interpretation of Bazzle. *Id.* at 387.

[36] Stolt-Nielsen SA v. AnimalFeeds Int'l Corp., 548 F.3d 85, 97-99. (2d Cir. 2008) rev'd and remanded sub nom. Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 130 S. Ct. 1758, 176 L. Ed. 2d 605 (2010).

[37] 9 U.S.C. §10(a) (2012).

[38] 559 U.S. at 671-72.

[39] *Id.* at 680.

[40] *Id.* at 680-81.

[41] *Id.* at 684.

[42] *Id.* at 687.

[43] 646 F.3d 113 (2d Cir. 2011).

[44] *Id.*

employment contract included a three-step dispute resolution procedure called "RESOLVE."[45] The RESOLVE process started with a written notification of the issue to the employer, was followed by mediation, and then moved on to arbitration.[46] Ms. Jock filed a complaint with the EEOC in 2005, and the EEOC issued a favorable determination letter in January, 2008. In March of 2008, Jock and other plaintiffs filed a class action lawsuit in the U.S. District Court for the Southern District Court and filed a class arbitration complaint with the AAA. In September of 2008, the EEOC filed suit against the company in the U.S. District Court for the Western District of New York.[47]

The plaintiffs asked the court to refer the case to arbitration. Sterling Jewelers, Inc. (Sterling) objected and asked the district court to resolve certain preliminary matters, including the issue of whether the RESOLVE arbitration agreement permitted class arbitration.[48] The district court concluded that the RESOLVE agreement was broad enough to allow it to decide the issue or refer the matter to the arbitrator, and that it made sense to resolve the question at that level.[49] Sterling argued before the arbitrator that certain provisions of the RESOLVE agreement were incompatible with class arbitration. As a national retailer, Sterling noted two specific provisions—a requirement that the arbitrator should apply local law, and a requirement that the arbitration should take place close to the employee's place of employment.[50] The plaintiffs argued that the RESOLVE agreement was silent on class arbitration, which meant that class arbitration was allowed under the Second Circuit's decision in Stolt-Nielsen. The arbitrator agreed with the plaintiff's position.[51]

Sterling asked the district court to either vacate the arbitrator's decision to allow class arbitration or stay the arbitration proceedings pending the final resolution of Stolt-Nielsen.[52] The court considered Sterling' argument that the arbitrator had exceeded her powers by allowing a single venue for multiple plaintiffs, but not being a

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] Jock v. Sterling Jewelers, Inc., 564 F. Supp. 2d 307, 311 (S.D.N.Y. 2008).

[49] *Id.* The district court concluded that the agreement addressed procedural matters, but used the term "may" which granted it discretion to refer the issue to an arbitrator. *Id.* Sterling also argued that since Ms. Jock had begun litigation, she was not a party aggrieved by another's failure to arbitrate or had repudiated arbitration. Accordingly, she could not then move to compel arbitration. *Id.*

[50] Jock v. Sterling Jewelers, Inc., 725 F.Supp. 2d 444, 445 (S.D.N.Y. 2010).

[51] *Id.*

[52] Jock v. Sterling Jewelers, 677 F. Supp. 2d 661 (S.D.N.Y. 2009).

licensed attorney in all the states that the plaintiffs might be employed in, by not resolving the claims under individual state laws, and by failing to require all class members to complete the first two steps of the RESOLVE agreement. It concluded that FAA Section 10(a)(4)[53] considers whether the arbitrator had the power to reach an issue, not whether the issue had been correctly resolved.[54] Sterling again argued that RESOLVE agreement was incompatible with class arbitration, and the arbitrator manifestly disregarded the law by granting class arbitration in this circumstance. The district court held that if the agreement were silent, the defendant's desired result would be at odds with the Second Circuit's decision in Stolt-Nielsen. The court went on to note that Stolt-Nielsen was on appeal to the Supreme Court of the United States, but was able to distinguish the instant case from Stolt-Nielsen on the basis that Stolt-Nielsen could be restricted to maritime law.[55] The district court also concluded that the decision to allow class arbitration if the inconsistencies were proven was not "…so indefensible as to violate what little is left of the 'manifest disregard' doctrine."[56] Sterling's request for a stay of arbitration pending final resolution of Stolt-Nielsen was also denied.[57]

Sterling appealed the district court's December 2009 decision, and, in April 2010, the Stolt-Nielsen case was resolved. In July 2010, the district court granted a consent order staying the arbitration proceedings for approximately 23 days.[58] Prior to the expiration of that order, Judge Rakoff issued a memorandum order stating that if jurisdiction were restored to the district court, he would reconsider the December 2009 order in light of Stolt-Nielsen and vacate the arbitrator's decision to allow class arbitration.[59] The Second Circuit did restore jurisdiction to the district court, and the district court vacated the arbitrator's award.[60] The plaintiff's appealed that decision, and the appeal reached the Second Circuit. The Second Circuit interpreted the Supreme Court's reading of the Stolt-Nielsen

[53] 9 U.S.C. §10(a)(4) (2012).

[54] 677 F. Supp. 2d at 665. The court referred to Westerbeke Corp. v. Daihatsu Motor Co., 304 F.3d 200, 220 (2d Cir. 2002) for support of this position.

[55] 677 F. Supp. 2d at 666.

[56] *Id.*

[57] *Id.* at 667. The district court again distinguished Jock v. Sterling, Inc. from Stolt-Nielsen, this time on the basis of maritime law compared to general commercial law, the contracts in Stolt-Nielsen were standard industry contracts, and both parties in Stolt-Nielsen were business enterprises. *Id.*

[58] 2010 U.S. Dist. LEXIS 69574.

[59] Jock v. Sterling Jewelers, Inc., 725 F. Supp. 2d 444 (S.D.N.Y. 2010).

[60] Jock v. Sterling Jewelers, Inc., 2010 U.S. Dist. LEXIS 80896.

clauses to mean that the parties had no express or implicit agreement to engage in class arbitration.[61] The Second Circuit found that the parties in this case did not agree on whether the agreement was silent, and concluded that the arbitrator did not exceed her authority in resolving this issue.[62]

Reed v. Florida Metropolitan University, Inc.[63]

Jeffery Reed attended and graduated from Everest University's online program with a degree in paralegal studies. He found that the degree was not accepted by law schools or the local police department.[64] Mr. Reed accumulated $51,000 in student loan debt over the course of his studies. He sued Florida Metropolitan University, Inc. and its parent Corinthian Colleges, Inc., which owned the Everest brand name,[65] in Texas state court for roughly the amount of his loans plus interest and legal fees.[66] Mr. Reed's state court filing was written as a class action.[67] The defendant moved for removal to federal court, and then to compel bilateral arbitration.[68] The district court granted the motion to arbitrate, but deferred the decision on class or bilateral arbitration to the arbitrator.[69] The arbitrator found an implicit agreement to allow Reed to represent a class, and Reed asked the district court to confirm the award. The district court confirmed the award, and the defendants appealed to the Fifth Circuit.[70]

The Fifth Circuit considered two issues. First, was it appropriate to allow the arbitrator to decide if class arbitration was appropriate, and second, did the district court correctly conclude that the arbitrator did not exceed his powers in granting class arbitration?[71] The Fifth Circuit concluded that the Supreme Court had not given conclusive guidance on whether class arbitration is a "gateway" issue for the court to decide.[72] The arbitration agreement that Reed signed as part of the admission process to Everest included an arbitration

[61] 646 F.3d at 113.
[62] *Id.* at 124.
[63] Reed v. Florida Metro. Univ., Inc., 681 F.3d 630 (5th Cir. 2012) abrogated by Oxford Health Plans LLC v. Sutter, _U.S._, 133 S. Ct. 2064, 186 L. Ed. 2d 113 (2013).
[64] 681 F.3d at 630.
[65] *Id.* at 632, n. 1.
[66] *Id.* at 632.
[67] *Id.*
[68] *Id.*
[69] *Id.* at 633.
[70] *Id.*
[71] *Id.*
[72] *Id.* at 634.

agreement referencing the AAA's Commercial Rules.[73] The rules regarding class arbitration are contained in Supplementary Rules,[74] and the Fifth Circuit noted that consent to the Commercial Rules also means consent to the Supplementary Rules.[75] Supplementary Rule 3 grants to the arbitrator the authority to determine if the agreement permits class arbitration.[76] The Fifth Circuit concluded that the district correctly submitted the issue to the arbitrator.[77]

The Fifth Circuit moved on to consider whether the arbitrator exceeded his powers under the FAA, and concluded that he did.[78] The Fifth Circuit's analysis relied heavily on *Stolt-Nielsen,* and paid special attention to some of the disadvantages of class arbitration laid out in *Stolt-Nielsen* as well as some of the points Justice Ginsburg brought up in the dissent.[79] The Fifth Circuit found that the arbitrator's conclusion that the contract implicitly allowed class arbitration—because the inclusion of an "any dispute" clause, because of the inclusion of an "any remedy" clause, and because of the silence in the contract regarding class arbitration exceeded his powers and the district court should have vacated the arbitration award.[80]

Sutter v. Oxford Health Plans, LLC[81]

John Sutter, M.D. (Sutter) filed a class action complaint against Oxford Health Plans (Oxford) in April of 2002.[82] This suit was filed in

[73] *Id.*

[74] The Fifth Circuit refers to 559 U.S. at 668 for a discussion of the history of the Supplementary Rules. *Id.*

[75] *Id.* at 635, citing 1 Commercial Arbitration § 16:16 (Apr. 2012); Bergman v. Spruce Peak Realty, LLC, No. 2:11–CV–127, 2011 WL 5523329, at *3 (D.Vt. Nov. 14, 2011); S. Commc'ns Servs., Inc. v. Thomas, 829 F.Supp.2d 1324, 1336–38, 2011 WL 5386428, at *10 (N.D.Ga. Nov. 3, 2011); and, Yahoo! Inc. v. Iversen, 836 F.Supp.2d 1007, 1011–12, 2011 WL 4802840, at *4 (N.D.Cal. Oct. 11, 2011). The American Arbitration Association (AAA) provides a summary on its website stating that "[t]he AAA administers Class Arbitrations for cases where (1) the underlying agreement specifies that disputes arising out of the parties' agreement should be resolved by arbitration and (2) the agreement is silent with respect to class claims, consolidation, or joinder of claims." American Arbitration Association, Class Arbitration, available at http://www.adr.org/aaa/faces/services/disputeresolutionservices/arbitration/classarbitration (last visited March 24, 2014).

[76] 685 F.3d at 635, citing AAA Suppl. R. 3.

[77] *Id.* at 636.

[78] *Id.* at 638.

[79] *Id.* at 638-40.

[80] *Id.* at 643-44.

[81] 675 F.3d 215 (3d Cir. 2012), as amended (Apr. 4, 2012), cert. granted, 133 S. Ct. 786, 184 L. Ed. 2d 526 (U.S. 2012) and aff'd, 133 S. Ct. 2064, 186 L. Ed. 2d 113 (U.S. 2013).

[82] Sutter v. Oxford Health Plans, LLC, CIV.A. 05-2198 JAG, 2005 WL 6795061

New Jersey state courts, and would eventually lead to a Supreme Court of the United States decision in June of 2013. The New Jersey Superior Court granted Oxford's motion to compel arbitration, and the arbitrator found that the arbitration clause between the parties authorized class arbitration.[83] Oxford filed a pair of motions with the United States District Court for the District of New Jersey. One motion requested that the court vacate the class determination award and the other requested a stay pending a transfer to the Southern District of Florida in conjunction with a motion filed with the Judicial Panel on Multidistrict Litigation.[84] The district court denied Oxford's motion to vacate the arbitration award.[85] The Third Circuit Court of Appeals affirmed the judgment of the district court.[86] The arbitration process then proceeded.[87]

After *Stolt-Nielsen*, Oxford asked the arbitrator to reconsider class certification, and, in Procedural Order 18, he reached the same conclusion as before. Oxford then asked the district court to reopen the case.[88] Oxford's formal motion was a request for the district court to either vacate the arbitrator's Order 18 or reopen the earlier decision to allow class arbitration.[89] The deferential standard of review under FAA §10(a)(4) required a showing that the arbitrator had exceeded his powers. Here the court found that the arbitrator had not implemented a policy in favor of class arbitration as seen in *Stolt-Nielsen*, but had interpreted the contract.[90] Similarly, the district court found that *Stolt-Nielsen* did not require the agreement to contain an express statement allowing class arbitration.[91]

Upon appeal to the Third Circuit Court of Appeals, the arbitrator's award was again sustained.[92] The Third Circuit stated its understanding after *Stolt-Nielsen*:

> Instead, Stolt–Nielsen established a default rule under the Federal Arbitration Act: "[A] party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for

(D.N.J. Oct. 31, 2005) aff'd, 227 F. App'x 135 (3d Cir. 2007).

[83] *Id.*

[84] *Id.*

[85] *Id.* This decision made the other two motions moot. *Id.*

[86] Sutter v. Oxford Health Plans LLC, 227 F. App'x 135, 138 (3d Cir. 2007).

[87] Sutter v. Oxford Health Plans LLC, CIV. 05-2198 GEB, 2011 WL 734933 (D.N.J. Feb. 22, 2011) aff'd, 675 F.3d 215 (3d Cir. 2012) aff'd, 133 S. Ct. 2064, 186 L. Ed. 2d 113 (U.S. 2013).

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.*

[92] 675 F.3d at 225.

> concluding that the party agreed to do so." Absent a contractual basis for finding that the parties agreed to class arbitration, an arbitration award ordering that procedure exceeds the arbitrator's powers and will be subject to vacatur under § 10(a)(4).[93]

The Third Circuit Court of Appeals found that the arbitrator did not exceed his powers and attempted to interpret the contract. This was sufficient to allow Procedural Order 18 to stand.[94]

The Supreme Court of the United States granted certiorari.[95] In June of 2013, the Court issued its opinion. The FAA provides for a limited review of an arbitration award. The Court stated that "…the sole question for us is whether the arbitrator (even arguably) interpreted the parties' contract, not whether he got its meaning right or wrong."[96] The Court found that the arbitrator in *Sutter* made his decision based on the contractual provisions of the parties' agreement, this differed from *Stolt-Nielsen* where the Court found that the arbitration panel had imposed class arbitration as a policy measure.[97] The Third Circuit's decision was affirmed.[98]

III. WHETHER THE COURTS WILL ENFORCE A WAIVER CLAUSE

AT&T Mobility LLC v. Conception[99]

The plaintiffs were cellular telephone customers of AT&T Mobility, LLC (AT&T). They brought a suit against AT&T for false advertising and fraud because AT&T had offered them a free cellular telephone and then had charged them the sales tax on the retail value of the telephone. AT&T's contract had an arbitration agreement that specifically waived class arbitration.[100] AT&T filed a motion to

[93] *Id.* at 222, citing 130 S.Ct. at 1775.

[94] 67 F.3d at 225.

[95] Oxford Health Plans LLC v. Sutter, __U.S.__, 133 S. Ct. 786, 184 L. Ed. 2d 526 (2012). The Supreme Court of the United States indicated that it granted cert to resolve a circuit split between the Second Circuit's decision in Jock v. Sterling Jewelers, Inc. and Third Circuit' decision in Sutter v. Oxford Health Plans LLC on one side and the Fifth Circuit's decision in Reed v. Florida Metropolitan University, Inc. on the other. Oxford Health Plans LLC v. Sutter, 133 S. Ct. 2064, 2068, 186 L. Ed. 2d 113 (2013) n. 1.

[96] 133 S. Ct. at 2068.

[97] *Id.*

[98] *Id.*

[99] 131 S. Ct. 1740, 179 L. Ed. 2d 742 (2011).

[100] 131 S. Ct. at 1744. AT&T's arbitration agreement contained several provisions that were consumer friendly. "[T]he agreement specifies that AT & T must pay all costs for nonfrivolous claims; that arbitration must take place in the county in which the customer is billed; that, for claims of $10,000 or less, the customer may choose whether the arbitration proceeds in person, by telephone, or based only on submissions;

compel arbitration, which the Concepcions opposed on the grounds that the arbitration agreement was unconscionable.[101] The United States District Court for the Southern District of California found that the clause was unconscionable under the California judicial doctrine expressed in *Discover Bank v. Superior Court.*[102] This doctrine stated that a class waiver would be unconscionable when (1) there was an adhesion contract, (2) there were a large number of plaintiffs each with a relatively small dollar amount at issue, and (3) a class action would act to deter wrongdoing.[103] The court found that the AT&T contract fit this standard, and refused to enforce the arbitration agreement.[104] The Ninth Circuit Court of Appeals affirmed the district court decision, adding that the FAA did not preempt the California judicial doctrine.[105]

The Supreme Court of the United States reversed the decision of the Ninth Circuit. They found that the class arbitration manufactured by the judicial doctrine rather than by agreement between the parties was not compatible with the FAA and that the FAA did preempt the judicial doctrine.[106] Since the contract did waive class arbitration, neither court nor arbitrator could conclude that the parties had agreed to class arbitration.

American Express Cos. v. Italian Colors Restaurant[107]

This case involved a lawsuit brought by merchants against American Express. The merchants alleged that American Express compelled them to accept fees approximately 30% higher than

that either party may bring a claim in small claims court in lieu of arbitration; and that the arbitrator may award any form of individual relief, including injunctions and presumably punitive damages. The agreement, moreover, denies AT & T any ability to seek reimbursement of its attorney's fees, and, in the event that a customer receives an arbitration award greater than AT & T's last written settlement offer, requires AT & T to pay a $7,500 minimum recovery and twice the amount of the claimant's attorney's fees." *Id.*

[101] *Id.* at 1745.

[102] 36 Cal. 4th 148, 113 P.3d 1100 (2005).

[103] Laster v. T-Mobile USA, Inc., 05CV1167DMS AJB, 2008 WL 5216255 10-12 (S.D. Cal. Aug. 11, 2008) aff'd sub nom. Laster v. AT & T Mobility LLC, 584 F.3d 849 (9th Cir. 2009) rev'd sub nom. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 179 L. Ed. 2d 742 (U.S. 2011) and amended in part, 06CV675 DMS NLS, 2012 WL 1681762 (S.D. Cal. May 9, 2012).

[104] *Id.*

[105] Laster v. AT & T Mobility LLC, 584 F.3d 849, 852 (9th Cir. 2009) rev'd sub nom. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 179 L. Ed. 2d 742 (U.S. 2011).

[106] AT&T Mobility LLC v. Concepcion, 563 U.S. 321, 131 S. Ct. 1740, 1750-51, 179 L. Ed. 2d 742 (2011).

[107] Am. Exp. Co. v. Italian Colors Rest., __ U.S. __, 133 S. Ct. 2304, 186 L. Ed. 2d 417 (2013).

competing companies.[108] They brought a class action lawsuit against American Express alleging antitrust law violations.[109] The contracts contained an arbitration agreement that specifically provided claims could not be arbitrated as a class arbitration.[110] American Express moved to compel arbitration, and the district court granted the motion.[111] The Second Circuit Court of Appeals reversed the district court's decision on the grounds that compelling each merchant into bilateral arbitration with American Express would be prohibitively expensive.[112] The Second Circuit relied on language from *Green Tree Financial Corp.-Alabama v. Randolph*[113] to conclude that the plaintiff must prove the costs of individual arbitration if that is to be a reason not to enforce the arbitration agreement.[114] The court found that the plaintiffs had introduced evidence documenting the cost of bilateral arbitration, and that the defendant had not produced any evidence to the contrary.[115] The court reversed the district court, and stated that enforcing the arbitration agreement "…would grant Amex de facto immunity from antitrust liability by removing the plaintiffs' only reasonably feasible means of recovery."[116]

The Supreme Court of the United States granted certiorari and remanded the case to the Second Circuit,[117] the Second Circuit returned the same result,[118] the Second Circuit reconsidered after *AT&T Mobility v. Conception*, reversed again,[119] and then denied rehearing en banc.[120]

The Supreme Court noted that the antitrust laws contain no requirement that a plaintiff have an economical way to redress grievances. Some elements of the antitrust rules, such as treble damages, show that Congress has an interest in the antitrust laws

[108] *Id.* at 2308.
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] In re Am. Express Merchants' Litig., 554 F.3d 300, 320 (2d Cir. 2009) cert. granted, judgment vacated sub nom. Am. Exp. Co. v. Italian Colors Rest., 130 S. Ct. 2401, 176 L. Ed. 2d 920 (U.S. 2010).
[113] 531 U.S. 79, 92, 121 S. Ct. 513, 148 L. Ed. 2d 373 (2000).
[114] 554 F.3d at 315.
[115] *Id.* at 315-16.
[116] *Id.* at 320.
[117] American Express Co. v. Italian Colors Restaurant, 559 U.S. 1103, 130 S.Ct. 2401, 176 L.Ed.2d 920 (2010).
[118] In re American Express Merchants' Litigation, 634 F.3d 187, 200 (2d Cir. 2011).
[119] In re Am. Exp. Merchants' Litig., 667 F.3d 204, 213 (2d Cir. 2012).
[120] In re Am. Exp. Merchants' Litig., 681 F.3d 139 (2d Cir. 2012). The Supreme Court of the United States noted that five of the Second Circuit's judges dissented from the decision to deny rehearing en banc. 133 S. Ct. at 2308.

that allows some departures from the "normal limits of law."[121] However, the Court could not conclude that Congressional intent extended to any and all departures from the normal limits of law that were perceived to be necessary to enforce the antitrust rules.[122] The Court found no Congressional intent to ban the waiver of class arbitration in the antitrust laws, noting that the Sherman and Clayton acts do not mention class actions.[123]

The Supreme Court also noted that the judicial doctrine of effective vindication of a statutory right did not apply here. The judicial doctrine deals with the "…prospective waiver of a party's right to pursue statutory remedies…"[124] The plaintiff's argument that the cost of pursuing a statutory remedy through arbitration would mean no plaintiff would enter arbitration, and was thus equivalent to a waiver of remedies did not find favor with the Court.[125]

IV. CONCLUSION

Had the Fifth Circuit's decision in *Reed v. Florida Metropolitan University, Inc.* been allowed to stand, it is likely that no arbitration agreement could justify proceeding in class arbitration. Pre-dispute arbitration agreements would not include express class arbitration provisions, and silence would not imply such provisions. After *Sutter*, it now seems clear that an arbitration agreement that is silent as to class arbitration, but contains broad language such as that in *Sutter*, will allow an arbitrator to find an implicit agreement for class arbitration. The arbitrator in *Sutter* focused on the "no civil action" and the "all such disputes" language from the clause below:

> No civil action concerning any dispute arising under this Agreement shall be instituted before any court, and all such disputes shall be submitted to final and binding arbitration in New Jersey, pursuant to the Rules of the American Arbitration Association with one arbitrator[126]

These phrases, or ones similar to them, are standard in arbitration agreements. The American Arbitration Association provided evidence that actions under the Supplementary Rules were very likely to permit class arbitration. Of 135 arbitrations that had reached the "Clause Construction Award" stage, 95 held that the arbitration

[121] 133 S. Ct. at 2309.
[122] *Id.*
[123] *Id.*
[124] *Id.* at 2310 citing Mitsubishi Motors Corp. v. Soler Chrysler–Plymouth, Inc., 473 U.S. 614, 637, 105 S.Ct. 3346, 87 L.Ed.2d 444 (1985).
[125] 113 S. Ct. at 2310-11.
[126] 675 F. 3d at 223.

clause permitted class arbitration and 33 were resolved by an agreement among the parties that class arbitration was permitted. This is a total of 95%. Only 7, or 5%, of the actions failed to certify a class.[127]

It is not clear that arbitrators will continue to make this decision as a routine matter. The Sixth Circuit Court of Appeals in *Reed Elsevier, Inc. ex rel. LexisNexis Div. v. Crockett*[128] determined that the interpretation of the parties' intent in an arbitration agreement with respect to class arbitration is a "gateway" issue that should be decided by the courts.[129] The *Crockett* court found no agreement to join class arbitration in the contract,[130] although the language appears very similar to that in *Sutter*.[131]

It is also clear that an attorney drafting an arbitration agreement may provide for a waiver of class arbitration in the agreement. If the attorney is the drafting attorney, and the client's desire is to include an arbitration agreement, then adding a class waiver is a low cost option to limit risk. Does the option to waive class arbitration make arbitration more attractive? There are several pros and cons to the arbitration process. The ability to waive class arbitration may tip the balance for businesses that are likely targets for class action lawsuits, but might not outweigh the cons for other businesses.

If there is a public interest to be served by allowing class arbitration, then it seems to be up to Congress to draft legislation. This action would likely have to be included in the FAA itself. Class action rights in other statutes are now in doubt in circumstances where the FAA can be used to compel arbitration. For example, the Age Discrimination in Employment Act (ADEA) specifically authorizes class actions by employees. In *Gilmer v. Interstate/Johnson Lane Corp*., the Supreme Court of the United States enforced an arbitration agreement in a suit that involved the

[127] Brief of American Arbitration Association as Amicus Curiae in Support of Neither Party. Stolt-Nielsen v. AnimalFeeds International Corp., 2009 WL 2896309 (U.S.), 22 (2009).

[128] Reed Elsevier, Inc. ex rel. LexisNexis Div. v. Crockett, 734 F.3d 594, 597 (6th Cir. 2013).

[129] *Id.*

[130] *Id.* at 600.

[131] The LexisNexis contract provided "[e]xcept as provided below, any controversy, claim or counterclaim (whether characterized as permissive or compulsory) arising out of or in connection with this Order (including any amendment or addenda thereto), whether based on contract, tort, statute, or other legal theory (including but not limited to any claim of fraud or misrepresentation) will be resolved by binding arbitration under this section and the then-current Commercial Rules and supervision of the American Arbitration Association ("AAA")." *Id.* at 594.

ADEA.[132] Mr. Gilmer was a stockbroker who was required to register with the New York Stock Exchange (NYSE). His application included an arbitration agreement that required arbitration when required under the rules of the NYSE, and Rule 347 required arbitration for employment disputes between registered representatives and member firms.[133] The Court determined that an employee could be compelled to arbitrate a claim under the ADEA.[134]

Section 7(b) of the ADEA incorporates by reference some of the enforcement terms of the Fair Labor Standards Act (FLSA), including the provisions that allow for a group of employees to proceed with a claim. As noted above, one party to a contract may require an arbitration agreement with a class action waiver. After *American Express Cos. v. Italian Colors Restaurant,* this waiver would seem to be effective even when the statute underlying the plaintiff's claim allows the plaintiffs to proceed as a class.[135]

Should Congress choose to act, it could follow the path of Rule 23 of the Federal Rules of Civil Procedure and the current class arbitration rules of the AAA and allow an arbitrator to certify a class and bind absent members unless they affirmatively opt out of the proceedings. On the other hand, it could follow the path of the FLSA and require that all class members affirmatively join the class. Congress simply referred to the appropriate provisions of the FLSA in drafting the ADEA, but those two statutes are much more similar than are the FLSA and the FAA. Sample language, pulling heavily from the FLSA, and shown in bold italic, suggests a change to 9 U.S.C. §2 as follows:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable ***by any one or more persons for and on behalf of themselves or others similarly situated,*** save upon such grounds as exist at law or in equity for the revocation of any contract. ***No person shall be a party to any such action unless he or she gives consent in writing to become such a party and such consent is filed with the arbitrator.***

[132] Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 29, 111 S. Ct. 1647, 1654, 114 L. Ed. 2d 26 (1991).

[133] 500 U.S. at 23.

[134] *Id.*

[135] The Second Circuit Court of Appeals has already reached a similar conclusion in Raniere v. Citigroup Inc., 533 F. App'x 11 (2d Cir. 2013).

The last sentence, containing the second part of the proposed changes, is unnecessary if Congress chooses to follow the opt-out path of the Rules of Civil Procedure.

RETIREMENT FUNDS IN BANKRUPTCY: *CLARK V. RAMEKER*

by Patricia Quinn Robertson* and Philip Tew**

I. INTRODUCTION

This article discusses whether those individuals who have filed for protection under Federal bankruptcy law should be permitted to shield funds in inherited Individual Retirement Accounts ("IRAs") from their creditors. There is a split among the U.S. Circuit Courts of Appeals which have issued opposing opinions about this issue. In the 2012 case of *In Re Chilton*,[1] the Fifth Circuit agreed with an earlier holding of the Bankruptcy Appellate Panel of the Eight Circuit[2] to rule that non-spousal inherited IRAs are exempt from the estate and may be shielded from the creditors.[3] However, in the 2013 decision in *Clark v. Rameker*,[4] the Seventh Circuit ruled that non-spousal inherited IRAs are not exempt from the bankruptcy estate.[5] On November 26, 2013, the U.S. Supreme Court granted certiorari in *Clark v. Rameker*.[6] Oral arguments were made before the U.S Supreme Court on Monday, March 24, 2014, in this case so a

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[1] 674 F. 3d 486 (5th Cir. 2012).

[2] In re Nessa, 426 B.R. 312, 314 (8th Cir. BAP 2010).

[3] *Chilton,* 674 F.3d 486.

[4] 714 F.3d 559 (7th Cir. 2013).

[5] *Id.*

[6] 134 S. Ct. 678, 2013 U.S. LEXIS 8421 (U.S., Nov. 26, 2013).

determination of this issue should be forthcoming in 2014. This article describes the relevant statutes and cases, and it analyzes arguments and public policy surrounding the issue.

In 2013, there were a total of 1,038,720 individual bankruptcy filings in the U.S. federal courts.[7] The annual consumer bankruptcy filings have been over one million every year but two since 1996.[8] As of September 30, 2013, household debt totaled $11.28 trillion or a 1.1% increase over the previous 6 months.[9] The increasing debt level does not lend itself to lower bankruptcy filings in the coming years.

As of December 31, 2013, over 52 million individuals held assets in a retirement account, which totaled nearly 5.7 trillion dollars[10] (or over 8.5% of all financial assets[11] or 6% of the total assets[12] held by individuals in the United States as of December 31, 2013). The economic importance of this asset class cannot be overestimated.

Under the 1974 Employment Retirement Income Security Act ("ERISA"),[13] a "qualified" retirement account[14] (such as a "401-k" or a "403-b" plan from an employer) does not ever become part of a bankruptcy estate of the employee/ debtor.[15] In *Patterson v. Shumate*,[16] the U.S. Supreme Court held that qualified accounts under ERISA did not become part of the bankruptcy estate due to §541(c)(2).[17]

While there is no confusion over the ability to shield the assets in an employee's qualified retirement accounts from the employee/debtor's creditor in a bankruptcy hearing,[18] there are opposing opinions as it relates to inherited IRAs[19] (and until 2005 as it related to the owner and their IRA account). The initial step in analyzing the issue before the court is to clarify the types of IRAs –

[7] Admin. Office of the U.S. Courts, 2013 Bankruptcy Filings (2014), *available at* http://www.uscourts.gov/Statistics/BankruptcyStatistics/2013-bankruptcy-filings.aspx.

[8] Historical Consumer Bankruptcy, American Bankruptcy Institute, http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=66471&TEMPLATE=/CM/ContentDisplay.cfm (last visited March 30, 2014).

[9] N.Y. Fed. Reserve, 2013 Economic Data for US (2014).

[10] Change in Average Account Balances (by Age and Tenure), Employee Benefit Research Institute, http://www.ebri.org/?fa=401kbalances.

[11] Fed. Reserve, 2013 Economic Data for US (2014).

[12] *Id.*

[13] 29 U.S.C. §§ 1001-1461 (2012).

[14] 26 U.S.C. §408 (2012).

[15] 26 U.S.C. §414(p) (2012).

[16] 504 U.S. 753 (1992).

[17] 11 U.S.C. § 543(c)(2) (2012).

[18] 11 U.S.C § 522(b)(3)(C) (2012).

[19] *Compare* In re Chilton, 674 F. 3d 486 (5th Cir. 2012) with Clark v. Rameker, 134 S. Ct. 678, 2013 U.S. LEXIS 8421 (U.S., Nov. 26, 2013).

(a) "normal" or "traditional" IRAs, (b) non-spousal inherited IRAs, and (c) spousal inherited IRAs. A "normal" or "traditional" IRA is a "trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries" if it meets certain requirements.[20] Upon reaching the age of 59 ½, the contributor may begin withdrawing funds from the IRA without being subject to any penalties.[21] The distributions from the IRA are taxable to the contributor at their applicable tax rate at the time of the distribution.[22] The popularity of these assets is that the contributions to the plans are not taxed,[23] so the contributor is able to postpone their taxes on this portion of their income, and possibly paying taxes at a lower rate in the future during their retirement.[24]

If the owner of the "normal" IRA dies, then the IRA and its' assets pass to the beneficiary set forth in the IRA documents.[25] IRAs may operate differently, depending upon whether the beneficiary is a spouse of the deceased IRA owner.[26] If the beneficiary is the spouse of the deceased owner, then the beneficiary has three options: (a) designate himself or herself as the account owner, (b) rollover the account into his or her own IRA, or (c) treat himself or herself purely as a beneficiary, and not as an owner of the account.[27] Therefore, under the first two options, the beneficiary becomes the owner of the IRA, and thus has all of the requisite rights and privileges bestowed upon the owner of an IRA. If the beneficiary is not the spouse of the deceased owner, then that non-spouse beneficiary may not rollover the account into his or her own IRA or treat it as his or her own IRA.[28] Therefore, non-spousal beneficiaries do not get the right to become the "owner" of the IRA, and may not get the benefits which come with being an "owner" of the IRA.

An additional benefit of qualified retirement accounts is that they are exempt from the attacks by creditors in bankruptcy hearings. Distributions from qualified retirement accounts,[29] rollovers from and

[20] 26 U.S.C. § 408(a) (2012).
[21] 26 U.S.C. § 72(t) (2012).
[22] 26 U.S.C. § 408(d)(1) (2012).
[23] 26 U.S.C. § 401 (2012).
[24] *Id.*
[25] Kennedy v. Plan Administrator for DuPont Savings & Investment Plan, 555 U.S. 285 (2009).
[26] *Id.*
[27] Internal Revenue Service, IRS Pub. No. 590, Individual Retirement Accounts (2013).
[28] 26 U.S.C. § 408(d)(3)(C) (2012).
[29] 11 U.S.C. § 522(b)(4)(D)(ii) (2012).

to qualified retirement accounts,[30] and the actual funds in the qualified retirement accounts[31] may be exempted from the bankruptcy estate of the debtor/owner. In 2014 the Supreme Court will decide whether the assets of an inherited IRA may be sought after by the creditors of the beneficiary, i.e., whether the beneficiary has the same benefits in bankruptcy as the original owner of the retirement account.[32] This issue is primarily directed to those non-spousal beneficiaries of IRAs, since the spousal beneficiary of an IRA is able to both designate himself or herself as the account holder or "rollover" the inherited IRA into their IRA and become the owner of the IRA that way.[33] Since the non-spousal beneficiary is unable to do the same, the issue is of primary importance for the non-spouse beneficiary.

II. THE CASE LAW

A. U.S. Supreme Court in 2005: Rousey v. Jacoway

In the U.S. Supreme Court's 2005 opinion in *Rousey v Jacoway*, [34] the Court determined whether Bankruptcy Code § 522(d)(10)(E) exempted an IRA account from the bankruptcy estate of the IRA owner.[35] In the case, the trustee argued that the IRA owner had a right to demand payment at any time to receive the funds, regardless of the age of the owner, so therefore it is not a "payment under a … plan…on account of … age."[36] The Court had previously found that in regards to the Bankruptcy Code, the phrase "on account of" is used to denote a "causal connection between the term that the phrase 'on account of' modifies and the factor specified in the statute at issue."[37] The Court focused on this causal connection between receiving the payment and the age requirement of the retirement plan. The Court found that under §72 of the Internal Revenue Code, the owners would be subject to a 10% tax penalty if they withdrew funds prior to turning 59 ½ years old.[38] The Court found that this penalty is a "deterrent to early withdrawals" and "suggests that Congress

[30] 11 U.S.C. § 522((b)(4)(D)(i) (2012).

[31] 11 U.S.C. § 522(d)(12) (2012).

[32] 134 S. Ct. 678, 2013 U.S. LEXIS 8421 (U.S., Nov. 26, 2013).

[33] Internal Revenue Service, IRS Pub. No. 590, Individual Retirement Accounts (2013).

[34] 544 U.S. 320 (2005).

[35] *Id.*

[36] 11 U.S.C. § 522(d)(10)(E) (2012).

[37] 544 US 320, 326.

[38] 26 U.S.C. § 72(t) (2012).

designed it to preclude early access to IRAs."[39] Furthermore, "this condition is removed when the account holder turns age 59 ½, [and] the [account holder's] right to the balance of their IRAs is a right to payment 'on account of' age".[40] Due to the penalty language within the tax code in regards to IRAs, the Court sided with the IRA owner that the payment is on account of age.[41]

The *Rousey* Court used the same tax penalty logic to dismiss the trustee's claims that the IRAs were not similar to qualified retirement accounts since the owner could access the funds at any time. The account holders argued that the IRAs had "the same primary purpose, namely, enabling Americans to save for retirement" as the qualified retirement accounts[42] The trustee argued that qualified retirement accounts are "deferred compensation" while "IRAs allow complete access to the funds and are not deferred at all."[43] The Court reasoned that the penalty was a deterrent to access prior to the age of 59 ½.[44]

Therefore, the Court found that IRAs were exempt from the owner's bankruptcy estate and the claims of their creditors.[45] This holding allows those who are the spousal beneficiary of an IRA to protect the assets from the claims of creditors if the beneficiary chooses to become the owner of the IRA or "rollover" the IRA into their own IRA. The *Rousey* Court did not discuss the issue of non-spousal beneficiaries and their bankruptcy exemptions.

After the *Rousey* decision, the Bankruptcy Code was clarified to provide in § 522(d)(12) an exemption for "[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986."[46] Section 408 of the Internal Revenue Code includes tax exemptions for IRAs that meet requirements described therein.[47]

B. The Fifth Circuit in 2012: Chilton v. Moore

In the Fifth Circuit Court of Appeals' 2012 opinion in *Chilton v. Moore*,[48] the court considered whether Bankruptcy Code § 522(d)(12)

[39] 544 U.S. 320, 327.
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.* at 329.
[44] *Id.*
[45] *Id.*
[46] 11 U.S.C. § 522(d)(12) (2012).
[47] 26 U.S.C. § 408 (2012).
[48] 674 F.3d 486 (5th Cir. 2012).

exempted from the debtor Chilton's bankruptcy a $170,000 IRA that the debtor inherited from the debtor's mother prior to the bankruptcy filing.[49] The Fifth Circuit held that Chilton's inherited IRA is exempt in bankruptcy, and therefore not reachable by creditors, because the inherited IRA satisfies both of the following criteria necessary for the exemption: (a) the IRA is "retirement funds;" and (b) the IRA is "in an account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code."[50] The *Chilton* court agreed with the earlier opinions of several other bankruptcy and district courts and a 2010 opinion of the United States Bankruptcy Appellate Panel for the Eighth Circuit.[51]

In connection with the first requirement for exemption from bankruptcy, the *Chilton* court looked at the "plain meaning" of the term "retirement fund" because the Bankruptcy Code does not define "retirement fund."[52] "Retirement" is defined in the dictionary as the

[49] *Id.*

[50] 11. U.S.C. § 522(d)(12) (2012); *Chilton*, 674 F.3d at 488.

[51] *Chilton*, 674 F.3d at 489. *See* In re Nessa, 426 B.R. 312, 314 (BRAP 8th Cir. 2010); In re Kuchta, 434 B.R. 837, 843-44 (Bankr. N.D. Ohio 2010); In re Tabor, 433 B.R. 469, 476 (Bankr. M.D. Pa. 2010); In re Thiem, 443 B.R. 832, 843-44 (Bankr. D. Ariz. 2011); In re Weilhammer, No. 09-15148-LT7, 2010 Bankr. LEXIS 2935, at *4-*6 (Bankr. S.D. Cal. Aug. 30, 2010); In re Stephenson, U.S. Dist. LEXIS 142360, at *7-*8).

In *Nessa* the debtor inherited an IRA from her father prior to her bankruptcy filing. The debtor did not roll the IRA over to her own IRA, and she did not take a distribution or deposit any of her own money into the inherited IRA. Instead, the debtor made a trustee-to-trustee transfer.

Although traditional IRAs and inherited IRAs have different rules about distributions and taxation, the *Nessa* court held that the debtor's inherited IRA was exempt property in the bankruptcy because the inherited IRA was retirement funds exempt from taxation under Internal Revenue Code § 408. The *Nessa* court held that the inherited IRA is retirement funds under the "plain language" of the Bankruptcy Code because although the Bankruptcy Code "requires that the account be comprised of retirement funds, it does not specify that it must be the *debtor's* retirement funds." *Nessa*, 426 B.R. at 315 n.3. The *Nessa* court further stated that holding that an inherited IRA is not exempt would make the Bankruptcy Code Section 522(b)(4)(C) "totally meaningless." *Nessa*, 426 B.R. at 315. Bankruptcy Code Section 522(b)(4)(c) provides as follows:

A direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986, under section 401(a)(31) of the Internal Revenue Code of 1986, or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.

The *Nessa* court held that both traditional IRAs and inherited IRAs are IRAs exempt from taxation under Internal Revenue Code § 408(e)(1). In addition, funds from a section 408 account remain exempt in bankruptcy under § 522(d)(2) even if transferred. *Nessa*, 426 B.R. at 315.

[52] *Chilton*, 674 F.3d at 488-9.

"withdrawal from office, active service or business."[53] "Fund" is "a sum of money or other resources the principal or interest of which is set apart for a specific objective or activity."[54] The Fifth Circuit held that, because Chilton's mother set the funds in the inherited IRA aside for retirement, those funds are retirement funds and they remain retirement funds in the hands of Chilton after Chilton inherits them.[55] The *Chilton* court held that the funds in Chilton's mother's IRA should be defined by the "purpose they are 'set apart' for, not what happens after they are 'set apart.'"[56]

In addition, the *Chilton* court held that the inherited IRA is exempt from taxation under Section 408 of the Internal Revenue Code, thus satisfying the second requirement for the bankruptcy exemption.[57] Section 408 includes provisions about inherited IRAs that are not inherited from a spouse.[58] Basically, according to the Fifth Circuit, inherited IRAs remain IRAs, even if the inherited IRAs function under somewhat different rules than traditional IRAs in connection with matters such as distribution and withdrawal penalties.[59]

C. The Seventh Circuit in 2013: Clark v. Rameker

In the 2013 case of *Clark v. Rameker*[60] the Seventh Circuit disagreed with the Fifth Circuit about exemption of inherited IRAs in bankruptcy.[61] In *Clark* the Seventh Circuit considered Ruth Heffron's IRA which passed to Ruth's daughter Heidi Heffron-Clark

[53] *Id.* (quoting Webster's Third New Int'l Dictionary 921, 1939 (1993)).
[54] *Id.*
[55] *Chilton*, 674 F.3d at 488-9.
[56] *Chilton*, 674 F.3d at 489.
[57] *Id.* at 490.
[58] *See Chilton*, 674 F.3d at 490 (quoting Internal Revenue Code § 408(d)(3)(C)(2)). Section 408(d)(3)(C)(2) provides as follows:

> An individual retirement account or individual retirement annuity shall be treated as inherited if – (I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual, and (II) such individual was not the surviving spouse of such other individual.

Also, Internal Revenue Code § 408(e)(1) provides in part as follows:

> Any individual retirement account is exempt from taxation under this subtitle unless such account has ceased to be an individual retirement account by reason of paragraph (2) or (3)." Paragraphs (2) and (3) deal with the loss of exemption of an account where an employee engages in a prohibited transaction and the effect of borrowing on an annuity contract.

[59] *Chilton,* 674 F.3d 486.
[60] 714 F.3d 559 (7th Cir. 2013).
[61] *Id.*

as the designated beneficiary upon Ruth's death in 2001.[62] Heidi was 22 years old when Ruth died.[63] Beginning in 2002, Heidi and her husband began taking monthly distributions from Ruth's IRA. In 2010, Heidi and her husband commenced bankruptcy proceedings.[64]

In *Clark*, the Seventh Circuit held that when Ruth died Ruth's IRA became "no one's retirement funds."[65] The Seventh Circuit held that "[e]xemption would depend on how Heidi used the property, not on how her mother used it."[66] The court noted that a large portion, if not all, of the funds will be distributed before Heidi's retirement.[67] The *Clark* court stated that "the 'IRA' part of 'inherited IRA' (as the Internal Revenue Code uses the phrase) designates the funds' *source,* not the assets' current status."[68]

The Seventh Circuit in *Clark* stated that exempting the IRA from Heidi's bankruptcy would "shelter from creditors a pot of money that can be freely used for current consumption."[69] The Seventh Circuit used several examples to explain the position that Ruth's IRA should not be considered an exempt retirement fund in Heidi's bankruptcy.[70] For example, if Ruth withdrew the funds from the IRA during Ruth's life and then gave them to Heidi, Heidi's creditors could reach those funds because they would not be retirement funds.[71] Similarly, inherited IRAs are no longer retirement funds and creditors should be able to reach those funds in the opinion of the Seventh Circuit. [72]

The *Clark* court also described an analogy between the IRA exemption and the homestead exemption, which reads as follows: "The debtor's aggregate interest, not to exceed $15,000 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence" may be exempt under the federal bankruptcy exemptions.[73] However, if Heidi inherited Ruth's house but rented the house to tenants instead of residing in the house, Heidi would not be entitled to the homestead exemption for Ruth's

[62] *Id.*
[63] Transcript of Oral Argument at 50, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).
[64] *Clark,* 714 F.3d 559.
[65] *Id.* at 561.
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] 11. U.S.C. § 522(d)(1) (2012); *Clark*, 714 F.3d at 562.

house in bankruptcy.[74] The mere fact that the house was Ruth's residence during Ruth's life would not make it Heidi's residence.[75] The Seventh Circuit opined that an inherited IRA should be treated similarly to an inherited house that is not the residence of the debtor in bankruptcy.[76] Neither the inherited house nor the inherited IRA should be exempt in bankruptcy according to the Seventh Circuit.[77] This analogy makes sense if the determination of exempt status of an asset consistently requires an examination of the debtor's use of and relation to that asset on the inception date of the bankruptcy.[78]

Therefore, the Seventh Circuit held that Ruth's IRA should also be reachable by Heidi's creditors in bankruptcy, because the status of the funds changed when Ruth died.[79] Inherited IRAs "are not savings reserved for use after their owners stop working," so they do not qualify for the exemption in § 522(b)(3)(C) and (d)(12), according to the Seventh Circuit.[80]

The debtors in *Clark* have appealed the Seventh Circuit's decision, and the U.S. Supreme Court granted certiorari.[81] Oral arguments occurred during the writing of this paper on March 24, 2014, so a U.S. Supreme Court decision settling this circuit split is forthcoming.[82]

III. ANALYSIS

The Fifth Circuit and Seventh Circuit opinions in *Chilton*[83] and *Clark*[84] indicate that reasonable minds may disagree about the bankruptcy exemption of inherited IRAs. Several arguments are described in Section II above. This section III analyzes several other important arguments on both sides of this issue. This section first discusses some additional statutory construction arguments and then discusses some policy arguments in connection with exemption of inherited IRAs in Bankruptcy.

When possible, courts should attempt to effectuate the intent of Congress when interpreting a statute. However, interpretation of § 522 of the Bankruptcy Code in connection with a potential inherited

[74] *Clark*, 714 F.3d at 562.
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] Clark v. Rameker, 134 S. Ct. 678 (2013).
[82] Transcript of Oral Argument, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).
[83] 674 F.3d 486.
[84] 714 F.3d 559.

IRA exemption is difficult. As Justice Kennedy said during oral argument of *Clark*, since there is no federal or state legislative history to help with the determination, "all we have is the statute on one hand and common sense on the other."[85] Later, during the oral arguments, Justice Breyer said, "[T]his is a case where common sense, frankly, in my case doesn't get me anywhere."[86]

A careful reading of the statute indicates that the IRA exemption is the only exemption in § 522(d) that does not contain the word "debtor."[87] The other eleven exemptions in that section all refer to the "debtor."[88] The failure to state that "debtor's IRAs" are exempt may indicate that, unlike the other bankruptcy exemptions, Congress did not intend to limit the IRA exemption to traditional IRAs, i.e., IRAs funded by the debtor for the debtor's retirement (as opposed to inherited IRAs).[89]

However, it is possible that this was an oversight by Congress or it is also possible that the reason the IRA exemption does not use the word "debtor" is that the use of the word "debtor" is only necessary in the other eleven exemptions to limit the amount of the exemption.[90] For example, federal exemptions for motor vehicles, personal items, and jewelry in § 522(d) are limited as follows: "The debtor's interest, not to exceed $2,400 in value, in one motor vehicle;" "The debtor's interest, not to exceed $400 in value in any particular item or $8,000 in aggregate value" in personal items such as household goods and clothing; and "The debtor's aggregate interest, not to exceed $1,000 in value, in [personal] jewelry."[91] This language referring to the

[85] Transcript of Oral Argument at 22, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[86] Transcript of Oral Argument at 33, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[87] Transcript of Oral Argument at 8, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[88] 11 U.S.C. §522(d) (2012); Transcript of Oral Argument at 8, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[89] Transcript of Oral Argument at 8, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[90] Transcript of Oral Argument at 34, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[91] 11 U.S.C. § 522(d)(2)-(4) (2012). These sections provide exemptions for

> (2)The debtor's interest, not to exceed $2,400 in value, in one motor vehicle.
>
> (3) The debtor's interest, not to exceed $400 in value in any particular item or $8,000 in aggregate value, in household furnishings, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments, that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor.
>
> (4) The debtor's aggregate interest, not to exceed $1,000 in value, in jewelry held

"debtor's interest" may not be necessary in connection with the IRA exemption, because, unlike the other eleven exemptions in §522(d), the amount of the IRA exemption is limited in a separate section (§ 522(n)) to "$1,000,000 in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require."[92]

As indicated by the examples above, Congress made the other federal exemptions rather small in amount.[93] For this reason, some may believe it unlikely that Congress would intentionally make the application of the relatively large IRA exemption so broad that it includes inherited IRAs that are immediately consumable.[94] On the other hand, it is not impossible for people to withdraw their own traditional (non-inherited) IRA funds before death (albeit with a penalty) for immediate consumption. Nevertheless, in spite of that possibility, Congress did allow for the $1,000,000 (or larger) exemption. Therefore, maybe Congress favors the IRA to such an extent that Congress would be content with an exemption that is broad enough to include inherited IRAs.[95]

Another statutory construction argument is that the words "retirement funds" appear to be superfluous in the statute unless you adopt the argument of the *Clark* bankruptcy trustee that IRAs are not retirement funds if they are not intended for the debtor's retirement.[96] The statute exempts "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code."[97] If inherited IRAs are included in the exemption, then the statute could have simply exempted "funds or accounts that are exempt from taxation under section 401, 403, 403, 408A, 414, 457, or 501(a)" without the words "retirement funds" tacked on at the beginning.[98] Did Congress intentionally include the "retirement

primarily for the personal, family, or household use of the debtor or a dependent of the debtor.

These exemption dollar amounts are adjusted periodically based upon changes in the Consumer Price Index. *Id.*

[92] 11 U.S.C. § 522(n) (2012).Transcript of Oral Argument at 34, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[93] 11 U.S.C. § 522(d) (2012).

[94] Transcript of Oral Argument at 5, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[95] *Id.*

[96] *See, e.g.,* Transcript of Oral Argument at 4, 16, 20, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[97] *Id.*

[98] *Id.*

funds" language for the purpose of excluding funds that are not the *debtor's* retirement funds?[99] That is possible. However, it is also possible that Congress intended the words "retirement funds" to be broad, but then limited the term retirement funds with the language following "to the extent that" so that later if Congress added educational IRAs or some other non-retirement IRA to one of the tax statutes mentioned in § 522(d)(12), those types of IRAs would not be exempt in bankruptcy.[100]

A possible argument against exemption in *Clark* is found in an examination of the Supreme Court's opinion in *Rousey v. Jacoway*[101] and an objective look at the characteristics of an inherited IRA.[102] In *Rousey* the Court asked whether the IRA is more like: (a) a pension or annuity to "provide income that substitutes for wages earned as salary or hourly compensation;"[103] or (b) a savings account with tax advantages.[104] Such an analysis might indicate that an inherited IRA should not be exempt in bankruptcy because an inherited IRA is more like a savings account from which funds may be withdrawn without penalty, unlike a traditional IRA.[105] Of course, money withdrawn from an IRA (inherited or not) loses its tax-deferred status, but an owner of a traditional IRA must pay an additional 10% penalty for withdrawal before age 59 ½ while an owner of an inherited IRA is not required to pay such a penalty.[106] In addition, an owner of an inherited IRA may actually be required to withdraw some funds well before the age of 59 ½,[107] while only 8% of households headed by a person under 59 took withdrawals from traditional (non-inherited) IRAs.[108] This analysis may weigh against the treatment of an inherited IRA as a pension or annuity to provide income that will be a substitute for wages, especially in cases of relatively young debtors in bankruptcy such as the debtor in *Clark*.[109] However, the young

[99] *Id.*
[100] *Id.*
[101] 544 U.S. 320 (2005).
[102] *See* Transcript of Oral Argument at 38-9, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).
[103] *Id.* at 331.
[104] *Id.* at 332. *See also* Transcript of Oral Argument at 38-9, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).
[105] *Id.*
[106] 26 U.S.C. §§408(a)(6); 401(a)(9) (2012)
[107] *Id.*
[108] Investment Company Institute, ICI Research Perspective 21 (Nov. 2013), available at http://www.ici.org/pdf/per19-11.pdf. *See also* Brief for Respondent at 12, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).
[109] During oral arguments in *Clark*, Justice Alito estimated that approximately 2/3 of the IRA Heidi inherited at age 22 would be distributed to Heidi before she reaches age

debtor in *Clark* may be the exception and not the norm because "the prime age for inheritance is between the age of 50 and 59."[110] Therefore, many beneficiaries of inherited IRAs may use the funds as a wage substitute.[111]

A policy argument in favor of exemption of inherited IRAs is the primary goal of bankruptcy law to afford the debtor a "fresh start."[112] However, of course, the fact that the Bankruptcy Code does not allow unlimited exemptions indicates some effort by Congress to balance the fresh start against the rights of creditors.[113] For example, a purpose of the dollar limits on exemptions, such as limiting the federal homestead exemption to $15,000, is protection of those creditors.[114] These limits are a method of balancing the following two competing concerns: (a) the provision of basic resources needed for the debtor to make the fresh start; and (b) the rights of creditors and the need to maintain a system that affords access to credit for the benefit of our economy and our society.[115]

If IRAs of all types, including inherited IRAs, are exempt in bankruptcy, this allegedly gives persons an additional incentive to save for retirement.[116] This argument focuses on the plans of a traditional IRA owner at the time the IRA is established and funded.[117] However, most persons who invest in an IRA probably do so primarily because they have tax incentives and retirement savings goals. The connection between a bankruptcy exemption for a person

65, and Justice Ginsburg noted that Heidi had already spent approximately $150,000 of the $400,000 inherited IRA by withdrawing more than the minimum required amounts. Transcript of Oral Argument at 10, 13, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

110 Transcript of Oral Argument at 50, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299)

111 *Id.*

112 *See* Cent. Va. Cmty. College v. Katz, 546 U.S. 356 (2006); *Local Loan Co. v. Hunt,* 292 U.S. 234 (1934). The U.S. Supreme Court stated that bankruptcy law "gives to the honest but unfortunate debtor…a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Local Loan Co.* at 244. In addition,"[c]ritical features of every bankruptcy proceeding are the exercise of exclusive jurisdiction over all of the debtor's property, the equitable distribution of that property among the debtor's creditors, and the ultimate discharge that gives the debtor a "fresh start" by releasing him, her, or it from further liability for old debts." *Cent. Va. Comm. College* at 363-4.

113 11 U.S.C. §522(d) (2012); Clark v. Rameker, 714 F.3d 559, 562 (7th Cir. 2013).

114 11 U.S.C. §522(d)(1) (2012).

115 Transcript of Oral Argument at 28-9, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

116 *Clark*, 714 F.3d at 562 (7th Cir. 2013).

117 Transcript of Oral Argument at 3, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

who inherits an IRA and the desire to fund an IRA appears possible, but somewhat weak. The possibility that a non-spouse will inherit the IRA, later declare bankruptcy, and exempt the inherited IRA in bankruptcy is probably so remote at the time of the investment that it is rarely considered by most persons considering investment in an IRA.[118] Further research may be necessary by policymakers to determine whether limiting the bankruptcy exemption to non-inherited IRAs will have any significant effect on retirement savings. In addition, it is arguable that the bankruptcy laws should not be interpreted to "assume that *whatever* furthers the statute's primary objective [retirement savings] must be the law" and "throw creditor's claims to the wolves in order to enhance the savings and bequest motives."[119]

Another possible reason to exempt inherited IRAs in bankruptcy is simplicity and reduction of litigation,[120] thus saving judicial and other resources.[121] If the U.S. Supreme Court decides in favor of the debtor in *Clark,* ruling that inherited IRAs are exempt in bankruptcy, this may eliminate some litigation. If all inherited IRAs are not exempt courts might be tempted to go down the path of a case-by-case approach.[122] Must courts look at each inherited IRA based upon the use by the debtor at the time of the bankruptcy filing to decide whether it is a "retirement fund"?[123] Would a 30 year old debtor be treated differently than a 60 year old debtor in this case?[124] Should the outcome in a case like *Clark* be different if the debtor was an older, retired adult when she inherited the IRA, because then she would be more likely to use the funds as "retirement funds"?[125] It is

[118] *Id*. at 28.

[119] *Clark,* 714 F.3d at 562. The Seventh Circuit stated in *Clark* that

> no legislation pursues its purposes at all costs. Deciding what competing values will or will not be sacrificed to the achievement of a particular objective is the very essence of legislative choice—and it frustrates rather than effectuates legislative intent simplistically to assume that whatever furthers the statute's primary objective must be the law." …Section 522(b)(3)(C) and (d)(12) does not throw creditors' claims to the wolves in order to enhance the savings and bequest motives. It provides a specific exemption for retirement funds—and inherited IRAs do not qualify, because they are not savings reserved for use after their owners stop working.

Id. (quoting Rodriguez v. United States, 480 U.S. 522, 525-26 (1987)).

[120] Brief for Petitioners at 16, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *Id.*

[125] *Id.*

certainly simpler to look at whether the IRA was "retirement funds" at the time it was funded by the deceased person than to consider whether it is "retirement funds" for a particular debtor at the time of the bankruptcy filing.

Tying bankruptcy exemptions to tax exemptions creates an arguably simple correspondence between bankruptcy law and tax law.[126] However, underlying motivations of the Bankruptcy Code and the Internal Revenue Code in connection with IRAs may be quite different.[127] While the Internal Revenue Code's motivation in connection with IRAs' tax benefits is to encourage retirement savings, the Bankruptcy Code's motivation for exemptions is to provide a fresh start to debtors while also preserving the rights of creditors.[128] Therefore, an exact, simplistic matching of the provisions of the Internal Revenue Code and the Bankruptcy Code may not be appropriate.[129]

The debtor's approach in Clark may promote uniformity and fairness for debtors.[130] Congress clearly wanted uniformity in the IRA exemption area because Congress made it possible for all debtors, even debtors who elect state exemptions instead of federal exemptions, to claim the IRA exemption.[131] Seven states have enacted statutes that provide express exemptions for inherited IRAs during the past three years.[132] If the Supreme Court in Clark holds that inherited IRAs are not exempt under the federal bankruptcy regime, persons who live in the seven states who have enacted those statutes with express exemptions have the option to choose the state exemption and therefore be treated more favorably than those persons who do not live in those states in connection with the inherited IRA exemption.[133] This is completely contrary to Congress' attempt to make treatment of IRAs in bankruptcy uniform through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) which revised several sections of the Bankruptcy

[126] Transcript of Oral Argument at 12, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[127] *Id.*

[128] Transcript of Oral Argument at 28, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[129] *Id.*

[130] *Id.* at 22.

[131] 11 U.S.C. § 522 (2012).

[132] Transcript of Oral Argument at 13, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[133] *Id.* at 22.

Code,[134] and it may be unfair to persons who do not live in those seven states.[135]

Also, overall uniformity in exemptions may be quite important for states and small business owners. A study conducted for the Small Business Administration indicated that small business owners are more likely to start businesses in states with higher exemptions in bankruptcy and less likely to do so in states with lower exemptions, especially if those states with lower exemptions border on states with higher exemptions. [136] Non-uniform exemptions among the states can lead to a zero-sum game in which states broaden or increase bankruptcy exemptions to attract individuals and small businesses away from neighboring states.[137]

Another policy concern is fairness and uniformity for debtors who inherit different types of assets. Why would Congress treat heirs who inherit an IRA differently than an heir who inherits cash or other assets?[138] One answer may be that an inherited IRA is different from cash because it remains tax-exempt until withdrawn so the tax consequences of withdrawal can be spread out over many years if it is exempt.[139] Also, Congress wants to encourage IRAs as a vehicle for retirement savings, and this exemption complements tax laws in furthering that goal. Finally, the law often favors those persons who know and understand the law and plan accordingly. Therefore, as in so many other situations, a person who inherits from a decedent who

[134] BAPCPA, Pub. L. No. 109-8, 119 Stat. 23 (2005); Transcript of Oral Argument at 22, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[135] Transcript of Oral Argument at 22, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299). *See* 11 U.S.C. § 522 (2012).

[136] Aparna Mathur, *A Spatial Model of the Impact of State Bankruptcy Exemptions on Entrepreneurship* (July 2005) *available at* http://archive.sba.gov/advo/research/rs261tot.pdf. This study states as follows:

> Entrepreneurs are more likely to start businesses in states with higher state bankruptcy exemptions. Business owners also find it easier to shut down businesses in states with higher bankruptcy exemptions. Thus bankruptcy law is a significant determinant of both entry and exit decisions by small business owners. The unique contribution of this paper is the addition of spatial terms measuring the effect of business conditions in surrounding states. Adding the spatial terms, the results suggest that resident state business conditions matter greatly in relation to business conditions in neighboring states on the decision to set up or close a business in the current state of residence. The results suggest that entrepreneurs choose the location of their businesses in response to competing business conditions, in and outside the state.

[137] *Id.*

[138] Transcript of Oral Argument at 8-9, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[139] *Id.* at 10.

funded an IRA after planning carefully with tax and bankruptcy laws in mind will often fare better than a person who inherits from a decedent who did not engage in such planning.[140]

If the U.S. Supreme Court reverses the Seventh Circuit's decision in *Clark,* Congress could revisit the large IRA exemption in the Bankruptcy Code. This exemption can be up to $1,000,000 or even more "if the interests of justice so require."[141] A criticism of the *bankruptcy law* is that, ironically, the bankrupt poor receive less favorable treatment than the bankrupt rich.[142] A poor person probably does not have an IRA to exempt from bankruptcy, so that person's "fresh start" is not as privileged as the "fresh start" of a person with an IRA of 1,000,000 (or possibly more) that is exempt. Given that a poor person probably doesn't have an inherited IRA, either, allowing debtors to exempt their inherited IRAs (which are immediately consumable) intensifies this effect of favoring the rich over the poor with the bankruptcy laws.[143]

IV. CONCLUSION

The aging of the "baby boomer" generation, the increased popularity of IRAs, and the increased overall debt levels of American households will likely continue to cause the courts to struggle with the issue of non-spousal inheritance of IRAs at an increasing rate over the foreseeable future. Absent clear language in the Bankruptcy and Tax Codes, the courts must attempt to weigh Congressional

[140] *See, e.g.,* Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Gap,* 65 ALA. L. REV. 139 (2013).

[141] 11 U.S.C. § 522(n) (2012). *See also* Transcript of Oral Argument at 34, Clark v. Rameker, 134 S. Ct. 678 (2013) (No. 13-299).

[142] Keith M. Lundin, *Ten Principles of BAPCPA: Not What Was Advertised*, 24-7 AM. BANKR. INST. J. 1 (September 2005).

[143] *Id.* at 70.

> Anyone who drills into BAPCPA [Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 which revised several sections of the Bankruptcy Code] can't help but be astonished by how often wealthier debtors get better treatment than less-wealthy debtors. Maybe it's the million-dollar "cap" on the exemption of IRAs--which can be more than a million if the bankruptcy court exercises vestigial discretion to enlarge the exemption. . . .
>
> Why are homeowners almost always better off than apartment-renters under BAPCPA? Is it good policy that debtors with higher incomes eat more food and buy more clothes than debtors with lower incomes? Why do we punish debtors' attorneys with special advertising rules only when they counsel debtors with less than $150,000 of non-exempt assets? Do attorneys who counsel wealthy debtors need less oversight than attorneys who counsel really poor people?

Id.

intent, public policy issues, and prior court decisions to determine how non-spousal inherited IRAs will be treated within bankruptcy proceedings.

Creditors and trustees will point out that these inherited funds are not "retirement funds" of the debtor; unlike traditional retirement accounts, they may be accessed at any time; and they represent a large pool of funds available for creditors to recover their claims from the debtor. The debtors will point out that the primary goal of the bankruptcy provisions is to provide a "fresh start" for the debtor; failure to allow the exemption of these funds may result in individuals having a disincentive to save for retirement; and this would allow for uniformity with exemptions for individuals in different states. These arguments will not cease until the Supreme Court makes a decisive ruling in the *Clark v. Rameker* case.

A DEFENSE OF EMINENT DOMAIN FOR SPORTS FACILITIES

by Jon Simansky* and Richard J. Hunter, Jr.**

INTRODUCTION

Within the past twenty-five years, a substantial number of professional and semi-professional sports organizations have been established in or relocated to new cities, where they have created new fan bases, immersed surrounding communities in a new found sports frenzy, and increased the visibility of these cities on a national level. In fact, Michael Birch, a sports lawyer who was a Sports Law Fellow at Northeastern University, noted "Since 2000, thirty-one major sports teams have opened a season in a new facility."[1] Prominent sports franchises, such as the Dallas Cowboys and Brooklyn Nets, have built multi-billion dollar sports venues to draw fans and create a buzz that will, at some future point, create significant value for the surrounding communities. However, at the same time, it has become increasingly difficult to amass the necessary funding for these types of operations. The majority of the funding for these new facilities comes from a mix of private investment and an infusion of state tax revenues, which is often necessary to secure the land, pay construction and labor costs, and any other overhead costs associated with building the facility.

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[1] Michael Birch, *Take Some Land for the Ball Game: Sports Stadiums, Eminent Domain, and the Public Use Debate*, 19 SPORTS LAW J. 173, 176 (2012).

While it has become increasingly difficult for sports organizations to build large facilities with preferable locations in many major cities, Mark S. Nagel and Richard M. Southall note, "… Teams have centered on governments' potential use of eminent domain to acquire land for new facilities, since acquiring contiguous acreage from disparate parcels to build a new stadium can be difficult and potentially expensive, especially in a large metropolitan area."[2]

THE EMINENT DOMAIN POWER

Eminent domain is the power that allows the government and certain governmental agencies (on both the state and federal levels) to take private property, with or without the consent of the owners, for a "public use."[3] Today, this power is often exercised in the name of creating an economic benefit for the general public. In order for the government to justify this taking of property, often accomplished through a formal legal process termed condemnation, the government must provide reasonable or "just compensation,"[4] along with complying with proper procedural due process (including a requirement that the property owner be given reasonable notice and a reasonable opportunity to be heard and to offer evidence relating to the amount of compensation due)[5] to ensure that the owners and government can come to a final resolution, or at least some reasonable accommodation in the absence of a voluntary agreement.

Although eminent domain was originally conceived to create projects such as hospitals, schools, and roads,[6] eminent domain has

[2] Mark S. Nagel & Richard M. Southall, *A Stadium in Your Front Yard? Eminent Domain and the Potential Sport Marketing Implications of Kelo v. City of New London,* 16(3) SPORTS MKTG. Q. 171 (2007).

[3] The Fifth Amendment to the Constitution states: "… nor shall private property be taken for public use without just compensation." U.S. CONST. amend. V. The Fifth Amendment applies to the states through the due process clause of the Fourteenth Amendment. *See* Chicago, Burlington & Quincy Railroad v. Chicago, 166 U.S. 226 (1897).

[4] *See, e.g.,* United States v. 564.54 Acres of Land, 441 U.S. 506 (1979).

[5] Bragg v. Weaver, 251 U.S. 557 (1919). *See* also Laura M. Bassett, *Takings in the Big Picture: The Impact of Prop. 4's Eminent Domain Restrictions on Urban Redevelopment in Michigan*, 53 WAYNE L. REV. 899, 902 (2007).

[6] In *Calder v. Bull*, Justice Chase noted that "it is against all reason and justice, for a people to entrust a Legislature with [the power to take property from A and give it to B]… and, therefore, it cannot be presumed that they have done it." 3 U.S. (3 Dall.) 386, 388 (1798). In fact, Elizabeth Gallagher notes that "Although there is no legislative history from the drafting of the Fifth Amendment, early case law suggests that, at that time, courts would have considered the use of eminent domain to transfer property from one private party to another to be a private use, which would not satisfy the public use requirement." Elizabeth F. Gallagher, *Breaking New Ground: Using Eminent Domain for Economic Development*," 73 FORDHAM L. REV. 1837, 1840

also been used in ways beyond these generic and traditional public uses. Bringing a sports organization into a struggling city can solidify a revitalization or redevelopment of the neighborhood through creating streams of new revenue, tourist attractions, and countless other immeasurable intangible benefits for the community. Most importantly, the sports arena, combined with a carefully constructed revitalization plan, can create astounding value within the real estate market for that neighborhood, which in theory will benefit the general public, rather than just the privately owned sports organization and private neighborhood developers. It is thus argued that a government should selectively exercise its eminent domain powers to encourage sports organizations to re-locate and build sports facilities in order to help revitalize an area rather than using direct tax revenues to fund such projects which may or may not have to be paid back at some point in the future.

In order to formulate a strategy to address the acceptability of the power to use eminent domain to build stadia and other sports facilities, an understanding of Supreme Court jurisprudence must be undertaken. The first case that is critical to this understanding is *Berman v. Parker*.[7] A review of the background of the case is in order.

The United States Congress had enacted the District of Columbia Redevelopment Act of 1945 in order to address the issue of blight in the District of Columbia. The Act created an appointed commission consisting of five members, called the District of Columbia Redevelopment Land Agency. Congress granted the Agency the power to redevelop blighted areas and eliminate any "blighting factors or causes of blight."[8] In pursuit of this objective, Congress had granted the Agency the power of eminent domain, if necessary, to transfer private property from the original owner to a *private entity* to serve the "public purpose" of redevelopment. On its fact, the Act was not only concerned with clearing slums and other blighted areas but also with modernizing the urban environment of an area that was close to the U.S. Capitol.

The first project under the Act was Project Area B in Southwest Washington, D.C. In 1950, the Agency developed a comprehensive plan for the area. Surveys indicated that "64.3% of the dwellings were beyond repair, 18.4% needed major repairs, only 17.3% were

(2005).

[7] 348 U.S. 26 (1954).

[8] For a discussion of the issue of blight as a requisite for the use of eminent domain, see Matthew Kokot, *Balancing Blight: Using the Rules Versus Standards Debate to Construct a Workable Definition of Blight*, 45 COLUM J.J. & SOC. PROBS. 45 (2011).

satisfactory; 57.8% of the dwellings had outside toilets, 60.3% had no baths, 29.6% lacked electricity, 82.2% had no wash basins or laundry tubs, 83.8% lacked central heating."[9] The plan made provisions for the types of dwelling units and provided that "at least one-third of them [were] to be low-rent housing with a maximum rental of $17 per room per month." The plan was approved by the Commissioners and the Agency began the redevelopment process. During the early stages of redevelopment, the plaintiffs brought suit to challenge the constitutionality of the taking of their department store, located at 712 Fourth Street, S.W. in Area B.

The plaintiffs in the case owned a department store that was not itself blighted; however, the property was scheduled to be taken by eminent domain in order to clear the larger blighted area in which it was located. Plaintiffs argued that since their property was neither blighted nor slum housing, it could not be taken for a project under the management of a private agency to be redeveloped for private use simply to make the community more attractive. Berman further argued that taking the land under eminent domain and giving it to redevelopers amounted to "a taking from one businessman for the benefit of another businessman" and did not constitute a public use, thus violating the 5th Amendment to the Constitution.

To the surprise of many who took seriously the words of the Fifth Amendment, the United States Supreme Court unanimously decided in favor of the Planning Commission by holding that the problem of large-scale blight needed to be addressed with a large-scale integrated redevelopment plan. Justice Douglas, who wrote for the Court, stated, "If owner after owner were permitted to resist these redevelopment programs on the ground that his particular property was not being used against the public interest, integrated plans for redevelopment would suffer greatly."[10] Justice Douglas noted: "In the present case, the Congress and its authorized agencies have made determinations that take into account a wide variety of values. It is not for us to reappraise them."[11] Justice Douglas stated that that there was is nothing in the 5th Amendment that prohibited those who governed the District of Columbia from deciding that the Capital should be "beautiful as well as sanitary."[12] As the object of cleaning up the area was said to be within Congress's authority, it then followed, that *the right to use eminent domain to accomplish the objective clearly exists.*

[9] 348 U.S. at 30.
[10] *Id.* at 35.
[11] *Id.* at 33.
[12] *Id.*

Justice Douglas addressed the issue presented by Berman of "a taking from one businessman for the benefit of another businessman"[13] by saying that a legitimate *public purpose* had been established by the Congress in creating the entire redevelopment plan, i.e., the purpose of the taking was to eliminate slums on an area-wide basis. Justice Douglas thus intentionally expanded the definition of "public use" to include "public purpose" based on physical, aesthetic, and monetary benefits and stated that the purpose of the redevelopment plan in this case was to address the broader blight issues in the area in order to prevent the neighborhood from reverting to blighted conditions in the future. The Court, however, refused to address the specifics of the redevelopment plan, saying that "[o]nce the question of the public purpose has been decided, the amount and character of the land to be taken for a particular tract to complete the integrated plan rests in the discretion of the legislative branch."[14]

The implications of *Berman v. Parker* are unmistakable in looking at the legitimacy of eminent domain for acquiring land on which to build an arena or a sports facility. Prior to *Berman*, it was generally thought that "public use" was a rather direct and simple requirement. However, since *Berman*, the Supreme Court has held that a use is "public" if it is rationally related to a conceivable public purpose, such as it furthers health, wealth, safety, moral, social, economic or even aesthetic ends. Later, in *Hawaii Housing Authority v. Midkiff*,[15] the Court determined that a "public use" may be found if there is a public advantage or benefit, even though the property will not be used by the general public in the traditional sense. Once a court determines that the "taking" meets this broad "public purpose criteria," the court will not consider the individual desirability of any particular taking or the extent to which the property must be taken in order to satisfy this broad public purpose requirement.

Kelo v. New London[16] is also especially relevant. *Kelo* involved litigation arising from the formulation of a redevelopment plan by the City of New London that would, if successful, increase tax revenues[17] and improve the overall economic picture for the city that had gone through a period of sustained decline. The city's goal was to revitalize the community through allowing Pfizer, the multi-national

[13] *Id.*
[14] *Id.*
[15] 467 U.S. 229 (1984).
[16] 555 U.S. 469 (2005).
[17] Northeast Parent & Child Society v. Schenectady Industrial Development Agency, 494 N.Y.S.2d 503, 504 (1985).

pharmaceutical company, to build a large research and office facility that would spur job creation for the neighborhood. Suzette Kelo, one of the property owners, refused to sell her land. She argued that the city was misusing its eminent domain power through taking the property and then transferring it to Pfizer to build the research and office facility on her plot of land, in hopes of creating a greater economic benefit for the community. Despite her land being solely used for the research facility, and not for any cognizable "public use," the United States Supreme Court ruled in favor of the City of New London in a 5-4 decision.

A majority of the Court determined that the entirety of the economic development is a justified means to exercise the city's power of eminent domain. In his opinion, Justice John Paul Stevens referenced *Berman vs. Parker,* which provided precedence in *Kelo*. He quoted from *Berman,* where the Court had stated: "… Community redevelopment programs need not, by force of the Constitution, be on a piecemeal basis—lot by lot, building by building… Once the question of the public purpose has been decided, the amount and character of land to be taken for the project and the need for a particular tract to complete the integrated plan rests in the discretion of the legislative branch."[18] Although this was language from a prior case, the precedence was dispositive and certainly relevant to his position in *Kelo.* Therefore, although Suzette Kelo's land would be used for a private research facility and office, the Court upheld the taking and stated that it must look at eminent domain on the basis of policy, rather than a case by case basis once it determines that the overall plan meets the threshold "public purpose" criteria.

It is now recognized that *Berman* created legal precedence that redefined and broadened the terminology of "public use" that became the cornerstone of its later decision in *Kelo*. Prior to *Berman*, there had been a narrow interpretation of eminent domain that focused on the words of the Constitution—that land condemned or taken through the exercise of eminent domain needed to be used for a clear "public use", i.e., schools, hospitals, roads or any other public areas or facilities that are open to the general public. The *Berman* Court had effectively transformed the requirement of a "public use" into a broad "public purpose." The public purpose standard would allow for a broader interpretation, in which the "purpose" could include, but not be limited to, creation of jobs, economic factors, social factors, or for the "use" of the land by the public in the most general terms cite. With regards to sports organization's facilities, although they are

[18] *Berman*, 348 U.S. at 35-36.

privately owned enterprises with most profits going towards owners and private investors, these potential projects can provide substantial direct and indirect economic benefits to the general public that cannot be captured strictly through analyzing financial statements and valuation tables. *Kelo* made this analysis and decision possible.

THE BROOKLYN NETS

A recent case involving the exercise of eminent domain in order to build a sport facility for a privately-owned organization involved the Barclay's Center, the new home of the Brooklyn Nets. New York Mayor Bloomberg, a huge backer of the plan to get the New Jersey Nets to relocate from New Jersey to Brooklyn, seized this opportunity to condemn the private housing of over 100 families, along with millions of square feet in retail space within a struggling urban neighborhood, which was seeking a source of revitalization. The redevelopment plan for Brooklyn, an area that was clearly lagging economically and struggling to create a quality of life for its residents, centered around creating prosperity through creating jobs, increasing revenues through new streams of taxation, drawing tourists to Brooklyn, and other intangible and immeasurable benefits for the community that inevitably would coincide with the relocation of a sports team to the Borough.

When attempting to value the impact that a redevelopment plan centering on a newly constructed sports facility may provide, there are many factors that must be weighed to understand properly the overall economic picture. On the surface, many studies may be cited which show that sports facilities do not provide instant financial prosperity. As Arline Schubert comments in an article in the *North Dakota Law Review*, "Public finance experts Roger Noll and Andrew Zimbalist concluded their research by noting no recent facility appears to have earned anything approaching a reasonable return on investment and no recent facility has been self-financing in terms of its impact on net tax revenues."[19] However, Aaron Mensh in a *Connecticut Law Review* article attacks the notion of using "economic returns" as a basis for deciding whether sports facilities qualify as a "public use." He states: "The Court chose not to put forth a 'reasonable certainty' test that public benefits – i.e. economic benefits – are required before a permissible taking occurs."[20] Thus, it appears

[19] Arline Schubert, *A Taxpayer's and a Politician's Dilemma: Use of Eminent Domain to Acquire Private Property for Sport Facilities*, 86 N.D.L. REV. 845, 877 (2010).

[20] Aaron Mensh, *'Upon Further Review': Why a Sports Stadium Can Justify an Eminent Domain Taking*, 40 CONN. L. REV. 1623, 1649 (2008).

that legal precedence allows for the Court to look beyond financial projections focused on the "reasonably certain"[21] test as dispositive and deem it as but one factor in the decision-making process for exercising eminent domain for privately owned sports facilities.

However, focusing on a purely financial approach involving dollar inflows derived from expected increases in tax revenue may be too narrow a focus. Is there an additional possible justification under the "public purpose" analysis? Proponents of the use of eminent domain argue there is more to valuation than just a consideration of tax revenues. The creation of jobs is not necessarily a factor that can be valued strictly in dollars, but also may involve a 'quality of life' aspect that may be factored into the decision behind exercising the power of eminent domain. It may also be argued that the creation of jobs within the neighborhood which accompanies the resurgence or relocation of a sports team creates a unique value to the surrounding neighborhoods and will drive the demand to live and work in these areas.

In addition, one of the most noticeable benefits that can be gained from the location of a sports organization to a city is the civic pride[22] and camaraderie that it can bring to the community itself. Despite the fact that large portion of the population may never step foot within these sports venues because of a wide variety of factors, there may be a certain essence or feel of a "big league city" that provides satisfaction to the masses within that corresponding city. In the discussion by Aaron Mensh on the existence of such intangible benefits, he states, "A study focusing on Pittsburgh showed that sixty-seven percent of its residents enjoyed having the NHL's Penguins in its city, even though less than forty percent of them ever attended a game."[23]

This might suggest that a majority of residents, whether they are fans or not, experience some form of gratification from having a sports organization tied to their city. Additionally, a social and psychological factor associated with a sports organization being located within a city should not be discounted when discussing the overall benefits of exercising eminent domain to acquire land for sport

[21] John T. Goodwin, *Justice and the Just Compensation Clause: A New Approach to Economic Development Takings*, 24 NOTRE DAME J.L. ETHICS & PUB. POL'Y 219, 246 (2010).

[22] *See* Mark S. Rosentraub, *Symposium: Sports Facilities and Development: Sports Facilities, Redevelopment, and the Centrality of Downtown Areas: Observations and Lessons from Experiences in a Rustbelt and Sunbelt City*, 10 MARQ. SPORTS L.J. 219, 220-21 (2000).

[23] Mensh, *supra* note 20, at 1653.

facilities. There are millions of people throughout the United States that tune into local sports talk shows and hold conversations with others that revolve around these local sports organizations. The psycho-social benefits associated with these organizations can certainly pass as a public benefit. It can thus be argued that these less tangible factors provide an additional rationale behind the application of eminent domain based on a broad "public purpose" analysis enunciated in *Berman* and more fully developed in *Kelo*.

However, the residents of Brooklyn who were displaced were less than enthusiastic in their appreciation of the revitalization plan, as they saw it as slightly too large of a project, where a large segment of the population was being affected in order to accommodate the new facility. As Arline Schubert noted: "It faced opposition from community groups and elected officials who opposed the size and scale of the project… They claimed the takings are for private use by the developer and that the plan only enriches private interests."[24] The developers asserted that eminent domain was the proper vehicle to condemn multiple blocks surrounding the proposed location due to the unsanitary and deteriorating infrastructure that existed. Thus, in order to create the "highest and best value" in the area, it became necessary to revitalize the entire community, and not just build the stadium. A redevelopment plan that is designed solely for a sports facility may be detrimental to the success of the overall plan as many people may continue to avoid coming to the area, and it would put in jeopardy the determination that the project was actually for a "public purpose." Overall, the sports arena, combined with the rebuilding of housing in the immediate area, can complement one another in creating value for the area as a whole, thus, providing a benefit to the people and meeting the requirement of a "public purpose."

It is certainly true that the private owners of sports franchises benefit most directly in these situations, but the real estate boom that it creates within these revitalized cities should not be overlooked. For example, since the opening of the Barclay's Center in Brooklyn, the demand for the real estate within Brooklyn has created a frenzy of buying and selling of property for values far greater than a few years ago. In an article which appeared in *The NY Daily News,* Phyllis Furman affirms: "The hotly sought-after borough saw its average rent climb to $3,035 in July, a hefty 8.2% jump from July 2012."[25] The Barclay's Center first opened in September 2012, demonstrating that

[24] Schubert, *supra* note 19, at 871-872.

[25] Phyllis Furman, *Brooklyn Rents Soar to $3,035 Average, Closing Gap with Manhattan*," *New York Daily News*, November 19, 2013, http://www.nydailynews.com/newyork/brooklyn/brooklyn-rents-soar-closing-gap-manhattan-article-1.1420948.

there was a drastic increase in real estate value throughout Brooklyn as a result of the facility and the housing revitalization that accompanied its building. With the increase of value within the housing market, it can be also asserted that the population as a whole is indirectly benefiting financially from the exercise of the power of eminent domain.

SOME CLOSING OBSERVATIONS

There is also a negative aspect to the government's actions that is most evident in *Kelo*. In spite of efforts to keep the project alive, the redeveloper (who stood to get a 91-acre (370,000 m^2) waterfront tract of land for $1 per year in return for completing the project) was ultimately unable to obtain the required project financing. The redevelopment project was abandoned. As of February 2014, the original *Kelo* property was a vacant lot, generating no tax revenue for the city. The promise of 3,169 new jobs and $1.2 million a year in tax revenues remained illusory.

Opponents also counter that the only people that benefit from these types of redevelopment plans are the private developers that partner with the government to 'change the scenery' around these sport facilities. As Justice Sandra Day O'Conner stated in her dissenting opinion in the *Kelo* case, "The beneficiaries are likely to be those citizens with disproportionate influence and power in the political process, including large corporations and development firms. As for the victims, the government now has license to transfer property from those with fewer resources to those with more."[26]

On balance, however, and despite the fact that over forty states have moved to limit the application of eminent domain in cases similar to both *Berman* and *Kelo*, the argument of Justice O'Connor may fail to recognize the broader context of issues in her dissent.

Harkening back to the original Douglas opinion in *Berman*, if over time the government fails to exercise its eminent domain power in critical areas for the purpose of economic redevelopment, this failure may inevitably result in a further deterioration in the area's economy. The transfer of private property through and exercise of the power of eminent domain to owners of sports franchises may be vital (and perhaps the only viable option) to spur economic growth within an area that has become depressed or abandoned, thus creating the potential of a better quality of life in the long run for the local population in dire need of economic resources.

[26] *Kelo*, 555 U.S. at 468 (O'Connor, J., dissenting).

In sum, it can be argued that the exercise of eminent domain promotes economic growth, a better standard of living, and a fundamental avenue to revitalize an area that, without this type of intervention, could not otherwise prosper. Privately owned sport organizations often trigger the revitalization of a community through non-financial factors that cannot be measured in dollars. *Kelo* was decided in light of cases which broadened the terminology of "public use" to "public purpose." It provided the legal basis needed to argue for the exercise of the power of eminent domain on the basis of financial factors under specific facts and circumstances. Although there are certainly demonstrable economic benefits that derive from these takings, *Kelo* follows the reasoning of *Berman v. Parker* and eliminates the "economic benefit" as the deciding factor in this debate. As a result, it may be legally permissible to exercise the power of eminent domain today to benefit privately owned sports facilities, and, at the same time, provide a less tangible and indirect benefit to the public. Overall, exercising eminent domain for building privately owned sports facilities can also elevate an otherwise obscure city or a neighborhood of a city (downtown Newark or the Borough of Brooklyn) into a nationally sought-after or recognizable locale that boasts an increased standard of living for the population of a city or an area as a whole.

EFFECTS OF STAKEHOLDER PRESSURES ON INTERNATIONAL BUSINESS: APPLE AND FOXCONN

by Christine M. Westphal* and Susan C. Wheeler**

INTRODUCTION

In order to remain competitive in the global marketplace American businesses are constantly monitoring their business practices in search of competitive advantage. This strategy has led many companies to offshore parts of their operations. Starting in the late 1990's many American companies looked to China in order to lower manufacturing costs. In China labor was cheap, workers were educated, eager and flexible, and government regulation was lax. The combination of abundant, low cost labor and lax government regulation meant that many companies found major economic benefits by offshoring manufacturing, especially to China. The Chinese were eager to modernize their economy by encouraging direct foreign investment, and they were willing to "overlook" violations of their labor and environmental laws if it would lead to accelerated economic growth. In this environment, exploitation of Chinese workers was inevitable, and American companies were willing to focus on the economic benefits that could be achieved while mostly ignoring the human costs involved in manufacturing in China. Apple is one of the American companies that has sent its manufacturing to China.

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Apple iPads and iPhones are produced primarily by Foxconn; a division of the Taiwan based Hon Hai Precision Industry Co., the largest manufacturer of electronics in Mainland China. Negative media coverage of Foxconn's employment practices has caused significant difficulties for Apple in recent years. Stakeholders, including consumers, investors, and the Chinese government, have pressured Apple to improve the conditions of workers who produce Apple products. Apple has responded by pressuring Foxconn to change its business practices. This paper briefly will describe the development of the relationship between Apple and Foxconn; the media coverage of Foxconn employment practices and both Apple's and Foxconn's attempts to address stakeholder concerns about its products and processes. We will also discuss the complexity of attempting to enforce ethical standards in the global economy and the stresses and realignments that both the Apple and Foxconn response to stakeholder pressure have caused.

APPLE

As Apple moved from being a manufacturer of computers to a consumer electronics company, its business practices changed. As a computer maker, Apple manufactured its products in the United States, using American workers and building modern production facilities. Apple enjoyed a good relationship with its American workers, offering the usual Silicon Valley stock options to key employees and encouraging its manufacturing employees to take pride in its products. For example, all of the employees who worked on the production of the first Apple Macintosh computer had their signatures embossed on the inside of the computer case. When Apple moved to production of consumer electronics it moved its manufacturing overseas to China. The primary reasons given for the move were that much of its supply chain was already in China and Asian factories "can scale up and down faster".[1] The executives at Apple also felt that semiskilled workers and engineers were more readily available in China, and could be hired quickly. This allowed products to be manufactured, "… almost as quickly as they are dreamed up…"[2] While the cost of labor was part of the consideration, it was not the primary driving factor, because labor is only a small part of the cost of consumer electronics.[3] Rather it was the ability of

[1] Charles Duhigg and K. Bradsher, *How the U.S. Lost Out on the iPhone Work*, N.Y. Times, Jan. 21, 2012, at B1.

[2] David Barboza and C. Duhigg, *Pressure, Chinese and Foreign, Drives Changes at Foxconn*, N.Y. TIMES, Feb. 19, 2012 at B1.

[3] Duhigg and Bradsher, *supra* note 1, at B1.

Chinese-based manufacturers to assemble large numbers of semiskilled workers and engineers who would be willing to work twelve hour shifts, literally within days of receiving an order for goods.[4] Apple created a Supplier Code of Conduct that was designed to address concerns about the possible exploitation of workers employed by its suppliers. The largest manufacturer of consumer electronics in China is a Taipei based firm that operates under the name Foxconn Technologies. Foxconn may also be the largest private employer in China. In 2010 over two hundred and fifty thousand workers were employed in Foxconn's Shenzhen manufacturing complex and Foxconn now has numerous sites in China.[5] In total Foxconn has approximately 1.2 million employees in China and assembles approximately 40% of the world's consumer electronics.[6] When Apple turned to China to manufacture its consumer electronics, Foxconn Technologies was the logical choice.

Foxconn's ability to meet Apple's manufacturing goals and deadlines was beneficial to both companies, but to reach the necessary levels of efficiency and productivity Foxconn implemented employment practices that resulted in a series of industrial accidents and worker suicides. The resulting negative publicity caused problems for both Apple and Foxconn. A diverse group of stakeholders including purchasers of Apple products, investors and the Chinese Government expressed concern about the way Apple was producing its products, and about Foxconn's employment practices. Apple, in turn, put pressure on Foxconn to resolve concerns about the treatment of its workers.

FOXCONN

Foxconn Technology Group is part of Hon Hai Precision Industry Company which was founded in 1974 in Taiwan. On its corporate website, Hon Hai/Foxconn describes its competitive advantages as follows:

> "Foxconn defines company products as speed, quality, engineering services, flexibility and monetary cost savings…" Foxconn has "...a commitment to continual education, investing in its people long term and localization globally…"[7]

[4] *Id.* at B1.

[5] Stephanie Wong, J. Liu and T. Culpan, *Why Apple is Nervous about Foxconn,* Bloomberg BusinessWeek, Jun. 7, 2010.

[6] Barbosa and Duhigg, *supra* note 2, at B1.

[7] Hon Hai/Foxconn *Competitive Advantages*, http://www.foxconn.com/GroupProfile_En/CompetitiveAdvantages_sub.html (last visited Mar. 15, 2014)

Foxconn uses what it describes as its revolutionary eCMMS model. "…eCMMS stands for e-enabled components, Modules, Moves and Services. eCMMS is the vertical integrated one stop shopping business model by integrating mechanical, electrical and optical capabilities altogether."[8]

Others describe the Foxconn system in less glowing terms,

> "Foxconn uses Taylorism-it breaks workers' every action into simple segments which can be easily analyzed and standardized to make production more efficient-and Fordism to organize its production process. As Founder Terry Gou said, its production philosophy is, 'dismantling, simplifying, and standardizing the entire business process according to the norm in order to gain more profit with least resources'[9]. This results in the majority of its workforce "...performing simple actions repeatedly, just like a robot…"[10], often for twelve hours a day, six days a week.

In China, Foxconn makes extensive use of student interns to perform basic assembly labor. Approximately 18% of the Foxconn workforce is between 16 and 18 years old, and about one third of those workers are student interns[11]. The majority of Foxconn's labor force is 25 years old or younger. In addition to the teenage interns, as many as 100,000 Foxconn workers in China may be student interns.[12] Because student-workers are considered students, they are not protected by Chinese labor laws and while they are paid for their work they do not require economic compensation when they are laid off, or insurance that would cover them if they are injured.[13] This allows Foxconn to cut costs. Foxconn also appears to systematically separate students from the same school in order to discourage "solidarity" which often results in the students feeling "deeply lonely and helpless"[14]. The majority of the workers live in company dormitories where six to eight workers share a room, but they are often on different work schedules.

This combination of long hours of repetitive, dull and boring activity combined with isolation from family and potential friends has proved toxic. In 2010, seventeen workers in Foxconn's Shenzhen 'campus' committed suicide, most by jumping off the dormitory buildings. In response, the company put up 'suicide nets' on the

[8] *Id.*

[9] Yihui Su, Student Workers in the Foxconn Empire: The Commodification of Education and Labor in China, J. WORKPLACE RTS, (2010-11).

[10] *Id.*

[11] *Id*. at 345.

[12] *Id.*

[13] *Id*. at 351.

[14] Id. at 355.

dormitory buildings. Foxconn also began having workers sign contracts where they promised not to try to commit suicide and not to sue the company if they were injured. While Apple found the suicides "very troubling", it did not initially appear to make any concerted attempt to change the culture at Foxconn or enforce its Supplier Code of Conduct.

Foxconn and Apple were both prospering. Foxconn had been so eager to win the assembly work for the Apple iPhone that its president had ordered the Foxconn business units that supplied components to sell them to the assembly unit at cost. This allowed Foxconn to win the Apple iPhone business. The success of the iPhone enriched not only Apple but Foxconn. Foxconn's net income jumped 37% in 2009.[15]

STAKEHOLDER PRESSURE ON APPLE

Apple instituted a Code of Conduct[16] for its suppliers in 2005 after it decided to shift the manufacture of its consumer electronics overseas, but it did not begin auditing facilities until 2007.[17] Over the course of the last seven years it has published an annual report of the results of its audits. Typical is the 2012 audit report which showed that the compliance rate for its audited suppliers was 74%, or viewed another way 26% of its suppliers did not comply with their code of conduct. Apple states that when a supplier is found to be in violation of its code of conduct it requests that the violation be remedied and, if it is not, Apple will stop using the supplier[18] Apple has consistently found that its suppliers require their employees to work more than 60 hours per week, and more than six days a week.[19] In 2012, Apple performed 229 audits and yet over the last five years, it has only terminated contracts with 15 small suppliers.

One former Apple executive interviewed by the New York Times observed "If half of the iPhones were malfunctioning, do you think Apple would let it go on for four years?"[20] Apple faces three problems when dealing with suppliers who do not meet the standards in its

[15] *Supra* note 5

[16] *Apple Supplier Code of Conduct*, Version 3.1 (2009), http://images.apple.com/supplierresponsibility/pdf/Supplier_Code_of_Conduct_V3_1.pdf (last visited Jun. 15. 2012)

[17] Charles Duhigg and D. Barboza, *In China, Human Costs Are Built Into an iPad*, N.Y. TIMES, Jan. 25, 2012 at 6.

[18] *Apple Supplier Responsibility 2012 Progress Report* https://www.apple.com/jp/supplier-responsibility/pdf/Apple_SR_2012_Progress_Report.pdf (last visited Mar. 25, 2014)

[19] *Id*. at 7.

[20] Duhigg and Barboza, *supra* note 2 at 3.

Code of Conduct. First, it is time consuming and expensive to find new suppliers; second, finding new suppliers means that Apple has to disclose its product plans to suppliers who may exploit that knowledge; and third, there is actually no available replacement for Apple's largest supplier, Foxconn.[21] On one hand, Apple would like its suppliers to treat their workers reasonably, on the other hand Apple shifted its consumer electronics manufacturing to China because they can "scale up and down faster…" which means that the workers will have to work substantial overtime hours to meet Apple's production requirements. Apple's Code of Conduct[22] states that workers will not work more than 60 hours per week, which actually exceeds the number of hours allowed under the Chinese labor laws.[23]

Apple also has a reputation for pushing its suppliers to produce at the lowest possible price. Apple doesn't just ask for bids, it requires pricing information for every part and calculates a price with a small profit margin for the supplier. Then, in the second year of production, Apple tries to bring down costs again. These business practices allow Apple to be very profitable, but its suppliers have to find ways to cut costs. Often the suppliers pressure the workers to put in longer hours without receiving an overtime pay premium, or they engage in unsafe practices (i.e. using more toxic chemicals or not installing adequate ventilation).[24] The inherent conflict between trying to obtain the lowest production cost for its products and wanting its suppliers to adhere to its Code of Conduct might be interpreted as Apple attempting to have its cake and eat it too. It does not leave the impression that Apple is sincere in seeking adherence to its Code of Conduct.

SUBSTANDARD WORKING CONDITIONS EXPOSED

In May 2011, there was an explosion in the Foxconn factory in Chengdu China. The explosion was caused by a spark which ignited combustible dust in the factory. The Chengdu explosion killed four workers and injured eighteen others. There was also a combustible dust explosion in a plant in Shanghai that injured 59 workers. Typically, combustible dust explosions occur in situations where the

[21] *Id*. at 4.

[22] *Apple Supplier Responsibility 2014 Progress Report* at 33. http://images.apple.com/supplier-responsibility/pdf/Apple_SR_2014_Progress_Report.pdf (last visited Mar. 28, 2014)

[23] Labour Law of the P.R.C., Art. 36 (Mar. 20, 2007) http://english.mofcom.gov.cn/aarticle/policyrelease/internationalpolicy/200703/20070304475283.html (last visited Mar. 28, 2014)

[24] *Id*. at 10.

ventilation in a factory is not sufficient so it seems likely that both of these explosions could have been prevented. The explosion in Chengdu received extensive press coverage in both China and the United States, and prompted several news organizations in the United States to launch investigations of the working conditions in the facilities supplying Apple products.

On January 25, 2012, the New York Times published "In China, Human Costs Are Built Into an iPad" as part of a series of articles that later won a Pulitzer Prize, which describe the explosion in Chengdu and outlined other practices on the part of Foxconn including the 'fact' that many workers were putting in 12 to 14 hour days six and seven day a week. In response to the New York Times article, Apple CEO Tim Cook sent an email the next day to all Apple employees that said in part "Any suggestion that we don't care is patently false and offensive to us."[25] Other media picked up the Apple story and a performance artist, Mike Daisey, began performing a show called "The Agony and the Ecstasy of Steve Jobs" [26] which purported to intertwine facts about Steve Jobs with descriptions by workers at Foxconns production facilities of horrible working conditions. Although Mike Daisey was forced to admit that he had made up the interviews with the Chinese workers, his show received a great deal of media coverage and continued the pressure on Apple.

On February 13, 2012, Apple asked the Fair Labor Association, an outside agency, to inspect the conditions in the factories that produce Apple products in China. There were complaints from some other groups, including the Labor Right Forum, that the Fair Labor Association was not independent.[27] The Fair Labor Association is collaboration between NGO's, corporate sponsors (who are also members) and universities who produce licensed goods such as logo apparel. Since much of their income derives from corporate members for whom they provide audits, there have always been concerns about their independence. Complaints about the thoroughness and independence of the Fair Labor Association continued even after it issued its first report.[28] In its first report, the Fair Labor Association

[25] *Tim Cook Responds to Claims of Factory Worker Mistreatment: We Care About Every Worker in Our Supply Chain* http://9to5mac.com/2012/01/26/tim-cook-responds-to-claims-of-factory-worker-mistreatment (last visited Mar. 14, 2014).

[26] The Agony and the Ecstasy of Steve Jobs, http://vimeo.com/31211973, (last visited Mar. 13, 2014).

[27] Charles Duhigg and N. Wingfield, *Apple Asks Outside Group to Inspect Factories*, N.Y. Times Bits, (Feb. 13, 2012), http://bits.blogs.nytimes.com.

[28] Scott Nova and Isaac Shapiro, *Polishing Apple Fair labor Association Gives Foxconn and Apple Undue Credit for Labor Rights Progress*, Economic Policy Institute Briefing Paper 352, Nov. 8, 2012.

found that workers at Foxconn were not being paid for overtime,[29] that workers often work ten to twelve hours a day, and that Foxconn "hired" large numbers of student interns. Also in February 2012 Change.org delivered petitions signed by 250,000 people asking Apple CEO Tim Cook to put pressure on Foxconn to improve the labor conditions in its factories.[30]

On April 18, 2012 CNBC's "Squawk on the Street" carried an interview critical of Apple. An analyst from Calvert Investments suggested that Apple should improve working conditions at Foxconn, "…if it hopes to sustain its iconic brand…". The sustained bad publicity was beginning to have a serious impact on Apple's public image. Apple was also facing more competition as other companies introduced smart phones and tablets; if Apple consumers became unhappy as a result of the bad publicity there were now other choices in the marketplace.

The Chinese government was also starting to increase pressure on manufacturers to adhere to the Chinese labor laws and increase worker's wages. As the Chinese economy has continued to develop and expand, China has had to balance its fear that manufacturers will relocate to other countries if they enforce their labor and environmental laws against increasing political and labor unrest.[31] The Chinese labor law provides that all companies with over 25 employees must allow the All-China Federation of Trade Unions, the only union permitted in China, to represent their workers. There are no restrictions on management participation in the Union's leadership, and there is widespread consensus that the Chinese use the Union to limit labor unrest; Foxconn facilities are "unionized".

The Chinese government has used a multi-pronged strategy in trying to achieve seemingly contradictory goals. It has made a substantial investment in infrastructure, building major highways from the highly industrialized coastal areas to the western provinces in order to allow manufacturing firms to easily access cheaper labor in Western China.[32] Chinese regulators have raised the minimum

[29] 2010 Annual Public Report, Fair labor Association http://www.fairlabor.org/report/2010-annual-public-report (last visited Mar. 15, 2014)

[30] Connie Gugliemo, Apple *Supplier Foxconn Raises Pay – Again*, http://www.forbes.com/sites/connieguglielmo/2012/02/17/apple-supplier-foxconn-raises-pay-again/ (last visited Feb. 17, 2012).

[31] Jason Dean and Ting-I Tsai, *Fallout from Hon Hai Widens; Chinese Official Calls for Better Conditions After Spate of Suicides; Company Plans 20% Raise*, WALL ST. J., (online) May 30, 2010.

[32] Christine M. Westphal & Susan C. Wheeler, *Increasing Wages in China: Government Manipulation of Wage Rates Without Direct Regulation*, 18 *N.E. J. OF LEGAL STUD.* 4 (2007).

wage in the industrialized coastal provinces, in order to encourage companies to move their operations inland and they have targeted companies that are either captive to the Chinese consumer market or that hope to capture a significant share of the Chinese consumer market for enforcement of its labor laws. Foxconn, with its significant investment in China and hopes of moving into the actual production of its own consumer electronics, and Apple, with its need to expand into China with its smart phones and tablets, are both now susceptible to enforcement pressure by the Chinese government.

THE RESPONSE OF FOXCONN AND APPLE

On February 17, 2012 Foxconn announced that it was going to significantly raise the wages of its workers by 16 to 25 percent. [33] The company also announced that it was hiring counselors and increasing social activities at its facilities.[34] Foxconn stated that it would limit working hours to 49 hours per week with a maximum of 36 hours of overtime per month, which would meet the expectations of the Chinese labor law. Some workers expressed dissatisfaction with the new rules, stating that they thought 60 hours of overtime per month was more reasonable.[35] Even with the reports of unsafe conditions and labor abuse, Foxconn continues to attract Chinese workers who migrate from the rural villages to seek manufacturing work.[36] Because labor costs are such a small part of the overall costs in the production of consumer electronics, the increase in wages at Foxconn is unlikely to have a significant impact on the cost of Apple products. Apple is still receiving a premium for innovation on its products, and would still be extremely profitable if it allowed its costs to rise without raising its product prices.

After negotiating with Apple, Foxconn ultimately raised wages by 30 per cent; Apple agreed to increase its payments to Foxconn in order to subsidize the higher wages.[37] Foxconn had already started to relocate its manufacturing facilities inland. It is estimated that wages and other costs at inland facilities in China are approximately one third cheaper. In order to further limit the impact of higher wages and the potential loss of productivity that might be caused by limiting overtime Foxconn had its subsidiaries increase their margins

[33] *Id*. at 6.

[34] Amanda Ciccatelli, *iPhone Supplier Foxconn Misses Labor Targets,* Inside Counsel, Dec. 2013.

[35] *Id.*

[36] Reuters, *Migrants Flock to Foxconn Jobs Despite Labor Probe*, http://www.cnbc.com/id/46500872 (Last visited Feb. 23, 2012)

[37] Reuters, *Foxconn Profit Surges in Third Quarter*, N.Y. TIMES, Oct. 31, 2012 at B1.

on the smaller components used in Apple products.[38] With these changes, Foxconn was able to triple its operating margins between 2011 and 2012.[39]

The combination of increased wages, less forced overtime and moving manufacturing facilities inland where migrant workers would be closer to their families, has resulted in an overall sense that working conditions have improved at Foxconn facilities. This was confirmed by the latest Fair Labor Association audit of Foxconn facilities, although the FLA did note that Foxconn is still requiring workers to put in more overtime than is specified in the Chinese Labor Law.[40]

Even though Foxconn has increased its profits as it has increased wages and improved working conditions, coping with the issues raised by Apple and other stakeholders has caused Foxconn and its parent Hon Hai Precision Industries to alter its basic strategy. The company has increased its focus on meeting stakeholder expectations with robust sections of its annual reports and website dedicated to social responsibility.[41] As costs have increased on mainland China, Hon Hai is looking to other Asian locations to lower costs and is in the process of investing in new facilities in Indonesia.[42] The company is also beginning to move directly into the production of its own consumer electronics and moving up the value chain.[43] Finally, Foxconn is anticipating that it will build high tech factories in the United States in order to build large scale TV screens of over 60 inches which are difficult to ship from Asia.[44] Moving some manufacturing to the U.S. will also allow Foxconn to get closer to U.S. based clients such as Apple.[45] The chair of Hon Hai, Terry Gou has called the U.S. '…a must-go market'.[46]

[38] Sarah Mishkin, *Foxconn Keeps Growing in Apple's Shadow*, FINANCIAL TIMES, Apr. 4, 2013.

[39] *Id.*

[40] *Labor Group Sees Progress at Major Apple Supplier*, N.Z. HERALD, Dec. 13, 2013

[41] *2012 SER Annual Report, at 13.* http://ser.foxconn.com/downloadAttachment/8abe98dc40ccfa2a0140e31573a6000a/2012+Foxconn+SERAnnual+Report.pdf (last visited Mar. 24, 2014)

[42] *Corrected-Hon Hai to Launch Indonesia Handset Operation in 2014*, (Oct. 7, 2013, 11:01 PM) http://www.cnbc.com/1010936 (last visited Jan. 15, 2014)

[43] *Hon Hai's Consumer-Led Shift to Boost Margins, Cut Costs,* (Nov. 12, 2013, 3:59 *PM)* http://www.cnbc.com/id/101192433 (last visited Jan. 15, 2014)

[44] Ansuya Harjani, *Apple Manufacturing Partner Looks to Build Factory in the US*, (Jan. 26, 2014, 8:32 PM) http://www.cnbc.com/id/101364554 (last visited Jan. 27, 2014)

[45] Faith Hung, *Update 2 – Foxconn Eyes Factories in US, Indonesia as China's Lustre Fades*, (Jan. 27, 2014, 2:27 AM) http:www.cnbc.com/id/101364995 (last visited Mar. 6, 2014)

[46] *Id.*

While Apple has not altered its fundamental business practices, it has become more nimble at addressing its stakeholder and image issues. As Foxconn has increased the cost of Apple products, Apple has begun to shift to other, less expensive manufacturing facilities in China. It has contracted with another Taiwan-headquartered company, Pegatron, to manufacture the new IPhone 6 in China.[47] While Pegatron will lower Apple's costs, it is experiencing many of the same labor problems that Foxconn faced including reports by China Labor Watch, a New York based worker's rights group that Pegatron is pressuring workers to put in excessive overtime, holding workers identification cards and endangering worker safety.[48]

When Reuters reported that a 15 year old worker had died as a result of working for Pegatron, Apple responded immediately, dispatching its own medical team to investigate.[49] That team determined that the 15 year old had used his 21-year-old cousin's identification to obtain work at Pegatron, and that his death from pneumonia was unrelated to his employment at Pegatron.[50] Other Apple suppliers, such as Biel Crystal, which manufactures screens for Apple, have also been accused of violating worker rights in the last year.[51] Apple continues to have the Fair Labor Association audit its suppliers and to pressure suppliers to conform to its supplier code of conduct.

CONCLUSION

Beth Stephens, in her article "The Amorality of Profit; Transnational Corporations and Human Rights", has pointed out that it is difficult for individual governments to regulate the employment, investment, and product practices of multinational corporations.[52] For many countries, direct foreign investment by multinational corporations is viewed as the only way to achieve economic expansion and alleviate the poverty of the majority of its citizens, which further limits their desire to regulate employment practices of multinational corporations. It would seem that stakeholder pressure may be the only way to insure that the low-wage workers who now manufacture

[47] *Pegatron Expanding China Capacity to Manufacture iPhone 6*, (Mar. 17, 2014, 11:45PM) http://www.cnbc.com/101501690 (last visited Mar. 19, 2014)

[48] Sarah Mishkin, *Apple Supplier Accused of Labour Violations*, FIN. TIMES, (Jul. 29, 2013) http://www.cnbc.com/id/100922725 (last visited Jan. 15, 2014)

[49] *Update 2-Appe Says Death at Pegatron Unrelated to Working Conditions,* (Dec. 12, 2013, 11:10 AM) http://www.cnbc.com/101268627 (last visited Jan. 15, 2014)

[50] *Id.*

[51] Beth Stephens, The Amorality of Profit: Transnational Corporations and Human Rights, 20 BERKELEY J. INT'L L., 45 (2002)

[52] *Id.* at 54.

the bulk of our consumer goods are treated fairly. While Foxconn appears to have altered its business strategy and practices to positively improve the lives of its workers in China, it remains to be determined whether their somewhat new found social responsibility will be transferred to its new lower cost facilities in Indonesia.

Apple's quick response to negative reports on the working conditions at its suppliers indicates that it remains concerned that the practices of its suppliers will tarnish its corporate image, but its unwillingness to rethink its business practices leave it vulnerable to ongoing bad publicity. Apple's code of social responsibility and the audits that are performed for it by the FLA have been instrumental in highlighting the abusive practices of its business partners. Apple's inability or unwillingness to rethink its own practice of aggressively negotiating the lowest possible costs from its suppliers will continue to result in foreseeable worker abuses. Achieving a balance between the desire for low cost and a commitment to its code of social responsibility may be impossible, but to the extent that Apple remains willing to pressure its suppliers to conform to its code of conduct, it may still be able to help bring better working conditions to the low wage workers in newly industrialized areas of the world.