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WHEN IS A BIDDER A PURCHASER WITHIN THE MEANING OF SECTION 2(a) OF THE ROBINSON-PATMAN ACT?

by WILLIAM E. GREENSPAN*

I. INTRODUCTION

Imagine a hypothetical situation whereby the City of Springfield is interested in buying a fleet of thirty dump trucks. It solicits prices from two Mack Truck Corporation independent retail dealers, one in Springfield, and one sixty miles distant in Newtown. Since dump trucks are made to order, each dealer solicits bids from Mack Truck, the manufacturer of the trucks. Mack Truck offers to sell the trucks to the Newtown dealer at a fifteen percent discount, and to the Springfield dealer at a ten percent discount. The Springfield dealer refuses Mack's offer solely because of the discriminatory price. The City of Springfield awards the contract to the Newtown dealer. Mack Truck sells the fleet of dump trucks to the Newtown dealer who then resells the trucks to the City of Springfield at a nice profit. The Springfield dealer sues Mack Truck, claiming a violation of Section 2(a) of the Robinson-Patman Act which prohibits a seller of commodities from discriminating in price between **purchasers** of goods of like grade and quality where the effect of such discrimination may lessen competition in any line of commerce.[1]

* Professor, School of Business, University of Bridgeport.

[1] 15 U.S.C. § 13 (a) (2006). *See* Mary Whisner, *What's in a Statute Name?*, 97 LAW LIBR.. J. 169, 174 (2005) (noting that "the Robinson-Patman Act has a raft of aliases: Antitrust Act of 1914 Amendment, Robinson-Patman Price Discrimination Act, Robinson-Patman Anti-Discrimination Act, Price Discrimination Act, Chainstore Act; Goodness, all

Mack Truck files a motion to dismiss for failure to state a claim upon which relief can be granted. More specifically, Mack claims no single sale can violate the Robinson-Patman Act. At least two transactions must take place in order to constitute a price discrimination. A purchaser is one who purchases, a buyer, a vendee, not a bidder or one who seeks to purchase. Uniquely, Mack is arguing that it tried to violate Section 2(a) of the Robinson-Patman Act, but it failed because the Springfield dealer refused to purchase Mack's product at the discriminatory price. Should the court grant Mack's motion to dismiss? The resolution of this narrow issue is of great importance to manufacturers, independent dealers, and consumers in situations where manufacturers entertain bids on the sale of their goods to independent dealers who then resell to consumers. Typically the manufactures who invite bids on products made to order include truck, bus, farm machinery, furniture, carpet, and drug manufacturers, as well as book publishers and producers of petroleum and electric equipment. The independent dealers encompass retail equipment dealers who sell agricultural, construction, industrial and outdoor power equipment; independent bookstores; healthcare and medical supply companies; gasoline service station dealers; and other business entities who are buyers and sellers of commodities. The consumers include contractors, architects, utilities, and municipalities, as well as ultimate consumers of the products. In a nutshell, price discrimination touches upon almost everyone, including taxpayers.

This paper will discuss: (1) a brief history of Section 2 (a) of the Robinson-Patman Act, (2) a summary of early Robinson-Patman cases deciding the issue whether a bidder is a purchaser, (3) a recent United States Supreme Court decision, *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.,*[2] clarifying the issue, and (4) analysis, observations and recommendations for further consideration.

II. A BRIEF HISTORY OF SECTION 2(A) OF THE ROBINSON-PATMAN ACT

Congress passed the first antitrust law in 1890, the Sherman Act, which outlaws contracts, combinations, or conspiracies in restraint of trade as well as monopolization and attempts to monopolize.[3] In order to supplement the Sherman Act and to keep large numbers of small competitors in business, Congress passed the Clayton Act in 1914.[4] The original Section 2 of the Clayton Act outlawed price discrimination

these names for a statute that only covers three pages in the *Statutes at Large!*").

[2] 126 S.Ct. 880 (2006).

[3] 15 U.S.C. § § 1-2 (2006).

[4] 38 Stat. 730, Ch. 323, 15 U.S.C. § § 12-30 (1914).

among purchasers where price differentials were not based upon differences in grade, quality, or quantity, or in cost of transportation, nor made in good faith to meet competition.[5] Because there were concerns that Section 2 of the Clayton Act permitted unconditional quantity discounts, and that the Act only regulated competition among sellers (primary-line violations), and did not cover discrimination among buyers (secondary-line violations), Congress enacted the Robinson-Patman Act in 1936 to amend Section 2 of the Clayton Act.[6] Commentators agree the purpose of the Act is to protect small retailers.[7]

Section 2(a) of the Robinson-Patman Act states in part: "It shall be unlawful for any person engaged commerce … to discriminate in price between purchasers of goods of like grade and quality … where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of any commerce." In addition, the Act provides for exceptions such as quantity discounts that are not unjustly discriminatory, and for meeting competition in good faith.[8]

For example, suppose Sun Oil Company, an integrated supplier-retailer of Sunoco gasoline, supplies gasoline to thirty-eight competing

[5] 15 U.S.C. § 13 (1914). Section 4 of the Clayton Act allows "any person injured in his business or property by reason of anything forbidden in the antitrust laws" to sue for treble damages and attorney's fees. 15 U.S.C. § 15 (2006). Congress also enacted the Federal Trade Commission Act 1914 which gives the Federal Trade Commission power to enforce violations of the antitrust laws. 15 U.S.C. § § 41 et. Seq. (2006).

[6] 15 U.S.C. § 13(a) (1936). *See* Federal Trade Commission v. Fred Myer, Inc., 390 U.S. 341, 349 (1968) (stating the preposition that "the Robinson-Patman Act was enacted in 1936 to curb and prohibit all devices by which large buyers gained discriminatory preferences over smaller ones by virtue of their greater purchasing power") ; Federal Trade Commission v. Anheuser-Busch, Inc., 363 U.S. 536 (1960) (commenting that "the 1936Robinson-Patman amendments to the Clayton Act were motivated principally by congressional concern over the impact upon secondary-line competition of the burgeoning of mammoth purchasers, notably chain stores."); Automatic Canteen Company of America v. Federal Trade Commission, 346 U.S. 61 (1953) (noting that "enforcement of the Clayton Act's original declaration against price discrimination was so frustrated by inadequacies in the statutory language that Congress in 1936 enacted sweeping amendments to that Act contained in what is known as the Robinson-Patman Act.").

[7] *See* David F. Shores, *Economic Formalism in Antitrust Decisionmaking,* 68 ALB. L. REV. 1053, 1083 (2005) (stating that Congress "intended to prohibit price discrimination undertaken with an intent to discipline or to exclude a competitor"); Richard C. Schragger, *The Anti-Chain Store Movement, Localist Ideology, and the Remnants of the Progressive Constitution, 1920-1940,* 90 IOWA L. REV. 1011, 1063 (2005) (commenting that there "was no question that the purpose of the Act was to protect the small retailer."); Kathleen Codey, *Convenience and Lower Prices, But at What Cost?: Watching Closely as Discount Superstores Creep into Manhattan,* 13 J.L. & POL'Y 249, 280-281 (2005) (nothing the Robinson-Patman Act "reflects congressional concern that the influx and spread of chain stores across the United States would destroy competition because small businesses would be unable to compete with the lower prices of chain stores.").

[8] 15 U.S.C.§ § 13(a) (b) (2006).

retail dealers in Jacksonville, Florida. Further, Sun grants a price reduction of four cents per gallon to one of its retail dealers, but not to any of the other thirty-seven retail dealers. In the absence of Sun being able to assert a defense such as quantity discount or meeting competition in good faith, this would violate Section 2 (a) of the Robinson-Patman Act. More specifically, this would be a secondary-line violation whereby Sun's price discrimination injures competition among its customers. The disfavored retail dealers are now at a competitive disadvantage and will probably lose business to the favored dealer.[9]

However, what if a disfavored Sun dealer refuses to purchase gasoline from Sun at a discriminatory higher price. Is an interested purchaser, who does not in the end consummate the deal, an injured party?

III. A SUMMARY OF EARLY ROBINSON-PATMAN CASES DECIDING THE ISSUE WHETHER A BIDDER IS A PURCHASER

The overwhelming authority, as evidenced by numerous court decisions since the passage of the Robinson-Patman Act, is that a prospective buyer, or one who seeks to purchase a commodity, is not a "purchaser" as the word is used in Section 2(a) of the Robinson-Patman Act. One of the first, often-cited cases deciding this issue is *Shaw's Inc. v. Wilson-Jones Co.*[10]

Wilson-Jones manufactured supplies for election purposes, and sold them to dealers such as Shaw's, who then resold the supplies to ultimate purchasers. Shaw's had been purchasing supplies from Wilson-Jones for three years when it stated to Wilson-Jones its intention to bid upon a contract to supply the Registration Commission of Philadelphia with certain materials required by the Commission. Wilson-Jones repeatedly refused to quote prices to Shaw's and five days before the bids were due, Wilson-Jones notified Shaw's that Wilson-Jones would not quote prices for Shaw's. Instead Wilson-Jones quoted a price only to Dunlap Company, a competitor of Shaw's. Dunlap won the contract with the Registration Commission. Shaw's sued Wilson-Jones alleging a violation of section 2(a) of the Robinson-Patman Act.[11] Affirming the district court, the court of appeals held there was no violation of the Robinson-Patman Act:

[9] Federal Trade Commission v. Sun Oil Co., 371 U.S. 505 (1963). If Sun lowered its price below cost (predatory pricing) to all its retail dealers in order to try to drive smaller gasoline suppliers in Jacksonville out of business, then this would be a primary–line violation, where Sun's discriminatory price adversely impacts competition with Sun's direct competitors. *See,* Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967).

[10] 105 F. 2d 331 (3rd Cir. 1939).

[11] *Id.* at 332.

> The discrimination in price referred to must be practiced "between different purchasers." Therefore at least two purchases must have taken place. The term purchaser means simply one who purchases, a buyer, a vendee. It does not mean one who seeks to purchase , a person who goes into the market-place for the purpose of purchasing. In other words, it does not mean a prospective purchaser, or one who wishes to purchase, as Shaw's contends.[12]

Shaw's argued that it was a purchaser because it had been doing business with Wilson-Jones for three years and therefore was a costumer, a purchaser. The court of appeals rejected this argument stating that "past purchases or conversations in respect to possible future purchases are insufficient" to meet the purchaser requirements of Section 2(a).

> We think it is clear that [Shaw's] has not alleged such facts as would constitute a cause of action under the provisions of Section 2 (a). Since no goods or commodities were offered to [Shaw's], the terms of [Section 2 (a)] are not met. The Act does not compel a seller of commodities to offer them to all persons who may wish to bid upon a contract to resell them to a third party. The discrimination in price prohibited by [Section 2 (a)] is discrimination in respect to commodities sold to purchasers.[13]

Shaw's stands as precedent for numerous cases in other jurisdictions. Consider *Monroe Company of Quincy v. American Standard Inc.,*[14] in which American Standard was in the business of selling plumbing and heating supplies and equipment to wholesalers, such as Monroe. Monroe was buying and reselling American Standard products to retailers for forty-seven years when American Standard announced that it would no longer sell to Monroe. American Standard refused to accept orders from Monroe. Monroe alleged American Standard committed a violation of Section 2 (a) of the Robinson-Patman Act.[15]

The court granted American Standard's motion to dismiss explaining "it is well settled that the Act does not require a seller to do business with anyone he chooses not to deal with." Citing *Shaw's*, the court stated "it is also well settled that for any discrimination in price 'between different purchasers' to have taken place within the meaning of the Act, there must have been at least two purchases." Finally, the court noted that the "language of the Act itself [indicates] that Congress did not intend to prevent sellers from selecting their own customers in bona fide transactions and not in restraint of trade." The "termination of one

[12] *Id.* at 333.
[13] *Id.* at 333-34.
[14] 368 F. Supp. 603 (D.C. Mass. 1973).
[15] *Id.* at 604.

distributor in favor of another has been upheld as perfectly lawful and not in restraint of trade under the Robinson-Patman Act.[16]

This review of Section 2 (a), as well as cases holding a bidder is not purchaser, sets the stage for a recent United States Supreme Court decision, *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.*[17] Decided on January 10, 2006, this was the Court's first Robinson-Patman Act case in the past twelve years.[18]

IV. *VOLVO TRUCKS NORTH AMERICA v. REEDER-SIMCO*

The *Volvo* decision has serious implications on a disfavored retailer's ability to mount a successful §2 (a) price discrimination claim in a competitive bidding situation. At the same time this decision will influence the ability of a manufacturer to engage in individual, case-by-case discounting practices in competitive bidding situations.

A. Volvo—Just the Facts

Volvo manufactures heavy-duty trucks. Reeder is an authorized Volvo heavy-duty truck dealer assigned a geographic territory encompassing ten countries in Arkansas and two in Oklahoma. Reeder sells trucks through a competitive bidding process. When a retail customer wants to buy a fleet of trucks, the customer seeks bid from franchised dealers of different manufacturers. The customer describes its specific product requirements and invites bids from several dealers. The customer's "decision to request a bid from a particular dealer is based on factors such as an existing relationship, geography, reputation, and cold calling."[19]

After a customer submits its product requirements to a Volvo dealer, the dealer turns to Volvo and requests a discount or concession off the wholesale price. It is common practice in the industry for a manufacturer

[16] *Id.* For other examples of cases finding that a bidder is not a purchaser under Section 2 (a), *see* Fusco v. Xerox Corp., 676 F.2d 332, 335 (8th Cir. 1982) (noting no single sale can violate the Act); M.C. Manufacturing Company, Inc. v. Texas Foundries, Inc., 517 F.2d 1059, 1065 (5th Cir. 1975) (recognizing there must be actual sales at two different prices); Maier-Schule GMC, Inc. v. General Motors Corporation, 780 F.Supp. 984,989 (W.D.N.Y. 1991) (noting the plaintiff failed to show that it was a purchaser of trucks at the time of the alleged discriminatory sale); Uniroyal, Inc. v. Hoff and Thames, Inc., 511 F.Supp. 1060, 1068 (S.D. Miss. 1981) (finding there was no proof that the plaintiff actually purchased tires at different prices); J.W. Burress, Inc. v. JLG Industries, Inc., 491 F.Supp. 15, 19 (W.D. Va. 1980) (holding no case has gone so far as to allow recovery for what the plaintiff here terms a "continue discriminatory offer to sell").

[17] 126 S.Ct. 860 (2006).

[18] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., Robinson-Patman Act does not ban all price differences charged to different purchasers of commodities of like grade and quality).

[19] 126 S.Ct. 860 at 866.

to offer a dealer a discount on a case-by-case basis, taking into account such factors as industry-wide demand and whether the retail customer has purchased a different brand of trucks in the past. After Volvo submits the discounted wholesale price to the dealer, the dealer then uses that price in preparing its bid for the retail customer. The dealer purchases trucks from Volvo only if and when the retail customer accepts the dealer's bid. So one might say the trucks are manufactured to order.[20]

Although a Volvo dealer may bid outside its territory, Volvo dealers rarely bid against each other. In the rare situation where a retail customer solicits a bid from more than one Volvo dealer, Volvo's policy is to provide the same price discount to each dealer competing head to head for the same sale.[21]

In 1997, Volvo announced its "Volvo Vision." Volvo felt it had too many dealers. It decided to enlarge each dealer's market while, at the same time, reduce the number of Volvo dealers by 50%. Reeder suspected it was one of the dealers Volvo decided to eliminate after Volvo gave a more favorable discount to another dealer. In February, 2000, Reeder filed suit in a federal district court against Volvo claiming, among other things, a secondary-line violation of Section 2 (a) of the Robinson-Patman Act.[22]

In the federal district court Reeder presented evidence of price discrimination in three categories: The first category included "comparisons of concessions Reeder received for four successful bids against *non-Volvo* dealers, with larger concessions other successful Volvo dealers received for *different* sales on which Reeder did not bid." These were "purchase-to-purchase comparisons." The second category included "comparisons of concessions offered to Reeder in connection with several unsuccessful bids against *non-Volvo* dealers, with greater concessions accorded other Volvo dealers who competed successfully for *different* sales on which Reeder did not bid." These were "offer-to-purchase comparisons." The third category included "evidence of two occasions on which Reeder bid against another Volvo dealer." These were "head-to-head" comparisons.[23]

The jury returned a verdict for Reeder finding "there was a reasonable possibility that discriminatory pricing may have harmed competition between Reeder and other Volvo truck dealers, and that Volvo's discriminatory pricing injured Reeder." The jury awarded

[20] *Id.* at 866-87.
[21] *Id.* at 867.
[22] *Id.*
[23] *Id.* at 870-71

damages to Reeder in the amount of $1,358,000 which the trial court trebled, and awarded Reeder attorney fees.[24] Volvo appealed.

B. Volvo—The Federal Court of Appeals

Volvo made two basic arguments before the U.S. Court of Appeals for the Eighth Circuit. First, in all the situations where Reeder claimed it lost sales because of Volvo's discriminatory pricing practices, Reeder was merely an unsuccessful bidder, not a "purchaser" as required by the Robinson-Patman Act.[25] Second, Reeder was not able to show a reasonable possibility of injury to competition in these competitive bidding situations as required by the Robinson-Patman Act.[26]

In response to Volvo's argument that Reeder was not a purchaser, the court of appeals agreed, citing *Shaw's*, that "an unsuccessful bidder is not a purchaser within the meaning of the Robinson-Patman Act." Applying that principle to this case, the court recognized that when "Reeder unsuccessfully bid on contracts because Volvo's price concessions were not favorable enough to obtain the contracts, Reeder did not actually purchase the trucks from Volvo…. Volvo may have offered to sell trucks to Reeder at a higher price than it offered to the other dealers, but mere offers to sell do not violate the Robinson-Patman Act."[27]

However, in this case, opined the court, "Reeder was more than an unsuccessful bidder. Reeder gave four examples where it actually purchased Volvo trucks following successful bids on contracts…. These successful bids clearly gave Reeder 'purchaser' status."[28]

Turning to Volvo's second argument, that Reeder was not able to show a reasonable possibility of injury in these competitive bidding situations as required by the Robinson-Patman Act, the court rejected this argument. The court explained that there is "no dispute the dealers all competed at the same functional level."[29] In addition, contrary to

[24] *Id.* at 868.

[25] Reeder-Simco GMC, Inc. v. Volvo GM Heavy Truck Corporation, 374 F.3d 701, 708 (2004).

[26] *Id.* at 709.

[27] *Id.* at 708.

[28] *Id.* at 709. Other recent cases support the view that unrelated successful bids give one "purchaser status." *See* DeLong Equip Co. v. Washington Mills Electro Minerals Corp., 990 F.2d 1186, 1202 (11th Cir. 1993) (identifying that DeLong was qualified for approval as a vendor; even "minimal sales" made by an otherwise unsuccessful bidder are enough for a bidder to state a Robinson-Patman Act claim); Toledo Mack Sales & Service, Inc. v. Mack Trucks, Inc., No. 02-CV-4373 , 2005 U.S. Dist. LEXIS 11052, at 22* (E.D. Pa. Mar. 29, 2005) (indicating that Toledo Mack was more than an unsuccessful bidder. Toledo supplemented it expert report and compared those successful sales to actual sales made by other dealers during the same time period.).

[29] *Id.*

Volvo's claim that Reeder did not compete within the same geographic market as the favored dealers, "although Reeder had an assigned geographic area, it was free to sell outside that area, and did so…. Reeder established that end-buyers of the trucks are very mobile and price-shop nationwide." Further, concluded the court, the "evidence presented by Reeder was sufficient for the jury to conclude Volvo's discriminatory concessions resulted in lost profits and sales to Reeder and other dealers, and that favored competitors received substantial price reductions over a substantial period of time."[30]

Thus, in a 2-1 decision, the Court of Appeals for the Eighth Circuit affirmed the jury's verdict, rejecting Volvo's arguments. In dissent, Judge Hansen wrote that the majority was making an "attempt to fit a square peg into a round hole" in secondary-line injury cases "in a unique marketplace where special order products are sold to individual, pre-identified customers only after competitive bidding":

> By its very nature, this process will never produce the kind of competition the Robinson-Patman Act was designed to protect…. Indeed, where at the time of the end purchase, only one possible seller and one possible buyer exist, competition is totally absent. It is the nature of competitive bidding, not price discrimination, that makes it so….
>
> The court properly recognizes that a competitive bidding situation will never involve two "purchasers," and … despite this determination, however, the court goes on to conclude that Reeder's purchases with respect to four transactions give it "purchaser status" as to separate instances in which it did not make a purchase…. Reeder cannot piggyback nonpurchaser transactions onto purchase transactions for the purposes of recovering under the Robinson-Patman Act.[31]

In essence, the majority was stating that if a buyer has preexisting relationship with a seller, the buyer is a "purchaser" for all transactions with that seller, even unconsummated transactions, for purposes of analysis under the Robinson-Patman Act. In addition, the majority decided that the entire United States was a relevant geographic market, thereby eliminating a manufacturer's choice to engage in separate pricing structures depending upon the unique conditions in a particular geographic area. In dissent, Judge Hansen, noted the majority's reasoning was clearly in conflict with the wording and intent of the Robinson-Patman Act which requires competitive injury, implying the result will be rigid, standardized pricing structures that will limit the vigor of competition in competitive bidding situations.

[30] *Id.* at 709-12.
[31] *Id.* at 718.

Because there was a conflict among the federal courts of appeals on the issue of "purchaser status" in competitive bidding situations, the United States Supreme Court granted Volvo's writ of certiorari on March 7, 2005. There was substantial interest in this case as partly evidenced by the number of amicus curiae submissions. These submissions included the United States of America, Washington Legal Foundation, American Petroleum Institute, National Electrical Manufacturers Association, Truck Manufacturers Association, North American Equipment Dealers Association, and National Automobile Dealers Association.[32]

C. Volvo—The United States Supreme Court

In a 7-2 decision, The United States Supreme Court reversed the Eighth Circuit. Delivering the opinion of the Court, Justice Ginsburg framed the question: "May a manufacturer be held liable for secondary-line price discrimination under the Robinson-Patman Act in the absence of a showing that the manufacturer discriminated between dealers competing to resell its product to the same retail customer?"[33]

Concerning the purchase-to-purchase comparisons and the offer-to-purchase comparisons, the Court stated these situations fall short of the injury to competition targeted by the Robinson-Patman Act since Reeder did not compete with beneficiaries of the alleged discrimination *for the same customer*. "Reeder simply paired occasions on which it competed with *non-Volvo* dealers for a sale to Customer A with instances in which other Volvo dealers competed with *non–Volvo* dealers for a sale to Customer B.... We decline to permit an inference of competitive injury from evidence of such a mix-and-match, manipulable quality.[34]

Turning to the two transactions in which Reeder claims it competed head to head with another Volvo dealer, the Court noted "Reeder did not establish that it was *disfavored* [as compared with] other Volvo dealers in the rare instances in which they competed for the same sale—let alone that the alleged discrimination was substantial."[35]

Commenting on Volvo's broader argument—"because Robinson-Patman only prohibits discriminating between different *purchasers,* the Act does not reach markets characterized by competitive bidding and special-order sales, as opposed to sales from inventory"—the Court refused to accept that interpretation. Instead, the Court responded: "We

[32] 125 S.Ct. 1596 (2005) (granting motions for leave to file briefs as amicus curiae to the National Association of State Directors of Pupil Transportation, the Truck Manufacturers Association, et al., and the Washington Legal Foundation; and granting petition for writ of certiorari to the United States Court of Appeals for the Eighth Circuit).

[33] Volvo Trucks North America, Inc. v. Reeder-Simco, Inc., 126 S.Ct. 860 (2006).

[34] *Id.* at 871.

[35] *Id.* at 872.

need not decide that question today."[36] However, the Court did give some guidance on how that issue might be resolved:

> The Robinson-Patman Act, we hold, does not reach the case Reeder presents. The Act centrally addresses price discrimination in cases involving competition between different purchasers for resale of the purchased product. Competition of that character ordinarily is not involved when a product subject to special order is sold through a customer-specific competitive bidding process. [37]

Finally, the Court noted that interbrand competition is the "primary concern of antitrust law." We "resist interpretation geared more to the protection of existing *competitors* than to the stimulation of competition…. By declining to extend Robinson-Patman's governance to [this case], we continue to construe the Act consistently with broader policies of the antitrust laws."[38]

V. ANALYSIS, OBSERVATIONS, AND RECOMMENDATIONS

So, one may ask, just what did the Supreme Court hold in *Volvo?* Manufacturers cannot be held liable for secondary-line price discrimination under the Robinson-Patman Act in the absence of a showing that the manufacturer discriminated between dealers competing to resell its product to the same retail customer. In addition, the Court suggested that even if a manufacturer discriminates in price between two dealers competing with each other to resell the manufacturer's products to the same customer, a court should consider which holding would be best serve the primary purpose of the antitrust laws which is to protect competition, not competitors. The Court did not decide that issue, although it noted the Robinson-Patman Act ordinarily does not apply to a customer-specific competitive bidding process.[39]

As a consequence of the *Volvo* decision, competitive bidding is alive and well. Interbrand competition is in while price rigidity is out. The Supreme Court has struck a delicate balance between the purpose of the

[36] *Id.*

[37] *Id.* at 866.

[38] *Id.* at 872-73. Justice Stevens, with whom Justice Thomas joined, dissenting, argued that "by adopting a novel, transaction-specific concept of competition, the Court eliminates that statutory protection in all but those rare situations in which a prospective purchaser is negotiating with two Volvo dealers at the same time…. Nothing in the statute or in our precedent suggests that competition is evaluated by a transactions-specific inquiry, and such an approach makes little sense." *Id.* At 873-876.

[39] *Id.* at 870-73. *See also,* B-S Steel of Kansas, Inc. v. Texas Industries, Inc., No. 04-905, 2006 U.S. App. LEXIS 5109, at *43 (10th Cir. Feb. 28, 2006) (noting that it is "well established that a refusal to deal simple does no fall within the proscription of Section 2(a) of the Robinson-Patman Act").

Robinson-Patman Act to protect competitors and the overall purpose of the antitrust laws to preserve interbrand competition. The Supreme Court correctly decided *Volvo*. Expanding competitive bidding to the prohibitions of Robinson-Patman would lead to price rigidity. Rather than risk liability, manufacturers would consider eliminating all discounts. It has long been settled that a manufacturer independently has the right to refuse to deal with a customer.[40] Reeder failed in its attempt to use Robinson-Patman to achieve what it could not obtain from Volvo through contract negotiations.

It is now a little easier to counsel companies on what competitive bidding structures are legal? What advice can one give to manufacturers, dealers, and consumers involved in competitive bidding situations? Manufacturers may continue to offer price discounts to selected independent dealers without running afoul of the Robinson-Patman Act as long as those dealers are not competing for the same consumer. When pricing a product, a manufacturer should consider factors other than price such as whether the consumer is a past customer who is inclined to stay with that brand. Is the consumer soliciting other manufacturers? Is the manufacturer operating at full capacity? What is the current demand for the product? Is the consumer price conscious? However play it safe in "head-to-head" bidding situations by offering the same discount to independent dealers who are working with the same potential consumer.

Independent dealers will have to compete on factors in addition to price. Successful dealers need to establish good relationships with consumers by emphasizing their efficient service, impeccable reputation and favorable geographical location. Give special payment terms and extended warrantees on products. Offer discounts on replacement parts and service. Provide technician and driver training. Make cold calls. Perform service to the community such as by sponsoring a little-league team.

Consumers should seek bids from several independent dealers. Negotiate , negotiate, negotiate. Ask about price, service, warranties, and other benefits. Compute the costs of switching from one brand to another. Check with local agencies and trade publications that report on the quality of products and the reputation of manufacturers.

VI. CONCLUSION

As a result of the *Volvo* decision, the winners are primarily manufacturers who engage in individual, case-by-case discounting practices in competitive bidding situations, as well as ultimate consumers who can secure the best possible prices. The losers are the

[40] Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 601 (1985).

independent dealers who will have a more difficult time mounting a successful § 2(a) price discrimination claim in competitive bidding situations such as the Springfield independent dealer described in the introduction to this paper. However, the Supreme Court leaves open the possibility of a successful Section 2(a) claim in head-to-head competitive bidding situations.[41] So now, in future § 2(a) cases, an alleged disfavored dealer in a competitive bidding situation will have to show that it is a "purchaser" and that it is engaged in "head-to-head" competition with a favored dealer. However, the question for another day in a § 2(a) case is whether a manufacturer's price quotes to two competing dealers will constitute separate "purchases" rather that offers to purchase. Meanwhile, *Shaw's* still stands as good precedent that a bidder is not a purchaser.

The United States Supreme Court has indicated that it is more concerned with the primary purpose of the antitrust laws, which is the protection of interbrand competition, rather than individual competitors. It appears there has been a shift in Robinson-Patman Supreme Court philosophy from protection of competitors to preserving competition. There is a tension between the Robinson-Patman Act's original purpose to protect small retailers from large chains and current Supreme Court economic, antitrust policy to preserve competition. There will be a continuing challenge for courts to apply the Robinson-Patman Act in such a way, with its "inherent complexity and confusion,"[42] to promote interbrand competition. In the words of one commentator, "perfect competition is a theoretical limiting case that exists only in our imagination."[43] The Supreme Court's decision in *Volvo* promotes leniency and flexibility in competitive bidding situations. It is a positive step in the direction for preserving free and open competition.

[41] *See* Clinton C. Carter, *The Robinson-Patman Act: The Law of Price Discrimination,* 64 ALA. LAW. 246, 248-49 (2003) (explaining it is "important to note that intent is not a necessary element to establish a valid claim under the Robinson-Patman Act. Sellers of goods must be aware of potential violations of antitrust law, and attorneys should be prepared to advise their clients of the proper steps to avoid liability.").

[42] *See* Marianne M. Jennings, *The Economics and Legalities of Slotting Fees and Other Allowances in Retail Markets,* 21 J.L. & COM. 1, 28 (2001) (recognizing the "history of the Robinson-Patman Act reflects substantial emotion and disagreement over its role despite its relatively brisk passage.").

[43] James C., Cooper, S. Tschantz, D.P. O'Brian, & L. Froeb, *Does Price Discrimination Intensify Competition? Implications for Antitrust*, 72 ANTITRUST L.J. 327, 369 (2005).

LEADERSHIP STYLES AND COMMON LAW LIABILITY: WHAT ARE THE RISKS?

by JANET W. HAGEN, PH.D.* and WILLIS W. HAGEN II, S.J.D.**

I. INTRODUCTION

Management is critically and properly concerned about the leadership of the organization. In the field of business management there are many journals solely dedicated to articles exploring the many facets of leadership including development and outcomes. What is leadership? According to most accounts, leadership is a process, act, or influence that "gets people to do something."[1] Yukl noted that "the study of leadership has been an important and central part of the literature of management and organization behavior for several decades."[2]

The importance of competent and ethical leadership within an organization cannot be over estimated. On one side of the issue is the positive result of good leadership. For example, in his book entitled "Good to Great," Jim Collins reviewed Fortune 500 companies that for fifteen years fell below the industry average for performance. From those companies, he found eleven companies that in the following fifteen years performed above the industry average. In each of the cases, the

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[1] Joanne B. Ciulla, *Leadership Ethics Mapping the Territory*, 5 BUS. ETHICS Q. 5, 5 (1995).

[2] G. Yukl,, *Managerial Leadership: A Review of Theory and Research*, 15 J. MGMT 251, 251 (1989).

turn-around could be attributed to a new chief executive officer (CEO) whose leadership changed the profitability of the company.[3]

On the other side of the issue is the negative result of poor leadership. In 1996 Texaco negotiated a $176 million settlement with its employees in order to avoid an employment discrimination lawsuit that Texaco would have likely lost. Critical to that settlement was the discovery of tape recordings of a 1994 meeting in which oil company executives disparaged black employees and plotted to hide or destroy evidence.[4]

In a more recent situation, the demise of Enron cost its employees more than $1 billion. Kenneth Lay and Jeffrey Skilling, former executives, denied more than thirty-six counts of conspiracy and fraud and attribute the failure to a "run on the stocks."[5] Nonetheless, according to some analysts, Enron's organizational culture and management style contributed to a culture of silence that forced employees to go along with questionable management decisions.[6]

In particular, Skilling's micro-management style and "rank and yank" policies resulted in an intense competition among Enron executives. Robert J. Hermann, Enron's former tax counsel, described the culture of Enron as "all about 'me first, I want to get paid,'" Hermann said. "I used to tell people if they don't know why people are acting a certain way, go look up their compensation deal and then you'll know. There were always people wanting to do deals that didn't make sense in order to get a bonus." Whenever possible, financial incentives were used to shore-up a 'loose-tight' management style."[7] Clearly, financial disaster can ensue from leadership gone amuck, but can potential common law liability be determined based on leadership style? In addition to profits, ethics and corporate culture, should researchers also examine the potential for common law liability since the common law has virtually universal application to business entities?

In this article, there will be an overview of two historical figures in leadership followed by a short history of the development of modern views of leadership styles culminating with the three styles of leadership most commonly discussed in the current management literature. Next, a review of potential areas of common law liability related to business leaders will be presented. Finally, an analysis will be presented of

[3] JIM COLLINS, GOOD TO GREAT: WHY SOME COMPANIES MAKE THE LEAP...AND OTHERS DON'T (2001).

[4] Thomas S. Mulligan, *Texaco Bias Case Decision Has Glass Ceilings Rattling*, N.Y. TIMES, Dec. 8, 1996.

[5] Peter Behr & April Witt, *Visionary's Dream Led to Risky Business*, WASH. POST, July 28, 2002, at A01.

[6] *See Id.*

[7] *See Id.*

leadership styles and their susceptibility, or lack thereof, to the significant areas of common law liability.

II. HISTORICAL BACKGROUND OF LEADERSHIP

The study of leadership obviously could be traced as far back as the beginnings of the social groupings of human kind; however, for the purposes of this article only two notable historical leaders will be referenced.[8] Genghis Khan is perhaps one of the most notorious leaders of all time. He conquered most of Asia and central Europe in the fifty years before 1258 A.D. His leadership style compares favorably to many attributes ascribed to leadership excellence by the modern theorist. Specifically, leadership and promotion were based on merit, high level of discipline and loyalty—achieved in no small measure by the egalitarian nature of his rule.[9] Even the choice of his successor, which was one of his three sons, was determined by the other two sons. Another factor was his openness to new technology, including an elaborate and accurate system of colored flags used to communicate, almost instantaneously, decisions for troop movement of tens of thousands of soldiers across vast distances.[10] His legendary ruthlessness was, at least in part, the result of a single-mindedness of purpose: to acquire new routes and technology. Because he was not particularly interested in new subjects, his troops routinely killed the entire population of any city or state that resisted him. Self-discipline, aggressiveness and flexibility characterized his leadership style. Management scholars sometimes compare the management styles of Dell and Walmart corporations, among others, to Genghis Khan.[11] Though Khan clearly showed no mercy to those who did not submit, most historians agree that he was not necessarily more bloodthirsty than the people he conquered, his organization was just more efficient.

In *Conversations of Socrates*, Xenophon reports that Socrates (469-399 B.C.) tries to dissuade one brother from pursuing politics, but encourages the other brother to enter the political arena. Naturally, this persuasion takes the form of questioning and in this questioning Socrates highlights the necessary abilities and concerns of heads of state: generation and preservation of material prosperity, as well as an understanding of the strength of the state's resources, strengths and

[8] Isaac Cheifetz, *Management Secrets of Genghis Khan*, Business/Technology Section, MINNEAPOLIS STAR TRIBUNE, Jan. 17, 2005, at A01.

[9] *Id.*

[10] *Id.*

[11] *Id.*

weaknesses.[12] Socrates, at least in this conversation, does not go into the style of leadership that would best be suited to achieve those goals.

III. MODERN LEADERSHIP THEORIES

The modern study of leadership can be traced to Max Weber (1864-1920), a German sociologist, who developed a cyclical model of organizational development to explain how and what type of leadership emerges in an organization at any given time. Weber postulated that the power to compel others to follow centered on the legitimacy of authority that is manifested in one of three leader/follower models: traditional, charismatic, and bureaucratic.[13]

According to Weber, the traditional leader has power through the force of tradition, inheritance or by cronyism.[14] Authority is given by the force of loyalty and legitimacy of status. Weber viewed capitalism as somewhat of an ideal in that people are provided for in a fair and equitable manner based on technical expertise. Traditional leadership is an anathema to capitalism which is its major disadvantage; the ability of the leader to make utterly capricious demands or rules. The advantage of traditional leadership is the potential for many years of stability to an organization; if traditional leaders are so inclined, they can provide high quality and stable leadership. [15]

The charismatic leader is an individual whose personality, morals, values, energy or vision sets him or her apart from other people. Weber equated this type of leader to a hero—a transformer. The basis of authority is personal charisma. Charismatic leadership occurs in an organization that is in need of rejuvenation. The most important advantage of this leadership style is that it allows the organization to escape from traditional inertia. The most important challenge is to maintain vigor in the inevitable transition to more traditional administration.[16]

The bureaucratic leader is one who rules through authority given by the organization. Followers do not obey the leader as a person but rather as a natural consequence of rules and a hierarchy of position and influence. Weber contended that capitalism fostered bureaucracy. Bureaucratic leadership in organizations has the potential to achieve the greatest efficiency. Nonetheless, in practice, pieces of the organization are frequently turned into small kingdoms, what is commonly called

[12] XENOPHON, CONVERSATIONS OF SOCRATES, translated by Tredennick/Waterfield (Penguin 1990).

[13] MAX WEBER, MAX WEBER: THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION, translated by A. M. Henderson & Talcott, Parsons. NY: The Free Press (1947).

[14] *See Id.*

[15] *See Id.*

[16] *See Id.*

"turf," which stunts the potential efficiency. Weber saw this bureaucratic form of organization and leadership and administration as one that paralleled the mechanism of industry that occurred during the same time frame as Weber developed his theory.[17]

Other early entries into organizational leadership theory were similarly influenced by the efficiencies of the new technology of industry but changed the focus. One school came to be known as "classical management theory" which focused on the design of the total organization.[18] This management theory was the precursor to such recent methods as "management by objectives" first outlined by Peter Drucker in 1954.[19] Drucker continues to be a management guru with many books and articles published. He is famously said to have reported: "Management by objectives works if you first think through your objectives: 90% of the time you haven't."[20]

Another school was "scientific management," postulated by Frederick Taylor, which focused on a systematic management of individual jobs. The emphasis of this theory was on control and efficiency. These innovations provided dramatic improvements in productivity and profitability when used judiciously. When used exclusively, they were dehumanizing to the workers and ultimately affected quality as well as quantity.[21]

Both of the preceding theories had, through different means, a similar purpose: to ensure the highest level of productivity in an organization. Prior to this, beginning in the mid-1940s, there was a shift from these mechanistic models to a more worker-centered style that understood that workers are more effective and efficient when their needs are met. Maslow's Hierarchy of Needs[22] provided a visual model to understand people's inborn needs. Those needs that must be satisfied first are those pertaining to our physical, social and safety issues. Further, in order to achieve worker productivity the higher order ego and self-actualizing needs postulated by Maslow must also be met. Herzberg's Dual Factor

[17] *See Id.*

[18] A. Stone Gregory & Kathleen Patterson, *The History of Leadership Focus*, PROCEEDINGS OF AM. SOCIETY OF BUS. & BEHAV. SCI.., vol. 13, no. 1, 2077 (Feb., 2006).

[19] PETER DRUCKER, THE PRACTICE OF MANAGEMENT (1954).

[20] PETER DRUCKER, THE BEST OF SIXTY YEARS OF PETER DRUCKER'S ESSENTIAL WRITINGS ON MANAGEMENT 257 (2003).

[21] FREDERICK WINSLOW TAYLOR, 1911 PRINCIPLES OF SCIENTIFIC MANAGEMENT, published in Norton Library by arrangement with Harper & Row (1967).

[22] Abraham Maslow in his book entitled "Motivation and Personality" used a pyramid to explain the needs of human beings. At the base of the pyramid were the physiological needs followed by safety and security, love and belonging, esteem and at the top of the pyramid, self actualization. When he was developing his theory he studied exemplary people such as Eleanor Roosevelt and Albert Einstein. The hierarchy of needs has since become one of the most popular and often cited theories of human motivation. ABRAHAM MASLOW, MOTIVATION AND PERSONALITY (1943).

Theory[23] similarly addressed the needs of workers: hygiene, or extrinsic rewards, which include working conditions, company policies, etc., and motivators, or intrinsic rewards, which include those factors of the job itself.

James MacGregor Burns studied the work of Weber and additionally incorporated Kohlberg's[24] scholarship regarding stages of moral development. Burns operationalized Kohlberg's theory of moral stages in terms of high or low moral behavior, rather than in a strict stage theory. Burns' theories were further developed by his observation of political leaders and, from their behavior, he postulated two types of leadership styles: transactional and transformational. In Burns' view, transactional leaders compared to the bureaucratic style, and transformational leaders compared to the charismatic style.[25]

Transactional leadership is based on bureaucratic authority, focuses on task completion, and relies on rewards and punishment. Transactional leadership has its focus on the management of the status quo

[23] Frederick Herzberg in his book entitled "The Motivation To Work" interviewed employees to determine which factors caused satisfaction and dissatisfaction with work. He developed the motivation-hygiene theory in which hygiene factors were maintenance factors, required for job performance, but not in themselves sufficient to provide satisfaction. Hygiene factors are things such as salary, company policies, and relationship to the boss. Motivation factors are those that bring satisfaction to an employee such as achievement, recognition and advancement. Despite its weaknesses, Herzberg is still widely read. His lasting contribution is the notion that true motivation comes from internal factors. FREDERICK HERZBERG, THE MOTIVATION TO WORK (1959).

[24] In the book entitled "Lawrence Kohlberg's Approach to Moral Education," Kohlberg breaks the development of morality into three stages. Each of these stages consists of two components. In the first stage—the *preconventional level* (self-focused morality: up to age nine) – morality consists of following rules and avoiding negative consequences. Further, anything that satisfies the child is seen by the child as good. In the second stage – *the conventional level* (other focused morality: from age nine to adolescence)—morality consists of understanding and adhering to the expectations of those important to them such as parents and teachers. Moral behavior is behavior that fulfills obligations and expectations. In the third stage—the *post conventional level* (higher focused morality: adulthood)—morality is understood as varying from group to group and cultural to culture. Behavior is understood as right or wrong from a contextual basis and upholding the values of one's own group or culture is moral. F.C. POWER, A. HIGGINS & L. KOHLBERG, LAWRENCE KOHLBERG'S APPROACH TO MORAL EDUCATION (1989). Carol Gilligan, the internationally recognized psychologist, criticized Kohlberg's work in her book entitled "In a Different Voice" because of the study sample he used: privileged, white men and boys. In Gilligan's view the limited sample selection caused a serious lack of generalizability and created a bias both in terms of gender and privilege. For example, in Kohlberg's stage theory of moral development, "individual rights and rules" were considered a higher stage of development than "caring in human relationships." The former is a stereotypical male world view and the second a stereotypical female world view. This demonstrates the insidiousness of both gender and cultural discrimination in terms of leadership selection and development. CAROL GILLIGAN, IN A DIFFERENT VOICE (1993) (second printing).

[25] JAMES MACGREGOR BURNS, LEADERSHIP (1978).

and maintenance of the daily operations of a business. Transactional leaders negotiate and bargain over the means to the end. The weakness in this leadership style is the lack of focus on identifying the organization's strategic plan, how employees can meet the goals toward fulfilling the plan, how productivity toward goals can be achieved and, ultimately, how to increase the organization's overall profitability. A transactional leader is a broker making the tradeoffs between competing interests in order to keep an enterprise or a ship of state on an "even keel."

Of transformational leadership, Burns wrote, "I define leadership as leaders inducing followers to act for certain goals that represent the values and the motivations-the wants and needs, the aspirations and expectations-of *both leaders and followers*. The leader is not merely wielding power, but appealing to the values of the follower … transforming leadership ultimately becomes moral in that it raises the level of human conduct and ethical aspiration of both leader and the led, and thus it has a transforming effect on both."[26] Burns believes that for leaders to have the greatest impact on the "led," they must motivate followers to action by appealing to shared values and by satisfying the higher order needs of the led, such as their aspirations and expectations.[27]

Bernard Bass developed the concept of transactional leadership more fully in his 1985 book *Leadership and Performance Beyond Expectations*. Bass reports that, according to several large meta analysis, transformational leadership is more effective, productive, innovative and satisfying to followers than is transactional leadership. Further, people's natural views of leadership tend to be transformational rather than transactional.[28] According to the most recent publication [29]regarding the characteristics of the transactional leader, the following are the essential attributes: 1) vision, 2) trust, 3) respect, 4) risk-sharing, 5) integrity, 6) modeling, 7) commitment to goals, 8) communication, 9) enthusiasm, 10) rationality, 11) problem-solving, 12) personal attention, 13) mentoring, 14) listening, and 15) empowering.

One of the weaknesses of transformational leaders is that they are very good at the vision, the big picture, but they are often not good at the details, where, as it is said, the devil often lurks. If they do not have people to take care of this level of information, then they are usually doomed to fail. An additional concern is that quintessential transformational leaders will be tireless and passionate about their vision,

[26] *See id.* at 13.
[27] *See id.*
[28] Gregory & Patterson, *supra* note 18.
[29] *Id.* at 2087.

charismatically encouraging people to follow their lead: some writers indicate that the power differential in leader to follower really does not give followers the control to promote their own self-interests.[30]

The third leadership style, commonly discussed and written about today, is servant leadership. Servant leadership is a style and term that originated with Robert Greenleaf. This style puts serving the greater needs of others as the primary goal of leadership.[31] Larry Spears reported that Greenleaf's writings incorporated ten major attributes of servant leadership. These included: 1) listening receptively to what others have to say, 2) acceptance of others and having empathy for them, 3) foresight and intuition, 4) awareness and perception, 5) having highly developed powers of persuasion, 6) an ability to conceptualize and to communicate concepts, 7) an ability to exert a healing influence upon individuals and institutions, 8) building community in the workplace, 9) practicing the art of contemplation, and 10) recognition that servant leadership begins with the desire to change oneself. Once that process has begun, it then becomes possible to practice servant leadership at an institutional level.[32]

Both researchers and leaders have gravitated toward transformational leadership in the last decade. Similarly, the concept of servant leadership has received significant attention in the contemporary leadership field. The research base on transformational leadership throughout the 1990s was well-grounded and extensive; the level of research regarding servant leadership has yet to move into significant empirical studies, although recently some empirical based literature has become available, notably team effectiveness.[33]

Recently, some researchers have questioned whether any significant difference lies between transformational and servant leadership. Professor A. Gregory Stone and his coauthors posit that the primary difference is one of leader focus.[34] In transformational leadership, the focus is directed toward the organization, and leadership behavior builds follower commitment toward organizational objectives, while the servant

[30] BERNARD M. BASS, LEADERSHIP AND PERFORMANCE BEYOND EXPECTATIONS (1985).

[31] R.K. GREENLEAF, SERVANT LEADERSHIP: A JOURNEY INTO THE NATURE OF LEGITIMATE POWER AND GREATNESS (1977).

[32] Larry Spears, *Reflections on Robert K. Greenleaf and Servant Leadership*, LEADERSHIP & ORGANIZATION DEV. J., vol. 17, no. 7, 33-35 (1996).

[33] Justin A. Irving & Gail J. Longbotham, *Servant Leadership Predictors of Team Effectiveness: Findings and Implications*, PROCEEDINGS OF AM. SOCIETY OF BUS. & BEHAV. SCI., vol. 13, no. 1, 862-73 (Feb., 2006).

[34] A. GREGORY STONE, ROBERT F. RUSSELL & KATHLEEN PATTERSON, TRANSFORMATIONAL VERSUS SERVANT LEADERSHIP: A DIFFERENCE IN LEADER FOCUS (2004).

leader's focus is on the followers, and the achievement of organizational objectives is a subordinate outcome.[35]

Other researchers have questioned whether the movement to develop more leaders in business is useful. They consider that when managers become leaders it is often unclear what better leaders are supposed to do, or how better leaders should treat people. This ambiguity poses problems in the ability of an organization to evaluate its leadership. Additionally, they consider the question of how much short-run profit must be exchanged for a more ethical corporate culture.[36]

The previous discussion sets the stage for the essential question, "In what ways might the potential legal liability of a leader be exacerbated by a particular leadership style." For example, at what point does a transactional leader sharing a vision become merely a power wielder insisting on his own vision? What legal liability might arise from power wielding?

IV. RELEVANT COMMON LAW CONCEPTS

A. Business Judgment Rule

The business judgment rule is a concept developed by common law which is designed to protect the discretion given to business leaders in handling the affairs of the organization.[37] Under this rule, courts will not second-guess the decision of the business leader,[38] provided the leader exercised a minimum level of care in making the decision.[39] Generally, the business judgment rule creates a presumption that in making a business decision, the business leader acted on an informed basis, in good faith, and honestly believed that the action taken was in the best interest of the entity.[40] The rule, however, applies only if there was, in fact, a business decision. In other words, the rule does not

[35] *Id.*

[36] Andrea Giampetro-Meyer, S.J. Timothy Brown, M. Neil Browne & Nancy Kubasek, *Do We Really Want More Leaders in Business?*, J. BUS. ETHICS., vol. 17, no. 15, 1727-36 (1998).

[37] *See* Ironite Products Co., Inc. v. Samuels, 17 S.W. 3d 566 (Mo. App. 2000).

[38] *See, e.g.* In re Bal Harbour Club, Inc., 316 F.3d 1192 (11th Cir. 2003); Federal Deposit Ins. Corp. v. Jackson, 1333 F.3d 694 (9th Cir. 1997).

[39] *See, e.g.* FDIC v. Castetter, 184 F.3d 1040 (9th Cir. 1999) (applying California law); Smith *ex rel* Boston Chicken, Inc. v. Arthur Anderson L.L.P., 175 F. Supp. 2d 1180 (D. Ariz. 2001) (applying Colorado law).

[40] Poth v. Russey, 281 F. Supp. 2d 814 (E.D. Va. 2003) (applying Virginia law); In re Sagent Technology, Inc. Deriv. Litig, 278 F. Supp. 2d 1079 (N.D. Cal. 2003 (applying Delaware law); Kloha v. Duda, 246 F. Supp. 2d 1237 (M.D. Fla. 2003) (applying Florida law).

protect a business leader where there has been an omission and the loss occurred from the business leader's passively doing nothing.[41]

In *Aronson v. Lewis,*[42] the Delaware Supreme Court stated that the rule creates a presumption that in making a decision the business leaders "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." The court went on to state that "absent an abuse of discretion, that judgment will be respected by the courts ... [and that the] burden is on the party challenging the decision to establish facts rebutting the presumption." Consequently, the business judgment rule immunizes the business leader from liability unless the plaintiff can demonstrate: 1) the business leader did not actually make a decision,[43] 2) the decision of the business leader was uninformed,[44] 3) the business leader was not disinterested or independent,[45] or 4) the business leader was grossly negligent.[46] While the business judgment rule relieves a business leader of liability except for gross negligence, generally a business leader must exercise the care that an ordinary prudent person would exercise under similar circumstances.[47] In applying the business judgment rule, a business leader is protected where the business leader exercised slight care in reaching the decision.[48] In applying the duty of care, courts examine the efforts of the business leader in arriving at the decision rather than the wisdom of the decision itself.[49]

[41] *See* Hoye v. Meek, 795 F.2d 893 (10th Cir. 1986) (finding semi-retired director, who usually failed to attend meeting liable for breach of his duty of care in delegating too much authority).

[42] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[43] Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (the rule did not protect directors where they did not make a decision); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (the directors were grossly negligent in informing themselves, the business judgment rule will not protect them).

[44] Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 384 (2nd Cir. 1980); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors were grossly negligent and the business judgment rule did not protect them).

[45] FDIC v. Castetter, 184 F.3d 1040 (9th Cir. 1999); Patrick v. Allen, 355 F. Supp. 2d 704 (S.D. N.Y. 2005).

[46] FDIC v. Jackson, 133 F.3d 694 (9th Cir. 1997); Resolution Trust Corp. v. Acton, 844 F. Supp. 307 (N.D. Tex 1994).

[47] FDIC v. Stahl, 854 F. Supp. 1565 (S.D. Fla. 1994); Resolution Trust Corp. v. Heiserman, 839 F. Supp. 1457 (D. Colo. 1993).

[48] McMullin v. Beran, 765 A.2d 910 (Del. 2000); Kahn v. Roberts, 679 A.2d 460 (Del. 1996); Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1993); Smith v. Van Gorkon, 488 A.2d 858 (Del. 1985) (business judgment rule did not protect uninformed decision).

[49] WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 1032 (2005).

B. Good Faith

An element of the business judgment rule is the concept of good faith. In order for the business leader to avail himself or herself of the business judgment rule, the business leader must have acted in good faith. The business judgment rule is premised on the concept that the business leader must, at least, have acted in good faith to avoid liability for a business decision or practice that has a negative effect on the organization.

The concept of good faith has its roots in Roman law[50] and countries having civil law generally require good faith in contracts.[51] In the nineteenth century, the courts in the United States were hesitant to recognize a "generalized duty of good faith."[52] Currently, the courts of the United States impose a duty of good faith in many business transactions and relationships.[53]

An understanding of the concept of good faith can be gleaned from various sources. In the general provisions of the Uniform Commercial Code (U.C.C.), which apply to all articles therein, the term good faith is defined as "honesty in fact in the conduct or transaction concerned."[54] In applying this definition a subjective test is used.[55] The reasonableness of the belief of the person is irrelevant to the issue of good faith.[56] Accordingly, under the U.C.C., if a person has a "pure heart and an empty head," he or she is acting in good faith.[57]

The Restatement of Contracts provides significant meaning to the concept of good faith by imposing a duty of good faith and fair dealing.[58] This concept, unlike Section 1-203 of the U.C.C., does not deal with good

[50] *See* E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 669-70 (1963).

[51] B.J. Reiter, *Good Faith in Contracts*, 17 VAL. U. L. REV. 705, 708 (1983).

[52] Eric M. Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381, 384 (1978).

[53] E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 667 (1963); Russell A. Eisengerg, *Good Faith Under the Uniform Commercial Code - - A New Look at an Old Problem*, 54 MARQ. L. REV. 1, 1 n.1 (1971).

[54] U.C.C. § 1-201 (19) (2006).

[55] WILLIS W. HAGEN II & GORDON H. JOHNSON, DIGEST OF BUSINESS LAW 130 (3rd ed. 1986).

[56] JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 9-10, at 353 (3rd ed. 1987); 1 RONALD A. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 1-201:84 (3rd ed. rev. 1992).

[57] CALAMARI & PERILLO, *supra* note 56, § § 11-38, at 509-10; ANDERSON, *supra* note 56, at § 1-201:96.

[58] RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979); *See* Robert S. Summers, *The General Duty of Good Faith. It's Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 824 n.61 (1982).

faith in the formation of a contract, but rather deals with business actions in general.[59] Consequently, since this concept of good faith seemingly involves an objective test, the courts can rule against business leaders that engage in improper conduct even though the party engaging in the challenged conduct believed it to be proper.[60]

In evaluating whether a person acted in good faith, the courts have held that the concept of good faith is broad, nebulous, and variable.[61] Moreover, the concept of good faith is used in a variety of relationships and its meaning varies somewhat with the relationship.[62] Good faith in the area of performance deals with faithfulness to an agreed common strategy.[63] The concept of fair dealing, which is implicit in good faith in this context, requires more than just honesty.[64]

Professor Summers concluded that the obligation of good faith is an "excluder."[65] He stated that good faith "is a phrase without general meaning (or meanings) of its own and serves instead to exclude a wide range of heterogeneous forms of bad faith."[66] Similarly, the Restatement provides that good faith excludes a variety of actions characterized as "bad faith" because such conduct does not adhere to community standards of decency, fairness or reasonableness.[67]

C. Duty of Care

In addition to being immunized for business decisions that negatively affect the organization, business leaders also have a duty of care that applies to the performance of their jobs. To meet the duty of care, business leaders must exercise an informed business judgment. The legal standard is whether the business leader availed himself or herself of all reasonably available material information concerning the basis for the decision.[68] This duty of care occurs because of the relationship of the employment and without any specification regarding such a duty.[69] Furthermore, a business leader, such as a corporate officer, will not be

[59] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 comment c (1979).

[60] RESTATEMENT (SECOND) OF CONTRACTS § 205 comment d (1979).

[61] Russell A. Eisengerg, *Good Faith Under the Uniform Commercial Code - - A New Look at an Old Problem*, 54 MARQ. L. REV. 1, 3-4 (1971).

[62] RESTATEMENT (SECOND) OF CONTRACTS § 205 comment a (1979).

[63] *Id.*

[64] RESTATEMENT (SECOND) OF CONTRACTS § 205 comment d (1979).

[65] Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 262 (1968).

[66] *Id*. at 201-02.

[67] RESTATEMENT (SECOND) OF CONTRACTS § 205 comment a (1979).

[68] *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[69] People's State Bank v. Jacksonian Hotel Co., 87 S.W.2d 111 (Ky. 1935).

relieved of liability for breach of a fiduciary duty by the fact that his or her superiors did not fulfill their fiduciary duty.[70]

Business leaders are liable for breach of a fiduciary duty even if they acted in good faith.[71] There is no liability, however, for a breach of the fiduciary duty where the breach did not cause any loss to the organization.[72] Nevertheless, there is liability for lack of profits from the breach of the fiduciary duty even though the corporation has not experienced any actual loss.[73]

Beyond the duty to exercise reasonable care, business leaders have been liable for other obligations to the organization that they lead. Business leaders are liable for wilful and intentional deviations from their duty,[74] fraudulent breaches of trust,[75] and *ultra vires* acts.[76] In addition, business leaders have been liable for the tort of interference with a contractual relationship for causing a breach of contract.[77]

The standard of care typically imposed on business leaders is that of ordinary care.[78] In the case of business leaders, ordinary care means the degree of care which men or women of ordinary prudence would exercise in similar circumstances, or in managing their own affairs.[79] The specific degree of care to which the business leader must adhere depends on the circumstances.[80] While business leaders are liable for negligence in management,[81] generally, more than mere ordinary negligence is required.

Specifically, in *In re United Artists Theater Company*, the court examined the issue of whether the management practice could be the basis for liability.[82] In this case, there was an agreement with the entity

[70] 19 C.J.S. 2d § 476, at 77.

[71] Robinson v. Watts Detective Agency, Inc., 685 F.2d 729 (C.A. Mass. 1982), *cert. denied* Consolidated Service Corp. v. Robinson, 459 U.S. 1105 (1983).

[72] Martin v. Hardy, 232 N.W. 197 (Mich. 1930).

[73] Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186 (6th Cir. 1974), *appeal after remand*, 625 F.2d 738 (6th Cir. 1980).

[74] McGinnis v. Corporation Funding & Finance Co., 8 F.2d 532 (D.C. Pa. 1925); Green v. National Advertising & Amusement Co., 162 N.W. 1056 (Minn. 1917).

[75] Deal v. Johnson, 362 So. 2d 214 (Ala. 1978).

[76] Fergus Falls Woolen Mills Co. v. Boyum, 162 N.W. 516 (Minn. 1917).

[77] Home Tel. Co. v. Darley, 355 F. Supp. 992 (N.D. Miss. 1973), *aff'd* 489 F.2d 1403 (5th Cir. 1974).

[78] Seafist Corp. v. Jenkins, 644 F. Supp. 1152 (W.D. Wash. 1986).

[79] Phoenix Savings & Loan, Inc. v. Aetna Casualty & Sur. Co, 427 F.2d 862 (4th Cir. 1970); Martin v. Hardy, 232 N.W. 197 (Mich. 1930).

[80] South Penn Collieries Co. v. Sproul, 52 F.2d 557 (3rd Cir. 1931); Harman v. Wilbern, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd* 520 F.2d 1333 (10th Cir. 1975).

[81] *See* Keyser v. Commonwealth Nat'l Financial Corp., 675 F. Supp. 238 (M.D. Penn. 1987); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240 (D. Neb. 1972), *aff'd* 473 F.2d 537 (8th Cir. 1973).

[82] 315 F.3d 217 (Del. 2003).

and its officers, directors and other managers to indemnify the employees for liability for negligence.[83] The court noted that under Delaware law the leaders of the business may obtain indemnity for their own negligence. Under the Delaware corporate statute, the business entity may indemnify the directors and officers "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interest of the corporation."[84]

Courts have had increasing difficulty in ascertaining whether the business leader was "negligent" as opposed to "grossly negligent" in the implementation of corporate governance. As the court in *United Artists* stated, "the art of governing (it is emphatically not a science) is replete with judgment calls and 'bet the company' decisions that in retrospect may seem visionary or deranged, depending on the outcome."[85] Furthermore, business leaders "do not choose between reasonable (non-negligent) and unreasonable (negligent) alternatives, but rather face a range of options, each with its attendant mix of risk and reward."[86] Thus, the court pointed out that the traditional negligence standard does not allow for the nuances to be examined.[87] Accordingly, the court in *United Artists* held that the "Delaware courts have resolved the negligence conundrum in the corporate sphere by evaluating the process by which business leaders reach decisions, rather than the final result of those decisions."[88] In terms of management practices, whether the decision of the business leader was substantially wrong, or resulted from 'stupid,' 'egregious,' or 'irrational' judgment provides no grounds for the business leader to be liable, "so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests."[89] Consequently, under *United Artists* it appears that a showing of gross negligence is necessary for a business leader to lose the protection of the business judgment rule.

D. Fiduciary Duty

In addition to the duty of care, business leaders must have fiduciary duty to the organization that they serve. Unlike mere employees, business leaders have a fiduciary duty to the entity and its stakeholders.[90] The fiduciary duty demands of the business leader "the most scrupulous observance of his duty, not only affirmatively to protect

[83] *Id*. at 222.
[84] 8 Del. Code § 145(a) (2003).
[85] 315 F.3d 217, 231 (2003).
[86] *Id*.
[87] *Id*.
[88] *Id*. at 232.
[89] *Id*.
[90] Herm v. Stafford, 466 F. Supp. 439 (W.D. Ky. 1979).

the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers."[91]

The fiduciary duty exists because the fiduciary serves as the substitute for the party who entrusted the fiduciary with responsibility. Another aspect of the fiduciary relationship is that the fiduciary obtains his or her power from the business entity for the primary purpose of enabling the fiduciary to act effectively.[92] The power that the fiduciary has is delegated to the fiduciary not for his or her own use, but only for the purpose of facilitating the performance of his or her functions.[93]

The bipartite nature of the fiduciary relationship, dealing with the substitution function and the delegation of power, create an inherent problem. While the fiduciary must be entrusted with power to perform his or her job, the possession of the power creates the risk that he or she will misuse it and injure the business entity.[94] Without a delegation of authority, the fiduciary cannot effectively serve the business entity and, simultaneously, the fiduciary then has the capacity to use his or her power to the detriment of the organization. Nevertheless, if the business entity reduces the power delegated to the fiduciary to lessen its exposure to loss, the organization reduces the benefit from the fiduciary relationship. Consequently, the vulnerability of the organization stems from the structure and nature of the fiduciary relationship.

The delegated power that empowers the fiduciary to provide benefit to the business entity also enables him or her to cause loss to the organization.[95] The extent to which the risk of misuse of power depends on the extent of the power delegated to the business leader. Risk may, however, be limited by the protective mechanisms that reduce the probability of the misuse of power.[96] For example, internal financial and operational audits prevent misconduct by business leaders and therefore make breaches of the fiduciary duty less likely.[97]

[91] Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[92] *See* Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in the Common Law*, 29 BUFFALO L. REV. 600 (1980); Samuels, *The Economy as a System of Power and its Legal Bases: The Legal Economics of Robert Lee Hale*, 27 U. MIAMI L. REV. 261, 277 (1973).

[93] Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 809 (1983).

[94] *Id.*

[95] *Id.*

[96] *Id.*

[97] *Id.*

V. APPLICATION OF COMMON LAW TO LEADERSHIP STYLES

A. Business Judgment Rule

The key elements of the business judgment rule are: the rule protects the discretion of the decision-maker, it requires that a decision be made (meaning that omissions are not actionable), and it requires that decision makers use a minimum level of care and act in an informed basis, in good faith, and with an honest belief that the action taken was in the best interest of the entity. In the case of the first element, discretion, the attributes of the three styles do not appear to increase or decrease liability.

In the case of omission however, the transformational style of leadership would seem to be somewhat susceptible since one of the weaknesses of this style of leadership is the tendency to focus on the big picture sometimes to the detriment of the details. Similarly, with the minimum level of care required to act on an informed basis, the transformational leader may not seek the detailed information necessary to make a fully informed decision.

Regarding the requirement that the decision be made in the best interests of the entity, several arguments could be made in favor, and against, each style. In other words, it depends on what you mean by "best interests of the entity." Giampetr-Meyer and her co-authors argue that leadership style requires a trade off between short-run profit (transactional leadership) and a more ethical corporate culture (transformational and servant leadership).[98] Which is the best interest of the entity? If it is short-run profit then both transactional and servant leadership are susceptible to legal liability. If the best interest is an ethical corporate culture, then transactional leadership is more susceptible. Of the three, the style potentially most liable for not acting in the best interests of the entity is the servant leadership style. The goal of servant leadership is to enhance the growth of the individuals within the organization. Greenleaf and his many followers, including Steven Covey and Ken Blanchard, would add, developing the individual *while keeping an eye on the organizational goals*.[99] Yet, those two objectives clearly can be competing.

[98] Giampetro-Meyer et al., *supra* note 36.

[99] R.K. GREENLEAF, SERVANT LEADERSHIP: A JOURNEY INTO THE NATURE OF LEGITIMATE POWER AND GREATNESS (1977). Steven Covey, is, of course, a motivational speaker and leadership guru, as is Ken Blanchard, each of whom have made a cottage industry from their line of books conveying their particular style of wisdom. Covey of the "7 Habits of Effective ... (insert a variety - parent, manager, etc.)" and Blanchard the "One minute ... (again, insert a variety - manager, parent, etc.)."

B. Good Faith

Good faith is somewhat difficult to address because, as the courts have pointed out, the definition is broad, nebulous, and variable. For the purpose of this discussion, the following elements will be considered: honest belief, absence of malice, and an absence of design to defraud or seek an advantage.[100] Additionally, standards of decency, fairness or reasonableness that are common place in the industry will be considered good faith.

In the case of good faith, the leadership style that is most susceptible to legal liability is the transactional style. While it is true that the underlying goal is to improve organizational purpose, the strategies involve specific incentives, a method of motivation by exchanging one thing for another. In other words, leaders provide employees with rewards for their performance compliance. Does the leader follow the standards for fairness or reasonableness? What are considered rewards and what is necessary for compliance? These will be the essential questions in this area of possible liability. As was presented earlier in the Enron case, the transactional style had run amuck with the purpose of the incentives to stabilize what was essentially a sinking ship. Further, compliance had reached the level of fear and silence so that those who were aware of the problems were unable to challenge their superiors.

Both transformational and servant leadership styles have components that, if followed, would always encourage a leader to act in good faith. In fact, much of the discussion of each style includes what can be described as an honest belief and absence of malice. Further, these concepts are underscored by the concepts of reciprocity in transformational leadership and self-sacrifice in servant leadership.

Indeed, according to Bass, moral character and ethical values are essential to the transformational leader. Therefore, leaders, such as Ghengis Khan, who meet many of the charismatic attributes of transformational leaders, cannot be considered transformational.[101] Nonetheless, authors have continued to comment on the problem of narcissism in modern-day transformational leaders. Narcism can result in questionable methods and unethical behavior for the sake of the vision. One such example is the story of the Ford Pinto and its exploding gas tank. [102] Lee Iaccoca, then President of the Ford Motor Company was able to move a car, the Pinto, from conception to production in under twenty-five months when the industry standard was forty-three

[100] BLACK'S LAW DICTIONARY 693 (6th ed. 1990).
[101] BASS, *supra* note 30.
[102] Mark Dowie, *Pinto Madness*, Mother Jones, Sept.-Oct. 1977.

months.[103] The same confidence and single-mindedness that allowed Iaccoca to excel also prevented engineers, once they knew of the Pinto's unsafe gas tank, to tell Iaccoca of the problem. As one engineer responded when asked if anyone had told Iaccoca, "Hell, no, that person would have been fired. Safety wasn't a popular subject around Ford in those days. With Lee (Iaccoca) it was taboo. Whenever a problem was raised that meant a delay on the Pinto, Lee would chomp on his cigar, look out the window and say 'Read the product objectives and get back to work.'"[104] Eventually even Iaccoca knew that the design and placement of the gas tank was faulty, but his cost-benefit analysis gave him the data to continue with production of the Pinto. The cost to Ford was the potential legal damages which he weighed against the profits of going forward with the unsafe design. Ultimately, the cost to between 500-900 Pinto owners was their life. In his autobiography Iaccoca never refers to the Pinto decision.[105] He does report that in his tenure in the automobile industry he made some mistakes, but, goes on to explain that overall his leadership averaged out to be good. Giamptro-Meyer put it succinctly "His lack of empathy for the families who suffered as a consequence of his leadership demonstrates the narcissistic side of his personality."[106] This is a classic example of the legal liability the overzealous transformational leader may incur.

C. Duty of Care

Duty of care requires the degree of skill customarily exercised by others in a similar circumstance which in this case requires business judgments that are informed. In other words, in order to avoid legal liability business decisions must be made on the basis of all reasonably available, and material, information for the business leader. The question becomes, was the process used to make a decision a reasonable process? The results, good or bad, are not considered in the legal concept of duty of care. The more important issue in meeting the duty of care is the requirement that a comparison be made to others in "a similar circumstance." As one can see from the previous discussion, each leadership style will create its own particular set of "circumstance." This is particularly true in that the courts rely on a description of the process of decision making rather than the results of the decision.

Of the three styles, the transactional style is most likely to have met the standard of duty of care in that transactional leaders tend to follow industry standards in terms of particular situations. Transformational

[103] *Id*.
[104] *Id.*
[105] LEE IACOCCA, LEE IACOCCA: AN AUTOBIOGRAPHY (1984).
[106] Giampetro-Meyer et al., *supra* note 36.

leadership, in contrast, does not support an analytical, reflective reasoning process. Further, an understanding of the ambiguity and interconnectedness of problems is anathema to the transformational leaders' ability to persuade followers. A transformational leader must be sure and confident and say "this is the way, I'm sure" rather than "there are many possible directions."

The servant leadership style is most likely to promote reflective behavior, at the same time they are the most likely to alienate their shareholders. Servant leaders typically do not strive for short-run profits. However, if the duty of care requires reflection and a reasonable process, rather than a reasonable outcome, then the servant leadership style is the most likely to avoid legal liability.

D. Fiduciary Duty

The fiduciary duty of a leader is to the entity and its stakeholders. The fiduciary duty requires that the leader protect the interests of the corporation, keep from doing anything that would injure the corporation or deprive it of profit or advantage that the leaders' skills could otherwise bring to it.

The leadership style most susceptible to violating the fiduciary duty is that of the servant leader. It is clear from the characteristics of the style that the profit of the organization is, at most, secondary to the service of the needs of others. Regardless of the duty of care, his or her style of leadership is probably acceptable in large, market leaders such as Johnson & Johnson who have the ability, at this time, to no longer have to focus exclusively on the bottom line. A nonprofit organization may also be one where the profit issue in the fiduciary duty is not applicable.

The emphasis on efficiency and profits in an organization is, by definition, the transactional style of leadership which would be the least likely to have difficulty with fulfilling the fiduciary duty. The transformational leader, if focused on the needs of the organization, rather than any narcissistic sidelines, would likewise be unlikely to have difficulty fulfilling the fiduciary duty.

VI. SUMMARY

Each leadership style has it weaknesses and strengths in developing and managing an organization. Similarly, each leadership style has its weaknesses and strengths related to potential legal liability. For example, in the case of the business judgment rule, both transactional and transformational leadership styles should have little difficulty avoiding liability. Servant leaders have a different focus which is more likely to have potential liability.

With regard to good faith, the transformational style and the servant leadership style support a leader to act in good faith and therefore less likely to have liability. The style most susceptible to liability is the transactional style because of the focus on performance compliance. Duty of care is most likely to have been met by the transactional style. Both transformational and servant leadership styles have limitations with regard to the duty of care that may increase, somewhat, the potential for liability.

In relation to the fiduciary duty, the leadership styles of transformational and transactional leadership will not typically have the potential for liability. Servant leaders, however, because of their focus, may have potential for liability. In summary, existing law provides the most protection for the transactional leadership style because, like the courts, the transactional style is concerned with rules, hierarchy and details. In other words, they are systems governed by similar processes.

Most leaders can avoid legal liability simply by a moral and ethical practice of leadership regardless of the particular style that suits them and their organization. Conversely, all leaders of whatever leadership style will incur serious legal liability if they practice in an unlawful, unethical or fraudulent fashion.

PARALLELS AND LESSONS OF *KELO*: PROPERTY ISSUES IN INTERNATIONAL BUSINESS

by RICHARD J. HUNTER, JR.*

Abstract

In June of 2005, the Supreme Court of the United States issued an important decision further defining the rights of a sovereign to "take" private property for a "public purpose." Although this decision occurred in the context of the American legal system, the principles enunciated nonetheless hold important international practical and policy implications for international business. This paper will outline and discuss the considerable risks posed by governmental property seizures in international business that may impact negatively on the overall investment and business climate. Specifically, *confiscation, expropriation, and nationalization* will be explored, contrasted, and differentiated.

AN AMERICAN CONTEXT

Consider this scenario. The government of *Setonia*,[1] a tiny "bicoastal" republic in Central America, announces its attention to force landowners along on its lush and accessible Pacific Coast to vacate their homes so that the *Setonian* government might develop the area as a part of a "South America Disney Park." While you like *Mickey, Minnie, and*

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[1] *Setonia* is a fictitious country created for the annual "Foreign Direct Investment for Development" workshop in New York City at the United Nations, held under the auspices of the United Nations Institute for Teaching and Research (UNITAR) and the Institute for International Business at Seton Hall University.

Goofey, you also love your vacation paradise! Can a foreign government take the private property of an American or foreign citizen or of an American or foreign corporation, with or without compensation, for such a purpose or for other *more or less* "lofty" ends? A brief view of a recently decided United States Supreme Court case provides an introduction and context to a parallel discussion of the various property risks present in international business.

Kelo v. City of New London—A Precise

On June 23, 2005, the United States Supreme Court rekindled a fierce debate and ruled that local governments had the legal power to force private property owners to sell their property in order to allow private economic development when public officials decide that such an action would benefit the public or would serve an important public purpose. The power of local officials would extend even under circumstances where the property is not "blighted" in the traditional sense and the "new project's success is not guaranteed."[2]

In 2000, the City of New London approved a comprehensive redevelopment plan. The plan, at the core of the dispute in *Kelo v. City of New London,*[3] involved the decision of the New London Development Corporation (NLDC) to turn slightly more than ninety acres of waterfront land into office buildings, modern, upscale housing, a marina, and other facilities to be built near to a $300 million research center being constructed by the pharmaceutical company Pfizer, an important multinational company or MNC.[4] The project, when completed, would create "in excess of 1,000 jobs" and generate nearly $700,000 in annual tax revenues for a city that was still reeling from the closing in 1996 of the Naval Undersea Warfare Center that had once employed more then 1,500 people. The NLDC projected that the development plan would especially "capitalize on the arrival of the Pfizer facility and the new commerce it was expected to attract. In addition to creating jobs, generating tax revenue, and helping to build momentum for the

[2] *See* Charles Lane, *Justices Affirm Property Seizures*, June 24, 2005, *at* http://www.washingtonpost.com (last visited Jan. 17, 2006) (providing commentary on the important implications of Kelo v. City of New London).

[3] 125 S. Ct. 2655 (2005).

[4] However, the facts indicated that the development plan was *not* intended to serve the particular interests of Pfizer or any other private entity. It has long been held that "the sovereign may not take the property of *A* for the sole purpose of transferring it to another private party *B,* even though *A* is paid just compensation." *Id.* at 2661. Likewise, "[a] purely private taking could not withstand the scrutiny of the public use requirement; it would serve no legitimate purpose of government and would thus be void." Missouri Pacific R. Co. v. Nebraska, 164 U.S. 403 (1896). At the same time, however, the Supreme Court has "long ago rejected any literal requirement that condemned property be put into use for the general public." 125 S. Ct. at 2655 (citing Hawaii Housing Authority v. Midkiff, 467 U.S. 229, 244 (1984)).

revitalization of downtown New London…."[5] The plan was also designed to make the City of New London more attractive and to create both leisure and recreational activities on the waterfront and in the park area of the city.

Owners of fifteen homes on 1.54 acres of the proposed site were less than enthusiastic about losing their homes. Two of the residents, Susette Kelo (who had extensively remodeled her home and simply liked the "view") and Wilhelmina Dery (who had been born in this same home in 1918) contacted the libertarian *Institute for Justice*[6] and initiated the lawsuit. There was no allegation that any of the fifteen properties were blighted or were in poor condition. They were *condemned*[7] only because they had the misfortune to be located in the development area. When Kelo and other plaintiffs lost in the Connecticut Supreme Court, they initiated an appeal to the United States Supreme Court on the ground that the scheme of redevelopment was an unconstitutional taking that violated the Fifth Amendment to the United States Constitution.[8]

The United States Supreme Court held that New London was justified in its use of the power of *eminent domain* for purposes of urban revitalization. The decision was not met with unanimous approval—far from it! Many opponents, most notably private property-rights activists for the elderly and for low and moderate income residents, argued that the forcible shift of ownership from one *private owner* to another *private owner*, even if accompanied by reasonable or generous compensation, violates the Fifth Amendment to the United States Constitution, which had traditionally been viewed as requiring that any taking of private property be made for a "public use."[9]

[5] 125 S. Ct. at 2659.

[6] *See* www.ij.org (the website of the Institute for Justice) (last visited Jan. 22, 2006).

[7] The term "condemnation" is used to describe the lawful act of a government in exercising its authority under eminent domain the inherent power of the state to appropriate private property for its own use without the owner's consent. The term *eminent domain* is used primarily in the United States, whereas *compulsory purchase* is used in England and Wales, and *compulsory acquisition* is used in Australia. The term eminent domain was derived in the mid-19th Century from a treatise authored by the Dutch jurist Hugo Grotius in 1625. *See, e.g., Eminent domain*, *at* http://en.wikipedia.org/wiki/Expropriation (last visited Jan. 21, 2006). *See also* James Casner & W. Barton Leach, CASES AND TEXT ON PROPERTY 1257-96 (1969).

[8] "Nor shall private property be taken for public, without just compensation." U.S. CONST. AMEND. V. This clause has been made applicable to the States by the Fourteenth Amendment. *See* Chicago, B. & Q. R. Co. v. Chicago, 166 U.S. 226 (1897).

[9] In 1941, the National Resources Planning Board outlined its views on customary *public uses*—"some of these have emerged within this century but are well established and accepted by the people." These include *public structures*: city halls, courthouses, post offices, office buildings, educational buildings, fire stations, police stations, prisons and jails, health clinics, recreation centers, public rest stations, homes for aged and indigent, libraries, aquariums, aviaries, museums, zoos, incinerators, sewage disposal plants, municipal warehouses, garages, repair shops, greenhouses, dikes and levees, statues,

The Majority View

Justice John Paul Stevens wrote for the majority of the Court. Justice Stevens, who was joined by Justices Anthony Kennedy, David H. Souter, Ruth Bader Ginsburg, and Stephen G. Breyer, cited numerous cases in which the United States Supreme Court had interpreted the "public use" requirement quite broadly[10]—including not only such traditional projects such as schools, highways, parks, and hospitals, but also activities such

monuments, fountains, historic sites, armories, arsenals, navy yards, forts, army-posts, bandstands, and shells; *public areas*: streets, alleys, open squares, parkways, bridge heads, parks, playgrounds, public beaches, canals, reservoirs, watersheds, artificial lakes, forests, woodlots, nurseries, experimental farms, cemeteries, fairgrounds, town commons, public gardens, botanical and zoological gardens, picnic grounds, esplanades, airports, parade grounds, proving grounds, poor farms, and refuse and dumps.

There are *quasi-public uses*—those from which the public will receive some compensation ("returns") for its services, which ordinarily will pay their cost in full or in part: public utility structures and rights-of-way (for water, gas, electricity, transit systems, terminals, etc.), docks, piers, public markets, abattoirs, asphalt plants, municipal milk plants, public laundries, hog farms, gravel pits, quarries, hospitals, stadiums, auditoriums, theaters, amphitheaters, golf links, swimming pools, filling stations (on public freeways and parkways), mausoleums and crematories, central heating plants. There are also "*emerging public uses*"—which are gradually evolving with the expansion of government and which may be operated directly by a public agency or by a private agency under special public control; and *emergency public uses* which arise under the "pressure of abnormal conditions." These include dams, dikes, lakes, and backwaters for flood control, allotment gardens when food shortages threaten, additional national defense areas such as landing fields, drill grounds, cantonments, bomb shelters, ammunition dumps, and supply bases. National Resources Planning Board, *Public Land Acquisition, Part II, Urban Lands* (Feb. 1941).

[10] *See, e.g.*, Fallbrook Irrigation Dist. v. Bradley, 164 U.S. 112 (1895). *See also* Hawaii Housing Authority v. Midkiff, 467 U.S. 229, 244 (1984) (reflecting this broad interpretation). For a discussion of the meaning of "public use," see Emily Dodge, *Acquisition of Land by Eminent Domain*, *in* JACOB H. BEUSCHER & ROBERT R. WRIGHT, LAND USE 709-10 (1969). The author writes that "By the weight of judicial opinion, public use may be defined as a use for which property may be taken by eminent domain for one of the following purposes:

(1) To enable the United States or a state or one of its agencies to carry on its governmental functions, and to preserve the safety, health and comfort of the public whether or not individual members of the public make use of the property so taken, provided the taking is made by a public body;

(2) To serve the public with some necessity or convenience which cannot be readily furnished without governmental aid, whether or not the taking is made by a public body, provided the public may enjoy such services as of right;

(3) In certain special and peculiar cases, sanctioned by ancient custom or because of unusual local conditions, to enable individuals to cultivate their land or carry on business in a way it could not otherwise be done, provided their success will indirectly enhance the public welfare. This is so even if the taking is made by a private individual and the public has no right to service from him or enjoyment of the property taken."

Id.

as slum clearance and land redistribution. Justice Steven followed the careful reasoning of Justice William O. Douglas enunciated in *Berman v. Parker*,[11] which had essentially blurred the important distinction between the Fifth Amendment's literal "public use" requirement and a more generalized notion of a "public purpose," the basis of zoning,[12] accomplished under a government's general police power.[13] Justice Stevens concluded, "because the plan unquestionably serves a *public purpose*, the takings challenged here satisfy the *public use* requirement of the Fifth Amendment."[14]

Justice Stevens noted that the Court would not choose to "second-guess" local governments who had decided that "promoting economic development is a traditional and long accepted function of government" that could be enhanced through the eminent domain process.[15] Justice

[11] 348 U.S. 26 (1954). In *Berman v. Parker*, a unanimous United States Supreme Court upheld a redevelopment plan that had targeted a blighted area in Washington, D.C. Under the D.C. plan, the area would be condemned and part of it would be utilized for the construction of streets, schools, and other "public facilities." The remaining portions, however, would be leased or sold to *private parties* for the purposes of redevelopment, including the construction of low-cost housing units for the area's 5,000 residents. Justice Douglas wrote: "Public safety, public health, morality, peace and quiet, law and order—these are some of the more conspicuous examples of the traditional application of the police power to municipal affairs. Yet, they merely illustrate the scope of the power and do not delimit it." *Id.* at 32.

In 1981, the Michigan Supreme Court had permitted the neighborhood of *Poletown* to be taken in order to build a General Motors Plant. *See* Poletown Neighborhood Council v. City of Detroit, 304 N.E.2d 455 (1981). This decision was later overruled in *County of Wayne v. Hathcock*, 471 Mich. 445, 684 N.W.2d 765 (2004). *See also* JEANIE WYLIE, POLETOWN: COMMUNITY BETRAYED 58 (1989) (noting that the Michigan plan uprooted the largely "lower-income and elderly" Poletown [Polish] neighborhood for the benefit of the General Motors Corporation). The parallel to *Berman v. Parker* is quite striking.

[12] 125 S. Ct. at 2663. For a brief history of zoning, see JACOB H. BEUSCHER & ROBERT R WRIGHT, *supra* note 10, at 323-26. A discussion of the constitutional basis for zoning may be found in *Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926). Prior to *Ambler Realty*, zoning ordinances were attacked on the grounds that they were in derogation of Section 1 of the 14th Amendment because they deprived property owners of liberty and property without due process of law and denied owners equal protection of the law. However, even after *Ambler Realty*, while zoning laws might pass general constitutional muster on the basis that they were enacted pursuant to a valid exercise of the police power, the United States Supreme Court would closely scrutinize individual zoning statutes. Thus, in *Nectow v. Cambridge*, the United States Supreme Court summarily declared a zoning ordinance unreasonable and unconstitutional as applied to a particular plaintiff. 277 U.S. 183 (1928).

[13] *Midkiff*, 467 U.S. at 249. The police power involves the right of the government to enact laws necessary for the health, safety, morals, and general welfare of the people. *See also* Berman v. Parker, 348 U.S. at 32.

[14] 125 S. Ct. at 2665 (emphasis added).

[15] *See id*. at 2668. Justice Stevens was clearly following the reasoning of Justice Douglas in *Berman v. Parker*. Justice Douglas had written: "It is within the power of the legislature to determine that the community should be beautiful as well as healthy,

Stevens wrote that "Our earliest cases in particular embodied a strong theme of federalism, emphasizing the "great respect" that we owe to state legislatures and state courts in discerning local public needs."[16] Justice Stevens stated that the statute in question expressed a clear legislative determination that the "taking of land, even developed land, as part of an economic development project is a *public use* and in the *public interest*."[17]

In his concurrence, Justice Kennedy rejected an expansive interpretation of the takings clause and stated that the takings were justified only in the context of a "comprehensive development plan" that had been enacted in order to address a "serious city-wide depression." Justice Kennedy noted that the economic benefits of the project cannot be characterized as *de minimis*."[18] Justice Kennedy, however, held out the prospect that the Court might wish to consider a "more demanding" or "higher" standard of review in a "more narrowly drawn category of takings"—although Justice Kennedy would decline to be more specific, stating "This is not the occasion for conjecture as to what sort of cases might justify more demanding standard…."[19]

The Minority Responds

The usually affable Associate Justice Sandra Day O'Connor issued a rather stinging dissent, joined by Chief Justice William H. Rehnquist, Justice Antonin Scalia, and Clarence Thomas. Justice O'Connor wrote: "Today the Court abandons this long-held, basic limitation on government power. Under the banner of economic development, all private

spacious as well as clean, well-balanced as well as carefully patrolled." 348 U.S. at 33. *See also* Shelley Ross Saxer, *Government Power Unleashed: Using Eminent Domain to Acquire a Public Utility or Other Ongoing Enterprise*, 38 IND. L. REV. 55 (2005) (discussing the power of a municipality to use its power under eminent domain to acquire a privately-owned utility company).

Justice Douglas had stated in *Berman*, "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*." 348 U.S. at 35-36 (emphasis added) (citing Shoemaker v. United States, 147 U.S. 282 (1893)).

[16] 125 S. Ct. at 2664 (citing Hairston v. Danville & Western R. Co., 208 U.S. 598 (1908)).

[17] *Id.* at 2660 (emphasis added) (citing 268 Conn. 1, at 18-28 (2004)). *See also* Courtesy Sandwich Shop, Inc. v. Port of New York Authority, 190 N.E.2d 402, *appeal dismissed*, 375 U.S. 78 (1963) (holding that statutes from New York and New Jersey, authorizing the Port Authority to effectuate a single port development project to consist of the Hudson & Manhattan Railroad system and a new development to be known as the "World Trade Center," were an effectuation of a valid public purpose and amounted to constitutional takings of private property, even though private persons were to be the immediate lessees).

[18] 125 S. Ct. at 2670 (Kennedy, J., concurring).

[19] *Id.* (Kennedy, J., concurring).

property is now vulnerable to being taken and transferred to another private owner, so long as it might be upgraded…."[20] Justice O'Connor is quite clear and direct in her analysis. She asks a straightforward question: "Are economic development takings constitutional?" And she answers it in a similar fashion: "I would hold that they are not."[21] Justice O'Connor wrote that the Supreme Court's majority ruling favored the most powerful and influential in society and leaves small property owners with little recourse. Justice O'Connor issued a rather ominous warning: "[The] specter of condemnation hangs over all property. Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory."[22] The dissenters, through Justice O'Connor, wrote that that the majority had unfairly tilted in favor of those with "disproportionate influence and power in the political process, including large corporations and development firms."[23]

Justice Clarence Thomas filed a separate dissent in which he sounded an uncharacteristic note of accord with the NAACP and other more liberal (perhaps libertarian) groups who had sided with the property owners. Justice Thomas asserted that similar programs that had resulted in more than 10,000 threatened or filed condemnations and in a transfer of property from one private party to another in forty one states between 1998 and 2002, often resulting in the displacement of minorities, the elderly, and the poor.[24] Justice Thomas concluded: "I would revisit our Public Use Clause cases and consider returning to the original meaning of the Public Use Clause: that the government may take property only if it actually uses or gives the public a legal right to use the property."[25]

While this issue has recently come to the forefront in America, the scenario that played out in *Kelo* is one that frequently confronts

[20] *Id.* at 2671 (O'Connor, J., dissenting).

[21] *Id.* at 2673 (O'Connor, J., dissenting). Justice O'Connor's opinion also runs contrary to the Court's earlier decision in *Miller v. City of Tacoma*, 61 Wash. 2d 374, 378 P.2d 464 (1963). Citing *Berman v. Parker*, the *Miller* court held that "the overwhelming number of the courts of last resort in other jurisdictions have held that urban renewal laws, similar to the one before us, are for a "public use" and constitutional; hence, the expenditure of public funds is for a public purpose." *Id.* at 473.

[22] *Id.* at 2676 (O'Connor, J., dissenting).

[23] *Id.* at 2677 (O'Connor, J., dissenting).

[24] Lane, *supra* note 2.

[25] 125 S. Ct. at 2687 (Thomas, J., dissenting). It is also quite instructive that Justice Thomas took cognizance of the fact that "[o]f all the families displaced by urban renewal from 1949 through 1963, 63 percent of those whose race was known were nonwhite, and of those families, 56 percent of nonwhites and 38 percent of whites had incomes low enough to qualify for public housing, which, however, was seldom available to them." *See also* BERNARD FRIEDEN & LYNNE SAGALAYN, DOWNTOWN, INC. HOW AMERICA REBUILDS CITIES 17 (1989).

American or foreign citizens or corporations when they set up subsidiaries or other business operation overseas. Several questions arise: Can a foreign government (or sub-entity or political division) take the property of a foreign citizen or a foreign corporation? For what purpose or purposes? Are there internationally recognized rules or norms that dictate the terms, conditions, and amounts of any compensation that may have to be paid? Are there any limitations on the right of taking?

CONFISCATION

The first and most extreme type of "taking" is a unique variety termed *confiscation*. Suppose that instead of wishing to take the land to be used for the new Disney Park, *Setonia* attempted to *seize* the land when it entered into hostilities with the United States after a dispute arises over coastal fishing rights off *Setonia's* west coast.

Confiscation is the taking or appropriation of private property for a public use *without compensation*.[26] Confiscation is an act by which "the estate, goods, or chattels of a person who has been guilty of some crime, or who is a public enemy, is declared to be forfeited for the benefit of the public treasury."[27] When property is confiscated as a punishment for the commission of a crime, it is usually termed as a *forfeiture*. Confiscation is often referred to as *expropriation without fair compensation* under international law.

Generally speaking, the property of the subjects of an enemy found within a country may be taken or appropriated by the government *without notice* unless there has been a treaty entered into that specifically deals with this issue. The right may also extend to "freezing or sequestering property of the state acted against or of its nationals."[28] In the view of the United States, "War gives to the sovereign full right to take the persons and confiscate the property of the enemy, wherever found."[29] Yet, at the same time, this power is not limitless. Courts in the United States and in many nations around the world may refuse to reciprocate in enforcing foreign judgments concerning confiscation and

[26] For the purposes of international law, "property means all movable or immovable property, whether tangible or intangible, including industrial, literary and artistic property, as well as all rights or interests of any kind in property…." *See, e.g.,* World War II War Claims Settlement, Italian Peace Treaty, February 10, 1947, 61 Stat. 1245, T.I.A.S. No. 1648.

[27] *Confiscation*, *at* http://www.lectlaw.com/def/c094.htm (last visited Jan. 22, 2006).

[28] WILLIAM E. BISHOP, INTERNATIONAL LAW 900 (1971).

[29] *Confiscation*, *supra* note 27.

may decline to "give effect to a foreign law that is contrary to our public policy."[30]

For example, in *Sulyok v. Penzintezeli Kozpont Budapest*, Judge Vorhees noted: "Our public policy does not require us to enforce foreign decrees of confiscation, even by recognized countries, against persons who were not citizens of those States at the times when the edicts of confiscation were issued."[31] Frequently, nations will provide by treaty that foreign nationals will be permitted to remain within a nation and continue their legitimate business interests, including the right of ownership of property, notwithstanding any "rupture" or difficulties between their governments, so long as the individuals conduct themselves properly and innocently. Even in the absence of such a treaty obligation, an intention not to seek the confiscation of the property of an enemy may be declared in the declaration of war between nations. Interestingly, as a matter of international law, the question of what should be done with the property of an enemy found in the country is considered as one of policy rather than of law and "is properly addressed to the consideration of the legislature and not to courts of law." As a result, the strict right of confiscation in the United States properly belongs within the powers of the Congress, and without a legislative act authorizing the confiscation of an enemy's property, the property cannot be condemned or subject to forfeiture.

EXPROPRIATION

Respect for the private property and the legal rights of aliens and foreign corporations is one of the main principles of international law, and a predicate to attracting foreign direct investment.[32] However, at the same time, "The expropriation of alien property for a public purpose has not been considered to be contrary to international law."[33] The United States has been clear in its view. In its *Note to Mexico of 21 July*

[30] Perutz v. Bohemian Discount Bank, 304 N.Y. 533, 537 (1953). *See also* Dougherty v. Equitable Life Assurance Soc., 266 N.Y. 71 (1934). Judge Crane wrote: "Recognition [of a government] does not compel our courts to give effect to foreign laws if they are contrary to our public policy…." *Id.* at 90. Interestingly, much of the discussion about the legality of nationalization has centered on the issue of the *recognition* of a foreign government by the United States. *See* Max Habicht, *The Application of Soviet Laws and the Exception of Public Order*, 21 AM. J. INT'L. L. 238 (1937).

[31] 279 App. Div. 528, 111 N.Y.2d 75, 82 (1st Dept. 1952), *aff'd*, 304 N.Y. 704 (1952).

[32] *See, e.g.*, Richard J. Hunter, Leo v. Ryan, & Robert E. Shapiro, *Legal Considerations in Foreign Direct Investment,* 28 OKLA. CITY U. L. REV. 851-872 (2003/04). *See also* Ralph Dolzer, *Indirect Expropriation of Alien Property*, FOREIGN INV. L.J. 41 (1986).

[33] Shigeru Oda, *The Individual in International Law*, *in* MANUAL OF PUBLIC INTERNATIONAL LAW 485 (Max Sorensen ed., 1968). Judge Oda was a judge on the International Court of Justice, appointed in 1976. His area of expertise was the Law of the Seas.

1938 on the Mexican agrarian expropriations,[34] the United States government, through Secretary of State Cordell Hull, stated that it was clearly the right of a sovereign government, such as Mexico, "freely to determine their own social, agrarian and industrial problems. This right includes the sovereign right of any government to expropriate private property within its borders in furtherance of public purposes."[35] With regard to the expropriations carried out by the Cuban Government in 1959, the United States expressed its view in a note to the Foreign Minister of Cuba as follows: "The United States recognizes that under international law a state has the right to take property within its jurisdiction for public purposes in the absence of treaty provisions or other agreement to the contrary."[36]

However, while recognizing the *right* to expropriate property as one of the important incidents of national sovereignty, the property of aliens or of foreign corporations may be expropriated, but only under conditions imposed by customary international law. What are these conditions?

First, the expropriation is permitted only to accomplish a "*public purpose*."[37] Secondly, there must be *no discrimination* against the property expropriated or against its owners. And thirdly, the acts of a government in depriving an alien or a foreign corporation of its property must be followed by the grant of *adequate compensation*.

The stated view of the government of the United States, known as the *Hull Rule*, is quite clear and has remained so since the 1930's. The *Mexican expropriations* provide the proper context:

- While there may be a right to take private property in pursuit of a nation's desire to "carry forward a program for the social betterment of the masses of its people," the issue is "whether in pursuing them the property of American nationals may be taken by the Mexican Government without making prompt payment of just compensation to the owner in accordance with the universally recognized rules of law and equity."[38]

[34] United States and Mexico, Discussion on Expropriations, 3 HACKWORTH, INTERNATIONAL LAW 55-665 (1942), U.S. Department of State, 19 Press Release 50, 136, 139, 165 (1938). Agrarian expropriations began in Mexico in 1915. Up to August 30, 1927, 161 moderate-sized properties owned by Americans had been expropriated. Subsequent to 1927, additional properties, mainly farms of moderate size, with a value over $10 million, were expropriated by the Mexican Government.

[35] *Id.*

[36] 40 DEP'T ST. BULL. 958 (1959).

[37] *See, e.g.*, Norwegian Shipowners' Claim (Norway-U.S.), 1 R.I.A.A. 307 (1922). Note the similar language to that found in *Kelo v. City of New London* permitting a taking for a *public purpose*.

[38] *Id.*

- The taking of property without compensation is not expropriation. It is confiscation. "It is no less confiscation because there may be an expressed intent to pay at *some time in the future*."[39]
- Expropriation of the property of a foreigner or alien can only be accomplished legally by the payment of *adequate, effective, and prompt compensation*.[40]

The position of the United States has been reflected in various commercial treaties concluded by the United States and its bilateral and multilateral treaty partners. For example, the *Hull Rule* is enshrined in a treaty concluded by the United States and France. The treaty contains the following language: "Property of nationals and companies… shall not be expropriated within the territories of the other High Contracting Party except for a public purpose and with payment of just compensation. Such compensation shall represent the equivalent of the property taken; it shall be accorded in an effectively realizable form and without needless delay. Adequate provision for the determination and payment of the said compensation must have been made no later than the time of taking."[41]

The American view is also strongly supported in the *Draft Convention on the Protection of Foreign Property* advanced by the O.E.C.D.[42] in 1962 which stated: "No Party shall take any measures depriving, directly or indirectly, of his property a national of another Party unless the following conditions are complied with: (i) The measures are taken in the public interest and under due process of law; (ii) The measures are not discriminatory or contrary to any undertaking which the former Party may have given; and (iii) The measures are accompanied by provision for the payment of just compensation. Such compensation shall represent the genuine value of the property affected, shall be paid without undue delay, and shall be transferable to the extent necessary to make it effective for the national entitled thereto."[43]

The United States position, however, has not been universally accepted. In this contrary view, it may be both unreasonable and unrealistic to require prompt payment of effective and adequate com-

[39] *Id.* (emphasis added).

[40] 5 U.S. FOR. REL. 685 (1938).

[41] Convention of Establishment of 1959 Between the United States and France, Art. 4 (3), U.N.T.S. 75, 80 (1959).

[42] OECD [The Organization for Economic Cooperation and Development] membership includes: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, South Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.

[43] 2 I.L.M. 241, 248 (1962). Notice the requirement that the taking be made in the "*public interest*."

pensation by states where an expropriation is being carried out as a part of a general program of large scale social, economic, or political reform by means of the nationalization of certain industries or more generally, of the means of production.[44] The availability of a "cash payment" may be truly problematic for either practical or political purposes.

For example, the Mexican Government in a note of August 3, 1938 to the United States, stated that "the future of a nation could not he halted by the impossibility of immediate payment of compensation for properties owned by a small number of foreigners who only seek a lucrative end."[45]

As might be expected, this viewpoint was strongly supported by the (former) Soviet Union. The Soviets believed that the core question of expropriation and the related questions *whether* compensation was to be paid to the former owners of the nationalized properties, *when* it is to be paid, and in *what proportions* to the value of the property, depends "on various economic and political factors." The Soviets thus reflected a very different viewpoint from that of the United States: "The State may decide to nationalize the property without compensation, or with partial or full compensation…. Such considerations of a social nature, like many others, may be decisive in fixing the size and procedure of compensation…."[46]

The Compensation Question

It should also be recognized that states that have engaged in one form of confiscation (termed as either *expropriation* or *nationalization)* frequently might at least *promise* to pay something to the former owners of the affected property. Disputes will thus arise over the *adequacy* of any payment rather than the absolute refusal to pay anything at all. Situations vary widely. No reasonable compensation has been made or has been offered in some of the major cases of the twentieth century—the 1918 Soviet nationalizations,[47] the Chinese-Communist

[44] *See, e.g.*, KONSTANTIN KATZAROW, THEORIE DE LA NATIONALISATION [Theory of Nationalization] 429-48 (1964).

[45] 5 U.S. FOR. REL. 679-80 (1938).

[46] Reports of the International Law Association 148, 149 (1962).

[47] *See, e.g.. The Russian Revolution*, *at* http://www.geocities.com (last visited Jan. 22, 2006) (discussing the various nationalizations conducted by the Russian government in the period immediately following World War I). Under the Act of August 9, 1955, 69 Stat. 572, 22 U.S.C. §1641(d), the Foreign Claims Settlement Commission of the United States was directed to determine the validity of claims of United States nationals against the Soviet Union arising prior to November 16, 1933—the date of the formal recognition of the Soviet Union by the United States and the *Litvinov Assignment*. Claims numbered 4,130 and amounted to $530,233,466. Awards were made on 1,925 claims, with principal in the amount of $70,466,109 and interest in the amount of $58,592,874. However, the *total* available fund was only $8,658,722.43 when the program was completed on August 9, 1959

seizures, or the expropriations made by Castro's Cuba[48] that are the subject of controversy even today. By way of contrast, the actions of the Mexican government in their land and petroleum expropriations, the Iranian seizure of Anglo-Iranian Oil,[49] the whole-sale nationalizations carried out by several Central and Eastern European nations after World War II,[50] the Egyptian seizure of the Suez Canal in July 1956,[51] all point to the willingness of nations or pay something—or at least pay "lip service" to the principle of compensation —as a concession to the customary rules of international law that required the payment of prompt, effective, and adequate compensation. However, as Professor Bishop notes, there exists "no satisfactory international law standard as to the amount or mode of payment."[52]

Some Examples

Judge Shigeru Oda notes "Compensation to foreign owners is not refused altogether but is paid in the form of a lump sum which may not necessarily be sufficient to satisfy all individual claims put forward by a foreign government on behalf of its nationals, and which is generally

or *1.63 percent of total claims*.

[48] *See* Amir Rafat, *Legal Aspects of the Cuban Expropriation of American-owned Property*, 11 ST. LOUIS U.L.J. 45 (1966). Cuba, an island of eleven million people, lies about ninety miles south of Florida. On February 7, 1962, the United States government imposed an embargo on trade with Cuba in retaliation for Castro's expropriation of property owned by foreigners. About 6,000 property claims have been certified by the United States, with more than half of them being held by United States corporations—holding a 1972 value of $1.8 billion. Under the terms of the *Helms-Burton Act of 1966*, the U.S. embargo of Cuba can only be lifted after these claims have been settled by a democratically elected government *that does not include either Fidel or Raul Castro*. *See* 22 U.S.C. § 6021-081 (1994). *See also Migration News*, *at* http://migration.ucdavis.edu (last visited Jan. 18, 2006). For a discussion of the "act of state" doctrine—which generally holds that a nation is sovereign within its own borders, and that its domestic actions may not be questioned in the courts of another nation— in the context of the Cuban nationalizations, see Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964). *See also Act of State Doctrine*, *at* http://www.trading-glossary.com (last visited Jan. 22, 2006).

[49] *See* Abolbashar Farmanfarma, *The Oil Agreement Between Iran and the International Law Consortium*, 34 TEX. L. REV. 259 (1955). The Abadan Crisis occurred in the period 1951-1954, after Iran nationalized the Anglo-Iranian Oil Company and expelled many Western companies from oil refineries in the city of Abadan. During an American-inspired coup d'etat (codenamed *Operation Ajax*), led by the CIA and the British MI6, Prime Minister Mohammed Mossadegh was ousted from office and replaced by Mohammed Reza Shah Pahlavi. In August 1954, the company was placed under the control of an international consortium.

[50] *See* Nicholas Doman, *Post-war Nationalization of Foreign Property in Europe*, 48 COLUM. L. REV. 1125 (1948).

[51] *See* Robert Delson, *Nationalization of the Suez Canal Co.*, 57 COLUM. L. REV. 755 (1957).

[52] BISHOP, *supra* note 28, at 865.

not paid promptly but over a period of years."[53] There are several important examples.

This practice is well reflected in agreements concluded by several Eastern European states with countries in Western Europe and North America respecting the takings that occurred during the period of communization after World War II.[54] When the Iranian Government enacted its Oil Nationalization Act in 1951, it deposited only *twenty five percent* of its then-current oil revenues, after a reduction of "exploitation expenses," in order to meet the eventual expected claims of the Anglo-Iranian Oil Company.[55] An agreement was reached in 1954 between the United Kingdom and Iran that dictated that the United Kingdom was to receive compensation, but only to a small percentage of the investment in the Company. In a series of cases that emanated from the Iranian nationalizations, various courts held that the nationalization was not contrary to international law, notwithstanding the delay in payments made by Iran or its inadequacy.[56] Concerning the case of the nationalization of the Suez Canal Company by the Egyptian Government carried out in 1956, the issue of compensation was settled by an agreement between the Government of Egypt and the Suez Canal Company in 1958, under which the sum offered by Egypt would not only not entirely meet the claims of owners, but also was to be paid in *installments* over a period of five years.[57]

What these examples may indicate is that the American position—supported by many Western Governments—requiring *adequate, effective, and prompt compensation*, is not maintainable in cases where the property of aliens or foreign corporations has been acquired (nationalized or expropriated) by the state in order to further a program of economic or social reform or pursuant to the dictates of a newly established revolutionary regime.

[53] Oda, *supra* note 33, at 488.

[54] *See* ISI FOIGHEL, NATIONALIZATION 97, 133 (1982). Dr. Foighel is a former Judge at the European Court of Human Rights in Strasbourg and former Minister of Taxation in Denmark. For the Czechoslovak expropriation of properties, 4,024 claims totaling $364 million were submitted to the Commission; 2,630 awards were made in the amount of $113,645,205.41 when the program was completed on September 15, 1962. The available fund for distribution was $8,540,768.41 or *2.34 percent*. For Polish nationalizations, 10,169 claims totaling $1,143,565,517 were submitted; 5,022 awards were made, totaling $100,737,681.63 in principal and $51,051,825.01 in interest. In order to pay these claims, Poland promised to pay $40 million in twenty annual installments of $2 million each under an agreement of July 16, 1960. *See* T.I.A.S. No. 4545 (1960).

[55] Anglo-Iranian Oil Co. Case, I.C.J. Rep. 36 (1956).

[56] *See* Anglo-Iranian Oil Company v. Idemitsu Kosan Kabushiki Kaisha, I.L.R. 305 (1953) (Japan); Anglo-Iranian Oil Co., Ltd. v. Societa SUPOR, I.L.R. 23 (1955) (Italy); Anglo-Iranian Oil Co., Ltd. v. Jaffrate (the Rosemary), I.L.R. 316 (1953) (Aden).

[57] *See* 54 AM. J. INT'L L. 498 (1960).

Is the discussion essentially "much ado about nothing"? Perhaps. The use of expropriation as a tool of national economic policy has decreased markedly over time. Professors Czinkota, Ronkainen, and Moffett report that while more than eighty three expropriations took place in a single year in the decade of the 1970s, by the turn of the century, this number had plummeted to fewer than three.[58] The authors comment "Apparently, governments have come to recognize that the damage they inflict on themselves through expropriation exceeds the benefits they receive."[59]

NATIONALIZATION

Nationalization is the act of taking assets normally of an *entire industry*—into state control or ownership.[60] Candidates for nationalization may include industries related to national security or national defense, industries that are related to political or economic motivations (especially in nations that follow the model of state central planning),[61] and those industries that generate large revenues.[62] The process of

[58] MICHAEL R. CZINKOTA, ILKKA A. RONKAINEN & MICHAEL MOFFETT, INTERNATIONAL BUSINESS 104 (2002).

[59] *Id.* (citing Michael Minor, *LDCs, TNCs, and Expropriations in the 1980s*, CYC REP. 53 (1988)).

[60] *See* Paul M. Johnson, *Nationalization*, *in* A GLOSSARY OF POLITICAL ECONOMY TERMS, *at* http://www.auburn.edu (last visited Jan. 26, 2006).

[61] The system of central planning, adopted in the region of Central and Eastern Europe as an aftermath of World War II, failed for four main reasons:

- Failure to create economic value or to improve the standard of living for the average citizen;
- Failure to provide adequate individual and organizational incentives;
- Failure to "measure up" to comparative economies, not only those capitalist economies in the West, but also several socialist economies in Central and Eastern Europe (most notably, Hungary Czechoslovakia—later the Czech Republic—and Slovenia); and
- Failure to satisfy basic consumer needs (essentially creating an unofficial *dollarization* of the economy through the existence of a large, open, "semi-official," and surprisingly efficient "black market," and the existence of "dollar" stores and shops).

See Richard J. Hunter & Leo V. Ryan, *The Polish Economy: After Fifteen Years, Still a "Work in Progress*," 5 GLOBAL ECON. J., art. 6, *at* http://www.bepress/globaleconomyjournal (last visited Jan. 23, 2006).

[62] The counterpoint to nationalization is the process of privatization—termed either *political* (carried on for political or philosophical purposes or ends) or *economic* (necessitated by the collapse of the former economic system). An example of political privatization would be Great Britain in the 1990s under Prime Minister Margaret Thatcher that succeeded in reversing the nationalization process carried out by the Labour Party after World War II. It has proven especially problematic to privatize many of the larger industries (sometimes called "economic dinosaurs") previously nationalized because many provided little or no real economic value in their national economies.

nationalization may be accomplished through either confiscation or expropriation.

Professors John Wild, Kenneth Wild, and Jerry Han outline four important underpinnings of nationalization:

1. Governments may nationalize industries when they believe that multinational companies (MNCs) may be *transferring profits* to business operations in countries with lower tax rates or into countries that have offered generous subsidies in order to attract foreign business operations. Nationalization thus will give the government control over the income and cash flow generated by the industry that has been nationalized.
2. Governments may engage in nationalization of an industry for *ideological* reasons.
3. Nationalization may be used as a *political tool or instrument*. For example, candidates for political office may promise to save local employment by nationalizing "high profile" or "strategic" industries.
4. Governments may nationalize industries where they were initially unwilling or unable to invest private capital, especially in utilities, roads, telecommunications,[63] and other infrastructure.

Some Notable Nationalizations[64]

Whether for political or economic reasons, nationalizations have occurred with great frequency in the "modern era"—especially post-World War I and post-World War II. Some of the more notable nationalizations have included:

- **Great Britain**: British Coal, British Gas, British Petroleum, British Steel, British Leyland, British Airways, the Bank of England, and the telephone division of the Post Office (now called British Telecom). All of these industries were privatized during the period of Conservative Party dominance from 1979-1997, with the exception of the Bank of England, which today enjoys a semi-independent status. Two industries—British Steel and British Leyland—performed very poorly while under nationalization. Interestingly, British Rail was broken into several sub-companies and privatized and these performed poorly *after* privatization. CEGB was a large, nationalized electrical generator utility. Its nationalization was supported by both the Labour Party and the

[63] JOHN J. WILD, KENNETH L. WILD & JERRY C.Y. HAN, INTERNATIONAL BUSINESS 89 (2003).

[64] *See, e.g.*, *Nationalization*, *at* http://en.wikipedia.org (last visited Jan. 25, 2006) (containing general information on prominent nationalizations).

Conservative Party. In addition, Conservative Prime Minister Edward Heath (1970-1974) led a successful effort to nationalize the aero-engine part of the bankrupt Rolls-Royce for "strategic purposes."

- **Canada**: Canada initially nationalized several nation-wide railroad systems after they declared bankruptcy following World War I, creating Canadian National Railways, which has since been privatized. During the politically inspired "Quiet Revolution," Quebec Minister Rene Levesque and the Lesage government nationalized the electric industry, creating Hydro-Quebec.
- **United States**: In 1939, President Franklin Roosevelt created the Tennessee Valley Authority, which entailed the nationalization of the Tennessee Electric Power Company. Amtrak is a *government corporation* created in 1971 in order to remove several American railroad lines from their legal obligation to carry intercity passengers. Conrail was created in 1976 in order to regularize the operations of several "financially troubled" or bankrupt rail lines, principally operating in the "Northeast Corridor." Interestingly, all United States railroads were nationalized during World War I as a wartime measure—but were returned to private ownership almost immediately after the conclusion of the war. No similar nationalizations were carried out during World War II.
- Nationalization of the oil industry occurred in many countries, including **Libya, Kuwait, Mexico, Saudi Arabia, and Venezuela**.
- **Cuba**: As noted, many companies (mainly involving U.S. assets) in Cuba were *expropriated without compensation* after Cuba's 1959 revolution.
- **Zimbabwe** nationalized its food distribution processes and infrastructure.
- **Soviet Union**: All manufacturing enterprises were nationalized —largely without compensation—in the Soviet Union in 1918. Many retailing and commercial enterprises, including the banking sector[65] and the insurance sector,[66] were likewise nationalized in

[65] *See* Petrogradsky Mejdunarodny Kommerchesky Bank v. National City Bank of New York, 170 N.E. 479 (Ct. App. 1930) (discussing the process by which the bank's assets were confiscated, its liabilities canceled, and its shares extinguished, and holding that the Soviet nationalization did not excuse a New York bank from an action for repayment of a balance allegedly due the plaintiff). The court, in an opinion by Judge Cardozo, noted: "We do not recognize the decrees of Soviet Russia as competent to divest the plaintiff of the title to any assets that would otherwise have the protection of our law." *Id.* at 481.

[66] *See* United States v. Pink, 315 U.S. 203 (1942) (concerning the decrees of the Soviet Government in 1918 and 1919 which wound up the affairs of the First Russian Insurance Company and nationalized its property, wherever located).

1918. Similarly, industrial enterprises and most private property were nationalized in the Soviet bloc post-1948.

- **France**: Renault, which had been seized from its owner, Louis Renault, after World War II in retaliation for his collaboration with Nazis in Germany, was nationalized in 1944. Although Renault operated successfully and profitably in France after its nationalization, the company was privatized in 1996.
- **India**: Banks were nationalized in 1969.
- **New Zealand**: The Labour Government in New Zealand took an eighty percent stake in the national air carrier Air New Zealand in return for a large infusion of cash.

ALTERNATIVES TO PROPERTY SEIZURES

Over the past decades, governments have become much more sophisticated in their dealings with owners of property—especially foreign owners. As a result, host governments have adopted numerous alternate strategies in order to achieve important political or economic ends. These measures ensure that the host government will be able to maintain at least some degree of *control* over foreign companies operating within their borders without resorting to more extreme or controversial measures such as nationalization or expropriation.

Domestication is a process by which a government attempts to gain control over a foreign investment by requiring either transfer of ownership or management responsibility to a local partner or business entity, shielding an industry within the host country from foreign competition. A foreign government may attempt to impose *local content regulations* (forcing a firm to purchase supplies or parts locally produced) in order to ensure that a portion of the final product is locally or domestically produced. In an effort to improve the local employment picture, a host government may require a foreign business operation to *hire local personnel*. A host government can require that a certain *percentage of the profit generated by a business activity be retained* in the host country through the use of a financial tool called a "blocked currency."

All of these strategies carry with them potential negatives. Requiring foreign companies to hire local personnel may be politically attractive, but such a strategy may force a company to employ inadequately trained employees or to take on an excess of employees. Local content laws may increase the cost of production, lessen efficiency, or reduce the quality of products produced.

CONCLUSION: MANAGING THE RISK OF PROPERTY SEIZURES AND OTHER ACTIONS OF HOST GOVERNMENTS

Owners of property may face risks associated with confiscation, expropriation, nationalization, or other threats of government interf-

erence in their foreign business operations.[67] Professors Wild, Wild, and Han indicate that companies might think about engaging in one or more of the four traditional methods of managing political and economic risk: *avoidance* (simply refusing to engage in foreign business operations, including owning property abroad); *adaptation* (incorporating proactive strategies into the planning for foreign business operations); *information gathering* (elicited from current or former employees or from agencies specializing in political/economic risk analysis);[68] and *influencing local politics* (through engaging in appropriate lobbying activities[69] or by attempting to be a visible, responsible, and appropriate "corporate citizen").[70]

Professors Czinkota, Ronkainen, and Moffett suggest that the most effective way to reduce (as far as possible) the risks associated with these practices is for an international company to adopt pro-active policies in order to "demonstrate that it is concerned with the host country's society and that it considers itself an integral part of the host country, rather than simply an exploitative foreign corporation."[71] Among the practical measures that can be undertaken include "intensive local hiring and training practices, better pay, contributions to [local] charities, and societal useful investments."[72] Additionally, foreign companies can form partnerships, enter into joint ventures or strategic alliances, or create entities that involve cross-holdings of company stock

[67] *See generally* Janet Koven Levit, *A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments*, 30 YALE J. INT'L L. 125 (2005) (discussing the issue of minimizing risk to a portfolio).

[68] *See, e.g.*, JOHN DANIELS & LEE H. RADEBAUGH, INTERNATIONAL BUSINESS 454 (2001) ("Companies may also rely on experts' opinions about a country's political situation, with the purpose of ascertaining how influential people may sway future political events affecting business.")

[69] United States companies must be mindful not to run afoul of the *Foreign Corrupt Practices Act (FCPA),* which prohibits U.S. companies and their employees from bribing foreign government officials or candidates for political offices in another nation. The prohibition extends to offering "anything of value"—money, gifts, or anything else of value—to any "foreign government official" who is empowered to make any "discretionary decision" that may be to the bribe-payer's benefit. The Act also requires firms to keep accounting records that accurately reflect their international activities. *See The Foreign Corrupt Practices Act of 1977*, 15 U.S.C. §§ 78dd-1, *et. seq*. (1977). *See also The Foreign Corrupt Practices Act*, *at* http://www.usdoj.gov/criminal/fraud/fcpa.html (last visited Jan. 27, 2005). Not all agree that the FCPA has been either efficacious or successful. *See, e.g.*, Robert S. Greenberger, *Foreigners Use Bribes to Beat U.S. Rivals in Many Deals, New Report Concludes*, WALL ST. J., Oct. 12, 1995, at 3. For a discussion of the extraterritorial application of the FCPA, see Daniel Patrick Ashe, Comment, *The Lengthening Anti-Bribery Lasso of the United States: The Recent Extraterritorial Application of the U.S. Foreign Corrupt Practices Act*, 73 FORDHAM L. REV. 2897 (2005).

[70] WILD, WILD & HAN, *supra* note 63, at 90-92.

[71] CZINKOTA, RONKAINEN & MOFFETT, *supra* note 58 at 109.

[72] *Id.*

with a local partner. Foreign business entities can also begin to practice *localization*[73]—involving the modification of a business operation, the particular product mix, or some other element of the business, in order to suit local business tastes, practices, and cultures— especially critical in international franchising operations.[74]

In addition, firms can procure insurance in order to cover any losses that might result from the political and economic risks associated with property seizures. In the United States, the *Overseas Private Investment Corporation* (OPIC) covers three types of risk insurance: *currency inconvertibility* insurance, covering the inability to convert profits, debt service, and other remittances from local currencies into U.S. dollars; *political violence* insurance, covering the loss of assets or income due to war, revolution, insurrection, or politically motivated civil strife; or *expropriation insurance*, covering the loss of an investment due to expropriation, nationalization, or confiscation by a foreign government.[75] The *Foreign Credit Insurance Association* (FCIA) insures companies against damages from war, revolution, and the cancellation of licenses.[76]

Many industrialized countries have also entered into *bilateral investment treaties* (BITS)[77] that generally provide host country insurance to

[73] *See, e.g.*, Edward E. Lucente, *Managing a Global Enterprise* (Pittsburgh-Carnegie-Bosch Institute for Applied Studies in International Management), Working Paper No. 94-2, 1993) (providing an example of IBM in Korea).

[74] *See, e.g.*, Hector R. Lozada, Richard J. Hunter, Jr. & Gary H. Kritz, *Master Franchising as an Entry Strategy: Marketing and Legal Implications*, 4 COASTAL BUS. J. 16 (Spring 2005).

[75] *See The Overseas Private Investment Corporation (OPIC), at* http://www.opic.gov (the official website of OPIC) (last visited Jan. 28, 2006). OPIC was established as an agency of the United States government in 1971. It charges "market-based fees" for its services and operates on a "self-sustaining basis at no net cost to taxpayers." *Id.* Germany provides export insurance through *Hermes Kreditanstalt*. *See* http://www.hermes.de (last visited Jan. 28, 2006). *Hermes* provides insurance for bad debt losses, bonds and guarantees, fraud, debt collection, and provides a creditworthiness check—but *not* for property seizure risks. *See also* Paul E. Comeaux & N. Stephen Kinsella, *Reducing Political Risk in Developing Countries: Bilateral Investment Treaties, Stabilizing Clauses, and MICA and OPIC Investment Insurance*, 15 N.Y.L. SCH. J. INT'L & COMP. L. 1 (1994).

[76] *See The Foreign Credit Insurance Association (FCIA), at* http://www.fcia.com (last visited Jan. 28, 2006). The FCIA, a private management company, is a subsidiary of Great American Insurance Company of Cincinnati, Ohio. As stated on the website of the FCIA: "Breach of government undertakings, expropriation or confiscation, nationalistic movements, war and strife, and currency controls, are among the political risks exposures of exporters and contractors." *Id.*

[77] *See, e.g.*, Tai-Heng Cheng, *Power, Authority and International Investment Law*, 20 AM. U. INT'L L. REV. 465 (2005) (discussing how MNCs establish their roles and "stabilize expectations through a framework of norms, projects agreements, guarantees, multilateral and bilateral investment treaties ("BITs"), arbitral awards and court decisions"). *Id.* at 466. *See also* Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BIT's Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 HARV. INT'L L.J.

cover losses from such actions as expropriation, political violence, contract cancellation by governments, and currency repatriation and controls.[78] Coverage is also available through many private insurers, through international agencies such as the World Bank's *Multilateral Investment Guarantee Agency*,[79] and through private insurance programs offered by host countries.

While "property risks" associated with confiscation, nationalization, and expropriation may still be in evidence, effective measures can be undertaken to manage and minimize such risks in order to continue to increase critical worldwide inflows of foreign direct investment.

67 (2005) (discussing the view that BITs have achieved their first goal of fostering investment protection).

[78] *See, e.g.*, Paul Jensen, *Political Risk Coverage Eases Entry into Perilous Markets*, EXPORT TODAY, Nov.-Dec. 1992, at 39-42.

[79] *See* http://www.MIGA.org (the official website of MIGA) (last visited Jan. 28, 2006).

PUBLIC INTEREST AND PRIVATE RIGHTS IN EMINENT DOMAIN: MOVING BEYOND *KELO V. NEW LONDON*

by DON MAYER*

The U.S. Supreme Court's eminent domain decision in *Kelo v. New London*[1] triggered an unusually large backlash, one which began almost immediately after the decision was announced on June 23, 2005.[2] A number of bills and proposals in Congress and the states would abolish or ameliorate what many see as the problem with the 5-4 decision in *Kelo*: governmental use of eminent domain power to transfer non-blighted property from one private party to another private party for the purpose of enhancing tax revenues and/or employment.[3] Some of the state legislation has already been enacted.[4]

This article reviews the controversy by looking at Supreme Court precedents on eminent domain as well as Michigan's well-known

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[1] Kelo v. City of New London, 125 S. Ct. 2655 (2005).

[2] *See, e.g.*, Paul Bass and Douglas Rae, *Eminent Disdain*, N.Y. TIMES, Aug. 5, 2005. ("The New Haven experiment operated on a fallacy that is being repeated today in New London, and that was enshrined in the majority decision signed by the Supreme Court: that government should be able to take away people's modest houses or grocery stores not just to construct a clearly needed road or hospital, but also to build housing or stores for wealthy people in the name of reducing poverty. That's not just morally abhorrent, as New Haven's experience shows, it's bad policy.")

[3] The media have characterized the Kelo decision as allowing, "government to take homes and businesses and replace them with more profitable private developments." Avi Salzman, *Homeowners Shown the Door*, N.Y. TIMES, July 3, 2005 (Section 14CN, at 1).

[4] *See infra* notes 68 - 79 and accompanying text.

"Poletown" decision in 1981, and the Michigan Supreme Court's pre-*Kelo* reversal of *Poletown* in the case of *County of Wayne v. Hathcock*. The article also reviews the *Kelo* decision and concludes that both Congress and state legislatures could move toward a better balance between private rights and public interest by following the logic and rationale of the *Hathcock* decision.

I. THE POWER OF EMINENT DOMAIN

Eminent domain is the power of the government to take private property for public use. The power probably pre-dates the Constitution as an incident of sovereign power, but is noted in the Takings Clause of the Fifth Amendment, which concludes with the caution "nor shall private property be taken for public use, without just compensation."[5] Most prominent among the "public use" cases over the past fifty years are *Berman v. Parker*,[6] *Hawaii Housing Authority v. Midkiff*,[7] and the *Kelo* case. In general, the Supreme Court's decisions give great deference to governmental decisions that use eminent domain for the condemnation of private property. In *Midkiff*, for example, the Court said that government decisions to use eminent domain will be upheld as long as it is "rationally related to a conceivable public purpose."[8]

Most state courts have followed the Court's deference in this area, including Michigan's Supreme Court in the 1981 case of *Poletown Neighborhood Council v. City of Detroit*.[9] In *Poletown*, the Michigan Supreme Court allowed the condemnation of private property to make way for a General Motors manufacturing plant in Detroit; the Court was persuaded that "public use" could be satisfied by the potential for the retention and creation of jobs. But in 2004 the Michigan Supreme Court overruled *Poletown* in *County of Wayne v. Hathcock*.[10] The *Hathcock* court adopted the dissenting opinion of Justice Ryan from *Poletown*, an opinion which would impose more stringent criteria to identify public use.

II. THE SUPREME COURT CASES: *BERMAN* AND *MIDKIFF*

Prior to Kelo, the Court's rulings in *Berman v. Parker* and *Hawaii Housing Authority v. Midkiff* had largely defined eminent domain law in

[5] U.S. CONST., amend. V.
[6] 348 U.S. 26 (1954).
[7] 467 U.S. 229 (1984).
[8] *Id.* at 241.
[9] Poletown Neighborhood Council v. City of Detroit, 304 N.W.2d 455 (Mich. 1981).
[10] County of Wayne v. Hathcock, 684 N.W.2d 765 (Mich. 2004).

the United States.[11] The issue in *Berman* was whether eminent domain taking of "blighted" property could be considered "public use." During the 1940's there were some areas in the District of Columbia that had become "slums." In 1945 the District of Columbia Redevelopment Act was chartered to clean up blighted areas by redesigning them to be safe and updated; the Act authorized the use of eminent domain to do this work.

In one part of southwest D.C., the planning commission charged with oversight of the Redevelopment Act reported that "64.3% of the dwellings were beyond repair, 18.4% needed major repairs, only 17.3% were satisfactory; 57.8% of the dwellings had outside toilets, 60.3% had no baths, 29.3% lacked electricity, 82.2% had no wash basins or laundry tubs, and 83.8% lacked central heating."[12] The commission decided to condemn and redevelop the area, and developed a comprehensive plan for the blighted area that included "housing, business, industry, recreation, education, public buildings, public reservations, and other general categories of public and private uses of the land."[13]

After a public hearing was held to present the plan to the citizens, the planning commission presented the plan to the District Commissioners for approval. Once approved, the plan was certified by the Redevelopment Agency, which authorized the use of eminent domain for assembling the land. The Agency would then transfer the land to private developers for demolition and construction. But Berman, who owned a department store in the area, contested the government's use of eminent domain because his property was still commercially viable, and because his property was not being taken for a "public use" but was instead going to be developed and operated by a private party.

With respect to Berman's store not being blighted, the Court's opinion emphasized the importance of redesigning the whole area, "so as to eliminate the conditions that cause slums—the overcrowding of dwellings, the lack of parks, the lack of adequate streets and alleys, the absence of recreational areas, the lack of light and air, the presence of outmoded street patterns."[14] The U.S. Supreme Court was not disposed to review each piece of property, its condition, and whether or not it contributed to the blight of the area; rather, the boundaries, size of the

[11] Advocates for Susette Kelo are convinced that the Supreme Court took a wrong turn some 50 years ago in the Berman decision. According to the Scott Bullock, senior attorney at the Institute for Justice, which represented Kelo and other New London residents, "the meaning of the public-use restriction on eminent domain was fundamentally altered by the Court's 1954 decision in Berman v. Parker. . ." See Scott Bullock, *Narrow 'Public Use*,' N.J. LAW JOURNAL, Aug. 23, 2004.

[12] *Berman*, 348 U.S. at 30.

[13] *Id*. at 29.

[14] *Id*. at 34.

project were deemed to be legislative prerogatives rather than issues suitable for judicial review. Further, the transfer of property to a private party was incidental to its "public use" of the elimination of blight, and property owners' rights were deemed satisfied when they ". . .receive that just compensation which the Fifth Amendment exacts as the price of the taking."[15] The property owners lost their property, but a "public use" of eliminating blight was served. Therefore, the two criteria for exercising eminent domain were met, the project served a "public use," and the property owners were fairly compensated.

Hawaii v. Midkiff was decided by the Court in 1984. The issue was whether eminent domain could be used to condemn property in good condition and transfer it to a private party. Early settlers of the Hawaiian Islands had a feudal land tenure system. Under this system one chief controlled all the land and gave control of smaller parcels to sub-chiefs, who would give control to others who would work the land. The high chief always maintained control of the land; there was no private land ownership.

In the 1960's the Hawaiian Legislature looked at the concentration of land ownership and found that 47% of the land was owned by 72 people. "The legislature concluded that concentrated land ownership was responsible for skewing the state's residential fee simple market, inflating land prices, and injuring the public tranquility and welfare."[16] In order to distribute land ownership more equitably the Hawaiian Legislature encouraged landowners to sell their properties, but owners generally refused because they would have to pay high taxes on the sale of their land. The legislature then enacted the Land Reform Act of 1967 to make the sale of the land involuntary so that the owners would face fewer tax consequences. In order for land to be condemned it had to meet certain criteria: it had to be a residential lot with a single family home, at least five acres in size, and either 25 tenants (or half of the tenants, whichever was less) had to want to purchase the property they were leasing. Once these criteria were met, a public hearing was held to determine if the condemnation served a "public purpose." If the condemnations served a "public purpose" then the price of acquisition was set by hearing, or by negotiations between seller and buyer. Stipulations were set that would not allow the property to be condemned if the tenant intended to "flip" the property for quick profit.

By the late 1970's the Hawaii Housing Authority tried to move forward with some property acquisitions using eminent domain, but some owners contested the takings as unconstitutional for lacking a "public use." The question certified by the Court in granting certiorari

[15] *Id.* at 35.
[16] *Midkiff*, 467 U.S. at 241, 242.

was whether the takings, with the intent to dissolve the high concentration of land ownership, constituted a "public use"? The Court answered in the affirmative.

> There were willing buyers, but the market didn't function properly as to allow the property to be purchased. The Act facilitated the proper functioning of the real estate markets. The people of Hawaii have attempted, much as the settlers of the original 13 Colonies did, to reduce the perceived social and economic evils of a land oligopoly traceable to their monarchs. The land oligopoly has, according to the Hawaii Legislature, created artificial deterrents to the normal functioning of the State's residential land market and forced thousands of individual homeowners to lease, rather than buy, the land underneath their homes.[17]

The U.S. Supreme Court decided that it did not have to determine whether the Act was likely to succeed in redistributing real estate ownership, but concluded that if the purpose was legitimate and the means were rational, the government did not have to take control of the land for the condemnations to be considered "public use." The purpose of the Act was to redistribute the property to help the real estate markets operate correctly.[18] Using eminent domain to condemn property and sell it to interested parties was merely the means to an end. Therefore, the use of eminent domain in those takings passed the scrutiny of the "public use" clause.

III. MICHIGAN SUPREME COURT CASES

A. Poletown v. Detroit

Detroit was suffering from severe economic recession in the early 1980's. Factories were shutting their doors, and unemployment was on the rise. Industrial cities like Detroit were losing factories to sun-belt states that could offer more "green field" sites and a lower cost of doing business. Detroit was hit especially hard due to its reliance on the auto industry. Overseas competition and more stringent environmental regulations were forcing automakers to become more competitive.

In 1980 General Motors announced its intention to close two plants in the City of Detroit by 1983, but also said that if they could find a suitable site in the city, they would be willing to stay and build a new 3 million square foot plant. GM set forth four requirements; first, a parcel of land of approximately 500 acres; second, a rectangular shape; third,

[17] *Id.*

[18] The Court states that "[r]edistribution of fees simple to correct deficiencies in the market determined by the state legislature to be attributable to land oligopoly is a rational exercise of the eminent domain power." *Id.* at 243.

access to a long haul rail way; and fourth, access to a freeway.[19] GM also requested that title to the land be turned over by May 1, 1981, less than a year from the time the request for land was made. The new plant was projected to create 6150 plant jobs, support the creation and maintenance of related businesses, and provide $15 million a year in tax revenues for the city.[20]

The City of Detroit evaluated 9 different sites, with one of them fitting the parameters set out by GM. The site included Poletown, a neighborhood of mostly second-generation Polish immigrants. The neighborhood was well-maintained, and could not be considered blighted. As the city moved to seize the property using eminent domain, a group of property owners claimed that their constitutional rights were being violated. The property owners invoked the Michigan Constitution to argue that their property was being taken for the benefit of a private corporation, not for "public use."[21] The property owners objected that GM was the primary beneficiary of the taking. The city argued that the purpose for taking the land was for "public use" because it would create jobs and, through an increased tax base, generally improve city services. The fact that ultimately the land would be owned by a private profit-seeking corporation was secondary.

The question raised to the Michigan Supreme Court was whether the eminent domain power could be used to take land and transfer it to a private, profit-seeking corporation. The Court ruled that "[t]he power of eminent domain is to be used in this instance primarily to accomplish the essential public purposes of alleviating unemployment and revitalizing the economic base of the community. The benefit to a private interest is merely incidental."[22] The Court said that not every project proposed by an economic development corporation would pass the scrutiny of the "public use" clause, but under the current circumstances it did. The Court also stated, "Such public benefit cannot be speculative or marginal but must be clear and significant if it is to be within the legitimate purpose as stated by the Legislature."[23] The opportunity of

[19] GM also requested 8 pages of other criteria, regarding everything from financing to the additional infrastructure required to be installed by the city.

[20] Poletown Neighborhood Council v. City of Detroit, 304 N.W.2d at 467.

[21] Article 10, § 2 of Michigan's 1963 Constitution provides that "private property shall not be taken for public use without just compensation therefor being first made or secured in a manner prescribed by law." The Michigan Constitutional clause is quite similar to the Fifth Amendment of the U.S. Constitution. The Michigan Supreme Court in both *Poletown* and *Hathcock* is basing its decisions on the Michigan "public use" clause rather than the Fifth Amendment.

[22] *Poletown*, 304 N.W.2d at 459.

[23] *Id*. at 460

keeping a major employer in the city, and adding to the tax base was a clear enough benefit to the public to pass "public use" scrutiny.

Justice Fitzgerald, joined by Justice Ryan, dissented in *Poletown*, believing that "the proposed condemnation clearly exceeds the government's authority to take private property"[24] The City relied heavily on many slum clearance cases to defend its position on the use of eminent domain. If in slum clearance cases the purpose was beautification and redevelopment, then it was incidental that the property was eventually transferred to private parties; yet in *Poletown* the purpose was not eradicating blight with incidental transfer of ownership to GM. He concluded that the potential for abuse of eminent domain was probable.

Justice Fitzgerald also disagreed with the majority's reliance on Michigan's Economic Development Corporations Act, which authorized the use of eminent domain for the alleviation of unemployment, and the promotion of industry. Justice Fitzgerald cited Lakehead Pipe Line Co. v Dehn[25] which stated that a "determination whether a taking is for a public or a private use is ultimately a judicial question"[26] Therefore, the fact that the legislature created the Act could not by itself provide a "public use" justification for taking land. He went on to say that if the legislature were allowed to decide which projects were for "public use," "citizens could be subjected to the most outrageous confiscation of property for the benefit of other private interests without redress." [27] Justice Fitzgerald also commented that Michigan had historically interpreted the "public use" clause narrowly, rejecting proposals to take property from one person and transfer it to another with the intention of economic development.

Justice Ryan joined Justice Fitzgerald in rejecting the view that the concept of "public use" was an evolving one, finding that prospects of greater employment, tax revenues, and general economic stimulation ". . .means that there is virtually no limit to the use of condemnation to aid private businesses."[28] Although their views did not prevail in 1981, the 2004 decision in County of Wayne v. Hathcock that reversed *Poletown* cited their views extensively, particularly those of Justice Ryan, who issued a separate dissenting opinion.[29] Justice Ryan's views provide a guide for governments wishing to navigate to a better balance between public and private interests in the use of eminent domain.

[24] *Id.*
[25] Lakehead Pipe Line Co v Dehn, 64 N.W.2d 903 (Mich. 1954).
[26] *Poletown*, 304 N.W.2d at 461.
[27] *Id*. at 461-62.
[28] *Id*. at 464.
[29] *Id*. at 464-82 (Justice Ryan, dissenting).

B. County of Wayne v. Hathcock

In the summer of 2004, the Michigan Supreme Court decided County of Wayne v. Hathcock,[30] over-ruling *Poletown* and restoring more stringent standards of "public use" in Michigan eminent domain decisions.

The Detroit Metro Airport completed a two billion dollar expansion in 2002, including the construction of a new jet runway. To prevent problems with property owners due to the increase in noise, Wayne County started purchasing land through voluntary sales. The Federal Aviation Administration (FAA) supplied part of the funds used to purchase the property with the condition that the land be put to economically productive use. In order to comply with this mandate, Wayne County's Job and Economic Development department drafted a plan to create a business and technology park called the Pinnacle Project.

The project would require approximately 1,300 acres of property adjacent to Metro airport. Wayne County acquired over 1000 acres through voluntary sales. The remaining land, 46 parcels scattered over the proposed Pinnacle project, was unable to be purchased by voluntary sales. The county moved to take the land by eminent domain. Having received the notice that the land was to be taken by eminent domain, 27 property owners sold their land to the Wayne County.[31] The remaining landowners challenged the condemnations, arguing that the county lacked statutory authority to exercise eminent domain, and that the Pinnacle Project did not serve a "public use" and therefore, the taking was unconstitutional.

The Michigan Supreme Court did affirm that Wayne County had the authority to seize property as part of a "public purpose," but still had to determine whether the project could be considered "public use." Using Justice Ryan's arguments in his *Poletown* dissent, the Court decided that the project could not be considered "public use." Justice Ryan had articulated three conditions for public use in eminent domain cases under the Michigan constitution: (1) there had to be a public necessity of the "extreme sort otherwise impracticable,"[32] (2) the post-eminent domain use of the land must have some continuing accountability to the public,[33] and (3) determination of the specific land to be condemned is made without reference to the private interests of the corporation.[34]

[30] County of Wayne v. Hathcock, 684 N.W.2d 765 (Mich. 2004).
[31] *Hathcock,* 684 N.W.2d at 771.
[32] *Poletown*, 304 N.W.2d at 478.
[33] *Id.* at 479.
[34] *Id.* at 480.

As to the first factor, the compelled "expropriation of property" must be essential to "the very *existence* of the enterprise pursued by the private corporation."[35] As examples, Justice Ryan points to highways, railroads, canals, and other instrumentalities of commerce; he notes that "it takes little imagination to recognize that without eminent domain these essential improvements, all of which require particular configurations of property—narrow and generally straight ribbons of land—would be 'otherwise impracticable' . . .(and) would not exist at all."[36] As to the second factor, he would reject any use of eminent domain for a public use where the public had no rights, supervision, or continuing interest in the property. Railroads, for example, have been subject to a "panoply of regulations" after eminent domain condemnations. Justice Ryan cited a number of cases under Michigan law where eminent domain was, prior to *Poletown*, rejected because of the lack of continuing public oversight or access to the condemned property. As to the third factor, Justice Ryan also made clear that General Motors' specifications as to the property it needed were contrary to extant case law.

The Hathcock decision used all three of Justice Ryan's conditions to reject the Pinnacle Project as a valid public use. First, the Court found that the project was not one "whose very *existence* depends on the use of land that can be assembled only by the coordination central government alone is capable of achieving."[37]

> To the contrary, the landscape of our country is flecked with shopping centers, office parks, clusters of hotels, and centers of entertainment and commerce. We do not believe, and plaintiff does not contend, that these constellations required the exercise of eminent domain or any other form of collective public action for their formation.[38]

Second, the project will be transferred to private enterprises with no public oversight.

> Rather, plaintiff intends for the private entities purchasing defendants' properties to pursue their own financial welfare with the single-mindedness expected of any profit-making enterprise. The public benefit arising from the Pinnacle Project is an epiphenomenon of the eventual property owners' collective attempts at profit maximization. No formal mechanisms exist to ensure that the businesses that would

[35] *Id*. at 478. (emphasis in original)
[36] *Id.*
[37] *Hathcock*, 684 N.W.2d at 783.
[38] *Id*.

> occupy what are now defendants' properties will continue to contribute to the health of the local economy.[39]

Third, the land that was to be condemned had no significance to the county, other than being part of its proposed project. The land did not need to be cleared of blight for the safety and benefit of the public. The reason the land was chosen was because it was it close proximity to the county's existing land. The sole reason for taking the land was to turn it over to a developer so he could pursue their purpose of profit maximization.

In all respects, the *Hathcock* majority followed Justice Ryan and returned to a pre-*Poletown* jurisprudence of "public use" under the Michigan Constitution. The only dissenting views on the Michigan Supreme Court related not to the result (all agreed the *Poletown* should be reversed), but as to the whether the decision should have retroactive effect (it did, which in effect invalidated the County's attempted acquisition of properties for the Pinnacle Park project by the use of eminent domain). There was also one dissent (Justice Weaver) from the view that "public use" should be defined through the eyes of those "sophisticated in the law" at the time of the Constitutional provision's ratification.

The Court ended its opinion in *Hathcock* by noting that every business does contribute to the public good in some way. But, "[t]o justify the exercise of eminent domain solely on the basis of the fact that the use of that property by a private entity seeking its own profit might contribute to the economy's health is to render impotent our constitutional limitations on the government's power of eminent domain."[40] If ownership of property would always be subject to the government's decision that "another private party would put one's land to better use, then the ownership of real property is perpetually threatened by the expansion plans of any large discount retailer, 'megastore,' or the like."[41]

While *Hathcock* effectively laid *Poletown* to rest in Michigan, other states were struggling with "public use." New London, Connecticut's plan to develop a shopping center, luxury hotel and conference center adjacent to a new Pfizer facility gave rise to a lawsuit that would reach the Supreme Court and present state and federal lawmakers with a case that raised the conflict between private rights and "public use" to a much more visible level.

[39] *Id.* at 784.
[40] *Id.* at 786.
[41] *Id.*

IV. KELO V. NEW LONDON

The 2005 Supreme Court decision in *Kelo v. New London* was the subject of considerable critical commentary, and has spawned a number of legislative proposals to counteract its effects. There are numerous law review articles and comments attesting to its significance.[42] The modest aim of this article is to suggest the strengths and limitations of the Michigan approach to the "public use" question, and to measure that approach against a number of legislative proposals that have emerged.

Like the City of Detroit in the *Poletown* case, New London, Connecticut was in need of economic development. By some accounts, long before the City of New London began acquiring property in the Fort Trumbull area, negotiations were being conducted with Pfizer to put its global research and development facility within city limits rather than in the nearby suburbs.[43] When Pfizer found the Fort Trumbull area—with lovely views along the banks of the Thames River—it notified New London that Fort Trumbull would have to be updated into a mixed-use

[42] *See, e.g.* Sonya D. Jones, Comment, *That Land Is Your Land, This Land Is My Land...Until the Local Government Can Turn It for a Profit: A Critical Analysis of Kelo v. City of New London*, 20 B.Y.U. J. PUB. L. 139 (2005); Trent Christensen, Note: *From Direct "Public Use" to Indirect "Public Benefit": Kelo v. New London's Bridge from Rational Basis to Heightened Scrutiny for Eminent Domain Takings*, 2005 B.Y.U. L. REV. 1669 (2005); Ashley J. Fuhrmeister, Note, *In the Name of Economic Development: Reviving "Public Use" as a Limitation on the Eminent Domain Power in the Wake of Kelo v. City of New London*, 54 DRAKE L. REV. 171 (2005); Brent Nicholson and Sue Ann Mota, *From Public Use to Public Purpose: The Supreme Court Stretches the Takings Clause in* Kelo v. City of New London, 41 GONZ. L. REV. 81 (2005/2006). Eric Rutkow, Comment, Kelo v. City of New London, 30 HARV. ENVTL. L. REV 261 (2006); Charles E. Cohen, *Eminent Domain After* Kelo v. City of New London: *An Argument for Banning Economic Development Takings*, 29 HARV. J.L. & PUB. POL'Y 491 (2006); Brett Talley, *Recent Development, The Supreme Court of the United States, 2004 Term*: *Restraining Eminent Domain Through Just Compensation*: Kelo v. City of New London, 125 S.Ct. 2655, 29 HARV. J.L. & PUB. POL'Y (2006); Orlando E. Delogu, Kelo v. City of New London – *Wrongly Decided and a Missed Opportunity for Principled Line Drawing With Respect to Eminent Domain Takings*, 58 ME. L. REV. 17 (2006); Randy J. Bates, II, *Casenote: What's the Use? The Court Takes a Stance on the Public Use Doctrine in Kelo v. City of New London*, 57 MERCER L. REV. 689 (2006); Christian M. Orme, Note, *Kelo v. New London: An Opportunity Lost to Rehabilitate the Takings Clause*, 6 NEV. L.J. 272 Fall (2005); Paul W. Tschetter, Kelo v. New London: *A Divided Court Affirms the Rational Basis Standard of Review in Evaluating Local Determinations of Public Use*, 51 S.D. L. REV. 193 (2006); Haley W. Burton, Case Note, Property Law, *Not So Fast: The Supreme Court's Overly Broad Public Use Ruling Condemns Private Property Rights with Surprising Results*. Kelo v. City of New London, *125 S. Ct. 2655 (2005)*, 6 WYO. L. REV. 255 (2006); Glen H. Sturtevant, Jr., Note, *Economic Development as Public Use: Why Justice Ryan's Poletown Dissent Provides a Better Way to Decide* Kelo *and Future Public Use Cases*, 15 FED. CIR. B.J. 201 (2005/2006).

[43] John McIlwain, *A Primer on Kelo v. New London; Eminent Domain on a Slippery Slope*, Urban Land Institute, August 26, 2005, available at http://www.uli.org/AM/Template.cfm?Section=Home&CONTENTID=33971&TEMPLATE=/CM/ContentDisplay.cfm

community in keeping with a world-class research facility.[44] As in *Poletown*, the development plan as approved by the city council contained all of Pfizer's requirements: a luxury hotel for it clients, upscale housing for its employees, and office space for its contractors . . . as *well as the overall redevelopment' of the . . . neighborhood adjacent to Pfizer*."[45]

Lawsuits and appeals by the property owners in the Connecticut judicial system followed.[46] After the Connecticut Supreme Court upheld the use of eminent domain,[47] largely on the basis of *Berman* and *Midkiff*, the owners petitioned the Supreme Court for certiorari. The Supreme Court granted certiorari in *Kelo* on September 28, 2004.[48] The Court heard oral arguments on February 22, 2005, and handed down the opinion on June 23, 2005.[49] The Court split five to four in favor of affirming the Connecticut Supreme Court's decision. Justice Stevens wrote the majority opinion, joined by Justices Kennedy, Souter, Ginsburg, and Breyer. Justice Kennedy also wrote a separate concurrence. Justice O'Connor wrote the leading dissent, joined by Chief Justice Rehnquist and Justices Scalia and Thomas.[50] Justice Thomas wrote a separate dissent as well.[51]

After reviewing the facts and the Court's prior public use decisions (including *Berman* and *Midkiff*), Justice Stevens noted broadly that the Court's "public use jurisprudence has wisely eschewed rigid formulas and intrusive scrutiny in favor of affording legislatures broad latitude in determining what public needs justify the use of the takings power."[52] He notes that New London has "carefully formulated an economic development plan that it believes will provide appreciable benefits to the community,"[53] and viewed "in light of the entire plan" that "unquestionably serves a public purpose, the takings challenged here satisfy the public use requirement of the Fifth Amendment."[54] Justice Stevens asserts that there is ". . .no principled way of distinguishing economic

[44] *Id.*

[45] Brief of Petitioners at 5, Kelo v. City of New London, 125 S. Ct. 2655 (2005) (No. 04-108) (emphasis added).

[46] Kelo v. City of New London, 2002 Conn. Super. LEXIS 789 (2002).

[47] Kelo v. City of New London, 843 A.2d 500 (Conn. 2004).

[48] Kelo v. City of New London, 125 S. Ct. 27 (2004) (granting certiorari).

[49] *Kelo*, 125 S. Ct. at 2655 (2005).

[50] *Id.* at 2671 (O'Connor, J., dissenting).

[51] *Id.* at 2677. (Thomas, J., dissenting).

[52] *Id*., at 2664.

[53] *Id*., at 2665.

[54] *Id*.

development from the other public purposes that we have recognized."[55] Moreover, Stevens acknowledges that the government's pursuit of a public purpose will often benefit individual private parties.[56] Ultimately, he rejects the petitioners' proposed "bright line rule" that would ". . .stop a city from transferring citizen *A*'s property to citizen *B* for the sole reason that citizen *B* will put the property to a more productive use and thus pay more taxes."[57]

Justice Stevens acknowledges that hardships may occur to property owners, and notes that States may place further restrictions on the takings power.[58] He notes that the "necessity and wisdom" of using eminent domain to promote economic development are "certainly matters of legitimate public debate,"[59] but claims that the Court can only construe public use within its role of interpreting the Fifth Amendment. Accordingly, he and four other Justices deny Kelo and the other petitioners the relief that they were seeking.

Justice O'Connor, in dissent, stated that there were just three types of takings that could comply with the "public use" requirement: private property transferred to public ownership; private property transferred to common carriers (railroads, public utilities) that will make it available to the public; and private property transferred to private parties "in certain circumstances and to meet certain exigencies,"[60] such as removal of urban blight or righting widespread social injustice.[61] Justice Thomas joined the O'Connor opinion, but also added his dissent, arguing for an

[55] *Id*. Given the similarities between the takings clause of the U.S. Constitution and the takings clause of the Michigan Constitution, Justice Ryan would find this statement arguable, at the least. There are principles that could be articulated; for example, economic development where the public retains some oversight or use. But we will still have to examine whether that principled way offers promise to legislatures and courts still struggling with these issues.

[56] *Id*. at 2666.

[57] *Id*. at 2667. "Such a one-to-one transfer of property, executed outside the confines of an integrated development plan, is not presented in this case. While such an unusual exercise of government power would certainly raise a suspicion that a private purpose was afoot, the hypothetical cases posited by petitioners can be confronted if and when they arise. They do not warrant the crafting of an artificial restriction on the concept of public."

[58] *Id*. at 2668. "Indeed, many States already impose "public use" requirements that are stricter than the federal baseline. Some of these requirements have been established as a matter of state constitutional law, while others are expressed in state eminent domain statutes that carefully limit the grounds upon which takings may be exercised."

[59] *Id*.

[60] *Id*. at 2673 (O'Connor, J., dissenting).

[61] O'Connor's framework of three categories bears a distinct resemblance to the three categories of public use takings noted in *Hathcock*.

"originalist" understanding[62] n50 of public use as actual use by the public. Justice Thomas also notes the importance of claims for social justice, observing that that the costs of economic development takings "will fall disproportionately on poor communities [that] are not only systematically less likely to put their lands to the highest and best social use, but are also the least politically powerful."[63]

There are merits in each of these dissenting views, but this article will focus on the post-*Kelo* reactions among state legislatures. The deference to states by the majority makes it clear that state legislatures now have primary authority to consider restraints on the use of eminent domain to create economic development by transfer of private property to other private owners. Judging by the number of proposals and bills already in the hopper or passed into legislation, that movement is considerable.[64] Prior to considering some of those proposals and bills, however, we can usefully measure the *Kelo* decision in light of *Hathcock*'s adoption of Justice Ryan's guidelines from his *Poletown* dissent.

V. *HATHCOCK* AND *KELO* COMPARED

Limitations on space prevent a complete comparison of the Pinnacle Park and Fort Trumbull developments in *Hathcock* and *Kelo*, respectively. But it seems doubtful that in either case that there was a public necessity of the "extreme sort otherwise impracticable."[65] Moreover, neither development would have featured any continuing accountability to the public.[66] Finally, in *Kelo* (but not *Hathcock*), a private party rather than the public (contrary to Judge Ryan's third criterion) specified the land to be condemned. In *Hathcock*, the specific preferences of an extant company or companies was not evident, and the proposed taking fit better with the public determination of which real property was desired for public purposes. In short, had the *Kelo* Court adopted the *Hathcock* approach, it would have granted relief to the property owners based on the first two of Justice Ryan's factors. But in doing so, it would have commanded compliance federally and among all fifty states; at present, each state may now consider the best approach

[62] For an explanation of "originalist" interpretations of the Constitution, see Richard Kay, *Originalist Values and Constitutional Interpretation*, 19 HARV. J.L. & PUB. POL'Y 335 (1996).

[63] Kelo, 125 S.Ct. at 2686-87 (Thomas, J., dissenting).

[64] *See generally* Eminent Domain in 2006 State Legislation [hereafter NCSL Eminent Domain], available at http://www.ncsl.org/programs/natres/emindomainleg06.htm (last accessed Mar. 28, 2006).

[65] *See infra* notes 32 – 36 and accompanying text.

[66] *Id.*

to balance private rights and public interests. Justice Ryan's guidelines may prove persuasive to at least some.[67]

VI. POST-*KELO* LEGISLATIVE INITIATIVES

According to the National Conference of State Legislatures, eminent domain legislation has been passed or introduced in at least 42 states during 2006 legislative sessions.[68] The Institute for Justice claims that 43 state legislatures have passed or will soon consider eminent domain reform in light of the *Kelo* decision.[69]

A. Enacted Legislation

Among the measures already enacted, Idaho now prohibits the use of eminent domain for "any alleged public use which is merely a pretext for the transfer of the condemned property or any interest in that property to a private person."[70] Indiana's response to *Kelo* specifies that use of eminent domain will accomplish more than "only increasing the property tax base of a government entity" and provides damages for "business losses."[71] The NCSL indicates that Indiana's bill also requires payment of compensation where the property condemned is the person's primary residence at a rate equal to 150 percent of fair market value.[72] South Dakota prohibits the use of eminent domain for transfer to private persons, nongovernmental entities, or other public-private business entities, or where the purpose is primarily to enhance tax revenue.[73] Alabama now prohibits the use of eminent domain (a) for retail, commercial, residential, or apartment development, (b) for purposes of generating tax revenues, or (c) for the transfer of private property to

[67] For a student note that approves of Justice Ryan's approach, see Glen H. Sturtevant, Jr., Note, *Economic Development as Public Use: Why Justice Ryan's Poletown Dissent Provides a Better Way to Decide Kelo and Future Public Use Cases*, 15 FED. CIR. B.J. 201 (2005/2006).

[68] NCSL Eminent Domain, *supra* note 64.

[69] Institute of Justice, *One Year After Kelo Argument National Property Rights Revolt Still Going Strong*, *available at*, http://www.ij.org/private_property/connecticut/2_21_06pr.html (last accessed Mar. 28, 2006).

[70] H.R. 555, 58th Leg., 2d Reg. Sess. (Idaho 2006), amending Chapter 7, Title 7, Idaho Code (see Section 7 – 701A. LIMITATION ON EMINENT DOMAIN FOR PRIVATE OR ECONOMIC DEVELOPMENT PURPOSES), *available at* http://www3.state.id.us/oasis/H0555.html.

[71] H.R. 1010, 114th Gen. Assem., 2d Reg. Sess. (Ind. 2006), *available at* http://www.in.gov/legislative/bills/2006/HB/HB1010.1.html. *See also* NCSL Eminent Domain, *supra* note 64.

[72] *Id.*

[73] 2006 S.D. Laws 1080 ("An Act to restrict the use of eminent domain under certain circumstances and to protect private property rights from acquisition by the use or threat of eminent domain.")

another private party.[74] Delaware restricts the use of eminent domain to a "recognized public use."[75] Ohio has placed a moratorium on eminent domain for economic development purposes where using the power would ultimately result in the property being transferred to another private party; the moratorium lasts until December 2006, while a task force studies eminent domain issues.

Just north of Ohio, in the Pleasant Peninsula,[76] Michigan voters will consider a proposal on the November 2006 ballot that if someone's house is taken for public use, "just compensation" shall be at least 125% of the property's fair market value; the proposal specifies that "public use" does not include transfers of property from one private entity to another, either for economic development or for generating additional tax revenue.[77] Kentucky has passed an act that defines public use as ownership by "the commonwealth" or its subdivisions, acquisition and transfer or property for the purpose of eliminating blight, slums, or substandard and unsanitary areas. The act specifically prohibits the condemnation and subsequent transfer of property to a "private owner for the purpose of economic development that benefits the general public only indirectly. . ."[78] Alabama's revision of eminent domain includes the proviso that neither the State nor its various subdivisions shall use eminent domain to condemn property for the purpose of private retail, office, commercial, industrial, or residential development, revenue enhancement perceived public good, or any purpose other than actual use by the public."[79]

B. Pending Proposals

The National Conference of State Legislatures has categorized these bills and other pending proposals in five categories: (1) Authorization for a Public Use, (2) Restriction of Eminent Domain Use to Blighted Properties, (3) Enhanced Public Notice, Hearing and Negotiation Criteria, (4) Local Government Approval, and (5)Prohibiting Eminent Domain for Specified Purposes.[80] The first category may not (as Delaware's legislation did not) define "authorized public use," and so may be of

[74] NCSL Eminent Domain, *supra* note 64.

[75] *Id.*

[76] According to the state's official website, Michigan's motto is "Si Quaeris Peninsulam Amoenam Circumspice" (translated: "If you seek a pleasant peninsula, look about you.") Available at http://www.michigan.gov/som/0,1607,7-192-29938-2606--,00.html (last accessed Aug. 1, 2006).

[77] NCSL Eminent Domain, *supra* note 64.

[78] *Id.*

[79] *Id*. *See also* http://alisdb.legislature.state.al.us/acas/searcableinstruments/2006rs/bills/sb297.htm (last accessed Mar. 28, 2006).

[80] NCSL Eminent Domain, *supra* note 64.

limited deterrence to *Kelo*-type takings. The second category may or may not follow *Berman* in allowing planned, comprehensive redevelopment of blighted areas with non-blighted properties. The third and fourth factors would only slow down the process of eminent domain condemnations, but the fifth factor would (as seen in Alabama and Kentucky) foreclose the kind of eminent domain taking seen in *Kelo v. New London*.

Even the Michigan proposal for voters may go too far in limiting state and local authorities. The more nuanced approach taken in *Hathcock* would clearly foreclose *Kelo*-type takings, but (following Justice Ryan) would allow for uses of eminent domain where necessity was exceedingly clear, where governmental supervision and control (even if not use) would continue, and where the private entities were not specifying the land and the type of development desired. The Michigan League of Municipalities is on record as opposing the ballot referendum, noting that the amendments to the current law will undermine *Hathcock*, which is "clearly articulated," and "lead to extensive and needless litigation," undermining "key protections afforded property owners under the Hathcock decision."[81]

To move beyond *Kelo v. New London*, state judiciaries and legislatures would be well-advised to start with *Hathcock* and the categories suggested by Justice Ryan in his Poletown dissent. The categories are not foolproof or self-evident, but promise to provide a more pragmatic course than the overly broad mandate to local authorities that Kelo provides, or the overly restrictive post-*Kelo* initiatives that would prohibit use of eminent domain powers for anything other than publicly owned infrastructure or developments. States should be wary of overly restrictive mandates that would disallow counties and municipalities the flexibility to use eminent domain to vest ownership in the private sector while retaining some controls, regulatory or otherwise, over the use of the property. Reversionary interests, conditions, restrictions, joint ventures, and leasing all can usefully modify a straight fee-simple grant to the new owner. Laws that mandate public's fee simple ownership may not provide the requisite flexibility for public interests balanced by private rights. For example, use of eminent domain to hand over fee simple ownership of condemned property to a major league baseball team would be prohibited under *Hathcock*, but is seemingly prohibited under *Kelo.* Yet requiring that the public be able to use the property and own it outright does not seem realistic; when the team leasing the stadium leaves town, the public ownership of the property may be a net liability to the public's interests. In any case, legislators can look not

[81] *Michigan Municipal League, Hot Bills and Issues*, *available at* http://www.mml.org/legislative/bills/eminentdomain.htm.

only to *Hathcock*, but to other state judiciaries that have limited eminent domain in ways that the Supreme Court has not[82] in order to avoid overly broad restrictions on eminent domain.

VII. CONCLUSION

The issue of public interest vs. private property rights continues to confound politicians and judges and commentators, including this one. At its root, however, the issue puts "rights" of property owners against the "greater good" to the public, a classic conflict of ethical perspectives ("rights" vs. "utilitarianism"). Post-*Kelo*, many critics pointed out how well-intentioned urban development projects have failed to have their intended economic benefits.[83] Because utilitarian justifications based on the "greatest good" inevitably depend on accurately predicting far more positive consequences than negative ones,[84] predictions that go awry give ample ammunition to critics of a public use doctrine that allows "economic development" to trump individuals' property rights. There are also the redistribution issues of seeming to take from the poor and provide for the wealthy or politically well-connected in cases like *Kelo* and *Poletown*. There are, of course, those who point to the success

[82] *See, e.g.* Arizona: Bailey v. Myers, 76 P.3d 898, (Ariz. Ct. App.2003) (taking of private property for retail redevelopment not a valid public use); Arkansas: Little Rock v. Raines, 411 S.W.2d 486 (Ark. 1967); Florida: Baycol, Inc. v. Downtown Development Authority, 315 So.2d 451 (Fla.1975); Illinois: Southwestern Illinois Development Authority v. National City Environmental, L.L.C., 768 N.E.2d 1 (Ill 2002); Kentucky: Owensboro v. McCormick, 581 S.W.2d 3 (Ky.1979); Maine: Opinion of the Justices, 131 A.2d 904, 908 (Me. 1957) (advisory opinion stating that eminent domain may not be used for industrial development purposes); New Hampshire: Merrill v. City of Manchester, 499 A.2d 216, 218-19 (N.H. 1985) (could not use eminent domain for an industrial park because it did not benefit the public); New Jersey: Casino Reinvestment Dev. Auth. v. Banin, 727 A.2d 102, 111 (N.J. Super. Ct. Law Div. 1998) (general deference to legislative determinations of public use rejected because here it was not clear that the public benefits were greater than the private ones); North Carolina: Tucker v. City of Kannapolis, 582 S.E.2d 697 (N.C.Ct. App.2003) (public must have a right to use the property); Oklahoma: City of Midwest City v. House of Realty, Inc., 100 P.3d 678 (Okla.2004) (city lacked the authority to condemn for economic development purposes.); South Carolina: Ga. Dept. of Transp. v. Jasper County, 586 S.E.2d 853, 856 (S.C. 2003) (holding that the condemnation of property for a marina was not a public use); Karesh v. City Council, 271 S.C. 339, 247 S.E.2d 342 (1978).Washington: In re Seattle, 96 Wash.2d 616,638 P.2d 549 (1981).

[83] *See, e.g.*, John Tierney, *Your Land is My Land*, N.Y. TIMES, July 5, 2005. Tierney, a Pittsburgh native, catalogues a number of public planning failures there using eminent domain. For example, he writes that "[b]ulldozers razed the Lower Hill District, the black neighborhood next to downtown that was famous for its jazz scene (and now famous mostly as a memory in August Wilson's plays). The city built a domed arena that was supposed to be part of a cultural 'acropolis,' but the rest of the project died. Today, having belatedly realized that downtown would benefit from people living nearby, the city is trying to entice them back to the Hill by building homes there." *Id.*

[84] See MANUEL VELASQUEZ, BUSINESS ETHICS: CONCEPTS AND CASES 60-67 (2006).

of urban renewal projects.[85] Still, it is difficult to know what kinds of positive economic activities would have transpired in the absence of government intervention; the former World Trade Center in New York City is a case in point.[86]

Fortunately, there is evidence of considerable pragmatic "tinkering" going on in the states. Justice Brandeis famously referred to the U.S. federal system as providing many potential laboratories of democracy that could experiment freely with new social and economic possibilities, from which other states could learn.[87] There is a great deal of experimentation going on with regard to public use and eminent domain; the Supreme Court has made a choice in *Kelo v. New London* that allows a multiplicity of responses that can fairly balance "rights" and the public good. A fairly persuasive case can be made that the *Poletown* experiment has run its course, and that the State of Michigan has rediscovered a better formula using its traditional restrictions on eminent domain as articulated in Justice Ryan's *Poletown* dissent and in *County of Wayne v. Hathcock*.

[85] *See, e.g.*, National League of Cities, *Press Release: Supreme Court Decision in Eminent Domain Case Supported by Cities*, June 23, 2005, available at http://www.nlc.org/Newsroom/press_room/5506.cfm.

[86] The World Trade Center project, started in 1962 and culminating in the dedication of the Twin Towers in 1970, has been described as "a massive and fully tax-exempt public intervention in the private real estate market through the development of the world's largest office building." See Roger Cohen, *Casting Giant Shadows: The Politics of Building the World Trade Center*, originally published in the Winter 1990/1991 issue of Portfolio: A Quarterly Review of Trade and Transportation, reprinted and available at http://www.greatbuildings.com/buildings/World_Trade_Center_History.html (last accessed March 30, 2006). Julia Vitullo-Martin writes that the WTC "wiped out hundred of businesses and depressed the downtown real estate market for most of the 1970s and 80s. And Battery Park City is an example not of private development but of state-sponsored development. Yet this gross misjudgment is touted by government as proof of the benefits of eminent domain." Julia Vitullo-Martin, Thinking About Eminent Domain, Manhattan Institute website, http://www.manhattan-institute.rog/email/cre_newsletter 02-05.html (last accessed March 20, 2006). *Accord* Gary North, *Eminent Remains: The Buried Legacy of the Original Ground Zero*, available at http://www.lewrockwell.com/north/north207.html (last accessed March 30, 2006.)

[87] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country.")

FOREIGN TAKEOVERS: THE BARRIERS, JURISDICTION OF AMERICAN COURTS AND THE U.S. FOREIGN PRIVATE ISSUER EXEMPTION

by FRED J. NAFFZIGER*

When proposed corporate mergers involve multiple nations more issues than the normal ones, i.e. is the proposed acquisition price a fair one?, is there a strategic value underlying the transaction?, are the corporate cultures compatible?, will it pass muster by the anti-trust authorities?, etc. arise. Be it an outcome of a growing trend in global consolidation among industry competitors[1] or private equity groups perceiving attractive value in foreign buyouts,[2] cross border mergers are increasing.[3]

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[1] Examples run the gamut from well recognized names, i.e. Daimler-Benz of Germany acquiring America's Chrysler Corporation in 1998, to lesser known ones such as America's Zimmer Holdings acquiring Switzerland's Centerpulse AG in 2003 to become the number one producer worldwide of artificial hips and knees.

[2] American Malcom Glazer's May 2005 acquisition of Britain's famous Manchester United soccer club, with partial financing from private equity groups, as one example, created a tremendous public uproar in the United Kingdom. Most private equity acquisitions go on relatively unnoticed, except in the localities where the acquired companies operate. This is despite their growing value which reached totals in 2004 in Britain of (in billions of dollars) $52.45, Germany 27.7, and France, 23.29. *The Bad Guy? Private Equity,* BUSINESS WEEK, May 16, 2005, p. 46. It is not simply American private equity funds that engage in this activity. In February of 2006 an Australian firm indicated that it would make a $2,9 billion offer for the Irish telecommunications operator Eircom Group. *See* Jason Singer, *Australian Firm Plans Eircom Bid,* WALL ST. J., February 22, 2006, at C4.

[3] The value of global announced acquisitions in the time period of January 1 until May 16,2005, hit $986 billion, up 30% from the previous year. *Mergers Snapshot*, WALL ST. J.,

NATIONAL BARRIERS TO FOREIGN INVESTMENT

For a variety of reasons, be it xenophobia, cultural, political, or economic, nations will restrict or prohibit foreigners from holding interests in domestic businesses. When they exist, such restrictions can assume a variety of forms.

Unofficial Governmental Policy

One major obstacle to transnational mergers is the desire of certain governments to promote "national champions" in certain industries. While not an official statutory bar, such political and economic policies are, nonetheless, real barriers. France exemplifies such nationalistic behavior. For instance, in 2004 the government publicly intervened to insure the merger of Sanofi-Synthelabo with its fellow French firm, Aventis, rather than have the Swiss pharmaceutical firm Novartis successfully acquire Aventis.[4] The resulting firm, Sanofi-Aventis SA is now the world's third largest pharmaceutical company.

Such policies utilize a two pronged strategy: a) prevent an official bid from a foreign entity, and b) encourage a competing bid from a domestic bidder, if a foreign bid does develop. Upon occasion such policies are designed to create national champions able to compete globally with American and Asian behemoths. Other times they are utilized to maintain the nation's cultural social or culinary patrimony. That such unofficial intervention can enlist officials at a nation's highest levels is exemplified again in France. In mid 2005, it was rumored that PepsiCo, Inc, the American soft drink and snack food company, was interested in acquiring Danone SA of France. In response, the French Prime Minister, Dominique de Villepin labeled the company a national "crown jewel" and remarked that he would "defend the interests of France' in the matter.[5] The French Labor Minister, Jean-Louis Borloo, commented publicly that the government would do "everything" in opposition to the takeover.[6] The following day the French Interior Minister, Nicolas Sarkozy, told the press that with regard to the matter the government "has not given

May 18, 2005, at C6. Interestingly, it is not simply the advanced industrialized nations doing transnational deals. Emerging nations (See the later discussion in the text of Dubai Ports World' acquisition of P&O) are becoming more active. In only about six weeks, companies from emerging markets have announced $9.3 billion of deals in Europe, thereby exceeding the total for the year 2003. In America, the record had been $10 billion by such countries in the year 2000, but it soared to $14 billion in consummating 96 transactions in 2005. Jason Singer and Dennis Berman, *Companies in Emerging Markets Spark Deal Wave,* WALL ST. J., February 13, 2006, at A1.

[4] Jo Wrighton, *Paris Leaps to Defense of Danone Against Pepsi*, WALL ST. J., July 21, 2005, at A9 (discussing the Sanofi-Aventis matter).

[5] *Id.*

[6] *Id.*

up, and will not give up, on using powerful means to protect France's economic and social interest".[7] What is the nature of such a business that can evoke a high degree of protection from such high level national leaders? It is a Paris based producer of Dannon yogurt and Evian bottled water.

Such nationalism can exist not only in feelings and actions against foreigners who constitute outsiders, but upon occasion, against entities that are members of the same economic group. The Netherlands, Spain, and Italy are all members of the European Union. As such, theoretically a legal open market exists in and between such nations preventing discrimination against businesses of member nations. Despite that, AntonioFazio, Governor of the Bank of Italy, has thus far successfully prevented non Italian EU member banks from taking control of an Italian bank. He has done so in the case of the Spanish bank, Banco Bilbao S.A.'s attempted takeover of Rome's Banca Nazionale del Lavoro and that of The Netherlans ABN Amro Holding NV's all cash takeover offer for the Italian financial institution Banca Antonveneta SpA. In the latter instance, he gave quick approval to a white-knight Italian bank's request to increase its stake in Banca Antonveneta to 30%, while delaying a decision on ABN Amro's request, and ultimately approving an increase in its holdings to only 20%.[8]

Opposition to foreign takeovers will also arise when the perception develops that the actions of private investors is contrary to the interests of the citizenry. Germany, which is Europe's largest economy, aimed to combine what it viewed as the better aspects of capitalism, i.e. private ownership, while protecting workers against its rougher effects, such as layoffs, granting employees' seats on a corporation's supervisory board via co-determination laws, and providing generous social benefits in what is labeled a social-market economy. In this struggle to seek a proper balance, there is increasing hostility to free market ideas as its economy struggles.[9] In 2004 private equity investors spent $27.7 billion on purchases in Germany,[10] but the depth of the emotion generated on the issue is reflected in remarks by the head of Germany's Social Democratic Party in 2005 that foreign buyout funds "fall upon companies like swarms of locusts, strip them bare and move on". [11]

[7] Deborah Ball, *Danone Reports Higher Sales, Vows to Fight Any Takeover Bid",* WALL ST. J., July 22, 2005 at C4.

[8] Gabriel Kahn, Edward Taylor & Jason Singer, *Battle Over Italian Bank Intensifies,* WALL ST. J, MARCH 2, 2005, at A3.

[9] Early in 2005 its national unemployment rate rose to 12%, its highest level since the 1930's.

[10] *The Bad Guy? Private Equity,* BUSINESS WEEK, May 16, 2005, at 46.

[11] Marcus Walker, *Among Germans, Foreign Buyouts Heighten Angst,* WALL ST. J., June 30, 2005, at A1.

Official Legal Barriers

Nations frequently enact bans against foreign control of sensitive industries, i.e. telecommunications (satellite, radio, and television), newspapers, transportation, natural resources, intelligence, and defense related. Sometimes the restriction's relationship to the national interest is direct, as in the case of defense related businesses, and upon other occasions more tangential, as in restrictions upon newspaper ownership.

Petroleos Mexicanos (Pemex) is currently the world's seventh largest oil producer. It is the national oil company of Mexico. It is the result of Mexican President Lazaro Cardenas' decision of March 18, 1938 to nationalize the petroleum industry. As a result foreign investment in any and all aspects of the oil and natural gas industry is not permitted. This legal barrier to foreign investment is inscribed in the Mexican national Constitution.[12]

In an illustration from the United States, Congress has provided that the Secretary of Transportation may only issue a certificate of public convenience for domestic service to an air carrier that is "a citizen of the United States".[13] A citizen is defined as a) an individual citizen, b) a partnership, each of whose partners is a citizen, or c) a corporation whose president, board of directors and managing officers are at least two-thirds citizens and at least 75% of the voting interest it is owned or controlled, by citizens of the United States.[14]

National Security Issues, Foreign Acquisitions, and the United States

In 1988 Congress granted the President of the United States the authority to suspend or prohibit any foreign acquisition, merger or takeover of a U.S. corporation that is determined to threaten the national security of the United States.[15] An investigation is mandatory

[12] Mexican Constitution of 1917, Art. 27. Oil & silver were the prime natural resources of the nation at that time. This constitutional provision wasn't enforced, with respect to petroleum, until an oil workers strike against the foreign owned oil companies. The government proposed settlement terms for the strike favorable to the workers and the companies rejected them. The result was a highly popular nationalization of the industry and a lengthy dispute as to the value to be paid for the expropriated property. The companies wanted complete compensation, including funds for recoverable oil in fields they were developing under state granted oil concessions, while the government said it was only appropriate for surface equipment and materials, since the oil already belonged to the nation. The ultimate financial settlement, not surprisingly, favored the Mexican government's interpretation.

[13] 49 U.S.C. § 41102 (2002). Certificates may be granted to foreign carriers (non U.S. citizens) for the provision of foreign air transportation. 49 U.S.C. § 41302 (2002).

[14] 49 U.S.C. § 40102 (15) (2002).

[15] 50 U.S.C. § 2170 (2002). While commonly known as the" Exon-Florio Provision", it is section 5021 of the Omnibus Trade and Competitiveness Act of 1988 which amended section 721 of the Defense production Act of 1950. Subsequently, what is commonly

whenever the acquirer is controlled or acting on behalf of a foreign government and the acquisition could affect the national security of the U.S.[16]

The President has within his discretion the determination as to what constitutes national security, as the statute fails to provide a definition. However, it does list factors that may be considered in reaching a determination as to the effects the foreign acquisition could have upon national security: 1) domestic production needed for projected national defense requirements, 2) the capability and capacity of domestic industries to meet such requirements, 3) the control of domestic industries by foreign citizens as it affects the capability of the U.S. to meet these defense requirements, 4) the potential effects of the transaction on sales of military goods and technology to nations that support terrorism or proliferates missile technology or chemical and biological weapons, and 5) the potential effects of the transaction on U.S. technological leadership in areas affecting American national security.[17]

Foreign entities must give notice of an acquisition and if an investigation is necessary it must begin no later than 30 days after the notice and the investigation is to end within 45 days.[18] The President created the Committee on Foreign Investment in the United States (CFIUS) and designated it to receive the notice, determine if an investigation is required, to undertake it, if necessary, and make a recommendation to the President.[19]

CNOC'S BID FOR UNOCAL

China National Offshore Oil Corporation's (Cnoc) bid for Unocal in the summer of 2005 set off an emotional debate in America about foreign takeovers by certain purchasers. Unocal had agreed to a $16.5 billion

referred to as the" Byrd Amendment" was added requiring a Presidential investigation whenever the acquirer is controlled by or acting on behalf of a foreign government and the acquisition could affect the national security of America. Section 721 of Pub. L. 100-418, 102 Stat. 1107, made permanent law by section 8 of Pub. L. 102-99, 105 Stat. 487 (50 U.S.C. App. 2170) and amended by section 837 of the National Defense Authorization Act for Fiscal Year 1993, Pub. L. 102-484, 106 Stat. 2315, 2463.

[16] 50 U.S.C. § 2170(b) (2002).

[17] 50 U.S.C. § 2170(e) (2002).

[18] 50 U.S.C. § 2170(a) (2002).

[19] Executive Order 11856 (1975) and Executive Order 12661 (1988). If a reader wonders how the formation of CIFUS can pre-date the " Exon-Florio Provision's", 1988 grant of authority to prevent foreign acquisitions, the answer is that previously Congress had granted the President the authority to collect information on international investment, 22 U.S.C. § 101 (2002), and CIFUs was created to fulfill that function and Congress also earlier directed the Secretary of Commerce to report annually to Congress on foreign direct investment in the United States, 29 U.S.C. § 3142 (2002). Since CIFUS was already operating in the arena, the President decided to expand its borders to now encompass these added duties.

merger with Chevron, after which Cnoc entered the fray with a bid of $18.5 billion. At about the same time, the Chinese company Haier Group made a $1.3 billion offer for the American appliance maker Maytag. Both followed the May 2005 $1.75 billion purchase by the Chinese computer manufacturer Lenovo Group Ltd. of IBM's personal computer division. The latter two bids did not create the uproar that Cnoc's did.

China is both a major trading partner and competitor of the United States in the economic, political, and military milieu of the world. Cnoc is not simply a privately owned oil company; it is 70% owned by the Chinese government. And, with the companies being in the petroleum industry, the proposed merger raised not only foreign policy issues between the two governments, but also posed the question of whether such a merger would create a danger to America's energy security. Because the Cnoc bid was to be funded by Chinese government loans at below market rates, (some valued this subsidy as the equivalent of $10 per Unocal share[20]) there was also the issue of fair trade involved. The Chevron offer consisted of both stock and cash, while Cnoc's was all cash. The antitrust issues were less compelling with Unocal's oil production being about 1% of the world's total. The takeover faced review by CFIUS but Congress entered the furor in a significant manner when it amended a pending bill on energy matters to require a separate 120 day review of China's energy demands prior to Cnoc's closing of the deal.[21] In any takeover battle, of course, added delay can serve as a large impediment to one's takeover bid, as shareholders may opt for a lesser price from a competing bidder when the deal is certain and the higher bid faces uncertainty as to its ultimate viability. On August 2, 2005, Cnoc announced the end of its bid attributing it to what it labeled "regrettable and unjustified" political opposition in Washington.[22]

DUBAI AND AMERICAN SEAPORTS

The political volatility that the issue can involve, depending upon the nature of the acquisition and the nationality of the acquirer, was again on display in 2006. The Japanese company, Toshiba, defeated another Japanese bidder and America's General Electric company for Pennsylvania based Westinghouse with a bid of $5.4 billion.[23] There was nary a peep of political objection.

[20] David O'Reilly, *Chevron's Pitch*, WALL ST. J., July 12, 2005, at A16.

[21] *Congress Raises New Roadblock In Cnoc's Path to Unocal Deal,* WALL ST. J., July 27, 2005 at C4.

[22] David Barboza, *Chinese Company Withdraws Bid to Acquire Oil Firm in California,* www.nytimes.com/2005/08/02/business/worldbus...

[23] Chip Cummins, *Toshiba Wins Westinghouse With $5.4 Billiuon Bid,* WALL ST. J., February 7, 2006, at C2.

But when it was announced that DP World of Dubai, which is one of the Persian Gulf emirates making up the United Arab Emirates, bid of $6.8 billion won control of London based Peninsular & Oriental Steam Navigation Co.(P&O) a real brouhaha exploded in America. Of what concern is a Dubai acquisition of a London company to America? Well P&O runs the commercial operations of such American seaports as New York and New Jersey, Philadelphia, Baltimore, New Orleans, and Miami. A 9-11 hijacker was from Dubai and some of the financing for that terrorist attack was carried out through its financial institutions, despite it being a U.S. ally in the war on terror. Despite the approval of the transaction by the Committee on Foreign Investment, Senator Bill Frist, Republican leader of the Senate, has said that he will introduce legislation to delay the matter until it "gets a more thorough review".[24]

FOREIGN TAKEOVERS AND AMERICAN SECURITIES LAW

When no legal barriers exist to prevent the takeover of a domestic company by a foreign entity, nonetheless there remain various regulatory issues. Such matters run the gamut from the tax consequences emanating from the acquisition, to which jurisdiction's antitrust authority is to pass on its anticompetitive effects, to whose corporate and securities laws are applicable to which portions of the tender offer, registration of securities, proxy solicitations, and shareholder meetings. Legal uncertainty can lead one to hesitate in the pursuit an otherwise attractive cross border merger. One does not want to unexpectedly become ensnared in another nation's legal system. Let us now examine the susceptibility of a foreign merger partner being subject to American securities law due to its activities in consummating the acquisition of a United States target.

Jurisdictional Assertion by American Courts

With the United States consisting of fifty sovereign states, questions frequently arise as to the proper exercise of jurisdiction by one state over activities that touch other states. With regard to property, a state exercises *in rem* jurisdiction over property present in the state.[25] A determination as to the physical whereabouts of tangible property is rather straightforward. Intangible property, such as securities, can have jurisdiction shared by multiple states.[26] Judicial exercise of *in personam* jurisdiction over non residents is restricted to instances where the defendant has had "minimal contacts" with that state.[27] When a

[24] Associated Press, *Frist Joins Call to Halt U.S. Ports Deal,* N.Y. TIMES, Feb. 21, 2006, www.nytimes.com/aponline/national.

[25] Rose v. Himely, 8 U.S. 241 (1807), 4 Cranch 241 (1807).

[26] Tax Comm. V. Aldrich, 316 U.S. 174 (1942).

[27] International Shoe Co. v. Washington, 326 U.S. 310, 319 (1945).

defendant exercises the privilege of conducting activity within a state, thereby enjoying the benefit and protection of its law, such a nonresident defendant is now subject to that state's jurisdiction.[28] Soliciting a contract in a state, having the offer accepted in the state, and payments made from the state grants a state jurisdiction over an out of state defendant.[29] However, a state lacks jurisdiction over a trust formed in Delaware by a Pennsylvania resident merely because the settlor of the trust becomes domiciled years later in the third state.[30] Likewise, a state lacks jurisdiction over an out-of-state automobile dealer that sold a vehicle to a resident of that other state, who later had an accident in the second state while merely in the process of driving through that second state.[31]

Less frequently questions have arisen in American jurisprudence with regards to American judicial jurisdiction over defendants in foreign nations. Not surprisingly, a course of continuous and systematic business contacts with the United States will subject one to American jurisdiction. This is so even when the activities are unrelated to the subject matter of the litigation. The intentional direction of activities towards the United States will also serve as the basis for an assertion of jurisdiction by a U.S. court when the lawsuit relates to that conduct.[32] When the overseas activity violates American law and has a serious effect upon American commerce, the American courts also will have jurisdiction.[33] If the United States has served as a partial base for a fraud perpetrated overseas and, the American conduct extend beyond merely preparatory fraudulent activities, the United States can properly assert jurisdiction.[34]

A lesser volume of activity also will grant jurisdiction to a court if it meets the "minimal contacts" test.[35] The minimal necessary contact is not met by a Japanese manufacturer of tire valve assemblies who sells them to a Taiwanese tire manufacturer who, in turn, incorporates them into finished tires sold worldwide to subject the Japanese manufacturer to product liability litigation in California. The Supreme Court has ruled that a contrary decision in such circumstances would be "unreasonable and unfair" under the Due Process Clause of the American Constitution.[36]

[28] *Id.*

[29] McGee v. International Life Ins. Co., 355 U.S. 220 (1957).

[30] Hanson v. Denckla, 357 U.S. 235 (1958).

[31] World-Wide Volkswagen v. Woodson, 444 U.S. 286 (1980).

[32] Helicopteros Nacionales de Colombia v. Hall, 466 U.S. 408 (1984).

[33] Schoenbaum v. Bradshaw, 405 F2d 200 (2d Cir. 1968)(the subject matter of the litigation involved Canadian conduct).

[34] Alfadda v. Fenn, 935 F.2d 475,478 (2d Cir. 1991).

[35] *See supra* note 25.

[36] Asahi Metal Industries v. Superior Court of California, 480 U.S. 102 (1987).

What guidance can be given as to the applicability of American securities law to a foreign corporation contemplating the takeover of an American entity? Can a foreign acquirer become embroiled in the American judicial system because the target company is American? Yes, as to some portions of the statute, and maybe, as to another. Unfortunately, for attorneys seeking certitude in shaping legal advice to a foreign client, the answer is unclear with respect to the question of whether or not the distribution of proxies will subject the foreign partner to that relevant portion of American securities law. Three cases, one a merger case involving French and American concerns, a second merger case with a German and an American partner, and a third case involving a shareholder's derivative suit with regard to a Japanese parent and American subsidiary do not provide clarity by giving the same answer.

Derivate Suits Against Japanese Corporations Under Japanese Law By American ADR Owners

The issue of foreign companies and their possible exemption from the American securities statutes arose as a somewhat tangential matter in a stockholder's attempted derivative action against a Japanese corporation filed in a U.S. federal court.[37] An American holder of 1,246 American Depository Receipts[38] of Honda Motor Company, Ltd., a Japanese corporation, which in turn is the sole stockholder in its American subsidiary American Honda Motor Co., Inc., sought to bring a derivative action on their behalf for alleged wrongs committed by its directors, officers, and employees. The depository agreement for the ADR's specified that the rights of the holders and the obligations of the Company with respect to such holders "shall be governed by the laws of Japan". The court recognized this choice of law provision and dismissed the plaintiff's complaint because, under Japanese law, a holder of an ADR he is not recognized to be a shareholder.

The stockholder attempted to preserve his suit in the American court by arguing that the company disseminated false and misleading proxy materials in the United States, relative to the qualifications of its directors (by failing to disclose their relevant actions or inactions in

[37] Batchelder v. Kawamoto, 147 F. 3d 915 (1998).

[38] In this Honda matter, 1 ADR equaled 10 shares in Honda. ADR's were created in the U. S. in 1927 and represent a specified number of shares in a foreign corporation. They trade as stock on a U.S. exchange, are traded in U.S. dollars, and if dividends are declared, they are paid in U.S. dollars. An investment bank buys the shares in the foreign company and issues the ADR's, determining the ratio of foreign shares to one ADR. Another institution, the depository bank, handles the issuance of ADR certificates, solicitation of proxies, etc. Sometimes the term ADS, American Depository Share will be used interchangeably.

these matters) in connection with its shareholders meeting. The 1934 Securities Exchange Act states that it is unlawful to solicit proxies in contravention of "such rules and regulations as the Securities and Exchange Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[39] The relevant proxy rule in this case provides, in pertinent part, that no "solicitation subject to this regulation shall be made by means of any proxy statement… which, at the time…it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."[40]

THE "FOREIGN PRIVATE ISSUER" EXEMPTION.

The American proxy solicitation rules exempt securities registered by a "foreign private issuer."[41] A "foreign private issuer" includes corporations organized under the laws of a foreign country, other than a foreign government issuer. This exemption will be lost if the issuer meets the following criteria: a) in excess of 50% of the issuer's outstanding voting securities are directly or indirectly held of record by United States' residents, and b) any one of the following three items: i) a majority of its executive officers or directors are U.S. citizens or residents; ii) in excess of 50% of its assets are located in the U.S.; or iii) the issuer's business is administered principally in the U.S.[42]

With very limited discussion the appellate court in the Honda ADR case ruled that the claim based upon alleged dissemination of misleading proxy material failed because, as a "foreign private issuer," the Honda securities are exempt from the American proxy provisions.[43]

Are French Companies "Foreign Issuers," Like the Japanese?

On December 8, 2000 the French concern Vivendi consummated a $36 billion merger with Seagrams and a $ 12 billion merger with Canal Plus. On July 3, 2002 Jean-Marie Messier, Vivendi's CEO resigned. Simultaneously, the company announced that it had a financial liquidity problem. A subsequent drop in the market price of the stock eventually led to the filing of a class action lawsuit in the United States against Vivendi, Messier, and Vivendi's Chief Financial Officer, Mr. Hannezo, by various holders of common stock and ADR's. The plaintiffs alleged that the defendants had caused material misrepresentations and omissions in the registration statement and prospectus issued in connection with the merger, as well as other financial statements

[39] 15 U.S.C. § 78n (a)(2000).
[40] Rule 14a-9, 17 C.F.R. § 240.14a-9.
[41] 17 C.F.R. 240.3a12-3(b).
[42] 17 C.F.R. 240.3b-4(c).
[43] Batchelder v. Kawamoto, 147 F. 3d 915 (1998), U.S. App. LEXIS 12658, at 10 (9th Cir. July 15, 1998).

subsequently filed with the SEC, thereby causing them a financial loss.[44] Further, they complained that Vivendi's proxy statement, included with the registration statement was materially false and misleading under § 14(a) of the Securities Exchange Act of 1934.[45]

Vivendi moved to dismiss the plaintiffs' portion of the complaint on the proxy issue on the basis that, as a "foreign private issuer," it was exempt from that provision of the American securities law. Vivendi is a corporation organized under French law. Thus, citing as authority the decision in the Honda ADR litigation,[46] the trial court granted the motion to dismiss.[47] Interestingly, the court did not explore the issue of Vivendi's activities in the United States. Earlier in its decision, it had refused Vivendi's motion to dismiss the claims of the foreign plaintiffs for lack of subject matter jurisdiction by citing Vivendi's actions in America.[48] It spoke of both the CEO and CFO spending one half of their time in the U.S. in an effort to increase the number of American investors in the company. The plaintiffs also had argued that Vivendi could be vicariously liable for Seagram's alleged misstatements in the Seagram proxy statement issued in connection with the merger. The judge refused to impute Seagram's actions to Vivendi by noting that the plaintiffs had presented no legal authority in support of its proposal.

Are German Companies "Foreign Issuers," Like the Japanese and French?

A new German corporation, DaimlerChrysler, was created on November 12, 1998 by the merger of the German automaker Daimler-Benz and the American automaker Chrysler. Consistent with the merger agreement, Chrysler became its wholly owned subsidiary. The former Daimler-Benz's shareholders controlled the new entity by holding 58% of the shares, with the former Chrysler shareholders being allocated 42% of the shares.

American billionaire, Kirk Kerkorian, is the Chairman, Chief Executive Officer and sole shareholder in Tracinda Corporation, which was the largest Chrysler shareholder, with approximately 13% of its

[44] While not the main focus of this article, foreign issuers' liabilities for material errors and omissions in a registration statement and prospectus, or for fraud under § 10, will be discussed in the text *infra*. These issues, with respect to the Vivendi decision, will not be discussed other than to note that the court generally upheld the right of the plaintiff investors to pursue their claims under these statutory provisions.

[45] Section 14(a), prohibits any person from soliciting any shareholder proxy in violation of rules adopted by the SEC; 15 U.S.C. § 78n (a)(2000). *See* note 36 *supra* and accompanying text for the language of the applicable rule, Rule 14a-9, 17 C.F.R. § 240.14a-9.

[46] *See supra* note 33.

[47] In re Vivendi Universal SA, 2003 U.S. LEXIS 19431, at 9 (S.D.N.Y. Nov. 3, 2003).

[48] *Id.*at 8.

common stock, prior to its merger with Daimler-Benz. Tracinda's Chrysler holdings of about 89 million shares had an average acquisition price of about $13.80 and their market price slightly exceeded $50 at the time of the merger, yielding a profit of almost $3.5 billion.

In accordance with German law, DaimlerChrysler has a two tiered board system.[49] For almost two years the shareholder representatives on the Supervisory Board were evenly divided between those designated by Chrysler and those chosen by Daimler-Benz. The make-up of the company's Management Board was both altered and reduced in size beginning about one year after the merger. Certain of its members were replaced and others voluntarily retired, including former Chrysler CEO Robert Eaton. The eventual result was that only one Chrysler executive continued to sit on it. Tracinda's designee on the Chrysler board, James Aljian, did not sit on either board. In November of 2000, Juergen Schrempp, Chairman of DailmerChrysler's Management Board gave two interviews, one in the Financial Times of London, and one in Barron's. In both, he characterized the deal more as a takeover of Chrysler rather than a merger of equals.[50]

On November 27, 2000, Tracinda sued DaimlerChrysler and several of its employees, including Jurgen Schrempp alleging violations of American securities laws, common law fraud, and conspiracy in connection with the merger.[51] Tracinda now sought approximately $ 1 billion in financial damages on the basis that, rather than the portrayed "merger of equals," the transaction was in reality a corporate takeover entitling the Chrysler shareholders to a larger financial premium for their shares. These actions by the defendants, Tracinda contended,

[49] The supervisory board, consisting of representatives elected by both the shareholders and labor, legally controls the corporation. It selects members of the management board which manages the daily operations of the company.

[50] In the Financial times article Mr. Schrempp was quoted as saying: "The structure we have now with Chrysler (as a standalone division) was always the structure I wanted. We had to go a roundabout way but it had to be done for psychological reasons. If I had gone and said Chrysler would be a division, everybody on their side would have said 'There is no way we'll do a deal.'" FINANCIAL TIMES, October 30, 2000. In Barron's he is quoted as saying "We said in spirit it was a merger of equals, but in our minds we knew how we wanted to structure the company, and today I have it. I have Daimler, and I have divisions." BARRON'S, November 4, 2002.

[51] Tracinda Corp. v. DaimlerChrysler AG, 2005 U.S. Dist. LEXIS 5830 (April 7, 2005). Other parties also initiated class action litigation over the merger but their issues are irrelevant to our discussion. *See* Tracinda, 197 F. Supp. 2d 42 (2002) and In re DaimlerChrysler I, 197 F. Supp. 2d 86 (2002). The plaintiffs in the class action subsequently reached an out-of-court settlement of their claims.

violated federal securities law fraud section 10(b)[52] and proxy section 14(a)[53].

Both DaimlerChrysler and Juergen Schrempp moved to dismiss the litigation on the basis that the court lacked jurisdiction over them under the proxy section of the securities law because, rather than them issuing the proxy statement, Chrysler did; and secondly, they held an exemption under the statute as a "foreign private issuer."

This court was not as quick, as were the ones in the earlier Japanese ADR and Vivendi takeover litigation, to simply grant a motion to dismiss simply based upon the defendants status as a foreign corporation. Several decades earlier, the U.S. Court of Appeals for the District of Columbia Circuit ruled that permitting the use of one's name in a manner substantially connected to a proxy solicitation can result in liability for material misstatements and omissions contained in the proxy statement.[54] In this instance, the trial court held that Daimler-Benz and Juergen Schrempp both met that standard. It noted the interest held by them in the outcome of Chrysler's proxy solicitation, by virtue of their desire that its shareholders approve the merger with Daimler-Benz. It also pointed to their joint participation in, and the allowance of the use of their names in, the proxy solicitation process. It quoted language from both the merger agreement, i.e. "Chrysler, Daimler-Benz and DaimlerChrysler AG shall prepare and file with the SEC the preliminary Proxy Statement/Prospectus," and the Proxy Statement itself, i.e. "all information contained in or incorporated by reference in this Proxy Statement/Prospectus relating to Daimler-Benz and DaimlerChrysler AG was provided by Daimler-Benz." The court also pointed to the simultaneous use by the defendants of the very same Proxy Statement/Prospectus for the Daimler-Benz shareholders in the United States as was used by Chrysler for distribution to its shareholders. Both companies also had agreed to share certain printing and mailing costs of the proxy material. As an individual defendant, Juergen Schrempp's name not only was prominently mentioned in the

[52] 15 U.S.C. §78(j)(b)(2000) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 make it unlawful in connection with the purchase or sale of securities to make any untrue statement of material fact or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading. It also makes it unlawful to employ a device or scheme to defraud one in connection with the purchase or sale of securities. These prohibitions apply to tender offers, exchanges of stock, mergers, and trading on the basis of material inside information.

[53] 15 U.S.C. §78n(a)(2000) and Rule 14a-9, 17 C.F.R. § 240.14a-9, promulgated thereunder, make it unlawful to solicit proxies utilizing material that is" false or misleading with respect to any material fact, or which omits to state a material fact necessary in order to make the statements therein not false or misleading.

[54] SEC v. Falstaff Brewing Corp., 629 F. 2d 62, 66-70 (D.C. Cir. 1980).

Proxy/Prospectus, but he also made abundant public representations concerning the merger and statements of his were contained in frequent press releases which constituted, in the opinion of the trial judge, communications in connection with the proxy solicitation.

While Tracinda did not dispute the status of Daimler-Benz as a "foreign private issuer," it did contend that Daimler-Benz failed to qualify for the statutory exemption on grounds that the challenged conduct did not relate to its securities registered as a foreign private issuer, but rather were aimed at obtaining the positive votes of shareholders of a U.S. domestic security, Chrysler. The court accepted this rationale, holding that the statutory language is specifically limited to a foreign private issuer's registered securities. Therefore, if Tracinda could prove the elements required to establish the material misrepresentations, falsehoods, or omissions the defendants would bear liability for violating the American securities law with respect to proxies.[55] To establish a violation of §14(a) a plaintiff must prove by a preponderance of the evidence that the defendant made a material misrepresentation or omission in a proxy statement, which caused injury, and that the proxy was an essential link in effectuating the proposed corporate action. Tracinda failed to meet this burden.

Tracinda's argument succinctly was that the defendants made material misrepresentations to Mr. Kerkorian, through former Chrysler CEO Robert Eaton, by describing the combination as a "merger of equals," with the entities being equal partners, promising that the Management Board would be evenly split and, that Eaton and Schrempp would be co-chairman of the combined company.

The court found that, as two independent companies negotiating a merger, neither was responsible for the statements of the other, and therefore Daimler-Benz was not responsible for Mr. Eaton's remarks. It also said that Tracinda was no mere neophyte, but rather a sophisticated investor, with an active representative on the Chrysler Board, employed a team of highly paid advisors, had negotiated a written agreement to vote its stock in favor of the merger which contained a clause saying that it superseded all other prior agreements both written and oral, which agreement was reviewed by Tracinda's legal counsel prior to its signature, and subsequently the combined proxy/prospectus also contained language stating that any representations outside of it were not to be relied upon. The court also noted that the merger agreement did not provide for an "even" split of company appointees to the Management Board and Kerkorian's

[55] To establish a violation of § 10(b) and its common law fraud claim it needed to show by a preponderance of the evidence the material misstatements and/or omissions done with *scienter*, its reasonable reliance on them, and that its reliance caused the injury. Tracinda failed to do so on these counts, as well on the issue of the proxies.

activities prior to the merger did not reflect any interest in corporate governance issues, but rather financial ones. In the view of the judge, a reasonable investor would not rely upon the type of vague, indefinite, and generally optimistic statements made by Eaton to Kerkorian. Even accepting them as misleading, for the sake of the argument, the judge said that it is not proper to characterize them as being "material," but rather they constitute soft puffing statements incapable of objective verification. Kerkorian claimed, and Eaton denied, that Eaton described it in oral conversations as a "merger-of-equals." The court said there is a plethora of definitions for the phrase and it is a vague, promotional phrase, general in nature, does not communicate objective or substantive information, and is insufficient to constitute an actionable oral misrepresentation.

The court also considered the charges by Tracinda that the merger agreement and proxy/prospectus contained actionable misrepresentations by utilizing the "merger-of-equals" phrase in describing the combination. Again, the court ruled that there was no misrepresentation in the use of such a general phrase. It noted that the documents accurately specified the number of individuals from each company to initially be recommended for service on both the Management and Supervisory Boards. The terms of the agreement allowed for subsequent changes to the corporate governance structure and also disclosed that Mr. Eaton would retire in three years.

Tracinda argued that Mr. Schrempp's interviews in the Financial Times and Barron's illustrated the defendants' lack of intention to meet their promise of a "merger-of-equals". The court rejected this argument by simply noting that the "merger-of-equals" described in the written documents did in fact come about.

While the court concluded that the defendants' statements were neither materially misleading nor evidenced material omissions, it noted that, even if the written representations pointed to by Tracinda were false or misleading, Tracinda failed to prove their materiality and its reliance upon them. Again the judge cited Tracinda's status as a sophisticated investor, who enjoyed representation on the Chrysler Board, had an ongoing relationship with those negotiating the merger, and possessed a surfeit of information unavailable to the average investor. Lastly, it noted Tracinda's agreement to vote for the merger prior to the distribution of the proxy/prospectus material and its focus upon the economics of the transaction, rather than on issues of the resulting corporate structure.

Extraterritorial Application of American Securities Law

Both the DaimlerChrysler and Vivendi cases also touch on the issues of assertion of jurisdiction and extraterritorial application of the American securities statutes. Certain members of the Vivendi

shareholder class were foreigners who had purchased their shares on foreign markets, thereby raising the question of whether the American securities laws apply extraterritorially to them. The Securities Exchange Act of 1934 is silent on the issue.[56] Section 30(b) of the 1934 Securities and Exchange Act does provide, however, that it is not applicable "to any person insofar as he transacts a business in securities without the jurisdiction of the United States…"[57] Under what is labeled the "conduct test,"[58] the Second Circuit has ruled that a U. S. court will have subject matter jurisdiction over such foreign claims when a "defendant's conduct in the United States was more than merely preparatory to the fraud, and particular acts or culpable failures to act within the United States directly caused losses to foreign investors abroad."[59] That same Circuit also has developed an "effects test" that grants a U.S. court jurisdiction when the acts in the foreign country are violative of the U.S. law and have "a sufficiently serious effect upon United States commerce."[60] While there are policy reasons against swinging the doors of the American judicial system open to litigants world wide, at the same time, we do not want to grant immunity to those based in the United States who might peddle fraudulent securities to a target audience of foreigners. On the other side of the coin, the Second Circuit also has ruled that subject matter jurisdiction exists over the issuance and purchase of shares in England when, in connection with the matter, filings were made with the S.E.C. that include substantial misrepresentations.[61] Citing the foregoing case precedents, the judge ruled in the Vivendi matter that he did have jurisdiction over the claims of the foreign plaintiffs and they were properly included in the class action lawsuit.[62]

One individual defendant in the DaimlerChrysler litigation was Manfred Gentz. He is a German citizen and was Daimler-Benz's chief financial officer. He was both a member of the DaimlerChrysler Management Board and previously the Daimler-Benz Management Board. He did not participate in the preparation of the proxy/prospectus, approve it, nor was his name used in connection with the solicitation of the proxies. As the CFO he had performed some valuation analyses

[56] 15 U.S.C. §78aa (2000). This provision gives exclusive jurisdiction to the federal district courts over "all actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder."

[57] 15 U.S.C. § 78dd(b)(2000).

[58] Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1336-37 (2d Cir. 1972).

[59] *See supra* note 32.

[60] Schoenbaum v. Bradshaw, 405 F.2d 200 (2d Cir. 1968)(the litigation revolved around transactions in Canada).

[61] Itoba Ltd. V. Lep Group PLC, 54 F.3d 118 (2d Cir. 1995).

[62] In re Vivendi Universal SA, 2003 U.S. LEXIS 19431 (SD NY Nov. 3, 2003).

related to the merger and did participate in a presentation in America before Standard and Poor's, unrelated to Tracinda's claims. The court ruled that he did not have the minimum contacts with the United States necessary for the court to assert personal jurisdiction over him.[63]

At an earlier stage of the proceedings, the court had also dismissed the claims against another of Daimler-Benz employees, a Mr. Kopper. He had attended meetings in his corporate capacity in both America and Germany related to the merger, but no final decisions were made with respect to the merger at those meetings and, in the judge's opinion, his conduct was not related to the Tracinda claims[64].

Potential Liability for Filing a Registration Statement & a Prospectus by a Foreign Entity

Not surprisingly, filing a registration statement with the SEC in connection with a securities issuance will subject a foreign company to American jurisdiction under § 11 of the 1933 Securities Act.[65] An allegation that the registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statement therein not misleading" supports a claim under the statute.[66]

Distribution of a prospectus within the United States will also give an American court jurisdiction under § 12(a)(2) of the 1933 Securities Act.[67] A claim is properly stated by an allegation of liability against "any person who…offers or sells a security…by the use of any means or instruments…in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which that were made, not misleading." [68]

[63] *See supra* note 49. He did sign the Registration Statement on behalf of Daimler-Benz which was filed with the U.S. Securities and Exchange Commission. Such action would subject him to American jurisdiction on that basis, if that document was a subject matter of the litigation. Tracinda's original complaint did allege misstatements and omissions in the registration statement in violation of § 11 of the Securities Act but, it voluntarily dismissed those claims prior to the trial. Tracinda Corp. v. DaimlerChrysler AG, 2005 U.S. Dist. LEXIS 5830, at 3, (April 7, 2005).

[64] In re DaimlerChrysler, 247 F. Supp. 2d at 583-595. For an excellent discussion of the liability borne by members of the board of directors, accountants, and attorneys for materially false registration statements, *see* Escott v. Barchris Constr. Co., 283 F.Supp. 643 (SD NY 1968).

[65] 15 U.S.C. § 77k(a)(2000).

[66] Herman & MacLean v. Huddleston, 459 U.S. 375 (1983).

[67] 15 U.S.C. § 771(a)(2)(2000).

[68] *Id.*

Is it a legal defense under these two statutes that the defendant issuer of the securities did not know of the falsity or omission? No; the standard is one of negligence. The Supreme Court has ruled that an issuer is absolutely liable for damages attributable to any such misstatement or omission.[69]

Foreigners' Liability Under Section 10(b) and Rule 10b-5.

Securities fraud claims in connection with the purchase or sale of securities are brought under §10(b)[70] and its counterpoint Rule 10b-5.[71] In pertinent part, section 10(b) provides that:

> "It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange…
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, …any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest of for the protection of investors."

Rule 10b-5 provides in relevant part:

> "It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange 1) to employ any device scheme, or artifice to defraud, 2) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading, or 3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Under both the language of the statute and the rule, the citizenship of the person is irrelevant. The entry into the United States by a foreign entity to use these components of interstate commerce in carrying out a securities fraud will subject itself to litigation in our judicial system. To establish a violation of §10(b) or Rule 10b-5, one must prove by a preponderance of the evidence both the existence of material misstatements and/or material omissions made with scienter, that it reasonably relied upon them, and that reliance caused its injury.[72]

[69] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207-08 (1976).
[70] 15 U.S.C. § 78j(b)(2000).
[71] 17 C.F.R. § 240.10b-5.
[72] These are the same standards of proof required when one also bases a complaint on a claim of common law fraud.

One does not violate these portions of the securities law by simply being careless or negligent. A defendant only bears liability when the plaintiff has proven that the conduct was engaged in with *scienter,* an intent to defraud, manipulate, or deceive.[73] With respect to these matters, as opposed to litigation with respect to alleged shortcomings in a registration statement or a prospectus, Congress has imposed a higher pleading standard.[74] Both §10(b) and Rule 10b-5 will have extra-territorial applicability when the fraudulent conduct produces detrimental effects within the American securities markets.[75] Transactions conducted entirely outside the United States that do not involve the use of American instruments of interstate commerce, the postal system, or the securities exchanges will not violate these legal provisions.

Do Choice-of-Law Clauses Offer a Potential Safe Harbor to Foreign Corporations?

Could the foreign partner in a merger with an American company structure the transaction in a manner to avoid jurisdiction under the American securities regulations via a choice-of-law provision? The United States Supreme Court has given its imprimatur to judicial recognition of choice-of-law and choice-of-forum clauses in "freely negotiated private international agreements."[76]

The freedom to choose the legal provisions that will govern the interpretation of a contract and, specify the venue for any litigation of disputes arising under it, can prove appealing when the parties to the agreement are from different nations. When the parties are familiar with the law of a particular nation, regard it as equitable and pragmatic, and have confidence in the integrity of a nation's judicial system, negotiating the inclusion of such clauses can bring an essential degree of predictability to the transaction.

As we have already observed in the *Batchelder* [77]case, an American court will recognize a choice-of-law provision in shareholder litigation, thereby permitting the rules of another nation to determine the outcome of the lawsuit. Citing case law, that same appellate court also gave deference to the "internal affairs" doctrine saying that the law of the

[73] *Supra,* note 48.

[74] The higher standard, a discussion of which is beyond the purposes of this article, was imposed by the Private Securities Litigation Reform Act; 15 U.S.C. § 78u-4(2000) and Fed. R. Civ. P.8 and 9(b).

15 U.S.C. § 78j(b)(2000).

[75] Strassheim v. Daily, 221 U.S. 280 (1911)(an assertion of jurisdiction case among the States).

[76] The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, at 12-13 (1972).

[77] *See supra* note 35 and accompanying text.

place of incorporation determines the rights of shareholders in foreign corporations.[78]

But, of course, it also was a provision in the U.S. securities law, the "foreign private issuer" exemption[79] and its accompanying SEC rule,[80] that allowed the dismissal of the pleadings regarding the alleged misleading proxy material claims. And, also notice the nature of the choice-of-law and choice-of-forum clauses approved by the Supreme Court, i.e. "freely negotiated private international agreements". Public policy is normally not overly concerned with the contents of private agreements between parties, other than that they concern a legal subject matter. There is slight public interest in the mechanics selected by shareholders for the internal governance of their corporation's internal affairs. Thus, when an American has purchased securities in a foreign company, and the terms of the agreement specify that disputes are to be settled under the corporate regulations of that foreign nation, there is no strong public policy argument against an American court giving deference to such an agreement. Under comity concepts, Americans would expect the same deference when a foreign court was asked to apply a choice of American law provision in a dispute between one of its citizen shareholders in an American corporation.

However, it would be, as they say, "a horse of a very different color" if a foreign corporation targeted an American corporation for a takeover (be it friendly or hostile) and included language in the registration statement/prospectus filed with the Securities Exchange Commission, and in the proxy distributed to the American shareholders, that the law of the foreign acquirer's *situs* would be controlling in all litigation relative to the acquisition. Giving recognition to such a compulsory choice-of-law provision would undermine American public policy with regard to securities matters as determined by Congress by deferring to the whims and wishes of unelected members of foreign parliaments. It is highly unlikely that any sovereign nation would cede control over such important internal matters, with their accompanying public policy consequences, to another nation. Arguing to an American court that it had no jurisdiction over a merger, where the acquired corporation was American, the majority of its stockholders were U.S. citizens, a filing was made with our regulatory agency, and proxies were distributed

[78] Batchelder v. Kawamoto, 147 F. 3d 915 (1998), 1998 U.S. App. LEXIS 12568, at 7 (9th Cir. July 15, 1998)..The court cited both cases solely involving corporations incorporated in the United States, including CTS Corp. v. Dynamics Corp of America, 481 U.S. 69,89 (1987), and decisions involving a Dutch corporation and an American subsidiary, Kostolany v. Davis, 1995 Del. Ch. LEXIS 135, (November 7, 1995) as authority.

[79] 17 C.F.R. 240.3a12-3(b).

[80] 17 C.F.R. 240.3b-4(c).

nationally, would be both ludicrous and an affront to our national sovereignty. An American court would neither cede jurisdiction to another nation, nor recognize the inapplicability of our securities statutes, under such a choice-of-law clause.

It has been demonstrated that such clauses can have value in securities transactions, but not to such a degree as to eject a nation from jurisdiction over critical matters of public policy. Thus, in answer to the question, Do choice-of-law clauses offer a potential safe harbor to foreign corporations to escape the applicability of U.S. securities statutes when entering the U.S. market to consummate a merger?, the answer is a clear and clarion "no".

Conclusion

As we have observed, a number of obstacles can confront a company which desires to acquire a company in another nation. They run the gamut from bans inscribed in constitutions to unofficial, but very real, impediments. They may spring from nationalistic fervor, a fear of cultural imperialism, or concerns of national security. They exist even in the United States, although it remains relatively free of such barriers. A perceived fear in global mergers can also be getting unnecessarily entangled in an unknown legal system or in a system with unattractive rules that one hopes to avoid.

Foreign corporations that enter America to transact a cross-border merger can subject themselves to our securities laws. The degree of such exposure will vary according to the nature of their activities. The "minimum contacts" requirement granting U.S. courts jurisdiction over their conduct will be met by filing a Registration Statement/Prospectus with the American Securities and Exchange Commission. If it contains materially false or misleading statements, or if it has material omissions, the filing company will have liability to purchasers of those securities. Strict liability for damages attributable to such misstatements or omissions exists.[81]

However, if the pleading asserts that the foreign entity has made fraudulent statements in the U.S. in violation of § 10(b)[82] of the securities law, a defense of lack of actual knowledge of the material falsities, misleading statements, or omissions will constitute a valid defense. A showing of negligence is insufficient, to prevail, a plaintiff must prove scienter, the intent to deceive, manipulate or defraud.

The liability of cross-border merger partners for alleged materially false and misleading statements used in the solicitation, within the U.S., of stockholder proxies, in the vote upon whether the merger should be

[81] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207-08 (1976).
[82] *See supra* note 68 and accompanying text.

approved, may be less extensive than under other provisions of the securities statutes. Clarity in this area is murky due to the decision of courts in the *Batchelder* [83] and *Vivendi*[84] cases to interpret foreign issuers as being exempt from the U.S. law on proxies, whereas in the *Tracinda*[85] litigation, the court said the issue must be examined on a case-by-case basis and denied the exclusion to a German acquirer.

Which judicial view will ultimately prevail? Unfortunately the opinions in *Batchelder* and *Vivendi* contain very little analysis of the matter. They quickly grant the foreign corporations an automatic exemption and move on to a discussion of other issues. *Tracinda,* on the other hand, treats the issue to a substantial discussion and reaches its contrary conclusion in a well reasoned opinion. It is reasonable to expect legal uncertainty on this point to remain unless the Supreme Court regards such diversity on the matter to be of sufficient importance that it grants certiorari in an upcoming case to bring uniformity to the issue or until the Securities and Exchange Commission or Congress decide to clarify the answer. No indications exist that any of these solutions would appear to be likely in the near future.

Tracinda does stand for one very important proposition with respect to cross border mergers that have otherwise successfully surmounted all obstacles in their path. It announces to parties world wide that the American courts are not available to sophisticated investors suffering from cognitive dissonance as a lever to judicially renegotiate more attractive financial terms than those accurately described in securities' filings and for which merger they voted.

[83] *See supra* note 35.
[84] *See supra* note 45.
[85] *See supra* note 49.

WHY PROCEEDS OF A SALE OF HOMESTEADED REAL ESTATE ARE PROTECTED, IF AT ALL, ONLY BY STATE STATUTE AND NOT SECTION 522(c) OF THE BANKRUPTCY CODE

by JOHN G. NEYLON*

INTRODUCTION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[1] provides the most substantial amendments to the U.S. Bankruptcy Code[2] since the 1978 adoption of the Code, which replaced the 1898 Bankruptcy Act. The "Reform" Act addresses perceived abuse by consumer debtors and substantially rewrites Section 707 of the Bankruptcy Code by providing for dismissal upon motion of certain Chapter 7 filings brought on or after October 17, 2005, where the debtor's means exceed median family income for the debtor's home state. In opposing such a motion, the debtor may assent to conversion of the Chapter 7 case to a Chapter 13 case, thereby providing at least some dividend for unsecured creditors as the cost of the debtor obtaining a discharge.

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[1] 11 U.S.C. § 101 et seq., as comprehensively amended by Pub. L. No. 109-8 (2005).

[2] 11 U.S.C. § 101 et seq. (2000).

Bankruptcy is an area in which federal law operates coexistent with state common law and statutes. Sometimes bankruptcy law preempts portions of state law, but in many instances, like those here examined, bankruptcy law specifically allows state law to control a portion of the outcome under the bankruptcy law system. Because the bankruptcy court is a court of record and bankruptcy judges try many cases within weeks of the issues being joined, the bankruptcy court often provides a number of variations on state law themes before the state's appellate court fully addresses an issue. Such is the case in the matter of *In re Maurice F. Cunningham*.[3]

A major goal of bankruptcy has been to provide the honest debtor a fresh start.[4] In a Chapter 7 liquidation case, the trustee, appointed by the Justice Department, acquires ownership of all assets of the debtor subject only in an individual case to the debtor's claim of exemptions. The trustee then liquidates the assets to provide a dividend to principally unsecured creditors, where secured creditors may look to their security for adequate protection or payment. In a reorganization case, Chapter 11, the debtor (unless dishonest or a poor record keeper) assumes the duties of the trustee under the debtor's role as debtor in possession (DIP). Chapter 13 cases resemble Chapter 11 cases for individuals with regular income and are either composition cases (creditors receive a percentage of their allowed claims) or extension cases (creditors receive their entire claim, but over a period of time, usually 3-5 years, in accordance with an approved plan).

States operating under their general police power in the mid-nineteenth century provided "homestead" protection by statute[5] for

[3] In re Maurice F. Cunningham, 2005 Bankr. LEXIS 2419 (Bankr. D. Mass. Dec. 7, 2005). In *Cunningham*, the debtor was a lawyer who breached his fiduciary duty to his disabled employer by converting cases and referral fees from the employer's practice. Although this debt was declared non-dischargeable both under 11 U.S.C. § 523(a)(4) and § 523 (a)(6), such a "garden variety" non-dischargeable debt could not be satisfied from debtor's homesteaded real estate. Debtor then voluntarily sold his Massachusetts residence, after having moved into a Florida condominium titled in his wife's name. When the former employer/creditor sought to reach those proceeds in state court, the Massachusetts Bankruptcy Court, Rosenthal, J relied on dicta from In re Hyde, 334 B.R. 506 (Bankr. D. Mass. 2005) and a Texas case, In re Reed, to determine that debtor's net cash proceeds of the sale were also exempt [*See* In re Reed, 184 B.R. 733 (Bankr. W.D. Tex. 1995)]. That determination is presently on appeal.

[4] Bankruptcy also seeks to treat like classes of creditors in an even handed fashion and by utilizing the automatic stay [11 U.S.C. § 362 (2000)] cut down the rush of creditors to the courthouse when otherwise the rule of "first in time, first in right" might prevail.

[5] MASS. GEN. LAWS ch. 188. In 1970 "a homestead estate (in the amount of $4,000) was exempt from the laws of conveyance, descent and devise, and from attachment, levy on execution and sale for the payment of debts and legacies, with certain limitations". Some 25 statutory amendments later, the sum of $500,000 is exempt via a so-called regular homestead (MASS. GEN. LAWS ch.188 § 1 (2004)) and a homestead for the elderly or

families after having codified protections for individual spouses extant at common law, such as dower and curtesy.[6] The twentieth century brought numerous updates to these schemes and also updated common law tenancy by the entirety[7].

Homestead

> An estate of homestead "is a provision by the humanity of the law for a residence for the owner and his family," free from attachment or levy on execution by creditors up to the amount allowed by law.[8]

The English common law of property had addressed the balance between creditors and property owners in an agrarian economy by dower and curtesy.[9] Homestead statutes provided new statutory protection for a spouse and family members (homestead) both during life and upon the death of the landowner, distinct from dower and curtesy.[10]

I. INDIVIDUAL BANKRUPTCY IN MASSACHUSETTS—CHOICE OF FEDERAL OR STATE EXEMPTIONS

Massachusetts is one of fifteen states, along with the District of Columbia, where a debtor may choose either federal or state

disabled is available in a similar amount for owners at least 62 years of age (MASS. GEN. LAWS ch. 188 § 1A (2004)). Stacking of the two statutory homesteads with one claimed by either spouse, in accordance with the bankruptcy court, is permissible [Walter Oney, *Homestead in Massachusetts—Termination with Extreme Prejudice*, Mass. Law. Wkly., Dec. 20, 2004].

[6] MASS. GEN. LAWS ch. 189 § 1 (1978). At common law, husband had a right of curtesy to a 1/3 life estate in real estate owned by his spouse upon her death. Similarly, wife had a dower right, being a life estate in 1/3 of the property owned in her husband's name alone. These rights were of little value, because less than available under the statutory forced share rights (MASS. GEN. LAWS ch. 191 § 15 (1992)). With the approval of the Supreme Judicial Court, the legislature in 1965 abolished inchoate dower and curtesy [*See* Opinion of the Justices 337 Mass. 786, 151 N.E.2d 475 (1958)], and thereafter in 1978 abolished statutory curtesy, making statutory dower applicable to a surviving spouse of either sex. When Massachusetts abolished inchoate dower and curtesy, the U.S. Supreme Court had long since settled that there was no constitutional prohibition on such an abolition [*See* Randall v. Dreiger 23 Wall. 137, 148, 23 L.Ed. 124 (1874)], and the Massachusetts Court noted that more than half of the states had abolished these common law creations [*See* POWELL, REAL PROPERTY, 217-218, Opinion of the Justices 337 Mass. at 793].

[7] MASS. GEN. LAWS ch. 209 § 1A (1989). *See infra* footnote 20.

[8] Ladd v. Swanson, 24 Mass App. Ct. 644, 646 (1907). Internal cites omitted.

[9] *See supra* note 6.

[10] *See supra* note 5.

exemptions.[11] An individual debtor can elect between two exemption schemes provided by the Bankruptcy Code:

- The federal exemptions;[12] or
- The exemptions permitted by state law and federal law other than the Bankruptcy Code.[13]

Federal Exemptions:

The federal exemptions provided by Section 522(d) of the Bankruptcy Code, while pervasive, provide only a modest protection for the debtor or a dependent's residence owned by debtor, some $18,450. Exemptions include differing amounts for motor vehicles, household items (with a per item and aggregate), jewelry, miscellaneous aggregate, life insurance, health aids, public benefits, alimony, support or separate maintenances, (in reasonably necessary amounts), stock bonus, pensions, annuities, injury and death benefits, and retirement funds. [14]

[11] The others are Arkansas, Connecticut, Hawaii, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, Texas, Vermont, Washington and Wisconsin. *See* STEPHEN ELIAS, HOW TO FILE FOR CHAPTER 7 BANKRUPTCY (12th ed. 2005).

[12] 11 U.S.C. § 522(d) (2000).

[13] 11 U.S.C. § 522(b) (2000).

[14] The Federal exemptions include, among others: *Residence*—Up to $18,450 of the equity in debtor's residence or the equity in a dependent's residence owned by debtor [11 U.S.C. § 522(d)(1)]; *Motor Vehicle*—Up to $2,950 of the equity in one motor vehicle [11 U.S.C. § 522(d)(2)]; *Household Items* - Up to $475 per item, totaling not more than $9,850 in the aggregate, in household furnishings and goods, apparel, appliances, books, animals, crops, or musical instruments held for personal or family use [11 U.S.C. § 522(d)(3)]; *Jewelry* - Up to $1,225 of jewelry [11 U.S.C. § 522(d)(4)]; *Miscellaneous/Aggregate* - A debtor is entitled to exempt his or her aggregate interest in any property, not to exceed $975, plus up to $9,250 of an unused amount of the residence exemption [11 U.S.C. § 522(d)(5)]; *Tools*—Up to $1,850 in implements, books, or tools of the trade of the debtor or a dependent [11 U.S.C. § 522(d)(6)]; *Life Insurance*—Any unmatured life insurance contract debtor owns, other than a credit life insurance contract [11 U.S.C. § 522(d)(7)]; *Insurance Dividend or Loan Value* - The debtor's interest, up to $9,850, in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract under which the insured is the debtor or a person of whom the debtor is a dependent [11 U.S.C. § 522(d)(8)]; *Health Aids*—Professionally prescribed health aids for the debtor or a dependent [11 U.S.C. § 522(d)(9)]; *Public Benefits*—Debtor's right to receive Social Security benefits, unemployment compensation, local public assistance benefits, veterans' or disability, or illness or unemployment benefits [11 U.S.C. § 522(d)(10)(A)-(C)]; *Alimony, Support, or Separate Maintenance*—The debtor's right to receive alimony, support, or separate maintenance… to the extent reasonably necessary for the support of the debtor and any dependent [11 U.S.C. § 522(d)(10)(D)]; *Stock Bonus, Pensions, and Other Annuities and Similar Plans*—Debtor's interest in an ERISA-qualified stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length or service, provided that the plan was not established by an insider [11 U.S.C. § 101(31) (2000)] and the payment is not on account of age or length of service, provided

State Exemptions:

Massachusetts State Exemptions:

Conversely, the state exemptions scheme available in Massachusetts is far more generous with respect to the debtor's homestead, affording $500,000 of protection subject to the newly imposed limitations of the Reform Act. [15] These exemptions include civil service pensions, workers' compensation benefits, credit union benefits, group life benefits, disability and accident insurance benefits, certain life insurance benefits, group annuity contracts, individual retirement accounts, and qualified retirement plans.

Nonbankruptcy Federal Exemptions:

There are several major nonbankruptcy federal exemptions available with a claim of state exemptions.[16] These include civil service retirement

the debtor may exempt the value of such a plan only to the extent reasonably necessary for the support of the debtor or any dependent. [11 U.S.C. § 522(d)(10)(E)]; *Injury and Death Benefits*—Certain injury and death benefits, including the following [11 U.S.C. § 522(d)(11)(A-E)]: Awards under the crime victim reparation law, payments on account of wrongful death or life insurance payments where reasonably necessary for the debtor's, a payment of up to $16,150 on account of personally bodily injury (not including pain and suffering or compensation for actual pecuniary loss), and a payment in compensation of loss of future earnings where reasonably necessary for the debtor's support; *Retirement Funds* - Retirement funds that are in a fund or account that is exempt from taxation under any one of several sections of the Internal Revenue Code (including individual retirement accounts) are exempt under 11 U.S.C. § 522(d)(12). There is a limit of $1 million on the amount that may be exempted [11 U.S.C. § 522(n)]. *See* 3 LAWRENCE P. KING, COLLIER ON BANKRUPTCY § 522.09, at 522-24 (15th ed. rev. 2005); *See also* MARK G. DEGIACOMO—REPRESENTING THE DEBTOR IN A CHAPTER 7 CONSUMER BANKRUPTCY 11-17 (MCLE, 4th ed. 2005).

[15] The most commonly used state-law exemptions available under the Section 522(c) exemption scheme are insurance and work related benefits, which include: Civil service pensions [MASS. GEN. LAWS ch. 171, § 84 (1990)]; Group life policies [MASS. GEN. LAWS ch. 175, §§ 36, 135]; Disability and accident insurance benefits [MASS. GEN. LAWS ch. 175, §§ 36B, 110A]; Certain life insurance benefits [MASS. GEN. LAWS ch. 175, §§ 125, 126 (1928)]; Group annuity contracts MASS. GEN. LAWS ch. 175, § 132C (1981)]; Minor exemptions involving assets with low values [MASS. GEN. LAWS ch. 235, § h. 32, § 19 (1998)]; Workers' compensation benefits [MASS. GEN. LAWS ch. 152, § 47 (2001)]; Credit union benefits [34]; Individual retirement accounts and qualified retirement plans [MASS. GEN. LAWS ch. 235 § 34A (1998)]. *See* DEGIACOMO, *supra* note 14 at 11-17.

[16] Civil service retirement benefits [5 U.S.C. §§ 729, 2265 (2000)]; Federal service retirement and disability payments [22 U.C.S. § 1104 (2000)]; Longshoremen's and Harbor Workers' Compensation Act death and disability benefits [33 U.S.C. § 916 (2000)]; Veterans' benefits [38 U.S.C. § 916 (2000)]; Special pensions paid to winners of the Congressional Medal of Honor [38 U.S.C. § 3101 (2000)]; Social Security payments [42 U.S.C. § 407 (2000)]; Railroad Retirement Act annuities and pensions [45 U.S.C. § 228(L) (2000)]; Wages of people who fish, serve at sea, or are apprentices [46 U.S.C. § 601]. *See*

benefits, federal service retirement and disability payments, Lonshoremen's and Harbor Workers' Compensation Act death and disability benefits, Veterans' benefits, special pensions paid to winners of the Congressional Medal of Honor, Social Security payments, Railroad Retirement Act annuities and pensions, and wages of people who fish, serve at sea, or are apprentices.

Massachusetts Homestead (Post Reform Act):

Under M.G.L. c. 188, §§1, 1A, and 2, if prior to the bankruptcy filing a proper homestead declaration has been recorded at the appropriate registry of deeds, debtor may protect up to $500,000 of the equity in his or her home, provided that the home was acquired more than three years and four months prior to the filing of the bankruptcy petition or, if acquired within this time period, was acquired with the proceeds from the sale of another home located in the same state. If the home does not qualify for exemption under Section 522 because of recent acquisition or if debtor has been convicted of a felony or owes certain debts such as those for securities fraud or arising out of a criminal or intentional act causing serious injury or death within the last five years, the homestead exemption will by limited to $125,000, unless the property is found to be "reasonably necessary for the support of the debtor and any dependent of the debtor."[17] The amount of the homestead exemption will be reduced by the amount of the homestead's value attributed to any nonexempt property disposed of within the ten-year period prior to the filing of the bankruptcy petition with the intent to hinder, delay, or defraud a creditor.[18]

Joint Tenancies and Tenancies by the Entirety Exempt from Process:

When the state exemption scheme is chosen, the debtor may also exempt any interest in property held as a joint tenant or a tenant by the entirety… provided that the tenancy "is exempt from process under applicable nonbankruptcy law."[19] Massachusetts provides no special exemption from process for the interest of a joint tenant. The husband's interest is subject to seizure but the purchaser acquires a right to possession and rents, but the record ownership in the fee is subject to the wife's survivorship rights. Massachusetts law (amended to apply to tenancies created February 11, 1980, or thereafter, or those common law tenancies that filed a written election to become statutory tenancies) provides that an interest in a statutory tenancy by the entirety may be

DEGIACOMO, *supra* footnote 14.

[17] 11 U.S.C. § 522(p), (q) (2000).

[18] 11 U.S.C. § 522(o) (2000); *see* DEGIACOMO, *supra* note 14.

[19] 11 U.S.C. § 522(b)(3)(B) (2000).

attached but is not subject to levy on execution,[20] unless it is a joint debt of both spouses for necessaries.

Common Law vs. Statutory Tenancy by the Entirety:

A common law tenancy by the entirety in Massachusetts vests all rights to rents and possession in husband, while wife merely has an expectancy if she survives husband. Massachusetts law provides that an interest in property as a tenant by the entirety is "exempt from process" if the interest is a wife's interest in a common law tenancy by the entirety (a tenancy by the entirety created before February 11, 1980).[21] The entire equity in a statutory tenancy by the entirety property gets the benefit of a Massachusetts homestead in a lien avoidance case under Section 522(f) of the Bankruptcy Code.[22]

II. FEDERAL LAW PERMITS STATES TO CHOOSE WHAT PROPERTY TO PROTECT BUT PREEMPTS A STATE DETERMINATION THAT CERTAIN CLAIMS ARE NOT SUBJECT TO HOMESTEAD PROTECTION

Congress has plenary power to enact uniform federal bankruptcy laws.[23] Consequently states may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide auxiliary regulations.[24] "Federal law determines whether property is exempted and immunized against seizure and sale for pre-bankruptcy debts."[25] The Court of Appeals for the First Circuit considered whether certain causes of action (such as debt incurred prior to when the homestead was filed) exempted under Massachusetts law[26] from the homestead shield were preempted by Section 522(c) of the Bankruptcy Code:

> …Congress afforded significant deference to state law by allowing bankruptcy debtors to choose state exemptions and…allowing states to opt out of the federal exemption scheme entirely. *See In re Boucher*, 203 B.R. 10 (Bankr. D. Mass. 1996) (citing 11 U.S.C. Section 522(b)). Yet, such deference does not warrant the conclusion that the "property exempted" in Section 522(c) must be defined by first applying all the built-in exceptions to the state exemption statute. As the Supreme

[20] MASS. GEN. LAWS ch. 209, § 1A (1989); Peebles v. Minnis, 402 Mass. 282 (1988).

[21] In re Paul, 67 B.R. 342 (Bankr. D. Mass. 1986) (Queenan, J.); In re Coombs, 86 B.R. 314 (Bankr. D. Mass. 1988) (Queenan, J.).

[22] In re Snyder, 249 B.R. 40 (Bankr. D. Mass. 2000).

[23] U.S. CONST. art. 1 § 8, cl. 4; International Shoe Co. v. Pinkus, 278 U.S. 261, 265, 49 S. Ct. 1081 110 (1929).

[24] *International Shoe Co.*, 278 U.S. at 265

[25] Bruin Portfolio, LLC v. Leicht *(*In re Leicht*)*, 222 B.R. 670, 678 n.9 (B.A.P. 1st Cir. 1998).

[26] MASS. GEN. LAWS ch. 188 § 1(2).

> Court recognized in discussing the interplay between Section 522(f) and state exemption exceptions in *Owen v. Owen*, 500 U.S. 291, 111 S. Ct. 1825, 114 L. Ed. 2d 337 (1991), the state's ability to define its exemptions is not absolute and must yield to conflicting policies in the bankruptcy Code. *See Owen*, 500 U.S. at 313, 111 S. Ct. at 1838…[T]he analysis applies equally where the debtor chooses the state exemption scheme.[27]
>
> Like the bankruptcy court and the district court below, Judge Feeney's analysis of the conflict is persuasive.[28] As Judge Feeney recognized, the Massachusetts exceptions overlap and conflict with Section 522(c).[29] Judge Feeney's conclusion is persuasive that because the exceptions to the Massachusetts homestead statute are preempted to the extent that it permits exempt property to be liable for debts other than those expressly enumerated in Section 522(c) (1)-(3), particularly because the language employed by Congress in Section 522(c) is devoid of ambiguity.[30]

On this basis, the First Circuit in *Patriot Portfolio* concluded that Section 1(2) of the Massachusetts Homestead Statute is preempted by Section 522(c) of the Bankruptcy Code.[31]

The Cash Proceeds of the Voluntary Sale of Homestead Property are not Exempt Property (Unless a State Statute Exempts Same):

Cash proceeds are not protected from the reach of post-petition creditors or those pre-petition creditors with garden variety, non-dischargeable debts. This is so because the Massachusetts Homestead Exemption Statute,[32] ("the Act"), does not provide for an exemption of the proceeds that derive from the sale of a homestead property. That statute reads as follows: "An estate of homestead… *in the land and buildings* may be acquired pursuant to this chapter…". There is no reference in the statutory scheme, nor is there any case law in Massachusetts, stating that the cash proceeds from the voluntary sale of a homestead estate are similarly protected. There is, however, legislative history behind the Act that demonstrates that the legislature did not intend to exempt proceeds of a homestead sale from attachment and execution. Further, a glimpse at the laws in other states further bolsters the fact that the legislature was well aware of how to exempt the proceeds of a homestead, but chose not to do so.

[27] Patriot Portfolio, LLC v. Weinstein *(*In re Weinstein*)*, 164 F3d 677 (1st Cir. 1999).
[28] In re Whalen-Griffin, 206 B.R. 277 (Bankr. D. Mass. 1997).
[29] *Id.* at 290.
[30] *Id.* at 291-92.
[31] *Patriot Portfolio*, 206 B.R. at 292.
[32] Codified and defined at MASS. GEN. LAWS ch. 188, §1 (2005) (emphasis added).

The Legislative History of the Massachusetts Homestead Act:

The legislative history of the Act demonstrates that, while at one time proceeds from an involuntary sale of the homestead were exempt, further amendments to the Act removed that provision, thus indicating intent by the Massachusetts legislature to leave proceeds unprotected. In the earliest version of the Homestead Act, entitled "An Act to exempt from Levy on Execution the Homestead of a Householder having a Family,"[33] ("the 1851 statute"), the legislature allowed limited protection to proceeds acquired from an involuntary sale. The 1851 statute provided that "the judgment creditor may require the premises to be sold by such sheriff or his deputy, at public sale… and out of the proceeds of said sale to pay to debtor the sum of five hundred dollars, to be exempted from liability from his debts for one year thereafter, and to apply the balance to such execution…".[34] Four years later, however, the legislature amended the homestead statute and, in the amended version, removed the provision exempting proceeds from attachment.[35] To this day, despite over twenty-five subsequent amendments to the homestead statute, the legislature has never provided an exemption for the proceeds of a homestead sale, whether that sale was voluntary or involuntary.

Consequently, it is entirely clear that the legislature was well aware of how to exempt the proceeds of a homestead sale from attachment, even to the point of differentiating between voluntary and involuntary sales. Further, after four years with such an exemption, they apparently decided to remove the exemption. The current version of the Act, first enacted in 1939, has never contained any such exemption for proceeds. It is beyond the power of a court to impose its own opinion on what the law should be when it is clear that the state legislature considered the matter, and chose not to allow an exemption for proceeds resulting from the voluntary sale of property protected by the Act.

Review of How Other States Exempt Proceeds:

Should the Massachusetts legislature want to exempt proceeds for the sale of homestead property, not only could it look at its own past Act, it could look to other jurisdictions, most of which do not exempt proceeds of the sale of a homestead. A survey of other states' statutes and case law reflects that there are thirty-three states that do not provide a

[33] *See* Mass. Acts St. 1851, c. 340, § 1 *et seq*.
[34] *See* Mass. Acts St. 1851, c. 340, § 7.
[35] *See* Mass. Acts St. 1855, c. 238, § 1 *et seq*.

statutory exemption for proceeds of the sale of a homestead,[36] there are fifteen states that provide a statutory exemption for proceeds[37] and two states that do not offer homestead protection at all.[38] Further, of the states that do not have statutory exemptions for proceeds, most of those jurisdictions' highest courts have refused to read an exemption into the homestead statute as it would be tantamount to improper judicial legislation.[39]

[36] Alabama (ALA. CODE § 6-10-2 (1980)); Arkansas (ARK. CODE ANN. § 16-66-210 (1981)); Delaware (DEL. CODE ANN. § 10-4902 (1974)); Florida (FLA. CONST. art. X, § 4); Georgia (GA. CODE ANN. § 44-13-1 (1976)); Hawaii (HAW. REV. STAT. § 651-92 (1978)); Idaho (IDAHO CODE ANN. § 11-601 (2004)); Illinois (735 ILL. COMP. STAT. 5/12-901 (2006)); Indiana (IND. CODE ANN. § 34-55-10-2 (2005)); Iowa (IOWA CODE § 561.16 (2005)); Kansas (KAN. STAT. ANN. § 60-2301 (1991)); Kentucky (KY. REV. STAT. ANN. § 427.060 (1980)); Louisiana (LA. CONST. art. VII, § 20); Maryland (MD. CODE ANN. § 11-504 (2002)); Massachusetts (MASS. GEN. LAWS ch. 188, § 1A (2004)); Michigan (MICH. COMP. LAWS § 600.6023 (1998)); Mississippi (MISS. CODE ANN. § 85-3-21 (1999)); Missouri (MO. REV. STAT. § 513.475 (1982)); Nevada (NEV. REV. STAT. § 21.090 (1997)); New Jersey (N.J. STAT. ANN. § 2A:17-17 (1991)); New Mexico (N.M. STAT. ANN. § 42-10-9 (1993)); North Carolina (N.C. GEN. STAT. (§ 1C-1601 (2005)); North Dakota (N.D. CENT. CODE § 28-22-01 (1985)); Ohio (OHIO REV. CODE ANN. 2329E.66 (2003)); Oklahoma (OKLA. STAT. tit. 31 § 1 (1999)); South Carolina (S.C. CODE ANN. § 15-41-30 (1962)); South Dakota (S.D. CODIFIED LAWS § 43-45-3 (2005)); Tennessee (TENN. CODE ANN. § 26-2-301 (2004)); Vermont (VT. STAT. ANN. 27 § 101 (2004)); Virginia (VA. CODE ANN. § 34-4 (1995)); West Virginia (W. VA. CODE R. § 38-9-3 (1996)); Wyoming (WYO. STAT. ANN. § 1-20-101 (1983)).

[37] Alaska (ALASKA STAT. § 09.38.010 (2004)) (proceeds must be reinvested in new homestead); Arizona (ARIZ. REV. STAT. § 33-1101 (1980)) (proceeds protected for 18 months); California (CAL. CIV. PROC. CODE § 704.730 (1986)) (proceeds protected for 6 months); Colorado (COLO. REV. STAT. 38-41-207 (2005)) (proceeds protected for 1 year); Connecticut (CONN. GEN. STAT. § 52-352b (2003)) (proceeds protected for 1 year); Maine (14 ME. CODE R. § 4422 (2001)) (proceeds protected for 6 months); Minnesota (MINN. STAT. § 510.02 (1993)) (proceeds protected for 1 year); Montana (MONT. CODE ANN. 70-32-201 (1979)) (proceeds protected for 18 months); Nebraska (NEB. REV. STAT. § 25-1552 (1993)) (proceeds protected for 6 months); New York (N.Y. C.L.S C.P.L.R. § 5206 (2005)) (proceeds protected for 1 year); Oregon (OR. REV. STAT. § 18.395 (1999)) (proceeds protected for 1 year provided that there is intent to purchase new homestead); Texas (TEX. PROP. CODE ANN. § 41.001 (2001)) (proceeds protected for 6 months); Utah (UTAH CODE ANN. § 78-23-3 (2004)) (proceeds protected for 1 year); Washington (WASH. REV. CODE § 6.13.070 (2006)) (proceeds exempt for 1 year); Wisconsin (WIS. STAT. § 815.20 (1995)) (proceeds exempt for 2 years, provided that there is an intent to purchase new homestead).

[38] Pennsylvania and Rhode Island.

[39] In re Schalebaum, 273 B.R. 1 (Bankr. D. N.H. 2001); Matter of England, 975 F.2d 1168 (5th Cir. 1992); Drennan v. Wheatley, 195 S.W.2d 43 (Ark. 1946); Millsap v. Faulkes, 20 N.W.2d 40 (Iowa 1945); Smith v. Hart, 49 N.W. 657 (S.D. 1926); Mack v. Boots, 239 P. 794 (Ariz. 1925) (legislature has since amended statute to protect proceeds); Fred v. Bramen, 107 N.W. 159 (Minn. 1906) (legislature has since amended statute to protect proceeds); Wright v. Westheimer, 28 P. 430 (Idaho 1891)].

Proposed Massachusetts Legislation Senate 917 (S. 917) Includes Specific Limited Proceeds Exemption Provisions:

In 2001, the Boston Bar Association's Legislative Committee proposed a replacement to the Homestead Act. The proposed Act included a provision specifically protecting the cash proceeds of a homestead sale until the debtor had established a new homestead.[40] Even under this provision a debtor would not be protected if debtor and debtor's spouse had already established a new homestead. The 2001 proposed act was side-tracked by the passage of an increase in value of real estate protected from $300,000 to $500,000. The present S. 917, sponsored by Senator Michael Creedon (who sponsored the recent increase) and the Boston Bar Association and the Real Estate Bar Association contains a similar provision. This is further persuasive authority that proceeds are not protected because S. 917 the proposed replacement act, includes a specific provision protecting proceeds from a homestead sale in a specially labeled "homestead account" with the inference being that the current act should not be interpreted as offering similar protection.

Cash Proceeds Do Not Go Back Into the Estate of the Debtor, but Are Available To Creditors with Non-Dischargeable Debts as a Matter of State Law:

In the case of *In re Cunningham*, the Bankruptcy Court relied heavily on both *In re Reed* and *In re Hyde* to support the conclusion that proceeds from the sale of exempt property are also exempt.[41] However, footnote 7 of the *Reed* decision explicitly states that the case does not make that assertion; it states:

> It is important to note that the court is *not* holding that the proceeds of the disposition of exempt property are therefore also "exempt." When a debtor claims exemptions under state law, only state law controls whether a given property is "exempt." Our holding is only that under bankruptcy law, if a given property owned by the debtor is removed from the estate, it is no longer property of the estate. The conversion

[40] William Hovey, *Automatic, Paperless Homesteads Would Eliminate Much Confusion*, Mass. Law. Wkly., Dec. 24, 2001.

[41] In re Cunningham (B.R. 2006); *See also* In re Reed, 184 B.R. 733 (W.D. Tex. 1995), The Bankruptcy Court, at page 3 "adopts the reasoning and holding of Lowe v. Yochem that the sale of exempt property (here real estate) does not make the sales proceeds property of the estate. "The majority of courts, however, hold that a post-petition change in the character of property claimed as exempt will not change the status of that property, relying on the principle that once property is exempt, it is exempt forever and nothing occurring post-petition can change that fact." (Rosenthal, J. decision dated December 7, 2005)

> of that property into some other form which under applicable law, would not be exempt will not restore the property to the estate, but that is not the same as saying the property as transmogrified is still exempt.[42]

The first sentence of the footnote makes it clear that the *Reed* court is not saying that the proceeds are exempt. The *Reed* decision is simply holding that when exempt property is converted into non-exempt property, such as the cash proceeds from a voluntary sale, this non-exempt property does not return to the debtor's estate. The Bankruptcy Court, in *Hyde*, observed this important distinction.[43] The fact that the property will not return to the debtor's estate does not prevent a creditor with a garden variety, non-dischargeable debt from attaching the proceeds because his debt is non-dischargeable.

Federal Bankruptcy Law Does Not Enlarge State Homestead Statutes to "Transmorgify" Non-Exempt Proceeds Into Protected Property:

Had Congress intended such a broad reading of Section 522(c) they could have easily provided for it as they have in other sections of the Bankruptcy Code, i.e. "property exempted under this section and the proceeds thereof."[44] Nothing changes this, although the bankruptcy court stated:

> With respect to the debtor, whatever share of the Homestead Proceeds belong to him under state law are exempt from the claims of his pre-petition creditors, including the Creditor. *See Patriot Portfolio v Weinstein* (*In re Weinstein*), 164 F.3d 677, 683 (1st Cir. 1999), quoting *In re Whalen-Griffin*, 206 B.R. 277, 290 (Bankr. D. Mass. 1997) ('Because the exceptions to the Massachusetts homestead have the same effect on the homestead as the exceptions set forth in § 522(c), … the Massachusetts homestead statute is preempted to the extent that it permits exempt property to be liable for debts other than those

[42] In re Reed, 184 B.R. at 738. (Emphasis in original).

[43] In re Phillip W. Hyde, 334 B.R. 506 (Bankr. D. Mass. 2005), In *Hyde*, debtor had endorsed pension checks payable to his deceased mother from the Chicago Teachers Retirement Board for some eighteen years following her death. Debtor's homesteaded real estate was exempt from creditors, including the Retirement Board, whose garden variety, non-dischargeability judgment (for fraud) was not one for taxes or child support or alimony that § 522 (c)(1) provides can trump exempted property. When debtor voluntarily sold his homestead, the Massachusetts Bankruptcy Court, Feeney, J., deferred acting on the Board's request to reach the proceeds, because it felt the same result would be achieved by the criminal court, which was garnishing the funds under a post-petition restitution order. Although the court recognized that the issue of whether proceeds from a sale was an issue of state law 334 B.R. at 515, it nonetheless hinted in dicta it might have ruled the proceeds exempt.

[44] *Patriot Portfolio*, 164 F.3d. 677 (1st Cir. 1999).

> expressly enumerated in § 522(c)(1)-(3), particularly because the language employed by Congress in § 522(c) is devoid of ambiguity.')[45]

The Proceeds of the Sale of Homestead Property Are Not Protected From the Reach of Creditors; This is Consistent with Results When a Debtor Converts Exempt Property to Non-Exempt Property:

Notwithstanding the fact that a debtor's homestead exemption in *Cunningham* expired when debtor abandoned the property, the cash proceeds following the sale of homestead property are not exempt from the reach of creditors under the Act. The plain language of the statute is clear: "An estate of homestead… *in the land and buildings* may be acquired pursuant to this chapter…" (Emphasis added). There is no reference in the statute, nor is there any case law in Massachusetts, stating that the liquid proceeds from the sale of a homestead estate are similarly protected. Nevertheless, there certainly are cases that involve the transformation of exempt assets other than the estate of homestead, and the courts in those cases held that, once the transformation occurs, the exemption is lost.[46]

In the case of *In re Toone* the debtor, former president of the First National Bank of Marlborough, had $220,000 in that bank's qualified plan and claimed the same as exempt under both Massachusetts law[47] and ERISA,[48] after he had his attorney in fact son Attorney David Toone withdraw the same for purposes of rolling them over into an IRA account so-called, in accordance with I.R.C. grace provisions. The FDIC, a pre-petition creditor, had a $48,000,000 judgment. The bankruptcy court (Hillman, J) found once the ERISA plan administrator wrote checks to Debtor's attorney in fact, as a matter of state law the funds were no longer exempt property and the pre-petition creditor recovered. Cunningham's conduct in the within proceeding, converting exempt real estate to non-exempt cash is exactly parallel.[49]

In the case of *In re Wiesner*, where homestead Massachusetts real estate was properly claimed as exempt, the court found the fire insurance proceeds payable after a fire were not exempt under the Homestead Act.[50] In *Hoult v. Hoult*, the defendant entered into a post-judgment stipulation to address a non-dischargeable judgment. The

[45] The cited language applies to real estate only, not the proceeds of the sale. *See* In re Cunningham, 2005 Bankr. LEXIS 2419, at *3 n.1 (Bankr. D. Mass. Dec. 7, 2005).

[46] Hoult v. Hoult, 373 F.3d 47 (1st Cir. 2004); In re Wiesner, 267 B.R. 32 (Bankr. D. Mass. 2001); In re Toone, 140 B.R. 605 (Bankr. D. Mass. 1992).

[47] MASS. GEN. LAWS ch. 235 § 34A.

[48] 29 U.S.C. 1056(d) (2000).

[49] In re Toone, 140 B.R. 605 (Bankr. D. Mass. 1992).

[50] In re Wiesner, 267 B.R. 32 (Bankr. D. Mass. 2001).

court found the anti-alienation provision of ERISA applies to benefits only where held by the plan administrator and not after they reach the hands of the beneficiary, although a different result would pertain under the Social Security Statute, but the First Circuit in *Hoult v. Hoult* did not need to reach that issue.[51]

A Debtor's Spouse is not Protected by a Homestead Once the Tenancy by the Entirety Is Severed by Sale:

The Act explicitly states that only "one owner may acquire an estate of homestead…". However, when the property that is subject to the homestead is a tenancy by entirety, the homestead held by one owner is effectively held by the other owner as well. This is because in a tenancy by entirety "husband and wife are seized of the estate so granted as one person, and not as ordinary joint tenants or as tenants in common."[52] Thus, a tenancy by entirety is a legal creation in which the "interests of both the husband and wife extend to the whole of the property, not merely to some fractional interest that the other does not also hold." *Id.*[53] Further, any creditors of one party may not encumber the property as it is also held by the other, non-debtor party. Rather, the creditor must wait until after the end of the tenancy by entirety to encumber the debtor.

Section 522(c)[54] only preempts state law from determining what kinds of debts exempt property can be subject to. This is different from creating a new broad federal category of exempt property, i.e. cash proceeds from the voluntary sale of exempt property. The Bankruptcy Code does not preempt the state from determining what kinds of property to exempt, and each state determines, as a matter of state law, the degree of protection given to the proceeds resulting from a voluntary sale of homestead property.

In *Bruin Portfolio*, the Bankruptcy Appellate Panel for the First Circuit provides: "states can determine the nature and amount of property that can be exempted, but not the nature of debts to which the exemption applies."[55] This underscores the proposition that state law controls the exemptability of homestead proceeds because it is a question of what nature of property the state is choosing to exempt. Massachusetts exempts certain qualifying real estate, but does not exempt proceeds of a voluntary sale of exempt real estate from post-

[51] Hoult v. Hoult, 373 F.3d 47 (1st Cir. 2004).

[52] In re Snyder, 249 B.R. 40, 44 (Bankr. D. Mass. 2000).

[53] In re Snyder, 249 B.R. 40, 44 (Bankr. D. Mass. 2000).

[54] 11 U.S.C. §522(c) (2000).

[55] Bruin Portfolio, LLC v. Leicht (In re Leicht), 222 B.R. 670 at 678, citing In re Whalen-Griffen 206 B.R. 281 at 282 and In re Scott 199 B.R. 586, 593 (Bankr. E.D.Va 1996).

petition creditors or garden variety pre-petition creditors whose debts have been declared non-dischargeable by the Bankruptcy Court. However, once a debtor abandons the homestead, and clearly once he sells the exempt property, Section 522(c) of Federal bankruptcy law no longer protects non-exempt proceeds from the sale of real property. The drafters of Section 522(c) knew of the different states schemes set forth above. They did not choose to preempt or broaden protection for exempt property or cash proceeds resulting from such a sale thereby making proceeds exempt property protected in perpetuity. Hence, the disposition of cash proceeds to debtor from the sale of homestead property is not preempted and remains a question that the Massachusetts Bankruptcy Court has already decided.

The Bankruptcy Court's Reliance in Cunningham upon In re Reed is Misplaced:

In the case of *In re Reed*, which was heavily relied upon by the bankruptcy court, the Western Texas Bankruptcy Court states: "When a debtor claims exemptions under state law, only state law controls whether a given property is exempt?"[56] The Massachusetts Bankruptcy Court in *Cunningham* does not take this language into account.

In the case of *In re Reed*, the Chapter 7 Bankruptcy trustee sought to include proceeds from the voluntary sale of exempt Texas homestead real estate in the bankrupt estate for the benefit of all pre-petition creditors.[57] Jerry Lee Reed filed for Chapter 11 protection in the Western District of Texas on February, 1991 and timely and properly claimed the "Reed Ranch" in Bandera County as exempt homestead property. The objection period had expired when on August 20, 1992 the debtor and his wife sold the ranch for cash and a $375,000 "Bartley (purchase) note". On February 16, 1993 (within the relevant 6 month period allowed by Texas statute) the Reeds purchased a new home using the Bartley note as collateral for a $583,637.67 note they gave to the McDades (sellers of 2nd house). On May 19, 1993 the case was converted to Chapter 7 and the trustee claimed that the Bartley note was property of the estate under Section 541(a) of the Bankruptcy Code. Debtor and his wife ultimately received, on July 27, 1993, a net of $106,574.28 from the then payment of the Bartley note after payment of other sale expenses and an additional $167, 352.12 of proceeds was applied on account to the McDade note.

The *Reed* case turned on the analysis of Section 541(a) of the Bankruptcy Code during an ongoing Chapter 11 case. Had Reed's sale and purchase transactions been entirely for cash, because within the six

[56] In re Reed, 184 B.R. 733 at 738, n.7.
[57] In re Reed, 184 B.R. 733.

(6) month protected period under Texas statute, no case would have been brought, as the cash proceeds were exempt under the Texas Homestead Law. The $375,000 Bartley note from the sale in *Reed* did not become property of the Chapter 11 estate when six (6) months from the sale of the homestead expired on February 20, 1992 because none of the relevant provisions of Section 541(a) of the Bankruptcy Code include such a note obtained from a sale of exempt property as property of the estate. That should end the *Reed* analysis and inquiry (parenthetically, a post-petition creditor of Reed could have reached the Bartley note).

The *Reed* court cites several cases immediately after a quoted passage that states:

> "The majority of courts, however, hold that a post-petition change in the character of property properly claimed as exempt will *not* change the status of that property, relying on the principle that once property is exempt, it is exempt forever and nothing occurring post-petition can change that fact."[58]

The first such cited case does not involve a change in the character of property post-petition at all, but merely the Chapter 7 debtor's death eight months after the Bankruptcy filing[59] and proper claiming of a state (North Dakota) homestead. Reciting familiar principals, the Eighth Circuit held that the exempt homestead status is determined as of date of Chapter 7 filing and: "[o]ne of the main goals of the Bankruptcy Code is to provide *honest* debtors with a fresh start."[60]

The *Payne* case involved which fire insurance proceeds for an Illinois Chapter 7 debtor's December, 1981 fire became property of the estate.[61] The estate's property was limited by insurance proceeds designated for certain personalty, properly and timely claimed as exempt. The *Wickstrom* case does not appear to revolve around any post-petition death by debtor (but rather alleged fraudulent transferees—debtor's parents) and does not stand for the proposition cited, or support either the *Reed* dicta or the Cunningham holding appealed from.[62] In the case of *In re Harlan*,[63] the Chapter 7 debtors filed a voluntary petition on October 14, 1982, having sold their homestead pre-petition on October 1, 1982 for $15,015.54 and a $48,000 note. Texas statute Article 3834

[58] In re Reed, 184 B.R. 733 at 738.

[59] Armstrong v. Peterson, 897 F.2d 935, 937 (8th Cir. 1990).

[60] In re Lindberg, 735 F.2d 1087, 1090 (8th Cir. 1986) (emphasis supplied).

[61] Payne v. Wood, 775 F.2d 202 (7th Cir. 1985).

[62] Estate of A. N. Wickstrom v. Wickstrom (Matter of Wickstrom), 113 Bankr. 339, 343-44 (Bankr. W.D.Mich. 1990); *See also* In re Reed, 184 B.R. 733.

[63] In re Harlan, 32 B.R. 91, Bankr. W.D.Tex 1983.

made said proceeds exempt for six (6) months, and a garden variety pre-petition creditor had no claim on such proceeds.

CONCLUSION

The intersection of bankruptcy and state law is a fascinating area to observe preemption at work. The recent heralded "Reform" Act, i.e., The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,[64] addressed perceived abuses including those perceived in the exemption system. While initial feedback from consumer advocates suggests Congress shot a flea with an elephant gun, the area of bankruptcy and homestead will doubtless generate more litigation, appeals and legislative tinkering.[65]

[64] *Supra* note 1.

[65] *See* National Association of Consumer Bankruptcy Attorneys (NACBA), *Bankruptcy Reform's Impact: Where are all the "Deadbeats"?*, February 22, 2006.

CLOUTIER V. COSTCO: THE CHURCH OF BODY MODIFICATION AND RISING LEGAL CHALLENGES TO BODY ART WORK RULES AS RELIGIOUS DISCRIMINATION.

by LUCILLE M. PONTE*

INTRODUCTION

For over a decade, religious discrimination claims have been steadily climbing with EEOC resolutions of religious discrimination claims doubling between 1994 -2004.[1] While other forms of discrimination have

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[1] U.S. EQUAL EMPLOYMENT OPPORTUNITY COMM'N, RELIGION-BASED CHARGES FY-1992-FY 2004 (2005), *at* http://www.eeoc.gov (last visited Feb. 2, 2006) [hereinafter RELIGION-BASED CHARGES]. In 1994, the EEOC received 1,546 religious discrimination claims and resolved 1,274 of them compared to 2,466 claims and 2,676 resolutions for religious discrimination in 2004. *Id*. Religious discrimination claims which have been increasing over time spiking to their highest levels in 2002 in the aftermath the tragedy of 9/11 (2,572 claims and 2,729 resolutions). *Id*. *See* Richard T. Foltin & James D. Standish, *Your Job or Your Faith? Under the Workplace Religious Freedom Act, Americans would not have to choose*, LEGAL TIMES, July 21, 2003, at 36, *available at* LEXIS Academic, News File; Sue Reisinger, *Getting Religion*, CORP. COUNS., Mar. 2005, at 74 (2005), *available at* LEXIS Academic, News File.

largely stabilized,[2] religious discrimination claims have reached their highest levels in the past three years.[3] Although only 3 percent of all discrimination claims filed,[4] religious discrimination cases are receiving new attention as employees have become more willing to bring legal actions against workplace restrictions on religious observances and expression.[5] Mainstream and minority religions[6] have allied to urge passage of the Workplace Religious Freedom Act of 2005 (WRFA), a highly-controversial legislative proposal,[7] aimed at expanding religious expression and freedom at work. While many employers assert respect for and train employees about the importance of workplace diversity,

[2] Foltin & Standish, *supra* note 1, at 36; Reisinger, *supra* note 1, at 74. Claims of race, gender, and national origin discrimination have increased 15 percent over the past decade, while religious discrimination claims have skyrocketed 85 percent. Foltin & Standish, *supra* note 1, at 36.

[3] RELIGION-BASED CHARGES, *supra* note 1.

[4] Reisinger, *supra* note 1, at 74.

[5] Marianne C. DelPo, *Never on Sunday, Workplace Religious Freedom in the New Millennium,* 51 ME. L. REV. 341, 342, 345 (1999); Reisinger, *supra* note 1, at 74.

[6] In this article, the author will use the term "majority" or "mainstream" religions, rather than "traditional", and "minority" religions, rather than "nontraditional" or "alternative" ones. The terms "nontraditional or alternative" religions can be perceived as devaluing these minority beliefs, while the word "traditional" religion suggests greater approval or validity of these institutional creeds. It is important to note that one's religious traditions are relative for each individual and many minority religions involved in these cases have longer historical lineage than some majority or mainstream religions. *See infra* notes 146-47 and accompanying text.

[7] S. 677, 109th Cong. (2005), H.R. 1445, 109th Cong. (2005), *available at*, http://www.thomas. Gov (last visited Mar. 6, 2006). The 2005 bill has received broad political and religious support from a diverse range of conservative and liberal groups. *Id*; Foltin & Standish, *supra* note 1, at 36*;* James A. Sonne, *Article: The Perils of Universal Accommodation: The Workplace Religious Freedom Act of 2003 and the Affirmative Action of 147,096,000 Souls*,79 NOTRE DAME L. REV. 1023, 1026 (2004). However, the WRFA has been introduced several times since 1994 and has failed on each occasion to be passed out of a committee or subcommittee. Gregory M. Baxter, *Employers Beware, The Workplace Religious Freedom Act of 2000*, 2 RUTGERS J. LAW & RELIG. 6 (2000/2001) (online journal-unpaginated); Robert A. Caplen, *Note: A Struggle of Biblical Proportions: The Campaign to Enact The Workplace Religious Freedom Act of 2003*, 16 FLA. J. LAW. & PUB. POL'Y 579, 600-01 (2005). For examination and criticisms of earlier versions of the proposed WRFA, *see generally*, Baxter, *supra,* at ns. 124-223; Caplen, *supra,* at 611-23; Sonne, *supra,* at 1051-80. The WRFA is opposed by many, including employer who fear its more stringent requirements and public interest groups, like the ACLU, which see it as a mechanism for increased proselytizing and religious harassment in the workplace and validation of religious-based conduct that harms the personal and civil rights of women, minorities, gays and lesbians. Caplen, *supra,* at 604-21. *See* Wilson v. U. S. West Comm., 58 F. 3d 1337 (8th Cir. 1995) (employee's graphic anti-abortion button worn as vow to her religious beliefs as form of religious harassment of co-workers); EEOC v. Townley Eng'g & Mfg. Co., 859 F.2d 610 (9th Cir. 1988) (court finds religion discrimination against employer who fired atheist employee who refused to participate in workplace devotional services).

most companies have struggled to deal with the evolving demands for greater respect of religious diversity.[8]

Contemporary calls for greater tolerance of religious differences have dovetailed with a growing interest in society in body modification, including tattoos, [9] body piercing,[10] and other forms of body manipulation.[11]

[8] DelPo, *supra* note 5, at 345-47; Foltin & Standish, *supra* note 1, at 36; Reisinger, *supra* note 1, at 74. *See also* Art Lambert, *God Goes to Work*, WORKFORCE WEEK, June, 2005, *available at* http://www.workforce.com (last visited June 28, 2005) (provides questions-and-answers on dealing with divisive religious issues in workplace). In addressing new employee calls for religious diversity in the workplace, Rev. Thomas Sullivan, director of spiritual life and professor of business ethics at Babson College, stated that

> [t]he old conventional wisdom was just don't talk about religion or spirituality in the workplace at all. The new conventional wisdom is that we still don't want proselytizing pressure in the workplace and we don't want people to feel unwelcome, but we know that folks who feel like they can bring their spiritual values to work are happier, are more productive, stay longer and help the company more than people who don't feel like they can bring their values to work. The challenge is finding a way to do that, that still respects the old conventional wisdom of seeing to it that people don't feel pressured or proselytized in any way.

Todd Henneman, *A New Approach to Faith at Work*, WORKFORCE WEEK, Oct. 2004, *available at* http://www.workforce.com (last visited June 28, 2005).

[9] About one in four of the 1.3 million college graduates in 2005 have a tattoo. Marilyn Rauber, *Tattoos finding wider appeal*, MEDIA GENERAL NEWS SERVICE, June 26, 2005, *available at* http://www.potomacnews.com (last visited Feb. 20, 2006). A Mayo Clinic study determined that about 23 percent of university students have up to three tattoos. *Id.* The increasing desire for tattoos is not limited to university students but has broadened out to wider age and social ranges of Americans. *Id.* An earlier 2003 Harris Poll found that 36 percent of adults aged 25-29 and 28 percent of adults aged 30-39 have at least one tattoo with 16 percent of all U.S. adults having at least one tattoo. Laurel A. Van Buskirk, *New Developments on Tattoos and Body Piercing in the Workplace*, N. H. BUS. REV., Dec. 2005, at n.1, *available at* http://www.gcglaw.com/resources/ employment/ tattoos2.html (last visited Mar. 6, 2006). *See generally* Paul Andrew Burnett, *Comment: Fairness, Ethical, And Historical Reasons For Diversifying The Legal Profession With Longhairs, The Creatively Facial-Haired, The Tattooed, The Well-Pierced, And Other Rock And Roll Refugees*, 71 UMKC L. REV. 127 (2002)(author calls for greater tolerance of appearance diversity in legal profession, including lawyers with visible tattoos and piercings). *See infra* note 12 and accompanying text.

[10] In a Mayo Clinic study, the report found that more than 50 percent of university students have at least one piercing that is not an ear piercing. Rauber, *supra* note 9. *See* Natasha Chilingeran, *Fashion replaces rebellion as motive for body piercing*, OR. DAILY EMERALD, Nov. 26, 2003, *at* http://www.dailyemerald.com (last visited Dec. 8, 2003). Similar to tattoos, piercings are gaining interest in diverse age and social groups. Chilingeran, *supra*. *See generally* Burnett, *supra* note 9. *See infra* note 12 and accompanying text.

[11] In reviewing the body modification practices of the Church of Body Modification, the *Cloutier I* district court discussed other body manipulation practices. The court stated that

> According to the mission statement on the CBM website, members of the CBM believe that the practice of body modification and body manipulation strengthens the bond between mind, body, and soul, thus ensuring that adherents live as spiritually complete and healthy individuals. *See* www.uscobm.com. Among the practices of members of the CBM are body modifications such as piercing, tattooing,

Although such ancient practices have been well established in other cultures,[12] the United States has only recently seen a growing interest in body modification.[13] Traditionally viewed as a sign of deviance or rebellion in American society,[14] this new trend in body modification may arise from a range of motivations, from an individual's transitory fashion preferences or desire for self-expression to strengthening spiritual awareness and/or cultural identity.[15] Employers have scrambled to devise "body art work rules" to deal with this societal shift,[16] often facing

> branding, transdermal [piece of metal that goes underneath and comes through skin] or subcutaneous implants, [stainless steel inserted under skin] and body manipulation, such as flesh hook suspensions and pulling. At one time, the CBM listed as one of its tenets that members should "seek to be confident models in learning, teaching and displaying body modification."

311 F. Supp. 2d at 193. (footnotes omitted). *See infra* note 12 and accompanying text.

[12] Body modification practices have clear spiritual roots and cultural significance in a number of early and present-day civilizations. *Bodies of Culture, A World Tour of Body Modification*, *at* http://www.museum.upenn.edu/new/exhibits/online _exhibits/body_ modification/bodmodpierce.shtml (last visited Feb. 20, 2006) [hereinafter *Bodies of Culture*]; Chilingeran, *supra* note 10. For example, the Aztecs and the Mayans pierced their ears to repel demons and their tongues to enhance communication with the gods. Chilingeran, *supra* note 10. Nose rings were also common in ancient Mexico and India while the indigenous Alaskans pierced their lips with lip-plugs called labrets. *Bodies of Culture, supra*; Chilingeran, *supra* note 10. Tattoos on the face and other parts of the body were part of the spiritual and social practices of ancient Egypt as well as the Maori, Samoan and native Alaskan cultures. *Bodies of Culture, supra.* Scarification is still practiced in some African nations, signifying one's social, spiritual and political status. *Id.*; Helen Coleman, *Scarification among African cultures* (November 2002), *at* http://www.randafricanart.com/Scarification_and_Cicatrisa- tion_among_African _cultures.html (last visited Mar. 6, 2006).

[13] Chilingeran, *supra* note 10; Rauber, *supra* note 9; Regina M. Robo, *Body Art in the Workplace*, *at* http://www.salary.com (last visited Dec. 8, 2003).

[14] Chilingeran, *supra* note 10; Rauber, *supra* note 9; Silja A. Tavi, *Keeping Up Appearances*, THE CHRISTIAN SCI. MONITOR, Sept. 11, 2000, *available at* http://www.csmonitor.com (last visited Dec. 8, 2003). Courts have reinforced such stereotypical views by upholding prosecutor's pre-emptory juror challenges of those with tattoos and piercings as nondiscriminatory and valid signs of nonconformity and liberal attitudes toward criminal behavior. *See, e.g.,* U.S. v. Smith, 324 F. 3d 922 (7th Cir. 2003); (female with visible tattoos and lip piercing); Wilson v. State, 2003 WL 203470 (Tex. App. Ct. 2003) (African-American juror with visible body piercing); Lee v. State, 949 S.W. 2d 848 (Tex. App. Ct. 1997) (male juror with pierced earring); Gambel v. State, 835 S.W. 2d 788 (Tex. App. Ct. 1992)(male juror with pierced earring).

[15] Chilingeran, *supra* note 10; Rauber, *supra* note 9; Robo, *supra* note 13.

[16] *See* Louis Pechman, *Tattoos and Piercings in the Workplace*, N.Y.L.J., Dec. 15, 2005 at 4; Andrea K. Johnstone and Laurel A. Van Buskirk, *Tattoos & Body Piercing: Avoiding Employment Discrimination Claims*, N. H. BUS. REV., Oct. 2004, *at* http://www.gcglaw.com/ resources/employment/tattoo.html (last visited Mar. 6, 2006); Van Buskirk, *supra* note 9.

employee resistance to such personal restrictions.[17] More traditional legal challenges to dress and grooming codes based on hair lengths, beards, and religious garb[18] are now giving way to growing litigation over body art work rules as unlawful discrimination,[19] including religious

[17] Kelly Lucas, *Should employers regulate appearance? While it is legal, many Americans do not believe employers should consider appearance when hiring*, THE IND. LAW., May 4, 2005, *available at* LEXIS Academic, News File; Johnstone & Van Buskirk, *supra* note 16; Jerry Shottenkirk, *Companies face social, legal challenges over evolving employee appearance policies*, THE DAILY RECORD, Apr. 15, 2005, *available at* LEXIS Academic, News File; *Get That Ring Out of Your Nose and Cut Your Hair—Can the Employer Legally Make Such Demands?*, HR MANAGER'S LEG. RPTR., April 2002, *available at* http://www.rbpubs.com (last visited Dec. 8, 2003). In a 2005 America at Work poll, the survey found that 61 percent of employees believed that employers should not be allowed to deny employment based on appearance, including visible tattoos and piercings, while 47 percent of supervisors felt that employers should be able to deny employment based on appearance. Lucas, *supra;* Shottenkirk, *supra*. *See infra* note 127 and accompanying text.

[18] *See generally* Baxter, *supra* note 7, at ns. 58-82; DelPo, *supra* note 5, at 344-46 (both authors discuss traditional religious discrimination challenges based on hair, beard, and dress).

[19] *See e.g.,* Kleinsorge v. Eyeland Corporation, 2000 U.S. Dist. LEXIS 812 (E.D. Pa. 2000), *aff'd*, 251 F.3d 153 (3rd Cir. 2000) (court upholds policy prohibiting males from wearing earrings finding no gender discrimination); Riggs v. City of Fort Worth, 229 F. Supp. 2d 572 (N.D. Tex. 2002) (police officer loses challenge to department dress code requiring him to cover tattoos as race, gender, and national origin discrimination); Ciafrei v. Bentsen, 877 F. Supp. 788 (D. R.I. 1994) (court finds for federal government when employee claims gender discrimination, due in part to her tattoos, in failure to promote dispute); Pecenka v. Fareway Stores, Inc., 672 N.W. 2d 800 (Iowa 2003) (employee fails in challenge to policy prohibiting males from wearing earrings as gender discrimination); Sam's Club, Inc. v. Madison EEOC, 668 N.W. 2d 562 (Wis. App. 2003)(court sustains employer's prohibition of nose rings against claim of appearance discrimination under state anti-discrimination law); Hub Folding Box Company, Inc. v. MCAD, 750 N.E. 2d 523 (Mass. App. Ct. 2001)(female employee wins challenge to employer mandate that female, but not male employee, cover tattoos in workplace); Capaldo v. Pan American Federal Credit Union, 1987 U.S. Dist. LEXIS 14475 (E. D. N.Y. 1987) (court upholds employer policy prohibiting males from wearing earrings finding no gender discrimination); In re Motion Picture and Television Fund and Hospital SEIU, 103 LA 992 (1994) (Gentile, Arb.) (in arbitration employee loses dispute with employer about removing nose ring despite claims of national origin discrimination and harassment). In some instances, plaintiffs have used evidence involving body modification to support of claims of sexual harassment. *See* Ocheltree v. Scollon Productions, Inc., 335 F. 3d 325 (4th Cir. 2003) (co-worker's display of photograph of pierced scrotum with chain to penis as part of overall pattern of sexual harassment against plaintiff); Lovelace v. Federal Express Corp., 1999 U.S. Dist. LEXIS 17683 (N. D. Ga. 1999)(plaintiff contends that supervisor pulled down her shirt to see her tattoo as part of workplace sexual harassment); Albertson's Inc., 115 LA 886 (2000) (Gangle, Arb.) (in arbitration, employee challenges enforcement of no-tongue-ring rule by manager who required her to repeatedly stick out her tongue as sexual harassment). In one instance, the plaintiff's piercing was used to undermine a claim of sexual harassment (*see* Ferencich v. Merritt, 2003 WL 22430394 (10th Cir. 2003) (evidence of plaintiff sticking out her tongue with tongue ring as probative of flirtatious behavior that may show that sexual advances were not unwelcome).

discrimination.[20] These modern body art religious discrimination cases reflect many of the same legal concerns that have long plagued Title VII enforcement of more traditional religious legal challenges.[21]

Recently, in *Cloutier v. Costco*[22], an employee challenged the company's body art work rules prohibiting facial piercings as religious discrimination against the Church of Body Modification and lost her case at both the district and appellate levels.[23] Although many companies cheered the victory,[24] this article will contend that the *Cloutier* decisions raise troubling legal issues that cast doubt on the adequacy of Title VII to properly protect religious practices in the workplace, particularly for minority faiths. Part I will set out the foundation principles of and defenses to religious discrimination in the workplace with a special focus on the development of notions of reasonable accommodation and undue hardship for workplace religious needs.[25] Part II will discuss the *Cloutier* district and appellate court decisions in which both courts found for the employer but on different grounds, one finding reasonable accommodation, the other concluding undue hardship, respectively.[26] Part III discusses how this current case illustrates the long-running weaknesses of judicial interpretations of Title VII in religious discrimination cases which is fueling calls for passage of the more expansive and hotly-debated WRFA.[27]

[20] Cloutier v. Costco Wholesale Corp., 311 F. Supp 2d 190, *aff'd on other grounds*, 390 F. 3d 126 (1st Cir. 2004) (court strikes down employee challenge to no facial jewelry policy finding no religious discrimination); EEOC v. Red Robin Gourmet Burgers, Inc., 2005 U.S. Dist. LEXIS 36219 (W. D. Wash. 2005) (court upholds employee's claim of religious discrimination in employer requirement that he intentionally cover his religious tattoos); Swartzenruber v. Gunite Corp., 99 F. Supp. 2d 976 (N. D. Ind. 2000) (court finds against employee on claim of religious discrimination based on employer demand to cover visible Klu Klux Klan tattoos). In the *Riggs* case, it is interesting to note that the plaintiff did not claim religious discrimination for the employer's grooming policy, but could have, as one of his tattoos was a two-foot by two-foot color rendering of St. Michael slaying Satan. *Riggs*, 229 F. Supp. 2d at 578.

[21] *See infra* notes 119-51 and accompanying text.

[22] 311 F. Supp 2d 190, *aff'd on other grounds*, 390 F. 3d 126 (1st Cir. 2004).

[23] *See infra* notes 80-116 and accompanying text.

[24] Joan Ackerstein, *Court Upholds Retailer's Dress Code Despite Employee's Body Piercing Beliefs*, Dec. 17, 2004, *at* http://www.jacksonlewis.com (last visited April 13, 2005); Michael S. Mitchell, *Costco Scores Big Win for Dress Codes*, HOSPITALITY LAB. LETTER, Jan. 2005, *at* http://www.laborlawyers.com (last visited April 13, 2005); Alison Stein Wellner, *Costco's Appearance Crusade*, WORKFORCE WEEK, Mar. 2005, *at* http://www.workforce.com (last visited April 6, 2005).

[25] *See infra* notes 28-67 and accompanying text.

[26] *See infra* notes 68-116 and accompanying text.

[27] *See infra* notes 117-51 and accompanying text.

I. RELIGIOUS DISCRIMINATION UNDER TITLE VII

The evolution of religious discrimination under the provisions of Title VII and the interpretive case law illustrates the continuing tensions surrounding religious diversity in the workplace.[28] Title VII originally included religion in its laundry list of protected classes without any requirement for reasonable accommodation of religious observances.[29] The 1966 EEOC guidelines called for employers to accommodate employees unless it would cause a "serious inconvenience to the conduct of the business" which was later revised to "undue hardship" under the 1967 Guidelines.[30] Despite the language in the Guidelines, courts were only willing to find religious discrimination for claims grounded in disparate treatment and were reluctant to require employers to reasonably accommodate religion in the absence of explicit statutory language.[31]

In the face of persistent complaints of discrimination against employee religious observances,[32] Congress revised Title VII's religion provision in 1972 in line with the EEOC guidelines requiring reasonable accommodation by employers, provided that the accommodation did not cause undue hardship on the operation of the employer's business.[33] This amendment sought to insure that employees would not be forced to choose between their faiths and their jobs, with employers and employees participating in the negotiation of alternatives that would resolve the conflict without the loss of employment.[34]

In the wake of the 1972 amendment, employers grew concerned that religious discrimination claims would proliferate with employees abusing

[28] *See generally*, Karen Engle, *The Persistence of Neutrality: The Failure of the Religious Accommodation Provision To Redeem Title VII*, 76 TEX. L. REV. 317 (1997) (excellent analysis of development of religious discrimination in employment and the often contradictory judicial review of such claims); Susannah P. Mroz, *NOTE: True Believers?: Problems of Definition in Title VII Religious Discrimination Jurisprudence*, 39 IND. L. REV. 145 (superb review of struggle to define religion in relation to Title VII employment discrimination claims).

[29] DelPo, *supra* note 5, at 342; Engle, *supra* note 28, at 362; Mroz, *supra* note 28, at 146-47.

[30] 29 C.F.R. App. A, §§1605.2 and 1605.3 (2006). *See* Mroz, *supra* note 28, at 147.

[31] Engle, *supra* note 28, at 362-70. *See* Dewey v. Reynolds Metals Co., 429 F.2d 324 (6th Cir. 1970), *aff'd by an equally divided court*, 402 U.S. 689 (1971) (per curiam) (court made distinction between disparate treatment religious discrimination as illegal and legal action of failure to accommodate); Riley v. Bendix Corp., 330 F. Supp. 583 (M.D. Fla. 1971), *rev'd*, 464 F.2d 1114 (5th Cir. 1972) (employer allowed to discharge Seventh Day Adventist's requesting schedule changes as employer not required "to accede to the wishes of every doctrine or religious belief").

[32] Engle, *supra* note 28, at 369-70; Mroz, *supra* note 28, at 147.

[33] Engle, *supra* note 28, at 370; Mroz, *supra* note 28, at 147-48.

[34] Engle, *supra* note 28, at 388, 417.

the protection in order to avoid normal work responsibilities.[35] In these early religious discrimination cases, employers often sought to defend against religious discrimination claims by contending that the employee's practices were not legitimate religions, but mere personal preferences,[36] or that the employee lacked sincerity in their religious beliefs through inconsistent religious observances.[37] These early decisions often exhibit intolerance for belief structures that did not conform to mainstream institutional religions.[38] Some courts found themselves in the awkward position of trying to assess the validity of religious practices and employee belief, a questionable practice in light of First Amendment rights to freedom of expression and religion.[39] Other

[35] DelPo, *supra* note 5, at 343; Engle, *supra* note 28, at 372, 375-76. However, the EEOC in its 1978 hearings found that

> Little evidence was submitted by employers which showed actual attempts to accommodate religious practices with resultant unfavorable consequences to the employer's business. Employers have appeared to have substantial anticipatory concerns, but no, or very little, actual experience with the problems they theorized would emerge by providing reasonable accommodation for religious practices.

29 C.F.R. App. A, §§1605.2 and 1605.3 (2006).

[36] Engle, *supra* note 28, at 372-73; Mroz, *supra* note 28, at 161, 170. *See* Brown v. Pena, 441 F. Supp. 1382 (S.D. Fla. 1977), *aff'd*, 801 F. 2d 396 (5th Cir. 1979) (plaintiff's belief in cat food as mere personal preference and not legitimate religion). *See generally* Engle, *supra* note 28, at 329-43 (discussing how courts find race, gender and national origin discrimination only for immutable traits, not characteristics viewed as volitional). In discussing the split in courts over religious mandates versus personal preference, Prof. Engle stated that,

> In particular, the courts that…deployed the institutional religion-personal preference distinction to refuse to protect belief and observance that was not decreed by the church (compelled) but was seen as merely a matter of personal preference (volitional). Thus, the institutional religion requirement functioned in the same way as the immutability requirement in the race, national origin, and sex cases: it defined what courts considered volitional out of the protected category.
>
> ….[T]the courts assume that, once one becomes a member of an organized religion, conduct is dictated by the church. To the extent that the claimed religious conduct is seen to represent only a preference, it is not beyond the individual's control, and is therefore not protected by the statute.

Engle, *supra* note 28, at 373.

[37] Engle, *supra* note 28, at 372; Mroz, *supra* note 28, at 166-70. *See Dewey*, 429 F.2d at 334 (court considered plaintiff's inconsistency in his religious beliefs as to sinful nature of seeking scheduling replacements on his Sabbath in determining validity of religious discrimination claim); Williams v. Southern Union Gas Co., 529 F.2d 483, 488 (10th Cir. 1976) (court considered consistency of plaintiff's World of Church beliefs in considering undue hardship as to employee request for scheduling changes).

[38] Engle, *supra* note 28, at 375-76, 381; Mroz, *supra* note 28, at 157-58, 166-68.

[39] Engle, *supra* note 28, at 359, 378-79; Mroz, *supra* note 28, at 156-57.

courts, including the Supreme Court avoided making such assessments out of sensitivity to these individual rights.[40]

Within five years, the Supreme Court undercut the protections of the 1972 amendment in its interpretation of undue hardship in religion discrimination cases. In *TWA v. Hardison*,[41] the Court stated that Title VII's limitation of undue hardship did not require an employer "to bear more than a de minimis cost."[42] By setting the bar so low, the Court made it easy for employers to claim undue hardship for just about any meaningful accommodation, the brunt of which the dissent asserted would fall disproportionately on adherents to minority faiths.[43]

[40] Engle, *supra* note 28, at 359, 378-79; Mroz, *supra* note 28, at 156-57, 159-60. *See* Thomas v. Review Bd. of Ind. Employment Sec. Div., 450 U.S. 707 (1981) (Court should respect even unclear or irrational religious beliefs as "courts should not undertake to dissect religious beliefs"); Fowler v. Rhode Island, 345 U.S. 67, 70 (1953) (in striking down ordinance banning religious speech in public park, Court stated that "it is no business of courts to say that what is a religious practice or activity for one group is not religion under the protection of the First Amendment"); Redmond v. GAF Corp., 574 F.2d 897 (7th Cir. 1978) (in case considering Jehovah's Witness claim of religious discrimination court followed *Fowler* precedent on not inquiring into validity of religious beliefs). As the *Redmond* court stated,

> …we note that to restrict the act [Title VII] to those practices which are mandated or prohibited by a tenet of the religion, would involve the court in determining not only what are the tenets of a particular religion, which by itself perhaps would not be beyond the province of the court, but would frequently require the courts to decide whether a particular practice is or is not required by the tenets of the religion. (footnote omitted) We find such a judicial determination to be irreconcilable with the warning issued by the Supreme Court in *Fowler v. Rhode Island,* 345 U.S. 67, 70, 97 L. Ed. 828, 73 S. Ct. 526 (1953), "It is no business of courts to say . . . . what is a religious practice or activity . . . ."

Id. at 900.

[41] 432 U.S. 63 (1977). The Court addressed an employee's accommodation request for Saturdays off under the Sabbath requirements of the Worldwide Church of God which accommodation would violate the seniority provisions of a collective bargaining agreement. *Id*. at 67-69. The Court found that the alternatives of replacing Hardison either with supervisory personnel or with qualified personnel from other departments or the payment of premium wages for a replacement worker would involve an undue hardship because of the lost job efficiency or the extra wage costs. *Id.* at 84.

0 *See* Engle, *supra* note 28, at 389-90; Mroz, *supra* note 28, at 148-49.

[42] *Hardison*, 432 U.S. at 84.

[43] The *Hardison* decision led some employers to erroneously believe that they no longer had a legal obligation to accommodate employees claiming religious needs at all. *See* Engle, *supra* note 28, at 381-82. In his stinging dissent in *Hardison*, Justice Marshall eloquently stated that

> One of the most intractable problems arising under Title VII….has been whether an employer is guilty of religious discrimination….Particularly troublesome has been the plight of adherents to minority faiths who do not observe the holy days on which most businesses are closed -- Sundays, Christmas, and Easter - but who need time off for their own days of religious observance….
>
> Today's decision deals a fatal blow to all efforts under Title VII to accommodate

In the wake of *Hardison*, the EEOC held hearings in 1978 that sought to clarify the employer's continuing duty to reasonably accommodate, particularly those with minority religious needs.[44] In 1980, the EEOC established revised guidelines that offered far-reaching recognition of religious beliefs and practices.[45] Under these Guidelines, the EEOC defined religion "to include moral or ethical beliefs as to what is right and wrong which are sincerely held with the strength of traditional religious views."[46] The Guidelines did not limit religion to theistic practices or to beliefs professed by organized religions.[47] Under this approach, many employee beliefs could be considered religious with most cases no longer involving a consideration of "whether or not a practice is religious."[48] But the Guidelines bounded this expansive term within the

> work requirements to religious practices. The Court holds, in essence, that although the EEOC regulations and the Act state that an employer must make reasonable adjustments in his work demands to take account of religious observances, the regulation and Act do not really mean what they say. An employer, the Court concludes, need not grant even the most minor special privilege to religious observers to enable them to follow their faith. As a question of social policy, this result is deeply troubling, for a society that truly values religious pluralism cannot compel adherents of minority religions to make the cruel choice of surrendering their religion or their job. And as a matter of law today's result is intolerable, for the Court adopts the very position that Congress expressly rejected in 1972, as if we were free to disregard congressional choices that a majority of this Court thinks unwise.

Id. at 85, 87 (Marshall, J., dissenting). *See* Mroz, *supra* note 28, at 172-74 (author contends that courts view mainstream religions as presumptively religious and worthy of Title VII protections, while minority beliefs are subject to more searching analysis and are less likely to receive protections that Title VII envisioned). *See infra* note 134 and accompanying text.

[44] *See* Engle, *supra* note 28, at 381. In opening the hearings, then EEOC Commissioner, Eleanor Holmes Norton referred to Hardison as a "troubling decision." *Id.*

[45] 29 C.F.R. §§1605.1 (1980).

[46] *Id.* at §1605.1.

[47] The EEOC's wide-ranging definition of religion was derived from early Selective Service cases that moved beyond institutional religions and theistic belief structures in handling exemptions to the draft and military service. Engle, *supra* note 28, at 373, 385-86; Mroz, *supra* note 28, at 152-55. *See* U.S. v. Seeger, 380 U.S. 163, 165 (1965) (defines religious belief to include individual's belief in Supreme Being that could incorporate political, sociological, or philosophical views or a personal moral code); Welsh v. U.S., 398 U.S. 333, 343-44 (1970) (allows for expansion of belief systems to include nonreligious ethical or moral codes). The Guidelines further state that "[t]he fact that no religious group espouses such beliefs or the fact that the religious group to which the individual professes to belong may not accept such belief will not determine whether the belief is a religious belief of the employee or prospective employee." *Id.* at §1605.1.

[48] *Id. See* Engle, *supra* note 28, at 359, 362, 372. *See supra* note 40 and accompanying text.

context of the employer's obligation to reasonably accommodate employees,[49] except in instances of undue hardship.[50]

As regards reasonable accommodation under the Guidelines, an employer must offer an alternative that "least disadvantages" the employee's employment status and opportunities.[51] An employer may completely refuse to accommodate an employee only when undue hardship would flow from all requested alternatives.[52] Undue hardship can not be claimed based solely upon the assertion that many other employees may request a similar religious accommodation.[53] Drawing from the *Hardison* precedent on undue hardship, the Guidelines indicate that the EEOC will determine what constitutes "more than a de minimis cost" based on a review of the "identifiable costs in relation to the size and operating costs of the employer and the number of individuals who will in fact need a particular accommodation."[54]

Under a claim of a failure to reasonably accommodate, the employee must show a bona fide religious belief that conflicts with an workplace requirement; that the employee notified the employer of this belief; and that the employee suffered an adverse employment action for failing to comply with the conflicting employment requirement.[55] The burden then shifts to the employer to show that it has made good faith efforts to reasonably accommodate the employee's religious beliefs and practices or that it cannot accommodate the request without undue hardship.[56]

[49] 29 C.F.R. §§1605.2-1605.3 (1980). Much of §1605.2 focuses on conflicts in work schedules, with suggestions as to voluntary substitutions, flexible scheduling, and transfers or changes in job assignments to accommodate religious practices and observances. *Id.* at §1605.2 (d)(1). In addition, the Guidelines allow for accommodation of religions that do not allow dues paying to unions through comparable donations to charitable organizations. *Id.* at §1605.2 (d)(2). The Guidelines also provide information on reasonable accommodations for religions in selection practices, including flexibility in employment test dates and limiting employer's ability to allow the applicant's need for religious accommodation to negatively impact job opportunities. *Id.* at §1605.3.

[50] *Id.* at §1605.2(e).

[51] *Id.* at §1605.2(c) (2)(ii).

[52] *Id.* at §1605.2(c)(1).

[53] *Id.*

[54] *Id.* at §1605.2(e).

[55] Mroz, *supra* note 28, at 150-51. *See e.g.*, Ansonia Bd. of Education v. Philbrook, 479 U.S. 60, 65-66 (1986); *Cloutier*, 390 F. 3d at 130; *Union Independiente*, 279 F. 3d at 55; Seaworth v. Pearson, 203 F.3d 1056, 1057 (8th Cir.) (per curiam), *cert. denied*, 531 U.S. 895 (2000).
Tiano, 139 F. 3d at 682; EEOC v. United Parcel Serv., 94 F.3d 314, 317 (7th Cir. 1996). Plaintiffs may also bring a claim for religious harassment under Title VII's provisions. *See* U.S. EQUAL EMPLOYMENT OPPORTUNITY COMM'N, RELIGIOUS DISCRIMINATION (2005), *at* http://www.eeoc.gov (last visited Feb. 7, 2006).

[56] Mroz, *supra* note 28, at 148-49. *See e.g.*, *Hardison*, 432 U.S. at 77; *Philbrook*, 479 U.S. at 68-69; *Cloutier*, 390 F. 3d at 133; *Union Independiente*, 279 F. 3d at 55; *Seaworth,* 203 F.3d at 1057; *Tiano*, 139 F. 3d at 682.

After the enactment of the Guidelines, the Supreme Court in *Ansonia Bd. of Education v. Philbrook*,[57] once more eased demands on employers through its narrow interpretation of the employer's duty of reasonable accommodation[58] in a case involving a request to use personal business leave for religious observances which was not allowed under school policy.[59] In *Philbrook*, the Court determined that employers could select any reasonable accommodation to meet their Title VII obligations without having to choose the employee's requested accommodation, even if the employee's proposal did not create an undue hardship.[60] The majority found that the employer-chosen reasonable accommodation of unpaid leave had adequately resolved the conflict between the employee's religious beliefs and the challenged workplace policy.[61] Once the employer proffered a reasonable accommodation, the Court stated that the employer had no further obligations to show that each of the employee's requested alternatives would result in undue hardship.[62]

Although the 1980 EEOC Guidelines broadened its definition of religion, the *Hardison* and *Philbrook* precedents narrowed employer obligations. Subsequently, most religious discrimination disputes now focus on the issues of reasonable accommodation and undue hardship, with the courts often glossing over determinations of what are religious practices and observances[63] or whether one sincerely holds certain

[57] 479 U.S. 60 (1986). *See* Engle, *supra* note 28, at 391-92; Mroz, *supra* note 28, at 149-50.

[58] Engle, *supra* note 28, at 391-92; Mroz, *supra* note 28, at 149-50.

[59] *Philbrook*, 479 U.S. at 64-65.

[60] *Id*. at 68-69. The Court indicated that the employer's offer of unpaid leave for religious observances was a reasonable accommodation, even though this accommodation had been tried and then rejected by the plaintiff as unsatisfactory. *Id*. at 64-65, 70.

[61] *Id*. at 70. The Court brushed off the loss of income to the employee, concluding that the loss of pay for a day not worked had 'no direct effect upon either the employment opportunities or job status' of the plaintiff. *Id*. at 70-71 (quoting Nashville Gas Co. v. Satty, 434 U.S. 136, 145 (1977)).

[62] *Id*. at 68. Once again dissenting as he had in *Hardison*, Justice Marshall believed that the Court's determination had not fully resolved the conflict between the employee's religious beliefs and the workplace requirement. He stated that, "[i]n my view, then, an offer of unpaid leave does not end the inquiry: If an employee, in turn, offers another reasonable proposal that results in a more effective resolution without causing undue hardship, the employer should be required to implement it." *Id.* at 74 (Marshall, J., dissenting).

[63] *See supra* note 40 and accompanying text. *But see* Swartzentruber v. Gunite Corp., 99 F. Supp 2d 976 (N. D. Ind. 2000) (court granted summary judgment against employee as claim of religious discrimination and harassment not applicable to political and fraternal organization of Ku Klux Klan); Slater v. King Soopers, Inc., 809 F. Supp. 809 (D. Colo. 1992) (court held that employee membership in Ku Klux Klan did not constitute religious discrimination, but involved only political and fraternal organization). *Compare* Peterson v. Wilmur Communications, Inc., 205 F. Supp. 2d 1014 (E. D. Wis. 2002)(court determined that World Church of the Creator with belief system grounded in white

religious beliefs.[64] In *Cloutier*, the court revisits the pre-1980 Guidelines as the employer contests the validity of the employee's religion and the sincerity of the employee's religious beliefs. While the district court uses reasonable accommodation to render its decision,[65] the appeals court applies undue hardship to reach its outcome,[66] showing the difficulty in addressing the intertwined, but distinct, issues of reasonable accommodation and undue hardship in religious discrimination cases.[67]

II. OVERVIEW OF *CLOUTIER*

A. Facts of Cloutier

In July 1997, Kimberly Cloutier began employment at Costco as a front-end assistant helping to pack customer purchases, finding item numbers, and putting merchandise back on warehouse shelves. At that time, she wore eleven visible ear piercings and four tattoos hidden under her clothing. She had no facial piercings and did not inform her employer of her religious practices during the interview or at the start of her employment. In September 1997, she transferred to the deli department, and in 1998 Costco revised its dress code to forbid food handlers from wearing any jewelry. Her manager advised her to remove her piercings, but she refused to comply and sought a transfer out of the deli department. She again did not notify her employer of her beliefs or request any accommodation of her jewelry at that time. [68]

supremacy constituted religion for purposes of Title VII).

[64] Engle, *supra* note 28, at 359, 362, 372. Prof. Engle concluded that,

> [d]ue to the broad interpretation the EEOC has given religion since 1980 (allowing almost any sincerely held belief to qualify), (footnote omitted) employers are expected at least to attempt to accommodate potentially numerous beliefs. Consequently, most contemporary litigation in this area centers around the question of whether it would cause an employer undue hardship to accommodate an employee's claimed religiously required conduct. Rarely do defendants or courts question the sincerity of employees' adherence to a particular religion or their claims that the religion requires particular conduct.

Id. at 359. *But see* EEOC v. Union Independiente, 279 F. 3d 49 (1st Cir. 2002) (appeals court remanded case to trial court for "delicate business" of fact-finding as to Seventh Day Adventist's refusal to pay union dues in light of conduct that called into question sincerity of his religious beliefs); Hussein v. The Waldorf-Astoria, 134 F. Supp. 2d 591 (S.D. N.Y.)(court questioned frequent litigant's claims of religious discrimination based upon review of his past behavior that ran contrary to his claimed religious beliefs as to wearing beard under grooming policy); Hussein v. The Pierre Hotel, 2001 U.S. Dist. LEXIS (S.D. N.Y. 2001)(court similarly questions sincerity of frequent litigant's calls for religious accommodation for wearing of beard in light of past behavior inconsistent with claimed religious beliefs).

[65] *See infra* notes 96-102 and accompanying text.

[66] *See infra* notes 103-16 and accompanying text.

[67] *See supra* notes 32-34, 41-44, & 51-62 and accompanying text.

[68] 311 F. Supp. at 192.

In June 1998, Ms. Cloutier returned to her position as front-end assistant and had her eyebrow pierced which she has not subsequently removed. Over a two-year period, the plaintiff engaged in more piercings, tattoos, cutting and scarification which held spiritual meaning for her, but were not part of any sectarian religious practices. In January 2001, Cloutier learned of the Church of Body Modification (CBM) which encourages both body modification and manipulation to strengthen "the bond between mind, body, and soul, thus ensuring that adherents live as spiritually complete and healthy individuals." Cloutier claimed that she became a member of CBM in March 2001.[69] At that time, the CBM states that one of its tenets calls for member to "seek to be confident models in learning, teaching and displaying body modification" which Cloutier interpreted as consistently mandating the display of one's piercings.[70]

As with many challenges to company grooming policies, the dispute in Cloutier arose out of a revision to Costco's existing grooming policy at the end of March 2001 and its subsequent enforcement of that policy starting in June 2001. Under the new policy, Costco prohibited any "visible facial or tongue jewelry," but permitted the wearing of earrings. The company indicated that it had instituted the neutral dress code in order to present a professional image to its customer base.[71]

On June 25, 2001, both Ms. Cloutier and a co-worker, Jennifer Theriaque, came to work wearing eyebrow piercings and the store managers called them to their office and advised them that under the

[69] *Id.* at 192-93. Costco disputed the timing of Cloutier's membership in the CBM, pointing to her application dated June 27, 2001, after it attempted to enforce its body art work rules against Cloutier. However, Cloutier testified that she had initially applied online for CBM membership in March 2001, but was prevented by a computer problem which was initially unbeknownst to her. She indicated that she contacted the CBM by telephone several times about the progress of her application, which she resubmitted in June 2001. *Id.* at 193. *See* http://www.uscobm.com/ (website of CBM) (last visited March 18, 2006). On the CBM website it currently indicates that,

> The Church of Body Modification is a nondenominational congregation that teaches ownership over our own bodies. The Church's purpose is for our modified society to harmoniously return to its spiritual roots that have been forgotten….
>
> The Church of Body Modification is an interfaith church whose members practice an assortment of ancient body modification rites which we believe are essential to our spirituality. We believe that especially in these uncertain modern times, it is doubly important that we never forget these activities, and that to do so would smother a part of us that we consider to be so important: our freedom of expression. Our desire to express our spirituality on our bodies. It is our belief that by practicing body modification and by engaging in rituals of body manipulation we strengthen the bond between mind, body, and soul and ensure that we live as spiritually complete and healthy individuals.

Id. See supra note 12 and accompanying text.

[70] 311 F. Supp. at 193.

[71] *Id.* at 193.

new policy they must remove their eyebrow rings to continue employment with Costco. Theriaque informed the managers that Cloutier and she were members of CBM and that the wearing of facial jewelry was a religious practice. Their managers allowed them to return to work that day. The next day the women returned with their eyebrow piercings and provided information to one of the store managers about the CBM. Upon consultation with another manager, the supervisor told Cloutier and Theriaque to remove their eyebrow piercings or go home. Cloutier offered to place a band-aid over her piercing, but Costco rejected this option.[72] Cloutier and Theriaque left work, and Cloutier filed an EEOC complaint the next day.[73]

At their respective work shifts on June 29, 2001, Cloutier and Theriaque went to Costco wearing eyebrow rings and were again told to remove them or leave work. Cloutier spoke with the store manager about her EEOC complaint and provided CBM materials about her religion. Cloutier offered to wear a band-aid over the eyebrow piercing, but her manager again refused this request. Later that same day, Theriaque's supervisors also confronted her and she asked about wearing a clear plastic retainer as a less visible method of preventing her piercing from closing up. Eventually, Costco allowed Theriaque to wear a plastic retainer.[74]

In the meantime, Cloutier missed several scheduled shifts, asserting that her manager told her to stay home until he called her to inform her about Costco's response to her EEOC complaint. She did not believe these absences would be counted against her since she did not report to work at her manager's behest. On July 14, 2001, Cloutier received a termination notice from Costco indicating that CBM was not a religion under anti-discrimination law, and that even if it were, the religion did not require the wearing of facial jewelry at all times. In addition, Costco indicated that since her absences were due to her violation of the company dress code they were unexcused absences for which she was being fired.[75]

During an EEOC conciliation session in August 2001, Costco offered to allow Cloutier to return to her job if she put a band-aid over her facial jewelry or wore a plastic retainer. This offer was followed up in an August 29, 2001 letter to Cloutier in which Costco sought Cloutier's

[72] *Id.* at 194.

[73] *Id.* at 193-94.

[74] *Id.* at 194. Another factual dispute arose over the issue of allowing Theriaque to wear the plastic retainer. Costco indicated that it accepted her proposal immediately. Cloutier argued that Theriaque hid her continued piercing for several weeks with a retainer or fishing wire until Costco gave in three or four weeks later. *Id.*

[75] *Id.*

response by September 6, 2001.[76] Disputes arose over whether or not Cloutier responded to Costco's offer to accommodate her piercing,[77] but ultimately she brought federal and state claims for religious discrimination.[78] Cloutier claimed that wearing the band-aid or plastic retainer would violate her religious beliefs which require her to wear her piercings at all times. She further argued that exempting her from this provision of the company dress code would be the only way to resolve the conflict between her beliefs and the workplace policy. Once the lawsuit was filed, Costco reverted back to arguing that the CBM was not a bona fide religion and that its tenets did not mandate that facial jewelry be worn at all times. In addition, Costco asserted that providing Cloutier an exemption from its neutral dress code would pose an undue hardship by undermining Costco's ability to put forward a professional appearance to its customer base.[79]

B. Summary of District Court Decision (Cloutier I)

i. Wrestling with Meaning of Religion and Sincerity of Belief

One of the main reasons for the passage of the 1972 amendment to Title VII and the broad definition of religion under the 1980 Guidelines was to protect unfamiliar and often misunderstood minority religions and their attendant practices from workplace discrimination.[80] Despite the broad definition of religion, Costco argued, in part, that the CBM was not a bona fide religion in its motion for summary judgment.[81] The *Cloutier I* court appeared to side with Costco on this point, at times displaying a dismissive attitude towards Cloutier's minority beliefs.[82] The district court's initial skepticism is shown early in the decision when the court claimed its opinion was not passing judgment

> on the substance or validity of the belief system of the Church of Body Modification. While its tenets may be viewed by some as *unconventional, or even bizarre*, the respect afforded by our laws to individual conscience, particularly in regard to religious beliefs, puts

[76] *Id.* at 195.

[77] *Id.* Costco claimed that Cloutier never responded, while she contended that she called her manager, who never returned her call *Id.*

[78] *Id.* Cloutier brought her federal action for religious discrimination under Title VII. *Id.* at 195-200. She also brought her state claim under Massachusetts anti-discrimination law (M.G.L. c. 151B, 4(1A) (1997)). *Id.* at 200-02.

[79] *Id.* at 195.

[80] *See supra* notes 36 & 43-50 and accompanying text.

[81] 311 F. Supp. at 198-99. The court indicated that Costco "hotly" and "vigorously" disputes that the CBM is a legitimate religion or that its associated practices are religious. *Id.*

[82] *See infra* notes 83-88 and accompanying text.

> any deconstruction of the Church's doctrine beyond the purview of the court.[83]

Despite this disclaimer, the *Cloutier I* court spent several pages of dicta dissecting aspects of this minority religion's beliefs through excerpts from the CBM's website[84] and its discussion of Cloutier's views of spirituality as not "part of any sectarian practice or belief."[85] Disturbingly, the *Cloutier I* often employed derogatory terms or placed cynical quotes around the word "religious" when referring to Cloutier's beliefs.[86] For example, the lower court discussed Costco's difficulty in challenging the plaintiff's claim, "no matter how *unconventional* the asserted religious belief may be."[87] The district court added that Title VII's protections are even extended to beliefs viewed as unacceptable, illogical, inconsistent or incomprehensible,[88] suggesting that Cloutier's beliefs under the CBM came within these negative descriptions.

Furthermore, after acknowledging that the First Circuit has indicated that there is "little room" for challenging the religious nature of an employee's belief,[89] especially at the summary judgment stage, the district court noted that it doubted the veracity of Cloutier's religious beliefs.[90] The *Cloutier I* court also indicated that such decisions should be left up to fact-finding in a trial,[91] but then offered its view that her views fall squarely within the context of mere "personal preference"[92]

[83] 311 F. Supp. at 191.
[84] *Id.* at 192-93.
[85] *Id.* at 192.
[86] *See infra* notes 87-88 & 93 and accompanying text.
[87] *Id.* at 196.
[88] *Id.*
[89] *Id.*
[90] *Id.* at 191 & n. 3, 199 & n. 10. *See infra* note 144 and accompanying text.
[91] *Id.* at 197. The court stated that

> While the "religious" basis of a challenged belief or practice is tricky to challenge as a matter of law, the sincerity of a practitioner's purported belief (once the belief is accepted as "religious") is virtually unassailable in the Rule 56 context. The First Circuit has stated explicitly that the sincerity of an employee's religious belief "ordinarily should be reserved 'for the factfinder at trial, not for the court at summary judgment.'" Union Independiente, 279 F.3d at 56; Vetter v. Farmland Indus., Inc., 120 F.3d 749, 751 (8th Cir. 1997) (stating that "a finding on the [element of sincerity] generally will depend on the factfinder's assessment of the employee's credibility")....

Id.

[92] *Id.* at 199. The lower court found that the CBM did not require the full-time display of facial piercings, but merely illustrated Cloutier's personal stridency in her beliefs. *Id.* In *Cloutier I*, Judge Ponsor opined that

> If Cloutier's belief that she must constantly display her body modifications is her religious belief, then it would appear she is entitled to accommodation pursuant to Title VII. Here again, however, the evidence of record fails to support Cloutier's position. As noted above,

and "self-styled 'religious' belief."[93] After displaying skepticism toward her religious beliefs, the district court only grudgingly determined that Cloutier had met her burden of proof for her prima facie case,[94] especially since reasonable accommodation provided easier grounds for granting the defendant's motion.[95]

ii. Finding Reasonable Accommodation

In assessing reasonable accommodation, Judge Ponsor then turned to the issue of Costco's grooming policy. He stated that Costco had a legitimate interest in presenting a professional image to its customers, with dress and grooming policies viewed as bona fide occupational qualifications.[96] Falling back to analysis that pre-dated the 1972 amendment to Title VII on reasonable accommodation,[97] the court asserted that it should enforce dress and grooming codes provided that they were not expressly directed at intentionally discriminating against religion.[98]

The district court then examined Cloutier's request for an exemption from Costco's grooming policy. The opinion looked at various court approaches to reasonable accommodation, noting that some expect that the accommodation must resolve the conflict with the employee's religious beliefs while others balance the costs and needs of the employer with the employee's interests. The decision also stated that Title VII requires both the employer and the employee to make good faith efforts at reasonableness. The court further noted that the employer's proffered alternative need not be the best one for the employee nor is the employer required to show that other options would impose an undue

when she first brought her religious practice to the attention of Costco, she herself offered the accommodation of her wearing a band-aid over her facial piercing. The outset of this lawsuit witnessed the first occasion when Cloutier took the position that any concealment of her piercings would violate her religious scruples. (footnotes omitted) [In addition, she permitted her tattoos to be covered.] All these facts suggest strongly that, while Cloutier may have a strong personal preference to display her facial piercings at all times -- her preference does not constitute a sincerely held religious belief.…It is not necessary for the court to wrestle with this troubling question, however, since Costco's offer of accommodation was manifestly reasonable as a matter of law.

[93] *Id.* at 198.

[94] *Id.* at 198-99.

[95] *See infra* notes 100-02 and accompanying text.

[96] *Id. See e.*g., Hussein v. The Waldorf-Astoria, 134 F. Supp. 2d 591 (S.D.N.Y. 2001) (upheld clean-shavenness as BFOQ for some businesses provided that requirement is not directed at religion), *aff'd*, 31 Fed. Appx. 740 (2d Cir. 2002) (unpublished); EEOC v. Sambo's of Georgia, Inc., 530 F. Supp. 86 (N.D. Geo. 1981) (holding that exempting Sikh job applicant from restaurant's no-facial-hair policy would constitute undue hardship).

[97] *See supra* notes 31-32 and accompanying text.

[98] 311 F. Supp. at 200.

hardship. The court stated that the accommodation only needed to reasonably balance the employee's religious observances and the employer's stated business needs.[99]

The *Cloutier I* court indicated that Cloutier had offered to cover up her eyebrow jewelry before litigation commenced, only mandating that it could not be covered under her religious beliefs after filing suit. The court concluded that either covering her piercing or using a clear plastic retainer were reasonable accommodations.[100] The *Cloutier I* court decided that these suggested alternatives fairly balanced the plaintiff's religious beliefs with the company's needs, concluding that no jury could reasonably find that Costco had not offered a reasonable accommodation.[101] Since there had been a showing of reasonable accommodation, the court determined that there was no need to consider the issue of undue hardship, granting Costco's motion for summary judgment.[102]

C. Summary of Appeals Court Decision (Cloutier II)

i. Examining Undue Hardship and Company Image

Unlike the district court, the appellate decision steered clear of pejorative comments about CBM or openly questioning the religion's tenets or Cloutier's sincerity in holding her beliefs, noting that courts are ill-suited to the dissection of religious beliefs.[103] The *Cloutier II* court also brushed aside the district court's reasonable accommodation analysis.[104] Instead the appellate panel indicated that since Cloutier's request evolved throughout the process,[105] their analysis of undue hardship must examine her final position in which she sought an exemption from the dress code as the only reasonable accommodation that would not violate her religious views.[106]

[99] *Id.* at 199-200.

[100] *Id.* at 199.

[101] 311 F. Supp. at 200.

[102] *Id.* In reviewing the Massachusetts anti-discrimination law claims, the court found that Title VII and the state law virtually mirrored each other on reasonable accommodation, yielding the same outcome. *Id.* at 200-01.

[103] 390 F. 3d at 132. The appellate panel indicated that

> Determining whether a belief is religious is "more often than not a difficult and delicate task," one to which the courts are ill-suited. Thomas v. Review Bd. of Indiana Employment Sec. Div., 450 U.S. 707, 714, 67 L. Ed. 2d 624, 101 S. Ct. 1425 (1981). Fortunately, as the district court noted, there is no need for us to delve into this thorny question in the present case.

Id.

[104] *Id.* at 132-33.

[105] *Id.* at 133 & n. 6.

[106] *Id.* at 134.

Looking to *Hardison*, the court indicated that de minimis cost might involve actual economic expenses such as lost business or adding new employees to allow for Sabbath observances as well as noneconomic costs such as protecting the integrity of a seniority system.[107] Further, the appeals court stated that courts are generally "skeptical of hypothetical hardships" on employers, but added that employers may offer evidence of undue hardship for accommodations not yet put into place.[108]

Cloutier claimed that no customers or co-workers had previously complained about her facial piercings and that her piercings did not impact her successful job performance. The plaintiff further argued that any perceived hardship for Costco was purely hypothetical.[109] The opinion also noted that the EEOC had found that Cloutier's actions were religiously based and that Costco had failed to show that allowing her facial jewelry presented undue hardship.[110]

However, the *Cloutier II* court contended that personal appearance standards play a key role in Costco's public image, especially for employees with a great deal of customer contact, such as Cloutier.[111] The appellate decision indicated that other courts have upheld company desires "to promote a professional public image" or "to appeal to customer preference" under Title VII.[112] Since Cloutier would not accept any accommodation short of exemption, the appeals court considered the employee's requested exemption almost exclusively from Costco's business perspective and its loss of control over its public image.[113] The appeals court stated that

[107] *Id.* at 134-35.
[108] *Id.* at 135.
[109] *Id. See infra* notes 144 & 148 and accompanying text.
[110] *Id.* at 131.
[111] *Id.* at 135.
[112] *Id.* at 135-36. *But see* Flowers v. Columbia College Chicago, 397 F. 3d 532 (7th Cir. 2005) (court contends that allowing Rastafarian to wear khofi religious head wrap over dreadlocks did not create undue hardship for college); Booth v. State of Md., 327 F. 3d 377 (4th Cir. 2003) (court found religion discrimination where employer refused reasonable accommodation for correctional officer's Rastafarian dreadlocks despite other religious exemptions for Jewish and Sikh employees); EEOC v. Red Robin Gourmet Burgers, Inc., 2005 U.S. Dist. LEXIS 36219 (W. D. Wash. 2005) (court found that employer had failed to provide sufficient evidence of undue hardship in accommodating employee's religious tattoos); Humphrey v. Lane, 728 N.E. 2d 1039 (Ohio 2000) (in religious discrimination case, court found that public employer had failed to use least restrictive means when it failed to permit Native American correctional officer to pin up hair rather than cut it); DeVeaux v. City of Philadelphia, 2005 Phila. Ct. Comm. Pl. LEXIS 331 (2005) (court granted preliminary injunction finding that city had failed to show no-beard policy for firefighters enforced against Muslim increased job safety).
[113] *Id.* at 135-37.

> Costco has a legitimate interest in presenting a workforce to its customers that is, at least in Costco's eyes, reasonably professional in appearance. Costco's dress code, included in the handbook distributed to all employees, furthers this interest. The preface to the code explains that, "Appearance and perception play a key role in member service. Our goal is to be dressed in professional attire that is appropriate to our business at all times. . . . All Costco employees must practice good grooming and personal hygiene to convey a neat, clean and professional image."
> It is axiomatic that, for better or for worse, employees reflect on their employers. This is particularly true of employees who regularly interact with customers, as Cloutier did in her cashier position. Even if Cloutier did not personally receive any complaints about her appearance, her facial jewelry influenced Costco's public image and, *in Costco's calculation*, detracted from its professionalism. (emphasis added)[114]

Seemingly turning over the judicial fact-finding role to the employer's own conclusory statements, the court found that granting the exemption would create an undue hardship because it would negatively impact Costco's public image by detracting from the company's professionalism.[115] The *Cloutier* appeals court stated that a business within its discretion may legally adopt a grooming policy that appeals to customer preference, thereby justifying its finding of undue hardship.[116]

III. TROUBLING LEGAL ISSUES UNDERLYING *CLOUTIER* DECISIONS

Many employers applauded the *Cloutier* outcome as a victory for managerial prerogatives and control in the development and enforcement of body art work rules.[117] This initial win for employers may become a Pyrrhic victory as increasing numbers of religious discrimination cases fuel calls for greater protection of religion in the workplace under the proposed WRFA.[118] Both *Cloutier I* and *II* raise troubling issues that reflect the continuing enforcement problems under Title VII in religious anti-discrimination cases, playing right into the hands of WRFA supporters. This segment will consider three main concerns raised by then *Cloutier I* and *II* decisions: 1) improper

[114] *Id.* at 135. (emphasis added)

[115] *Id.* at 136. The appeals court indicated that

> Granting such an exemption would be an undue hardship because it would adversely affect the employer's public image. Costco has made a determination that facial piercings, aside from earrings, detract from the "neat, clean and professional image" that it aims to cultivate. Such a business determination is within its discretion.

Id.

[116] *Id.*

[117] *See supra* note 24 and accompanying text.

[118] *See supra* notes 6-7 and accompanying text. *See infra* notes 135-36 & 150-51.

questioning of religious tenets; 2) placing customer preference above reasonable accommodations that support religious diversity; and, 3) the acceptance of unsupported assertions of more than de minimis cost to justify undue hardship.

A. Overstepping Bounds of Religious Inquiry

In this case, it is disturbing that Costco challenges the validity of the CBM as a religion and Cloutier's practices as religious. This approach seems to be a throwback to pre-1980 cases in which employers often challenged the legitimacy of minority religions before the enactment of the EEOC guidelines.[119] The revised 1980 Guidelines were adopted after hearings indicated that employers often discriminated against the less familiar practices of minority faiths.[120] Even a cursory reading of the definition of religion under the Guidelines would illustrate that the CBM's beliefs and Cloutier's view of her practices as spiritual would fall within this broad definition of religion. Costco's intolerance and questioning of the religion provides support for those who want to strengthen religious protections in the workplace, especially for minority religions, under the WRFA.[121]

Also in *Cloutier I*, the district court overstepped the appropriate bounds for judicial inquiry into religion and religious practices, especially at the summary judgment stage. The Supreme Court and many other courts have indicated that courts are ill-suited to dissect religious beliefs and the believer's sincerity in religious discrimination cases. In part, courts do not wish to become the arbiters of religious doctrine, but more importantly courts do not wish to tread upon the cherished rights of free exercise of religion and freedom of expression.[122] The *Cloutier I* court claims to accept the notion of limited judicial review and the importance of leaving such questions up to fact-finders at trial, but then does just the opposite in extensive dicta. The language and tone of the *Cloutier I* opinion is often very critical and dismissive of tenets of the CBM and Cloutier's belief in spirituality through cuttings and piercings.[123] Similar to Costco's approach, the district court's apparent lack of religious tolerance adds credence to demands for greater religious protection under the proposed WRFA.

[119] *See supra* notes 36-39 and accompanying text.

[120] *See supra* note 44 and accompanying text.

[121] *See supra* notes 6-7 and accompanying text. *See infra* notes 135-36 & 150-51 and accompanying text.

[122] *See supra* note 40 and accompanying text.

[123] *See supra* notes 82-88 & 103 and accompanying text. Fortunately, the *Cloutier II* court did not follow this same improper discussion of the validity and sincerity of religious beliefs.

B. Placing Customer Preference Above Religious Diversity and Reasonable Accommodation

The EEOC makes it clear that customer preference is not a justification for discriminatory behavior, including religious discrimination. In the wake of 9/11, the EEOC developed materials for employers that consistently reinforce the principle that employee qualifications and job performance are appropriate workplace considerations, not customer preferences or biases.[124] Many courts have also echoed this well-recognized concern that customer preference is often a thinly-veiled excuse for discrimination against women and minority groups.[125]

Similarly, employers often tout their respect for diversity in the workplace, spending time and money training employees about diversity as they seek to capture an increasingly diverse marketplace. Yet some companies seem to drop this support for diversity when they contend that customer preference requires them to demand uniformity in their grooming codes. It may be one thing to expect employees to be neat and clean or to don a company uniform to aid customer identification of staff, but quite another to expect them to conform to majority preferences or biases as to religious practices that do not impair job performance.
There has been a continuing disconnect about employer grooming and dress codes grounded in claims of customer preference and requests for reasonable accommodations for religious practices. Regardless of the accommodationist language in Title VII and the Guidelines, courts seldom require employers to show flexibility in their workplace rules,

[124] *See* U.S. EQUAL EMPLOYMENT OPPORTUNITY COMM'N, QUESTIONS AND ANSWERS ABOUT THE WORKPLACE RIGHTS OF MUSLIMS, ARABS, SOUTH ASIANS, AND SIKHS UNDER THE EQUAL EMPLOYMENT OPPORTUNITY LAWS (2002), *at* http://www.eeoc.gov/facts/backlash-employee.html (last visited Feb. 7, 2006) (indicates explicitly that employer relying on customer preference or uncomfortable feelings of customers or co-workers regarding religious dress are engaging in discriminatory practices under Title VII); U.S. EQUAL EMPLOYMENT OPPORTUNITY COMM'N, QUESTIONS AND ANSWERS ABOUT EMPLOYER RESPONSIBILITIES CONCERNING THE EMPLOYMENT OF MUSLIMS, ARABS, SOUTH ASIANS, AND SIKHS (2005), *at* http://www.eeoc.gov/ facts/backlash-employee.html (last visited Feb. 9, 2006) (indicates that customer preference regarding religious attire not acceptable workplace justification and employer may need to grant exemptions in dress and grooming codes).

[125] *See e.g.*, Diaz v. Pan Am. World Airways, Inc., 442 F. 2d 385 (5th Cir. 1971) (customer preference cannot justify female over male flight attendants); Hylind v. Xerox Corp., 380 F. Supp. 2d 705 (D. Md. 2005) (assignment of female salesperson to customer who preferred females and openly discussed hobby of photographing partially nude women as gender discrimination); Ames v. Cartier, Inc., 193 F. Supp. 2d 762 (S.D. N.Y. 2002) (employer claims of customer preference for "pretty blonds" over male Filipino salesperson as adequate basis for gender and national origin discrimination case); EEOC v. Joe's Stone Crab, Inc., 15 F. Supp. 2d 1364 (S.D. Fla. 1998) (restaurant may not hire only male waiters based on traditional perceptions of customer preference).

especially regarding dress and grooming codes.[126] Courts often reflexively accept at face value employer claims that dress codes are essential to their corporate image and customer acceptance, without ever probing if these alleged concerns represent anything more than illegal biases or discriminatory beliefs.[127] Both *Cloutier* courts clearly place Costco's claim of customer preference above offering an exemption to the company's dress code as an accommodation to Cloutier's religious beliefs.[128] Therefore, the courts have maximized employer control in the name of customer preference while minimizing the value of personal appearance for employees,[129] especially for adherents to minority faiths with nonconforming dress practices.[130]

The *Cloutier* courts also consider Costco's dress code in terms of its neutrality. The courts seem to take the view that since the dress code does not intentionally discriminate against certain religions, it passes Title VII muster. This approach may have been appropriate before the 1972 amendment on reasonable accommodation, but Title VII demands more from employers in cases of religious discrimination. The duty to make reasonable accommodations for religious beliefs and observances clearly contrasts with the concept of neutral treatment.[131] Employer claims about neutral codes do not alleviate employers from their duty to accommodate religion in a reasonable manner,[132] especially when job performance is not impacted by the employee's conduct, as in *Cloutier*.[133] In addition, the contention of neutrality often fails to consider that such codes may actually establish a preference for mainstream religions that

[126] Engle, *supra* note 28, at 406-07.

[127] *See generally*, Camille Gear Rich, *Performing Racial and Ethnic Identity: Discrimination by Proxy and the Future of Title VII*, 79 N.Y. U. L. REV. 1134, 1249-53 (2004) (discusses grooming codes as racial and national origin discrimination by proxy through reliance on majority customer preferences and stereotypical biases); Karl E. Klare, *Power/Dressing: Regulation of Employee Appearance*, 26 NEW ENG. L. REV. 1395 (1992)(author criticizes appearance regulation in workplace as continued form of suppression of women and minorities); Robert Post, *Prejudicial Appearances: The Logic of American Antidiscrimination Law,* 88 CALIF. L. REV. 1 (2000) (discusses Santa Cruz anti-lookism ordinance and criticizes courts upholding of employer grooming codes as reinforcing illegal stereotypes, especially as to gender).

[128] *See supra* notes 96-98 & 111-16 and accompanying text.

[129] Klare, *supra* note 127, at 1401. Prof. Klare states that "judges create a peculiar dissonance by trivializing appearance claims while at the same time asserting the need for authorities to possess vast powers to enforce conventional attitudes and prejudices." *Id*.

[130] *See supra* note 43 and accompanying text. *See infra* note 134 and accompanying text.

[131] *See* Engle, *supra* note 28, at 323, 357-62 (author discusses tensions between anti-discrimination laws emphasis on neutrality and Title VII language requiring reasonable accommodation or preferences for religious practices and observances).

[132] *See supra* notes 51-52 and accompanying text.

[133] *See supra* notes 109-10 and accompanying text.

seldom mandate visible religious dress, often required in minority belief structures.[134]

The frustration of religious groups as to issues of dress and grooming codes for religious garb are reflected in the proposed WRFA. That act would protect an employee who "with or without reasonable accommodation, is qualified to perform the essential functions" of the job.[135] So long as the employee can perform the core job requirements, religious practices related to dress, time off for religious observances, or those practices with only "a temporary or tangential impact on the ability to perform job functions" are protected from workplace discrimination.[136] Under the WRFA, Costco would be required to accommodate Cloutier since her piercings did not impact her core job requirements or her job performance. As more diverse religious groups appear in the workplace, religion discrimination cases and calls for the WRFA are bound to continue as the promise of religious accommodation continues to elude some employees.

C. Accepting Unsupported Claims of Undue Hardship

Using its under its de minimis standard, the *Hardison* Court found undue hardship based on additional premium wage costs, the administrative burdens of finding replacements, and the protection of the existing seniority system.[137] De minimis cost should equate with at least some nominal burden, such as legitimate safety concerns,[138]

[134] Klare, *supra* note 127, at 1404-12 (author discusses how appearance law favors mainstream white Christian over minority religions with distinct and visible dress or grooming practices); Mroz, *supra* note 28, at 172 (author discusses view that courts struggle with proper recognition of "less traditional belief systems"). *See* Goldman v. Weinberger, 475 U.S. 503, 521 (1986) (Supreme Court upheld Air Force grooming policy against request by Orthodox Jew to wear yarmulke indoors) (Marshall, J., dissenting). Once more dissenting, Justice Marshall stated that,

> I am also perplexed by the related notion that for purposes of constitutional analysis religious faiths may be divided into two categories -- those with visible dress and grooming requirements and those without….The practical effect of this categorization is that, under the guise of neutrality and evenhandedness, majority religions are favored over distinctive minority faiths. This dual category analysis is fundamentally flawed….

Id.

[135] WRFA, S. 677 at §2(a)(2)(A).

[136] *Id.* at §2(a)(2)(B).

[137] 432 U.S. at 84.

[138] *See, e.g.,* Bhatia v. Chevron U.S.A., Inc., 734 F.2d 1382 (9th Cir. 1984) (affirming summary judgment for employer who required Sikh employee to be clean-shaven to insure gas-tight face seal for respirator for protection against potential exposure to toxic gases). *But see* DeVeaux v. City of Philadelphia, 2005 Phila. Ct. Comm. Pl. LEXIS 331 (2005) (court granted preliminary injunction finding that city had failed to show no-beard policy for firefighters enforced against Muslim increased job safety).

additional costs,[139] workplace disruption,[140] or detrimental impact on third party rights due to a proposed reasonable accommodation.[141] The employer must prove undue hardship through evidence of real hardships, not hypothetical or abstract ones.[142]

Over time, the meaning of undue hardship has been diluted in court decisions, such as *Cloutier II,* with courts finding undue hardship without ever requiring the employer to show any actual hardship has occurred or will follow. In *Cloutier II*, the court merely restates the language in Costco's handbook to justify undue hardship, even though there is no showing of any customer complaints over the nearly three-year period Cloutier worked with her facial piercing at the warehouse store or the existence of any of the other standard reasons that justify undue hardship. Rather Costco's claim of undue hardship is accepted at face value, even though it is unclear if it would suffer any real burden.[143]

The EEOC had raised concerns about employer hypothetical hardships in the past[144] and a recent district court decision in *EEOC v. Red Robin Gourmet Burgers, Inc.*[145] echoed this sentiment. In that case,

[139] *See, e.g., Hardison*, 432 U.S. at 84 (replacing Sabbath observer with supervisor or other qualified staff or payment of premium wages for replacement worker as undue hardship due to lost job efficiency and extra wage costs and impact integrity of seniority system). *But see Townley Eng'g*, 859 F.2d at 615-16 (claim of spiritual costs on company and its Christian owners if atheist employee exempted from devotional services during work hours not adequate basis for undue hardship). *See generally* Ernest F. Lidge, *Financial Costs as a Defense to an Employment Discrimination Claim*, 58 ARK. L. REV. 1, 39-41 (2005) (discusses relevance of costs as to job-relatedness and business necessity in hypothetical workplace discrimination situations, including religious discrimination).

[140] *See, e.g., Wilson*, 58 F. 3d at 1339 (employer not required to accommodate employee's religious vow to wear graphic anti-abortion pin which had caused workplace disruption amongst co-workers).

[141] *See, e.g., Hardison*, 432 U.S. at 84 (employer need not contravene integrity of existing seniority system to accommodate employee's Sabbath observance); *Wilson*, 58 F. 3d at 1339 (employee's graphic button worn as vow to her religious beliefs as form of religious harassment of co-workers).

[142] *Cloutier II*, 390 F.3d at 134 (court indicated that undue hardship "applies both to economic costs, such as lost business or having to hire additional employees to accommodate a Sabbath observer, and to non-economic costs, such as compromising the integrity of a seniority system"); *Townley Eng'g*, 859 F.2d at 615-16 (claim of spiritual costs on company and its Christian owners if employee exempted from devotional services is not actual imposition on coworkers or disruption of work routine under undue hardship); Tooley v. Martin-Marietta Corp., 648 F.2d 1239, 1243 (9th Cir.), *cert. denied*, 454 U.S. 1098, 102 S. Ct. 671, 70 L. Ed. 2d 639 (1981) (court determines that claims of undue hardship must not be hypothetical or conceivable burdens but actually hardships imposed on co-workers or causing workplace disruption); *Red Robin,* 2005 U.S. Dist. LEXIS at **17-*19* (court contends that hypothetical hardships without showing of added burdens on co-workers or disruption of work routine does not support undue hardship);

[143] *See supra* notes 111-16 and accompanying text.

[144] *See supra* note 35 and accompanying text.

[145] 2005 U.S. Dist. LEXIS 36219 (W. D. Wash. 2005).

a restaurant chain wanted a six-month employee who practiced Kemetecism[146] to cover up small tattoos surrounding his wrists under a new grooming policy.[147] Unlike *Cloutier II*, the district court indicated that the employer had failed to show any actual hardship through customer complaints about the tattoos or provide adequate support for its assertion that the tattoos contravened the company's family-oriented image.[148] In addition, the court warned that mere fears about other requesting similar religious accommodations would not support a finding of undue hardship under the law.[149]

It is this frustration about the slide of undue hardship into any hypothetical employer burden that is also helping to drive the proposed WRFA. Drawing from the language of the Americans with Disabilities Act, the proposed legislation spells out the explicit factors for undue hardship.[150] The Act calls for a showing of "significant difficulty or expense" taking into consideration "identifiable costs" associated with the accommodation, the employer's financial resources and size, and the geographic or administrative burdens on employer's with multiple facilities.[151] Under this approach, Costco would have been unlikely to meet its burden, since it largely provided only its handbook with its stated dress code to support its claim of undue hardship.

CONCLUSION

The *Cloutier I* and *II* decisions echo some of the troubling issues of the past regarding the enforcement of Title VII provisions against religion discrimination in the workplace, especially as to minority faiths. The questioning of minority religious tenets, the overemphasis on unsupported claims of customer preference at the expense of religious

[146] Kemeticism dates back to ancient Egypt and focuses on communal prayer, meditation and ritual ceremonies showing "servitude to Ra, the Egyptian god of the sun." *Id.* at *2.

[147] The employee, Edward Rangel, received the tattoos (less than a quarter-inch wide) around his wrists as part of a religious ceremony. *Id.* at *2. The tattoos were Coptic prayers which Rangel believed he could not intentionally hide without committing a sin under Kemetecism. *Id.* at *3. The only time his religion would allow him to purposefully cover the tattoos was during the religious month of Mesura when Ra was believed to die and then reborn. *Id.*

[148] *Id.* at *18-19. Unlike Costco, Red Robin did provide a company profile and a customer study that indicated that the restaurant chain was viewed as both family- and child-friendly, and that Red Robin considered Rangel's tattoos as inconsistent with that image. *Id.* at *18. However, the court indicated that the company provided no evidence that his visible Coptic tattoos were incongruous with these goals or that Red Robin customers held a negative view of these religious tattoos. *Id.* at *18-19.

[149] *Id.* at *19.

[150] Caplen, *supra* note 7, at 601-02; DelPo, *supra* note 5, at 344; Sonne, *supra* note 7, at 1025-26.

[151] WRFA, S. 677 at §2(B)(3).

diversity, and the negligible or nonexistent demands on employers to provide undue hardship are all issues that have constantly plagued the development of religious discrimination law. While *Cloutier I* and *II* may seem like solid victories for employers and their dress and grooming codes, it is these types of decisions that are helping to bolster calls for the WRFA which would impose much more significant legal demands on employers. If religious groups continue to band together in their frustrations over how courts interpret religious practices and observances, reasonable accommodation, and undue hardship under Title VII, then pressures to pass the WRFA will further mount. Although Costco may have won this round in the battle over body art work rules as religious discrimination, employers may ultimately lose the war over grooming and dress codes that impact religious diversity in the workplace.

BUSINESS METHOD PATENTS CHALLENGE THE PURPOSE AND INTENT OF THE PATENT SYSTEM

by MARGO E.K. REDER*

"The Congress shall have power…To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries…."
United States Constitution, art. 1, section 1.

INTRODUCTION

In ways that could not have been predicted even a few years ago, the patent system is in crisis. A series of unplanned mutations have transformed patents into a positive threat to the digital economy. The patent office has grown entangled in philosophical confusion of its own making; it has become a ferocious generator of litigation; and many technologists believe that it has begun to choke the very innovation it was meant to nourish.[1]

This paper examines the sources and purpose of patent law, the history of software patents, and how such patents challenge the purpose and intent of the patent system. This is due to a number of phenomena, including for example, the grant of patent rights for ideas that were clearly obvious (consider whether online payments for goods could have been anticipated, thus non-patentable due to obviousness), to the present business environment demand of interoperability (making it

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[1] *See* James Gleik, *Patently Absurd,* available at http://www.around.com/patent.html (last visited Mar. 15, 2006).

necessary to cross-license with competitors). The explosion of communications technologies and the concomitant patenting of these, have created a perverse scenario whereby the patenting system has impeded innovation, in contravention of the purpose of the patenting system. This paper explores the challenges this presents, as well as recommends modifications to the present system.

I. HISTORY OF PATENT LAW

Created in 1790 by the First Congress, the U.S. patent system is intended to promote progress and innovation, by way of offering an incentive for inventors to create and innovate—and also act as a barrier to theft. The Framers considered patenting of crucial importance to the fledgling economy. Patents represent both a positive right in the form of a grant of an exclusive property right in an invention, including the rights to make use, license, or sell the invention during the patent term[2]—and a negative right, in the form of the power to exclude others from using the invention, or even its equivalent.[3]

The United States Patent and Trademark Office (PTO), an agency within the Department of Commerce, is charged with enforcing patent laws, and overseeing all patent matters, including the prosecution of patent applications, award of patent rights, and review of patent interference proceedings.[4] The PTO formulates patent policy and patent decisions.[5]

With regard to policy, the patent term length is designed to balance competing demands of inventor protection, with public access. Thus, the term of protection granted is meant to maximize the return on investment, and simultaneously, not be so overly long as to act as an oppressive, monopolistic barrier to creating new products/wealth, or a concentrator of economic power.[6] That then, is the trick: to strike a balance between the interests of those who innovate – the inventors, and

[2] 35 U.S.C. section 101 (2005), available at http://www.law.cornell.edu/uscode/html/uscode35/usc_sec_35_00000101----000-.html (last visited Mar. 6, 2006).

[3] 35 U.S.C. sections 271-297 (2005), available at http://www.law.cornell.edu/uscode/html/uscode35/usc_sup_01_35_10_III.html (last visited Mar. 6, 2006).

[4] Patent laws passed by Congress are found at 35 U.S.C. et seq., and patent enforcement matters are found on the PTO website, available at: http://www.uspto.gov/main/profiles/patty.htm (last visited Mar. 6, 2006).

[5] *Id*.

[6] *See* John F. Duffy, *Rethinking the Prospect Theory of Patents*, 71 U. CHI. L. REV. 439, 493-94 & n.156 (2004); William D. Nordhaus, Invention, Growth, and Welfare: A Theoretical Treatment of Technological Change 76 (MIT 1969) 76 (1969); William Slate, *The Sky Is Not Falling: The Effects of Term Adjustment under the American Inventors Protection Act on Patent Prosecution*, 4 YALE J. L. & TECH. 7 (2001).

the interests of those who would benefit from innovation—the public.[7] The balance is—or should be—an economic one.

The PTO, concurrently with the courts, regulates patent matters. The PTO considers whether to grant patent rights to inventors, construes the validity of patents, as well as challenges to patents and so forth.[8] The Court of Appeals for the Federal Circuit considers appeals to claims alleging infringement of patents, as well as challenges to validity and inventorship.[9] Litigation among parties may proceed concurrently at the Patent Office and in court. In fact, this was true for the recent case, *NTP, Inc. v. Research in Motion, Ltd.* (RIM).[10] For example, on February 1, 2006, the PTO issued a preliminary ruling rejecting all claims of an NTP patent—the same patent that NTP was relying upon in its patent infringement case against Research in Motion's BlackBerry wireless email function.[11] And on February 24, 2006, during the pendency of the PTO proceedings, federal district Judge James Spencer held a hearing to consider an injunction that would force RIM to stop infringing NTPs mobile-messaging patents.[12] Judge Spencer was thus 'set to act against a company for violating patents that patent officials are signaling shouldn't have been granted.'[13] (The case recently settled, and so we won't be able to draw any further conclusions on the interplay between the concurrent and parallel decisionmaking processes at the PTO and in the courts.[14])

[7] *See* Remarks by Chairman Alan Greenspan, *Intellectual Property Rights*, at 3, Feb. 27, 2004, available at http://www.federalreserve.gov/BoardDocs/speeches/2004/200402272/default.htm (last visited Mar. 6, 2006).

[8] *See* the website for the PTO, available at http://www.uspto.gov/ (last visited Mar. 6, 2006).

[9] The federal district courts still have original jurisdiction in patent litigation, but appeals are sent to this specialized court, whose site is available at http://www.fedcir.gov/ (last visited Mar. 6, 2006).

[10] NTP, Inc. v. Research in Motion, Ltd., 418 F.3d 1282 (Fed. Cir. 2005) (vacating infringement judgment against RIM, and remanding case to district court for reconsideration of jury verdict). The Supreme Court denied certiorari in this case. NTP, Inc. v. Research in Motion, Ltd., 2006 U.S. LEXIS 1053 (Jan. 23, 2006). The case finally settled on March 3, 2006). *See infra* note 13.

[11] *See* Ian Austen, *Ruling Aids Manufacturer of BlackBerry*, N.Y. TIMES, Feb. 2, 2006, at C4.

[12] *See* Carmen Nobel, *Judge Sets Date for BlackBerry Hearing*, eWeek.com, Jan. 25, 2006, available at http://www.eweek.com/article2/0,1895,1915511,00.asp (last visited June 28, 2006).

[13] *See* Anne Marie Squeo and Mark Heinzl, *Broader Conflict Continues as NTP Seeks to Pursue Shutdown Through Court*, WALL ST. J., Feb. 2, 2006, at A2.

[14] *See Research In Motion and NTP Sign Definitive Settlement Agreement to End Litigation*, available at http://www.rim.com/news/press/2006/pr-03_03_2006-01.shtml (last visited Mar. 6, 2006).

II. HISTORY OF BUSINESS METHOD PATENTS

Business method patents are not entirely a product of the information age. In fact, financial apparatus and method patents date back to 1799 when the Patent Office granted a patent for an invention of a process that detects counterfeit notes.[15] On January 8, 1889, the era of automated financial/management business data processing method patents was born. United States patents 395,781; 395,782; and 395,783 were granted to inventor-entrepreneur Herman Hollerith on that date. Mr. Hollerith's method and apparatus patents automated the tabulating and compiling of statistical information for businesses and enterprises. They were acclaimed nationally and viewed as revolutionizing business data processing. The protection of his patents allowed his fledgling Tabulating Machine Company to succeed and thrive. In 1924, Thomas J. Watson, Sr. changed the company name to International Business Machine Corporation.[16]

Judicial Decisions Construing Business Method Patents:

Courts, as does the PTO, construe the patentability of software and business methods. In an early case, *Rubber-Tip Pencil Co. v. Howard*, the Court cautioned that 'an idea of itself is not patentable.'[17] Later, the Court in *Mackay Co. v. Radio Corp*. noted that, 'while a scientific truth, or the mathematical expression of it, is not a patentable invention, a novel and useful structure created with the aid of knowledge or scientific truth may be.'[18] The first judicial decision to consider the patentability of computer program-related inventions is the *In re Prater* case, in which the court reversed the PTO's decision, and found the computer program to be statutory subject matter.[19] In 1972, the Supreme Court in *Gottschalk v. Benson* considered for the first time a process in the form of a mathematical algorithm (a formula which underlies so many of the current business method patent claims).[20] In *Gottschalk*, the claim was for a method of programming a general purpose digital computer to convert signals from binary-coded decimal form (*i.e.*, data expressed as digits using the 10 symbols, 0 through 9), into pure binary form (*i.e.*, data expressed as just 0s and/or 1s).[21] The procedure for executing this

[15] *See* USPTO White Paper, *Automated Financial or Management Data Processing Methods* (Business Methods) (2000), available at http://www.uspto.gov/web/menu/busmethp/ (last visited Mar. 6, 2006).

[16] *Id.*

[17] 87 U.S. (20 Wall) 498, 507 (1874).

[18] 306 U.S. 86, 94.

[19] 415 F.2d 1393 (C.C.P.A. 1969).

[20] 409 U.S. 63 (1972) (granting certiorari to the U.S. Court of Custom and Patent Appeals).

[21] *Id.* at 66-67.

data conversion is accomplished through creating an equation known as an algorithm. From this generic formulation, programs may be developed as to specific applications. The pattern of decisions continued, whereby the PTO initially rejected patent applications for these claims, and the United States Court of Customs and Patent Appeals reversed those cases.[22] The Supreme Court ultimately agreed with the PTO however, ruling that Respondent's program was not statutory subject matter because the 'mathematical formula involved here has no substantial practical application….and in practical effects would be a patent on the algorithm itself.'[23] Justice Douglas presciently wrote about the patentability of such processes, observing that:

> It may be that the patent laws should be extended to cover these programs, a policy matter to which we are not competent to speak. The President's Commission on the Patent System rejected the proposal that these programs be patentable….If these programs are to be patentable, considerable problems are raised which only committees of Congress can manage, for broad powers of investigation are needed, including hearing…the technological problems tendered in the many briefs before us indicate to us that considered action by the Congress is needed.[24]

During this time, as the courts signaled their willingness to consider business methods as statutory subject matter, the PTO continued to maintain its position that business methods cannot be statutory subject matter, and rejected applications for inventions utilizing computer-generated results. The PTO's position was that statutory subject matter extended only to processes, machines, articles of manufacture, and compositions of matter. Then in 1981, the Supreme Court granted certiorari in *Diamond v. Diehr* to consider whether a process for curing synthetic rubber was patentable, notwithstanding the use of a software program.[25] The patent examiner rejected the claims 'on the sole ground that they were drawn to non-statutory subject matter' because computations for curing rubber are 'carried out by a computer under control of a stored program, and thus constituted non-statutory subject matter under this Court's decision in *Gottschalk*.'[26] In a 5-4 decision, the Court rejected the PTO's view, and ordered the Office to grant a patent to the inventors despite the fact that it was for a software program.[27] The Court distinguished this decision from its earlier decision in

[22] *Id*. at 64.
[23] *Id*. at 71-72.
[24] *Id*. at 72-73.
[25] 450 U.S. 175 (1981).
[26] I*d*. at 179-80.
[27] *Id*. at 192-94.

Gottschalk, where the inventors were attempting to patent a mathematical formula with no practical application. The *Diamond* Court reasoned that the inventors' 'claims describe a practical application of a mathematical formula: the 'claim containing a mathematical formula implements or applies that formula in a structure or process which, when considered as a whole, is performing a function which the patent laws were designed to protect.'[28] The PTO, as well as inventors, now puzzled over determining when an invention was merely a mathematical algorithm, and when it was in fact a patentable invention that simply contained a mathematical algorithm.[29]

In 1998, business methods in the form of software programs were definitively recognized as statutory subject matter. In *State Street Bank and Trust Co. v. Signature Financial Group, Inc.*, the court concluded that the transformation of data by a machine through a series of mathematical calculations constitutes a practical application of a mathematical algorithm because it produces a useful, concrete and tangible result.[30] *State Street* made clear that software programs for business methods were statutory subject matter, and this led to an explosion in patent filings (as well as in litigation) for business methods.[31] The ascendancy of the internet as the pre-eminent communications medium for data, audio and video continues to fuel the demand for business method patents.

The Current Business Environment

We've witnessed a remarkable shift recently, from patents for tangible goods—to patents for intangible, conceptual goods—today, ideas are the raw material of economic progress. Ideas are at the core of value creation.[32] Ideas are the day's preeminent resources. This represents quite a noteworthy change over 200 years, when historically our patent system primarily addressed tangible, physical products and processes. Our economy was formerly primarily agrarian, and we derived our gross domestic product by creating value from physical goods and raw materials. Today, it's all about intellectual property.

In this transition from patents for tangible goods, to an era of granting patents for conceptual/intangible goods, a number of collateral developments have exacerbated tensions regarding these software

[28] *Id*. at 192.

[29] See http://www.bitlaw.com/software-patent/history.html (last visited Mar. 6, 2006).

[30] 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 525 U.S. 1093 (1999). *See also* AT&T Corp. v. Excel Comm'ns, Inc., 172 F.3d 1352, *cert. denied*, 528 U.S. 946 (1999) (concluding that an algorithm transforming data in a call messaging recording program was statutory subject matter).

[31] *See* http://www.uspto.gov/go/taf/reports.htm (last visited Mar. 6, 2006).

[32] *See supra* note 6 and accompanying text.

business method patents, in general. Further still, because of this convergence of data, audio and video, we're witnessing the coalescence of information technology (IT) and telecommunications (telecom). And IT and telecom companies succeed only if there exists 'network effects,' meaning that a system's usefulness is directly correlated to the number of users—so that the best systems are those with the most users.[33] Therefore, interoperability, compatibility, and common standards are essential—yet at the same time, each of these qualities is at odds with the proprietary nature of patents.

As an example, Qualcomm's CDMA (Code Division Multiple Access) technology underlies the third-generation (3G) mobile-telephone standard. Qualcomm created this technology, which is therefore integrated into all 3G wireless networks. This means that all companies wishing to use this technology must work with Qualcomm. And 3G equipment makers must negotiate a license with Qualcomm. This is a quite different from the era of patents for goods made by one business, and sold by that one business. Today's goods that are in demand are composed of technologies from many different businesses.[34]

Because of these consumer demands and marketplace realities, companies are increasingly willing to accept innovations of others, rather than creating their own vertically-integrated inventions. These pressures of interoperability, compatibility and common standards militate against completely proprietary inventions, and instead require a pooling of licenses or cross-licensing agreements. It quickly becomes evident how entangled patent claims have become, since companies are so enmeshed with the technology of others due to these factors. Finally, another phenomenon is the rise of opportunistic patent-holding companies (such as NTP)—companies that do not exploit the underlying patent technology in order to create products or wealth. Rather, they exist as licensing entities, to charge others for using the technology. Pejoratively known as patent trolls,[35] the practice further erects barriers to technology by exacting a toll on users. Patents have become another business strategy, an asset to be used as a competitive and defensive strategy, rather than purely a reward for innovation.[36] This is another

[33] *See* Survey of Patents and Technology, *A Market for Ideas*, ECONOMIST, Oct. 22, 2005, at 4.

[34] 3G technology includes wireless email, web, digital picture taking/sending, assisted-GPS position location applications, video and audio streaming and TV broadcasting.

[35] *See* http://en.wikipedia.org/wiki/Patent_troll (last visited Mar. 6, 2006).

[36] See Tom Krazit, *For NTP, is there life after RIM?*, available at http://www.nytimes.com/cnet/CNET_2100-1047_3-6046573.html (last visited Mar. 7, 2006) (noting how NTP is a one-person operation – founded by a former PTO employee – and it has no products and its only business model has been to invoke patent rights).

factor in which patents are now perceived as creating a significant source 'of legal and business uncertainty.'[37]

Within this litigious environment over software patents, and of legal and economic uncertainty, here is a representative sampling of pending litigation regarding software patents on business methods:

Mercexchange, LLC v. eBay, Inc.[38] ('buy it now' software used in eBay's site)—401 F.3d 1323 (Fed. Cir. 2005), *cert. granted*, 73 U.S.L.W. 3733 (U.S. Nov. 28, 2005) (No. 05-130). (Supreme Court Oral Argument date: Mar. 29, 2006);
NTP, Inc. v. Research in Motion[39] (wireless email technology used in RIMs Blackberry devices) (The Supreme Court denied certiorari in this case, and the parties eventually settled the lawsuit, with RIM agreeing to pay NTP over $600 million based on the patent infringement claim—despite steps taken by the PTO towards revoking these patents….);
Eolas Technologies v. Microsoft[40] (software code used in Microsoft's IE browser);
Visto Corp. (partly owned by NTP) v. Research in Motion, Microsoft Corp., and Good Technology, Inc.[41] (wireless technology used in Microsoft's Mobile 5.0);
Freedom Wireless v. Boston Communications Group, Inc.[42] (technology used in pre-paid cellular plans);
Creative Technologies v. Apple Computer[43] (software covering the way users navigate iPod music selections);
Rates Technology v. Google[44] (software Google uses for its gtalk service);

[37] *See supra* note 6 and accompanying text.

[38] *See* Alorie Gilbert, *Supreme Court: We'll review eBay's patent case*, CNET News, Nov. 28, 2005, available at http://news.com.com/Supreme+Court+Well+review+eBays+patent+case/2100-1028_3-5973511.html (last visited June 12, 2006).

[39] *See* Joseph Rosenbloom, *BlackBerry Blues*, Law.com, Sept. 15, 2005, available at http://www.law.com/jsp/article.jsp?id=1126688711482 (last visited June 12, 2006).

[40] *See* James Evans, *Microsoft, Eolas in court over patent dispute*, InfoWorld.com, Oct. 25, 2000, available at http://www.infoworld.com/articles/hn/xml/00/10/25/001025hnpatentdispute.html (last visited June 12, 2006).

[41] *See* Tony Dennis, *Visto sues RIM, Microsoft, Good,* The Inquirer.net, May 2, 2006, available at http://www.theinquirer.net/default.aspx?article=31387 (last visited June 12, 2006)

[42] *See* William M. Bulkeley, *Patent litigants pose growing threat to business*, post-gazette.com, Sept. 14, 2005, available at http://www.post-gazette.com/pg/05257/571396.stm (last visited June 12, 2006).

[43] *See* Ina Fried, *Creative sues Apple over iPod Interface*, CNET News.com, May 15, 2006, available at http://news.com.com/Creative+sues+Apple+over+iPod+interface/2100-1047_3-6072488.html (last visited June 12, 2006).

[44] *See* Elizabeth Montalbano, *Patent Firm Rates Technology suing Google over Talk*, InfoWorld.com, Dec. 20, 2005, available at http://www.infoworld.com/article/05/12/30/HNpatentgoogletalk_1.html (last visited June 12, 2006).

Hewlett-Packard Co. v. Gateway, Inc.[45] (patents covering keyboard features, and power management in Gateway notebook computers); and *Gateway, Inc. v. Hewlett-Packard Co.* (Gateway responded with its own patent infringement suit, alleging HP violated a number of Gateway patents).[46]

Moreover, if one reads through corporate filings literature, it is almost the exception to find a company *not* involved in some sort of litigation over software patents, a material business risk necessitating mention in the filings.[47]

Strategies to Mitigate Uncertainty in the Business Environment over Software Business Method Patents

The interconnectedness of businesses through their hardware and software programs undermines the proprietary nature of patents of these same businesses. So as businesses amass these private patent rights on business methods, and simultaneously assert patents rights over infringers, thereby impeding innovation and raising costs, there is a definite need to improve the patent system. By way of example, 'Microsoft is among the companies most frequently sued for patent infringement: it is currently involved in 35 patent disputes, and spends close to $100m a year in legal costs.'[48] Patent rights, which are privately-owned, have clearly trumped the goal of promoting progress. This has created an inefficient market for the transfer of technology, and instead promotes an unstable, uncertain business environment.

Former Federal Reserve Board Chair Alan Greenspan spoke on this point in 2004 and raised these insightful questions:

> If our objective is to maximize progress (and Mr. Greenspan evaluates progress by measuring economic growth) he asked, 'are we striking the right balance in our protection of intellectual property rights? Are the protections sufficiently broad to encourage innovation but not so broad as to shut down follow-on innovation? Are such protections so vague

[45] *See* John G. Spooner, *Gateway-HP patent tussle continues*, ZDNet.com, July 6, 2004, available at http://news.zdnet.com/2100-9584_22-5258776.html (last visited June 12, 2006).

[46] This litigation just concluded in March when parties settled, with Gateway agreeing to pay HP $94 million. *See* http://www.hp.com/hpinfo/newsroom/press/2006/060301b.html (last visited Mar. 6, 2006).

[47] *See supra note 33,* at 12; *see also* Microsoft's most recent quarterly filing outlining patent litigation, available at http://www.microsoft.com/msft/sec.mspx, and click on 2006 1st quarter results (last visited Mar. 7, 2006).

[48] *See supra* note 33, at 12; *see also* Microsoft's most recent quarterly filing outlining patent litigation, available at http://www.microsoft.com/msft/sec.mspx, and click on 2006 1st quarter results (last visited Mar. 7, 2006).

> that they produce uncertainties that raise risk premiums and the cost of capital? How appropriate is our current system—developed for a world in which physical assets predominated—for an economy in which value increasingly is embodied in ideas?'[49]

Ideas are central to our productivity growth through innovations, and are negatively impacted by the current litigious environment. Mr. Greenspan recommended further study, specifically in the areas of: (1) the interplay of ideas and economic growth; and (2) the effect of the length of patent terms on overall economic growth in an effort to develop a framework capable of analyzing the growth of an economy increasingly dominated by conceptual products.[50] Important to consider too, are the effects of patent infringement remedies on overall economic growth.[51] For if an injunction is to be the default remedy for patent infringement as it is presently, (rather than a damages award) the incentive is ever-greater to assert patent rights.

This expansive reading of statutory subject matter for business methods to include software has created strong incentives to patent such inventions. There are collateral effects however, to this phenomenon, most notably the use of patents for defensive and competitive purposes, which has had the perverse effect of slowing innovation while raising the cost of doing business. There are a range of options for Courts, Congress, the PTO, and patentholders going forward.

The Patent and Trademark Office

The Patent and Trademark Office (PTO) understands that, as the gatekeeper to the award of a patent, it has responsibility to insure the legitimacy of patent grants, and to best accomplish this, they first need to develop a plan that represents a consensus of opinion with Congress, and the Courts. For the PTO to construe patent statutory subject matter narrowly, while at the same time the Courts construe that subject matter broadly leads to endless litigation, and an expensive, uncertain business environment. Once such a consensus is reached, there will be higher level of predictability in the legal environment. There are three important initiatives, in the areas of making patent examinations more rigorous; adding opportunity for review by third parties; and shortening the patent term length.

The PTO understands that its examination system for patent applications is in need of repair. The PTO announced an Action Plan for

[49] *See supra* note 6, at 4.

[50] *See supra* note 6, at 4.

[51] *See* Tony Kontzer, *Supreme Court to hear eBay Patent-Infringement Appeal*, GovernmentEnterprise.com, Nov. 28, 2005, available at http://governmententerprise.com/news/174402273 (last visited July 14, 2006).

business method patents to improve the quality of the examination process in technologies related to electronic commerce and business methods.[52] Within this initiative the PTO specifically points out the problematic issue of prior art, which negates the patentability of an invention because the invention fails the non-obviousness test for statutory subject matter.[53] The challenge of identifying prior art in an emerging technology area is especially acute, and speaks to the need for additional resources, including specialized training of patent examiners. Examiners would be able to conduct a more rigorous investigation of patent, as well as non-patent literature, and thereby re-focus attention to the question of obviousness. Another strategy the PTO could pursue with improved resources is to promote the judicious use of interference proceedings. Such proceedings are called for when there is potential for a new application to interfere with a pending application or an unexpired patent.[54]

Finally, there are ways to improve patents from competitors and other third parties, and even other agencies. Recognizing that the patent examiner may not be all that familiar with the technology in question, third parties may now ask the PTO to re-examine patents, and may appeal the decision to a board. But third parties have only limited status. While they may not appeal that decision to the Court of Appeals for the Federal Circuit; the patentholder may pursue an appeal. Even the Federal Trade Commission has generated proposals for improving the patent system, in recognition that there are anticompetitive effects in the present system.[55]

[52] *See Business Method Patents Initiative: An Action Plan*, March 2000, United States Patent and Trademark Office, available at http://www.uspto.gov/web/offices/com/sol/actionplan.html (last visited June 28, 2006). This is also the issue before the Supreme Court in the *eBay v. MercExchange* litigation in which the Court is being asked to reconsider the judicial standard for 'when it is appropriate to grant an injunction against a patent infringer.' 401 F.3d 1323 (Fed. Cir. 2005), *cert. granted*, 73 U.S.L.W. 3733 (U.S. Nov. 28, 2005) (No. 05-130).

[53] *See supra* note 52 and accompanying text; *see also* 35 U.S.C. section 135 (2006) (outlining statutory requirements for remedies). The PTOs criteria is available at http://www.uspto.gov/web/offices/pac/doc/general/index.html#novelty (last visited Mar. 15, 2006).

[54] *See FTC Issues Report on How to Promote Innovation Through Balancing Competition with Patent Law and Policy,* available at http://www.ftc.gov/opa/2003/10/cpreport.htm (last visited June 28, 2006. For the full Report, see *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy*, available at http://www.ftc.gov/os/2003/10/innovationrpt.pdf (last visited June 28, 2006).

[55] *See* Brenda Sandburg, *FTC Floats Controversial Patent Plan*, available at http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1067350952811 (last visited Mar. 15, 2006).

Congress—Legislative Strategies

Congress could decide to take a more active role in overseeing agency actions, or it may modify the present legislative scheme. For example, Congress could vote to amend the present statutory scheme to shorten the patent term length.[56] Improving the quality, and limiting the duration of patents were in fact two recommendations made by Amazon CEO Jeff Bezos, of 1-click ordering fame.[57] Even in March 2006, he understood the urgency of the issues that we still face. Mr. Bezos wrote this Open Letter, excerpted here:

1. That the patent laws should recognize that business method and software patents are fundamentally different than other kinds of patents.

2. That business method and software patents should have a **much** shorter lifespan than the current 17 years—I would propose 3 to 5 years. This isn't like drug companies, which need long patent windows because of clinical testing, or like complicated physical processes, where you might have to tool up and build factories. Especially in the age of the Internet, a good software innovation can catch a lot of wind in 3 or 5 years.

3. That when the law changes, this new lifespan should take effect retroactively so that we don't have to wait 17 years for the current patents to enter the public domain.

4. That for business method and software patents there be a short (maybe 1 month?) public comment period **before** the patent number is issued. This would give the Internet community the opportunity to provide prior art references to the patent examiners at a time when it could really help.[58]

Finally, Congress may consider amending the burden of proof standard. There is a presumption of validity for patents,[59] and an accused infringer bears the burden of proving, by clear and convincing evidence, that the PTO erred in awarding the patent.[60] The FTC and others assert that the lowered standard of preponderance of the evidence is sufficient to defend against claims of infringement, since

[56] *See* 35 U.S.C. section 154 (2005), available at http://www.uspto.gov/web/offices/pac/mpep/documents/2700_2701.htm#sect2701 (last visited Mar. 15, 2006).

[57] *See* Troy Wolverton, *Amazon CEO see solutions in patent reform*, available at http://news.com.com/Amazon+CEO+sees+solutions+in+patent+reform/2100-1017_3-237801.html (last visited Mar. 15, 2006).

[58] *See* http://www.oreilly.com/news/amazon_patents.html (last visited Mar. 15, 2006).

[59] *See* 35 U.S.C. section 282 (2005).

[60] *See* 35 U.S.C. section 273 (2005).

software patentholders already enjoy too much protection for their inventions.[61]

Courts—Judicial Decisions on Patents

Courts possess the power 'to say what the law is.'[62] It is evident from this discussion that, with regard to software, courts have historically engaged in an expansive interpretation of statutory subject matter. Courts have also engaged in an expansive interpretation of the scope of patent claims. Furthermore, the Court developed an additional equitable relief theory in the form of the Doctrine of Equivalents through which a court may impose liability for infringement on a party *even though that party's product does not literally infringe the claims*.[63] There are indications that the era of expansive interpretations of patent holders is closing. During this Term, the Supreme Court chose to hear two patent cases, both presenting quite basic questions relating to patents.

In one, *LabCorp v. Metabolite Laboratories*[64], the Court is considering the scope of statutory subject matter, specifically just what type of discoveries and inventions may be patented. One reporter commented that this case highlights how the courts are granting patents at a level of abstraction that is unwise.[65] The Petitioners caution that, "This case amply demonstrates the danger of allowing someone to use a vague claim to patent the very act of thinking about a scientific principle."[66]

In another case, *eBay v. MercExchange*, the Court is being asked to reconsider the judicial standard for 'when it is appropriate to grant an injunction against a patent infringer,'[67] and thus whether injunctions should remain the default remedy for patent infringement. Again, as in the *NTP v. RIM* case, MercExchange is seeking to enforce patent rights in court, even while the PTO in engaged in a proceeding that may

[61] *See supra* note 47 and accompanying text.

[62] Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177-78 (1803).

[63] *See* Warner-Jenkinson Co., Inc. v. Hilton Davis Chemical Co., 520 U.S. 17, 40 (1997) (noting that the essential question under the Doctrine of Equivalents is: "Does the accused product contain features identical or equivalent to each claimed limitation of the patented invention?"). The Court has narrowed this Doctrine recently, however. *See* Festo Corp. v. Shoketsu Kinzoku Kinzoku Kogyo Kabushiki Co., 535 U.S. 722 (2002).

[64] LabCorp v. Metabolite Labs, Inc., 370 F.3d 1354 (Fed. Cir. 2004), *cert. granted*, 126 S. Ct. 543 (Oct. 31, 2005).

[65] *See* Michael Crichton, Op-Ed, *This Essay Breaks the Law*, N.Y TIMES, Mar. 19, 2006, Section 4 (Week in Review), at 13.

[66] Brief for the Petitioner at 43, LabCorp v. Metabolite Labs, Inc., No. 04-607 (Fed. Cir. June 8, 2004), available at http://patentlaw.typepad.com/patent/brief_20for_20 petitioner.pdf (last visited Mar. 30, 2006).

[67] *See supra* note 43 and accompanying text.

invalidate its patents.[68] This injunction standard has been settled law for nearly 100 years, with courts imposing injunctions against infringers as a default remedy, rather than as an extraordinary remedy—even for patent holders who do not use or commercialize their inventions.[69] eBay asserted that the injunctions overly favor patent holders, and in the end, impede innovation and fail to promote progress or innovation. eBay urged the Court to apply the four-factor test prescribed for patents, that involves a consideration of: the public interest, the circumstances of the case, the likelihood of prevailing in a trial, and whether the patent holder would be irreparably harmed without an injunction, or whether monetary damages would suffice.[70] MercExchange countered that patent holders were granted exclusive rights to use, or even just to keep others from using their inventions, and so injunctions are necessary to protect exclusive property rights in the patent, including the right to exclude others. Without this equitable relief in the form of an injunction, the Court would endorse a sort of mandatory licensing paradigm which would diminish patent holders' property rights in their inventions.

CONCLUSIONS

We need to modify the present system in ways that work to promote innovation, as well as follow-on innovation, through strengthening the PTOs decisionmaking process; and by reducing potential legal threats in the form of abusive patent litigation. One important initiative that bears further investigation is to modify terms lengths for software patents. It is unrealistic to invalidate the entire class of patents. Congress and the PTO are best placed to address shortcomings in the patent system. With law, we need continuity and predictability, yet we also need to respond to realities, and need to build in the requisite flexibility to respond to economic and societal circumstances. Promoting progress, the stated purpose of U.S. Constitution, art. 1, section 8, is presumably accomplished through innovation and economic growth, yet

[68] *See* Grant Gross, *Supreme Court weighs eBay patent dispute*, itworld.com, Mar. 29, 2006, available at http://www.itworld.com/Man/2687/060329ebay/pfindex.html (last visited Mar. 31, 2006).

[69] *See* Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. 405 (1908) (ruling that an injunction was appropriate for patent infringement even if patent holder did not use the patent; non-use of a patent does not affect the validity of a patent); *see also* Jess Bravin & Mylene Mangalindan, *In Patent Case, eBay Tries to Fight Its Way Out of Paper Bag*, WALL ST. J. Mar. 29, 2006, at B1 (noting the *Continental* case precedent, and the impact of its automatic injunction rule).

[70] *See* Declan McCullagh, *Supreme Court hears eBay's patent appeal*, zdnet News, March 29, 2006, available at http://news.zdnet.com/2102-1040_22-6055547.html (last visited Mar. 31, 2006).

our present patent system works at cross-purposes to the accomplishment of these goals.

EXPLORING UNCHARTED WATERS: THE STILL EVOLVING LONG-ARM JURISDICTION DIMENSIONS OF ELECTRONIC COMMERCE

by DAVID SILVERSTEIN*

I. INTRODUCTION

Since the emergence and rapid development of electronic commerce ("e-commerce") during the 1990s, courts across the United States have struggled to apply traditional jurisdictional rules to this new and ever-morphing technological phenomenon.[1] Adapting pre-internet jurisprudence regarding the boundaries of so-called "long-arm" statutes and the principle of "doing business" as a basis for asserting personal jurisdiction over an out-of-state business to a bewildering array of new e-commerce business strategies challenged the courts and led, at least initially, to "a sprawling, untidy, and inconsistent body of Internet jurisdiction law."[2] So far, the U.S. Supreme Court has not decided any cases in this context

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[1] *See generally* Dennis T. Yokoyama, *You Can't Always Use the Zippo Code: The Fallacy of a Uniform Theory of Internet Personal Jurisdiction*, 54 DEPAUL L. REV. 1147 (2005); TiTi Nguyen, *A Survey of Personal Jurisdiction Based on Internet Activity: A Return to Tradition*, 19 BERKELEY TECH. L. J. 519 (2004); Amanda Reid, *Operationalizing the Law of Jurisdiction: Where in the World Can I be Sued for Operating a World Wide Web Page?*, 8 COMM. L. & POL'Y (2003); Brian E. Daughdrill, *Poking Along in the Fast Lane on the Information Super Highway: Territorial Based Jurisdiction in a Technological World*, 52 MERCER L. REV. 1217 (2001).

[2] Yokoyama, *supra* note 1, at 1148.

leaving it to the state courts and lower federal courts to develop a body of case law.

One early line of cases in what has been termed "Internet personal jurisdiction jurisprudence"[3] simplistically analogized maintaining an Internet website (of whatever nature) to nationwide marketing and, on this basis, upheld personal jurisdiction over a business maintaining a website in every state from which the website could be accessed (arguably, from anywhere in the world!).[4]

A second, somewhat more sophisticated, line of Internet personal jurisdiction cases, however, distinguished between so-called passive websites and interactive websites.[5] A passive website has been defined as one "that merely transmits information and does not solicit business," whereas an interactive website has been defined as one that "does solicit business,"[6] although alternative, more fluid definitions can be found in the literature and related case law. Thus, in one variation of the passive/interactive website dichotomy, the critical distinction between these two types of websites might be based on whether a customer could or actually had completed a commercial transaction on-line (e.g., by filling a shopping cart icon with a selection of products/services, proceeding to a check-out counter icon, entering a credit/debit card number, and clicking on a Buy Now icon to complete the transaction).[7]

[3] *See*, e.g., Yokoyama, *supra* note 1, at 1147-1148; Daughdrill, *supra* note 1, at 1227. Brief descriptions of the Internet and its recent emergence as a major channel of commerce can be found in Yokoyama's and Daughdrill's journal articles. Yokoyama, *supra* note 1, at 1153-1156; Daughdrill, *supra* note 1, at 1218-1222.

[4] *See, e.g.*, Heroes, Inc. v. Heroes Found., 958 F. Supp. 1 (D.D.C. 1996); Maritz, Inc. v. Cybergold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996); Inset Systems, Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D. Conn. 1996). *But see* Hearst Corp. v. Goldberger, 1997 WL 97097, *1 (S.D.N.Y. 1997) (commenting on the absurdity of finding such broad personal jurisdiction). "[A] finding of personal jurisdiction in New York based on an Internet Web site would mean that there would be nationwide (indeed, worldwide) personal jurisdiction over anyone and everyone who establishes an Internet Web site . . . such nationwide jurisdiction is not consistent with traditional personal jurisdiction caselaw nor acceptable to the Court as a matter of policy". *Id.*

[5] *See* Zippo Mfg. Co. v. Zippo Dot Com., 952 F. Supp. 1119 (W.D. Pa. 1997). *See, e.g.*, William E. Greenspan, *Federal Personal Jurisdiction in Cyberspace in Trademark Infringement Cases*, 38 BUS. L. REV. 41, 46-49 (2005). Although a number of courts have explicitly adopted the *Zippo* approach, other courts have resorted to the "effects test" articulated by the U.S. Supreme Court in 1984. *See* Calder v. Jones, 465 U.S. 783, 789-790 (1984); Reid, *supra* note 1, at 237-239. In applying the "effects test," however, many of these courts have, in essence, distinguished "passive" from "interactive" websites even if they have not adopted the *Zippo* terminology per se. *See* Reid, *supra* note 1, at 240-256.

[6] G.R. FERRERA et al., CYBERLAW 25 (2d ed. 2004).

[7] One commentator has recently argued, for example, that "[f]or purposes of clarity and consistency in determining whether the defendant purposefully availed itself of the forum state, the dividing line separating passive from active websites should be whether forum residents have made purchases online. Under this proposed rule, *Zippo's* murky middle

A still more nuanced sliding scale version of the passive/interactive website approach emerged in the often-cited *Zippo Manufacturing Company v. Zippo Dot Com, Inc.*, a 1997 U.S. District Court decision.[8] The *Zippo* sliding scale approach divided the spectrum of Internet jurisdiction cases into three regions: (a) "[a]t one end of the spectrum are situations where a defendant clearly does business over the Internet;" (b) "[a]t the opposite end are situations where a defendant has simply posted information on an Internet website which is accessible to [Internet] users [wherever they may be located];" and (c) "[t]he middle ground is occupied by interactive websites where a user can exchange information with the host computer."[9] According to the *Zippo* court, in a middle ground type of case, "the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the website."[10]

At first glance, the *Zippo* sliding scale approach might appear to be as comprehensive and rational a test as could be devised to handle the Internet jurisdiction cases. Indeed, a number of courts and several commentators enthusiastically embraced the *Zippo* approach.[11] Other courts and commentators, however, recognized the limits of the *Zippo* approach: that it perpetuates jurisdictional uncertainties, leads to seemingly inconsistent case law, and fails to resolve the myriad ever-changing dimensions of modern e-commerce.[12] The *Zippo* approach, for example, fails to explicitly address the jurisdictional impact of what have become familiar e-commerce strategies such as pop-up ads, adware, spyware, and cookies, and the interaction between a seemingly passive website and a growing number of Internet search engines which can bring such a website (sometimes preferentially) to consumers' attention.[13]

These and other limitations of or defects in the *Zippo* approach suggest that the scope of Internet jurisdiction in an e-commerce context is far from being settled but rather is likely to experience considerable evolution in coming years and may eventually provoke several U.S. Supreme Court decisions. It is, therefore, timely to consider how Internet personal jurisdiction jurisprudence is likely to evolve, and how new proposals might impact the resolution of e-commerce jurisdiction questions which have yet to be conclusively decided. Several recent law

level of interactivity would be abolished. Instead of a sliding scale, a website should be placed in one of two categories: revenue-generating websites and all other websites," Yokoyama, *supra* note 1, at 1169.

[8] 952 F. Supp. 1119 (W.D. Pa. 1997).

[9] *Id.* at 1124.

[10] *Id.*

[11] *See, e.g.,* Reid, *supra* note 1, at 238-256; Greenspan, *supra* note 5, at 49.

[12] *See, e.g.,* Yokoyama, *supra* note 1.

[13] *See infra* part III.

review articles explicitly criticize the *Zippo* approach as inadequate and inconsistent in results, and propose instead their own alternative approaches.[14]

In one article, the author Reid analyzes fourteen federal Court of Appeals decisions between 1996 and 2002 involving Internet personal jurisdiction issues.[15] She found that, of the fourteen cases, "eight implicitly or explicitly used the effects test [of *Calder v. Jones*] or the Zippo test. In the remaining six cases, three did not expressly adopt a test but seemed to use an intergrade criteria thereby making them hard to classify, one was disposed of under the state long-arm statute, and two applied a minimum contacts analysis specifically tailored to the Internet."[16]

Reid concludes, however, that "the '*Zippo* test' fails to consistently take an accurate account of the complete picture of the contacts generated from Internet use, and the '*Calder* effects test' is not applicable in all cases."[17] As an alternative, the author proposes what she calls a Web-contacts approach "as a consistent way to operationalize 'purposeful availment' for personal jurisdiction based on contacts via the Web."[18]

In the second of these recent articles,[19] the author Yokoyama contends that, following the *Zippo* decision, "many courts, in their zealous and understandable quest to adopt a single standard for all Internet jurisdiction issues, have improvidently chosen to apply a unitary test based on *Zippo* to all Internet jurisdiction issues. These courts have mistakenly found the *Zippo* test is applicable simply because the defendant's conduct involved Internet activities."[20] Yokoyama argues, however, that in automatically applying the *Zippo* analysis, some of these courts "have failed to consider fully the factual and legal underpinnings of the lawsuit [which are considerations] . . . essential to proper application of the traditional model of personal jurisdiction."[21]

As an alternative approach, Yokoyama proposes abandoning the ultimately futile search for "any uniform theory of Internet jurisdiction" and, instead, returning to jurisdictional principles which are "grounded in, rather than divorced from, the traditional model of personal jurisdiction."[22] He proposes a model that he says "explicitly recognizes

[14] *See, e.g.,* Yokoyama, *supra* note 1; Reid, *supra* note 1; Patrick J. Borchers, *Symposium: Personal Jurisdiction in the Internet Age*, 98 NW. U. L. REV. 473 (2004).
[15] Reid, *supra* note 1.
[16] Reid, *supra* note 1, at 240-241.
[17] Reid, *supra* note 1, at 227.
[18] Reid, *supra* note 1, at 259-263.
[19] Yokoyama, *supra* note 1.
[20] Yokoyama, *supra* note 1, at 1149.
[21] Yokoyama, *supra* note 1, at 1149.
[22] Yokoyama, *supra* note 1, at 1149.

that resolving personal jurisdiction issues requires the assessment of the defendant's Internet contacts with the forum state in light of the factual and substantive legal underpinnings of the lawsuit."[23] The commonality between this approach and the Web-contacts approach proposed by the first author seems to be that both approaches eschew any simplistic rule fashioned specifically to cover e-commerce cases in favor of a case-by-case approach that directly links the technological realities of e-commerce to foundational principles of long-arm jurisdiction.

This article substantially concurs with criticisms of the Zippo approach and with the need to better relate the technological realities of e-commerce to traditional jurisdictional principles. Accordingly, after highlighting key historical and case law developments which have shaped current jurisprudence in this field, this article will relate those foundational concepts to certain aspects of e-commerce where there is still little or no controlling jurisdictional case law and, on this basis, offer some predictions about how such cases might be decided.

II. FOUNDATIONS OF "DOING BUSINESS" JURISDICTION

A. Jurisdictional Prerequisites to a Civil Lawsuit

The essential jurisdictional prerequisites to commencing a civil lawsuit are familiar to every first-year law student: a plaintiff must select a court that has subject matter jurisdiction over the subject matter of the lawsuit, coupled with personal (*in personam*) jurisdiction over the intended defendant, *in rem* jurisdiction over the property at issue (for an *in rem* lawsuit), or alternatively *quasi-in-rem* (attachment) jurisdiction over property belonging to the intended defendant (for a *quasi-in-rem* lawsuit).[24]

Ordinarily, establishing the court's personal jurisdiction over the defendant is preferable to trying to establish *quasi-in-rem* jurisdiction based on placing a lien on the defendant's property because, with personal jurisdiction, there is no need to locate and legally attach the defendant's property in the forum state, because the plaintiff's monetary recovery is not limited by the value of the attached property, and because injunctive relief (if desired) can only be directed against a defendant over whom the court exercises personal jurisdiction.[25]

[23] Yokoyama, *supra* note 1, at 1150-1151.

[24] *See, e.g.*, HENRY R. CHEESEMAN, THE LEGAL ENVIRONMENT OF BUSINESS & ONLINE COMMERCE 37-38 (4th ed. 2005).

[25] *See generally* A. von Mehren & D. Trautman, *Jurisdiction to Adjudicate: A Suggested Analysis*, 79 HARV. L. REV 1121 (1966); A. von Mehren & D. Trautman, *Adjudicatory Jurisdiction: General Theories Compared and Evaluated*, 63 B.U.L. REV 279 (1983); Graham C. Lilly, *Jurisdiction Over Domestic and Alien Defendants*, 69 VA. L. REV. 85 (1983).

Historically under English common law, the three traditional grounds for a court to assert personal jurisdiction over a defendant were consent, domicile, and catching or presence.[26] Because every natural person and business entity has one (but only one) legal domicile at any point in time, the traditional common law rule meant that every intended defendant would be subject to the personal jurisdiction of some court somewhere. In many instances, however, the defendant's legal domicile was not in the plaintiff's home state, and the defendant would neither consent to personal jurisdiction in the plaintiff's home state nor would the defendant travel to the plaintiff's home state and risk being caught. This situation would force a plaintiff seeking personal jurisdiction to bring the civil action in the defendant's state/country of domicile, which typically involved added expense, inconvenience, might require retaining two lawyers (one in the plaintiff's home state and another licensed to practice in the forum state), and, conceivably, could mean trying the case before a judge and jury with a bias against a foreign plaintiff suing a local defendant.[27]

B. Historical Emergence of Personal Jurisdiction Based on "Doing Business"

Prior to World War I, the impact of these jurisdictional constraints was limited by the reality that legal disputes between citizens of different states were uncommon.[28] Limitations imposed by the travel and communications technologies of those earlier eras insured that commercial interactions between citizens of different states were relatively infrequent. In part because of a persistent mistrust by both consumers and businesses about dealing with a distant, faceless business run by a stranger you may have never met and with whom you could communicate only by mail, consumers tended to buy their products and services locally, if possible, and preferably, directly from the producer/ manufacturer (e.g., the farmer who raised/grew the foods or the artisan who fabricated the goods). Similarly, businesses generally preferred to source their parts/supplies/raw materials locally whenever possible so they could negotiate face-to-face, assure themselves they were dealing with a dependable, reputable supplier, and, at least periodically, personally inspect the supplier's operations and the products they were contracting to buy.

War-time rationing during World War I, however, led to supply shortages that forced businesses and consumers alike to begin looking

[26] See Restatement (Second) Conflict of Laws (1971) §§ 28 ("catching" or presence), 29 (domicile) and 32 (consent).

[27] *See, e.g.*, Mehren & Trautman, *supra* note 25.

[28] *See Business and the Law; Unsettled Issue of Jurisdiction,* N.Y. TIMES, March 16, 1987, at D2 (asserting emergence of interstate commerce after World War I).

further afield to supply their commercial needs. Rapidly improving transportation and communication technologies further facilitated an explosive growth in interstate commerce during WWI and the post-war period.[29] With such growth in interstate commerce, however, also came a rapid escalation in consumer complaints about the products and/or practices of some less responsible out-of-state businesses: these included selling shoddy or hazardous products merchants subsequently refused to stand behind; selling insurance policies without adequate financial reserves to pay claims; and selling shares of stock in companies that existed only on paper (a practice which led to the term "blue sky laws" to describe early twentieth century state securities regulations).[30]

Disgruntled consumers hoping to pursue legal action against such disreputable out-of-state businesses found themselves stymied by the restrictive common law rules regarding personal jurisdiction. Often the one place these businesses assiduously refrained from doing business was in their domiciliary state where they could easily be sued by state residents operating on their "home turf." During the 1920s and early 1930s, a variety of legislative initiatives sought a way to remedy this growing out-of-state business problem.[31]

During this same period, an interestingly analogous situation emerged with respect to automobiles. In 1908, the first Model-T Ford rolled off the Ford Motor Co. assembly line in Dearborn, Michigan.[32] For the first ten to fifteen years of mass-produced automobiles, however, the price of an automobile was so high relative to median family wealth that only a small proportion of Americans could afford this wonderful new luxury. Because there was little if any driver training, few traffic safety laws, and substantially no enforcement of speed limits or common driving courtesies, accident rates among the lucky few who owned automobiles in those early days were, on a proportional basis, astonishingly high.[33] But, because there were relatively few automobiles

[29] *See* Wessinger v. S. Ry. Co., 470 F.Supp 930, 932 (D.C.S.C. 1979) (asserting improved automotive technology increases interstate travel).

[30] *See* Paul G. Mahoney, *The Origins of the Blue Sky Laws: A Test of Competing Hypotheses*, 46 J. L. & ECON. 229, 229 (2003) (noting forty-seven out of forty-eight states passed blue sky laws between 1911 and 1931).

[31] *Id.*

[32] *See* Sally H. Clarke, *Unmanageable Risks: MacPherson v. Buick and the Emergence of a Mass Consumer Market*, 23 L. & HIST. REV. 1, 11 (2005) (detailing history of automobile production). *See also Reynold M. Wik*, Henry Ford Grass Roots America (1972).

[33] *See*Year of First State Driver License Law and First Driver Examination, in Federal Highway Administration Website, *at* http://wwwcf.fhwa.dot.gov/ohim/summary95/dl230.pdf (detailing years in which first drivers license laws were passed and driver tests established) (last visited June 12, 2006).

on the roads, the overall incidence of driving accidents was still generally low.

By the 1920s, however, the miracle of mass production technology combined with the magic of a seemingly irrepressible stock market to bring the price of a car within the reach of a large number of Americans.[34] As an increasing number of automobiles crowded onto typically narrow dirt or cobblestone streets, perhaps originated as cattle paths, and shared with pedestrians, horses, and carriages, a rapidly growing number of automobile accidents was inevitable. Especially in certain urban centers, such as Boston, Massachusetts, located within a short driving distance of several surrounding states, a high proportion of these automobile accidents involved out-of-state drivers, which led Massachusetts to become one of the first states to enact a motorist "implied consent" law.[35]

In such situations, the errant driver would return to his/her home state after the accident leaving the victim (who may have suffered personal injuries and/or property damage as a result of the accident) with a difficult lawsuit choice: chase the errant out-of-state driver to his/her home state, where personal jurisdiction could be established based on "domicile" (but with all of the attendant inconvenience, additional costs, and possible bias against the out-of-state plaintiff), or hope to catch the defendant on a future visit to the plaintiff's state before the statute of limitations expired. In theory, the out-of-state driver could consent to personal jurisdiction in the state where the accident had occurred; in reality, this was usually little more than wishful thinking.

Creative state legislators frustrated by the limitations of traditional jurisdiction principles began to respond to the out-of-state motorist problem with a pioneering legal tactic—the passage of motorist "implied consent" laws.[36] These laws represented a twist on the traditional jurisdictional basis of defendant "consent": under the legal fiction of these "implied consent" laws, by the willing act of driving into the forum state, an out-of-state motorist was deemed to have implicitly "consented" to be sued in that state in connection with any accident that might result. This legal fiction was premised on the logic that if a state had the right to require out-of-state motorists to register with a state official and agree

[34] *See* Mike Greissel, *100 Years Young*, Industrial Paint & Powder, Nov. 1, 2003, at 12 (celebrating Model T and noting its decrease in price resulted in millions of Americans becoming car owners). *See also* Douglas Brinkley, Wheels for the World (2003).

[35] *See* notes 36-39 *infra*, and accompanying text.

[36] One of the earliest and best examples of such laws was Massachusetts Gen. Laws, c. 90, as amended by Stat. 1923, c. 431, §2, which provided that use of the Commonwealth's highways by a non-resident motorist shall be deemed equivalent to an appointment by him of the state motor vehicle registrar as his attorney upon whom process may be served in any action growing out of any accident or collision in which the non-resident may be involved while operating the motor vehicle.

to abide by state motor vehicle laws as a condition for operating a motor vehicle in the state (a requirement similarly imposed on the state's own citizens), then an out-of-state motorist's voluntary act of driving into the state could be deemed equivalent to actually registering with the state official and actually agreeing to be bound by the state laws, including consenting to personal jurisdiction.[37]

Out-of-state motorists who were snared by the early implied consent laws protested bitterly in court, but to no avail. In the leading 1927 case of Hess v. Pawloski,[38] the U.S. Supreme Court found no unfairness and no Constitutional violations in holding a motorist who had voluntarily driven into a state, and caused an accident there, answerable in the courts of that state. Once the constitutionality of such motorist implied consent laws was clearly established, other states quickly followed suit. Before long, every state had an implied consent law covering out-of-state motorists, a situation that continues to this day.

Perceptive state legislators quickly appreciated the many similarities between out-of-state motorists causing injuries to local citizens and out-of-state businesses selling defective goods and services or engaging in deceptive or unfair business practices within the state. Could the principle of implying jurisdictional "consent" by a defendant motorist's act of engaging in knowing, willful conduct within the state that resulted in harm to a citizen of the state be extended to out-of-state businesses? In the landmark case of *International Shoe Co. v. State of Washington*,[39] the U.S. Supreme Court answered affirmatively, in the process

[37] The reasoning underlying this "implied consent" fiction was that, just as a state can require its own citizens to register with a state official (and agree to be bound by certain motor vehicle regulations to insure safe operation) in return for enjoying the privilege of operating a motor vehicle in the state, so too may a state Constitutionally require non-resident motorists (under substantially similar terms as applied to its own citizens) to register with the state official before operating a motor vehicle in the state. From this foundation, it is a relatively short leap to the assumption that a non-resident motorist is aware of the relevant state law, and that his/her voluntary act of driving into the state constitutes implied acceptance of the conditions imposed by the law, including appointment of a state official as his/her agent to accept service of process.

[38] 274 U.S. 352 (1927). This case involved the Constitutionality of the Massachusetts motorist implied consent statute. After declaring that the "privileges and immunities clause of the Constitution, §2, Art. IV, safeguards to the citizens of one State the right to pass through or to reside in any other state . . . ." *Id.* at 355. The Court went on to observe that "[m]otor vehicles are dangerous machines; and, even when skillfully and carefully operated, their use is attended by serious dangers to persons and property." *Id.* at 356. Accordingly, the Court held: "In the public interest the State may make and enforce regulations reasonably calculated to promote care on the part of all, residents and non-residents alike, who use its highways. The measure in question operates to require a non-resident to answer for his conduct in the State . . . [and] the implied consent is limited to proceedings growing out of accidents or collisions on a highway in which the non-resident may be involved." *Id.*

[39] 326 U.S. 310 (1945).

substantially redefining the sixty-year old precedent of *Pennoyer v. Neff*.[40] In *International Shoe*, the Court held that, so long as a defendant had purposefully availed itself of the benefits and protections of the forum state by establishing minimum contacts with the forum state, and the lawsuit arose out of those contacts, the exercise of personal jurisdiction over the defendant in the forum state would not offend "traditional notions of fair play and substantial justice."[41] *International Shoe* is thus the origin of, and the ultimate touchstone for assessing, the exercise of personal jurisdiction based on "doing business."

As with the out-of-state motorist implied consent laws, however, the logic underlying the legal fiction of implied consent in out-of-state business cases was that, if a forum state had the right to require an out-of-state-state business to register with a state official and agree to observe state commercial laws as a condition for entering the state and doing business there, then the voluntary act of a business entering the state and doing business there could be deemed equivalent to its actually registering to do business. Minimum contacts and purposeful availment as utilized in *International Shoe* are therefore, really shorthand for "minimum contacts sufficient to empower a state to require an out-of-state business to register to do business in the state." By abbreviating this cumbersome phrase to the simple minimum contacts/ purposeful availment tests, courts and commentators seem to often lose sight of the legal fiction foundation for long-arm jurisdiction.

C. Limiting the Expanding Reach of "Long-Arm Statutes"

Following the Supreme Court's decision in *International Shoe* affirming the principle of basing personal jurisdiction on a defendant business' voluntary acts in a forum state, state legislators across the country jumped on the bandwagon of enacting such implied consent laws to better protect their citizens from out-of-state businesses.[42] These laws became popularly known as long-arm statutes because, like a long arm, these laws empowered courts to extend their jurisdictional reach across state lines to grab an out-of-state business and hale it before a court in the forum state.[43]

The early long-arm statutes enacted in the immediate wake of the *International Shoe* decision were generally modest in scope and

[40] 95 U.S. 714 (1877).

[41] 326 U.S. at 316.

[42] *See* Kristopher B. Knox, *CASE NOTE: Davis v. St. John's Health System, Inc.: General Jurisdiction, the Door is Ajar, But How Far Will it Open?*, 56 ARK. L. REV. 647, 661 (2003) (explaining states passage of long-arm statutes in wake of *International Shoe).*

[43] *See* James Wm. Moore et al., Moore's Federal Practice 108.60[1] (3d ed. 1997) (defining long-arm statute).

patterned after the out-of-state motorist model that had inspired them.[44] Thus, these statutes were typically directed to out-of-state businesses, such as International Shoe, that had willingly and blatantly injected themselves into the stream of commerce of the forum state by such unambiguous actions as regularly and systematically engaging in manufacturing and/or sales activities in the state or by sending company-employed salespersons into the state more or less permanently to reside there and solicit business from prospective customers.[45]

Not surprisingly, however, voters, consumer groups and local businesses were soon lobbying their state legislators to expand the reach of their states' long-arm statutes.[46] More expansive long-arm jurisdiction, it was argued, would better serve the interests of local consumers and establish a more level jurisdictional playing field for local businesses vis-à-vis out-of-state business competitors.[47] Courts too were pressed to extend the reach of these statutes through novel interpretations and applications of the long-arm statutes.[48] Before long, the U.S. Supreme Court found itself forced to define the outer Constitutional boundaries of the jurisdictional can of worms it had opened with the *International Shoe* decision. A trio of 1950s U.S. Supreme Court decisions addressed the extent to which due process under the Fourteenth Amendment circumscribed the limits of state long-arm statutes.

McGee v. International Life Ins. Co.[49] has been called the high water mark in the progressive expansion of state long-arm jurisdiction.[50] In *McGee*, the Supreme Court upheld personal jurisdiction in California over a Texas insurance company based on its mailing a single reinsurance certificate into California, and thereby successfully soliciting the continuation of a life insurance policy originally contracted for elsewhere.[51]

[44] *See* Douglas D. McFarland, *Dictum Run Wild: How Long-Arm Statutes Extended to the Limits of Due Process,* 84 B.U. L. REV. 491, 493-94 (2004) (noting small incremental steps by state legislators after *International Shoe*).

[45] *See* Paul Eric Clay, *Recent Development: Quest for a Bright Line Personal Jurisdiction Rule in Contract Disputes,* 61 WASH. L. REV. 703, 705 n.17 (1986) (explaining initial long-arm statutes in wake of *International Shoe* attached to non-residents doing business in the state).

[46] *See generally* Wetzel, The Elongated Reach of the Long-Arm, 3 The Institute Report No. 28 (1974) (Illinois Institute for Continuing Legal Education).

[47] *See* Knox, *supra* note 42, at 661 (noting Illinois' expansive long-arm statute as model for others states)

[48] *See infra* notes 49-56 and accompanying text (discussing Supreme Court's response to long-arm statutes).

[49] 355 U.S. 220 (1957).

[50] *See, e.g.*, W. Reese & M. Rosenberg, Conflcit of Laws 109 (1971).

[51] 355 U.S. at 223.

An earlier case, *Perkins v. Benquet Consol. Mining Co.*,[52] at least on its face appeared to go even further than *McGee*. In *Perkins*, the Supreme Court upheld application of Ohio long-arm jurisdiction over a Philippine corporation in a lawsuit by a non-Ohio plaintiff based on a cause of action which neither arose in Ohio nor had any connection with the corporation's limited activities in Ohio.[53] This holding, however, may well be restricted to the specific, unusual fact situation of that case (because of the Japanese occupation of the Philippines during World War II, Ohio was, for all practical purposes, the only forum where this lawsuit could be brought).[54]

Hanson v. Denckla[55] is often regarded as the Supreme Court's line in the sand concerning the Constitutional limits of long-arm jurisdiction. In *Hanson*, the Supreme Court refused to hold a Delaware trustee subject to Florida long-arm jurisdiction where the only *contacts* between Florida and the trustee were letters received from the trust settlor, who became domiciled in Florida after execution of the deed of trust.[56] In essence, *Hanson v. Denckla* stood for the principle that the implied consent of an intended defendant cannot be predicated on actions initiated by another party which occur after a voluntary interaction between the intended defendant and the other party.[57] The outcome in *Hanson* is completely consistent with the legal fiction that underlies long-arm jurisdiction: in this case, the Delaware trustee performed no act that would have justified the State of Florida to require the trustee to register to do business in that state.

The next significant U.S. Supreme Court case to address the limits of state long-arm statutes was *World-Wide Volkswagen Corp. v. Woodson*. In *World-Wide Volkswagen*,[58] the plaintiff, who had purchased a car from a New York state automobile dealer, tried to use the Oklahoma long-arm statute to assert personal jurisdiction in Oklahoma (where the car accident had occurred) over the New York dealer who sold him the car and the New York-based regional distributor. The motivation for plaintiff's unusual selection of Oklahoma as the forum for this lawsuit was the length of Oklahoma's statute of limitations. Even though the plaintiff clearly would have had personal jurisdiction over the dealer and regional distributor in New York state, those suits would have been time-barred.

[52] 342 U.S. 437 (1952).

[53] *Id.* at 448.

[54] *See, e.g., Note, Developments in the Law—State Court Jurisdiction,* 73 HARV. L. REV. 909, 932 (1960).

[55] 357 U.S. 235 (1958).

[56] *Id.* at 254.

[57] See infra note 58 and accompanying text (discussing fundamental principle in landmark Supreme Court case).

[58] 444 U.S. 286 (1980).

An important element in the plaintiff's argument for personal jurisdiction in Oklahoma was that the product at issue was a car, and that the dealer and regional distributor should have anticipated that the car would be driven into other states. But, the U.S. Supreme Court held that assertion of personal jurisdiction under these circumstances would violate the due process clause of the Fourteenth Amendment.[59] Although the Court agreed that it was foreseeable that the car would be driven outside New York, the Court was not willing to recognize that type of foreseeability as satisfying due process requirements.[60]

The Court's decision in *World-Wide Volkswagen* is thus completely consistent with the principles of *Hanson v. Denckla*: the implied consent of an intended defendant cannot be based on actions initiated by another party (in this case, the automobile buyer) which occur after a voluntary interaction between the intended defendant and the other party (here, the sale of the car), even if those subsequent actions would have been foreseeable at the time of the interaction. Continuing the analogy drawn above between the doing business cases and the motorist implied consent statutes, *World-Wide Volkswagen* stands for the principle that the legal fiction of implied consent requires the defendant (auto dealer/regional distributor) to drive the car into another state; the plaintiff cannot drive it there for him.

One additional important wrinkle that emerged in post-*International Shoe* personal jurisdiction jurisprudence was the distinction drawn between specific personal jurisdiction and general personal jurisdiction. This jurisdictional dichotomy can be traced to the scholarship of two eminent Harvard Law School faculty in a 1965 textbook[61] and a 1966 law review article.[62] According to their jurisdictional model, if a court asserted personal jurisdiction based on the affiliations between the forum and one of the parties without regard to the nature of the dispute, it was exercising "general" jurisdiction. Alternatively, if a court asserted personal jurisdiction based on affiliations between the forum and the controversy, it was exercising "specific" jurisdiction.[63]

Courts gradually adopted this terminology, and the U.S. Supreme Court expressly recognized the general/specific jurisdiction distinction in *Burger King Corp. v. Rudzewicz*[64] and *Helicopteros Nacionales de*

[59] *Id.* at 299.
[60] *Id.* at 295.
[61] A. von Mehren & D. Trautman, The Law of Multistate Problems 654 (1965).
[62] Mehren & Trautman, *supra* note 25, at 1136.
[63] Mehren & Trautman, *supra* note 25, at 1136. *See also* Mary Twitchell, *The Myth of General Jurisdiction,* 101 HARV. L. REV. 610 (1988). Professor Twitchell proposed the terms "dispute-blind" and "dispute-specific" to distinguish these two varieties of personal jurisdiction. *Id.* at 613.
[64] 471 U.S. 462 (1985).

Columbia, S.A. v. Hall.[65] In applying this approach to actual cases, courts have typically required that a defendant have a systematic and continuous pattern of contacts with the forum state to support the exercise of general jurisdiction,[66] whereas in some instances a single business contact with the forum state has been deemed sufficient to support specific jurisdiction. Analogizing again to the motorist implied consent laws, a single car trip into the forum state was sufficient to establish personal jurisdiction over the out-of-state motorist if the accident leading to the lawsuit arose out of that single visit.[67]

III. APPLYING ALTERNATIVE JURISDICTION APPROACHES TO SPECIFIC E-COMMERCE PRACTICES

This section of this article will explore how some of the different approaches described above for deciding Internet jurisdiction cases might be applied to certain types of familiar e-commerce practices. Specifically, this section will consider the possible personal jurisdiction implications of using pop-up ads on an Internet browser, the use of adware and/or spyware (including the practice of planting cookies on an Internet user's computer), and the possible impact of increasingly sophisticated Internet search engines on the status of what might, under earlier standards, have been judged a purely passive website.

A. Hyperlinked Pop-up Advertisements

So-called pop-up ads are the annoying windows that suddenly open on a computer screen while a user is perusing a website, often at least partially obscuring other information on the screen.[68] The pop-up ads often are in the form of discrete boxes, which remain in view for a short time and then automatically disappear as suddenly and mysteriously as they had appeared. In some cases, a user may have to click on a close icon to remove the ad. In other cases, the ad may be in the form of a banner with moving typeface and/or images running across the screen. These ads typically hyperlink to a website operated by the advertiser so that, by clicking on the ad, a user is brought to the advertiser's website.

[65] 466 U.S. 408 (1984).

[66] *See* Brilmayer, *How Contacts Count: Due Process Limitations on State Court Jurisdiction,* 1980 SUP. CT. REV. 77; Lewis, *A Brave New World for Personal Jurisdiction: Flexible Tests Under Uniform Standards,* 37 VAND. L. REV. 1 (1984); Brilmayer et al., *A General Look at General Jurisdiction*, 66 TEX. L. REV. 721 (1988).

[67] For example, in Ruston Gas Turbines, Inc. v. Donaldson Co., the Court of Appeals observed: "A single act by the defendant directed at the forum state can be enough to confer in personam jurisdiction over him, if the cause of action arises out of that act." 9 F. 3d 415, 419 (5th Cir. 1993).

[68] *See, e.g.*, Sotelo v. DirectRevenue, LLC, 384 F. Supp. 2d 1219, 1228 (N.D. Ill. 2005) (plaintiff complained that the defendant's software "bombards users' computers with pop-up advertisements that obscure the web page a user is viewing . . . .").

Pop-up ads are especially commonplace on the Home pages of the popular Internet browsers which commonly serve as the gateways into the World Wide Web. These ads are placed on website pages as a result of businesses buying ad space from the website provider. Internet browsers are typically supported by the advertising revenue obtained from selling such pop-up ads. Such payments may be set up to be proportional to the number of users who click through to the advertiser's own website, where additional marketing information is provided.

The advertiser's website to which the pop-up ad is hyperlinked may, in turn, be classified as either passive or an interactive under existing legal rules. How might current and proposed approaches to Internet personal jurisdiction be applied to this common e-commerce practice? Should the same rules apply as with regard to other passive or interactive websites, or does the use of pop-up ads and hyperlinking convert a passive website into an interactive website? Should the pop-up ads and hyperlinking be addressed, from a jurisdictional standpoint, as separate and distinct from the nature of the advertiser's website, or as part and parcel of an integrated marketing strategy?

Of course, under the early line of Internet jurisdiction cases that equated maintaining a website with universal personal jurisdiction,[69] personal jurisdiction would attach in this situation irrespective of the hyperlinked pop-up ads. Similarly, under an Internet jurisdiction approach based on a simple dichotomy between whether or not an online sale of goods or services via the website had been made to at least one resident of the forum state,[70] the presence or absence of hyperlinked pop-up ads would be irrelevant to a determination of specific jurisdiction. The business' utilization of such ads, and the extensiveness of such use could, however, have a bearing on whether general jurisdiction applied.[71]

Under the *Zippo* approach, it would be difficult to predict an outcome in this type of case. It is conceivable that one court, trying to apply the *Zippo* test, would focus exclusively on the character of the website and what degree of interactivity it provided. Under this scenario, hyperlinking pop-up ads to a passive[72] website with essentially no interactivity would presumably not subject the website operator to personal jurisdiction. Another court, supposedly also applying the *Zippo* test, however, could regard the hyperlinked pop-up ads as providing the necessary interactivity to turn the passive website into an interactive website.

By contrast, applying a foundational principles approach to e-commerce based on a combination of traditional minimum contacts and

[69] *See supra* note 4 and accompanying text.
[70] *See supra* note 7.
[71] *See supra* note 66 and accompanying text.
[72] *See supra* notes 8-9 and accompanying text.

purposeful availment standards leads to a very different line of inquiry. Instead of focusing on the character of the website in accordance with *Zippo*, or on the effects a business strategy might have on the forum state in accordance with *Calder*, a foundational principles approach would focus on a series of very differently oriented questions.

The first question would be what is the scope of the forum state's long-arm statute?[73] Although most states have extended their long-arm statutes to full Constitutional limits, they are not required to do so, and there may be benefits to a state in more narrowly circumscribing its long-arm statute.[74]

Assuming the assertion of personal jurisdiction is within the boundaries of the long-arm statute, does this particular application comport with due process constraints under the Fourteenth Amendment?[75] This analysis, in turn, leads to the question of whether the out-of-state business has voluntarily entered the forum state, in such a way and to such a degree, that the business could have been required to register to do business there. Has the out-of-state business, metaphorically at least, driven into the forum state and caused an accident there?

If this question can be answered affirmatively, the next question would be whether the lawsuit arises out of the business' voluntary entry into the forum state. If so, there would be specific personal jurisdiction.[76] On the other hand, if the lawsuit did not arise out of the business' voluntary entry into the forum state, it would be necessary to examine whether the business had a sufficient pattern of systematic and continuous contacts with the forum state to support general personal jurisdiction.[77]

Applying such a foundational principles approach to websites associated with hyperlinked pop-up ads would, it is believed, lead to reasonably consistent and logical jurisdictional outcomes. If a business has contracted and paid for hyperlinked pop-up ads to be displayed on a website that it knows is regularly accessed by users from across the country (e.g., on the Home page of one of the major Internet browsers like Microsoft Explorer, Netscape of Yahoo), that alone should satisfy the

[73] For example, in *Planet Beach Franchising Corp. et al. v. C3UBIT, Inc. et al., No. 02-1859,* the Court begins its analysis of the Internet personal jurisdiction issue consistent with this approach by observing: "A court has personal jurisdiction over a nonresident defendant if (1) the forum state's long-arm statute confers personal jurisdiction over that defendant; and (2) the forum state's exercise of such jurisdiction complies with the due process clause of the Fourteenth Amendment." 2002 U.S. Dis. LEXIS 18349 at 4-5.

[74] *See, e.g.,* Reid, *supra* note 1.

[75] *See supra* note 73.

[76] Here again, the Court in *Planet Beach*, follows this stepwise analytical pattern. 2002 U.S. Dis. LEXIS 18349 at 8-17.

[77] Continuing to follow the proposed analytical pattern, the *Planet Beach* court next addresses the possible application of "general" jurisdiction. *Id.* at 17-20.

voluntary entry into the forum state standard irrespective of the character of the associated website. For a lawsuit arising out of one of those pop-up ads (e.g., a breach of contract, defamation, negligence, or trademark infringement matter), specific personal jurisdiction would exist potentially in every state in the country.[78]

On the other hand, the hyperlinked pop-up ads, either alone or in combination with a substantially passive website, would probably not support the exercise of general personal jurisdiction.[79] A plaintiff would have to establish a more extensive systematic and continuous presence of the business in the forum state, perhaps based at least in part on an interactive website, to meet the higher standard for general jurisdiction.[80]

B. Adware, Spyware and "Cookies"

The terms adware,[81] spyware,[82] and cookies[83] as used in the context of e-commerce refer broadly to somewhat overlapping techniques by which some portion of a user's computer is essentially subverted (typically without the user's knowledge or consent) by software transmitted to the

[78] A good example here is the analysis of "specific" jurisdiction in *Planet Beach*. *See supra* note 76 and accompanying text.

[79] A good example here is the analysis of "general" jurisdiction in *Planet Beach*. *See supra* note 77 and accompanying text.

[80] *See, e.g.,* Patrick J. Borchers, *Symposium: Personal Jurisdiction in the Internet Age,* 98 NW. U. L. REV. 473 (2004).

[81] "Adware" or advertising-supported software has broadly been defined as "any software package which automatically plays, displays, or downloads advertising material to a computer after the software is installed on it or while the application is being used." Adware Definition, in Internet Encyclopedia, at http://en.wikipedia.org/wiki/Adware (last *visited May 21, 2006).*

[82] "Spyware" has broadly been defined as "a broad category of malicious software designed to intercept or take partial control of a computer's operation without the informed consent of that machine's owner or legitimate user . . . [particularly] software that surreptitiously monitors . . . [and] subverts the computer's operation for the benefit of a third party." Spyware Definition, in Internet Encyclopedia, at http://en.widipedia.org/wiki/Spyware (last visited May 21, 2006). In an alternative approach, "Spyware" has been defined as "any type of software that transmits information without the user's knowledge." Spyware Definition, in Internet Dictionary, at http://dictionary.reference.com/seach?q=spyware (last visited May 20, 2006). See generally Peter S. Menell, *Symposium: Spyware: The Latest Cyber-Regulatory Challenge,* 20 BERKELEY TECH. L. J. 1363 (2005).

[83] "Cookies" have been defined as "small pieces of information that are automatically stored on a client computer by a Web browser and referenced to identify repeat visitors to a Web site and to tailor information in anticipation of the visitor's interests." _Cookie Definition, in Communication Industry Website, *at* http://www.atis.org/tg2k/_cookie.html (last visited May 21, 2006). In addition to being programmed to identify repeat visitors to a website, however, "cookies" can also be utilized to track the sequence of a session on a website, including how long a user spent on each web page. Because of these capabilities, there have been growing privacy concerns about such uses of "cookies."

user's computer from an outside source (e.g., from a website) for certain commercial, usually marketing-related, purposes. The usage of this terminology has not yet become standardized: as a result, the terms are sometimes used substantially interchangeably while, at other times, one of the terms may be used to identify a reasonably distinct subtype of such computer highjacking activity.

In a broad sense, adware, spyware and cookies are types of computer viruses that invade and infect a user's computer system and cause effects that are ordinarily regarded as detrimental to the user's infected system. These types of computer viruses are distinguished, however, from the dangerous virus varieties that cause system crashes or destroy stored applications and data, as well as from less-destructive but nevertheless annoying computer viruses that can hijack a computer.[84] The distinction is that adware, spyware and cookies are normally comparatively benign, do not usually cause permanent damage, and are not done maliciously but rather for some commercial purpose.[85] In the case of *cookies* not associated with adware, the computer user may not even know that his/her system has been infected.[86]

For purposes of this article, the question is whether the act of an out-of-state business transmitting a software package to a user's computer, without his/her knowledge or consent, which software is downloaded and causes his/her computer to operate differently than it did before, with the objective of commercial gain confers long-arm jurisdiction over the out-of-state business. Only a single court case on point has been located; and, as explained below, the decision in that case was not dispositive on the central issue of personal jurisdiction.

In *Sotelo v. DirectRevenue, LLC*,[87] a 2005 U.S. District Court decision, plaintiff Stephen Sotelo filed a five-count putative class action complaint against an interrelated group of defendants alleging that, without his consent, the defendants caused spyware to be downloaded onto his personal computer.[88] The complaint alleged that the spyware tracked plaintiff's Internet use, invaded his privacy, and caused damage to his computer.[89] The complaint further alleged that the spyware was secretly

[84] "Spyware differs from viruses and worms in that it does not usually self-replicate. Like many recent viruses, however, spyware – by design – exploits infected computers for commercial gain. Typical tactics furthering this goal include delivery of unsolicited pop-up advertisements; theft of personal information (including financial information such as credit card numbers); monitoring of Web-browsing activity for marketing purposes; or routing of HTTP requests to advertising sites. *See* Spyware Definition, *supra* note 82, at http://en.wikipedia.org/wiki/Spyware.

[85] *See* Spyware Definition, *supra* note 82, at http://en.wikipedia.org/wiki/Spyware.

[86] *See supra* note 83.

[87] 384 F. Supp. 2d 1219 (N.D. Ill. 2005).

[88] *Id.* at 1223.

[89] *Id.* at 1224.

installed on his computer by bundling it with other legitimate software (e.g., games) that is available free on the Internet.[90] Furthermore, the complaint alleged that the spyware was purposely designed to be difficult to remove from a computer hard drive once it was installed.[91]

Through such spyware, advertisers and advertising agents were alleged to gain access to millions of computers.[92] Through its monitoring function, the spyware could track and identify areas of interest to the computer owner, and then bombard him/her with targeted advertising that constantly pops up covering whatever web page the computer user might be viewing.[93] Additionally, the complaint alleged that the targeted ads were designed to bypass commonly-used software designed to block pop-up ads.[94] Such ads would be sent not just once but repeatedly over periods lasting weeks or even months.[95] The *Sotelo* case thus represented a classic example of the use of spyware or adware.

In partial response to the complaint, defendant DirectRevenue Holdings (DR Holdings), presumably the only deep pocket among the multiple defendants, filed a motion to dismiss under Fed. R. Civ. P. 12(b)(2) for lack of personal jurisdiction.[96] This defendant contended that, although it was the parent of another defendant, which in turn was the parent of two other defendants in the case, it had not personally engaged "in any of the Internet-related business activities that are alleged in the Complaint."[97]

Specifically, DR Holdings argued that it was not registered to do business in Illinois (the forum state); did not maintain any websites that were accessible to customers in Illinois; did not maintain any office facilities, bank accounts or personnel in Illinois, or conduct any business in Illinois.[98] Thus, DR Holdings argued that it lacked the minimum contacts with the forum state that would justify the exercise of personal jurisdiction, that it had not purposefully availed itself of the privilege of conducting activities in Illinois, and that it could not have reasonably anticipated being haled into court in Illinois.[99]

Based on the general rule that "the jurisdictional contacts of a subsidiary corporation are not imputed to the parent,"[100] and on plaintiff's failure "to allege or make any effort to demonstrate that the

[90] *Id*.
[91] 384 F. Supp. 2d at 1224.
[92] *Id*.
[93] *Id*.
[94] *Id*.
[95] 384 F. Supp. 2d at 1224.
[96] *Id*. at 1225.
[97] *Id*.
[98] *Id*.
[99] 384 F. Supp. 2d at 1225.
[100] *Id*. at 1226.

corporate veil should be pierced,"[101] the Court granted DR Holding's motion to dismiss for lack of personal jurisdiction.[102] Under the particular facts of this case, it is hard to see how any of several different approaches to Internet jurisdiction reviewed above would have led to a different outcome.

On the other hand, if not for the protection of the corporate veil, it appears that all of the Internet jurisdiction approaches previously discussed would have clearly led to the exercise of personal jurisdiction in Illinois.

C. Impact of Internet Search Engines on Passive Websites

Still another familiar aspect of modern e-commerce is the existence of a growing number of increasingly sophisticated Internet search engines such as Google. Internet search engines use proprietary software technology and extensive data bases to assist computer users in carrying out highly targeted key word searches. Some of the complex Boolean logic that early computer users had to employ to search for desired information on the World Wide Web has now been designed into the software that runs the current generation of Internet search engines.

In response to a key word or phrase entry, an Internet search engine will identify a number of Internet websites responsive to a request, in a priority order that is based partly on the perceived relevance of the website (which can be dramatically impacted by careful website design) and sometimes based partly on payment for priority positioning, together with a click-on hyperlink to each identified website. As a result of such Internet search engines, even what might be regarded as a completely passive website[103] may be brought to a computer user's attention, not because the user specifically sought out that website but rather because of the intervening actions of a third party, namely the search engine provider.

On the one hand, because the computer user needs to both initiate the search engine function and, subsequently, also initiate the hyperlink connection to the website, this e-commerce situation could be seen as fitting comfortably into previous Internet jurisdiction case law. But, complicating wrinkles may exist. What if the website was specifically tailored and customized to be highly prioritized in the search engine requests of particular categories of consumers? What if the website owner has paid the search engine provider for preferential prioritization in reporting search results? Although these are not per se website interactivity factors in the context of the *Zippo* sliding scale approach,[104]

[101] *Id.* at 1227.
[102] *Id.*
[103] *See* notes 5-10 and accompanying text.
[104] *Id.*

they may have a bearing on the jurisdictional outcome under alternative Internet jurisdiction approaches, particularly under the fundamental principles approach discussed earlier.

CONCLUSION

The rapid growth and changing dimensions of electronic commerce have confounded the courts, especially in connection with personal jurisdiction issues. The *Zippo* sliding scale approach, once touted as a flexible, enlightened model for addressing Internet personal jurisdiction questions, has now largely been discredited. In its place, commentators approaching this problem in different ways and from different starting points seem to be converging on a back to basics theme that would directly link the technological realities of e-commerce to traditional principles of long-arm jurisdiction.

After exploring the historical foundations of traditional long-arm jurisdiction principles, this article examined how some familiar e-commerce practices might be analyzed under different approaches to personal jurisdiction, including under a foundational principles approach. This article argued that such a foundational principles approach is more likely to lead to a consistent, predictable body of case law in connection with current e-commerce practices than other competing approaches, and it will also better assimilate new e-commerce strategies, as they emerge, into the existing body of personal jurisdiction jurisprudence.

THE EFFECT OF *MINNESOTA V. WHITE* ON CAMPAIGNING FOR THE JUDICIARY

by LOUIS ALFRED TROSCH, SR.[*] AND RONALD A. MADSEN[**]

I. INTRODUCTION

Candidates running for judicial office in states that require them to be selected by popular election face an impossible dilemma. On one hand, they must be able to express their viewpoints on various legal or political issues to the populace in order to attract the needed votes and monetary finances to run an effective political campaign. However, by taking positions on controversial legal and political topics, the candidate may be in violation of Canon 7 of the 1972 American Bar Association Model Code of Judicial Conduct[1] which provides that any candidate running for political office:

> Should not make pledges or promises of conduct in office other than the faithful and impartial performance of the duties of the office; announce his views on disputed legal or political issues; or misrepresent his identity, qualifications, present position or other fact.[2]

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[1] MODEL CODE OF JUDICIAL CONDUCT CANON 7B(1)(c) (1972).

[2] *Id.*

Many states, including Minnesota, have adopted a version of Canon 7. Violation of the provision could cause the candidate to be disbarred, placed on probation or suspended.[3]

It is this judicial dilemma that was squarely addressed by the United States Supreme Court in the landmark case, *Republican Party of Minnesota v. White*[4] in 2002. The Supreme Court ruled that Minnesota's version of Canon 7 violates the judicial candidate's right of free speech. Candidates for judicial office may now speak in a partisan fashion without fear of reprimand from either the state judicial standards commissions or the state bars. Some of the expected consequences are politicization of the judiciary, an increase in the number of opportunistic candidates "playing to the public,"[5] and an increased use of deceptive sound bites on radio and television.[6]

It is the purpose of this article to analyze the legal reasoning leading to the decision protecting a judicial candidate's freedom of speech rights during an election campaign. The article will also discuss the negative ramifications of the court decision, other methods of judicial selection and finally recommend a proposal for reforming the system so that the impartiality and integrity of judicial decisions can be maintained.

II. THE ANNOUNCE CLAUSE LIMITED JUDICIAL CAMPAIGN SPEECH

The American Bar Association first created a model code of judicial ethics in 1924.[7] Recognizing the potential ill effects of political speech in judicial elections, the original provision restricting judicial campaign speech stated that a judge "should not announce in advance his conclusions of law on disputed issues to secure class support."[8] The canons also declared that judicial candidates "should avoid making political speeches."[9] In this context, "political" appears to have meant "partisan;" thus judges were to refrain from giving speeches that

[3] *See* MINN. RULES OF BD. ON JUDICIAL STANDARDS R. 4(a)(6), 11(d) (2003).

[4] 536 U.S. 765 (2002).

[5] Amy M. Craig, *The Burial of An Impartial Judicial System: The Lifting of Restrictions on Judicial Candidate Speech in North Carolina*, 33 WAKE FOREST L. REV. 413, 436 (interview with Thomas W. Ross, Resident Superior Court Judge for Guilford Co., N.C., in Concord, N.C. (Jan. 13, 1998)) (1998).

[6] *See id.* (citing *Judges on the Stump?,* NEWS & OBSERVER (Raleigh, NC), July 18, 1997, at A14).

[7] *See* STEPHEN GILLERS & ROY D. SIMON, JR., REGULATION OF LAWYERS: STATUTES AND STANDARDS 621 (2003).

[8] ABA CANONS OF JUDICIAL ETHICS CANON 30 (1924). Only Montana employs this standard of restraint of judicial speech. *See* Mont. Canons of Judicial Ethics Canon 30 (1963).

[9] ABA CANONS OF JUDICIAL ETHICS CANON 28 (1924).

advanced or were connected to a particular political party's cause.[10] The Canons of Judicial Ethics were adopted and relied upon by most states for nearly fifty years.[11]

During the late 1960s, the ABA created the Special Committee on Standards of Judicial Conduct "to draw up modern standards and to replace the Canons of Judicial Ethics."[12] The American Bar Association adopted the committee's Code of Judicial Conduct in 1972.[13]

Canon 7 of the 1972 Code of Judicial Conduct forms the basis of the announce clause which states that a candidate, including an incumbent judge, "should not…announce his views on disputed legal or political issues…."[14] The announce clause was adopted in part because it was believed that a candidate's views on these issues were irrelevant to his or her tasks as a judge.[15] The 1972 rule is more restrictive than the 1924 canons in that it prohibits a judicial candidate from announcing his or her position on any contemporary political matter that may be controversial.[16] The announce clause was stricken down in 2002 by the landmark decision, *Republican Party of Minnesota v. White.*[17]

Canon 7 does permit candidates to engage in some political activities aimed at improving the law.[18] The 1972 Model Code allows candidates to engage in political activities "on behalf of measures to improve the law, the legal system, or the administration of justice."[19] This provision has been criticized as being a type of "catch-22." Judge Posner opined that, "almost anything a judicial candidate might say about 'improving the law' could be taken to cast doubt on his capacity to decide some case impartially, unless he confined himself to the most mundane and technical proposals for law reform."[20] The 1972 Model Code was

[10] *See* PATRICK M. MCFADDEN, ELECTING JUSTICE: THE LAW AND ETHICS OF JUDICIAL ELECTION CAMPAIGNS 86 (1990).

[11] GILLERS & SIMON, *supra* note 7, at 621.

[12] *Id*. The Special committee on Standards of Judicial Ethics was chaired by noted jurist and then California Supreme court Justice Robert Traynor. *Id*.

[13] *Id*.

[14] MODEL CODE OF JUDICIAL CONDUCT CANON 7B(1)(c) (1972). The Model Code provides that candidates for judicial office, "should not make pledges or promises of conduct in office other than the faithful and impartial performance of the duties of the office; announce his views on disputed legal or political issues; or misrepresent his identity, qualifications, present position, or other fact." *Id*.

[15] *See* MCFADDEN, *supra* note 10, at 85.

[16] *See id*. at 86.

[17] 536 U.S. at 780-81.

[18] *See id*. at 87.

[19] MODEL CODE OF JUDICIAL CONDUCT CANON 7A(4) (1972).

[20] Buckley v. Illinois Judicial Inquiry Bd., 997 F.2d 224, 229 (7th Cir. 1993) (alteration in original).

designed to be more enforceable than the 1924 canons.[21] The 1972 Model Code announce clause was adopted by half of the states.[22]

In the 1980s, the ABA examined the Model Code in an effort to provide more guidance on the political conduct of judges and judicial candidates.[23] In 1990, the ABA issued a redrafted Model Code of Judicial Conduct.[24] The 1972 version of Canon 7 was renumbered as Canon 5 in the 1990 Model Code. The 1990 Model Code replaced the announce clause with narrower language. Canon 5A(3)(d) declares that a judicial candidate shall not:

> Make pledges or promises of conduct in office other than the faithful and impartial performance of the duties of the office; make statements that commit or appear to commit the candidate with respect to cases, controversies or issues that are likely to come before the court; or knowingly misrepresent the identity, qualifications, present position or other fact concerning the candidates or an opponent.[25]

The 1990 Model Code attempts to replace the broad prohibition that the 1972 Model Code imposed against candidates announcing their views on disputed legal or political issues with a more narrow rule against making statements that appear to improperly commit the candidate to matters likely to come before the court to which the candidate seeks election.[26] The ABA promulgated the revised rule to balance the need for a rule consistent with the constitutional guarantee of free speech, and the need to prevent the harm that can come from statements damaging to the appearance of judicial integrity and impartiality.[27] Since the 1990 Model Code addresses the ethical conduct of elected, appointed and merit-based judges, its commit clause has been adopted by many states.[28]

[21] *See* THEODORE J. BOUTROUSE, JR., ET AL., STATE JUDICIARIES AND IMPARTIALITY; JUDGING THE JUDGES 121 (Roger Clegg & James D. Miller, eds., 1996); *see also* MODEL CODE OF JUDICIAL CONDUCT pmbl. (1972).

[22] *See id*. The states that had adopted the prohibition include: Alaska, Arkansas, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Minnesota, Mississippi, Missouri, Nebraska, New York, North Carlina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Tennessee, Washington, West Virginia, and Wyoming. *Id*.

[23] *See id*. at 121.

[24] THE MODEL CODE OF JUDICIAL CONDUCT (1990) was adopted by the House of Delegates of the American Bar Association on August 7, 1990. Model Code of Judicial Conduct, preface (1990).

[25] MODEL CODE OF JUDICIAL CONDUCT CANON 5A(3)(d) (1990).

[26] *See* LISA L. MILORD, THE DEVELOPMENT OF THE ABA JUDICIAL CODE 50 (1992).

[27] *See id*.

[28] Prior to the Court's decision in White, the following states had language similar to the 1990 Model Rule's commit clause: Alaska, Arizona, Arkansas, Georgia, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Nebraska, New Mexico, New York, North

III. *REPUBLICAN PARTY OF MINNESOTA V. WHITE*

Former Minnesota Supreme Court candidate Gregory Wersal sought a declaratory judgment that the announce clause[29] in Minnesota's Judicial Ethics Canon violated the First Amendment. Minnesota's judicial election codes required that a "candidate for a judicial office, including an incumbent judge: shall not…announce his or her views on disputed legal or political issues…."[30]

Minnesota selects its judges by popular election.[31] The judicial candidates have been subject to the restrictions of Minnesota Judicial Ethics Canon 5 since 1974.[32] The campaign restrictions place a significant burden on candidates as they are subject to disciplinary action for failure to comply.[33] Disciplinary action for an incumbent judge who is found in violation of the cannons may include removal, censure, civil penalties and suspension without pay.[34] Attorneys running for judicial office who fail to comply with the Code of Judicial Conduct may be disbarred, placed on probation or suspended.[35]

Wersal ran for associate justice of the Minnesota Supreme Court in 1996.[36] During his campaign, he distributed literature criticizing several Minnesota Supreme Court decisions on issues such as crime, welfare, and abortion.[37] One piece of his campaign literature stated, "[t]he Minnesota Supreme Court has issued decisions which are marked by their disregard for the legislature and a lack of common sense."[38] It went on to criticize a decision excluding from evidence confessions by criminal

Dakota, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Washington, Wisconsin, and Wyoming.

[29] The announce clause is found in Minnesota Code of Judicial Conduct Canon 5(A)(3)(d)(i), which says a candidate for judicial office:

> Shall not make pledges or promises of conduct in office other that the faithful and impartial performance of the duties of the office; announce his or her views on disputed legal or political issues; or misrepresent his or her identity, qualifications, present position or other fact, or those of the opponent….

MINN. CODE OF JUDICIAL CONDUCT CANON 5(A)(3)(d)(i) (2003).

[30] *White*, 536 U.S. at 769-70; *see also* Republican Party of Minn. v. Kelly, 996 F. Supp. 875, 878 (D. Minn. 1998).

[31] *See* MINN. CONST. art. VI, 7.

[32] *See White*, 536 U.S. at 768.

[33] *See* MINN. RULES OF BD. ON JUDICIAL STANDARDS R. 4(a)(6), 11(d) (2003).

[34] *See id.*

[35] *See* MINN. RULES ON LAWYERS PROF'L RESPONSIBILITY R. 8-14, 15(a) (2003). Attorneys running for judicial office must comply with the Code of Judicial Conduct. MINN. RULES OF PROF'L CONDUCT R. 8.2(b) (2003).

[36] *See White*, 536 U.S. at 768.

[37] *See id.*

[38] *Id.* at 771.

defendants that were not tape-recorded, asking "should we conclude that because the Supreme Court does not trust police, it allows confessed criminals to go free?"[39] Other campaign literature criticized a decision striking down a state law restricting welfare benefits, asserting that "it's the Legislature which should set our spending policies."[40] Wersal characterized a decision requiring public financing of abortions for poor women as "unprecedented" and as a "pro-abortion stance."[41]

A complaint against him was filed with the Office of Lawyers Professional Responsibility, the agency which, under the direction of the Minnesota Lawyers Professional Responsibility Board, investigates and prosecutes ethical violations of lawyer candidates for judicial office.[42] The complaint was dismissed by the Director of the Lawyers Board upon a finding that Wersal's criticism of prior Minnesota Supreme Court decisions did not violate the announce clause and noting that language similar to the announce clause had been either struck down or interpreted narrowly in other jurisdictions.[43] Nevertheless, Wersal withdrew his candidacy for judicial office, "fearing that further ethical complaints would jeopardize his ability to practice law."[44]

Two years later, Wersal ran again for associate justice.[45] During his 1998 campaign, he sought an advisory opinion from the Lawyers Board regarding whether the announce clause of Canon 5 would be enforced.[46] The Lawyers board replied that it could not advise him on whether it would enforce the announce clause as he had not provided information about any particular statements he wished to make.[47] Wersal filed suit in Federal District Court seeking a declaration that the announce clause violates the First Amendment and an injunction against its enforcement.[48] Wersal alleged that the announce clause restrained him from answering questions during his 1998 campaign, and that his inability to announce his views cost him potential voter support.[49] The district court denied Wersal's motion for an injunction,[50] and the Eighth Circuit affirmed.[51]

[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *See id.* at 768-69.
[43] *See* Republican Party of Minn. v. Kelly, 247 F.3d 854, 859 (8th Cir. 2001).
[44] *Id.*
[45] *See id.*
[46] *See id.*
[47] *See id.*
[48] *See White*, 536 U.S. at 769-70.
[49] *See id.*
[50] *See Kelly*, 996 F. Supp. at 880.
[51] *See Kelly*, 247 F.3d. at 885.

Writing for a five justice majority, Justice Scalia stated that Canon 5 regulates a form of speech that is "at the core of our electoral process and of the First Amendment freedoms"[52] and cannot do so unless it is narrowly tailored to protect a compelling state interest.[53] The Lawyers Board and the Minnesota Board on Judicial Standards ("Judicial Board") argued that the announce clause is a narrowly tailored mechanism for protecting the dual state interests of electing an impartial state judiciary and creating the appearance of an impartial state judiciary.[54]

Because it had not been defined by the Minnesota Code of Judicial Conduct, the ABA Codes of Judicial Conduct, the Eight Circuit's opinion or the briefs of the parties,[55] Justice Scalia assessed three possible definitions of "impartiality" to test the viability of the purported state interest.[56] The first possible meaning of "impartiality" in the judicial context is "the lack of bias for or against either *party* to the proceeding."[57] Impartiality in this sense, Justice Scalia observed, "guarantees a party that the judge who hears his case will apply the law to him in the same way he applies it to any other party."[58] Minnesota's announce clause is not narrowly tailored to prevent this harm as it restricts speech for or against particular issues rather than speech for or against particular parties.[59] If a candidate has taken a stance on a particular issue, any party taking the opposite position is likely to lose because the judge is applying the law, as he sees it, evenhandedly.[60] The announce clause, therefore, does not even address impartiality or the appearance of impartiality in this sense.[61]

Justice Scalia observed that another, less common, usage of "impartiality" in the judicial context is "the lack of preconception in favor of or against a particular *legal view*."[62] This type of impartiality would guarantee litigants an equal opportunity to persuade the court on the legal points of their case.[63] While this may be the type of impartiality protected by Minnesota's announce clause, Justice Scalia cautioned that

[52] *White*, 536 U.S. at 781.
[53] *See id.*, at 777.
[54] *See id.*, at 775.
[55] *See id.*
[56] *See id.* at 775-85.
[57] *Id.* at 775 (emphasis in original) (noting that this is the traditional use of the term)(citing WEBSTER'S NEW INTERNATIONAL DICTIONARY 1247 (2d ed. 1950) (defining "impartial" as "not partial; esp., not favoring one more than another; treating all alike; unbiased; equitable; fair; just")).
[58] *Id.* at 776.
[59] *See id.* at 776.
[60] *See id.* at 776-77.
[61] *See id.*
[62] *Id.* at 777.
[63] *See id.*

it is not the sort of interest that justifies restricting political speech.[64] He noted that this type of impartiality or its appearance is not only impossible to achieve, it is not desirable.[65] The Minnesota constitution requires judicial candidates to be learned in the law[66] and the majority of such candidates are likely to come to the bench when their legal careers have been well established. Thus, "proof that a justice's mind at the time he joined the Court was a complete *tabula rasa* in the area of constitutional adjudication would be evidence of lack of qualification, not lack of bias."[67]

Finally, the Court analyzed a third possible meaning of "impartiality": open-mindedness.[68] This sort of impartiality would require a judge to remain open to persuasion when issues arise in a pending case.[69] The Lawyers Board and the Judicial Board argued that the announce clause serves this type of impartiality because "it relieves a judge from pressure to rule a certain way in order to maintain consistency with statements the judge has previously made."[70] Justice Scalia admonished that this function of impartiality is implausible as judicial candidates often express their views on disputed legal issues in classes, books, papers and speeches[71] and are encouraged to do so by the Minnesota Code.[72] Statements made in election campaigns are such a small portion of public commitments to legal positions in comparison.[73] Justice Scalia observed that the announce clause is "woefully under inclusive" as a means of pursuing the objective of open-mindedness because it creates an absurdity.[74] Judicial candidates may state their views on disputed legal issues prior to announcing their candidacy and after being elected to the bench, but are prohibited from making the same statements while running for office.[75] Furthermore, the problem of judges feeling compelled to rule consistently with views previously expressed is addressed by a separate provision of the Minnesota Code of

[64] *See id*.

[65] *See id*. at 778.

[66] MINN. CONST. art. VI, §5.

[67] *See White*, 536 U.S. at 778 (quoting Laird v. Tatum, 409 U.S. 824, 835 (1972) (memorandum opinion)).

[68] *See id*.

[69] *See id*.

[70] *Id*. at 778-79.

[71] *See id*. at 779.

[72] *See id*. at 779 (citing MINN. CODE OF JUDICIAL CONDUCT 4(B) (2002) (a judge may write, lecture, teach, speak and participate in other extra-judicial activities concerning the law…"); MINN CODE OF JUDICIAL CONDUCT 4(B), Comment. (2002) ("To the extent that time permits, a judge is encouraged to do so…")).

[73] *See id*.

[74] *See id*. at 780.

[75] *See id*.

Judicial Conduct which prohibits campaign "pledges or promises."[76] Justice Scalia regarded as doubtful that:

> a mere statement of position enunciated during the pendency of an election will be regarded by a judge as more binding—or as more likely to subject him to popular disfavor if reconsidered—than a carefully considered holding that the judge set forth in an earlier opinion denying some individual's claim to justice.[77]

Finally, Justice Scalia warned that allowing the government to prohibit candidates from freely expressing their views on matters of public importance contravenes First Amendment jurisprudence.[78] He further noted that "'debate on the qualifications of candidates' is 'at the core of our electoral process and of the First Amendment freedoms….'"[79]

IV. EFFECT OF *WHITE* ON JUDICIAL CAMPAIGNS

Candidates for judicial office may now speak in a more partisan fashion with less fear of reprimand from either the state judicial standards commissions or the state bars.

A. Politicization of the Judiciary

Clearly, the relaxed standards serve only to increase the politicization of state judicial elections. The judiciary has long served as a check on the power of the elective branches of government and as a mechanism that ensures the stability of transcending legal principles imbedded in the Constitution, statutes and common law. The politicization of the judiciary threatens to erode not only public respect for the judiciary, but also the ability of the courts to fulfill their constitutional role.

Partisan elections in general have many disadvantages. Opponents often argue that judicial candidates are not selected based on merit, but rather on the basis of political criteria,[80] resulting in elections turning on national politics rather than judicial qualifications.[81] Besides spending money on campaigns, a judge must spend time that otherwise could be

[76] *See id.*
[77] *Id.* at 780-81.
[78] *Id.* at 780-81.
[79] *Id.*
[80] *See* Kurt E. Scheuerman, *Rethinking Judicial Elections*, 72 OR. L. REV. 459, 461 (1993) (citing Patrick W. Dunn, *Comment, Judicial Selection in the States: A Critical Study with Proposals for Reform*, 4 HOFSTRA L. REV. 267, 289-90 (1976)).
[81] *See id.* (citing W. St. John Garwood, *Democracy and the Popular Election of Judges: An Argument*, 16 SW. L.J. 216, 222 (1962)).

used for fulfilling judicial duties, such as hearing and deciding cases.[82] Partisan elections may also serve as a deterrent to lawyers who might otherwise seek judgeships. Many successful lawyers may be reluctant to invest their "reputation, time, money and effort seeking a job that is neither guaranteed nor highly paid."[83] An additional deterrent is the possibility of having to answer to political parties and contributors.[84] Partisan elections are also believed to damage the prestige and dignity of the judiciary.[85]

Another problem raised by partisan elections is the "majoritarian difficulty."[86] A major function of an independent judiciary is judicial review, whereby the courts can step in and protect the interests of the minority against the actions of the majority when they overstep constitutional bounds. However, if the judiciary is also electorally accountable, there will be a tendency for judges to follow the whims of the majority, possibly at the expense of the minority.[87] Alexis de Tocqueville, in 1835, recognized judicial elections as an encroachment on judicial independence.

> Some other state constitutions make the members of the judiciary elective, and they are even subjected to frequent re-elections. I venture to predict that these innovations will sooner or later be attended with fatal consequences; and that it will be found out at some future period that by thus lessening the independence of the judiciary they have

[82] *See* Judith L. Maute, *Selecting Justice in State Courts: The Ballot Box or the Backroom?*, 41 S. TEX. L. REV. 1197, 1205 (2000).

[83] *Id*. at 1205 (citing CHARLES H. SHELDON & LINDA S. MAULE, CHOOSING JUSTICE: THE RECRUITMENT OF STATE AND FEDERAL JUDGES 70 (1997)).

[84] *Id*.

[85] Scheuerman, *supra* note 80, at 461 (quoting Dorothy W. Nelson, *Variations on a Theme—Selection and Tenure of Judges*, 36 S. CAL. L. REV. 4, 30 (1962) ("Under the partisan system, there is the spectacle of tavern electioneering and billboard advertising by judges.")).

[86] A full discussion of majoritarianism and counter-majoritarianism is beyond the scope of this piece. See generally Steven P. Croley, *The Majoritarian Difficulty: Elective Judiciaries and the Rule of Law*, 62 U. CHI. L. REV. 689, 725 (1995); Scheuerman, *supra* note 80, at 471-76; Maura Anne Schoshinski, *Towards an Independent, Fair, and Competent Judiciary: An Argument for Improving Judicial Elections*, 7 GEO. J. LEGAL ETHICS 839, 843-44 (1994).

[87] *See generally* Croley, *supra* note 86; Scheuerman, *supra* note 80, at 471-76. "This independence of the judges is equally requisite to guard the constitution and the rights of individuals, from the effects of those ill humors, which the arts of designing men, or the influence of particular conjunctures, sometimes disseminate among the people themselves, and which, though they speedily give place to a better information, and more deliberate reflection, have a tendency, in the meantime, to occasion dangerous innovations in the government, and serious oppressions of the minor party in the community." ALEXANDER HAMILTON, THE FEDERALIST NO. 78, at 508 (First Modern Library ed., 1941) (quoted in Scheuerman, *supra* note 80, at 472).

> attacked not only the judicial power, but the democratic republic itself.[88]

William Howard Taft also criticized judicial elections. In an article published in 1913, he stated, "the instances of great and able judges who have been placed on the bench by election are instances of the adaptability of the American people and their genius for making the best out of bad methods, and are not a vindication of the system."[89] Thus, partisan elections have many disadvantages and have been criticized from their inception to the present day. Because of these problems and criticisms, all but seven states have abandoned this method of selection.

Most commentators argue that nonpartisan elections are an inferior alternative to partisan elections rather than an improvement.[90] Voters are less informed than in partisan elections because they lack the important party voting cue, resulting in votes based upon other irrelevant factors, such as ballot position and name.[91] Low voter turnout and drop-off are also prevalent in nonpartisan elections.[92] Like partisan elections, nonpartisan elections are becoming more expensive and time consuming.[93] Some commentators argue they are more expensive than partisan elections because it costs more to inform the voters in the absence of party labels.[94] William Howard Taft specifically criticized nonpartisan elections because they made it possible for unqualified candidates who could not even get the support of a political party to get elected.[95] One commentator aptly stated that nonpartisan elections "possess all the vices of partisan elections and none of the virtues."[96]

Appellate and trial level judicial candidates must be able to reevaluate their views in the light of an adversarial presentation and to

[88] 1 ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 289 (Vintage ed. 1954) (quoted in Robert L. Brown, *From Whence Cometh Our State Appellate Judges: Popular Election Versus the Missouri Plan*, 20 U. ARK. LITTLE ROCK L. J. 313, 314-15 (1998)).

[89] William H. Taft, *The Selection and Tenure of Judges*, 38 A.B.A. REP. 418, 421 (1913).

[90] *See* Peter D. Webster, *Selection and Retention of Judges: Is There One Best Method?*, 23 FLA. ST. U.L. REV. 1, 26 (1995).

[91] *See id.*

[92] *See id.*

[93] *See id*. (noting also that the problems of campaign financing and the perception that justice is for sale apply equally to nonpartisan elections). Former Chief Justice Exum groups all elections—partisan, nonpartisan, and retention—when describing the disadvantages of raising money, distractions from regular judicial duties, deterrent to many able lawyers, and that "they are at odds with the notion that judges should be career public servants." James Exum, *Judicial Selection in North Carolina,* 35 N.C. ST. B.Q., Summer 1988, at 8-10.

[94] *See id*. at 27 (citing Anthony Champagne, The Selection and Retention of Judges in Texas, 40 SW. L.J. (Special Issue), May 1986, at 63).

[95] Taft, *supra* note 89, at 422-23 (cited in Croley, *supra* note 86, at 723-24).

[96] Webster, *supra* note 90, at 26.

apply the governing rule of law even when inconsistent with those views.[97] Trial court judges in particular have an obligation to follow the precedent of the State's highest court, not his or her personal proclivities or the whims of the populous.

As the judiciary becomes politicized, lawmakers become more willing to criticize judges for controversial decisions. Campaigns that emphasize a candidate's personal predilections rather than his or her qualifications for judicial office compromise the judicial reputation for impartiality.[98]

> Informed criticism of court rulings, or of the professional or personal conduct of judges, should play an important role in maintaining judicial accountability. However, attacking courts and judges—not because they are wrong on the law or the facts of a case, but because the decision is considered wrong simply as a matter of political judgment—maligns one of the basic tenets of judicial independence—intellectual honesty and dedication to enforcement of the rule of law regardless of popular sentiment. … What is so troubling about criticism of court rulings and individual judges based solely on political disagreement with the outcome is that it evidences a fundamentally misguided belief that the judicial branch should operate and be treated just like another constituency-driven political arm of government.[99]

Public criticism of judicial decisions by the legislative and executive branches implies that judges should modify their rulings even if they are consistent with controlling legal precedent. This criticism misrepresents the role of the judiciary to the public, giving voters the false impression that a candidate for the judiciary will be able to and should decide cases based on his or her personal views rather than consistently with the legal principles that have ensured the stability of American jurisprudence for over two hundred years.

While the courts have never been entirely divorced from politics, one poll shows that politics are more influential today than ever before.[100] Former federal appeals court judge, congressman and White House counsel, Abner J. Mikva recalled "When I started practicing law in Chicago [in 1952]…. It was a patronage operation, and you became a judge by kowtowing to the powers that be."[101] The Justice at Stake Campaign, a political watchdog group in Washington, polled eight

[97] *See id.*

[98] *See* White, 536 U.S. at 801 (Stevens, J., dissenting).

[99] *Id.* (Stevens, J., dissenting) (quoting De Muniz, *Politicizing State Judicial Elections: A Threat to Judicial Independence*, 38 WILLIAMETTE L. REV. 367, 387 (2002)).

[100] *See* Mike France and Lorraine Woellert, *How Politics, Ideology, and Special Interests are Compromising the Courts*, BUSINESS WEEK, Sept. 27, 2004, at 38.

[101] *Id.*

hundred ninety-four elected judges in 2001 and 2002.[102] The findings were disturbing. Forty-eight percent of the polled judges "felt a 'great deal' of pressure to raise money during election years" and forty-six percent admitted that campaign contributions influenced their decisions.[103]

B. Unqualified Candidates

Complete freedom in political speech among judicial candidates will increase the number of ill-qualified candidates running for office. Former North Carolina Supreme Court Chief Justice James Exum commented on this problem when he addressed a Judicial Selection Study Committee:

> The skills needed for the job of judging have little or no relation to the skills needed to win elections. Although there are good judges who can also win elections, there are many potentially excellent judges who, for one reason or another, cannot, or do not want to try. The skills needed to be a good judge are not readily discernable in the electoral process.[104]

John Hill, former Chief Justice of the Texas Supreme Court offered a similar assessment:

> The qualities that make a good judge are different from the qualities that make a good politician, and it is by no means always the case that the two sets of qualities exist in the same person. When they do not, the chances are that in the primary election the less capable judicial candidate will be nominated.[105]

In 2002, a seat on the North Carolina Supreme Court was filled by a candidate with no judicial experience.[106] This is the first time a candidate with little or no judicial experience had won an appellate seat.[107] The election of judges thus opens up the bench to unqualified candidates and can also shut out those who are exceptionally qualified but not as well suited to the rigors of campaigning.

[102] *See id.*

[103] *See id.* (stating that 4% said that contributions had "a great deal of influence" on their decisions, 22% said "some influence," and 20% said "just a little influence").

[104] Exum, *supra* note 93, at 8.

[105] John L. Hill, Jr., *Taking Texas Judges Out of Politics: An Argument for Merit Election*, 40 BAYLOR L. REV. 339, 349 (1988) (citing McKnight, *How Shall Our Judges Be Selected?*, 5 TEX. L. REV. 470, 472-3 (1928)).

[106] *See* COURT WATCH OF NORTH CAROLINA, INC., ANALYSIS OF THE NORTH CAROLINA 2002 JUDICIAL ELECTIONS 3 (2003) (also reporting that two candidates with no judicial experience won seats on the North Carolina Court of Appeals in 2002).

[107] *See id.*

C. Special Interest Money Controls the Elected Judiciary

Judicial candidates are running attack ads, completing questionnaires detailing their beliefs, and soliciting funding from large donors—all things that were once considered beneath the dignity of the office.[108] The *White* decision has opened the door to a class of campaign speech that is "driving away potential judges, making partisan credentials of nominees more important than intellectual heft, putting pressure on jurists to favor contributors, eroding public respect for the bench, and little by little diminishing the ability of the courts to fulfill their constitutional role as a check on the power of the elective branches."[109]

Candidates seeking seats on appellate courts must often run statewide campaigns, attempting to reach as many voters as Senatorial candidates without the commensurate financial or staffing resources. Traditionally, judicial candidates relied on the local and state bars to support their campaigns with financial contributions and to educate the public about their qualifications. Special interest groups are increasingly turning to the courts to advance goals they cannot win legislatively[110] and candidates are finding the donations necessary to win elections.[111] In nine out of ten of the 2002 state judicial races in which television advertisements were used, the candidate with the most combined spending by himself and special interest groups won the election.[112]

There are two broad categories of interest groups fighting over the state judiciaries.[113] The first category consists of stake-holders in tort reform. The U.S. Chamber of Commerce, major corporations such as Home Depot and Wal-Mart Stores and some small businesses seek to outbid plaintiff's law firms and the Association of Trial Lawyers of America.[114] State judges are the target of these special interest groups because the majority of large product-liability and consumer-protection cases are filed in state courts.[115] "For the past decade or so, momentum has been on the side of the business community, which helped oust incumbents in Alabama, Mississippi, and North Carolina in 2000."[116]

[108] *See id.*
[109] France and Woellert, *supra* note 100, at 38.
[110] *See id.*
[111] *See* DEBORAH GOLDBERG & SAMANTHA SANCHEZ, JUSTICE AT STAKE CAMPAIGN, THE NEW POLITICS OF JUDICIAL ELECTIONS 2002: HOW THE THREAT TO FAIR AND IMPARTIAL COURTS SPREAD TO MORE STATES IN 2002 (Burt Brandenburg, ed. 2004) 7 (2004).
[112] *See id.*
[113] *See* France and Woellert, *supra* note 100, at 40.
[114] *See id.*
[115] *See id.*
[116] *Id.*

The second category of special interest groups focuses on social controversies such as gay marriage, affirmative action and abortion.[117]

The *White* decision enables judicial candidates to comment on policy issues, "prompting interest groups to elicit candidates' views on … hot-button issues—and [to] use the information to decide who gets money."[118] In Illinois in 2004, the Illinois Civil Justice League sent a questionnaire to all judicial candidates in the state seeking their positions on issues ranging from class-action rules to the constitutionality of punitive damages.[119] Similarly, the League of Christian Voters sought responses from Alabama Supreme Court candidates to questions about their church attendance and their definition of marriage.[120]

Candidates and interest groups spent over eight million dollars on television airtime in America's top one hundred media markets and the number of special interest groups buying airtime for state judicial races doubled from 2000 to 2002.[121] Advertisements are routinely crafted to offer voters clues as to how the candidate is likely to decide future cases.[122] Only thirty-six percent of 2002 Supreme Court candidate television advertisements focused on candidate qualification.[123] Jess Dickinson, a candidate for the Mississippi Supreme Court televised an advertisement saying, "frivolous lawsuits are costing us our health care and our jobs. Mississippi is suffering while a few lawyers are becoming multi-millionaires."[124] The opponent responded that "rich lawyers and big companies shouldn't control our courts,"[125] listing the business contributors to Dickinson's campaign.[126] Sue Myerscough, a candidate for the Illinois Supreme Court claimed that she "kept children safe from sexual predators and kept violent juveniles off our streets.… On the Supreme Court, I'll keep fighting because as any crime victim will tell you, there's a lot more to be done."[127] Myerscough's opponent defended

[117] *See id.*
[118] *Id.* at 41.
[119] *See id.*
[120] *See id.* (also citing a Christian Coalition questionnaire circulated among Georgia candidates inquiring whether they agreed with the majority opinion or the dissent in the U.S. Supreme Court's gay-rights case, Lawrence v. Texas).
[121] *See id.*
[122] *See* GOLDBERG & SANCHEZ, *supra* note 111, at 11 (also noting that in officially nonpartisan elections in which political parties were not mentioned on the ballot, third parties went out of their way to mention the party affiliation of candidates). *Id.*
[123] *See id.* at 12.
[124] *Id.*
[125] *Id.*
[126] *See id.*
[127] *Id.*

herself, stating that "she's worked with police, prosecutors and victims to put violent criminals and sexual predators in jail."[128]

All of the interest group advertisements in 2002 state judicial elections alluded to divisive political topics.[129] In the 2000 elections, eighty percent of special interest advertisements attacked candidates while fewer that twenty percent of candidates engaged in such tactics.[130] After significant voter backlash to such tactics, several 2002 candidates disavowed interest group support and less than fifty percent of special interest advertisements were negative in 2002.[131]

The *White* decision has created a judicial campaign culture that has become unmanageable as candidates cast aside traditional customs of civility and diplomacy and degrade themselves to the tactics of special interest politicking. This new tenor of judicial speech will diminish public respect for the judiciary and will cast doubt on any judicial politician's commitment to impartiality. "As more voters come to see court campaigns as a series of thinly veiled appeals to decide cases the 'right' way, they will increasingly wonder whether their judge's decisions are based on the facts and the law, or on pressure and promises and interest group dollars."[132]

V. A PROPOSAL FOR REFORM

States relied on provisions such as the "announce clause" to deter the type of polarizing political speech that has become common in judicial elections. Politicization and mud-slinging campaigns are not likely to be deterred by the more narrowly drawn restrictions of the "commit clause." The commit clause merely prevents a candidate from making statements that commit or appear to commit the candidate with respect to cases, controversies or issues that are likely to come before the court. The provision is too narrowly drawn and permits more general ideological statements about hot-button issues. In this new political climate in which money wins elections, candidates will continue to feel compelled to jump into the pockets of special interest groups.

[128] *Id.*

[129] *See id.* at 13.

[130] *See id.* at 14 (noting that the Law Enforcement Alliance of America produced an advertisement calling Jess Dickinson "a strong leader who supports the death penalty to keep our families same…a common sense leader who supports our right to bear arms. And Chuck McRae? He was the only judge to vote to reverse the conviction of the murderer of a three-year-old girl"). *Id.*

[131] *See id.*

[132] *Id.*

A. Eliminate the Electoral Process

Appointment was initially the most common method of selection in the early years after independence.[133] The independence of the judiciary is always cited as the major advantage of the appointive method of selection.[134] Proponents also argue that this method enables more women and minorities to reach the bench while weeding out unqualified candidates.[135] Currently, only four states use gubernatorial appointment and two more use legislative appointment.[136]

An appointive system of judicial selection would cure many of the ills of the election process, particularly in the wake of the *White* decision. A pure appointive system, however, has its disadvantages. Opponents argue that appointments are no less political than partisan elections,[137] and that appointments are most often based, not on qualifications, but primarily upon political considerations.[138] Opponents further argue that placing the appointment power in one individual leaves open the risk of a mistake in judgment, while legislative confirmation is an inadequate safeguard of judicial qualification.[139] That is, the system promotes judicial independence by having no substantial check on the judge after the confirmation process."[140] The Merit selection method is often suggested as an alternative that combines the benefit of the appointment process with public accountability.

The American Judicature Society, formed in 1913 for the purpose of improving the quality of the judiciary, proposed a system of selecting judges that utilized a "special commission" composed of members of the

[133] Norman Krivosha, *In Celebration of the 50th Anniversary of Merit Selection*, 74 JUDICATURE 128, 128 (1990).

[134] *See e.g.*, Scheuerman, *supra* note 80, at 462 (citing Harold J. Laski, The Technique of Judicial Appointment, 24 MICH. L. REV. 529, 532-33 (1926)).

[135] Webster, *supra* note 90, at 14 (citing Nicholas O. Alozie, *Distribution of Women and Minority Judges: The Effects of Judicial Selection Methods*, 71 SOC. SCI. Q. 315 (1990)). Another major advantage of appointment is the elimination of the need for judges to participate in lengthy campaigns that are expensive, consume valuable time, and degrade the dignity and prestige of the judiciary.

[136] *See* Larry C. Berkson, *Judicial Selection in the United States: A Special Report*, 64 AM. JUD. SOC'Y 176 (1980), *updated by* Rachel Caufield, *available at* http://www.ajs.org/js/berkson_2005.pdf (last visited February 16, 2006). Gubernatorial appointment is also used to fill unexpired terms in a majority of states, regardless of normal method of selection employed. *See* Webster, *supra* note 90 at 13.

[137] Scheuerman, *supra* note 80, at 462.

[138] *See* Webster, *supra* note 90, at 16 (citing Robert P. Davidow, *Judicial Selection: The Search for Quality and Representativeness*, 31 CASE W. RES. L. REV. 409, 428 (1981)).

[139] *See* Scheuerman, *supra* note 80, at 462-63 (citing Glenn R. Winters, *One-Man Judicial Selection*, 45 J. AM. JUDICATURE SOC'Y 198, 200 (1962)).

[140] *See* Anthony Champagne, *The Selection and Retention of Judges in Texas*, 40 SW. L.J. (Special Issue), May 1986, at 58 (quoted in Webster, *supra* note 6, at 14).

bar and the public.[141] First adopted by Missouri, this method has become known as merit selection.[142] Merit selection is generally viewed as a compromise between appointive methods and elective methods.[143] It originated in 1914 with a proposal by Albert M. Kales, law professor at Northwestern University and American Judicature Society (AJS) director of research. Kales' plan called for nomination by a nonpolitical committee, appointment by a popularly elected chief justice from the commission's list of nominees, and periodic unopposed retention elections.[144] The AJS endorsed the proposal in 1928 as modified by British political scientist, Harold Laski, who in 1926 suggested that the governor make the nomination instead of the chief justice.[145] The American Bar Association adopted the merit plan in 1937.[146] Currently,

[141] *See id*. at 415-16.

[142] *See id*. at 416. The Missouri Plan adopted in 1940 provided for the commission selection of judges of the supreme court, court of appeals and the circuit courts for Jackson County (Kansas City) and the city of St. Louis. *See* Peter D. Webster, *supra*, note 90 at 30. California actually adopted a type of merit plan before Missouri. California's plan for its supreme court and intermediate courts, still in use today, provides for the governor to make nominations to fill vacant seats which must be approved by a commission composed of the chief justice, a justice of the court of appeals and the attorney general. The judge must then stand for retention at regular intervals. *See* Maute, *supra*, note 82, at 1207-08.

[143] Webster, *supra* note 90, at 29. *See also* Scheuerman, *supra* note 80, at 463 ("This system is designed as a compromise between the accountability of elections and the independence achieved by appointment.").

[144] *See* Jona Goldschmidt, *Selection and Retention of Judges: Is Florida's Present System Still the Best Compromise?: Merit Selection: Current Status, Procedures, and Issues*, 49 U. MIAMI L. REV. 1, 7 (1994) (stating that the thirteen original colonies retained, but diffused the appointive power).

[145] *See id*. at 9 (citing Harold J. Laski, *The Technique of Judicial Appointmen*t, 24 MICH. L. REV. 529, 533 (1926) and *The Eligible List of Judicial Candidates*, 11 J. AM. JUDICATURE SOC'Y 131, 131-32 (1928)).

[146] *See id*. at 9-10. The ABA plan proposed

> (a) The filling of vacancies by appointment by the executive or other elective official or officials, but from a list named by another agency, composed in part of high judicial officers and in part of other citizens, selected for the purpose, who hold no other public office.
>
> (b) If further check upon appointment be desired, such check may be supplied by the requirement of confirmation by the State Senate or other legislative body of appointments made through the dual agency suggested.
>
> (c) The appointee shall after a period of service be eligible for reappointment periodically thereafter or go before the people upon his record with no opposing candidate, the people voting upon the question, Shall Judge Blank be retained in office?

See John Perry Wood, Basic *Propositions Relating to Judicial Selection, in Fourth Session*, 23 A.B.A. J. 102, 105 (1937) and Fourth Session, 23 A.B.A. J. 102, 108 (1937) (both cited in Goldschmidt, *supra* note 144, at 9-10.

sixteen states use some form of merit selection as their primary method of judicial selection.[147]

The primary argument in favor of merit selection is that it removes politics from the process of selecting judges,[148] while the periodic retention elections preserve accountability to the electorate.[149] Opponents to merit selection argue that politics is not removed from the selection process; rather it is moved "outside the light of the electoral system and into the backroom, allowing for private decision-making by politically-appointed nomination committees."[150] Both proponents and critics "agree that one key to the success of any type of 'merit' plan lies in the provisions regarding the composition and powers of the nominating commission."[151] Very often this key issue has not been adequately addressed, with the result being that politics is still a factor.[152] Opponents have also criticized merit selection for minimizing accountability by vesting control of the judicial system in the legal profession rather than the electorate.[153] Many of these same critics argue that unopposed retention elections are "undemocratic, misleading to voters, and allow little meaningful choice."[154] With the recent politicization of retention elections,[155] campaign contributions must still be sought if a judge is targeted by a special interest group.[156] Thus, retention elections

[147] *See* Larry C. Berkson, *Judicial Selection in the United States: A Special Report*, 64 AM. JUD. SOC'Y 176 (1980), *updated by* Rachel Caufield, *available at* http://www.ajs.org/js/berkson_2005.pdf (last visited February 16, 2006).

[148] Webster, *supra* note 90, at 31.

[149] *See* Scheuerman, *supra* note 80, at 463 (quoting Albert M. Kales, *Methods of Selecting and Retiring Judges*, 11 J. AM. JUDICATURE SOC'Y 133, 143 (1928)).

[150] *Id*. (citing Webster, *supra* note 90, at 32).

[151] Webster, *supra* note 90, at 32. "To have any hope of achieving its asserted goals, such a plan must be based upon provisions which ensure a truly independent, impartial, and diverse commission, with the power and resources to investigate thoroughly those who come before it as candidates. Most objective observers agree, further, that, in general, the plans currently in use have not included such provisions." *Id*.

[152] *Id*.

[153] *See* Scheuerman, *supra* note 80, at 464 (citing R. Neal McKnight et al., *Choosing Judges: Do the Voters Know What They're Doing?*, 62 JUDICATURE 94, 98 (1978)).

[154] Maute, *supra* note 82, at 1209 (citing John M. Roll, *Merit Selection: The Arizona Experience*, 22 ARIZ. ST. L.J. 837, 863-68 (1990)).

[155] *See* generally Brown**,** *supra* note 89, at 316 (discussing the 1986 Supreme Court retention election in California where three justices were removed and the 1996 Supreme Court retention election in Tennessee where one justice was removed after being targeted by special interest groups); See *Comment, Judicial Selection and Decisional Independence*, 61 LAW & CONTEMP. PROB. 141, 145-47 (1998) ("There is little if any discernible difference in tone among the contested partisan elections in Texas and Alabama, the Missouri Plan retention elections of Penny White in Tennessee and Rose Bird in California, and the confirmation hearings of Robert Bork and Clarence Thomas in the United States Senate."); Webster, *supra* note 90, at 35-37.

[156] Maute, *supra* note 82, at 1209-10.

can become very much like partisan and nonpartisan judicial elections, with the same problems and criticisms.[157] For example, as in nonpartisan elections, voters lack party label as a meaningful voting cue. Finally, the usually low-key nature of retention elections, the lack of information about judges up for retention, and the lack of understanding of the retention election itself have resulted in more significant voter drop-off than in either partisan or nonpartisan judicial elections.[158] Thus, without voter participation, accountability is lost and the merit selection system begins to look more like the appointive system, only with the addition of retention elections that can become nasty, partisan battles when special interest groups target a sitting judge for defeat.

We propose a modified gubernatorial appointment system. This method would provide for gubernatorial appointment of all judges from a pool of applicants screened by a "State Judicial Council"[159] subject to Senate confirmation. The screening is a variation on the nomination process found in traditional merit selection systems. Under this plan, the State Judicial Council (SJC) would constantly accept applications from attorneys, examine their qualifications, and make determinations as to their fitness for judicial office. The SJC would apply stringent standards regarding qualification, experience and integrity. Applicants for trial and appellate seats would be required to have demonstrated sufficient experience practicing at the trial and appellate levels.[160]

[157] *See* Webster, *supra* note 90, at 34 (stating that the "empirical evidence suggests that retention elections are subject to virtually all of the criticisms directed at partisan and nonpartisan judicial elections, and then some."). *See also* Exum, *supra* note 93, at 8-10 (describing disadvantages of partisan, nonpartisan, and retention elections together).

[158] *See id.*

[159] This "State Judicial Council" should be modeled after the one proposed by the Futures Commission. *See* Commission for the Future of Justice in the Courts of N.C., *Without Favor, Denial or Delay: A Court System for the 21st Century*, at 9 (1996) [hereinafter FUTURES COMMISSION REPORT]. Thus, it would be composed of the chief justice, chief judge of the Court of Appeals, a district attorney appointed by the district attorneys (the Futures Commission also proposed a unified circuit, but for our purposes we will use districts), a public defender chosen by that group, a district judge selected by district judges (circuit judge in FUTURES COMMISSION REPORT), two lawyers appointed by the State Bar, one lawyer and one nonlawyer appointed by the chief justice, and three members (two nonlawyers and one lawyer) appointed by each of the following: the governor, the speaker of the House, and the president pro tem of the Senate (these nine, would thus represent half the members). *See* FUTURES COMMISSION REPORT, at 34.

[160] The amounts of experience required should be determined by the State Judicial Council. The Council could also institute some type of examination, modeled after the Bar exam, as part of the screening process. If nothing more, this would increase public confidence in the qualifications of judges. *See also* Maute, *supra* note 82, at 1226 (suggesting the use of "special examinations to be administrated to all judicial aspirants, whether elected or appointed, and to those up for retention or renewal of appointment. The National Conference of Bar Examiners, or another professional test-drafting organization, could be commissioned to design an exam format to test for competent mastery over the

Approved applicants' names would then be submitted to the governor for nomination. The nominee would then be presented to the legislature for confirmation by simple majority vote. This process would place another check on the governor's appointment power[161] and further the goal of accountability.[162] Judges would serve ten-year terms under this plan and judicial vacancies would be filled using the same process.

A "reconfirmation" process should be instituted for retention purposes. To serve an additional term, the judge would be subject to a performance evaluation conducted by the SJC.[163] The Council should establish uniform standards for judicial performance by drawing on recommendations from the ABA and information should be collected from other judges, litigants, attorneys and jurors who appeared before the judge as well as a self-evaluation by the judge.[164] We propose that the Council's recommendation go the legislature for "reconfirmation." The Council's recommendation would be accorded "extraordinary" weight, requiring two-thirds vote of the legislature for reversal.[165] The judge could complete this process one more time, imposing a three-term

categories of law encountered by different types of courts, making distinctions among trial and appellate courts, and the context in which procedural, substantive and ethical questions are likely to arise.").

[161] John Korzen compares this check to that of the nominating commission in Missouri plan jurisdictions. *See* John J. Korzen, *Changing North Carolina's Method of Judicial Selection*, 25 WAKE FOREST L. REV. 253, 284 (1990). He also points out that the General Assembly, in its implementing legislation, would need to address recess appointments since it is not in session for several months in odd numbered years and for almost all months in even numbered years. *See id*.

[162] Exum, in describing his plan for gubernatorial appointment with legislative confirmation, states that it "puts responsibility for selection squarely on our elected representatives." Exum, *supra* note 93, at 10. Exum also discusses generally the proposition that elections are not necessary to hold judges accountable for what they do, noting that all North Carolina judges are susceptible to administrative removal by action of the Judicial Standards Commission. *See id*.; *see also* Paul D. Carrington, *Judicial Independence and Democratic Accountability in Highest State Courts*, 61 LAW & CONTEMP. PROB. 79, 114 (1998) (stating that "citizens who disapprove the selections know which elected politicians to blame for appointments they disapprove and can punish them if they stand for reelection.").

[163] Judicial performance evaluations are used in several merit selection states to provide information to voters in retention elections. *See* Samuel Latham Grimes, *"Without Favor, Denial, or Delay": Will North Carolina Finally Adopt the Merit Selection of Judges?*, 76 N.C. L. REV. 2266, 2322 (1998) (citing *Editorial, The Need for Judicial Performance Evaluations for Retention Elections,* 75 JUDICATURE 124, 124 (1991)).

[164] *See* FUTURES COMMISSION REPORT, supra note 159, at 36.

[165] The Judicial Selection Study Commission made a similar proposal in 1989. Under that proposal, the Judicial Standards Commission would recommend to both houses whether to reconfirm the judge. The recommendation would be given "extraordinary" weight, with a two-thirds vote in both houses required for reversal. *See* Korzen, *supra* note 161, at 256 (citing JSSC REPORT, *supra* note 59, at 10-12). *See supra* notes 58–66 and accompanying text.

limit with any ten year term expiring when the judge reaches a mandatory retirement age of seventy-two. The three-term limit would avoid the problem of a judge losing touch with the real world as may happen with life tenure and would provide for reasonable turnover in the judiciary.[166] To further ensure accountability, there should be a provision for recall elections, initiated by citizen petition.

B. Provide Public Funding for Judicial Campaigns

If judicial elections are to be continued, cost and fund raising issues will need to be addressed. With the costs of judicial campaigns soaring to record highs,[167] there is an urgent need for campaign finance reform. As the cost of elections rise, so does the influence of those who contribute to these campaigns. Money has become one of the most important factors in nonpartisan judicial races.[168] State legislatures must eliminate the need for special interest money by financing judicial elections. The American Bar Association is advocating for publicly financed elections.[169] In 2002, North Carolina became the first state to fully fund judicial campaigns.[170]

North Carolina's Judicial Campaign Reform Act creates four necessary components to successful campaign finance reform. Candidates for the appellate level courts who raise a threshold amount of money and who agree to strict spending and fundraising limits are entitled to receive a lump sum of public funding to run their general election campaign.[171] The law also provides for rescue money in the event that a publicly financed candidate is dramatically outspent by their non-publicly financed opponent.[172] The law lowers contribution limits to help keep special interest money out of the courtrooms. Political action committees, as well as individuals, are limited to a one thousand dollar campaign contribution to candidates for statewide judicial office.[173] This lowered limit applies to all candidates, including those who opt-out of the public funding program.[174]

[166] *See* Exum, *supra* note 93, at 10

[167] *See* COURT WATCH OF NORTH CAROLINA, INC., *supra,* note 106, at 1-8 (reporting that spending in the 2002 North Carolina Supreme Court race peaked, and that spending in the superior and district court had risen since 2002).

[168] *See id.* at 9.

[169] *See* France and Woellert, *supra,* note 100, at 44.

[170] *See* 2001 N.C. Sess. Laws 2002-158.

[171] *See id.*

[172] *See id.*

[173] *See id.*

[174] *See id.*

The passage of the Reform Act also called for the creation of a Public Campaign Fund.[175] This Fund pays for both the production of a voter guide and the financing of candidates' campaigns.[176] In North Carolina, the Fund is supported by three main sources: private donations, voluntary contributions of fifty dollars from attorneys when they file their annual privilege license renewal forms, and a three dollar designation that citizens can make on their state income tax forms.[177] The sources under the North Carolina scheme are unreliable and could render the fund useless.[178] We propose that states should appropriate mandatory funding to carry out public financing.

States should adopt a similar system of public financing for judicial elections with appropriations for funding public financing. Such reform will ensure a level playing field for aspirants by providing financial aid to qualified candidates. More candidates will be able to raise the threshold amount needed to gain statewide name recognition. A voter guide funded and promulgated by the state will create a more informed electorate, providing voters with useful information about the candidates' experience and qualifications for the judiciary. Public financing coupled with contribution limits will free judges from the pressure of special interests.

Finally, state bar associations should create bipartisan committees to oversee state campaigns and criticize candidates who employ misleading ads, overtly partisan rhetoric or positions that cast doubt on their ability to rule impartially.

VI. CONCLUSION

The inherent weaknesses of the process of selecting state judges by popular election have been exacerbated by the *White* decision. Issues of policy are properly decided by majority vote in a democracy such as ours.[179] While it is the business of legislators and executives to be popular, "it is the business of judges to be indifferent to unpopularity"[180] when considering issues of law or fact in litigation.[181] Unlike executives and legislators, judges do not serve a constituency. Judges have a duty to uphold the law and to follow the dictates of the Constitution.

[175] *See id.*
[176] *See id.*
[177] *See id.*
[178] *See* COURT WATCH OF NORTH CAROLINA, INC., *supra,* note 106, at 11 (arguing that if less that ten percent of voters use the check off on their state tax returns, the fund probably won't have sufficient money to fully finance the public financing provisions let alone the voter guide).
[179] *See* White, 536 U.S. 765, 799 (Stevens, J., dissenting).
[180] *Id.*
[181] *See id.*

Political speech among judicial candidates presents three dangers. The first danger is that such speech may compromise the appearance of institutional impartiality. The second danger is that a judge, once elected, may feel pressured to decide a particular case or issue consistently with ideological statements or promises made on the campaign trail, thereby preventing litigants from receiving a fair hearing. Finally, politicizing judicial elections may increase the number of unqualified candidates getting on the bench.

We strongly recommend the modified gubernatorial appointment plan which offers many of the advantages of a merit selection system without the problems associated with nominating commissions and preserves accountability through the legislative confirmation and reconfirmation processes. This plan would enhance judicial independence by eliminating judicial elections and the attendant problems. Finally, if judicial elections are to be continued we do recommend that states adopt laws similar to North Carolina's Judicial Campaign Reform Act (modified to ensure adequate and mandatory campaign funding).

ETHICAL CONCERNS AND CONSIDERATIONS FOR ORGANIZATIONS IN THE NEW MILLENIUM

by BRUCE W. WARREN* and LEONID GARBUZOV**

I. INTRODUCTION

During the first five years, the twenty-first century has brought with it substantial legal reforms and a number of intriguing cases. Perhaps no other area of law has undergone such considerable alteration and development as the field of ethics, especially in employment-related matters. A host of new questions and problems has arisen for employers and employees, which will continue to expand and evolve in the new millennium. Moreover, it is already clear that the ability and willingness of businesses and organizations to address these issues will be of crucial importance to their vitality and success in the twenty-first century.

Now, more than ever, it has become imperative for virtually all businesses and organizations to consider and review a number of employment-related and ethics-oriented topics. One such topic deals with the rights for illegal aliens to equal rights and treatment in the workplace. Another important issue deals with the rights of employees in cases of wrongful termination, and the permissible legal and ethical standards for employee dismissals. Sexual harassment in the workplace has been and continues to be a highly pertinent area, which requires considerable attention from all businesses and organizations and

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development of comprehensible workplace rules and guidelines. Employers must likewise understand their legal obligations, such as their duty to prevent violence in the workplace; they must likewise know moral and legal limitations and obstacles related to employees' personal privacy, the efficacy of monitoring employee emails, phone calls, and other personal communications, and legal repercussions for rules and procedures governing mandatory drug testing. All these issues and concerns require the twenty-first century company to develop and integrate new workplace policies and procedures.

The modern organization and its ethical responsibilities to its employees and the community require the employer to be more responsive to all ethics-related issues and concerns. Responsible organizations have developed ethics programs, established codes of conduct and appointed ethics officers. Additionally, such responsible entities have established systems to monitor and enforce ethical standards and conducted ethical training for employees and management. At a minimum, the modern organization must recognize new obligations and responsibilities through the aforementioned proactive conduct. The adherence to these procedures may be vital for the viability and success of the organization and its stakeholders.

II. UNEQUAL TREATMENT OF IMMIGRANT WORKERS

One of the most fundamental ethical dilemmas in the workplace is whether all employees should be entitled to the same rights regardless of their citizenship status, especially when such employees do not have a legal right to reside or work within the United States. This topic is part of a broader ethical debate concerning illegal aliens (or illegal immigrants) and their impact on society. Some economists speculate that illegal aliens, who are often grossly underpaid and perform unappealing and backbreaking manual labor jobs, are a source of cheap and efficient labor that is ultimately beneficial to the U.S. economy.[1] If so, should they be entitled to the same protection from wrongful termination, sexual harassment, or retaliatory discharge as the other employees?

Others contend, meanwhile, that the hiring of illegal aliens only furthers the high level of unemployment for legal U.S. residents and citizens, and reduces wages for employed workers, particularly manual

[1] Opinion Headlines. Stephen H. Karlsen. The *Positive Role of Illegal Immigration*, February 11, 2004. http://www.midweeknews.com/opinion/articles/021104-immigration.html.

laborers.[2] Furthermore, they argue that foreigners who are employed illegally should not be entitled to legal remedies or the protection of our justice system. The implications of this debate are especially significant, considering that, according to estimates, there are approximately 10 million people currently living in the United States illegally.[3]

At the present time, the overwhelming majority of illegal aliens that reside and work in the United States have no legal rights to continued employment and few other constitutionally protected human rights. In fact, illegal aliens may be arrested at any time by the Department of Homeland Security, tried in an immigration court, and deported. [4] The Immigration Reform and Control Act of 1986 prohibits employers from hiring illegal aliens, requires them to inquire and ascertain that the employee has a right to work in the United States, and sets fines and penalties for failure to comply with and enforce certain federally-mandated guidelines regarding employment.[5] Another important source of federal law on this issue is the Immigration and Nationality Act, which makes it illegal for any person with knowledge or reckless disregard to induce or attempt to bring an illegal alien into the country or to transport, conceal, harbor, or shield such aliens.[6] The Act likewise contains a number of employment-related provisions that make it illegal to knowingly hire for employment at least ten illegal aliens. Violations of these employment provisions may lead to fines, a term of imprisonment up to twenty, years or a combination of both.[7]

Another serious federal question that has arisen in connection with employment of illegal immigrants, is whether such employment may be deemed a violation of the Racketeer Influenced and Corrupt Organizations Act (RICO).[8] This issue was considered in the Eleventh Circuit case of *Williams v. Mohawk Industries, Inc.* where the employer, the second largest carpet and rug manufacturer in the United States, stood accused of recruiting, harboring, and hiring illegal aliens, in an effort to depress wages and reduce worker's-compensation claims.[9] It was further alleged that, upon hiring of such illegal aliens, the

[2] Center for Immigration Studies. George J. Bjorgas. *Increasing the Supply for Labor Through Immigration: Measuring the Impact on Native Born Workers*, May, 2004. http://www.cis.org/articles/2004/back504.html

[3] NewsMax.Com. March 21, 2005. http://www.newsmax.com/archives/articles/2005/3/21/114853.shtml.

[4] Edwin T Gania, US Immigration Step by Step 174 (Sphinx Publishing 2004).

[5] "Immigration Reform and Control Act of 1986" and "8 U.S.C. 1101 note". *See also* http://www.oig.lsc.gov/legis/irca86.htm.

[6] 8 U.S.C. § 1324.

[7] *Id.*

[8] For more information, see 18 U.S.C. §1961 - 18 U.S.C. §1968.

[9] Williams v. Mohawk Industries, Inc. 411 F.3d 1252 (11th Cir. 2005).

defendant attempted to conceal this fact, by purposely destroying documents and actively assisting illegal workers in evading detection by the immigration authorities and other law enforcement representatives.

The Court of Appeals for the Eleventh Circuit found that the employer's activities were not only in violation of federal immigration laws, but also of RICO. The Court ruled that the test for determining standing under RICO is whether the alleged injury was directly caused by the RICO violation, not whether such harm was reasonably foreseeable.[10] Citing the four-part test that was applied in a non-immigration case,[11] the Court explained that to establish a federal civil RICO violation under 18 U.S.C. § 1962(c), the plaintiffs must satisfy four elements of proof: (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity.[12] The Court found that under 18 U.S.C. § 1962(c), it is illegal "for any person employed by or associated with any enterprise . . . which affect interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity."[13] The Court also noted that under 18 U.S.C. § 1961(1)(F), racketeering activity means any act, which is indictable under Section 274 of the Immigration and Nationality Act, if such activity was committed for financial gain.[14] It remains to be seen whether other jurisdictions will follow the lead of the Eleventh Circuit by holding that employers who are guilty of hiring illegal aliens may also be prosecuted for racketeering.

U.S. courts have been reluctant to recognize the right of illegal aliens to compensation or participation in other lawful employment-related activities. Perhaps the leading case on the subject is that of *Hoffman Plastic Compounds, Inc. v. NLRB.*[15] Employer, Hoffman Plastic Compounds, hired Jose Castro, who had presented false documents to verify his right to work in the United States. He was later laid off for union-related activities, and the National Labor Relations Board contended that he was entitled to backpay and other relief for improper dismissal. The Supreme Court disagreed, however, by deciding that no backpay could be awarded for employees found guilty of serious illegal conduct in connection with their employment. It further stated that, as an illegal alien, Castro was never entitled to employment within the United States, and that therefore, the employer did not violate any existing or tangible rights by his subsequent firing. Finally, the Court

[10] *Id.* at 1263.
[11] Jones v. Childers, 18 F.3d 899, 910 (11th Cir. 1994).
[12] *Williams*, 411 F.3d at 1256.
[13] *Id.*
[14] *Id.* at 1257.
[15] Hoffman Plastic Compounds, Inc. v. NLRB, 535 U.S. 137 (2002).

concluded that, despite the alleged improper conduct by the employer in terminating an employee for lawful unionizing and union-related activities, the Board had no right to seek reinstatement or backpay for Castro because he had "committed serious criminal acts" by misrepresenting his right to work in the United States and presenting false documents.[16]

Presently, a minority of courts are beginning to recognize the right of all employees to a non-abusive and non-discriminatory working environment, as well as the right to ethical and humane treatment in the workplace, notwithstanding their immigration status. In *Rivera v. NIBCO*,[17] twenty-three Latina and Southeast Asian female immigrants, formerly employed as production workers at NIBCO's factory in Fresno, California, filed a lawsuit alleging disparate impact discrimination based on national origin. Some time in 1997 or 1998 these women were required to take a basic skills examination test offered only in English. Although fluency in English was not a required or necessary part of the job description, these women were demoted, transferred and otherwise punished for their poor test performance. When the suit was filed, all employees sought backpay, compensatory and punitive damages and attorneys fees, while only some sought reinstatement and front pay reimbursement. They also wanted to compel NIBCO to expunge any record of wrongdoing from personnel files, as well as injunctive relief prohibiting NIBCO from continuing its English-language testing policy. Defendant meanwhile, challenged the immigration-status of several of the employees claiming that illegal aliens were not entitled to reinstatement, backpay, front pay, or any other compensations or privileges.

Both the district court and the Court of Appeals for the Ninth Circuit held that the employer was prohibited from making inquiries regarding the immigration status of the employees, and that such prohibitions were necessary to protect employees' interests in abolishing workplace discrimination and protecting the public interests of the employees to procure a non-discriminatory work environment. In this case, the Court chose to focus upon Title VII of the Civil Rights Act of 1964, which prohibits workplace discrimination and termination based on national origin.[18]

Despite the holding in *Rivera*, most courts continue to follow the example set in *Hoffman Plastics*, almost always finding that illegal aliens are not entitled to damages, backpay, or any other remedies. With the number of illegal immigrants continuing to rise, it will be

[16] *Id.* at 143.
[17] Rivera v. NIBCO, Inc., 364 F.3d 1057 (9th Cir. 2004).
[18] *See* 42 U.S.C. § 2000e.

interesting to see whether more courts will follow the example of *Rivera*, or whether the legislature and the Supreme Court will adopt even stricter measures to prosecute employment of illegal aliens and deprive them of even the basic human rights. Primarily these dilemmas will define the organizations' ethical obligations and responsibilities to the employees, even if the employees are illegal aliens.

Presently there is no agreement among politicians about how to address these and other immigration-related issues. While John McCain and Ted Kennedy aim to reform existing immigration laws and to offer greater prospective amnesty to illegal aliens,[19] the House of Representatives is presently considering the Border Protection, Anti-Terrorism, and Illegal Immigration Control Act of 2005, which will impose mandatory criminal sanctions upon all illegal immigrants and all parties that shield or support them.[20] The resolution of these issues, whether by court decisions or act of Congress may have a drastic effect on many aspects of employment and immigration law, and may likewise alter our legal perception of the employers' obligations for providing a safe and non-discriminatory working environment.

III. SEXUAL HARASSMENT

Arguably, no area has proved more controversial to employers than the area of sexual harassment. Questions abound from both the employees' and employers' perspectives such as: what is sexual harassment, what are the boundaries of legal conduct in the workplace, and what are the employers' ethical and professional obligations to combat and eliminate sexual discrimination and harassment in the workplace. The Sexual Harassment Guidelines that were promulgated in 1980 by the Equal Employment Opportunity Commission[21] are now being reshaped by new scandals and allegations, as well as recently decided cases. In the twenty-first century, it will be imperative for all employers to develop, implement, and follow a company-wide sexual harassment policy. Failure to implement such policies places the employer at high risk for substantial damage awards from judges and juries,[22] especially if the company has a prior history of sexual

[19] Front Page Magazine. Mark Landsbaum. *Amnesty by Any Other Name*, June 21, 2005.http://www.frontpagemag.com/Articles/ReadArticle.asp?ID=18494

[20] *See* House of Representatives Judiciary Committee. F. James Sensenbrenner, Jr. Peter King. *Border Protection, Anti-Terrorism, and Illegal Immigration Control Act of 2005.* http://judiciary.house.gov/media/pdfs/immbillsection.pdf

[21] Guideline on Discrimination on the Basis of Sex, (Washington, D. C.) Equal Employment Opportunity Commission, November 10, 1980, 29 C.F.R. sec. 1604.11 (a) (3) (1993).

[22] *See, e.g.*, Parrish v. Sollecito, 280 F. Supp. 2d 145 (S.D.N.Y. 2003).

harassment complaints.[23] Besides acknowledging that sexual harassment violates Title VII of the Civil Rights Act of 1964,[24] judges and juries have come to recognize many different kinds of sexual harassment, and set high damage awards for failure to correct such behavior. For example, in *Eich v. Board of Regents for Cent. Mo. State University*, the jury awarded over two hundred thousand dollars to Deborah Eich, a detective sergeant at the Department of Public Safety for Central Missouri State University ("CMSU").[25] In this case, Eich alleged that a coworker ran his fingers through her hair, touched her thighs and breasts, and simulated sex acts behind her. She also complained to her supervisor of a hostile work environment, but was continually mistreated despite her complaints. Because the employer was aware of the recurring inappropriate behavior, and yet failed to remedy the situation, the jury's award was appropriate.

For the last several years the leading case on sexual harassment in the United States was *Burlington Industries Inc. v. Ellerth*.[26] In *Burlington* the U.S. Supreme Court explained that an employer may be subject to vicarious liability for a supervisor's actions, which create a hostile work environment when the supervisor had "immediate (or successively higher) authority over the employee."[27] However, when there are no tangible consequences as a result of the harassment, the employer may raise an affirmative defense by demonstrating that he/she exercised reasonable care to prevent or correct the harassing behavior.

More recently, however, the Supreme Court has slightly modified its stance on this issue in *Pennsylvania State Police v. Suders*.[28] In this case, the Court stated that to prevail in a sexual harassment suit, the plaintiff would have to show merely that the abusive working environment was so intolerable that the resignation was a fitting response. The decision elaborates that if the plaintiff establishes these facts, the employee's resignation will be deemed as a constructive discharge. Once constructive discharge is established, the employee can seek both punitive and contractual damages from the employer.[29] Additionally, in the recent case of *Noviello v. City of Boston,* the First Circuit Court of Appeals suggested that an employer may be liable even

[23] *See, e.g.*, Benjamin v. Anderson, 2005 MT 123 (Mont. 2005).

[24] Lori A. Tetreault. *Liability of Employer, Under Title VII of Civil Rights Act of 1964 (42 U.S.C.A. §§ 2000e et seq.) for Sexual Harassment of Employee by Customer, Client, or Patron*, 163 A.L.R. Fed. 445 (2004).

[25] Eich v. Board of Regents for Cent. Mo. State Univ., 350 F.3d 752 (8th Cir. 2003).

[26] Burlington Industries Inc. v. Ellerth, 524 U.S. 742 (1998).

[27] *Id.* at 765.

[28] Pa. State Police v. Suders, 542 U.S. 129 (2004).

[29] *Id.*

when appropriate action is taken to remedy the sexual harassment.[30] In *Noviello,* a parking security officer was sexually harassed by a superior officer, who had used derogatory sexual remarks and ripped off her bra. Although the offender was fired for his conduct, the woman continued to be ridiculed over the incident, thereby creating a hostile work environment. The Court found that Noviello presented sufficient evidence to bring both state and federal retaliatory harassment claims against her employer.[31]

Employers should likewise be mindful of the Supreme Court ruling in *Desert Palace, Inc. v. Costa.*[32] In *Desert Palace*, the employee alleged that her supervisors made and tolerated sexist comments towards her, that one of the supervisors stalked her, and that she was subjected to harsher discipline and treated less favorably in assignment of overtime pay than males. Although the employer claimed that she failed to adduce "direct evidence" that sex was a motivating factor in her dismissal, the Supreme Court affirmed the district court's mixed-motive instruction to the jury. Citing Title VII of the Civil Rights Act[33], the Court ruled that direct evidence of discrimination is not required for a plaintiff to obtain a mixed-motive jury instruction under Title VII and that the employee had only to show that the employer used illegitimate considerations in employment practices. Through *Desert Palace*, the Supreme Court not only showed a willingness to consider workplace evidence not directly linked to sexual discrimination, but also established lenient standards for burdens of proof and jury instruction for sexual harassment cases.

Another important issue, which has often been overlooked, is whether the employer has any obligations to respond to sexual harassment complaints of employees, when the hostile and sexual conduct is perpetrated by non-employees. The Supreme Court of the United States has never addressed the non-employee harassment issue; yet, several jurisdictions throughout the country have ruled that employers may indeed be liable whenever they are aware of the situation, but do not take appropriate corrective or disciplinary action. In *Folkerson v. Circus Enterprises*, one of the most influential cases dealing with this controversial topic, the Ninth Circuit Court of Appeals considered the accusations of a former casino employee who claimed that she was harassed by a patron and fired by her employer in retaliation for her refusal to tolerate such harassment.[34] Although the Court entered

[30] Noviello v. City of Boston, 398 F.3d 76 (1st Cir. 2005).
[31] *Id.*
[32] Desert Palace, Inc. v. Costa, 539 U.S. 90 (2003).
[33] 42 U.S.C. § 2000e-2(m).
[34] Folkerson v. Circus Enterprises, 107 F.3d 754 (9th Cir. 1997).

summary judgment in favor of the defendant, it stated in dicta that an employer would be "liable for sexual harassment on the part of a private individual . . . where the employer either ratifies or acquiesces in the harassment by not taking affirmative and/or corrective actions when it knew or should have known of the conduct." [35] *Folkerson* has been cited and followed by many jurisdictions throughout the country,[36] and even cases that do not follow *Folkerson*, have commonly taken a similar stance on this issue.[37]

Together these cases suggest that the employer needs to be assertive and take immediate action when the employer is placed on notice as to sexually harassing conduct. However, as some recent cases show, these defenses may not be enough to discharge the employer from all liability. The promulgation and enforcement of the organization's sexual harassment policies and procedures is crucial to the protection of human rights of the employees and the company's reputation and integrity. It is imperative for the employer to have a detailed, clearly expressed and printed sexual harassment policy. These policies should be developed in compliance with state law, which often sets forth the definition of sexual harassment and sets requirements regarding policies that must be implemented.[38] All employees should be informed about the organization's promulgated policies, and be referred to a company-designated contact person with all further concerns and inquiries. If a complaint is filed, the senior member of management should immediately conduct a thorough investigation and make recommendations to senior management as to the disposition of the case. When performing such an investigation, however, the company should respect its own confidentiality policy and the employees' rights of privacy. The aforementioned process should be delineated in the organization's sexual harassment policy and procedures contained in the organization's human resources manual. Lastly, organizations should conduct sexual harassment training for all employees and managers in order to define sexual harassment and to delineate the company's stance on proper and improper workplace conduct, thereby reinforcing their ethical obligations to the employees.

[35] *Id.* at 756.

[36] *See, e.g.*, Lockard v. Pizza Hut, 162 F.3d 1062 (10th Cir. 1998); Also see Van Horn v. Specialized Support Serv., 241 F. Supp. 2d 994 (S. D. Iowa 2003); Costilla v. State, 571 N.W.2d 587 (Minn. App. 1997).

[37] *See, e.g.*, Crist v. Focus Homes, 122 F.3d 1107, 1112 (8th Cir. 1997).

[38] *See, e.g.,* ALM GL ch. 151B, § 3A.

IV. WRONGFUL TERMINATION

The issue of wrongful termination continues to evolve and will continue to be a very important legal issue and ethical consideration for the employer and employees in the new millennium. Although historically an employee essentially had no rights in his or her job and was always an employee-at-will, most jurisdictions have begun to recognize that union members, senior management employees with contracts and tenured college professors may have a right to their jobs. The right to employment has developed from a list of exceptions, which have included public policy exceptions,[39] implied contracts,[40] and violations of good faith and fair dealing.[41] Oftentimes, the issue centers on whether or not the employee has any rights in his/her job other than those stated in the employment contract. Some questions that may need to be addressed in the new millennium are: which employees are members of a "protected class" and what are the company's legal and ethical obligations to protect their employment-related rights?

Gradually, courts have started to acknowledge that employees who have been treated in a particular manner by their employer fall under what is called a public policy exception. For example, an employee who is discharged because he/she failed to lie and commit perjury may be protected by the public policy exception.[42] The case where an employee was discharged so that the employer would not have to pay benefits was likewise determined to fall under a public policy exception.[43] Furthermore, employees who are terminated wrongfully for demanding something that they were entitled to either by existing law or by an underlying agreement, may be entitled to compensation for retaliatory discharge. In *Valerio v. Putnam Associates Inc.*, an employer who dismissed an employee for asking for overtime pay that had been promised to her earlier was ordered to reimburse the employee for lost overtime wages, as his conduct was deemed to be a violation of the Fair Labor Standards Act.[44]

Other employees have been found to be removed from the employee-at-will category, under the doctrine of implied contract. Some employees are deemed to fall under an implied contract as a result of promises or references to employment in the personnel handbook or manual utilized by the employer in its employment practices.[45] It seems that the courts

[39] *See, e.g.*, Himmel v. Ford Motor Co., 342 F.3d 593 (8th Cir. 2003).
[40] Desanzo v. Titanium Metals Corp., 351 F. Supp. 2d 769 (S.D. Ohio, 2005).
[41] Ayash v. Dana-Farber Cancer Inst., 443 Mass. 367 (Mass. 2005).
[42] Briones v. Ashland, Inc. 164 F. Supp. 2d 228 (D. Mass. 2001).
[43] Fortune v. Nat'l Cash Register Co., 364 N.E.2d 1251, 1255-57 (Mass. 1977).
[44] Valerio v. Putnam Associates Inc., 173 F.3d 35 (1st Cir. 1999).
[45] *See, e.g.*, Patriarca v. Center for Living and Working, Inc. et al. 10 Mass. L. Rep. 486 (Mass. Super. 1999).

are now willing to recognize that there is a constitutionally protected right to employment that protects employees from unreasonable discharges, especially when the employee is discharged for refusing to perform illegal tasks and activities.[46] Employers need to promulgate procedures and policies, found in human resources manuals, to outline and define the employees' rights and responsibilities within the organization. These steps will not only make the employers compliant with their legal obligations, but will also reaffirm the organizations' commitment to employees' legal and human rights.

V. PRIVACY

Another pertinent topic that will be very significant in the new millennium involves the employer's rights to supervise the employees in connection with office technology, surveillance equipment, monitoring of employees' personal communications, wiretapping, and reviewing of employees' e-mail. The issue, which is in conflict, is where does the line between proprietary information owned by the employer and the employees' privacy expectations merge or become divided. The U.S. Supreme Court has not yet defined the "outer limits" of employee privacy, and jurisdictions have varying interpretations regarding employers interfere with the employee's rights of privacy and human rights. The question, therefore, becomes: what policies, procedures, and measures are appropriate for employers, in order to protect and maintain the employees' rights to privacy and employers ethical obligations and responsibilities to employees?

The issue of privacy in the workplace continues to be a problem for employers and employees, especially in regards to employer surveillance of employees' e-mails, telephone conversations, and work areas (via video recorders). Title III of the Omnibus Crime Control and Safe Streets Act of 1968 explicitly prohibits the intentional interception of any wire, oral, or electronic communications, "except as otherwise specifically provided."[47] The Act has been applied in the context of wire-tapping and recording of personal telephone conversations, but does not cover e-mail, video recordings, and many other technologies and mediums of communication. Privacy-related issues concerning e-mails and video recordings are not clearly defined, and are usually determined by applicable state law and precedent. More recently, with the advent of cellular phones, instant messaging, and other technological innovations, the Act has become hopelessly outdated,[48] and was

[46] Negron v. Caleb Brett U.S.A., Inc., 212 F.3d 666 (1st Cir. 2000).

[47] 18 U.S.C. § 2511(1)(a).

[48] Michelle Skatoff-Gee, *Changing Technologies and the Expectation of Privacy: A Modern Dilemma,* 28 Loy. U. Chi. L.J. 189 (1996).

superseded by the Electronic Communications Privacy Act (ECPA)[49], which explicitly addresses the medium of electronic communication, and generally expanded the number of permissible procedures that can be utilized over the course of a criminal investigation.[50] Since then courts have been vigilant to interpret the subtle differences between the two Acts.[51] Courts have also recognized that under 18 U.S.C. § 2511(2)(c), the ECPA permits the employer to lawfully intercept an electronic communication, whenever the employer is a party in the communication, or when the employee has given a prior written consent for such monitoring.[52] Although Sections 201 and 202 of the 2001 USA Patriot Act could hypothetically justify investigation of private communications of employees suspected of terrorist activities, courts throughout the country have not applied the Patriot Act to non-governmental invasion of privacy nor permitted private causes of action for violation of its provisions.[53]

Throughout the country, many jurisdictions have addressed the question of employers' legal rights and ethical considerations to intrude upon private matters of the employees. In Massachusetts, for instance, the seminal case regarding employee privacy is *Cort v. Bristol Myers*,[54] which has been both cited and followed by more recent cases. [55] Three salesmen sued for breach of privacy after they were fired from their positions for refusing to answer a questionnaire that they felt was too intrusive. The Massachusetts Supreme Judicial Court held for the employer, indicating that the degree of intrusion is the key issue. Here the Court noted that higher-level employees should be expected to divulge more personal information than lower-level employees and found the salesmen to be in the mid-to-high range. The Court also noted that most of the information requested on the questionnaire could have been found in public records.[56]

Across the country, courts have considered and attempted to identify the extent to which such issues as email,[57] video, electronic, or audio surveillance of employees both at their work station and in their locker

[49] 18 U.S.C. § 2510.

[50] It appears that "oral communication" is the only medium of communication specified for which the ECPA explicitly recognizes the expectation of privacy.

[51] *See, e.g.*, Fraser v. Nationwide Mut. Ins. Co., 352 F.3d 107 (3rd Cir. 2003).

[52] *See, e.g.*, Berry v. Funk, 331 U.S. App. D.C. 62 (D.C. Cir. 1998), (explicitly recognizing the "prior consent exception").

[53] *See, e.g.*, Medical Supply Chain, Inc. v. US Bancorp, NA, et al. 2003 U.S. Dist. LEXIS 10787 (D. Kan. 2003).

[54] Cort v. Bristol Myers, 385 Mass. 300 (1982).

[55] See e.g. Joyal v. Hasbro, Inc., 380 F.3d 14 (1st Cir. 2004).

[56] Cort 385 Mass. at 310.

[57] United States v. Councilman, U.S. App. LEXIS 16803 (1st Cir. 2005); United States v. Ropp, 347 F. Supp. 2d 831 (C. D. Cal. 2004).

rooms,[58] and the monitoring of employee telephone conversations[59] are permissible in the workplace. Presently, there exists no uniform legal definition regarding "privacy". All jurisdictions acknowledge, however, that there are some human rights that organizations should strive to protect. Such protection would include carefully defined policies regarding the processing and dissemination of confidential employee information, and the appointment of a senior member of management to supervise and coordinate such dissemination so as to protect the human rights of the employees and the organizations legal and ethical responsibilities and obligations. Additionally, the organization should have clearly promulgated policies regarding employees' email, telephone conversations, surveillance of employees and employee dating in the work environment.

Other important legal and ethical considerations relating to privacy that must be recognized by employers is the issue of drug testing. The 2005 congressional inquiry into the use of steroids in professional sports has raised questions in regards to the extent to which the legislature can regulate and legitimize drug testing, despite the athletes' constitutionally protected rights. Problematic questions facing employers include: which employees should be subject to drug testing, whether there is a difference between testing procedures in the private and public sectors, whether mandatory drug testing should serve as a prerequisite for employment, and which policies are appropriate so as not to violate the human and legal rights of employees while maintaining a drug free workforce.

In practically every jurisdiction across the country, courts continue to acknowledge the rights of employers to subject their employees to drug testing. In *Relford v. Lexington-Fayette Urban County Gov't.*,[60] Robert Relford, an electrician employed within the Lexington-Fayette County since 1993, was arrested in 1997 for criminal trespass and possession of drug paraphernalia, which prevented him from going to work on the following day. When the County found out about the arrest, they insisted that he be tested, sighting the Reasonable Cause Testing (hereinafter RCT) policy from the County's Alcohol and Drug Free Workplace Guidelines. The employee, who subsequently resigned from his employment, alleged that the non-random drug policy violated his due process rights under the Fifth and Fourteenth Amendment. In dismissing his claim, the Sixth Circuit Court of Appeals reaffirmed that

[58] State v. Meredith, 337 Ore. 299 (Or. 2004); Bowyer v. Hi-Lad, Inc., 609 S.E.2d 895 (W. Va. 2004).

[59] Deal v. Spears, 980 F.2d 1153 (8th Cir. 1992).

[60] Relford v. Lexington-Fayette Urban County Gov't., 390 F.3d 452 (6th Cir. 2004).

employers have a right, as a matter of law, to subject their employees to drug tests, so long as there is a reasonable suspicion for such testing.[61]

The rights of private and public institutions to conduct drug-testing is recognized nationwide. In the context of drug testing for schools, courts generally recognize the right to implement drug testing for sporting events and other voluntary or extra curricular activities, and have ruled that such testing is not unconstitutional,[62] and does not constitute unreasonable search and seizure or impinge upon the students' privacy interest.[63] Similar leeway has generally been granted to employers in both private and public sectors. For most employment-related drug-testing cases, courts have adopted a balancing test that assesses the employees' interest in privacy against the employer's competing interest in determining whether its employees are using drugs.[64] Courts across the country have been reluctant to sanction or punish the employer accused of negligent drug testing, as employers generally do not owe a duty to at-will employees to perform a drug test in a competent manner,[65] nor to extend common law tort claims brought by employees for failure to comply with certain federal regulations.[66]

The above-cited cases seem to suggest that any reason deemed as "important and compelling" by a company, could justify mandatory drug testing. However, in *Ferguson v. City of Charleston*, the U.S. Supreme Court has made it clear that this is not the case. [67] In *Ferguson*, the Supreme Court ruled that a hospital's mandatory drug testing policy of potentially pregnant patients was not legitimate, despite the compelling interest to protect the lives of the mother and the baby, and that such testing would be prohibited without the patient's consent.[68] The Supreme Court has also addressed the issue of employee drug testing in *National Treasury Employees Union v. Von Raab.*[69] In this case, a union for federal employees commenced the lawsuit, alleging violation of their Fourth Amendment rights in response to the Commissioner of the Customs Service implementation of a drug testing program for any employee whose position met one or more of the following criteria: direct

[61] *Id.*

[62] *See, e.g.*, Northwestern Sch. Corp. v. Linke, 763 N.E.2d 972 (Ind. 2002).

[63] *See, e.g.*, Joye v. Hunterdon Cent. Reg'l High Sch. Bd. of Educ., 176 N.J. 568 (N.J. 2003).

[64] *See, e.g.*, Webster v. Motorola, Inc. 418 Mass. 425 (Mass. 1994).

[65] *See, e.g.*, Mission Petroleum Carriers, Inc. v. Solomon, 106 S.W.3d 705 (Tex. 2003) and Bellinger v. Weight Watchers Gourmet Food Co., 756 N.E.2d 1251, 1257 (Ohio App. 5 Dist. 2001).

[66] *See, e.g.*, Graham v. Contract Transp., Inc., 220 F.3d 910 (11th Cir. 2000).

[67] Ferguson v. City of Charleston, 532 U.S. 67 (2001).

[68] *Id.*

[69] National Treasury Employees Union v. Von Raab, 489 U.S. 656 (1989).

involvement in drug interdiction or enforcement of related laws, possession of any firearm, or handling of "classified" material. The U.S. Supreme Court found for the Customs Service stating, "the Government's need to conduct the suspicionless searches required by the Customs program outweighs the privacy interests of employees engaged directly in drug interdiction and of those who otherwise are required to carry firearms".[70] Employers need to balance the employees' interest in privacy with the employer's competing interest in ascertaining if the organization's employees are using illegal drugs. The organization's need to ascertain drug use among its employees, and its corresponding policies will in part be influenced by the nature of the employees' duties, e.g. police officer, train engineer, airplane pilot, machine operator, or heavy-equipment operator. Organizational policies and procedures regarding drug testing must be communicated to employees as part of the initial employment interview, if appropriate, and if employment is contingent on satisfactory drug testing. Subsequent drug testing, if appropriate, should be reviewed in the employee orientation and documents disseminated to the employee in the orientation process. All these steps will assist in insuring the balance between the organization's needs, particularly as to safety, and the employees' human and legal rights as to privacy.

VI. WORKPLACE SAFETY

Since the recent unfortunate and tragic shootings at schools and offices across America, safety in the workplace has become another crucial legal and moral issue for businesses and organizations. The question then becomes what reasonable precautions should school officials and/or employers take in providing a safe learning and employment environment for their students and workers. The failure of an employer to review their workplace procedures and the attendant safety requirements will not only result in serious injury and/or death to employees, but will expose the employer to negligence and/or wrongful death actions by employees or the estates of the deceased employees. Therefore, unless adequate measures and procedures are in place in order to assure a safe work environment, the employer will face potentially expensive litigation and the company could suffer a tremendous negative financial impact.

At the present time there have only been a few cases where an employer has been sued for failing to provide a safe work environment. Although most courts have been reluctant to assign liability to employers accused of failure to provide a safe working environment[71]

[70] *Id.* at 668.
[71] Francisco v. Burlington Northern R.R., 204 F.3d 787 (8th Cir. 2000).

there are several cases, which recognize the right of the employees to collect damages sustained as a result of injuries due to unsafe working conditions.[72] Furthermore, it is certainly probable that such tortuous actions will become more prevalent in the twenty-first century. The question then becomes: what are the duties and obligations of an employer to the employees for providing a safe working environment both from the legal and ethical perspectives.

It has been clearly established under agency principles and case law that employers can be held liable for the conduct of supervisors and managers, even if the supervisor or manager could not be sued personally.[73] An exception to this general rule exists when a supervisor partakes in isolated, illegal acts. An employer may also be liable to a third party based upon the actions of a non-employee, if that person undertakes the action at the coaxing of the employer. This again is based upon the rules of agency.

Two areas that have significant impact on employees' human rights and exposure for the organization are negligent retention of employees and negligent supervision. Negligent retention, also known as negligent hiring, is an area of law, which continues to expand in various jurisdictions across the nation. The decisions for the most part have been limited to where the employee had direct contact with the public.

In *Foster v. The Loft Inc. & Another*,[74] the plaintiff brought a claim of negligent retention against the defendant as a result of injuries sustained when two employees at the defendant's bar assaulted him. The Court found for the plaintiff indicating that the employer was aware that the employee had been convicted of violent crimes and had placed him into a position as a bartender where he was required to handle customer complaints, was presented with situations that might deteriorate into heated confrontations and, therefore, was responsible for his actions.[75] The Court continued:

> we emphasize again that our decision does not mean that an employer cannot hire or retain a person known to have a criminal record. Circumstances will differ from case to case, and what might be perfectly acceptable hiring or retention under one of circumstances might be highly unreasonable under another.[76]

There is no nationwide agreement about the tort of negligent supervision. For example, in the Massachusetts case of *Choroszy v.*

[72] *See, e.g.*, Syverson, v. Consolidated Rail Corporation, 19 F.3d 824 (2nd Cir. 1994).

[73] Strahm v. WSI Corp., 1993 U.S. DIST. LEXIS 19166 (D. Mass. 1993).

[74] Foster v. The Loft Inc. & Another, 26 Mass. App. Ct. 289, rev. granted, 403 Mass. 1102 (1988) (settled prior to review).

[75] *Id.* at 295.

[76] *Id.*

Wentworth Institute of Technology[77] the Federal District Court assumed without deciding, that Massachusetts would recognize a negligent supervision action by an employee against an employer.[78]

Presently there are several cases pending, which may have a significant influence on the development of this area of law. A particularly noteworthy case deals with the death of Imette St. Guillen. Although the investigation of this case has not been concluded, newspapers have reported that, St. Guillen, a twenty-four year old graduate student, was brutally slain on February 25, 2006, after leaving the Falls bar, located in the Soho area of New York City.[79] In connection with this murder, the authorities have detained Darryl Littlejohn, a bartender with seven prior criminal convictions, who was working as a bouncer at the Falls, and allegedly helped to escort Ms. St. Guillen out of the bar on the night of the crime.[80]

Although Mr. Littlejohn has not been convicted of any crime, authorities point out that he was on parole for an armed bank robbery, and had seven prior criminal convictions.[81] Should the charges against Mr. Littlejohn prove to be meritorious, the inquiry will inevitably turn to whether the owners or managers of the Falls bar were negligent in hiring a former felon to fill such a position, and to entrust him with escorting patrons. Generally, courts have the authority to impose liability on an employer for the actions of their employees.[82] In the present case, however, the court may be called upon to resolve the more difficult issues of whether the employer had performed a negligent hiring, whether bar management had acted with inadequate supervision given Littlejohn's prior criminal history, whether the criminal conduct was foreseeable, and whether the tort doctrines of "duty of care" and "respondeat superior" should be applicable.

To avoid litigation and protect the company's reputation, the employer must strive to protect employees and maintain a working environment that is safe both from internal and external agents. It is advisable to not only promulgate rules and policies for handling these issues, but likewise to provide employees with the necessary education to explain the purpose and content of the policies. Employers must thoroughly review employment applications and conduct necessary background checks to insure the employees' qualifications for a

[77] *Choroszy v. Wentworth Institute of Technology, 915 F. Supp. 446 (D. Mass. 1996).*

[78] *Id.* at 451.

[79] Boston Globe. Christina Silva and Brian MacQuarrie. *Suspect NYC Victim Allegedly Seen in a Car*, March 8, 2006. http://www.boston.com/news/local/articles/2006/03/08/suspect_nyc_victim_allegedly_seen_in_car.

[80] *Id.*

[81] *Id.*

[82] *See, e.g.*, Foster v. Red Top Sedan Service, 257 So.2d 92 (Fla. App. 1972).

particular position and to be aware of the candidates' with a history of violent behavior in the workplace. Alleged violations of company policies and procedures, particularly ones that may be harmful to employees, must be thoroughly investigated with appropriate dispositive action taken. The actions of managers and supervisors, particularly as to disciplinary matters, should be appropriately documented, so as to provide the employer with the appropriate defenses in an arbitration, mediation or litigation environment. Because of the complexity of these employment issues, employers should also consider seeking the advice of professionals, particularly employment attorneys. Employers may likewise consider educational seminars for both managerial and non-managerial employees, so as to provide a basis for the employees' understanding and reinforcing the aforementioned employment issues.

VII. CONCLUSION

Without a doubt, the preceding discussion does not include all issues that could expose employers to litigation, either from employees or regulatory agencies. Other such concerns would include workers compensation, pension benefits, maternity and paternity leave, vacation pay, overtime, wage and salary issues, handicap issues, age discrimination, AIDS, same sex benefit plans, and dress codes to include items that may include formal/informal office attire and mandatory uniforms. As we move into the new millennium, employers must strive to balance the interests and goals of the organization with the human rights and ethical duties towards its employees. Despite all the new challenges and perils that may arise, it is already clear that the organization's ability and willingness to recognize, consider, and respect the moral and legal rights of and ethical responsibilities to the employees will be crucial to its viability and business success in the new millennium.