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## TABLE OF CONTENTS

# PATENT LICENSEE ESTOPPEL: THE BALANCE OF POWER BETWEEN PATENT HOLDERS AND LICENSEES

by MALCOLM ABEL*

## I. INTRODUCTION

Patent licensee estoppel would require the licensee breach the patent license agreement prior to challenging the validity of the patent. But, breaching a patent license agreement by the licensee risks a lawsuit by the patent holder for willful patent infringement. This paper discusses whether or not the U.S. Constitution requires that a patent licensee run such a risk in light of a U.S. Supreme Court decision on a drug patent in *MedImmune v. Genentech*.[1] The prior cases of case or controversy and patent licensees are summarized and the cases following *MedImmune* are analyzed.

The patent license agreement insures that the patent holder retains all property rights under the statutes arising from a lawfully applied for patent granted by the Patent and Trademark Office, while granting the licensee limited use of the patent. Since the agreement gives a benefit to the licensee—an economic value gained with calculable costs—there is an assumption the benefit is mutual and agreed upon under contract law. The benefit to the licensee for the payment implies that the payment of the royalties is exchanged for the 'authorized' infringement by the licensee. This 'authorized' infringement postpones any legal

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[1] MedImmune v. Genentech, 549 U.S. 118 (2007).

recourse by the patent holder, as long as the licensee continues payment of the royalties due. If the licensee ceases to pay the royalties due, then the patent holder may consider the breach of the agreement to constitute 'unlawful' infringement, and the patent holder may sue the licensee. If the licensee is paying the royalties when due, the licensee is prevented—estopped—from suing the patent holder as to the validity of the patent, since the licensee is benefiting form the licensing of a valid patent.

The doctrine of patent licensee estoppel seeks to prevent the patent licensee from having her cake and eating it too. This estoppel doctrine is based on the actual case or controversy requirement of Article III of the U.S. Constitution. Given an agreement between the patent holder and the licensee for the use of the patent, there is no threat of harm to either party of the agreement from the other. However, a material breach of a license agreement by either party would cause such an apprehension of being sued. Anything short of a material breach would not be considered adequate to give rise to a real or actual apprehension. If a patent licensee wanted to invalidate the patent, the licensee would have to stop paying the royalty payments due under the license to create an actual case or controversy. The patent licensee would not only risk the suit, but also the payment of treble damages and attorneys fees allowed under the applicable statutory scheme. The patent licensee should not be required to risk so much to challenge the validity of the patent.

## II. PRIOR CASES

### *A. Aetna Life Ins. Co. v. Haworth*

*Aetna Life Ins. Co. v. Haworth*[2] involved an Illinois corporation that constructed a large building, known as the Auditorium Building, in 1886 on land leased for 99 years.[3] The shareholders of the corporation had only received one dividend in forty years and the building was obsolete and needed to be replaced to make best use of the property for financial gain.[4] There were no provisions in the leases allowing the corporation to replace the building but, in fact, there was language in the leases which could have been interpreted as denying the corporation the right to do so.[5] The corporation filed suit to remove cloud of title by having the court declare that it had the right to tear down the building and replace it

[2] 300 U.S. 227 (1937).
[3] Willing v. Chicago Auditorium, 277 U.S. 274, 284-85 (1928).
[4] *Id.* at 285.
[5] *Id.* at 285-86.

without recourse by the lessees.[6] The Court held that fears or doubts about outcomes did not constitute a case or controversy under Article III at law or equity.[7]

Aetna Life sought a declaratory judgment on insurance policies for nonpayment of premiums.[8] The District Court dismissed the suit because it did not present a case in controversy to satisfy either the constitutional or statutory requirements.[9] A dispute as to contractual rights and obligations of the insurer and the insured under a policy was declared to be neither hypothetical nor abstract but definite and concrete.[10] An insured's claim of benefits upon stipulation of prescribed conditions relieved the insured of continued premium payments.[11] Likewise, the insurer's rejection of the insured's claim in concurrence with the cessation of premium payments caused a lapse of the policy, resulting in the termination of the insurer's obligations under the policy.[12] Thus, there was a controversy regardless of who presented the case, whether it was the insured or the insurer.[13]

### *B. Altvater v. Freeman*

In *Altvater v. Freeman*,[14] an action was initiated "for specific performance of a license agreement under [a] reissue patent . . ."[15] A counterclaim asserted that the agreement covered the original patent but not the reissue patent and payments were made under protest.[16] Altvater asked for a declaratory judgment because they would have been subject to an infringement suit if they had cancelled the license agreement.[17] The Court found that the controversy did not end upon the lower court's decision of noninfringement because payments were made involuntarily and under protest, thus preserving the right to recover upon a successful challenge of the claim by Freeman.[18]

[6] *Id.* at 287-88.
[7] *Id.* at 289-90.
[8] *Aetna*, 300 U.S. at 239.
[9] *Id.* at 236. *See* Aetna Life v. Haworth, 11 F. Supp. 1016 (W.D. Mo. 1935), *aff'd*, 84 F.2d 695 (8th Cir. 1936).
[10] *Id.* at 242.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] 319 U.S. 359 (1943).
[15] *Id.* at 360.
[16] *Id.*
[17] *Id.* at 360-61.
[18] *Id.* at 363-65.

### *C. Lear v. Adkins*

In *Lear v. Adkins*,[19] Adkins developed a method of constructing improved gyroscopes for aviation navigation and Lear began using that method immediately to advantage over its competition.[20] An agreement between the two called for royalties to be paid unless Adkins failed to obtain a patent, in which case Lear would have the option of terminating the license or the agreement.[21] When the license had concluded and Adkins had not received a patent, Lear discontinued payment.[22] Three years later, Adkins obtained his patent and he sued in California courts finally resulting in a decision constructing the license under state law but relying on the doctrine of estoppel to deny Lear's invalidation claim.[23] The U.S. Supreme Court held that state law may cover unpatented inventions, but without estoppel under federal patent law, Lear could avoid patent royalty payments due after the date Atkins obtained the patent only if Lear could prove that the patent was invalid.[24]

### *D. Studiengesellschaft v. Shell Oil*

In *Studiengesellschaft v. Shell Oil*,[25] Shell Oil licensed a process to polymerize propylene from Studiengesellschaft (SGK) and was to account to SGK for its entire polypropylene production, including that production which fell outside of the license.[26] Shell began production with a new process without disclosing it to SGK and six years later SGK terminated the license and brought suit to recover unpaid royalties and infringement thereafter.[27] The Court ruled that the patent upon which the licensed relied was invalidated by an earlier filing of another patent and dismissed SGK's claims regarding that license.[28] Further, it ruled that Shell could not invoke the *Lear* doctrine "until it (i) actually ceases payment of royalties, and (ii) provides notice to the licensor that the reason for ceasing payment of royalties is because it has deemed the relevant claims to be invalid."[29]

[19] 395 U.S. 653 (1969).
[20] *Id.* at 655.
[21] *Id.* at 657.
[22] *Id.* at 658-59.
[23] *Id.* at 660-62.
[24] *Id.* at 674-75.
[25] 112 F.3d 1561 (Fed. Cir. 1997).
[26] *Id.* at 1563.
[27] *Id.*
[28] *Id.* at 1564-65.
[29] *Id.* at 1568.

### *E. Gen-Probe v. Vysis*

In *Gen-Probe v. Vysis*,[30] Gen-Probe was granted a nonexclusive license to a patented method of diagnostic assays to "test blood for DNA found in the HIV or hepatitis C viruses."[31] It filed a suit for declaratory judgment for noninfringement and to invalidate the patent, and continued to pay royalties in fulfillment of the license.[32] Vysis moved to dismiss because Gen-Probe was not in a position of reasonable apprehension of being sued because it was in good standing under the license.[33] The *Lear* doctrine requires, at a minimum, that Gen-Probe must stop paying on the license before bringing suit or challenging the validity of Vysis' patent.[34] *Altvater* does not apply because the royalty payments there were made under the threat of a court injunction, not under the demands of a license agreement.[35] The totality of the circumstances does not support Gen-Probe's assertion that it is apprehensive about a suit in forming a basis for an actual case in controversy.[36]

## III. MEDIMMUNE V. GENENTECH

### *A. District Court Decision*

MedImmune's Synagis, an antiviral drug used on children, uses the production techniques covered by the patents owned by Genentech.[37] The patents at issue were initially issued to both Genentech and Celltech, and Genentech advised the U.S. Patent and Trademark Office (PTO) of the conflict between the two patents.[38] After several actions before the PTO and in court, Genentech and Celltech entered into a Settlement Agreement and an Amended and Restated License Agreement.[39] Genentech filed certified copies of the order and judgment with the PTO, and the PTO directed that its pending application be

[30] 359 F.3d 1376 (Fed. Cir. 2004).
[31] *Id.* at 1377.
[32] *Id.* at 1378.
[33] *Id.* at 1379.
[34] *Id.* at 1381.
[35] *Id.* at 1382.
[36] *Id.* at 1382.
[37] MedImmune v. Genentech, 2003 U.S. Dist. LEXIS 23443 (C. D. Ca., Dec. 22, 2003) at *2.
[38] *Id.* at *4. Genentech filed its application for a patent on April 8, 1983 and Celltech filed its application on November 14, 1984. *Id.*
[39] *Id.* at *6. The parties filed notice for entry of settlement with the court, and the Order and the Judgment were executed on March 16, 2001. *Id.*

returned for examination.[40] After several additional interviews with the PTO, the new patent was issued to Genentech.[41]

MedImmune alleged that the resolution of that priority dispute did not require either Genentech or Celltech to give up anything of value, but effectively created a 29 year monopoly over the same technology.[42] Genentech argued that the *Noerr-Pennington* doctrine barred MedImmune's claims that involved antitrust,[43] and the court agreed. MedImmune contended that the priority resolution did not require government action and, thus, that immunity was unavailable.[44] The court ruled that the application of the immunity was not whether it could have been achieved by private action, but whether the alleged violation involved government action in fact.[45] MedImmune failed to claim any other injury resulting from action not immune by the *Noerr-Pennington* doctrine, and the court granted summary judgment to Genentech.[46]

MedImmune filed a motion to amend its complaint,[47] and the court denied the motion as an attempt to avoid the court's previous summary judgment.[48] Celltech moved for Entry of Final Judgment,[49] and Genentech, subsequently, joined the motion.[50] The court considered the appropriateness of separating the claims determined by the summary judgment and the other claims not yet adjudged.[51] It decided that the issues of antitrust were fully adjudicated and timely for appeal, and granted judgment.[52] MedImmune continued to pursue its remaining claims, including patent unenforceability and invalidity and Genentech

[40] *Id.* at *6-7.
[41] *Id.* at *7.
[42] *Id.* at *3.
[43] *Id.* at *9. "The *Noerr-Pennington* doctrine essentially grants antitrust immunity to parties engaged in petitioning activities. This doctrine has its basis in the state action immunity doctrine - the idea that the government cannot be held liable for anticompetitive acts because the Sherman Act prohibits only those anticompetitive conditions that are sought to be or are created by 'individuals or combinations of individuals or corporations.' *Standard Oil Co. v. United States,* 221 U.S. 1, 51-62, 55 L. Ed. 619, 31 S. Ct. 502 (1911)." *Id.* at *9-10.
[44] *Id.* at *16.
[45] *Id.* at *16-17.
[46] *Id.* at *35-36.
[47] MedImmune v. Genentech, 2004 U.S. Dist. LEXIS 28681 (C. D. Ca., Feb. 17, 2004) at *2.
[48] *Id.* at *3-4.
[49] MedImmune v. Genentech, 2004 U.S. Dist. LEXIS 28678 (C. D. Ca., Feb. 17, 2004) at *2.
[50] *Id.* at *4.
[51] *Id.* at *8.
[52] *Id.* at *11-12. As a result of the judgment, Celltech was no longer a party to MedImmune's remaining claims. *Id.* at *12.

moved to dismiss for lack of subject matter jurisdiction.[53] The court scheduled a *Markman* hearing,[54] since all claims were for declaratory judgment. Prior to that hearing, however, there was a Federal Circuit decision which seemed to indicate that the court did not have subject matter jurisdiction,[55] and all claims were stayed until it was resolved.[56]

Subject matter jurisdiction in this case meant that there had to be an "actual controversy" between MedImmune and Genentech. Prior to the decision in *Gen-Probe*, "actual controversy" did not preclude a patent's validity from being challenged by the licensee.[57] In *Gen-Probe*, the court declared that the validity of the patents could not be challenged by licensees who were in good standing, as there was no reasonable expectation of being sued unless there was a material breach of the license.[58] MedImmune argued that *Gen-Probe* was not controlling because subject matter jurisdiction was procedural and not related to patent law, and that the court should apply the precedent of the Ninth Circuit not requiring a breach of the license prior to seeking declaratory judgment.[59] The court held that because the evaluation of a reasonable apprehension of infringement by MedImmune involved patent law, the decisions of the Federal Circuit on patent law were controlling.[60] It further found that there were no facts distinguishing *MedImmune* from *Gen-Probe* in dismissing the case against Genentech.[61]

### *B. Court of Appeals Decision*

MedImmune appealed[62] arguing that it was not estopped from challenging the validity or enforceability of Genentech's patent under *Lear*[63] and that *Gen-Probe* "improperly resurrected the licensee estoppel that was abolished in Lear, and should be overturned."[64] Genentech

[53] MedImmune v. Genentech, 2004 U.S. Dist. LEXIS 28680 (C. D. Ca., Apr. 23, 2004) at *2.

[54] A Markman hearing is conducted to determine the meaning of terms in a patent claim. *See* Markman v. Westview, 517 U.S. 370 (1996), where the court concluded that the interpretation of terms and construction of a patent claim were to be determined by a judge, not a jury.

[55] *See* Gen-Probe, Inc. v. Vysis, Inc., 2004 U.S. App. LEXIS 11991 (Fed. Cir. 2004) at *3.

[56] MedImmune v. Genentech, 2004 U.S. Dist. LEXIS 28680 (C. D. Ca., Apr. 23, 2004) at *4.

[57] *Id.* at *6-7.

[58] *Id.* at *7.

[59] *Id.* at *8-9.

[60] *Id.* at *9-13.

[61] *Id.* at * 17.

[62] 427 F.3d 958 (Fed. Cir. 2004).

[63] *See* Lear, Inc. v. Adkins, 395 U.S. 653 (1969).

[64] *Id.* at 963.

responded that in *Lear* the patentee was suing for royalties not paid by the licensee and in *Gen-Probe* the licensee was complying with the license and not subject to suit by the patentee.[65] The court agreed that the adverse interests of the licensee and patentee alone do not create a controversy which was adequately definite and concrete as to require judicial intervention.[66] The reasonable apprehension test to be applied required both a reasonable apprehension of facing a suit and an activity in the present which would be an infringement.[67] The court did not find that the threat to MedImmune was either reasonable or immediate.[68]

MedImmune also argued that there was an independent basis for attacking the patent because the settlement between Genentech and Celltech of the interference was fraudulent and involved collusion between the two parties.[69] The court rejected this argument as both against public policy to encourage settlement of suits and lacking precedent at law.[70] Likewise, the claim of collusion in the joint submission of the settlement agreement was rejected as not prohibited or against public policy.[71] MedImmune's further claim that Genentech's use of additional references after its patent application was returned to the patent examiner violated the antitrust laws was insufficient to give it standing or show a violation of the Patent and Trademark Office's own rules.[72] The court also ruled that all counts should remain the decision of one court, the Federal Circuit, and not returned to the Ninth Circuit in any case.[73]

### *C. Supreme Court Decision*

The Supreme Court reversed and remanded.[74] In an 8-1 opinion, the Court initially addressed whether the dispute at issue was "a freestanding claim of patent invalidity"[75] or a claim of an invalid patent and noninfringement, that is, there was no license breach and no royalties owed.[76] Genentech claimed that MedImmune was not challenging its obligations under the license contract for two reasons. First, there was not a dispute that MedImmune's Synagis infringed on

[65] *Id.*
[66] *Id.* at 964.
[67] *Id.*
[68] *Id.* at 965.
[69] *Id.*
[70] *Id.* at 966.
[71] *Id.* at 966-67.
[72] *Id.* at 967-68.
[73] *Id.* at 968-69.
[74] MedImmune v. Genentech, 127 S. Ct. 764 (2007).
[75] *Id.* at 768.
[76] *Id.* at 769.

Genentech's patent and, as a result, royalties were due from MedImmune and payable to Genentech.[77] Second, though there was in fact a dispute over the validity of Genentech's patent, the contract required that MedImmune pay royalties regardless of the validity of Genentech's patent.[78]

Genentech's first reason was inconsistent with the amended complaint.[79] MedImmune not only requested a declaratory judgment on its rights and obligations under the license agreement with Genentech, but stated that its contractual obligations under that license agreement were being disputed because its product, Synagis, did not infringe on any valid claim of Genentech's patent.[80] MedImmune's complaint that its product did not infringe on 'any valid claim' was based on its position that the Genentech patent in question was invalid. MedImmune made the claim repeatedly throughout its complaint.[81]

As for Genentech's second reason, MedImmune "did contend that it had no obligation under the license to pay royalties on an invalid complaint."[82] The license contract required that royalties be paid until the patent was invalidated,[83] and MedImmune disputed its contractual obligations.[84] Genentech argued that MedImmune waived any contract claim because it did not argue it in the Federal Circuit.[85] While that is true, MedImmune did argue the contract questions in its appellate brief, but recognized that the Federal Circuit's precedent in *Gen-Probe* did not permit jurisdiction over the contract claims.[86] A limitation of argument on an issue in an appellate brief without oral argument does not constitute a waiver of a claim, the Court found that MedImmune "had raised and preserved a contract claim."[87]

The key to the case, however, was the jurisdictional question. The Court has long considered the compatibility of the Declaratory Judgment Act (DJA)[88] with the requirement of a case in controversy found in Article III.[89] The DJA provides that "[i]n a case of actual controversy within its jurisdiction . . . any court of the United States . . . may declare the rights and other legal relations of any interested party

[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.* at 770.
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] 28 U.S.C. §2201(a) (2000).
[89] *See MedImmune*, 127 S. Ct. at 771.

seeking such declaration, whether or not further relief is or could be sought."[90] The cases following the enactment of the DJA were not crystal clear as to whether or not the declaratory judgments satisfied the case or controversy requirements.[91] Effectively, the U.S. Supreme Court has required that there be a real, definite, concrete and substantial dispute which goes to legal interests of parties adverse to each other, not a state of facts in the hypothetical.[92] There has to be a controversy "of sufficient immediacy and reality to warrant the issuance of a declaratory judgment."[93]

There was no doubt that the standards of the court under the DJA and Article III would have been satisfied, had MedImmune refused to make the royalty payments to Genentech.[94] The law and the facts were defined clearly enough to support a judicial resolution but for MedImmune's "continuing to make royalty payments."[95] Absent a claim for anticipatory breach, continuing to pay royalties to Genentech would seem to make the threat remote, not imminent, at best, and, at worse, nonexistent.[96] The question, then, becomes whether there is still "a case or controversy within the meaning of Article III.[97]

One does not need to wait until being exposed to the liability of an action threatened by the government before challenging the legal basis for that threat.[98] Enforcement of government action involves threat of forfeiture of property, fines, actual prosecution and imprisonment for violations of law.[99] This threat should not require that one should have to violate the law first, risking actual prosecution and its consequences, to challenge the constitutionality of that law.[100] The coercive threat to one having to choose between giving up one's individual rights and being prosecuted for that risk is the purpose of the DJA, to give one an opportunity for a declaratory judgment as an alternative to engaging in an illegal activity.[101]

Very rarely has the U.S. Supreme Court applied the DJA where imminent threat of injury is posed by an enforcement action of a non-government party.[102] But, the case nearest to being on point found that

[90] *Id.* at 770-71 (citing 28 U.S.C. §2201(a) (2000)).
[91] *Id.* at 771.
[92] *Id.*
[93] *Id.*
[94] *Id.* at 771-72.
[95] *Id.* at 772.
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *See id.*
[100] *See id.*
[101] *Id.* at 772-73.
[102] *Id.* at 773.

the continuation of payment of royalties under protest, being required by an injunction in a previous case, "did not render nonjusticiable a dispute over the validity of the patent."[103] There the patentees sued the licensees over territorial restrictions and the licensees countersued for a declaratory judgment on the validity of the patents.[104] The Court rejected the patentee's argument that there was no real controversy because of the continuation of royalty payments, as the royalties were being made under the compulsory requirement of a court injunction.[105] That coercion, mandated by the injunction, preserved the right of the licensees to fees and sums expended in challenging the patents and subjecting the licensees to actual and treble damages if they stopped payments was found to meet the requirements of a case or controversy.[106]

There is no support in Article III for the proposition that one must destroy the subject of a contract, bet all business assets on winning a outcome of no discernable probability, or risk actual and treble damages prior to pursuing a declaratory judgment of legal rights in a live contest.[107] Genentech argued that its agreement with MedImmune was, in effect, an insurance policy immunizing MedImmune from infringement suits by Genentech for so long as it continued to make royalty payments.[108] The Court found that any promise to pay patent royalties on a valid patent does not equate to a promise not to challenge the validity of that patent.[109] Genentech's argument that the common law rule of not permitting a contractual party to benefit from a contract while challenging the contract's validity at the same time was found not to defeat the Article III jurisdiction.[110] MedImmune's assertion was, rather, that the proper interpretation of its agreement with Genentech allows it to challenge the validity of the patents because the agreement doesn't require royalty payments for invalid patents.[111]

The DJA does provide that courts "may declare the rights and other legal relations of any interested party."[112] While the DJA vests discretion in the district courts because of the uniqueness of the remedy of declaratory judgment and its application to particular facts, that discretion was never considered by the District Court, but rather

[103] *Id. See* Altvater v. Freeman, 319 U.S. 359 (1943).
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] *See id.* at 775.
[108] *Id.* at 776.
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Id.* (citing 28 U.S.C. § 2201(a) (2000)).

dismissed based on the *Gen-Probe* case.[113] The Federal Circuit, in turn, affirmed the District Court for the same reason. The U.S. Supreme Court held the Article III doesn't require MedImmune to break its agreement with Genentech before seeking to challenge the patents underlying that agreement.[114]

## IV. FOLLOWING CASES

On remand, the Court of Appeals, recognizing that the remand order was not amenable for its determination on the record available as various issues required development of further facts, recalled its previous mandate and remanded the case further to the District Court.[115] The District Court, in turn, conducted a *Markman* hearing and "issued a Claim Construction Order construing several terms"[116] on the patent at issue. MedImmune stipulated that Synagis infringed on Genentech's patent, except for the agreement, and then moved for a summary judgment that Synagis only infringed on the covenant claim of the patent.[117] Genentech filed "an unconditional, irrevocable covenant not to sue or seek royalties . . . with respect to Synagis on any Claim of the '415 Patent other than Claim 33 . . ."[118] The Court accepted the covenant as proper and extinguishing of all other claims, including the subject matter as to the counterclaims by MedImmune.[119] The Court also rejected an attempt by MedImmune to continue its counterclaims by its assertion of a newer product, NuMax, as an issue in the suit.[120]

The court next turned to the ongoing obligations and contractual rights of MedImmune.[121] While the language of the contract might have been unambiguous, the validity of the patent, contrary to Genentech's contention otherwise, was part and parcel of the obligations under the contract, and Genentech's motion for summary judgment on the obligations and rights under the contract was denied.[122] The licensee estoppel doctrine, long considered the definitive statement and based on *Lear v. Adkins*, did not prevent MedImmune from asserting the invalidity of Genentech's patent.[123] The court also left, for further

[113] *Id.* at 776-77.
[114] *Id.* at 777.
[115] MedImmune v. Genentech, 219 Fed. Appx. 986, 2007 U.S. App. LEXIS 7669 (Fed. Cir. 2007).
[116] MedImmune v. Genentech, 2008 U.S. Dist. LEXIS 12198 (C.D. Ca. 2007) at *5.
[117] *Id.* at *5-6.
[118] *Id.* at *6.
[119] *Id.* at *11-20.
[120] *Id.* at *20-25.
[121] *Id.* at *25-27.
[122] *Id.* at *28-31.
[123] *Id.* at *32-52.

consideration, MedImmune's cause for the unenforceablility of the patent.[124] The U.S. Supreme Court also vacated another MedImmune case and remanded it to consider its decision in *MedImmune v. Genentech*.[125]

Teva Pharmaceuticals filed an Abbreviated New Drug Application (ANDA) for generic famciclovir and certified that if either it didn't infringe any of the five patents held by Novartis Pharmaceuticals or, if it did, the patents weren't valid.[126] Novartis brought suit of infringement of one patent and Teva sought a declaratory judgment on the other four patents.[127] Novartis moved to dismiss as Teva did not have a reasonable apprehension of being sued for infringement on the four patents, and the District Court agreed.[128] The Federal Circuit applied the *MedImmune v. Genentech* "all circumstances analysis" to find that Teva had an injury which was real and actual, that could be traced to Novartis, and was resolvable by a judicial determination.[129] However, when Apotex filed an ANDA for a generic version of Merck's Fosamax, Merck, subsequently, "granted Apotex a comprehensive covenant not to sue."[130] The analysis of *MedImmune v. Genentech* requires that the actual controversy be continuous in existence, and the granting of a comprehensive covenant not sue distinguishes *Teva* and prevents Apotex' claim of declaratory judgment against Merck.[131]

The reasonable apprehension of a suit test has been replaced by an analysis of all the circumstances of sufficiency to warrant a declaratory judgment.[132] Facts may now be alleged establishing an Article III case or controversy that gives rise to declaratory judgment jurisdiction.[133] Other courts have also held that the granting of a covenant not to sue by the patent holder removes the noninfringement and invalidity claims of generic manufacturers,[134] except where the covenant not to sue did not overcome the statutory exclusion from the market for a substantial

[124] *Id.* at *53-54.

[125] MedImmune v. Centocor, 223 Fed. Appx. 979, 2007 U.S. App. LEXIS 10012 (Fed. Cir. 2007).

[126] Teva Pharmaceuticals v. Novartis Pharmaceuticals, 482 F.3d 1330, 1334 (Fed. Cir. 2007).

[127] *Id.* at 1334-35.

[128] *Id.* at 1335 (Fed. Cir. 2007). *See* Teva Pharmaceuticals. v. Novartis Pharmaceuticals, 2005 U.S. Dist. LEXIS 38649 at *10-11.

[129] *Id.* at 1346.

[130] Merck & Co. v. Apotex, Inc., 488 F. Supp. 2d 418, 422 (D.C. Del. 2007).

[131] *Id.* at 423-24.

[132] Micron v. Mosaid, 518 F.3d 897, 901 (Fed. Cir. 2008).

[133] SanDisk v. STMicroelectronics, 480 F.3d 1372, 1382 (2007).

[134] *See* Janssen v. Apotex, 2007 U.S. Dist. LEXIS 75967 (D.C. N.J. 2007).

period of time.[135] Some courts have held that a competitor or licensee is required to show that it was engaged in an activity which would subject it to an infringement claim by the owner of a patent to support declaratory judgment jurisdiction or that it was not precluded from doing so.[136] In suits to declare patents invalid, there is no longer a case or controversy after an agreement in settlement was reached on all issues or issues remaining after a judgment of invalidity of one or more claims.[137] And, a letter of intent to pursue a legal remedy for a licensee's refusal to pay royalties is considered sufficient to create a controversy requiring declaratory judgment on the validity of a patent.[138]

## V. CONCLUSION

Patent licensee estoppel served to give the patent holder the upper hand when it came to negotiating, holding, or threatening the use of power in the enforcement of rights and interests against all potential and actual users of the benefits of a patent. By overturning the previous rule of nonjurisdiction over declaratory judgment cases by nonlicensees or licensees who have not repudiated their obligations under the license, the federal courts have shifted that power away from the patent holder. The balance achieved by this shift now puts the licensee, in particular, in the favorable position of not having to risk the treble damages and attorneys fees of a breach of a licensee to challenge the validity of the patent. However, without the risk of expense in repudiating a license, it may also increase the number of challenges to patent validity and its collateral burdening of the federal courts.

The lack of repudiation of obligations under a license does preclude jurisdiction per se, but some form of protest by the licensee as to the basis of the royalty payments and some indication of the intent of the patent holder to enforce its rights is indicated. And, though the licensee may protest the validity of the patent and its royalty payments, it still must continue to make those payments until such times as the patent is declared invalid. The litigation may well be rather lengthy, but, in the end, the royalty payments are probably not recoverable. On the other hand, a licensee who breaches an agreement will not have to pay the

[135] *See* Caraco Pharmaceutical v. Forest Laboratories, 2008 U.S. App. LEXIS 6838 (Fed. Cir. 2008).

[136] *See* Benitec v. Nucleonics, Inc., 495 F.3d 1340, 2007 U.S. LEXIS 17299 (Fed. Cir. 2007); Metrologic v. Symbol, 254 Fed. Appx. 128, 2007 U.S. App. LEXIS 26593 (3rd Cir. 2007).

[137] *See* Rite Aid v. Purdue Pharma, 2007 U.S. Dist LEXIS 61583 (S.D. N.Y. 2007); Pfizer, Inc. v. Ranbaxy Laboratories, 525 F. Supp. 2d 680, 2007 U.S. Dist. LEXIS 88030 (D.C. Del. 2007).

[138] *See* Adenta GMBH v. Orthoarm, Inc., 501 F.3d 1364, 2007 U.S. App LEXIS 22315 (Fed. Cir. 2007).

royalties that were due up until the time of the declaration of invalidity, but will owe the back payments if patent is determined to be valid, if only until the conclusion of the litigation.

For *MedImmune* to apply, the case or controversy must be continuous. Any agreement or collateral action which extinguishes the threat of enforcement of rights of a patent holder particularly to the licensee removes the all circumstances of sufficiency necessary for a declaratory judgment. The only exception is where the grant of a comprehensive covenant not to sue does not affect the statutory exclusion form the market for a substantial period of time as granted by the ANDA for generic drug manufacturing. For nonlicensees, the burden of proof requires that an engaged activity would subject the nonlicensee to an infringement claim by the patent holder, with that proof supporting a jurisdiction for a declaratory judgment.

The U.S. Supreme Court has clearly opened the door for declaratory judgment suits, at least for patent infringement issues. An explicit threat creating an apprehension of legal action is no longer required. A nonlicensee or licensee need only send a letter to a patent holder that it intends to engage in an activity which would be subject to an infringement claim. The patent holder, then, only needs to send a letter of its intent to pursue a legal remedy against the licensee who refuses to continue to pay royalties or a nonlicensee who refuses to sign a license agreement or acknowledge that it is infringing on the holder's patent.

# COMMERCIAL REGULATION OF DECEPTIVE ADVERTISING: WHY MORE REGULATION IS NOT NECESSARILY BETTER

by ROBERT C. BIRD*

Advertising has a significant impact on consumer preferences for goods and services. Advertising can efficiently communicate information to consumers, increase choice in the marketplace, open new markets for products, and encourage competition between rivals. False advertising distorts these important goals by reducing consumer trust, discouraging attribute-based competition, and suppressing the effects of legitimate product innovation. Thus, the influence and visibility of advertising makes it an important object for government regulation.

The Federal Trade Commission (FTC) is the agency primarily responsible for the regulation of advertising. The FTC's original charge was to enforce section 5 of the 1914 Federal Trade Commission Act and prevent "unfair methods of competition."[1] Originally created to address antitrust violations, in 1938 the FTC was empowered by the Wheeler-Lea Act to regulate unfair deceptive acts or practices in consumer transactions.[2] Today, the FTC enforces a federal false advertising law

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1 Ross D. Petty, *FTC Advertising Regulation: Survivor or Casualty of the Reagan Revolution?*, 30 AM. BUS. L.J. 1, 2 (1992) (citing Act of Sept. 26, 1914. Ch. 311, § 45(a)(1), 38 Stat. 717, 719 (1914)).

2 Victor E. Schwartz, Cary Silverman & Christopher E. Appel, *'That's Unfair!' Says Who – The Government or the Litigant?: Consumer Protection Claims Involving Regulated Conduct,* 47 WASHBURN L.J. 93, 96 & n.13 (2007).

encompasses of two types of false statements. First, the Lanham Act prohibits literally false factual commercial claims.[3] Second, the Lanham Act prohibits statements that, while not literally false, may convey a false impression, are misleading in context, or are somehow likely to deceive consumers.[4] This includes statements that are true, but still have a tendency to mislead or deceive.[5] Armed with the Lanham Act and charged by Congress, the FTC has been successful in stopping deceptive advertising on a number of occasions and levying significant fines in the process.

The FTC, however, is not the only entity that can enforce false advertising laws. Significant research exists on the importance of commercial actors in regulating false advertising.[6] Competitors, suppliers, franchisors, and consumer groups have an important role to play in enforcing false advertising laws.[7] Private actors can use litigation to influence the type of advertising firms create and how much information consumers receive. The effect of private actors is separate and distinct from the influence of the FTC.

At first glance it may appear that the more entities are available to enforce false advertising laws the better. The FTC will be relieved of its enforcement burden, ad campaigns will be more closely scrutinized, and fewer false claims will go unpunished. A closer look, however, reveals that unrestricted enforcement of false advertising laws can have unintended effects that counteract perceived benefits and may thwart the goal of the Lanham Act to encourage fair methods of competition.

The purpose of this paper is to show that granting unrestricted enforcement power to private actors to enforce false advertising laws does not always serve the public good. While private rights of action can play

[3] Courtland L. Reichman & M. Melissa Cannady, *False Advertising under the Lanham Act*, 21 FRANCHISE L.J. 187, 188 (2002).

[4] *Id.* at 189.

[5] *Id.*

[6] *E.g.,* Petty, *supra* note 1; Avery M. Abernethy & George R. Franke, *FTC Regulatory Activity and the Information Content of Advertising*, 17 J. PUB. POL'Y & MKTG. 239 (1998); Ross D. Petty, *Supplanting Government Regulation with Competitor Lawsuits: The Case of Controlling False Advertising*, 25 IND. L. REV. 351 (1991); Roger E. Schecter, *Letting the Right Hand Know What the Left Hand's Doing: The Clash of the FTC's False Advertising and Antitrust Policies*, 64 B.U. L. REV. 265 (1984).

[7] Consumers may also be potential litigants. However, virtually all courts agree that the Lanham Act does not enable consumers to sue firms for false advertising. *See* James S. Wrona, *False Advertising and Consumer Standing under Section 43(a) of the Lanham Act: Broad Consumer Protection Legislation or Narrow Pro-Competitive Measure?*, 47 RUTGERS L. REV. 1085 (1995). Therefore, the issue of consumer plaintiffs in false advertising cases is not pursued in this manuscript. *See* Richard A. De Sevo, *Consumer Standing Under Section 43(a)—An Issue Whose Time Has Passed,* 88 TRADEMARK REP. 1 (1998).

a helpful role, overzealous pursuit of false and deceptive advertising claims can impose social costs which impede the goals of false advertising law. This manuscript will first examine the benefits and costs of broad private rights of enforcement of false advertising laws. Given that legal reform of false advertising law is unlikely, the next section of the manuscript focuses on strategies for firms who conduct advertising campaigns in the current legal environment. This section suggests ways for firms to avoid false advertising disputes, and if a dispute should occur, an inexpensive way to resolve them through industry self-regulation.

## I. DECEPTIVE ADVERTISING AND THE MARKETING ENVIRONMENT

Advertising is almost as ancient as civilization. Ancient Greeks would inscribe advertisements on sheets of lead that were affixed to statutes of deities. Regulation of advertising also has a lengthy history. In twelfth-century Europe, King Louis VII enacted an elaborate series of rules limiting the number of town criers, the then primary advertising method, in a given city.[8] With the advent of the Industrial Revolution and economic expansion, advertising became increasingly sophisticated by incorporating greater use of art, photography, and behavioral psychology to woo consumers.[9] Firms also did not hesitate to cover over their advertisements of their rivals, timing their advertising activity early enough in the day to avoid detection, but late enough to deface the work that had been posted earlier in the day.[10] The number of advertisements and their sophistication increased incrementally, and so did the number of deceptive advertisements.

The most important statute regulating advertising for the purposes of this paper is the Lanham Act of 1946.[11] The Lanham Act requires anyone who is challenging an advertisement to prove the following five facts in order to win in court:

> (1) that the defendant has made a false or misleading statement of fact concerning his product or another's; (2) that the statement actually or tends to deceive a substantial portion of the intended audience; (3) that

[8] Business Historical Society, *Curiosities from the History of Advertising*, 3 BULL. BUS. HIST. SOC. 12, 12-13 (1929).

[9] Steven Wilf, *The Making of the Post-War Paradigm in American Intellectual Property Law*, 31 COLUM. J.L. & ARTS 139, 164 (2008) ("Already by the early twentieth century, a revolution had taken place in marketing, which introduced both color and striking visual statements. . . . Throughout the 1920s, advertising served up a broad array of consumer goods in a plethora of new forms. Cultivating desire was indeed a sign of cultivation."); Richard W. Pollay, *The Subsidizing Sizzle: A Descriptive History of Print Advertising, 1900-1980*, 49 J. MKTG. 24 (1985).

[10] Business Historical Society, *supra* note 8, at 13.

[11] 15 U.S.C. § 1051 (2008).

> the statement is material in that it is likely to influence purchasing decisions; (4) that the product traveled in interstate commerce; and (5) that there is likelihood of injury to the plaintiff in terms of declining sales, loss of goodwill, etc.[12]

False advertising law recognizes two types of false statements: literally false factual claims and literally true claims that convey a false impression, are misleading in their context, or are otherwise likely to deceive consumers. Given that specific damages are difficult to prove, most successful plaintiffs obtain relief through termination of the advertising campaign.[13]

The primary enforcer of false advertising rules nationwide is the FTC. However, consistently monitoring every tributary in the stream of American commerce is virtually impossible. The FTC has a limited budget. In 2004, for example, the agency received only $186 million from Congress to regulate millions of American advertisements and a wide range of consumer activity.[14] Funding and enforcement philosophy fluctuate according to the political orientation of the executive branch. After a relatively inactive period in the 1960s,[15] the FTC responded to criticism with a decade of aggressive enforcement in the 1970s.[16] Enforcement faded in the 1980s, returned in the 1990s under the Clinton administration, and likely has relaxed again under the second Bush Administration.[17] Under the Obama administration, increased attention is expected to be upon online advertising and privacy issues.[18] The FTC

[12] Charles M. Hosch & Lauren T. Becker, *Business Torts*, 60 SMU L. REV. 713, 727 n.101 (2007). *See also* Richard J. Leighton, *Literal Falsity by Necessary Implication: Presuming Deception with Evidence in Lanham Act False Advertising Cases*, 97 TRADEMARK REP. 1286, 1288-89 (2007); Cynda E. D'Hondt, *Another Small Step for the Second Circuit Might be a Giant Leap for Section 43(a) of the Lanham Act,* 3 BROOK. J. CORP. FIN. & COMM. LAW. 127 (2008).

[13] Kevin M. Lemley, *Resolving the Circuit Split on Standing in False Advertising Claims and Incorporation of Prudential Standing in State Deceptive Trade Practices Law: The Quest for Optimal Levels of Accurate Information in the Marketplace*, 29 U. ARK. LITTLE ROCK L. REV. 283, 313 (2007).

[14] Jon Mize, *Fencing off the Path of Least Resistance: Re-Examining the Role of Little FTC Act Actions in the Law of False Advertising*, 72 TENN. L. REV. 653, 666 (2005).

[15] Abernethy & Franke, *supra* note 6, at 241.

[16] *Id.*

[17] *Id.* at 241-42 (describing Clinton-era activity). *See also* Michael J. Malinowski, *Choosing the Genetic Makeup of Children: Our Eugenics Past-Present, and Future?*, 36 CONN L. REV. 125, 181 n.288 (2003) (describing Bush administration treatment of direct promotion of off-label use practices); Arthur Delaney, *Free Credit Report: How the Ads Soak Consumers*, THE HUFFINGTON POST (Mar. 5, 2009), http://www.huffingtonpost.com/2009/03/05/free-credit-report-how-th_n_172190.html (describing FTC practices under Bush administration as "overly business friendly.").

[18] Kate Kaye, *Obama to Nominate Leibowitz to Head FTC*, CLICKZ, (Mar. 2, 2009), http://www.clickz.com/3632974.

is thus placed in the difficult position of ever-fluctuating responsibilities and insufficient resources to meet market demands.

Filling that gap is the private actor. Private actors have significant incentives to help the FTC enforce deceptive advertising laws. Competitors want to stop rivals from gaining an unfair advantage through misleading statements made to the public. Consumers have an incentive to report deceptive advertising in order to avoid being misled by untrue product claims. Non-governmental organizations such as the Consumers Union fulfill their mission by questioning the veracity of advertisements and publicizing deceptive claims.[19] If the Lanham Act did not provide for a private right of action, many deceptive advertising practices would go unchecked.

The regulation of advertising promotes fair play and truthful disclosures. Truthful disclosures, in turn, promote market efficiency by allowing consumers to easily compare competing products. If even a small segment of consumers is well-informed, consumers who have not even viewed advertising will benefit as firms compete to attract the well-informed segment of the market.[20] Fair and free advertising also promotes price competition,[21] and this effect occurs whether or not the advertising directly addresses price or not.[22] Finally, accurate advertising builds consumer trust in advertising messages. A large pool of potential enforcers could bring more false advertisers to court and discourage others from engaging in deceptive advertising in the future.

Although regulation of false advertising is important, unregulated enforcement by private actors can impede the development of a free and fair market for advertising. Unlimited commercial private rights of action increase the number of sources of private enforcement. The number of possible firms who can sue multiplies from only competitors to suppliers, retailers, distributers, manufacturers, franchisers, and trade associations as possible plaintiffs.

[19] *See generally* Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law,* 108 HARV. L. REV. 1785, 1842-1844 (1995) (describing activities of Consumers' Union).

[20] Abernethy & Franke, *supra* note 6, at 240.

[21] C. Robert Clark, *Advertising Restrictions and Competition in the Children's Breakfast Cereal Industry*, 50 J. L. ECON. 757, 758 (2007) ("If advertising is informative, it should help overcome perceived product differentiation and so should lead to price competition and lower prices."). John R. Schroeter, Scott L. Smith & Steven R. Cox, *Advertising and Competition in Routine Legal Services Markets: An Empirical Investigation*, 36 J. INDUS. ECON. 49, 49 (1987) ("The bulk of empirical evidence from [studies examining the impact of price on professional service markets] supports the hypothesis that prices in professional service markets in which sellers advertise are lower, relative to costs, than they would be if such advertising were banned.").

[22] *See generally* Lee Benham, *The Effect of Advertising on the Price of Eyeglasses,* 15 J.L. ECON. 337 (1972).

Private enforcement of false advertising law can dilute the influence of public opinion over how false advertising is regulated. Political administrations can reel in enforcement by the FTC if it is overly vigorous or appoint leadership that will encourage enforcement if the FTC acts ineffectively.[23] Through this mechanism FTC enforcement is indirectly accountable to public sentiment. Private actors, on the other hand, are accountable to their shareholders and not the public. The result is that broad commercial rights of action give the public less control over how false advertising is regulated.

Private enforcement can also promote erroneous results. Two errors are possible in efforts to prevent deceptive advertising. The first error is that the enforcer fails to stop deceptive advertisements.[24] Failures of this type are easy to spot.[25] Misleading advertisements that go unchecked or consumer complaints that go unanswered are obvious evidence.[26] Preventing these Type I errors, or 'false negatives' as they are otherwise known, is relatively simple. The FTC, consumer groups, and private actors are all interested in discovering false negatives and eliminating them, although the reasons each has for doing so may differ. Thus, the cash-strapped FTC receives significant assistance in curing this kind of oversight.[27]

Interests diverge, however, in detecting Type II, or 'false positive', errors. These errors occur when legitimate advertising is halted because of a mistaken conclusion that such advertising violates the Lanham Act. False positives are difficult to spot because most FTC challenges to advertising are settled rather than litigated.[28] As most information about the case remains private, outsiders cannot evaluate whether the FTC overstepped its bounds.[29]

Eliminating false positives is particularly important because it is these kinds of errors that impose a chilling effect on non-party advertisers. Although settlements are private, the fact that the FTC took action against a given firm for a given reason may be widely known. When false positives occur, not only do legally compliant advertisers suffer improper sanction, but otherwise legal advertisements by other firms

[23] Abernethy & Franke, *supra* note 6, at 241-42.

[24] Andrew J. Strenio, *Book Review,* 15 J. PUB. POLY & MKTNG. 319, 320 (1996) (reviewing CHARLES C. MANN AND MARK L. PLUMMER, THE ASPIRIN WARS 1991)). *See also* Paul H. Rubin, *Regulation of Information and Advertising*, (Emory University Department of Economics and Emory University School of Law, Working Paper 04-05), *available at* http://ssrn.com/abstract = 498683.

[25] Strenio, *supra* note 24, at 320.

[26] *Id.* at 320.

[27] *Id.*

[28] *Id.* at 320-21.

[29] *Id.*

fearing litigation are delayed significantly or never created at all. For example, although scientists were aware that aspirin prevented heart attacks as early as 1950, aspirin manufacturers could not secure the blessing of the FDA, and implicitly the FTC, to advertise aspirin's benefits for many years afterward.[30]

Fortunately, the FTC is subject to an important control. As a public agency, the FTC is sensitive to any allegations of over-enforcement and interference with legitimate business transactions. Responding in part to a backlash against aggressive new FTC rules banning advertising to children and restricting drug firm advertising language,[31] President Reagan appointed a chairman who disliked social regulation and shared the President's view that commerce works best if government leaves it alone.[32]

Private actors, on the other hand, have little concern for preventing false positive errors. The motivation of a private firm is to defend its products from unfair competition and achieve advantages over rivals. If litigation or even the threat of litigation through an attorney letter triggers a false positive result—the retraction of an otherwise legal advertisement—the enforcer benefits. The enforcer has neutralized a rival's potentially effective campaign. The rival absorbs the costs of creating a commercial advertisement without the benefit of increased revenue from that advertisement. The rival is then forced at its own expense to modify and develop a new promotion that avoids the threatened litigation. Like false positives caused by the FTC, false positives caused by industry are difficult to detect. Pre-litigation negotiations as well as settlement agreements generally are not subject to any disclosure requirements. There is little way of knowing when an aggressive firm has used false advertising law to force a rival into retracting an otherwise legal promotional campaign. A rival might retract an otherwise legal campaign because it cannot bear the cost of legal fees to defend the action or it cannot bear the cost of an adverse court decision should their assessment of the campaigns' legality be incorrect. Thus, private enforcement does not always further the goals of the Lanham Act and the FTC.

Relaxed enforcement rules may also encourage private litigants to engage in selfish and even invidious behavior. One of the many goals of the FTC is to improve information content and eliminate unfair competition. The FTC does not profit from its own enforcement actions.

[30] Strenio, *supra* note 24, at 321.

[31] William J. Baer, *At the Turning Point: The Commission in 1978*, *in* MARKETING AND ADVERTISING REGULATION: THE FEDERAL TRADE COMMISSION IN THE 1990S 94 (Patrick E. Murphy and William L. Wilkie, eds., 1990).

[32] Abernethy & Franke, *supra* note 6, at 241.

Private entities, by contrast, are not motivated by such lofty goals. Self-interested commercial motives lead to false advertising litigation. Some of these motives align with the purpose of the Act. Defensive litigation against a competitor who gains an unfair advantage from providing deceptive information helps cleanse the marketplace of misleading advertising. Some motives, however, are more self-seeking. Private actors may use the Lanham Act as a sword to impede the success of competitors. Even an unmeritorious lawsuit may absorb months of time, impose significant legal bills, and require the defendant to temporarily cease the advertising campaign.

Furthermore, litigation (meritorious or otherwise) increases perceived risk by the financial community. Private investors may restrict further funding, banks may charge higher interest rates on loans, and stockholders may witness their shares decline in value. Although the defending firm may ultimately win the case and be vindicated, the imperfect nature of information dissemination may dilute the perceived integrity of the advertisement or the firm. Consumers doubting the integrity of the product or the firm in question may switch to a substitute.

Furthermore, the benefits of a broad commercial right of action will fall disproportionally on large firms who want defend their products against the deceptive advertising of their competitors. Large firms will have the resources to file expensive lawsuits against rivals who mislead. Even if a trial verdict is unfavorable to the large firm, the appellate process can delay a final judgment for years, a further cost that many firms cannot absorb easily. Exacerbating this inequality is the increasing judicial reliance on survey evidence in trademark cases generally.[33] Survey evidence involves polling the relevant consumer market to determine whether the advertisement at issue has a deceptive effect.[34] Surveys are time-consuming and extremely expensive to conduct.[35] Only firms of significant size are able to pay for such evidence, and courts are not sympathetic to parties who claim they cannot afford it.[36] The result is that small and cash-poor enterprises may be unable to challenge a competitor's deceptive ad campaign even when the desire and the right exist to do so.

[33] J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 32:195 (2008).

[34] *See generally* Robert C. Bird, *Streamlining Consumer Survey Analysis: An Examination of the Concept of Universe in Consumer Surveys Offered in Intellectual Property Litigation*, 88 TRADEMARK REP. 269 (1998).

[35] Robert C. Bird, *The Impact of the Moseley Decision on Trademark Dilution Law*, 26 J. PUB. POLY. & MKTG. 102, 104-05 (2007).

[36] *E.g.,* Sports Traveler, Inc. v. Advance Magazine Publishers, Inc., 25 F. Supp. 2d. 154, 164 (S.D.N.Y. 1998).

Conversely, the burdens of a broad commercial right of action will fall disproportionally on small firms. The broader the rules, the more potential plaintiffs exist and the greater risk a small firm has of being sued. Small companies may lack the resources to aggressively defend claims against them. Defending a false advertising case in federal court is no less expensive than pursuing one. Furthermore, the difficulty of obtaining monetary damages in false advertising suits makes lawsuits based upon contingency fees unattractive.[37]

Small firms may react by restricting their informational advertising campaigns to general statements about their product. Small firms selling products with superior attributes may not be willing to run product comparison advertising against an inferior product sold by a large competitor for fear of inciting litigation. Whereas large firms will use comparative or factual advertising with little fear, small firms will perceive even truthful campaigns against a well-funded rival as a risky venture.

Negative effects will also rest on consumers. There are, of course, clear benefits to consumers in the form of more accurate information and fair competition.[38] Yet, as mentioned previously, broad commercial enforcement will cause litigation-sensitive firms to simply offer less information to consumers in their advertisements. For example, when the FTC threatened the Campbell Soup Company with legal action because their slogan, "soup is good food," was used without reference to the product's high sodium content, Campbell simply withdrew the slogan and replaced it with the even less informative slogan, "mmm mmm good."[39] The result may be that firms will advertise in only the most general of fashion, further speeding the trend away from product attribute advertising and toward advertising that emphasizes non-informational and ephemeral notions of emotion and lifestyle choices.

Increased false advertising litigation may also inflate consumer costs. If more lawsuits result in more settlements and fines for advertisers, this raises the cost of product marketing and such costs will ultimately be passed along to the consumer. Further, if aggressive deceptive advertising enforcement encourages advertisers to employ general, non-informational advertising messages rather than informative ones, this will reduce available information for consumers, and increase the search costs of consumers to gain that information. This effect contradicts the purpose of trademark law (upon which deceptive advertising law is based), which is to decrease search costs as much as possible.[40] In addition, increased

[37] Lemley, *supra* note 13, at 313.
[38] Abernethy & Franke, *supra* note 6, at 239-40.
[39] *Id.* at 251.
[40] Lemley, *supra* note 13, at 286-87.

search costs decrease a consumer's sensitivity to price[41] and may increase the marketing expenditures necessary to pull consumers away from one product choice to another. The overall benefit to consumers of privately-enforced false advertising regulation may still be positive, but aggressive and potentially frivolous litigation prompted by abusive practices can neutralize advantages that consumers receive from the Lanham Act.

Over the long-term, if false advertising claims become widely utilized in the private sector, they may undermine the FTC's important enforcement role. Already incentivized by a small budget to pursue only a limited number of promising cases,[42] a fiscally-pressured Congress may contend that FTC funding should not be a top priority because the private sector has filled the enforcement gap. The result would be that the primary motivation for stopping deceptive advertising campaigns would become the commercial self-interest of wealthy firms who can afford litigation, rather than the protection of the public. This supplanting effect is far from imminent, however, and both the FTC and private firms participate in enforcement.

## II. DEFENSIVE STRATEGIES IN AN UNCERTAIN LEGAL ENVIRONMENT

A variety of defensive strategies are available to firms in order to minimize their chance of attracting litigation or regulatory scrutiny. The most obvious recommendation for firms heavily engaged in advertising is to lobby Congress and restrict the ability of private actors to sue rivals. Such reform is unlikely to occur. The life cycle of a deceptive advertisement may be too short to justify the cost and time of lobbying for action.[43] Even if corporate political action were an option for a long-term solution, many companies would lack the political resources or legislative experience to participate in lobbying activities. Collective action in the form of trade groups may alleviate these problems, but such groups only indirectly represent individual firms and are likely to be swayed by its largest, most influential members. These larger members may not be interested in restricting their power to challenge their competitors advertising campaigns if necessary.

Since firms want to avoid being sued for false advertising, but may wish to retain the right to sue others, business rather than legal strategies may be more effective in minimizing dispute risks. Advertisers and the

[41] *See generally* J. Yannis Bakos, *Reducing Buyer Search Costs: Implications for Electronic Marketplaces*, 43 MGMT. SCI. 1676 (1997).

[42] Jeff Sovern, *Private Actions under the Deceptive Trade Practices Acts: Reconsidering the FTC Act as Rule Model*, 52 OHIO ST. L.J. 437, 442 (1991).

[43] *See generally* Douglas A. Schuler & Kathleen Rehbein, *The Filtering Role of the Firm in Corporate Political Involvement*, 36 BUS. & SOC. 116 (1997).

agencies they hire should scrutinize carefully the promotions they disseminate for false or deceptive information. For firms reliant on lifestyle or non-comparative promotional strategies, false advertising rules do not constitute a significant constraint. Managers promoting products dependent upon characteristic-based competition, however, might feel the pinch. However, in the ardent desire for an aggressive promotional campaign in a market environment already overcrowded with advertising, the careful adherence to truthful facts and inferences may accidentally be set aside.

Marketers and their advertising agencies engage in a complex relationship that influences the creativity of the promotions created.[44] Yet, it is not the perspective of the ad agency that is most important for assessing the veracity of advertising, but that of the ordinary consumer. Managers can screen advertising campaigns before a focus group of consumers to determine if the campaign affects attitudes towards the product or increases the tendency to purchase. During these focus groups, administrators should also test for indicia of deceptiveness. If consumers believe that a product offers a certain attribute that it does not have as a result of the promotion, the source of that inference needs to be examined. Consumers may also view an advertisement as making claims or offering comparisons that were never intended by the designers of the advertisement.

Searching for consumer misperceptions has two benefits. First, it can eliminate any deceptive material in a planned advertisement and thus reduce the possibility of a deceptive advertising charge later. Second, informally-gathered data about consumers showing no misperceptions about an advertisement can be useful later if a firm is faced with an accusation of deceptive advertising from a rival or the FTC. Although such anecdotal evidence may be less persuasive than a formal consumer survey, both surveys and individual responses of consumers are acceptable evidence to prove or refute false advertising allegations.[45] Courts have perceived such pre-litigation evidence as more inherently trustworthy than information developed for or during litigation.[46] Low cost veracity checks before an advertisement becomes public can reduce the risk of subsequent scrutiny by rivals or the FTC.

The best defense in an uncertain legal environment may be to resolve disputes through self-regulatory bodies established by industry. Self-

[44] *See* Scott Koslow, Sheila L. Sasser & Edward A. Riordan, *Do Marketers Get the Advertising They Need or the Creativity They Deserve? Agency Views of How Clients Influence Creativity*, 35 J. ADVERTISING 81, 81-83 (2006).

[45] Harry S. Gerla, *Federal Antitrust Law and the Flow of Consumer Information*, 42 SYR. L. REV. 1029, 1072 (1991).

[46] *E.g.,* Nestle Company Inc. v. Chester's Market Inc., 571 F. Supp. 763, 775 (D. Conn. 1983).

regulation has been an important regulatory force since the early twentieth century, when newspapers and magazines developed simple advertising codes to prevent publication of false advertisements for patented medicines.[47] Decades later, four advertising-related associations created the National Advertising Division (NAD) and the National Advertising Review Board (NARB), a private entity that investigates complaints about the accuracy of national advertising upon request and resolves disputes through a negotiation process.[48] Supported by an elaborate procedural and regulatory system, the NAD mediates disputes, issues written decisions, and offers an appeal process to the NARB.[49] The NAD and NARB have processed over 4,000 cases since their inception in 1971.[50] Less than five percent of these cases have been referred to government agencies for resolution.[51] Non-compliance by participating advertisers to the self-enforcement bodies has been rare.[52]

The NAD and NARB represent an important opportunity for firms to resolve their differences in a forum dedicated to the industry's needs. Although decisions are not legally binding on the parties, they can have some influence on the judiciary. A number of NAD cases, for example, have been cited by federal courts.[53] Unfortunately, the reasoning of a NAD or NARB body has yet to explicitly find its way into the core rationale of a court's opinion.[54] However, given the success rate of these bodies and the level of voluntary compliance, their influence is only likely to increase.

Although the NAD and NARB accept a wide variety of advertising disputes, their self-established jurisdiction is not limitless. The boards will not accept any complaints that do not concern "national advertising," meaning that the advertisements at issue must be disseminated at a minimum to a substantial portion of the United States.[55] Advertisements of a regional or local nature are left to be reviewed through traditional regulatory means. In spite of this limitation, self-regulation by private

[47] Jeffrey S. Edelstein, *Self-Regulation of Advertising: An Alternative to Litigation and Government Action*, 43 IDEA 509, 515 (2003).

[48] *Id.* at 516.

[49] *Id.* at 518-25.

[50] *Id.* at 527.

[51] *Id.*

[52] *Id.* at 528.

[53] *Id.* at 529. *E.g.*, Coca-Cola Co. v. Procter & Gamble Co., 642 F. Supp. 936, 939 (S.D. Ohio 1986), *rev'd on other grounds*, 822 F.2d 28 (6th Cir. 1987); AMF Inc. v. Brunswick Corp., 621 F. Supp. 456 (D.C.N.Y. 1985); Am. Home Prods. Corp. v. Johnson & Johnson, 436 F. Supp. 785, 789 (S.D.N.Y. 1977), *aff'd*, 577 F.2d 160, 163 (2d Cir. 1978).

[54] Edelstein, *supra* note 47, at 529.

[55] NATIONAL ADVERTISING REVIEW COUNCIL, THE ADVERTISING INDUSTRY'S PROCESS OF VOLUNTARY SELF-REGULATION § 1.1A (2007), *available at* http://www.nadreview.org/07_Procedures.pdf.

actors offers a medium to resolve deceptive advertising claims without being subjected to uncertain judicial rules, contradictory case precedent, and costly legal fees.

## III. CONCLUSION

The Federal Trade Commission has sought to defend the marketplace against unfair competition for nearly one hundred years. The result has been a largely free market where participating firms have an equitable opportunity to compete against rivals. One part of the FTC's enforcement role, the prevention of unfair advertising, has waxed and waned in importance over the decades as the Commission has reflected the attitudes of the executive branch to which it has been accountable. Encouraged at some times and suppressed at others, the always under-funded FTC has consistently attempted to improve information content, quality, and quantity in the marketplace.

While the current state of broadly permitting commercial interests to enforce false advertising laws would seem to improve information quality, it can come at a price. Legitimate advertisers may be less willing to present attribute-related claims for fear of being sued. Consumers receiving less information from ads may find it more difficult to make easy product comparisons. Large firms who can afford costly litigation can use false advertising litigation as a weapon against smaller rivals. The result may be an advertising environment that is less robust and informative as a result of over-enforcement.

Until the law improves, there are measures both legal and non-legal that firms can implement to minimize risk. Firms can scan their advertisements for potentially deceptive messages before disseminating those messages to the public. Consumer data gathered before a dispute arises offers trustworthy evidence of the advertisement's non-deceptive nature while also showing an attitude of good faith towards creating fair promotions. The most efficient solution may be self-regulation of the industry, whereby firms use a private entity to resolve disputes in a forum free from complex and contradictory legal rules.

The prevention of deceptive advertising is an important goal for ensuring free and open markets. However, the availability of redress must be carefully circumscribed in order to curb the negative effects that private enforcement can have on competitive equality and information flows. Until the Supreme Court or Congress decides to address the issue, uncertainty will likely remain and firms will have to engage in defensive measures to avoid litigation from rivals or regulation by the FTC.

# TO PARAPHRASE W.S.: "SUGAR BY ANY OTHER NAME MIGHT SURELY *NOT* BE AS SWEET": MERISANT v. MCNEIL

by MARK BLODGETT[*], HECTOR R. LOZADA[**] AND
RICHARD J. HUNTER, JR.[***]

## INTRODUCTION, CONTEXT, AND PARALLELS

"Big Pharma" today necessarily means "Big Advertising"! But does it also mean a misplaced emphasis on promotion and advertising at the expense of research and development activities and a guaranty of "hand-to-hand combat" between some of the giants of a similar industry? A debate is literally raging in the United States among major research organizations and several private researchers who have very different views—and data—on the subject. Two major pharmaceutical research groups, CAM Group and IMS, provide important data in order to evaluate competing claims. In their 2004 report, CAM Group[1] detailed

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[1] The Cegedim website (http://www.cegedim-crm.com/index.php?id=12) describes CAM as a "global company dedicated to auditing promotional activities of the pharmaceutical industry, established in 36 countries worldwide." CAM annually surveys a representative sample of 2,000 primary care physicians and 4,800 *specialists* in a variety of medical specialties in selected locations in the United States. *See* http://csd.cam-group.com/www_assets/pages/downloads/USNewsletterQ404.pdf (the website of the CAM Group).

total *promotional spending* by the pharmaceutical industry in the United States at $33.5 billion, while IMS Health[2] reported $27.7 billion for the same year. Based upon these reports, and adjusting for the methodological differences found in ways that IMS and CAM collect data, Gagnon and Lexchin arrived at the staggering sum of $57.5 billion for the total amount spent on pharmaceutical promotion in 2004.[3] A major part of promotion, of courses, lies in the area of direct and indirect advertising. Overall, *EMarketer* predicted that $25.8 billion would be spent for general web advertising in 2008 and web advertising would rise by 28.9% in 2009[4] across all industries. Yet, pharmaceutical ad spending in the United States dropped by 6% in the first eight months of 2008, to $3.2 billion, following a 3% decline for all of 2007, to $5.3 billion.[5] Interestingly, the increasing emphasis on product advertising—especially in online advertising—has come at a time of *slowing* drug sales, attributable to competition with generic drugs. Thus, while there was an overall increase of 2.6 percent in general media ad spending (including TV, magazines, radio, outdoor, newspapers, and the Internet), there was an absolute drop of 14.7% in Internet ad spending. That is, while *pharma* spent $58.1 million on the Internet in Q1-Q3 2006, it spent only $49.5 million in the same period in 2007.[6]

Surprisingly, on one side of the *research vs. promotion* debate is the U.S. General Accounting Office. Largely relying on data provided by IMS, as noted, a firm specializing in "pharmaceutical market intelligence," the GAO has concluded that "pharmaceutical companies spend more on research and development initiatives than on all drug promotional activities."[7] This view is not unsurprisingly supported by the Pharmaceuticals Research and Manufacturers of America (PhRMA),

[2] IMS is a firm specializing in pharmaceutical market intelligence. Its research is generally considered to be the authority for assessing pharmaceutical promotion expenditures. IMS is a global company established in more than 100 countries. IMS gathers data from 29,000 data suppliers at 225,000 supplier sites worldwide. According to company data provided, IMS monitors 75% of prescription drug sales in over 100 countries and 90% of prescription drug sales in the United States. It also tracks more than *1 million products* from more than 3,000 active drug manufacturers. IMS Health, http://www.imshealth.com/portal/site/imshealth (last visited Feb. 9, 2009).

[3] Interestingly, the research estimated that the industry spent approximately *$61,000 in promotion per physician* during 2004.

[4] *See Pharma Recession, Part Deux: Online Ad Spending Sinking!* http://pharmamkting.blogspot.com/2008/03/pharma-recession-part-deux-online-ad.html (March 25, 2008, 06:30 EST) [hereinafter *Pharma Recession*].

[5] Peter Loftus, *Drug Companies Trim Advertising Spending, Tweak Approach*, WALL ST. J., Dec., 9, 2008, http://online.wsj.com/article/BT-CO-20081209-705596.html.

[6] *Pharma Recession*, *supra* note 4.

[7] U.S. GEN. ACCOUNTING OFFICE, PRESCRIPTION DRUGS: FDA OVERSIGHT OF DIRECT-TO-CONSUMER ADVERTISING HAS LIMITATIONS 3 (2002), *available at* http://gao.gov/new.items/d03177.pdf.

which also concluded that pharmaceutical firms spent more on research and development than on marketing: $29.6 billion on R&D in 2004 to $27.7 billion for all promotional activities.[8]

However, contrary to the industry's claim, a recent study conducted by two researchers from York University located in Toronto, Canada, estimates that the pharmaceutical industry in the United States spends almost twice as much on promotion and advertising as it does on research and development. The estimate is based on the systematic collection of data directly from the industry and participating doctors during 2004. The study indicates that the pharmaceutical industry in the United States spent 24.4% of its sales dollar on promotion, versus 13.4% for research and development, as a percentage of U.S. domestic sales of $235.4 billion.[9]

Having made these observations concerning "Big Pharma," it is possible to draw some significant parallels between the pharmaceutical industry and a closely allied industry that calls upon "chemistry" in a very different fashion. Nowhere have the advertising wars been more heated than in the multimillion dollar artificial sweetener business dominated by two American corporate giants. This article deals with many important legal, marketing, and policy issues that were raised in an unusual case that involved the Merisant Company and McNeil Nutritionals.

## THE CONTROVERSY

Merisant Company Inc. (Merisant) manufactures several premium brands of sweetener that includes the brand names Equal, NutraSweet, and Canderel, the European equivalent of Equal.[10] The key ingredient

[8] IMS Health, Total U.S. promotional spend by type, 2004 (2005), *available at* http://www.imshealth.com/ims/portal/front/articleC/0,2777,6599_49695992_75406357,00.html.

[9] *Big Pharma Spends More on Advertising Than on Research and Development*, SCIENCE DAILY, Jan. 8, 2008, http://www.sciencedaily.com/releases/2008/01/080105140107.htm (citing Marc-Andre Gagnon & Joel Lexchin, *The Cost of Pushing Pills: A New Estimate of Pharmaceutical Promotion in the United States*, PLOS MEDICINE (2008), *available at* http://www.pubmedcentral.nih.gov/articlerender.fcgi?artid=2174966). The study was conducted by Ph.D candidate Marc-Andre Gagnon and long-time researcher of pharmaceutical promotion, Joel Lexchin. It appears in the January 3, 2008 issue of *PLoS Medicine*, an online journal published by the Public Library of Science.

[10] According to the Memorandum and Order of Judge E.K. Pratter, Equal brand sweetener was launched in the United States in 1982 by G.D. Searle & Company. Merisant Co. v. McNeil Nutritionals, LLC, 515 F. Supp. 2d 509, 512 n.2 (E.D. Pa. 2007) (citing Merisant's Statement of Facts ¶¶ 2, 4, 5 and 6). In 1985, the Monsanto Company acquired Searle. In March 2000, Merisant acquired Monsanto's "tabletop sweetener" business—including Equal in the United States, and Canderel (internationally). At that time, Monsanto sold its NutraSweet business to a new company called NutraSweet Company, Inc. In the United States, Merisant US, Inc. is a subsidiary of Merisant. It sells both Equal and NutraSweet.

in Equal is aspartame.[11] McNeil Nutritionals, LLC, a Delaware limited liability company with its principal place of business in Fort Washington, Pennsylvania, and McNeil-PPC, a New Jersey corporation with a principal place of business in Skillman, New Jersey (collectively, McNeil), markets and distributes the artificial sweetener Splenda, which relies on sucralose to provide its sweet flavor.[12]

McNeil has been in the business of selling Splenda since 1999 and has reportedly spent the enormous sum of approximately $235 million in advertising between 2000 and 2006 "in an effort to create and develop a 'unique brand identity' for Splenda."[13] Splenda ranks as the leading non-calorie sweetener manufactured in the United States. McNeil manufactures Splenda under the primary logos and phrases such as:

- "*Made from sugar*";
- "*Tastes like sugar*"; and
- "*Made from sugar so it tastes like sugar*."

It is also interesting to note that since September of 2000, all television commercials and print advertising for Splenda included the line "made from sugar so it tastes like sugar" or "Splenda tastes like sugar because it's made from sugar."[14]

As noted by Theodore J. Kobus and David J. Shannon, "artificial sweetener manufacturers attempt to avoid the term 'artificial' in their advertising," believing that the term "artificial" conveys a decidedly negative taste or a distinct health and safety concern to consumers of such products.[15] As a result, both McNeil and Merisant have consistently used the term "no-calorie sweetener" to describe their products. From a marketing stand point, other companies market their

[11] Aspartame (or APM) is the name for an artificial, non-saccharide sweetener, *aspartyl-phenylalanine-1-methyl ester*; i.e., a methyl ester of the dipeptide of the amino acids aspartic acid and phenylalanine. Aspartame was discovered in 1965 by James M. Schlatter, a chemist working for G.D. Searle & Company. Searle applied for and was granted United States patent 3,492,131 and various international patents, and the initial discovery was successfully commercialized. The U.S. patent expired in 1992, and the technology became readily available.

[12] Sucralose is an artificial sweetening ingredient that is made through a process that begins with sucrose or sugar, replacing certain groupings on the sucrose molecule. Sugar or sucrose is not an ingredient in Splenda. The Food and Drug Administration approved sucralose for use as a food additive in 1998. In 1999, FDA approval was expanded to permit the use of sucralose as a general purpose sweetener.

[13] *Merisant Co.*, 515 F. Supp. 2d at 512 (citing McNeil's Statement of Facts ¶¶ 34-36).

[14] *Id.* (citing McNeil's Statement of Facts ¶¶ 51-52).

[15] Theodore J. Kobus & David J. Shannon, *Splenda Not "Equal" to Real Sugar in Lanham Act False Advertising Suit*, 192 N.J.L.J. S-9 (April 14, 2008). *See also Merisant Co.*, 515 F. Supp. 2d at 512 (citing McNeil's Statement of Facts ¶ 15). ("In response to these concerns, manufacturers of artificial sweeteners have attempted to avoid using certain language, such as the term "artificial," that many convey negative taste or health safety concerns."). *Id.*

products by describing them as "like" sugar, or "tastes like sugar" in conjunction with advertising and promotional efforts.[16]

On October 22, 2004, Merisant sent a letter to the National Advertising Division of the Council of Better Business Bureau challenging McNeil's advertising for Splenda.[17] McNeil did not respond directly to Merisant's contention; rather, on November 18, 2004, McNeil preemptively filed a complaint against Merisant in the District Court for the District of Puerto Rico seeking a declaratory judgment that McNeil's advertising and marketing for Splenda was *not* false or misleading.[18]

Merisant responded and filed in the Federal District Court for the Eastern District of Pennsylvania a five-count complaint against McNeil, four counts of which alleged various violations of Section 43(a)(1)(B) of the Trademark Act of 1946, more commonly known as the Lanham Act.[19] In order to make out a prima facie case under the Lanham Act, a plaintiff must meet a heavy burden. A plaintiff must show:

1. The defendant made false or misleading statements about its product;
2. There is actual deception or a tendency to deceive a substantial portion of the intended audience;
3. The deception is material in that it is likely to influence purchasing decisions;
4. The advertised goods traveled in interstate commerce; and
5. There is a likelihood of injury to the plaintiff.[20]

McNeil subsequently consented to the dismissal of its complaint in the action filed in Puerto Rico. Merisant, however, persisted and alleged that McNeil's claim that Splenda is "made from sugar," and "made from sugar so it tastes like sugar" was both false and misleading to consumers. Specifically, Merisant argued that:

[16] *Merisant Co.*, 515 F. Supp. 2d at 512 (citing McNeil's Statement of Facts ¶ 15).
[17] *Id.* (citing McNeil's Statement of Facts ¶ 75).
[18] *Id.* (citing McNeil's Statement of Facts ¶ 76).
[19] 15 U.S.C. §1125 (1946). Section 43 provides:

> False designations of origin; false description or representation (a) (1) Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which… (B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.

*Id.*

[20] *See* Highmark, Inc. v. UPMC Health Plan, 276 F.3d 160 (3d Cir. 2001).

(1) McNeil's claim that Splenda is "Made From Sugar" is both literally and impliedly false, and is misleading;
(2) The claim that Splenda is "Made from Sugar So It Tastes Like Sugar" is literally false and misleading;
(3) McNeil's implied claim that Splenda is natural is false and misleading; and
(4) The implied claim that Splenda contains sugar is false and misleading.

Finally, Merisant argued in Count Five of the complaint that McNeil's advertising campaign and packaging, including the "use of the Splenda logo and tagline," are misleading to consumers, have caused actual consumer confusion, and have caused injury to Merisant, in violation of the Pennsylvania common law of unfair competition.[21]

Merisant sought a permanent injunction[22] to stop McNeil from the use of the logos and ads. In addition, Merisant sought damages for diverted sales [loss of income] and loss of good will and reputation, and an order directing McNeil to initiate a corrective advertising campaign of "comparable size and scope to its existing advertising campaign,"[23] clarifying that Splenda is not sugar or natural, but is in fact an *artificial sweetener* using a synthetic chemical whose taste does not come from sugar. Merisant also sought an award of treble and other exemplary damages, pursuant to 15 U.S.C. Section 1117, and an award of all costs and expenses incurred by it in connection with the action, including reasonable attorney's fees and disbursements.[24]

In general, a plaintiff may prove false advertising in one of two ways: "either the advertisement must be literally false, or it must be literally true but misleading to the consumer."[25] As the third circuit noted in *Novartis Consumer Health, Inc. v. Johnson & Johnson-Merck Consumer Pharms. Co.*, "Liability arises if the commercial message or statement is either (1) literally false or (2) literally true, but has the tendency to deceive consumers."[26]

The distinction and implication was further illuminated by the *Highmark* court which noted:

[21] *Merisant*, 515 F. Supp. 2d 509 at 514 (citing Complaint ¶¶ 47-66).

[22] Four factors are generally considered in determining whether a court should grant a preliminary injunction: (1) whether the movant has a reasonable probability of success on the merits; (2) whether the movant will be irreparably harmed by denying the injunction; (3) whether there will be greater harm to the nonmoving party if the injunction is granted; and (4) whether granting the injunction is in the public interest. *See* Am. Civil Liberties Union v. Reno, 217 F.3d 162, 172 (3d Cir. 2000).

[23] *Merisant Co.*, 515 F. Supp. 2d at 514 (citing Complaint ¶¶ 18-19).

[24] *Id.*

[25] *Highmark*, 276 F.3d at 171 (citing Castrol Inc. v. Pennzoil, 987 F.2d 939, 943 (3d Cir. 1993)).

[26] 290 F.3d 578, 586 (3d Cir. 2002).

> If an advertisement is literally false, the plaintiff does not have to prove actual consumer deception. If, on the other hand, an advertisement is literally true but misleading, the plaintiff must prove actual deception by a preponderance of the evidence. If a claim is literally true, a plaintiff 'cannot obtain relief by arguing how consumers could react; it must show how consumers actually do react.'[27]

Merisant's argument is fairly straightforward. It contended that Splenda's claim "made from sugar, tastes like sugar" was impliedly false and thus was in violation of Section 43(a) of the Lanham Act because the phrase implies to consumers that Splenda contains sugar. McNeil countered that its advertising statements are literally true and cannot be perceived to mean that Splenda contains sugar or is a natural product.

THE "TIME" ARGUMENT: SHOULD MERISANT BE BARRED BY THE DOCTRINE OF LACHES?

Before the main argument concerning false or misleading advertising could be considered, McNeil raised a significant threshold issue and argued that Merisant's four-year delay in bringing its claim should now bar its suit. McNeil filed a motion for a summary judgment,[28] arguing that the equitable doctrine of *laches*[29] should bar Merisant's claims.[30] Laches generally consists of two elements: (1)

[27] *Highmark*, 276 F.3d at 171. *See also Castrol*, 987 F.2d at 943 (noting that a plaintiff must prove either literal falsity or consumer confusion, but *not* both).

[28] Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). An issue is *genuine* if the evidence is such that a reasonable jury could return a verdict for the non moving party. *See, e.g.,* Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 249 (1986).

[29] Laches is an equitable doctrine that is within the discretion of the trial court. *See* Univ. of Pittsburgh v. Champion Prods., Inc., 686 F.2d 1040, 1045 (3d Cir. 1982) (citing Gruca v. U.S. Steel Corp., 495 F.2d 1252, 1258 (3d Cir. 1974)). Likewise, a plaintiff must come into a court of equity with "clean hands." The guidepost of equity actions is the maxim that "he who comes into equity must come with clean hands." Monsanto Co. v. Rohm & Haas Co., 456 F.2d 592, 598-99 (3d Cir. 1972) (quoting Precision Co. v. Automotive Co., 324 U.S. 806, 814-16 (1945)).

[30] The motion also argued that McNeil was entitled to summary judgment on Merisant's "implied falsity" claim and that Merisant was not entitled to damages in the form of disgorgement of McNeil's profits. In addition, Merisant and McNeil filed a motion alleging that testimony from one or more of the opposing party's expert witnesses is inadmissible under Rule 72 of the Federal Rules of Civil Procedure. Because of its important legal and marketing implications, this issue will be addressed later in the paper.

inexcusable delay in bringing suit, and (2) prejudice to the defendant as result of the delay.[31] McNeil conceded that the four year period did not exceed the six-year statute of limitations under the Pennsylvania Unfair Trade Practices and Consumer Protection Law[32] that would normally govern the issue of the timeliness for filing a law suit. McNeil, however, argued that it would be fundamentally unfair for the suit to continue.

McNeil stated that Merisant was aware of McNeil's "made from sugar" advertising prior to its launch of Splenda in 2000. McNeil further contended that several months *before* the launch, Merisant's "institutional investors were aware that McNeil would likely promote Splenda using the phrase 'tastes like sugar because it's made from sugar.'"[33] McNeil also asserted that following Splenda's entry into the market, Merisant's market share and profits fell steadily from 2000 to 2003, yet Merisant "did nothing whatsoever to try and stop McNeil's supposed misconduct for more than four years after the product's nationwide launch."[34] Because Merisant had waited until November 2004 to file its complaint, McNeil argued that Merisant's delay in bringing the suit—essentially not enforcing whatever it believed its rights to be—had caused severe prejudice to its rights because it (Mc Neil) had invested $125 million in its extensive marketing campaign in the interim period.

Merisant responded that at the outset of McNeil's advertising and promotional campaign, it did not believe that a substantial portion of consumers would be either misled or confused, but that over time, McNeil's advertising had "changed and evolved."[35] It also argued that it faced what is sometimes termed a *"David and Goliath"* problem, in that a decision to sue McNeil would have "essentially been a decision to also sue McNeil's parent company, Johnson & Johnson, one of the largest and most well-capitalized companies in the world."[36] Merisant instead opted to try to resolve the potential conflict by contacting McNeil informally.

In pursuit of this informal policy, Merisant stated that its CEO had sent a letter to Mr. Colin Watt, then-President of McNeil, in April 2002, asking that McNeil determine the appropriateness of continuing to use its advertising claims that "imply that Splenda is more natural or less artificial than other sugar substitutes."[37] Because it lacked "any

[31] *See* Santana Prods. v. Bobrick Washroom Equip., Inc., 401 F.3d 123, 138 (3d Cir. 2005).

[32] 73 Pa. Stat. Ann. § 201-1 *et seq.*

[33] *Merisant Co.*, 515 F. Supp. at 517 (citing Def. Mem. Supp. 28).

[34] *Id.* (citing Def. Mem. Supp. 28-29).

[35] *Id.*

[36] *Id.*

[37] *Id.* (citing Merisant's Statement of Facts ¶ 15).

actionable evidence of consumer confusion," Merisant believed that filing a Lanham Act lawsuit would have been clearly premature and that a more reasonable course would be to "continue to observe the market and McNeil's actions."[38] In addition, it had made numerous "informal contacts" with McNeil to review the nature of its advertising and attempted to address the situation through public relations campaign clarifying that "Splenda is not natural."[39] Interestingly, Merisant stated that McNeil had denied that consumers were in fact confused and had continued to maintain that it did not market Splenda as a natural sweetener.[40] It was only when these "contacts" proved unsatisfactory that Merisant was forced to initiate the law suit in 2004.

In rendering a decision whether Merisant's suit should be barred on a ground such as laches, the trial court disagreed with McNeil and denied summary judgment. The trial court held that while Merisant cannot

> [I]dly sit by and wait to see whether Splenda would be successful before deciding whether to sue, there is a legitimate difference between waiting to see whether an advertising campaign would be successful and whether the same campaign would be misleading to consumers.[41]

DAMAGES

It is a basic principle of law that "[T]he claimant generally has the burden of proving by credible evidence to a reasonable certainty his damage, and the amount thereof must be established at least to a reasonable certainty."[42] Subject to the general principles of equity, under Section 35(a) of the Lanham Act, a successful plaintiff is entitled to recover (1) defendant's profits;[43] (2) any damages sustained by the plaintiff; and (3) the costs of the action.[44] In determining the amount of

[38] *Id.* at (citing Pl. Mem. Opp'n 15).
[39] *Id.* at 518.
[40] *Id.* (citing Pl. Mem. Opp'n 20).
[41] *Id.* (citing Pl. Mem. Opp'n 22).
[42] *See, e.g.*, Plywood Oshkosh, Inc. v. Van's Realty & Constr. of Appleton, Inc., 257 N.W.2d 847, 849 (Wis. 1977).
[43] Profits may be recovered when (1) the defendant has been unjustly enriched, (2) the plaintiff sustained damages, or (3) disgorgement of profits is necessary to deter infringement. Disgorgement is also known as "accounting for profits."
[44] 15 U.S.C. §1117(a). Section 35(a) further provides:

> The court shall assess such profits and damages or cause the same to be assessed under its direction. In assessing profits the plaintiff shall be required to prove defendant's sales only; defendant must prove all elements of cost or deduction claimed. In assessing damages the court may enter judgment, according to the circumstances of the case, for any sum above the amount found as actual damages, not exceeding three times such amount. If the court shall find that the amount of the recovery based on profits is either inadequate or excessive the court may in its discretion enter judgment for such sum as the court shall find to be just, according

damages, a court will take into account the following factors:[45]

1. Whether the defendant had the intent to confuse or deceive;
2. Whether sales have been diverted;[46]
3. The adequacy of other remedies;
4. Any unreasonable delay by the plaintiff in asserting its rights;
5. The public interest in making the misconduct unprofitable; and
6. Whether it is a case of "palming off."[47]

Merisant claimed that it would incur lost profits of $24 million as a result of McNeil's false advertising and that McNeil had realized $20.1 million in profits from sales it had diverted from Merisant. Merisant also requested $176.1 million of McNeil's profits earned since 2001. McNeil countered that an accounting of profits would be neither equitable nor appropriate because it would result in a windfall to Merisant; it would raise the risk of multiple recovery against McNeil from other lawsuits that had been filed against it; and in the context of the false advertising claim, accounting of profits would only be appropriate when the advertisement *specifically targets* the plaintiff.[48]

Because an accounting of profits to the plaintiff is a decision that lies "within the court's discretion," the Court decided that it would be decidedly premature to decide the issue at the juncture of a motion for summary judgment because "these are highly contested disputes of material facts that preclude the Court from granting summary judgment on this issue."[49] McNeil's motion for summary judgment was denied with respect to this claim.[50]

> to the circumstances of the case. Such sum in either of the above circumstances shall constitute compensation and not a penalty. The court in exceptional cases may award reasonable attorney fees to the prevailing party.

*Id.*

[45] *See* Banjo Buddies, Inc. v. Renosky, 399 F.3d 168, 174-175 (3d Cir. 2005) (quoting Quick Technologies, Inc. v. Sage Group PLC, 313 F.3d 338, 347-48 (5th Cir. 2002)).

[46] In an analogous false advertising cases under Section 1125 (a) of the Lanham Act, the aggrieved party must demonstrate that the false advertisement actually harmed its business. However, "[A] precise showing is not required, and a diversion of sales, for example, would suffice." *See, e.g.,* Quabaug Rubber Co. v. Fabiano Shoe Co., Inc., 567 F.2d 154 (1st Cir. 1977).

[47] *See* Dastar Corp. v. Twentieth Century Fox Film Corp., 539 U.S. 23 (2003) (citing O. & W. Thum Co. v. Dickenson, 245 F. 609, 621 (6th Cir. 1917)). *Passing off* or *palming off*, as the practice is sometimes called, occurs when a producer misrepresents the producer's own goods or services as someone else's. "Reverse passing off" occurs when the producer misrepresents someone else's goods or services as the producer's own.

[48] *Merisant Co.,* 515 F. Supp. 2d at 529.

[49] *Id.* at 530.

[50] The Court also rejected the contention of McNeil that Merisant should be precluded from seeking relief because of its own "unclean hands." *See generally id.* at 530-538. As with the question of laches, "a district court has wide discretion in refusing to aid unclean

## THE ESSENTIAL ARGUMENTS

McNeil vigorously defended its position. McNeil consistently argued throughout the trial that its slogans did not in fact confuse consumers. It stated that it simply had a better product than Merisant that was backed by superior advertising and promotion. Merisant alleged that McNeil had rejected a plan to have a statement appear on the front of Splenda's yellow boxes that it does not contain sugar, which Merisant argued would have clearly and directly cleared up any confusion. McNeil countered that because the manufacture of Splenda begins with sugar, McNeil could accurately claim that Splenda is made from sugar and tastes like sugar.

During the trial, counsel for both Merisant and McNeil focused on the use of consumer surveys, arguing that its surveys were valid while the other parties' surveys were flawed. In their article published in April, 2008, Kobus and Shannon stated that McNeil had argued that questions do not always have a "black and white" or objective answer and that "consumers can see "shades of grey when it comes to a natural product."[51]

## THE BATTLE OF THE EXPERTS

By 2004, Splenda had replaced Equal as the U.S.'s top-selling sugar substitute. In its lawsuit, Merisant stated the main reason why Splenda had won a growing share of the $200 million-a-year U.S. market for artificial sweeteners was that since September 2000 all television commercials and print advertisements for Splenda included the tagline "made from sugar so it tastes like sugar" or "Splenda tastes like sugar because it's made from sugar," therefore unfairly playing up the product's "natural" qualities.

Addressing McNeil's motions for summary judgment, the court rejected out of hand McNeil's assertion that the company's claims of "Made from Sugar" and "Tastes like Sugar" could not reasonably be interpreted as implying that Splenda contains sugar or is a "natural" product. Both parties also filed *Daubert*[52] motions seeking to preclude

parties, and the court is not bound by any formula which would limit that discretion." *Id.* at 530 (citing Haft v. Dart Group Corp., 841 F. Supp. 549, 577 (D. Del. 1993)). While the Court rejected the application of the doctrine in the instant case, it noted that the doctrine *would be* applicable in seeking relief under the Lanham Act. *See* Highmark, Inc. v. UPMC Health Plan, 276 F.3d 160, 174 (3d Cir. 2001).

[51] Kobus & Shannon, *supra* note 15, at S-18.

[52] Under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), and subsequent rulings, the judge must be a gatekeeper and exclude unreliable evidence prior to trial. Federal Rule of Evidence 702 governs the admissibility of expert testimony. It provides:

certain expert testimony on behalf of the other. McNeil moved to exclude the expert testimony of a marketing researcher on the ground that he was merely going to give duplicative opinions on McNeil

> To understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

Fed. R. Evid. 702.

*See also* ID Sec. Sys. Canada, Inc. v. Checkpoint Sys., Inc., 198 F. Supp. 2d 598, 601-02 (E.D. Pa. 2002) (quoting *Daubert*, 509 U.S. at 589). The gatekeeper function of the district court extends beyond scientific testimony to "testimony based on… 'technical' and 'other specialized' knowledge." *Id.* at 602 (quoting Kumho Tire Co. v. Carmichael, 526 U.S. 137, 141 (1999)).

Federal Rule of Evidence 702 provides "three distinct substantive restrictions on the admission of expert testimony: qualifications, reliability and fit." *Id.* (quoting Elcock v. Kmart Corp., 233 F.3d 734, 741 (3d Cir. 2000)).

The first requirement, *qualifications*, encompasses a "broad range of knowledge, skills, and training." *Id.* (quoting In re Paoli R.R. Yard PCB Litig., 35 F.3d 717, 741 (3d. Cir. 1994)). The second prong, *reliability*, requires that the expert's opinion "must be based on the 'methods and procedures of science' rather than on 'subjective belief or unsupported speculation'; the expert must have 'good grounds' for his or her beliefs." *Id.* (quoting *In re Paoli*, 35 F.3d at 742). In considering whether there are "good grounds" for an expert's opinion, a district court should look at a series of factors:

(1) whether a method consists of a testable hypothesis;
(2) whether the method has been subject to peer review;
(3) the known or potential rate of error;
(4) the existence and maintenance of standards controlling the technique's operations;
(5) whether the method is generally accepted;
(6) the relationship of the techniques to methods which have been established to be reliable;
(7) the qualifications of the expert witness testifying based on the methodology; and
(8) the non-judicial uses to which the method has been put.

*Id.* (quoting In re Paoli, 35 F.3d at 742 n.8).

The list of factors "is non-exclusive and … each factor need not be applied in every case." *Id.* (quoting *Elcock*, 233 F.3d at 746).

The final prong requires that the expert testimony "fit" by assisting the trier of fact. *Id.* at 602-603 (quoting Oddi v. Ford Motor Co., 234 F.3d 136, 145 (3d Cir. 2000)). Thus, "[a]dmissibility thus depends in part upon 'the proffered connection between the scientific research or test result to be presented and particular disputed factual issues in the case. *Id.* at 603 (quoting *In re Paoli*, 35 F.3d at 743). The test does not require that the opinion have the "best foundation" or be "demonstrably correct," but only that the "particular opinion is based on valid reasoning and reliable methodology." *Id.* (quoting *Oddi*, 234 F.3d at 146). The proponent of the expert's testimony need not "demonstrate to the judge by a preponderance of evidence that the assessments of their experts are correct, they only have to demonstrate by a preponderance of evidence that they are reliable." *Id.* (quoting *In re Paoli*, 35 F.3d at 744).

documents that did not require expert knowledge. Applying the *Daubert* criteria, the court disagreed. It found that the expert was qualified by experience and education and his testimony would aid the jury. The expert offered to testify on McNeil's use of the objectionable claims to position Splenda with respect to the "sugar" product class, as contrasted with the "artificial sweetener" product class. The court also rejected Merisant's motion to exclude a McNeil expert's rebuttal testimony based on the expert's biology-based background. The court found that his expertise and report were adequate with respect to how Splenda worked to sweeten human taste.

The court also rejected McNeil's attack on Merisant's consumer perception survey, which purported to show consumer takeaway of the alleged implied claims. McNeil argued that the survey was unreliable for advertising media because its respondents only were shown the claim on packages. This argument was given short shrift: "If a jury were to find that 'made from sugar' is impliedly false on a product package, the Court would be hard pressed to find the logic in permitting McNeil to utilize the exact same claim in other forms of media."[53]

When the trial commenced,[54] Merisant's lawyers began by showing jurors a collection of Splenda ads, including a television commercial that featured parents and children enjoying a variety of Splenda-sweetened baked goods with the tagline "Think Sugar, Say Splenda." Merisant's main claim was that McNeil knew that its ads for Splenda misled consumers into believing it was natural or contained sugar. To build the case, they summoned a procession of McNeil employees and consultants to the stand. These included Ann Davis, an outside marketing consultant for McNeil, who addressed the results of a 2004 study she conducted on Splenda packaging. Davis' study found that almost half of those surveyed believed the product actually contained sugar. Moreover, she conceded that the study strongly suggested that the prime cause of that confusion was Splenda's "made from sugar" slogan. Eric Paul, McNeil's director of market research, was called subsequently in an attempt by Merisant to show that Davis' findings were not an isolated case. Paul acknowledged that between 2001 and 2004, McNeil conducted a dozen similar surveys that all found consumer confusion over whether Splenda contained sugar or was natural. Making matters worse, Paul was boxed in a position to refute the suggestion that a consumer who said Splenda was "natural" must be confused, a point that he had conceded during a videotaped deposition.

[53] *Merisant*, 515 F. Supp. 2d at 525.

[54] *See Trial Tips: No Witness Protection Program Here*, KIRKLAND & ELLIS, October 2007, http://www.kirkland.com/print.cfm?contentID=230&itemId=8141.

McNeil president Debra Sandler, under the questioning of her company's lawyers, indicated that none of Splenda's commercials claim it is natural or contains sugar, and that Splenda boxes explicitly say it is a no-calorie sweetener. Sandler stated that consumers switched to Splenda not because they were misled, but because it is much better for baking and has a superior taste. McNeil lawyers then called on survey expert Susan McDonald, who claimed that the consumer studies she had conducted showed confusion among a mere 2 to 3 percent of Splenda users. Her survey, she insisted, which used "open-ended" questions, let respondents freely describe their reactions to an ad and, therefore, was more accurate. McNeil also attacked the Merisant survey on the ground that it did not show that a substantial portion of the claim's audience was misled. McNeil argued that the answers to the survey's closed-ended questions were unreliable because they were responses to improper leading questions. It then reasserted that the answers to McDonald's open-ended questions showed only 9% of consumers taking away a false "contains sugar" claim and 4% taking away a "natural" claim.

A problem with McDonald's criticism of Equal's surveys was highlighted by Merisant's lawyers during cross examination. As it is often the case in consumer research, McDonald conceded that McNeil's own marketing department frequently relied on closed-ended survey questions. Additionally, McDonald was confronted with testimony she had given in a previous false advertising case, in which she claimed open-ended questions are not reliable because the answers tend to be random.

## THE CASE IS RESOLVED OR RATHER SETTLED

Closing arguments may have proved to be critical in determining the ultimate outcome of the case. Merisant argued that McNeil in fact knew that consumers would be confused about whether or not Splenda contained sugar but had made ambiguous statements to keep its product from being labeled as an "artificial sweetener"—a designation that conveyed a decidedly negative taste or health and safety concern to consumers. McNeil stated that consumers simply preferred the taste of Splenda, which was directly correlated with its significant market gains since the product was launched in 2000. McNeil denied any attempt to confuse consumers and stated that it had simply relied on the superior taste of Splenda providing for its marketing (and sales) advantage.

After a one month trial, the jury may have stunned attorneys by requesting a calculator and expert reports from both parties on how to determine damages. At this point, the parties requested that the court delay the jury's verdict and requested a recess in order to pursue a settlement conference.[55] The parties then settled the case before the jury announced its verdict. The settlement amount was confidential but Kobus and Shannon reported that jury members were reportedly set to award damages to Merisant, but at an amount less that Merisant had been seeking. Purportedly, noted one juror, "I don't think the company necessarily set out to mislead, but I don't think they did anything to stop it."[56]

It appears that the jury agreed with the essence of Merisant's argument that McNeil had engaged in some sort of false and misleading advertising under the Lanham Act. It also appeared that McNeil would rather offer a settlement than risk a final determination that it had engaged in a type of advertising—perhaps bordering on the unethical—that might forever taints its premier product. Future events will determine if the matter will resurface in a new round of "sugar disputes."

[55] The Sugar Association reported that the jury was "outraged and wanted to punish Johnson & Johnson." The parent company, Johnson & Johnson, fearing a "damaging verdict," settled the Splenda misleading advertising lawsuit. The Association notes that three verdicts in foreign jurisdictions have previously found the slogans to be misleading. These include New Zealand, Australia, and France. *See Fearing Damaging Verdict, Johnson & Johnson Settles Splenda Misleading Advertising Lawsuit,* PR-INSIDE, May 14, 2005, http://www..pr-inside.com/fearing-damaging-verdict-johnson-amp-r123765.htm (citing the Sugar Association's website, http://www.TruthAboutSplenda.com) (last visited April 27, 2008).

[56] Kobus & Shannon, *supra* note 15, at S-18.

# APPLICATIONS OF THE FIRST SALE DOCTRINE TO COPYRIGHTED WORKS MANUFACTURED AND SOLD ABROAD

by WILLIAM E. GREENSPAN*

## I. INTRODUCTION

A student approaches Professor Black after class and shows the professor a Business Law text with a United States copyright. The student asks: "Is this book that I purchased on the Internet OK to use for the class?" Professor Black examines the book. The contents appear to be exactly the same as the hard cover edition that sells at retail for $170. However this book, which sells at retail for $50, has a soft cover. The quality of the pages, ink, and binding may be inferior, and some of the photos and diagrams are in black and white. On the cover of the book appear the words: INTERNATIONAL EDITION. The first page of the book offers further explanation: "This book cannot be re-exported from the country to which it is sold by the publisher. The International Edition is not available in North America. Some ancillaries, including electronic and print components may not be available to customers outside the United States." Professor Black wonders whether the **first sale** of the International Edition of the copyrighted book abroad and the **unauthorized importation** of the book into the United States violates United States copyright law.

The resolution of this question is of particular interest not only to book publishers, book distributors, college bookstores, Internet book

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resellers, and students, but also to buyers and sellers of other United States copyrighted works such as watches and computer software programs intended for sale abroad where the labels, packaging, and artwork bear a copyright notice. Publishers and manufacturers desire to price their products keyed to local international markets, while retailers and consumers benefit when they can buy and resell copyrighted works at discount prices.

This paper will review the relevant statutory law relating to the first sale doctrine and the unauthorized importation sections of the Copyright Act of 1976, and how the United States Supreme Court identified and partially resolved the apparent conflict between these two sections in *Quality King Distributors, Inc. v. L'anza Research International, Inc.*[1] Then this paper will examine recent court decisions resolving issues not settled by *Quality King*, mainly concerning the legality of purchasing copyrighted works intended for sale abroad. Finally, this paper will make recommendations for United States copyright owners on how to protect their copyrights when marketing products abroad.

## II. RELEVANT STATUTORY LAW

Congress enacted the first copyright law of the United States in 1790 in the exercise of its constitutional power "To promote the progress of Science … by securing for limited Times to Authors … the exclusive Right to their … Writings …. "[2] Comprehensive revisions were made in 1831, 1870, and 1976.[3] Congress enacted several minor revisions since the 1976 revision. The philosophy behind U.S. copyright law is well expressed in leading U.S. Supreme Court cases. In *Twentieth Century Music v. Aiken*, the Court observed: "The immediate effect of our copyright law is to secure a fair return for the author's creative labor. But the ultimate aim is, by this initiative, to stimulate artistic creativity for the general public good."[4] As stated in *Sony Corp. v. Universal City Studios*, one purpose of copyright law is to create a balance between "the interest of authors … in the control and exploitation of their writings … on the one hand, and society's competing interests in the free flow of ideas [and] information on the other hand."[5] Consistent with this ultimate aim and purpose, copyright law gives a person who creates an original[6] work of authorship fixed in any tangible medium of expression

[1] 523 U.S. 135 (1998).

[2] U.S. CONST. Art. I, § 8, cl. 8.

[3] 17 U.S.C. §§ 101 *et. seq*. (2009).

[4] 422 U.S. 151, 156 (1975).

[5] 464 U.S. 417, 429-30 (1984).

[6] Feist Publications, Inc. v. Rural Telephone Service Co., Inc., 499 U.S. 340, 345 (1991). ("Original, as the term is used in copyright, means only that the work was independently created by the author (as opposed to copied from other works), and that it

six exclusive rights, including the exclusive right to distribute copies, with limitations. One of these limitations is known as the first sale doctrine.

### *A. First Sale Doctrine*

The first sale doctrine in copyright law was first expressed by the United States Supreme Court in *Bobbs-Merrill Co. v. Straus*.[7] Bobbs-Merrill Company sold its copyrighted novel "The Castaway" to wholesalers with a conspicuous notice placed on each copy: "The price of this book at retail is one dollar net. No dealer is licensed to sell it at a less price, and a sale at a less price will be treated as an infringement of the copyright."[8] When R. H. Macy & Company sold copies of the book at retail for eighty-nine cents a copy, Bobbs-Merrill sued Isidor and Nathan Straus, partners trading as R. H. Macy & Company, to restrain the sale of the book at less than one dollar for each copy.[9]

The United States Supreme Court held there was no infringement of copyright. Although recognizing the current copyright statute gave the copyright owner the "sole right to vend," the Court held copyright law did not give the copyright owner the right to place restrictions beyond the first sale of the novel. The Court stated: "[O]ne who has sold a copyrighted article … has parted with all right to control the sale of it. The purchaser of a book, once sold by authority of the owner of the copyright, may sell it again, although he could not publish a new edition of it."[10]

The most recent codification of the first sale doctrine as expressed in *Bobbs-Merrill*, is incorporated in sections 106(3) and 109(a) of the Copyright Act of 1976.[11] Section 106(3) gives the copyright owner exclusive distribution rights in one's copyrighted work.[12] Section 109(a), known as the first sale doctrine, places a limitation on the exclusive rights granted in section 106(3) by allowing a copyright owner the right to control only the first sale of a copyrighted work.[13]

possesses at least some minimal degree of creativity.")

[7] 210 U.S. 339 (1908).

[8] *Id*. at 341.

[9] *Id*.

[10] *Id*. at 350.

[11] 17 U.S.C. §§ 101 et. seq. (2009).

[12] Subject to sections 107 through 121, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following: … (3) to distribute copies … of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending….17 U.S.C. § 106(3) (2009).

[13] Notwithstanding the provisions of section 106(3), the owner of a particular copy …lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy ….17 U.S.C. § 109(a) (2009). *See* Sturgis v. Target Corp., No. 08-13986, 2009

Legislative history explains the relationship between sections 106(3) and 109(a) by making it clear that once a copyright owner distributes a copy of one's work, all further rights of distribution cease with respect to that particular copy.[14] Thus one who owns a particular copy may further distribute that copy without permission from the copyright owner.[15] Later legislative history, explaining section 109(a), distinguishes between the rights of the copyright owner versus the owner of a particular copy.[16]

For example, it is clearly legal under United States copyright law if at the end of an academic term one student, without permission from the copyright owner, sells, gives, or lends his lawfully owned textbook to another student. The author owns the copyright in the book, while the student owns that particular copy of the book. Considering the immediate effect, ultimate aim, and purpose of copyright law, the author has received his financial reward for the sale of that particular copy.[17]

WL 1124458 (E.D.Mich. Apr. 20, 2009) (holding that once Sturgis permitted Authorhouse to publish and distribute his book, *Why Are Americans So Afraid?*, Sturgis had no control over Authorhouse selling copies of the book to Target which offered the book for sale on its website).

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

[15] Under this principle, … the copyright owner's exclusive right of public distribution would have no effect upon anyone who owns a particular copy … lawfully made under this title and who wishes to transfer it to someone else or to destroy it. *Id*. at 5693. *Also see*, John Horsfield-Bradbury, *"Making Available" as Distribution: File-Sharing and the Copyright Act*, 22 HARV. J.L. & TECH. 273 (2008) (explaining as the legislative history of the Act summarizes, the two purposes of the distribution right independent of the reproduction right are (1) to ensure an author has "the right to control the first public distribution of an authorized copy … of his work," and (2) to protect against the "unauthorized public distribution of copies … that were unlawfully made," even if the distributor did not himself make the copies).

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

[17] Copyright owners have tried, often unsuccessfully, to evade the limitations of the first sale doctrine by claiming there was a licensing agreement rather than a sale. The first sale doctrine does not "extend to any person who has acquired possession of the copy … from the copyright owner, by rental, lease, loan, or otherwise, without acquiring

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

### *B. Unauthorized Importation*

Section 602(a) was added to the Copyright Act of 1976 in response to copyright owners seeking protection from unauthorized importation of copies.[18] The legislative history explaining the intention of Congress in enacting this section distinguishes between unauthorized "piratical" copies and unauthorized importation of copies lawfully made abroad. Section 602 makes both situations illegal.[19]

An example of a violation of section 602(a) would occur if a publisher in China, without permission from the copyright owner, makes copies of a United States copyrighted book. The publisher then attempts to import the copies into the United States. The United States Customs Service may prohibit importation of these piratical copies. Once again, considering the immediate effect, ultimate aim, and purpose of copyright law, the author has not received his financial reward for the sale of these particular copies.

Now consider what happens when a copyrighted work is produced in the United States and copies are sold to a foreign distributor who promises to resell the copies abroad. Violating this agreement, the

ownership of it." 17 U.S.C. § 109(d). *See*, UMG Recordings, Inc. v. Augusto, 558 F.Supp.2d 1055 (C.D. Cal. 2008) (holding the transfer of numerous songs on a CD to selected members of the public for personal use only for purposes of promoting and advertising the release of the new CD was a sale or gift, not a license, because title passed to the recipients who did not have to return the promotional CDs to UMG); Vernor v. Autodesk, Inc., 555 F.Supp.2d 1164 (W.D. Wash. 2008) (deciding Autodesk's transfer of AutoCAD software with restrictions was actually a sale, rather than a license, because the buyer was allowed to retain possession of the software copies in exchange for a single up-front payment).

[18] Importation into the United States, without the authority of the owner of copyright under this title, of copies … of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies … under section 106.…17 U.S.C. § 602(a) (2009).

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

distributor resells the copies to a United States distributor who resells to retailers in the United States. How do courts reconcile the first sale doctrine stated in section 109(a) with the unauthorized importation rule stated in section 602(a)?

## III. THE APPARENT CONFLICT

The unauthorized importation rule in section 602(a) appears to conflict with the first sale doctrine in section 109(a). The first sale doctrine seems to permit conduct prohibited by section 602(a). The United States Supreme Court addressed this issue in *Quality King Distributors, Inc. v. L'anza Research Intern, Inc.*[20] The Court framed the issue as "whether the 'first sale' doctrine endorsed in § 109(a) is applicable to imported copies."[21]

*Quality King* involved "round trip" importation whereby L'anza manufactured in the United States hair care products with United States copyrighted labels. In one instance L'anza sold its products to a foreign distributor with the understanding that the products would be distributed in Malta, and possibly Libya. In violation of the agreement the distributor sold the products to Quality King Distributors who imported the goods back into the United States and resold the goods at discounted prices to retail drug stores in California.[22]

When L'anza brought suit against Quality King, the United States Supreme Court recognized (as stated by the court of appeals) that "it is unclear whether § 602(a) creates a right that is distinct from § 106(3) and therefore is not limited by § 109(a) (argument for L'anza), or alternatively, whether § 602(a) is merely an extension of § 106(3) and therefore is limited by § 109(a) (argument for Quality King)."[23] The Court chose the latter interpretation, holding in favor of Quality King, especially relying on the literal language of the relevant provisions of the copyright statute and the accompanying legislative history.

Consequently, *Quality King* clearly stands for the rule of law that if a copyrighted product is produced in the United States and lawfully sold to a foreign distributor who, without permission from the copyright owner, imports the product back into the United States, current copyright law will not help the copyright owner to prevent the product from being imported into the United States. However, *Quality King* is important not only for what it does decide, but also for what it does not decide. What if the United States copyrighted goods were manufactured

[20] 523 U.S. 135 (1998).
[21] *Id*. at 138.
[22] *Id*. at 138-39.
[23] L'anza Research Intern. v. Quality King Distributors, 98 F. 3d 1109, 1113 (9th Cir. 1996).

abroad, rather than in the United States. If, with permission from the copyright owner, a copyrighted product were manufactured abroad and then, without permission from the copyright owner, a foreign distributor imported the product into the United States for resale, does United States copyright law allow the copyright owner to prevent importation of the offending product? The Court in *Quality King* left this issue for another day, leaving the lower courts to handle this issue on a case-by-case basis.[24]

## IV. COPYRIGHTED PRODUCTS MANUFACTURED AND SOLD ABROAD

Recent court cases have examined the relationship between the section 109(a) first sale doctrine and the section 602(a) unauthorized importation rule when goods have been manufactured abroad. The courts appear to be in agreement that sales abroad of foreign manufactured United States copyrighted goods do not terminate the United States copyright holder's exclusive distribution rights in the United States.

### *A. Watches*

In *Omega S.A. v. Costco Wholesale Corp.*,[25] Omega manufactured watches in Switzerland that had a United States copyright for its "Omega Globe Design" on the underside of the watches. Costco Wholesale Corporation purchased the watches through a chain of buyers and sellers in the "gray market" and, without Omega's permission, imported the watches into the United States for resale.[26] When Omega sued Costco for copyright infringement, Costco asserted the *Quality King* first sale doctrine as an affirmative defense.[27]

The court noted that the first sale doctrine of section 109(a) limits section 602(a). However, the court recognized that for the first sale doctrine to apply to a case, the copy in question must be one "lawfully made under this title." The phrase "lawfully made under this title" in

[24] 523 U.S. 135, 154 (Ginsberg, J., concurring) (recognizing we do not today resolve cases in which the allegedly in fringing imports were manufactured abroad).

[25] 541 F. 3d 982 (9th Cir. 2008).

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

[27] 541 F. 3d. at 984.

section 109(a) grants first sale protection only to copies legally made and sold in the United States. For the first sale doctrine to apply as a defense to unauthorized importation, either the goods (1) must have been made in the United States, or (2) the goods must have been manufactured abroad and imported into the United States with authority or permission from the copyright owner. Distinguishing this case from *Quality King*, the court observed that Omega manufactured its watches in Switzerland, and Costco sold the watches without Omega's authority in the United States. Thus Costco did not have a valid section 109(a) defense to Omega's claims.[28] No authorized sale occurred in the United States.

### *B. Computer Software Programs*

In *Microsoft Corp. v. Big Boy Distribution LLC*,[29] Microsoft manufactured and assembled Microsoft Student Media Software in Ireland intended for schools and other educational users in Europe, the Middle East, and Africa, but not in the United States. Microsoft obtained a United States copyright on the software. The software was clearly labeled "not for retail distribution" and "not for resale." Without authorization from Microsoft, Big Boy purchased 10,000 units of Microsoft Student Media Software from the Jordanian Ministry of Education which was authorized to acquire the software only for its faculty, staff, and students. Big Boy then imported the software to resellers and retailers in Las Vegas, Nevada, who were not qualified educational users. When Microsoft sued Big Boy for copyright infringement, Big Boy claimed the first sale doctrine as an affirmative defense.[30]

Microsoft admitted that the first sale doctrine in §109(a) generally limits § 106(3) and § 602(a), but contended that § 109(a) did not apply to this case because, although the software was copyrighted in the United States, the software was manufactured and first distributed abroad in Ireland. Thus software was not "lawfully made under this title."[31] Relying on *Quality King*, Big Boy argued it was protected by the first sale doctrine because Microsoft's initial distribution of the product to the Jordanian Ministry of Education was in fact a "sale," that it lawfully took title of the software from the Jordanian Ministry of Education by sale, and that it was thereafter free to redistribute the product in the United States.[32]

[28] *Id*. at 985-86.
[29] 589 F. Supp.2d 1308 (S.D. Fla. 2008).
[30] *Id*. at 1312-14.
[31] *Id*. at 1315.
[32] *Id*. at 1316.

The court agreed with Microsoft that the first sale doctrine is no bar to a copyright claim where the copyrighted software is manufactured and first sold abroad. The first sale doctrine protects only resales of works lawfully made "under this title," a phrase which is generally interpreted to mean works legally made in the United States. The first sale doctrine has no application to copyrighted works manufactured abroad because such works are not made "under this title." Since the software in this case was manufactured in Ireland, and since there was no evidence that the software was voluntarily sold by Microsoft in the United States, Big Boy did not have a valid first sale defense.[33] The court further noted that "even an unwitting purchaser who buys a copy in the secondary market can be held liable for infringement if the copy was not the subject of a first sale by the copyright holder. Thus unless title to a copy passes through a first sale by the copyright holder, subsequent sales do not confer good title."[34]

### *C. Textbooks*

In *Pearson Educ., Inc. v. Liao*,[35] the plaintiffs (Pearson Education, John Wiley & Sons, Cengage Learning, and McGraw-Hill) alleged that defendants (Jun Liao and Zhengshu Gu) purchased United States copyrighted educational textbooks that were both manufactured and intended for sale outside the United States (International Editions), and then, without the plaintiffs' permission, the defendants resold the textbooks within the United States on Internet bookselling sites (such as www.abebooks.com) using the store name "Readmate." Each of the textbooks was published in both a United States edition and an International Edition. The editions were substantially identical in content, but the International Editions were published using inferior ink, paper, and binding materials. The plaintiffs were able to prove that during the past three years prior to the commencement of this action defendants sold in the United States at least one copy of an International Edition of 166 subject works within the United States. When the plaintiffs sued the defendants for copyright infringement, the defendants claimed in defense that they were protected under the first sale doctrine.[36]

Recognizing that a copyright holder's exclusive right to sell copies is tempered by the *Quality King* first sale doctrine, the court also noted the

[33] *Id*. at 1317.

[34] *Id*. at 1318. *See also*, Microsoft Crop. v. Intrax Group, Inc., No. C 07-1840 CW, 2008 WL 4500703 (N.D. Cal. Oct. 6, 2008) (holding that even though Student Media Software manufactured in Germany and Ireland were not counterfeit copies, defendant was not permitted to dispose of those copies in any manner he chose).

[35] No. 07-Civ-2423 (SHS), 2008 WL 2073491 (S.D.N.Y. May 13, 2008).

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

first sale doctrine does not protect persons who purchase copies of copyrighted works manufactured outside the United States, and then import them into the United States for resale without the copyright owner's permission. Stated otherwise, the first sale doctrine defense only applies to copies lawfully made under this title (the Copyright Act). In this case, since the textbooks were manufactured abroad, and since the defendants imported the textbooks into the United States without the permission of the plaintiffs, the defendants were liable for copyright infringement. In addition to issuing injunctive relief, the court awarded the plaintiffs $750 for each of 166 infringing works for a total of $124,500 in damages.[37]

Returning to the introduction to this paper where a student approaches Professor Black after class and shows the professor an International Edition of the Business Law text that has a United States copyright, the student asks whether this International Edition purchased on the Internet is OK to use for the text for the class. Professor Black examines the book and wonders whether the resale of the textbook in the United States violates United States copyright law. The answer requires Professor Black to ask three questions.

First, did the copyright owner manufacture, publish, or print the textbook in the United States and then ship the textbook abroad for resale outside the United States? If so, then the *Quality King* first sale doctrine defense applies. United States copyright law will not help the copyright owner to control further distribution of that copy. The distributors, resellers, and purchasers of that copy have not violated United States copyright law.[38]

Second, did the copyright owner manufacture, publish, or print the textbook abroad, and then, at some point, give permission or authority to a distributor to resell the textbook in the United States? If so, the first sale rule applies and the distributors, resellers, and purchasers of that copy have not violated United States copyright law.[39]

Third, did the copyright owner manufacture, publish, or print the textbook abroad, intended for sale only in countries outside the United States? Then the first sale doctrine does not apply. Thus any distributor or reseller of the book in the United States will be liable for copyright

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

[38] Quality King Distributors, Inc. v. L'anza Research Intern, Inc., 523 U.S. 135, 152 (1998) (deciding the "whole point of the first sale doctrine is that once the copyright owner places an item in the stream of commerce by selling it, he has exhausted his exclusive statutory right to control its distribution").

[39] Omega S.A. v. Costco Wholesale Corporation, 541 F. 3d 982, 986 (9th Cir. 2008) (stating section 109(a) "can apply to copies not made in the United States so long as an authorized first sale occurs here").

infringement for unauthorized importation of copies under section 602(a) of the Copyright Act.[40]

But what about the ultimate purchaser – the student; would the student be liable for copyright infringement? Fortunately for the student § 602(a)(2) states that the § 602(a) infringing importation section does not apply to "importation of copies … for the private use of the importer and not for distribution, by any person with respect to no more than one copy … of any one work at any one time, or by any person arriving from outside the United States with respect to copies … forming part of such person's personal baggage…."[41] Thus the student has not committed copyright infringement by purchasing the International Edition of the textbook on the Internet for his private use.

## V. RECOMMENDATIONS AND STRATEGIES

In view of the "first sale" limitation placed on the exclusive right of a copyright holder to authorize the distribution of a copyrighted work, what can a copyright owner do to control distribution of one's copyrighted works from parallel imports or gray market goods? There are several strategies.

First, if a copyright owner desires to sell copyrighted works abroad, and not for sale in the United States, the copyright owner should manufacture the goods overseas. Nevertheless, consider placing a conspicuous notice on the goods: "not for resale in the United States." Mark the goods with code numbers to allow tracing. Thus if a distributor violates an agreement to sell the goods overseas, the copyright owner will be able to identify which distributor committed the violation. Send the distributor a cease and desist letter. This might end the matter. If the distributor does not cease and desist, the copyright owner may sue the distributor for damages for copyright infringement if the goods were manufactured abroad. If the goods were manufactured in the United States, the copyright owner may sue a distributor on some other theory of recovery such as breach of contract, and/or terminate the relationship with the distributor.[42]

[40] Pearson Educ., Inc. v. Liao, No. 07-Civ-2423 (SHS), 2008 WL 2073491 at *3 (S.D.N.Y. May 13, 2008) (ruling that "because a first sale defense only applies to the sale of copies that are 'lawfully made under this title,' 17 U.S.C. § 109(a), the resale in the United States of copies manufactured outside the United States is not protected under the terms of the statute" ).

[41] 17 U.S.C. § 602(a)(2) (2009).

[42] *See* Tait R. Swanson, *Combating Gray Market Goods in a Global Market: Comparative Analysis of Intellectual Property Laws and Recommended Strategies,* 22 HOUS. J. INT'L L. 327, 366 (2000) (offering strategies to protect a copyright owner against parallel imports, such as differentiating products directed toward foreign market, marking products by distributor and intended country, and moving manufacturing

Another strategy one might consider is to provide advertising support abroad and price the works at the same price as in the United States. Thus there would be no advantage to a distributor who wants to essentially engage in an arbitrage business by taking advantage of price discrepancies. With the advent of the Internet, copyright owners must realize it is so easy for consumers to compare prices worldwide, taking advantage of the best deal at any particular time.[43]

If uniform pricing would not be feasible, considering the per capita income and economic conditions of consumers in the countries that cannot afford American prices, the copyright owner could sell the goods overseas under a different brand name. In the case of textbooks, the publisher could make sure some of the text material and cases are different, keyed to the interests of local markets.[44]

In the case of software, the copyright owner might consider licensing the goods to the consumer rather than selling the goods. However, the copyright owner must remember that merely calling an agreement a license does not necessarily make it a license. A true license requires the consumer to return the goods to the copyright owner after the license terminates.[45]

operations to foreign countries to avoid application of the first sale doctrine); Bryan P. Stanley, *Preventing the Import of Gray Market Goods in Light of Quality King Distributors, Inc. v. L'anza Research International, Inc.,* 38 WASHBURN L.J. 871, 876-882 (1999) (discussing alternatives to copyrights in order to curb parallel imports, from eliminating sales in foreign markets to restricting distributors through contractual provisions).

[43] *See* R. Anthony Reese, *The First Sale Doctrine in the Area of Digital Networks*, 44 B.C. L. REV. 577 (2003) (suggesting "while in some circumstances the new technological landscape may make access to copyrighted works more affordable and available, in many circumstances digital transmission and encryption might combine to reduce the affordability and availability of copyrighted works, as compared to the traditional model of wide distribution of copies subject to the first sale doctrine").

[44] *See* William Richcelieu, *Gray Days Ahead?: The Impact of Quality King Distributors, Inc. v. L'anza Research International, Inc.,* 27 PEPP. L. REV. 827, 855-858 (2000) (recommending strategies to circumvent *Quality King*, such as producing goods for foreign distribution to different specifications, using lot numbers on the packaging of products, taking decisive action against distributors who do not adhere to their distribution agreements, and lobbying Congress to pass new legislation to assist with closing off the gray market); John C. Roa, *Gray Market Goods and the First Sale Doctrine: The Last Nail in the Coffin?,* 20 MISS. C. L. REV. 211, 234 (1999) (suggesting where manufacturers should turn to solve their problems of gray market imports, such as changing the name of the goods or charging higher prices to foreign distributors).

[45] *See* Orit Fischman Afori, *Implied License: An Emerging New Standard in Copyright Law*, 25 STANTA CLARE COMPUTER & HIGH TECH. L.J. 275, 315 (2009) (noting that "underlying the sale of software licenses is that what is acquired is not the physical good, but is actually the license to use the software contained within the physical good. The physical copy itself remains under the ownership of the copyright owner").

## VI. CONCLUSION

Currently, courts appear to be in agreement that sales abroad of foreign manufactured United States copyrighted goods do not terminate the United States copyright holder's exclusive distribution rights in the United States. Nevertheless, with the advent of the Internet, distributors, sellers, and consumers have found it easier to secure the lowest possible prices for products sold worldwide, and they have taken advantage of these low prices regardless of the possible legal consequences.[46] Copyright owners must police their copyrights and continually review the various strategies available to protect these rights. Congress should review from time to time whether technological changes have upset the balance between the author's right to be rewarded for one's creative works versus the right of the public to the free flow of ideas and information.

[46] *See, Students Find $100 Textbooks Cost $ 50, Purchased Overseas*, N.Y. TIMES, Oct. 21, 2003, at A1.

# MODERN LAW FOR GLOBAL SUPPLY CHAINS: THE ROTTERDAM RULES

by CAROLYN HOTCHKISS*

## I. INTRODUCTION

From the time of the ancient Egyptians, Phoenicians, and Greeks, international trade has depended on travel by sea. For just as long, that travel has been risky business, with ships delayed by bad weather, wrecked by storms or by the mistakes of captains and crews, hijacked by pirates, or seized by foreign navies. Even in the modern era of e-commerce, air freight, good roads, and rail transport, more than ninety percent of global commerce moves at some point in its journey by ship.[1] The journey is still full of perils, from pirates off the coast of Somalia to storms in the North Pacific.[2]

The legal regime for ocean transport has been a complex problem for almost as long as the ships have carried cargo from one city-state or nation to another. The key issues include: who should bear the responsibility for loss, damage or delay; what legal system should govern and

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[1] International Maritime Organization (IMO) Maritime Knowledge Centre, *International Shipping and World Trade Facts and Figures* 7, (2008), http://www.imo.org/includes/blastDataOnly.asp/data_id%3D23754/InternationalShippingandWorldTrade-factsandfigures..pdf. (*sic*).

[2] In 1998, for example, Typhoon Babs damaged the M/V APL China, causing the loss of more than 400 containers of goods, damage to more than 1000 additional containers, and financial losses in excess of $100 million. Several other ships in the same area also sustained damage from the storm. Countryman & McDaniel, The Cargo Letter (1998), http://www.cargolaw.com/apl_china.html.

decide the international disputes over cargo; and whether shipper and carrier responsibilities could be limited or altered by contract. Throughout history, governments have intervened in the allocation of risk between the shippers of goods and the carriers of goods. Until the mid-nineteenth century, carriers were presumed to be insurers of the safe delivery of goods. There were four traditional exceptions to the carrier's liability. If the carrier could show no fault of its own, and that the goods were damaged by an Act of God, act of public enemies, shipper's fault, or "inherent vice" of the goods, the carrier could escape liability for loss, damage or delay.[3]

By the late nineteenth century, carriers were able to use courts' willingness to support freedom of contract to draft exculpatory clauses exempting them from much of their historic legal liability for lost, delayed, or damaged cargo. Different legal systems enforced the clauses to varying degrees, and the language of bills of lading became so complex that insurers and bankers, as well as the original parties to the contract, found it difficult to know the risks they were undertaking relative to specific cargos and voyages.[4]

The twentieth century saw several attempts to create a uniform international law governing the carriage of goods by sea. Each of the attempts helped to regulate the worst contractual problems, but no treaty found acceptance by all the major trading nations. In addition, the invention of the container and the adoption of electronic documentation transformed maritime transport in a way that none of the treaties attempting to regulate carriage of goods by sea could have anticipated. By the late twentieth century, shippers, carriers, port operators, freight forwarders and governments were all looking for a new approach to a uniform international law governing sea transportation.

In 1996, the United Nations Commission on International Trade Law (UNCITRAL) noted the patchwork of law governing sea transport and the failures of existing law to account for containerized shipping and electronic documentation.[5] In 2001, UNCITRAL established a Working Group on Transport Law to draft a new convention to regulate sea transport. After several years the Working Group produced the *Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea*, which the United Nations General Assembly approved on December 11, 2008.[6] The new treaty will be known as the Rotterdam

[3] Samuel Mandelbaum, *Creating Uniform Liability Standards for Sea Carriage of Goods under the Hague, COGSA, Visby and Hamburg Conventions,* 23 TRANSP. L.J. 471, 474 (1996).

[4] *Id.* at 475.

[5] Report of the United Nations Commission on International Trade Law on the Work of its Twenty-Ninth Session, May 28-June 14, 1996 (Doc. 17A/51/17) 49.

[6] G.A. RES. 63/122, U.N. DOC. A/RES/63/122 (Dec. 11, 2008).

Rules, as it will be opened for signatures on September 23, 2009 at a ceremony in Rotterdam, The Netherlands.

At issue now is whether the Rotterdam Rules have resolved the conflicting approaches of existing treaties and national laws with respect to lost, damaged or delayed cargo in a manner that all of the major nations engaged in ocean transport will choose to accept. The Rotterdam Rules are a significant departure from the current state of the law. If they are accepted widely, they will help manage the risks involved in operating global supply chains across our global economy. If they are not widely accepted, they will become just another layer of complexity in an already complex legal environment.

## II. THE EXISTING LEGAL LANDSCAPE

The array of laws covering international transport of goods creates real problems for businesses using global supply chains. A simple hypothetical transaction illustrates the complexity of the legal environment.[7] Suppose a seller in Berlin wishes to ship goods to Chicago. Traditionally, the seller might have arranged three contracts: a contract covering the rail trip from Berlin to the port at Rotterdam; a contract covering a voyage from Rotterdam to Montreal; and another contract for rail transport from Montreal to Chicago. In modern practice, the seller would contract with one transporter, who would subcontract the various legs of the journey. The legal result, however, is still the same. As many as six different governing laws could control the six segments of the journey.

> (1) The European CMR would govern any cargo damage that occurred during the Berlin-to-Rotterdam road leg. (2) The bill of lading would probably govern any cargo damage that occurred in the port of Rotterdam after delivery by the trucker before loading on the vessel (although the bill of lading terms could be displaced by mandatory Dutch law to the extent applicable). (3) The Hague-Visby Rules would govern any cargo damage that occurred during the Rotterdam-to-Montreal sea leg. (4) The bill of lading would probably govern any cargo damage that occurred in the port of Montreal after discharge from the vessel before delivery to the railroad. (5) The mandatory Canadian law governing domestic rail carriage would govern any cargo damage that occurred on the train before crossing the U.S. border. (6) The U.S. Carmack Amendment might (or might not) govern any cargo

[7] This example comes from Michael Sturley, *Sea Carriage Goes Ashore: The Relationship Between Multimodal Conventions and Domestic Unimodal Rules*, 1, UNCITRAL Congress "Modern Law for Global Commerce," Vienna, Austria, July 9-12, 2007, http://www.uncitral.org/pdf/english/congress/Sturley.pdf.

> damage after crossing the U.S. border (depending on the U.S. court in which the dispute was heard).[8]

The Rotterdam Rules represent a significant attempt to consolidate the rules governing the "door-to-door" transport of goods in international commerce. They are a significant departure from the three major treaties currently governing the sea leg of the journey, and would displace much national and international law governing land-based legs of transportation.

In order to understand the scale and scope of the Rotterdam Rules, it is important to examine the current treaties comprising the legal environment for sea transportation. Each of the three treaties represents an attempt to strike a balance between the needs of shippers and carriers, and each treaty strikes that balance differently.

*The Hague Rules*:[9] The Hague Rules, opened for signature in 1924, were the first successful attempt to create uniform international rules for global shipping. They still form the conceptual basis for the modern legal framework. As of 2005, sixty-one nations were parties to the Hague Rules, including the United States.[10] The Hague Rules require national implementation. In the United States, the Carriage of Goods by Sea Act (COGSA)[11] is the implementing legislation for the Hague Rules. Other nations have adopted their own implementing statutes, or have incorporated all or parts of the Hague Rules into their commercial codes.[12]

The Hague Rules created the basic structure for the regulation of sea cargo, using the ocean bill of lading as the vehicle for the legal structure. They did not attempt to regulate any of the land-based modes of transport, so they are said to be "tackle to tackle"; that is, applicable from the time the carrier loads the goods to the time the carrier unloads the goods from the ship. Loss or damage while the goods are in port awaiting further transport or while the goods are in transit by rail or truck are not covered by the Hague Rules.[13]

[8] *Id*. at 2, *citing* the Convention on the Contract for the Carriage of Goods by Road (CMR), May 19, 1956, U.N. E/ECE/Trans 489, http://www.unece.org/trans/conventn/cmr_e.pdf, and the Carmack Amendment, 49 U.S.C. §14706 *et seq*.

[9] Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, Aug. 25, 1924, 51 Stat. T.S. No. 931, 120 I.N.T.S. 155 [*hereinafter* the Hague Rules].

[10] George Chandler, *A Survey of the Cargo by Sea Conventions*, (2005) http://www.admiraltylaw.com/papers/countrytable.pdf.

[11] 46 U.S.C. § 1300 *et seq*.

[12] *See* Chandler, *supra* note 10 for references to implementing legislation.

[13] Many carriers extend the protections of the Hague Rules or COGSA beyond the "tackle-to-tackle" scope using what is known in Admiralty Law as a Himalaya Clause. Typically inserted in a Bill of Lading or other transport document, it is form extending Hague Rule defenses and limitations of liability to third parties dealing with the cargo.

The Hague Rules strike a balance between the interests of shippers and carriers that may have made sense in 1924, but over time has come to be seen as favoring the interests of carriers at the expense of shippers. Under the Hague Rules, the carrier has the obligation: to provide the shipper with a proper bill of lading covering the cargo shipped; to load and stow the cargo properly; and to provide a seaworthy ship, properly maintained for cargo, and properly manned.[14] Once the carrier meets these conditions, the Hague Rules provide a long list of causes for loss, damage or delay for which the carrier bears no liability.[15] Among the expected exemptions from carrier liability are those caused by perils of the sea and acts of war. Among the more controversial exemptions is that excusing the carrier for losses stemming from the "Act, neglect, or default of the master, mariner, pilot, or the servants of the carrier in the navigation or in the management of the ship"[16]

Unless the carrier deviates from the terms of the bill of lading, generally through unauthorized deck stowage of cargo or material deviation from the expected course of the voyage, the carrier bears no liability for loss, delay or damage. Even if the carrier doesn't qualify for complete avoidance of liability, the Hague Rules limit the carrier's liability. Under the original Hague Rules, liability was limited to £100 per package ($500 under COGSA), unless the shipper declared a higher value on the bill of lading.

The Hague Rules were useful in creating a standardized form of ocean bill of lading and in putting all parties on notice of the need for insurance during the ocean leg of cargo transport. Over time, however, the Hague Rules proved unable to evolve in response to changes in cargo practices. Their focus on the written bill of lading proved difficult to adapt to electronic documentation. The Hague Rules covered only the sea leg of the journey, so multimodal containerized transport required multiple contracts for one journey. Finally, over time, the $500 per package limitation became generally inadequate, and more specifically inadequate when the "package" under transport was a container, rather than a case or a pallet.

*The Hague-Visby Rules*:[17] The rise of containerized shipping created pressure to change some of the provisions of the Hague Rules to strike

The clause takes its name from a decision of the English Court of Appeal, Adler v. Dickson (The Himalaya), [1954] 2 LLOYD'S REP.267 (1955), 1 QB 158 [1].

[14] Hague Rules, *supra* note 9, Arts. 1-3.

[15] *Id*. Art. 4.

[16] *Id*. Art (4)(2)(a).

[17] Protocol to Amend the International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, Brussels, Feb. 23, 1968, 2. U.N. Register of Texts ch. 2 at 180 (entered into force June 23, 1977) [with the Hague Rules, *hereinafter* the Hague-Visby Rules].

a better balance between the obligations of the carrier and those of the shipper. In 1968, the Hague Rules were amended to account for the emerging problems with the Hague Rules and shift the balance of rights and liabilities in favor of the shippers. While the Visby amendments to the Hague Rules left in place the basic carrier obligations and the seventeen exemptions from liability, they imposed liability on carriers for reckless or intentionally wrongful conduct.[18] More importantly, they provided that where goods are consolidated into a container or pallet, the package for purposes of limitations of liability is the number of units disclosed on the bill of lading. [19] Finally, the amount of liability was adjusted to the higher of 666.67 Special Drawing Rights (a unit of measure from the International Monetary Fund), or two SDRs per kilogram.[20]

Since 1968, fifty-three nations have adopted all or most of the Hague-Visby Rules.[21] In the United States, shippers tended to support the Hague-Visby Rules, urging Congress to ratify the changes and enact enabling legislation. Carriers, however, almost uniformly opposed the new rules, and prevailed upon Congress to leave COGSA in place.[22] Although many major trading nations did adopt the amendments, the end result was a lack of uniformity in the legal environment for ocean transport.

*The Hamburg Rules*:[23] Almost as soon as the Hague-Visby Amendments were adopted, the United Nations began work on a major overhaul of the governing law for sea transport. The Hamburg Rules resulted from the work of UNCITRAL, were opened for signature in 1978 and came into effect in 1992. Largely sponsored by developing nations, very few significant sea powers have adopted the Hamburg Rules. As of 2005, thirty countries, eleven of which are landlocked, have ratified or acceded to the Hamburg Rules.[24] The per package limitation of liability was increased to 885 SDRs or 2.5 per kilogram, and the package could no longer be defined as the container.[25]

[18] Hague-Visby Rules, *supra* note 17, Art, IV (5)(e).
[19] *Id*. Art. IV (5)(c).
[20] *Id.* Art. IV (5)(a).
[21] Chandler, *supra* note 10.
[22] Allen Mendelsohn, Why the U.S. Did Not Ratify the Visby Amendments, 23 J. MAR. L & COM. 29, 40 (1992).
[23] United Nations Convention on the Carriage of Goods by Sea, Hamburg, Mar. 31, 1978, U.N. Doc A/Conf.89/13, 17 I.L.M. 608 (1978) (entered into force Nov. 1, 1992) [*hereinafter* the Hamburg Rules].
[24] Chandler*, supra* note 10.
[25] For a defense of the Hamburg Rules, see Eun Sup Lee, The Changing Liability System of Sea Carriers and Maritime Insurance: Focusing on the Enforcement of the Hamburg Rules, 15 TRANSNAT'L LAW. 241 (2002).

The Hamburg Rules radically altered the balance of liability between the carrier and the shipper. They start with the presumption that the carrier is negligent and place the burden on the carrier to prove that it exercised all reasonable measures to prevent the loss.[26] The seventeen defenses of the Hague and Hague-Visby Rules were reduced to three. It is unlikely that major shipping nations will adopt the Hamburg rules, but their existence created an additional level of complexity to the legal environment for sea transport.

## III. THE ROTTERDAM RULES

When it became clear that the Hamburg Rules would not gain widespread acceptance, UNCITRAL returned to work to draft a more acceptable reform of the legal regime for sea transport. The new Rotterdam Rules[27] represent a broad reimagining of the legal environment for sea transport. Where the three existing Conventions are concise in wording and limited in scope, the Rotterdam Rules consist of 96 Articles in 18 Chapters. While there are many changes from the earlier Conventions, several key features will be the flashpoints in the debates over ratification of the Rotterdam Rules.

The first significant change posed by the Rotterdam Rules is the applicability to an entire transportation contract, rather than just to the bill of lading. For the first time, international law will cover a container transaction "door-to-door" rather than "tackle-to-tackle." [28] It recognizes that the form of a contract may differ from a bill of lading, and it specifically authorizes and regulates electronic transportation records and documents.[29] As a result, many participants in the transportation business will be subject to the Rotterdam Rules. Terminal operators and stevedores will be subject to the responsibilities and limitations of liability of the Rotterdam Rules. Carriers may be subject to the Rotterdam Rules even for portions of the transport occurring on land.[30]

The second major change to the existing transportation landscape is the upward adjustment of the liability limits to 875 SDRs per package, or 3 SDRs per kilogram of weight.[31] The Rotterdam Rules retain the American approach to package definitions. Unless the transportation contract declares otherwise, for goods consolidated on a pallet on in a

[26] Hamburg Rules, *supra* note 23, Art. 5(1).

[27] UNCITRAL Draft Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea, A/CN.9/XLI/CRP.9, June 27, 2008 [*hereinafter* the Rotterdam Rules].

[28] *Id*. Art. 5.

[29] *Id*. Arts. 8-10.

[30] *Id*. Art. 26.

[31] *Id*. Art. 59 (1). The IMF calculates the value of SDRs on a daily basis. As of March 20, 20009, 875 SDRs equaled $1,323.45 USD, while 3 SDRs equaled $4.53 USD.

container, the pallet or container will constitute the package for purposes of limitations of liability.[32] Some carriers are concerned about the upward revision in liability limits, although both the Hague and Hague-Visby amounts are widely seen as inadequate. Adjusted simply for inflation, the $500 that seemed a reasonable compromise for shippers and carriers when COGSA was adopted in 1936 would be about $7,145 today.[33]

The third area of significant change in the Rotterdam Rules relates to the scope of and exemptions from liability of the carrier. The Rotterdam Rules largely follow the Hague Rules, but eliminate the exemption from liability for errors in navigation, restrict the exemption for loss by fire, and add an exemption for loss due to terrorism.[34] The Rotterdam Rules clarify the carrier's obligation to provide a seaworthy ship, not just at the beginning of the voyage, but throughout, and restrict the carrier's ability to avoid liability for reckless intent to cause damage.

A fourth area of change, added at the insistence of the United States, affects the jurisdiction of courts hearing cases for damages resulting from cargo losses. Under existing U.S. law, choice of forum clauses in bills of lading are enforced, allowing non-U.S. courts to hear cases involving COGSA bills of lading, so long as the foreign court applies COGSA as the governing law. [35] Under the Rotterdam Rules, even if there is a choice of forum clause, disputes between parties to the contract may be brought in a court in the place of receipt of the goods, delivery of the goods, port of loading and unloading, or in the domicile of the carrier, as well as the place designated in the contract.[36]

Finally, and most controversially, the Rotterdam Rules allow parties to "volume contracts" to opt out of the applicability of most of the Convention. A volume contract is defined as a "contract of carriage that provides for the carriage of a specified quantity of goods during an agreed period of time," including contracts with minimum amounts, maximum amounts or ranges of quantity.[37] The Rotterdam Rules allow parties to volume contracts, under conditions that would give them

[32] *Id*. Art 59 (2).
[33] David Maloof, As the UN General Assembly Nears Adoption of a New Proposed Shipper Compensation Treaty, Should the United States Ratify it or Simply Amend Existing Law, (Draft), 7 (Oct. 30, 2008) unpublished manuscript, *available at* http://www.mcgill.ca/files/maritimelaw/Maloof_Draft_Paper.pdf.
[34] Rotterdam Rules, *supra* note 27, Art. 17.
[35] Vimar Seguorosy Reaseguros, S.A. v. M/V Sky Reefer, 15 U.S. 199 (1995).
[36] *Id*. Art. 66.
[37] *Id*. Art. 1 (2).

notice of changes and an option for a standard contract, to change the balance of shipper and carrier responsibilities and liability.[38]

## IV. PROSPECTS FOR RATIFICATION

Now that the Rotterdam Rules have been approved by the General Assembly, the key question becomes whether enough countries will sign and ratify the new Convention, then follow up with domestic implementing legislation, to create a harmonized structure for sea trade. Despite widespread acknowledgement of the inadequacies of the current system, the prognosis for the Rotterdam Rules is guarded. To be successful, the new rules will need adoption from nations engaged in the shipment of imported and exported products as well as from the nations controlling the global fleet of ocean transport.

The United States, for example, is the world's largest importer of commerce by sea, and the second largest exporter, but controls only one percent of the world's fleet of carriers.[39] The U.S. entered the negotiations process for the Rotterdam Rules with the experience of having industry groups block ratifications of earlier shipping treaties. So the State Department invited representatives from major industry groups, including the Maritime Lawyers Association, the World Shipping Council, National Industrial Transportation League, The Transportation Intermediaries Association, Federal Express, United Parcel Service, and others, to participate in the negotiation process.[40]

The United States achieved most of its objectives in the Rotterdam Rules. For the State Department, there were two "deal-breaker" provisions. The first was the provision on choice of forum. The inclusion of this provision allows U.S. plaintiffs to bring suit in U.S. courts in almost every instance of loss. Although the European Union and others initially opposed the provision, it ultimately was included in the Rotterdam Rules.[41]

The second "deal-breaker" provision for the United States was the inclusion of the volume contract provision. There were strong objections from other countries to the volume contract provisions, on the ground that the provision would undercut the minimum standards requirement of Hague, Hague-Visby and Hamburg, resulting in a possible global race to the bottom in transportation contracts. According to the chief U.S. negotiator:

[38] *Id*. Art. 80.

[39] Maloof, *supra* note 33, at 13.

[40] Mary Helen Carlson, U.S. Participation in the International Unification of Private Law: The Making of the UNCITRAL Draft Carriage of Goods by Sea Convention, 31 TUL. MAR. L.J. 615, 627 (2007).

[41] *Id*. at 633-34.

> The rationale for the U.S. position is that the existing mandatory regimes were developed for a commercial context that no longer exists, and that they do not meet today's commercial realities. It can no longer be assumed that carriers always have the more powerful bargaining position vis-a-vis shippers; nor can it be assumed that transport contracts are always adhesion contracts, which the shipper must take or leave.[42]

It appears that the two deal-breaker provisions for the United States may become deal-breaker provisions for other nations. The Belgian Maritime Law Association released a position paper on the Rotterdam Rules opposing the new rules, both because they extend beyond purely maritime transport and because the volume contract provisions do not sufficiently protect small and medium-sized shippers.[43] It is not clear at this point what the positions of the European, Nordic, and Mediterranean nations will be, nor are China and India telegraphing their intent with respect to the Convention. The Canadian Government has called for public comment on signing and ratification of the Rotterdam Rules, and is noncommittal at this point.[44]

One prominent American critic has noted that the volume contracts provision amounts to effective deregulation of global shipping, since 90% of containerized cargo worldwide now moves under contracts that could convert to volume contracts.[45] In his view, the volume contracts provision operate as a stealth deregulation of the ocean shipping business, undoing nearly a century of treaties striking a balance between shippers and carriers, and creating disincentives for carriers to exercise minimal standards of care in the handling of cargo.[46]

While there will be many nations present at the signing ceremony in Rotterdam in September 2009, when it comes to ratification, the future is not at all clear. The maritime bar associations worldwide are still formulating their positions on the new rules, and shippers, freight forwarders and terminal operators are expressing concerns. The world is waiting to see whether the new U.S. administration will support the

[42] Carlson, *supra* note 40, at 636.

[43] Belgian Maritime Law Association, The Belgian Position on the New UNCITRAL Convention, October 12, 2008, http://www.mcgill.ca/files/maritimelaw/Belgian_Position_Paper.pdf.

[44] Transport Canada, United Nations Commission on International Trade Law Convention on Contracts for the Carriage of Goods Wholly or Partly by Sea Information Paper, Feb. 2009, 12, http://www.admiraltylaw.com/papers/UNCITRAL.pdf.

[45] David Maloof, Questions and Answers Why the MLA Needs and Open Debate Concerning the "Volume Contracts" Exception to the Proposed Rotterdam Rules, 2 (Nov. 5, 2008), http://www.mcgill.ca/files/maritimelaw/Questions_and_Answers_USMLA.pdf.

[46] Maloof, *supra* note 33, at 143.

work in negotiations of the prior administration. If it does, other nations may well swallow their objections and ratify the rules.

## V. CONCLUSION

The original Hague Rules in 1924 represented a carefully negotiated balance of interests between carriers and shippers. Over time, those rules became fragmented, as some nations signed on to changes while others did not. Uniform rules frayed further as national governments created variations in their national legislation and courts interpreted that legislation sometimes disregarding the need for uniformity.

It is time to strike the balance again, with new rules, widely accepted by trading and shipping nations. The Rotterdam Rules, on the whole, do a good job at updating the legal environment of sea transport to recognize the multimodal nature of most transactions, the increased acceptance of electronic documentation, and the need to adjust liability amounts and exceptions. The basic rebalancing of interests is sensible, even if it is a bit more onerous for some parties. It is unfortunate that the United States insisted on adding a provision that has the potential to gut the entire scheme in the name of deregulating markets and freedom of contract. The volume contract provisions have the potential to scuttle the treaty, or create a treaty that once again, only some nations will ratify. The provision will serve as a focal point for opponents who are concerned about other narrower issues.

Without the volume contract provisions, the Rotterdam Rules would likely achieve widespread ratification. The Rules are probably too long and complex, and certainly not perfect. But they are workable and practical from a business point of view. With the volume contract provisions, it is not clear that the Rotterdam Rules will gain widespread acceptance. Failure will be a problem. Having four different cargo regimes would complicate the job of shippers and carriers and impede the free flow of global trade. It is likely that individual nations will revise their implementing legislation unilaterally (as the United States has indicated it may), resulting in even more uncertainty in international commerce. Yet acceptance of the Rotterdam Rules as written may be equally problematic, given the ability of carriers and shippers to sidestep their provisions. The result may be a missed opportunity to create modern law for global commerce.

# SAME-SEX MARRIAGE IN NEW JERSEY: A LEGAL, BUSINESS AND SOCIAL PERSPECTIVE

by ROBERT D. KING*

## INTRODUCTION

In 2006, the New Jersey Supreme Court ruled in *Lewis v. Harris*[1] that barring committed same-sex couples (hereinafter referred to as gay, in its most inclusive sense, or same-sex couples) from the financial and social benefits and privileges afforded married heterosexual couples denied gay couples equal protection guarantees under the New Jersey Constitution.[2] The court, however, did not find that gay couples had a constitutional right to marriage, but only to the "same rights and benefits enjoyed by married opposite-sex couples."[3] The court left the Legislature with the decision of how to effect the court's ruling, either by amending the marriage statutes to include gay couples or enacting a "parallel statutory structure by another name"[4] guaranteeing gay couples the rights, benefits, obligations and burdens of civil marriage. The Legislature chose the latter option.[5]

When New Jersey's civil union law went into effect in 2007, the State joined Vermont, Connecticut and New Hampshire in permitting gay

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1 908 A. 2d 196 (N.J. 2006).
2 *Id.* at 220-21.
3 *Id*. at 221.
4 *Id*. at 224.
5 *See* New Jersey Civil Unions Act, N.J. Stat. Ann. § 37:1-31 (West 2007).

couples to enter into a civil union.[6] Indeed, New Jersey's position affording gay couples the right to enter into a civil union is a significant step in the advancement of gay rights: one more state has joined the ranks of recognizing equality for same-sex unions. But the move hardly made New Jersey a pioneer in recognizing gay rights. In 2004, Massachusetts had already begun marrying gay couples.[7] Furthermore, in 2008 California[8] and Connecticut[9] began to permit gay marriages. In early 2009, Iowa,[10] Vermont[11] and Maine[12] increased the total number of states that plan to afford the right to same-sex marriage. In addition,

[6] *See* "Gay Marriage Timeline," The Pew Forum on Religion & Public Life, *available at* http://pewforum.org/docs/?DocID=292 (last accessed 12 November 2008).

[7] *Id. See also* Goodridge v. Dep't of Pub. Health, 798 N.E.2d 941 (Mass. 2003) (ruling that barring same-sex couples from the protections, benefits and obligations of civil marriage violates the Massachusetts Constitution's equal protection principles).

[8] *See* In re Marriage Cases, 183 P.3d 384 (Cal. 2008) (ruling that: the California Constitution guarantees to all individuals and couples the fundamental right to marry, regardless of their sexual orientation; statutes that impact based on sexual orientation implicate a suspect classification requiring a heightened level of judicial scrutiny; and, the limitation of marriage to opposite-sex couples only is a violation of the California Constitution's equal protection clause). On November 4, 2008, however, California voters approved Proposition 8, a ballot measure that would ban same-sex marriages by amending the state's constitution to prohibit gay marriage. *See* Glenn Kessler, *California Voters Narrowly Approve Same-Sex Marriage Ban*, WASH. POST, Nov. 6, 2008, at A44. *See also* Richard Salas, *In Re Marriage Cases: The Fundamental Right to Marry and Equal Protection Under the California Constitution and the Effects of Proposition 8,* 36 Hastings Const. L.Q. 545 (2009) for an analysis of the California Supreme Court's decision permitting same-sex marriage and the legal effects of Proposition 8. The legality of Proposition 8 as a means of amending the California Constitution was challenged in court. On May 26, 2009, the California Supreme Court upheld Proposition 8. *See* John Schwartz, *California Supreme Court Upholds Ban on Same-Sex Marriage*, N.Y. TIMES, May 26, 2009, *available at* http://www.nytimes.com/2009/05/27/us/27marriage.html?hp. *See also infra* note 86.

[9] *See* Kerrigan v. Comm'r of Pub. Health, 957 A.2d 407 (Conn. 2008) (ruling that: plaintiffs, same-sex couples, had a legally cognizable injury by virtue of their exclusion from marriage; sexual orientation establishes a quasi-suspect classification for purposes of analyzing gay rights under the state constitution; and, same-sex couples are denied equal protection by limiting marriage to heterosexual couples only). Connecticut began permitting gay marriages on November 12, 2008. *See* Lisa W. Foderaro, *Gay Marriages Begin in Connecticut*, N.Y. TIMES, Nov 12, 2008, *available at* http://www.nytimes.com/2008/11/13/nyregion/13marriage.html?hp.

[10] *See* Varnum v. Brien, 763 N.W.2d 862 (Iowa 2009) (ruling that the state statute restricting marriage to only heterosexual couples denied same-sex couples the equal protection afforded by the Iowa Constitution).

[11] *See* Andrea Stone, *Vt. Lawmakers Legalize Gay Marriage*, USA TODAY, April 8, 2009, at A3 ("The Vermont Legislature on Tuesday gave same-sex couples the right to marry, shifting a battle fought mostly in courts and at the ballot box into a new arena and giving gay rights activists their second victory in a week.").

[12] *See* Abby Goodnough, *Maine Governor Signs Same-Sex Marriage Bill as Opponents Plan a 'Veto'*, N. Y. TIMES, May 7, 2009, at A21.

the New Hampshire Legislature recently passed a same-sex marriage bill.[13] Although the governor has expressed in the past his intention to veto such a bill, it is unclear whether or not he will do so.[14]

Among the four states that had taken the path of affording civil unions rather than marriage for gay couples,[15] New Jersey was arguably in the best position to move to gay marriage through the legislative process. However, of those four states, only New Jersey remains no closer to offering marriage for same-sex couples.[16] This is despite a confluence of legal, economic and social factors presently existing in New Jersey that suggests the time is ripe for the state's legislature to move from civil union to same-sex marriage.

The gay demographic in the United States is estimated to range anywhere from 14 million[17] up to as high as 10% of the nation's population.[18] Moreover, it is estimated to have a spending power between $400-475 billion annually, with $55 billion being spent on travel annually.[19] It is no wonder then that many businesses, particularly the travel industry, have recognized the gay market segment and have increasingly courted the gay community's patronage.[20] Moreover, studies suggest that the wedding industry and related businesses, as well as state coffers, stand to reap significant financial gains from gay weddings.[21]

This paper will explore: the legal case for gay marriage in New Jersey by examining the commitment to equality for same-sex couples found in the New Jersey Supreme Court's decision in *Lewis v. Harris*;[22] the economic case for gay marriage by examining the State's present economic and business climate that suggests the business community would likely be receptive to the added revenue resulting from fostering

[13] *See* Abby Goodnough, *New Hampshire Senate Narrowly Approves New Version of Same-Sex Marriage Bill,* N. Y. TIMES, April 30, 2009, at A16.

[14] *Id.*

[15] Vermont, Connecticut, New Jersey and New Hampshire are the only states to date ever to offer civil unions for gay couples. *See supra* text accompanying note 6. Connecticut, however, moved to marriage for gay couples by court order. *See supra* note 9. In 2009, Vermont moved to same-sex marriage by legislative action. *See supra* note 11. In April 2009, the New Hampshire Legislature sent a same-sex marriage bill to the governor; it remains unclear whether or not the governor will sign the bill. *See supra* text accompanying notes 13-14.

[16] *See supra* note 15.

[17] Robert D. King, Karen L. Stewart & Jennifer Barr, *Gay Rights: The Impact and Interaction of Popular Culture, Business Practices and Law,* 14 Journal of the Northeastern Association of Business, Economics and Technology 39, 41 (2008).

[18] *See* Gay and Lesbian Families in the United States: Same-Sex Unmarried Partner Households (2001) *available at* http://www.hrc.org//documents/gayandlesbianfamilies.pdf.

[19] King, *supra* note 17 at 41-42.

[20] *See generally* King, *supra* note 17.

[21] *See infra* text accompanying notes 88-92.

[22] *Supra* note 1.

a gay-friendly environment; and, the social case for gay marriage by examining the State's social climate that supports the proposition that marriage is the only way to ensure true equality for same-sex unions.

## CIVIL UNION COMES TO NEW JERSEY

In 2004 New Jersey enacted the Domestic Partnership Act[23] permitting same-sex couples and unmarried heterosexual couples aged 62 and older to enter into a domestic partnership agreement. The statute permitted couples who entered such an agreement to have access to joint status for state tax purposes, exemption from state inheritance tax, and hospital visitation and medical decision-making rights.[24] While subsequent amendments to other state statutes provided for some additional rights,[25] the Domestic Partnership Act clearly "failed to bridge the inequality gap between committed same-sex couples and married opposite-sex couples."[26]

Prior to the enactment of the Domestic Partnership Act, however, seven same-sex couples, each of whom had been in a committed relationship for more than ten years, brought suit claiming that New Jersey's laws restricting marriage to the union of a man and a woman violated the New Jersey Constitution.[27] The couples based their claims of constitutional deprivation on the liberty and equal protection guarantees[28] found in the New Jersey Constitution. The trial court

[23] Domestic Partnership Act, N.J. Stat. Ann. § 26:8A-1 et seq. (2004).

[24] See "Lamda Legal: New Jersey" *available at* http://www.lamdalegal.org/our-work/states/new-jersey.html?print=t (last accessed 11 November 2008).

[25] Additional rights obtained later related to matters such as making funeral arrangements and directing the disposition of remains for a deceased partner, permitting inheritance privileges when the deceased partner dies intestate, and providing for guardianship rights upon a partner's incapacitation. *Lewis,* 908 A. 2d at 215.

[26] *Id*. Among rights given to married couples exclusively were the right to change one's surname without petitioning the court, the right to ownership of property as tenants by the entirety, the right to survivor benefits under New Jersey's Workers' Compensation Act, and the right to tax deductions for spousal medical expenses. *Id*.

[27] *Id.* at 200. The couples had applied for marriage licenses in the municipalities in which they resided, but were told by the licensing officials that the law did not permit same-sex couples to marry. *Id.*at 201.

[28] The couples argued that marriage is a fundamental right and therefore guaranteed to them under the State constitution's liberty protections. The trial court, however, dismissed the plaintiffs' claim by finding that same-sex couples do not have a right to same-sex marriage under the State's constitution because the right was not "rooted in the collective conscience and traditions of the people of this State as to be deemed fundamental." *Id.* at 203. With respect to the equal protection claim, the trial court found that "limiting marriage to mixed-gender couples is a valid and reasonable exercise of governmental authority." *Id.* Moreover, the court noted that same-sex couples could seek protections similar to those enjoyed by heterosexual married couples by petitioning the New Jersey Legislature. *Id*.

granted the State's motion for summary judgment, noting that the plaintiffs were not merely trying to lift a barrier to marriage, but rather "to change its very essence."[29]

A divided three-judge panel of the Appellate Division affirmed the trial court's decision.[30] The court found that the marriage statutes do not contravene either the plaintiffs' substantive due process rights[31] or their equal protection guarantees.[32] In essence, the appellate court took the position that only the Legislature could implement same-sex marriage.[33]

The dissenting judge, however, concluded that the substantive due process and equal protection guarantees of the State's constitution do indeed obligate the State to afford same-sex couples the right to marry on equal terms with opposite-sex couples.[34] He noted that the current application of the marriage laws in New Jersey prohibit a life choice of central importance based solely on the sexual orientation of the parties,[35] and that the State was unable to offer a rational basis for such a limitation.[36] He concluded, therefore, that the State deprived the plaintiffs of their substantive due process right and equal protection of the laws.[37]

[29] *Id.*

[30] Lewis v. Harris, 875 A.2d 259, 274 (App.Div. 2005).

[31] *Id.* at 271. The majority held that same-sex marriage was clearly not a fundamental right when examined pursuant to the text of the New Jersey Constitution, the State's history and tradition, and contemporary and social standards. *Id.*

[32] *Id.* at 271-72. The Appellate Court applied a balancing test to the plaintiff's equal protection claim. The balancing test looks at the nature of the affected right, the extent of the government's intrusion on the right, and the public need for the restriction on the right. *Id.* However, because the appellate court had already concluded there was no fundamental right to same-sex marriage, it reasoned that the plaintiffs could not demonstrate that they had a right that was affected. Consequently, the court found that the State was not required to show an intrusion of such a right, nor a public need for limiting marriage to opposite-sex couples. *Id.*

[33] *Id.* at 274.

[34] *Id.* at 280-90. The dissent noted the evolving nature of the institution of marriage, as well as that of the gay rights movement. *Id.* at 282-85. Writing in dissent, Judge Collester dismissed the notion that procreation or the ability to procreate is a central mission of marriage today. *Id.* at 285. The State's Attorney General, however, appeared to have disavowed that rationale anyway. *Id.* at 269 n.2. But the majority appellate opinion nonetheless did mention marriage between a man and a woman as playing a vital role in procreating and providing the ideal environment for raising children. *Id.* at 269.

[35] *Id.* at 289.

[36] *Id.* at 289-90.

[37] *Id*. at 280-90.

*The Supreme Court's Decision*

An appeal as of right was made to the State's Supreme Court. Because the case on appeal raised no factual issues,[38] the court needed only to address the questions of law that the plaintiffs' case presented.[39]

A divided Supreme Court ruled partially in favor of the plaintiffs. Although the majority agreed with the Appellate Court that there was no fundamental right to same-sex marriage found in the traditions, history and conscience of the people of New Jersey such that the liberty guarantees of the State Constitution would be implicated by a denial,[40] the court did hold that the equal protection provision of the New Jersey

[38] *See supra* text accompanying note 29.

[39] Lewis v Harris , 908 A.2d at 205.

[40] *Id.* at 211. The State argued that the long-held view of marriage as a union between a man and a woman was a sufficient basis to uphold the existing marriage statutes, and that any change in the traditional view of marriage should come from the people through the legislative process. *Id.* at 206. In concluding that there was no fundamental right to same-sex marriage, The New Jersey Supreme Court essentially agreed with the State's position with regard to determining the process for articulating what rights are fundamental. The court utilized the same standard applied by the United States Supreme Court when it determines what rights are fundamental under the United States Constitution. *Id.* at 207. For example, the court, quoting Griswold v. Connecticut, 381 U.S. 479, 493 (1965), stated that it must "look to the 'traditions and conscience of our people to determine whether a principle is so rooted … as to be ranked as fundamental.'" *Id.* In assessing such criteria for New Jersey, the court noted the advancement of gay civil rights in the State with respect to both legislation (*see, e.g., N.J.S.A.* 10:5-4 (prohibiting discrimination on the basis of sexual orientation) and *N.J.S.A.* 26:8A -1-13(providing rights to gay couples under the Domestic Partnership Act)) and case law (*see, e.g.,* In re adoption of a Child by J.M.G., 632 A.2d 550 (Ch.Div. 1993) (case determining that a lesbian partner was entitled to adopt the biological child of her partner)). *Id.* at 209. Furthermore, the court noted the advancement of gay civil rights at the United States Supreme Court level in Romer v. Evans, 517 U.S. 620 (1996) and Lawrence v. Texas, 539 U.S. 558 (2003). *Id.* at 209-10. In *Romer* the Court struck down an amendment to the Colorado Constitution whereby the state's voters approved the prohibition of all legislative, executive, or judicial action designed to protect gays from discrimination premised on sexual orientation. *Romer*, 517 U.S. at 623-24. The Court held that Colorado's constitutional amendment violated the Fourteenth Amendment's Equal Protection Clause by imposing a disability on a single group where the motivation for the disability appeared to be nothing more than animus toward gays and lesbians. *Id.* at 632. In *Lawrence* the Court invalidated, on Fourteenth Amendment due process grounds, the Texas sodomy law which made it a crime for homosexuals to engage in certain consensual sexual intimate conduct. *Lawrence*, 539 U.S. at 562. The Court held that the liberty guaranteed by the Due Process Clause prevented Texas from controlling the private life of gays by making their private sexual conduct a crime. *Id.* at 578. Notwithstanding the New Jersey Supreme Court's recitation of the recent advancements in gay civil rights at the state and federal level, in particular at the United States Supreme Court level, the court nonetheless found that such advances "fall far short of establishing a right to same-sex marriage deeply rooted in the traditions, history and conscience of the people of the State." Lewis v. Harris, 908 A.2d at 210 (N.J. 2006).

Constitution guarantees committed same-sex couples be "afforded on equal terms the same rights and benefits enjoyed by married opposite-sex couples."[41] The State did not meet its burden of showing a public need for such "disparate treatment."[42]

[41] *Lewis,* 908 A.2d at 220-21. Although the court noted the many advances gays had made with regard to civil rights protections, particularly in New Jersey, it nonetheless made clear that, notwithstanding the Domestic Partnership Act, same-sex couples were still denied many of the benefits and privileges afforded heterosexual couples in New Jersey. *Id.* at 215. Among the rights given to married couples but not same-sex couples were: the right to a surname change without the necessity to petition the court; survivor benefits under New Jersey's Workers' Compensation Act; back wages owed to a deceased spouse; free tuition at public institutions of higher education for the surviving spouses and children of certain members of the New Jersey National Guard; tuition assistance for higher education for spouses and children of volunteer firefighters and first-aid responders; tax deductions for spousal medical expenses; exemption from the realty transfer tax for transfers between spouses; and, the testimonial privilege given to the spouses of an accused in a criminal action. *Id.* The court also noted that same-sex domestic partners also receive fewer workplace protections than married couples; for example, employers are not required to provide health insurance for an employee's domestic partner. *Id.* at 216. Perhaps the most compelling arguments the court presented related to the disparity between the State's treatment of married couples and same-sex couples had to do with the disparity's impact on the children of same-sex couples. The court cited the shortcomings of the Domestic Partnership Act with regard to the family law protections available to married couples. *Id.* at 216-17. For example, the court noted that the Domestic Partnership Act provides no presumption of dual parentage to the non-biological parent of a child born to a domestic partner, thus requiring expensive second-parent adoption procedures to achieve parity with married couples. *Id.* at 216. Furthermore, the court noted the Act's silence on issues related to custody, visitation and partner and child support in the event of a termination of a domestic partnership. *Id.* With regard to the impact on the children, the court stated: "With fewer financial benefits and protections available, those children are disadvantaged in a way that children in married households are not. Children have the same universal needs and wants, whether they are raised in a same-sex or opposite-sex family, yet under the current system they are treated differently." *Id.* at 216-17. Finally, the court noted that same-sex couples face stricter requirements to enter into a domestic partnership than opposite-sex couples face in marrying. *Id.* at 217. For example, domestic partners must prove a common residence, assumption of joint responsibility for each other's common welfare as evidenced by joint financial arrangements or joint ownership of real or personal property, agreement to be jointly responsible for each other's basic living expenses, and a choice to share each other's lives in a committed relationship. Married couples have no such proof hurdles. *Id.*

[42] *Id.* at 220. The State did not attempt to justify its disparate treatment of same-sex couples with regard to marriage on the basis of procreation or the optimal living environment for children. *Id.* at 217. As the court noted, however, it would have made no sense to make such an argument in a state that recognizes the right of same-sex couples to raise natural and adopted children, and permits foster children to be placed with gay couples. *Id.* at 218. Rather, the State argued against gay marriage because of its interest in maintaining uniformity with the majority of other states with regard to the issue of marriage and gays. *Id.* The court responded to the State's rationale by noting how much New Jersey's public policy was clearly already at odds with the majority of states

Although the New Jersey Supreme Court ruled that same-sex couples were entitled equally with married couples to the same rights and benefits of marriage, it did not rule that the State must afford gays the right to marriage. Rather, the court left the decision on how to deal with its ruling up to the Legislature.[43] The court suggested that the Legislature could simply amend the marriage statutes to include gay couples, or it could create a "separate statutory structure, such as a civil union."[44] As expected, the Legislature chose to go the route of a separate statutory structure; it made civil union and not marriage available to same-sex couples.[45]

The majority opinion, although seeming in some respects to be tepid with regard to the issue of same-sex marriage, really was quite supportive of gay rights as a general matter. Furthermore, it seemed to leave an opening for the prospect of gay marriage in the future.[46] While ultimately concluding that there was no substantive due process deprivation under the State's Constitution by the State denying gays the right to marry, the court strictly applied the principle that substantive

where there is "open hostility toward legally recognizing committed same-sex relationships." *Id.* The court held that the burdens remaining on same-sex couples denied the privileges and benefits of marriage far outweighed the State's articulated rationale for limiting the privileges and benefits of marriage to opposite-sex couples. *Id.*

[43] *Id.* at 221. The court adopted in this instance a reading of the equal protection clause as only guaranteeing same-sex couples the same rights, benefits and privileges as married couples, but not including usage of the word "marriage" among the rights, benefits and privileges. "Under our equal protection jurisprudence, however, plaintiffs' claimed right to the name marriage is surely not the same now that equal rights must be conferred on committed same-sex couples." *Id.* The majority of the court reached this conclusion notwithstanding that the plaintiffs raised the issue that limitation of the word marriage to opposite-sex couples raised the separate-but-equal and second-class citizenship status for same-sex couples. The court adopted the State's position that such a fundamental change in the meaning of marriage rested with the Legislature where the judgment of the people on an issue of considerable controversy could be heard. *Id*. "We will not presume that a difference in name alone is of constitutional magnitude." Id. at 222.

[44] *Id.*

[45] *See supra* text accompanying notes 4-5.

[46] *Lewis*, 908 A.2d at 222. "Although we do not know whether the Legislature will choose the option of a civil union statute, the dissenters presume in advance that our legislators cannot give any reason to justify retaining the definition of marriage solely for opposite-sex couples. A proper respect for a coordinate branch of government counsels that we defer until it has spoken." *Id.* The wording suggests that the court could revisit the issue of same-sex marriage after the New Jersey Legislature acts, particularly if it can be shown that denial to gay couples of use of the word "marriage" ultimately denies equal protection to their relationships. *See infra* text accompanying notes 113-18. Furthermore, the court's decision was by a one vote majority. The dissenting justices found that only marriage would afford gay couples true equal protection. *See infra* text accompanying notes 63-66.

rights that are fundamental must be found rooted in the traditions and collective conscience of the people.[47]

Of course the court was not able to find a substantive right to same-sex marriage where it applied a narrow interpretation and perspective of what constitutes "rooted" traditions and conscience of the people.[48] The gay rights movement is, relatively speaking, very new. For example, prior to the Supreme Court's 2003 decision in *Lawrence v. Texas*,[49] it was still legal in many states to criminalize intimate sexual conduct between consenting adult males.[50] Although New Jersey has been among the states at or near the vanguard of the gay civil rights movement with regard to its court decisions and legislation,[51] it cannot be gainsaid that virtually all of these advances have been made in the last two decades, the most significant of which have occurred since the turn of the century. Notwithstanding the recent vintage of such advancements in New Jersey, the court noted that a number of them have come about through the will of the people by way of the legislative process.[52] However, the court felt constrained to apply the same standard developed and utilized by the United States Supreme Court in assessing what rights are deemed fundamental.[53]

In its equal protection analysis, the majority decision once again exhibited clear sympathy for the plaintiffs' position.[54] The court took pains to articulate how the State seemingly wanted to attack sexual orientation discrimination by passing numerous laws to outlaw it.[55] However, the court also noted the State's seemingly inconsistent position when it came to the State's opposition to treating gay couples' relationships similar to those of married couples, particularly where same-sex couples were in many instances raising children—biological, adopted, or foster.[56]

The court's tone**,** sympathetic to gays throughout its opinion, can be read to suggest that the court wanted to find a basis under the State's Constitution for permitting gay marriage, but it was obviously mindful of the public controversy surrounding the issue and the charge of

[47] *Lewis*, 908 A.2d at 211.
[48] *Id.*
[49] 539 U.S. 558 (2003).
[50] *See, e.g.,* Bowers v. Hardwick, 478 U.S. 186 (1986).
[51] *See supra* notes 40-42.
[52] *Lewis*, 908 A.2d at 213. "Perhaps more significantly, New Jersey's Legislature has been at the forefront of combating sexual orientation discrimination and advancing equality of treatment toward gay and lesbians." *Id.*
[53] *See, e.g.*, Griswold v. Connecticut, 381 U.S. 479, 493 (1965).
[54] *Lewis,* 908 A.2d at 215-21.
[55] *Id.* at 213-14.
[56] *Id.* at 216-17.

judicial activism so often leveled by opponents when the courts rule favorably on matters involving gay civil rights.[57] Clearly, when reading the dissenting opinion[58] along with the majority opinion, *Lewis v. Harris*[59] is a case suggesting a positive stance on gay marriage in New Jersey.

### *The Dissent*

The three dissenting justices[60] in *Lewis* dissented because the majority did not go far enough in finding for the plaintiffs. The dissent felt that "there was no principled basis … to distinguish those rights and benefits [of marriage] from the right to the title of marriage…."[61] Moreover, the dissent disagreed with the majority's holding that there is no fundamental substantive due process right to same-sex marriage.[62]

With regard to the equal protection basis of the majority's holding, the dissent argued that it incorrectly limited the scope of equal protection to only those tangible benefits afforded by New Jersey's marriage statutes.[63] The dissent argued that the intangible benefit flowing from being civilly married carried with it "enormous private and social advantages," including fulfillment of "yearnings for security, safe haven, and connection that express our common humanity", and that "civil marriage is an esteemed institution…[where] the decision whether and whom to marry is among life's momentous acts of self-definition."[64] Proclaiming that "what we 'name' things matters, language matters,"[65] the dissent noted that "labels are used to perpetuate prejudice about differences that, in this case are embedded in the law, [and that by] excluding same-sex couples from civil marriage, the State declares that it is legitimate to differentiate between their commitments and the commitments of heterosexual couples."[66]

[57] "Nevertheless, a court must discern not only the limits of its own authority, but also when to exercise forbearance, recognizing that the legitimacy of its decisions rests on reason, not power." *Lewis,* 908 A. 2d at 223.

[58] *See infra* text accompanying notes 60-70.

[59] 908 A. 2d 196 (N.J. 2006).

[60] The New Jersey Supreme Court is comprised of seven justices. Three justices joined the dissent. However, they concurred with the majority with regard to its holding that denying to same-sex couples the rights and benefits afforded married couples violated the New Jersey Constitution's equal protection guarantee. *Id.* at 224.

[61] *Id.*

[62] *Id.*

[63] *Id.* at 225-27.

[64] *Id.* at 225, quoting the Massachusetts Supreme Judicial Court in Goodridge v. Dep't of Pub. Health, 798 N.E. 2d 941, 954-55 (2003).

[65] *Id.* at 226.

[66] *Id.*

The dissent was similarly critical of the majority's holding that there is no substantive due process right to same-sex marriage, and that therefore it is not a fundamental right.[67] Arguing that the standard of looking to what is "rooted in the traditions and collective conscience of the people of New Jersey" was too narrowly applied by the majority, the dissent posited that the examination should not be whether same-sex marriage is so rooted but marriage itself.[68] The dissent labeled the majority's reasoning on this issue circular: "Of course there is no history or tradition including same-sex couples; if there were, there would be no need to bring this case to the courts."[69] As the dissent noted, arguing that marriage is heterosexual because it just is, is circular reasoning.[70]

As long as courts continue to apply mechanically a narrow, history-based interpretation of what constitutes a fundamental right, it is unlikely that the right to same-sex marriage will be deemed such a right in the foreseeable future. Proponents of gay marriage, therefore, must urge courts to consider the traditional analysis of finding fundamental rights being rooted in the traditions and collective conscience of the people as only a starting point, not the sole factor in determining the scope and content of fundamental rights.[71] As the *Lewis* dissent noted, "this Court has repeatedly rejected a 'mechanical' framework for due process … analyses … of our State Constitution."[72] Moreover, just as the United States Supreme Court held in 1967 in *Loving v. Virginia*[73] that a Virginia law barring interracial marriage deprived interracial couples the fundamental right to marriage even though at that time interracial marriage was clearly not rooted in the traditions and collective conscience of the people of Virginia,[74] proponents of same-sex marriage must similarly urge the courts to look beyond what society once recognized as permissible limitations on the fundamental right of marriage. As the Court did in *Loving,* courts today must be urged to determine the scope and content of fundamental rights in the context of contemporary American society. As noted earlier, the gay rights movement is a relatively recent civil rights movement, but one that has made significant advancements in many states, New Jersey in particular.[75] Today, gay couples are frequently living together openly.

[67] *Id.* at 228.
[68] *Id.*
[69] *Id*.
[70] *Id.*
[71] *See* Salas, *supra* note 8, at 548-49(discussing the California Supreme Court decision upholding the right to same-sex marriage as a fundamental right).
[72] *Id.* at 227.
[73] 388 U.S. 1 (1967).
[74] *Id.* at 12.
[75] *See supra* notes 40-41.

Many have children.[76] They participate in and contribute to society as any other family does. Clearly, marriage is inextricably bound up with establishing a home, often with children. Marriage is the deeply rooted, traditional means officially intended to recognize a family.

*A Favorable Decision for Same-Sex Marriage*

Although the New Jersey Supreme Court did not ultimately rule that gays have a constitutional right to same-sex marriage, its decision in *Lewis*[77] could hardly be more positive in terms of presenting a sympathetic and legally supportable right to same-sex marriage in New Jersey. The tone of both the majority and dissenting opinions clearly exhibited a sense that the court would prefer to see same-sex marriage permitted in New Jersey. Nonetheless, the majority, likely influenced in part by the frequent charge of judicial activism so often leveled by opponents of gay rights at any court ruling in support of gay rights,[78] preferred to leave it to the Legislature to decide the ultimate issue of what to call the 'equal treatment' for same-sex couples: marriage or some 'equivalent' such as civil union. Suggesting that if same-sex couples want to be able legally to call their committed unions marriage, the court majority wrote that gays must take their case to the public: "The great engine for social change in this country has always been the democratic process. Plaintiffs'…next appeal must be to their fellow citizens whose voices are heard through popularly elected representatives."[79]

What *Lewis v. Harris*[80] makes abundantly clear is that the New Jersey Supreme Court has no issue with affording marriage to same-sex couples; the majority simply wants the Legislature to bear the ramifications of making the determination, while the dissent believes marriage is constitutionally mandated as both a substantive due process right and under equal protection of the law.

[76] *See infra* text accompanying notes 56 and 116-18.

[77] *See supra* text accompanying notes 1-3.

[78] *See, e.g.,* Richard Lavoie, *Issues Facing the Judiciary: Activist or Automaton: The Institutional Need to Reach a Middle Ground in American Jurisprudence*, 68 Alb. L. Rev. 611 (2005).

[79] Lewis v. Harris, 908 A.2d 196, 223 (N.J. 2006). The dissent suggests this advice is shallow in the case of same-sex marriage: "Had the United States Supreme Court followed the traditions of the people of Virginia, the Court would have sustained the law that barred marriage between members of racial minorities and caucasians." *Id.* at 228, citing Loving v. Virginia, 388 U.S. 1 (1987).

[80] 908 A.2d 196 (N.J. 2006).

## THE BUSINESS CASE FOR SAME-SEX MARRIAGE IN NEW JERSEY

As noted earlier, the gay demographic is estimated to have substantial spending power.[81] Places like Las Vegas, Nevada, not historically considered to be an especially gay-friendly destination, have recently begun to make efforts to attract gay travelers.[82] The Las Vegas initiatives with regard to the gay market were a response to a 2004 marketing research study commissioned by the Las Vegas Convention and Visitors Authority.[83] The study found that Las Vegas was the second most popular travel destination for gays; New York City came in first.[84]

However, it is not just the gambling mecca that recognizes the financial benefits found in catering to the gay market segment. Indeed, a sizeable portion of the publicity attending the California Supreme Court's decision mandating the availability of same-sex marriage in the state had to do with the anticipated surge in gay tourism, particularly in the wedding industry and related businesses.[85] Similarly, publicity surrounding the potential demise of same-sex marriage in California has not only focused on the civil rights issues, but also on the loss of revenue for the State and many of its businesses.[86] In fact, the prospect of losing

[81] *See supra* text accompanying notes 17-21.

[82] Harrah's Entertainment, Inc., in Las Vegas began marketing to the gay community in 2006 after research showed gay men spend an average of 30% more than their straight counterparts when traveling. Casinos, clubs, hotels and spas are marketing themselves as gay-friendly in various gay media. Furthermore, commitment ceremonies are offered by MGM Mirage at several of its Las Vegas properties (civil union and marriage are not a likely prospect in Nevada). And Harrah's has decided its romance-themed Paris hotel is its best suited property to market to gays because most gay tourists come in couples. Tama Audi, *Las Vegas Goes All Out To Attract Gay Travelers*, WALL ST. JOURNAL, Nov. 2, 2007, at B1.

[83] Steve Friess, *Vegas and Beyond: Come as you are, the party is a la carte*, L.A. TIMES, June 19, 2008, at H33.

[84] *Id.*

[85] *See, e.g.*, William M. Welch, *Businesses will reap benefits; weddings set to have huge economic impact in California,* USA TODAY, June 9, 2008, at 3A; Alana Semuels, *Same-sex weddings could be a gift to California's economy,* L.A. TIMES, June 2, 2008; Patricia Leigh Brown, *California Braces for 'New Summer of Love,'* N. Y. TIMES, June 14, 2008, at A10.

[86] *See, e.g.,* Jesse McKinley, *Demise of Same-Sex Weddings Disheartens Businesses*, N.Y. TIMES, November 7, 2008, at A20. Upon approval of Proposition 8 by California voters on November 4, 2008, the State's Constitution was amended to recognize only marriages between men and women. Upon learning of Proposition 8's passage by voters, the mayor of San Francisco, Gavin Newsom, was prompted to say, "'It's a great day for Massachusetts.'" *Id.* The California Supreme Court heard a challenge to the legality of Proposition 8 based on whether the subject of the proposition (the proposition seeks to amend the Constitution to take away a right that the California Supreme Court had earlier found inherent as a fundamental right in its Constitution, *See* In re Marriage Cases, 183 P.3d 384, 452 (Cal. 2008)) is one that allows for changing the Constitution by

the financial benefits accruing from gay marriage in California by virtue of a successful voter initiative to amend the Constitution to recognize only marriages between a man and a woman, known as Proposition 8, prompted San Francisco Mayor Gavin Newsom to respond "It's a great day for Massachusetts."[87]

Mayor Newsom's comment was directly related to the substantial economic loss to businesses and state and local governments attending the loss of same-sex marriage in California. In a study conducted by the Williams Institute at UCLA's School of Law,[88] it was estimated that spending in the first three years that same-sex marriage was made legal by resident and out-of-state same-sex couples on their weddings and related tourism would boost California's economy by over $683 million dollars.[89] Moreover, the same study estimated that during the same time period, state and local governments would receive $63.8 million in revenue.[90]

The authors of the Williams Institute study on the impact of same-sex marriage on the California economy did a similar study for New Jersey.[91] They conservatively predict that were same-sex marriage legal

way of a ballot initiative amendment. That is, should the amendment process or the more involved revision process for changing the Constitution have been used? The revision process requires more than a mere public vote on the issue. *See, e.g.,* Maura Dolan, *Ruling on Proposition 8: Activists Rally; Justices Hear Arguments; Court looks unlikely to kill Prop. 8; State Justices appear unwilling to overturn the gay-marriage ban but suggest pre-vote weddings are valid,* L.A. TIMES, March 6, 2009, at A1. On May 26, 2009, the California Supreme Court upheld Proposition 8. *See* Schwartz, *supra* note 8.

[87] *See* Jesse McKinley, *Demise of Same-Sex Weddings Disheartens Businesses*, N.Y. TIMES, November 7, 2008, at A20. At the time of Mayor Newsom's comment, only Massachusetts and Connecticut permitted same-sex marriage. Subsequently, Iowa, Vermont and Maine have been added to the states permitting same-sex marriage. *See supra* notes 6-12.

[88] *See* Brad Sears & M.V. Lee Badgett, *The Impact of Extending Marriage to Same-Sex Couples on the California Budget* (2008) *available at* http://www.law.ucla.edu/williamsinstitute/publications/EconImpactCAMarriage.pdf.

[89] *Id*. at 2.

[90] *Id.*

[91] *See* Brad Sears & M.V. Lee Badgett, *The Impact of Extending Marriage to Same-Sex Couples on the New Jersey Economy* (2008) *available at* http://www.law.ucla.edu/williamsinstitute/publications/NJEconImpactMarriage.pdf *See also* Lee Badgett, *Economic Benefits from Same-Sex Marriage in New Jersey* (2006) available at http://www.massploicy.org/pdf/publications/badgett.pdf The 2006 study used figures that presumed that Massachusetts would continue its provision of affording marriage to only resident gay couples. *Id*. at 1. The restriction on residency was pursuant to a 1913 state statute that prohibited marriages for out-of-state residents if the marriage would not be legal in the couple's state of residency. *See, e.g., New England in Brief*, BOSTON GLOBE, Aug. 16, 2008, at B2. Badgett notes, however, that "Even if other states eventually allow same-sex couples to marry, New Jersey would likely remain a prime destination for same-sex couples on the east coast. New Jersey is within a short driving range of several cities

in New Jersey, spending on wedding and tourism-related businesses during the first three years that same-sex marriage was permitted would rise by $248 million, and that the State's gross tax revenues would increase during the same time period by $19 million.[92]

With the recent onset of the precarious state of the national and state economies accepted as a new, unanticipated and unexamined variable in the above-mentioned studies, it would seem nonetheless that New Jersey would still be in the best position to recognize same-sex marriage now and receive its attendant economic benefits. The states presently recognizing same-sex marriage are Massachusetts,[93] Connecticut[94], Iowa,[95] Vermont[96] and Maine[97]. California has ceased to permit same-sex marriage after the voters on November 4, 2008, approved an amendment to the state Constitution.[98] The California Supreme Court recently upheld the legality of the amendment despite a vigorous challenge to it.[99]

Although New Jersey would face competition for the gay market from the states permitting same-sex marriage, it has some advantages for securing that market that the other states do not: a gaming mecca, Atlantic City.[100] As noted earlier, the gay market segment is one that has impressive spending power,[101] travels often,[102] and likes to frequent Las Vegas.[103] Were New Jersey to permit same-sex marriage, surely the

with concentrations of same-sex couples, suggesting that the state would retain appeal for out-of-state couples." *Id.* at 1. The 2008 study slightly reduces the estimates given in the 2006 study. The reduction is related to the quickly changing landscape of same-sex marriage in the United States. For example, after the first study, Massachusetts removed the 1913 statutory impediment for out-of-state gay couples, thus making Massachusetts a more attractive competitor for New Jersey. Also, in the 2008 study, the authors premise their figures on California permitting same-sex marriage; gay marriage is not presently permitted in California. *See supra* note 86. However, after the 2008 study, same-sex marriage was approved in Iowa, Vermont, and Maine. *See supra* notes 10-12.

92 *See* Sears, *supra* note 91.

93 *See supra* note 7.

94 *See supra* note 9.

95 *See supra* note 10.

96 *See supra* note 11.

97 *See supra* note 12.

98 *See supra* note 8.

99 *See supra* notes 8 and 86.

100 Connecticut does have gaming casinos, Foxwoods and Mohegan Sun, but these properties are not within the context of a city largely dedicated to gambling, such as Las Vegas and Atlantic City.

101 *See supra* text accompanying notes 17-20.

102 King, *supra* note 17 at 41-42.

103 *See supra* text accompanying notes 83-84.

Atlantic City casino industry and all the peripheral industries supporting the marriage industry would benefit.

Like most other areas of the current economy, the casino industry in Atlantic City is feeling the effect of the downturn.[104] By the beginning of 2009, the casino industry had already terminated 1,000 employees, and more lay-offs are anticipated.[105] Furthermore, because Atlantic City's economy is so dependent on the success of its casino industry, the effects of the downturn at the casinos has begun to impact all of the industries that support the casino industry, from suppliers to cab drivers.[106] The economic woes and credit crunch have also resulted in a halt to a number of new casino projects in Atlantic City that had already been scheduled, thus reducing tax revenues that would have been made from the suspended or scuttled multi-billion dollar projects.[107]

It is undeniable that Atlantic City is in desperate need of an infusion of business. With a change in state law to permit same-sex marriage in New Jersey, the State's economy, and very likely Atlantic City's casino industry, would be the beneficiaries of not only wedding celebrations of resident same-sex couples, but also the many gay couples across the country that wish to marry, and do so in an environment featuring the experiences of a gambling town.[108] Las Vegas may be courting the gay market segment, even doing so with the lure of performing commitment ceremonies,[109] but it would not likely challenge Atlantic City any time soon as a venue for same-sex wedding ceremonies. New Jersey, already considered a leading liberal state[110] and one already permitting civil unions for same-sex couples, is light years ahead of Las Vegas in potentially being able to offer same-sex couples the right to marry. The move from civil union to marriage is one that will have minimal, if any,

[104] Caren Chesler, *All That Glitters, Not Quite Golden, Atlantic City Struggles in the Face of Competition, Political Upheaval and a National Recession,* N.Y. TIMES, January 4, 2008, at NJ1, 6.
[105] *Id.* at NJ1.
[106] *Id.*
[107] *Id.* at NJ6.
[108] *See supra* text accompanying notes 83-84.
[109] *See supra* note 82.
[110] Adrienne Lu, *New Jersey is a leading liberal state*, PHILA. INQUIRER, April 11, 2008, at A01. Among the support given for concluding New Jersey is a leading liberal state is the State's public policy providing paid family leave, abolishing the death penalty, apologizing for slavery, and permitting civil unions for gays. *Id.*

financial cost to the State.[111] However, a decision not to move will likely cost the State financially.[112]

THE SOCIAL CASE FOR SAME-SEX MARRIAGE IN NEW JERSEY

When the New Jersey Legislature enacted the civil union law establishing civil unions for same-sex couples in New Jersey, it also established the New Jersey Civil Union Review Commission to evaluate the law's effectiveness.[113] Fulfilling its mandate, the Commission has issued two reports to the Legislature and the Governor. The first report was issued on February 19, 2008, approximately one year after civil union was available to same-sex couples.[114] The second report was issued on December 10, 2008.[115]

In its first report, the Commission noted a number of problems that New Jersey civil union partners had encountered since entering into the relationship. Among them were: discrimination by employers; failure by the public to understand civil union status, including giving a sense of second-class status to couples in civil unions; the harmful impact on children of couples in civil unions; unequal treatment and uncertainty when seeking medical assistance, particularly during health care emergencies; and difficulty in dealing with institutions, including governmental, where their employees were unfamiliar with civil unions or unable to categorize civil unions on forms.[116]

In its second and final report, the Commission, based on what it termed "overwhelming evidence," unanimously recommended that the Legislature and Governor amend the law to allow same-sex marriage, and do so expeditiously to avoid harm to the people of New Jersey arising from any delay in marriage equality in the State.[117]

Also in the final report, the Commission reaffirmed its findings from the interim report, and it discussed in detail the bases for its recommendation that marriage be made available to same-sex couples. The Commission found: a separate legal structure for gays is never going to be equal; the word "marriage" has a universal and powerful meaning; children of gay couples would benefit by society's recognition

[111] *See* Final Report of the New Jersey Civil Union Review Commission, Dec. 10, 2008, *available at* http://www.NJCivilRights.org/curc "The State would have little, if any, cost associated with the enactment of marriage, as any such costs would already have been realized as a result of the implementation of the Civil Union Act." *Id.* at 28.

[112] *See supra* note 92, and text accompanying note 92.

[113] N.J Stat. Ann. § 37:1-36.

[114] *See* First Interim Report of the New Jersey Civil Union Review Commission, Feb. 19, 2008, *available at* http://www.NJCivilRights.org/curc.

[115] *See supra* note 111.

[116] *See supra* note 114 at 17-18.

[117] *See supra* note 111 at 3.

that their parents are married; there is uncertainty about the recognition of civil unions in other states; civil unions continue economic harm to same-sex couples; civil unions impact health care challenges and equal health care access; civil union status perpetuates psychological harm to gay couples and their children; and, same-sex marriage would likely enhance the State's economy without adding costs.[118]

In addition to the abundant evidence the Commission heard to support its findings, its report also noted that ten of the 150 witnesses who appeared before it spoke in opposition to same-sex marriage or submitted written testimony expressing some level of concern or opposition.[119] The opposition's position was essentially premised on three bases: the institution of marriage as only between a man and a woman has a meaning that transcends law, and the social understanding of marriage, an institution of ancient origin, should not be altered; marriage has a biblical foundation and sexual orientation is a lifestyle choice; and, civil unions afford a sufficient level of equality that could be enhanced through greater educational and enforcement efforts.[120]

Of the opposing arguments, only the first and third suggest a viable basis for consideration. The first mentioned argument is essentially the reasoning of the majority in *Lewis v. Harris*[121] when it held that there was no substantive due process right to same-sex marriage, that same-sex marriage is not a fundamental right.[122] The third objection raised before the Commission, that is that civil union essentially already provides equal treatment, also finds support in the *Lewis* majority decision. The majority found that same-sex couples were only entitled to the same statutory benefits afforded married couples, but not to the use of the word "married" to connote their relationship.[123]

Obviously, the Commission found the arguments in support of same-sex marriage more compelling. Although not specifically premised on the *Lewis* dissent, the Commission unanimously supported a change in the law to permit same-sex marriage for much of the same reasons espoused by the dissenting justices.[124]

Despite the fact that the Commission report could not have been more supportive of a shift to same-sex marriage, and the opposition to marriage was relatively tepid at the Commission's hearings on the matter, the political ramifications of a shift to same-sex marriage must,

[118] *See supra* note 111 at 8-32.
[119] *See supra* note 111 at 39.
[120] *See supra* note 111 at 39-41.
[121] 908 A. 2d 196 (N.J. 2006).
[122] *See supra* note 40.
[123] *See supra* note 43.
[124] *See supra* text accompanying notes 60-70.

as always in dealing with this issue, be factored into the likelihood of success in achieving the right to same-sex marriage.

While some commentators suggest that New Jersey has never appeared so close to enacting gay marriage,[125] the timing for a shift to same-sex marriage may not be opportune. Although the State has already lived with civil unions for gay couples for almost two years without significant protest, and the State has an increasingly progressive reputation,[126] the precarious state of the economy, both at the state and federal levels, suggests to some political strategists that lawmakers may be reluctant to have voters think there are not more urgent matters to attend to than passing a gay marriage law.[127] As one strategist pointed out, "There could be a backlash; there are other issues that are more pressing at this time."[128]

On the other hand, there appears to be a confluence of significant circumstances that suggests the present may be the best time to move to same-sex marriage in New Jersey: a sympathetic Supreme Court; a sympathetic Legislature;[129] a sympathetic Governor;[130] a sympathetic report from the Commission on Civil Union; an economy that can use all of the assistance it can find; and, a potential monopoly on offering gays a state where they can legally marry, and still be in an environment, if they so choose, that competes with Las Vegas. The simultaneous occurrence of such circumstances may or may not last after the November 2009 elections.

To be sure, it is true that the Supreme Court's decision and the Commission Report will be no less supportive over time. However, the same cannot necessarily be said of the Legislature, the Governor, and the economic climate. Were New Jersey to enact marriage legislation for gays now, it would place New Jersey among the early states where gay marriage came about through legislation and not court order.[131] If nothing more, that aspect would likely have symbolic worth in the gay community. But perhaps the most compelling point, at least in terms of

[125] Caren Chesler, *Push for Gay Marriage Meets Election Concerns*, N.Y.TIMES, Jan. 4, 2009, at NJ6. Governor Jon Corzine (D), the president of the State Senate, and the leader of the Democratic-controlled Assembly have recently stated their support for same-sex marriage. *Id.*

[126] *See supra* note 110.

[127] *See supra* note 125.

[128] *Id*. Among the other pressing issues facing New Jersey are job losses, high foreclosures, and extremely high property taxes.

[129] *See supra* note 125.

[130] *Id.*

[131] *See supra* notes 11-13. Vermont and Maine are the only states so far that have enacted laws permitting same-sex marriage without a court order to do so. New Hampshire is expected to be the third state. *See N.H. Governor to OK Gay Marriage*, PHILA. INQUIRER, May 15, 2009, at A10.

potentially assuaging public opposition, is the economic gains the State would likely realize by moving to gay marriage. Spending on weddings and tourism is estimated not only to produce significant revenue for the State,[132] but it is also predicted to create or sustain over 800 jobs in the State. [133] New Jersey will undoubtedly approve of same-sex marriage at some time in the future. The State might as well reap the benefits now.

## CONCLUSION

The right to enter into same-sex marriage appears to be likely for gay couples in New Jersey. The question is, will the State move now to permit gay marriage? By enacting same-sex marriage legislation now, New Jersey will continue its progressive path with regard to social issues such as the abolition of the death penalty, the introduction of paid family leave, and the provision of civil unions for same-sex couples. If it chooses to wait, it will likely miss out on benefits that surely have accrued and will continue to do so for those early states offering same-sex marriage. Although being among the states at the forefront of social change may be deemed a benefit by itself, New Jersey can also receive pragmatic benefits from affording gay marriage: an infusion of much needed money and jobs.

No doubt a move to gay marriage will have ardent detractors. However, those New Jersey citizens who are ambivalent or undecided about the issue may find the economic benefit to the State is just the deciding factor needed to support marriage equality. The State already offers committed same-sex couples the right to enter into civil unions; the stretch to marriage will involve no added costs to the taxpayers.[134] If the economic benefit to be derived from same-sex marriage is put forth to the public with equal force to the social equity rationale, there is a good likelihood that marriage equality for gays will become a reality in New Jersey sooner rather than later.

[132] *See supra* note 111 at 25.
[133] *Id.*
[134] *See supra* note 111.

# STRENGTHENED PRIVACY PROTECTION FOR HEALTH INFORMATION UNDER THE 2009 HITECH ACT

by CARTER MANNY*

## I. INTRODUCTION

The economic stimulus legislation passed by Congress in February 2009, known as the American Recovery & Reinvestment Act of 2009 or "ARRA,"[1] included funding for computerization of health records as a way of improving the efficiency of the health care system and providing business for the information technology sector of the economy. The electronic health records provisions were included in a portion of ARRA known as the Health Information Technology for Economic and Clinical Health Act or "HITECH Act."[2] In addition to providing approximately $20 billion in funding, Congress included provisions in the HITECH Act which strengthen privacy protection for health information in existing federal regulations adopted in 2003 pursuant to the Health Insurance Portability and Accountability Act of 1996 or "HIPAA".[3]

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1 American Recovery & Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009)

2 American Recovery & Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, §§ 13001 - 13424 (2009). Sections 13001 – 13424 are known as the Health Information Technology for Economic and Clinical Health Act [hereinafter *HITECH Act*]

3 Privacy of Individually Identifiable Health Information, 45 C.F.R. §§ 164.102 – 164.534 (2007), [hereinafter *HIPAA Privacy Rules*]. The rules were adopted pursuant to the Health Insurance Portability and Accountability Act of 1996, Public Law 104-191, 110 Stat. 1936 (1996) [hereinafter *HIPAA*].

The most significant feature of the 2009 legislation is the creation of the first federal data breach notification law requiring private sector institutions to inform individuals when their personal information has been improperly disclosed to an unauthorized user. Most states have data breach notification laws, but their provisions are not uniform and health information is usually not explicitly covered.[4] The HITECH Act may be a model for future federal data breach notification legislation covering other types of information. Like the HIPAA Privacy Rules which took effect in 2003, the HITECH Act does not preempt state law and continues to allow states to have privacy standards for health information that are stricter than federal law.[5] The HITECH Act strengthens privacy protection in several ways. First, it expands the scope of institutions who must comply. Second, it requires notification of breaches. Third, it strengthens security requirements. Fourth, it establishes additional limits on using the information in health records for marketing and fundraising. Fifth, it improves the ability of individuals to track how their information has been used. Finally, it strengthens enforcement by increasing penalties and by expanding the institutions authorized to pursue violations. This article begins with an examination of recent incidents in which health information has been improperly disclosed and the harms those disclosures have produced. The major privacy provisions of the HITECH Act will then be covered with explanations of how they address problems caused by data breaches. There will also be some discussion of how the HITECH Act fills gaps in the HIPAA Privacy Rules.

## II. TYPES OF DATA BREACHES AND THE HARMS THEY CAUSE

Harmful breaches of health information involve data that has not been adequately protected through encryption or other technology. Breaches tend to fall into four categories: (1) loss or theft of data resulting from negligence on the part of the primary institution holding the information or by a third party service provider (known under the

[4] As of December 2008, 44 states, the District of Columbia, Puerto Rico and the Virgin Islands had data breach notification laws. The six states lacking such laws were Alabama, Kentucky, Mississippi, Missouri, New Mexico and South Dakota. *See* National Conference of State Legislatures, State Security Breach Notification Laws, *available at* http://www.ncsl.org/programs/lis/dip/priv/breachlaws.htm (visited Mar. 22, 2009). In January 2009, bills to enact such laws were introduced in the legislatures in Mississippi and Missouri. *See Mississippi, Missouri Breach Notice Bills Join Wave of State Privacy, Security Legislation*, 8 Privacy & Sec. L. Rep (BNA) 177 (2009). Breach notification laws in California and Arkansas explicitly cover health information. *See, e.g., Medical Identity Theft Becoming Widespread National Fraud Problem*, 7 Privacy & Sec. L. Rep. (BNA) 1236 (2008).

[5] *HITECH Act* § 13421

HIPAA Privacy Rules as a "business associate"), (2) misuse of the information by a worker inside the organization, (3) theft of information by someone outside the organization, and (4) fraudulent schemes to collect health information directly from individuals.

### *A. Negligence*

Most negligent breaches involve loss of a laptop or portable storage device like a flash drive, optical disk or backup tape that is either misplaced by an employee outside of the workplace or which has been stolen from a vehicle, hotel room or residence. Negligent breaches can occur without the loss of the hardware which contains the data. For example, if a worker at a hospital or insurance company copies health records from a business computer to a flash drive, and works on the files on a computer at home, the home computer's peer-to-peer software for sharing music files will make that data available to other computers on the Internet. A research project at Dartmouth College has discovered that peer-to-peer software has made a considerable number of sensitive health records available online.[6]

Negligent breaches can involve information that is on paper. For example, Blue Cross/Blue Shield of Georgia sent over 200,000 letters containing explanations of benefits to the wrong subscribers.[7] In another incident, a hospital billing records staff member, who had been working at home, lost paper records containing patient information when she left them on a Boston subway train when returning to work.[8]

### *B. Misuse by an Insider*

Misuse of information by a worker inside the organization is another common source of breaches of health information. Often the insider is motivated by financial gain. For example, a receptionist at a medical clinic in South Florida sold health the information of over 1,000 patients to a relative who generated $7 million in false Medicare claims for equipment and services which were never provided.[9] In another case, a worker in a cardiac clinic transferred patient information to a flash

[6] *See* File-Sharing Networks Used to Uncover Thousands of Medical Records *available at* http://www.nextgov.com/nextgov/ng_20090227_9147.php (visited Mar. 2, 2009).

[7] *See Health, Private Data in Over 200,000 Letters Sent to Wrong Addresses by Georgia Insurer*, 7 Privacy & Sec. L. Rep. (BNA) 1159 (2008).

[8] *See Mass. General Paperwork For 66 Patients Lost on Red Line Train*, BOSTON GLOBE, Mar. 24, 2008, *available at* http://www.boston.com/news/local/massachusetts/articles/2009/03/24/mass_general_ paperwork.html (visited Mar. 24, 2009).

[9] *See, e.g., Medical Identity Theft Becoming Widespread National Fraud Problem*, 7 Privacy & Sec. L. Rep. (BNA) 1236 (2008).

drive which was then sold at a price of approximately $25 per name to an organization engaged in fraudulent billing.[10]

Curiosity, with or without financial gain, is another factor in insider misuse. The hospital records of celebrities, including the wife of the governor of California, were improperly viewed by over 100 employees at UCLA Medical Center.[11] Hospital employees who improperly snooped through the records may have provided information to reporters who wrote sensational newspaper articles about celebrities' health problems. Revenge can also be a motivator. A disgruntled former information technology employee of a healthcare company posted on her personal web site a schematic containing health information of individuals who were covered by the company's plan. The former worker, who called herself "the Diva of Disgruntled," revealed that the schematic, which was part of a test for a new information system, had been accessible to the public through the company's web site in violation of state law.[12] In some instances, insensitivity of health care workers can explain insider misconduct. For example, emergency room workers at one hospital took photos of patients' injuries with cell phone cameras and then posted the photos on a social networking web site.[13] Moreover, web sites devoted to the discussion of health issues can contain sufficient information to reveal patient identity.[14]

### *C. Theft by an Outsider*

Some breaches involve criminal activity without negligence on the part of the organization or misconduct by insiders. In one case, a thief of health information tried to extort money not only from the large pharmacy benefits company that was the victim of the theft, but from the individuals whose prescription information was stolen, by

[10] *See, e.g., Medical Identity Theft Becoming Widespread National Fraud Problem*, 7 Privacy & Sec. L. Rep. (BNA) 1236 (2008).

[11] *See More UCLA Medical Center Employees Peeked at Celebrities' Records, State Says*, Los Angeles Times, Aug. 5, 2008, *available at* http://articles.latimes.com/p/2008/aug/05/local/me-health5 (visited Mar. 25, 2009).

[12] *See, e.g. California Agency Fines Kaiser $200,000 For Disclosure of Patient Data on Web Site*, 4 Privacy & Sec. L. Rep. (BNA) 836 (2005). There were no reports that either the company's disclosure of the data, or the former employee's posting of the data, led to any harm to the individuals whose records were available on the web.

[13] *See Hospital Axes Staff Over Cell Phone Camera Photos Taken of ER Patients, Posted Online*, 7 Privacy & Sec. L. Rep. (BNA) 1446 (2008). The workers were dismissed from the hospital and the photos were removed from the web site. The photos contained no identifiable characteristics of the people who were being treated in the emergency room.

[14] *See, e.g., Health Blogs May Threaten Patient Privacy*, 7 Privacy & Sec. L. Rep. (BNA) 1130 (2008).

threatening to publicize the information unless payment was made.[15] Other thefts of health information have been connected to illegal drug activity. Medical identities have been used to obtain narcotics by using fraudulent prescriptions.[16] Some breaches have been the result of unauthorized intrusion into an organization's computer system, without indication of intent to profit from the intrusion. For example, there was no indication an intruder used any of the records of 330,000 dental patients for fraudulent purposes following unauthorized access to the University of Florida College of Dentistry's computer system.[17]

### *D. Fraudulent Collection Schemes*

Another type of breach involves a fraudulent scheme to collect health information directly from individuals and then use it to collect payment for non-existent goods and services. One scenario, called a "clinic takeover" consists of setting up a phony clinic or acquiring a legitimate clinic and then providing sham health services. For example, a group of conspirators including a physician acquired a clinic in Milpitas, California, and enticed prospective patients to use the facility by promising free checkups, free transportation to the clinic and gifts including nutritional supplements. The conspirators used data from the patients' Medicare identification cards to bill Medicare for over $1 million worth of diagnostic services that were never performed.[18]

### *E. Types of Harm Caused by Breaches*

Disclosure of heath information causes several types of harm to the individuals whose records have been breached. Because many health care records include the patient's social security number and date of birth as well as his name and address, a breach creates a risk of financial harm through conventional financial identity theft. The thief can use the information to obtain a credit card in the victim's name and then make fraudulent charges.

There can be financial harm when an imposter uses the victim's identity to obtain medical services at the expense of an insurance provider. This type of fraud can limit the victim's access to health care if the imposter runs up expenses that exhaust the amount of coverage under a policy. More significantly, the imposter's fraud can harm the

[15] *See Rx Benefits Firm Offers $1 Million Reward In Health Data Brach Extortion Scheme*, 7 Privacy & Sec. L. Rep. (BNA) 1658 (2008).

[16] *See, e.g., Medical Identity Theft Becoming Widespread National Fraud Problem*, 7 Privacy & Sec. L. Rep. (BNA) 1236 (2008).

[17] *See University of Florida Reveals Hacker Breach of Personal Data on 330,000 Dental Patients*, 7 Privacy & Sec. L. Rep. (BNA) 1658 (2008).

[18] *See, e.g., Medical Identity Theft Becoming Widespread National Fraud Problem*, 7 Privacy & Sec. L. Rep. (BNA) 1236 (2008).

victim physically. If the victim's medical records become tainted with the imposter's health information, the victim may later receive incorrect treatment. For example, if the victim and the imposter's blood types are incompatible, and the victim's records show only the imposter's blood type, the victim could receive a transfusion of incompatible blood and die.[19] One privacy rights organization has emphasized the seriousness of medical identity theft by describing it as "the information crime that can kill you."[20] Tainted health information can also adversely affect the victim's employment opportunities if it is used in a pre-employment physical exam to reject an application for a job.

Breaches can also embarrass individuals and contribute to mental health problems. In some instances, people may be deterred from seeking treatment for a stigmatized condition like mental illness or a sexually transmitted disease out of fear that the health condition will be disclosed to employers, co-workers, friends and family. Lack of proper treatment could not only harm the individual, but lead to increased risks of violence and transmission of infectious diseases. Moreover, reduced treatment for stigmatized conditions could have adverse economic consequences by lowering productivity.

## III. USE OF HEALTH INFORMATION IN MARKETING AND FUNDRAISING

Health information used for the purposes of marketing and fundraising can also be harmful. With respect to marketing, pharmaceutical companies who use prescription information to target advertising can improperly influence health care decisions of patients and doctors. Pharmaceutical companies that learn which doctors are prescribing a competitor's product can increase their marketing efforts toward those physicians. This can lead to distortions in the market and give heavily promoted drugs an unfair advantage over cheaper or more effective substitutes.

Use of health information in fundraising can also be harmful. Fundraising appeals to patients can create a belief that the patients who fail to donate will receive inferior care in the future. Accordingly, a patient might feel coerced into making a donation. In addition, the patient might feel betrayed because his confidential health information is being misused for the hospital's economic benefit.

[19] *See, e.g., Medical Identity Theft Becoming Widespread National Fraud Problem*, 7 Privacy & Sec. L. Rep. (BNA) 1236 (2008).

[20] World Privacy Forum, *Medical Identity Theft: the Information Crime that Can Kill You*, *available at* http://www.worldprivacyforum.org/pdf/wpf_medicalidtheft2006.pdf (2006) (visited Apr. 2, 2009).

## IV. PRIVACY PROVISIONS IN THE HITECH ACT

Many of the types of harm noted previously are either addressed by statutory provisions, or are to be addressed by regulations to be adopted by the Department of Health and Human Services. The following discussion explains the major privacy protections in the HITECH Act.

### *A. Expansion of Entities Subject to Health Privacy Law*

The HITECH Act expands the scope of businesses and individuals who must comply with federal health privacy law. The HIPAA Privacy Rules which took effect in 2003 apply only to "covered entities" like hospitals, doctors, insurers and pharmacies.[21] Other entities, called "business associates," that provide services for covered entities are not directly obligated to comply with the HIPAA Privacy Rules, but must comply with privacy assurances made in contracts with the covered entities which they serve. Business associates include companies providing offsite storage of backup files, collection agencies, management consulting firms, accounting firms and law firms. This loophole has led to various abuses, including a threat by one business associate to publish health information in order to pressure a covered entity to pay a disputed fee.[22] The HITECH Act closes the loophole by specifying that business associates are subject to the provisions of the HIPAA Privacy Rules and HITECH Act, including their civil and criminal penalties.[23] In addition, business associates must notify covered entities of data breaches and are subject to the same penalties for data breaches as covered entities under the HITECH Act.[24]

"Cloud computing" describes the practice of using web-based applications software, including data storage, via an Internet connection. Companies like Google and Microsoft, for example, offer to store data of individuals on their computer servers (i.e. in the "cloud.") Companies

[21] Covered entities include health plans as well as health care providers. The latter include physicians, dentists, nurses, psychotherapists, homeopaths, acupuncturists, hospitals, clinics, pharmacies and sellers of medical equipment. Covered entities also include businesses known as health care clearinghouses which translate health information into a standardized electronic format for electronic transactions. Covered entities do not include pharmaceutical companies, life insurers, law enforcement agencies or providers of rescue services. *HIPAA Privacy Rules,* 45 C.F.R. § 160.103 (2007). *See, e.g., Summary of HIPAA Privacy Rule 3, available at* http:// www. healthprivacy. org/usr_doc/RegSummary2002.pdf (visited Mar. 30, 2003); Robert Gellman, Health Privacy: The Way We Live Now, *available at* http:// www. Privacyrights. org/ar/gellman-med.htm (visited Feb. 27, 2003).

[22] *See* American Civil Liberties Union, *The American Recovery and Reinvestment Act of 2009 Health Information Technology Privacy Summary, available at* http://www.acly.org/privacy/38771leg20090219.html (visited Mar. 23, 2009).

[23] *HITECH Act* §§ 13401, 13404.

[24] *HITECH Act* §§ 13402(b), 13404.

that provide storage of personal health information are covered by the HITECH Act.[25] Such companies were not covered under the HIPAA Privacy Rules which took effect in 2003 because they did not fit within the definition of "covered entities" and would not be acting as "business associates" of covered entities when providing services to individuals. Under the HITECH Act, a company storing health information must notify each individual whose information has been breached and must also notify the Federal Trade Commission, which in turn must notify the Department of Health and Human Services.[26] Failure to comply with breach notification requirements will be treated as an unfair or deceptive practice violation of Section 5 of the Federal Trade Commission Act.[27] In addition, third party businesses providing services to the "cloud" companies which store health information are also required to comply with breach notification provisions.[28]

### *B. Notification of Breaches*

The HITECH Act takes an expansive approach to the question of what constitutes a breach requiring notification. Prior proposals for general federal data breach legislation had difficulty defining what type of breach would trigger a duty to notify individuals that their personal information had been compromised. Many legislative proposals defined a breach by trying to describe the magnitude of the risk produced by the improper release of personal information. Rather than focusing on risk, the HITECH Act focuses first on defining the way in which the information has been revealed, and then by considering the level of security which has been used to protect the information. The first part of a breach analysis under the HITECH Act involves the application of a broad, statutory definition of breach as the "unauthorized acquisition, use or disclosure of protected health information which compromises the security or privacy of such information."[29] The second part of the analysis involves the question of whether the information involved in the breach was adequately secured. The HITECH Act requires notification of a breach only when the health information was *unsecured*.[30] The standard for securing health information will be defined in regulations adopted by the Department of Health and Human Services and will

[25] A company which offers to store personal health information is called a "vendor of personal health records." HITECH Act § 13400(18).

[26] *HITECH Act* § 13407.

[27] *HITECH Act* § 13407(e).

[28] *HITECH Act* § 13407(b).

[29] *HITECH Act* § 13400(1)(A).

[30] *HITECH Act* § 13402(h).

likely include some type of encryption.[31] The significance of the data security standard is examined below.

Some types of disclosures are excluded from the definition of breach. One exception covers a disclosure to an unauthorized person who would not reasonably be able to retain the information. The exception could apply to a situation in which a hospital visitor walks past a computer screen containing information about a patient.[32] There are other exceptions for unintentional access by, and an inadvertent disclosure to, coworkers within a covered entity like a hospital, provided there is no further access, disclosure or use of the information.[33] These exceptions are reasonable and are limited to situations which involve little risk to the patient.

When a hospital worker looks at the records of a celebrity patient out of curiosity rather than out of legitimate need, there has been a breach requiring notification. The snooping was an unauthorized acquisition, and if the worker lacked a legitimate reason for viewing the records, the records arguably were "unsecured." However, the extent to which snooping by an insider is a breach which requires notification will depend upon the security standards to be defined in Department of Health and Human Services regulations.

The timing of the notification is important to the protections of the individuals' interests. Notification must be given "without unreasonable delay," and in no case more than 60 days after the breach is discovered.[34] However, the party giving the notice has the burden of proving the necessity of any delay.[35] Accordingly, there is an incentive to give notice as promptly as possible, without the rigidity of a fixed deadline that could be unrealistic if a large number of notices must be given. Notice may be delayed if a law enforcement official determines that it would impede a criminal investigation or damage national security.[36]

The method of the notice is also important. Generally, notice must be given to individuals by postal mail, unless an individual has expressed a preference for communications by e-mail.[37] If there is insufficient, or out-of-date, contact information, substitute notice must be given. If there are ten or more individuals with insufficient or out-of-date contact information, a notice of the breach must either be posted on the entity's web site or be placed with major print or broadcast media. The notice

[31] *HITECH Act* § 13402(h)(1)(A). The regulations are to be adopted by April 17, 2009. Id. § 13402(h)(2).
[32] *HITECH Act* § 13400(1)(A).
[33] *HITECH Act* § 13400(1)(B).
[34] *HITECH Act* § 13402(d)(1).
[35] *HITECH Act* § 13402(d)(2).
[36] *HITECH Act* § 13402(g).
[37] *HITECH Act* § 13402(e)(1)(A).

must include a toll-free number where an individual can learn whether his or her information in possibly included in the breach.[38] If the information of 500 or more residents of any State are believed to have been involved in the breach, notice must be given to "prominent media outlets" serving the State[39] and to the Department of Health and Human Services.[40] If the information of fewer than 500 individuals was involved in a breach, the entity must note the event in a log which must be submitted annually to the Department of Health and Human Service. These provisions reasonably assure that everyone affected by a breach is likely to receive some sort of notice in a timely fashion. In addition, the self-reporting requirements will provide the Department of Health and Human Services with annual data that can be used to improve its enforcement activities.

The notice must contain quite a bit of detail including a brief description of what happened, the date of the breach and the date of the breach's discovery. It must contain a description of the type of information involved in the breach (e.g. name, address, Social Security Number, date of birth, etc.). In addition, the notice must inform the individual of protective actions he or she should take, and must include what corrective action is being taken prevent further breaches. Finally, the notice must contain information about how to contact the entity to ask questions.[41] By requiring so much information in the notice, the HITECH Act gives individuals the ability to minimize harm caused by the breach.

### *C. Data Security*

Because no notification is required in the event of a breach of *secured* personal health information, businesses subject to the HITECH Act will be paying close attention to data security regulations to be adopted by the Department of Health and Human Services in mid-April 2009. Several states already have general requirements that companies provide "reasonable security" for personal information.[42] Two states, Nevada and Massachusetts, go further and explicitly require encryption of personal information.[43] The Massachusetts standard, which is

[38] *HITECH Act* § 13402(e)(1)(B).

[39] *HITECH Act* § 13402(e)(2).

[40] *HITECH Act* § 13402(e)(3).

[41] *HITECH Act* § 13402(f).

[42] The states which require "reasonable security" for personal information are Arkansas, California, Connecticut, Maryland, Nevada, Rhode Island, Oregon, Texas and Utah. *See, e.g. New State Regulations Signal Significant Expansion Of Corporate Data Security Obligations*, 7 Privacy & Sec. L. Rep. (BNA) 1518 (2008).

[43] *See, e.g. New State Regulations Signal Significant Expansion Of Corporate Data Security Obligations*, 7 Privacy & Sec. L. Rep. (BNA) 1518 (2008).

scheduled to take effect on January 1, 2010,[44] is the most restrictive, and requires businesses to encrypt all personal information that will be transmitted across public networks, including wireless transmissions, and all personal information which is stored on portable devices.[45] Prior to the enactment of the HITECH Act, it was expected that the Massachusetts encryption regulation would become the de facto national standard for many companies.[46] The prediction may still be accurate if the Department of Health and Human Services sets a data security standard that is lower than, or similar to, the one in Massachusetts.

### *D. Additional Limits on Use of Health Information*

Because the HIPAA Privacy Rules have such a narrow definition of covered entities, a market in electronic health information developed among companies outside of the HIPAA regulatory framework. Health information was collected, packaged and sold by data aggregation companies to pharmaceutical companies, employers and insurers.[47] As noted earlier, this regulatory loophole enabled pharmaceutical companies to discover which physicians were prescribing their products, thus allowing them to reward certain doctors, increase marketing efforts towards others, and promote the sale of more expensive drugs. The HITECH Act restricts the market in health information by prohibiting the sale of electronic health records unless authorized by the patient.[48] However, there are a number of exceptions for research, monitoring of public health, operations and treatment, and the possibility that additional exceptions will be created by regulations adopted by the Department of Health and Human Services.[49]

Although the HIPAA Privacy Rules which took effect in 2003 contain a general ban on marketing to patients, an exception allows the ban to be circumvented if the message from a covered entity to a patient

[44] The effective date for the regulations which contain the Massachusetts encryption standard was extended from January 1, 2009 to January 1, 2010. *See* Massachusetts Office of Consumer Affairs, *Office of Consumer Affairs Files Revised ID Theft Regulations, available at* http://www.mass.gov/?pageID-ocapressrelease&L=1&L=0=Home&sid=Eoca&b=pressrelease&f=20090210_idtheft&csid=Eoca (2009).

[45] *See* Standards for the Protection of Personal Information of Residents of the Commonwealth, 201 CMR 17.04.

[46] *See New State Regulations Signal Significant Expansion Of Corporate Data Security Obligations*, 7 Privacy & Sec. L. Rep. (BNA) 1518 (2008).

[47] *See* American Civil Liberties Union, *The American Recovery and Reinvestment Act of 2009 Health Information Technology Privacy Summary, available at* http://www.acly.org/privacy/38771leg20090219.html (visited Mar. 23, 2009).

[48] *HITECH Act* § 13405(d)(1).

[49] *HITECH Act* § 13405(d)(2).

concerning "treatment."[50] The exception has allowed what in reality are advertising messages to be sent to patients on behalf of health plans and pharmacies. The HITECH Act restricts, but does not eliminate, these practices. It limits the content of the messages to a description of a drug which the patient is currently taking. It also limits the amount of money a covered entity is allowed to receive for sending a message to an amount which is "reasonable" as defined in a future Department of Health and Human Services regulation.[51] While these restrictions are improvements over the previous system, tighter restrictions on marketing to patients are needed.

The HIPAA Privacy Rules contained no limitations on the use of health information for fundraising. The HITECH Act continues to allow fundraising, but enables patients to opt out of having their information used by hospitals and others for fundraising purposes.[52] By opting out, a patient can reduce the fear that his rejection of a fundraising request will affect his ability to receive good medical care in the future. Opting out may be beneficial by lessening the feeling that the health information is being misused for a hospital's economic benefit. While an opt-out system is an improvement over a total absence of restrictions, it would be better from the patient's point of view to have an opt-in system requiring the patient's permission before his information could be used for fundraising.

The HITECH Act allows a patient to prohibit the transfer of information about health services he has paid for out of his own pocket.[53] This provision may be useful to patients who want to maintain maximum confidentiality for treatment of mental health conditions and reproductive issues, treatment which could cause extreme embarrassment if disclosed.

### *E. Improved Ability to Track Transfers of Information*

Although the HIPAA Privacy Rules give an individual the right to learn about disclosures of his health information, this right is subject to numerous exceptions, the broadest of which is for disclosures made for treatment, payment and health care operations.[54] The HITECH Act largely eliminates this exception, but provides that the type of information which must be collected about disclosures made for

[50] *HIPAA Privacy Rules,* 45 C.F.R. § 160.501 (2007). *See* American Civil Liberties Union, *The American Recovery and Reinvestment Act of 2009 Health Information Technology Privacy Summary, available at* http://www.acly.org/privacy/38771leg 20090219.html (visited Mar. 23, 2009).

[51] *HITECH Act* § 13406(a).

[52] *HITECH Act* § 13406(c).

[53] *HITECH Act* § 13405(a).

[54] *HIPAA Privacy Rules,* 45 C.F.R. § 160.528(1) (2007).

payment, treatment and health care operations will be defined in regulations to be adopted by the Department of Health and Human Services by August, 2009.[55] It also limits the time period for the accounting to the three years prior to the request. Both covered entities and business associates must provide the information. Congress provided flexibility in how quickly the provisions must be implemented. The statutory compliance deadlines set for January 2011 and January 2014, may be extended by regulation to 2013 and 2016.[56]

### *F. Strengthened Enforcement*

The HIPAA Privacy Rules provided for administrative enforcement by the Office of Civil Rights within the Department of Health and Human Services, and for criminal enforcement by the Department of Justice. In general, enforcement has been lenient. During the period between the effective date of the HIPAA Privacy Rules in April 2003 and the 2007, the Office of Civil Rights (OCR) received over 25,000 complaints with corrective action resulting in approximately 10% of the cases. Most of the claims (approximately 65%) were resolved after "intake and review." The balance of the claims (approximately 25%) resulted in a finding of no violation.[57] High profile cases with large administrative payments were rare. The first case with a significant settlement did not occur until July 2008 and involved payment of $100,000 for loss of laptops and backup tapes.[58] As of early 2009, the only other major settlement was for $2.25 million and involved negligent disposal of patient information by a pharmacy chain.[59]

The HITECH Act strengthens enforcement in several ways. There are significant financial consequences for data breaches depending upon the level of carelessness of the covered entity or business associate. The civil penalties range from a low of at least $100 per violation (with an annual cap of $25,000 per year) for a violation without the entity's knowledge, to a high of $50,000 per violation (with an annual cap of $1.5 million) for a violation involving willful neglect.[60] Amounts collected by the Department of Health and Human Services can be used to fund enforcement activities and can be distributed to victims of data

[55] *HITECH Act* § 13405(c).

[56] *HITECH Act* § 13405(c)(4).

[57] *See HHS Resolved HIPAA Privacy Rule Complaints In Increasing Numbers Every Year Since 2003*, 7 Privacy & Sec. L. Rep. (BNA) 736 (2008).

[58] *See HHS Announces First Resolution Agreement On HIPAA Data Privacy, Security Compliance*, 7 Privacy & Sec. L. Rep. (BNA) 1087 (2008).

[59] *See Drug Chain Settles FTC, HHS Privacy Cases; CVS to Pay $2.25 Million on HIPAA Charges*, 7 Privacy & Sec. L. Rep. 295 (2009).

[60] *HITECH Act* § 13410.

breaches.[61] State attorneys general are authorized to enforce the HITECH Act through civil actions seeking an injunction or damages on behalf of residents of his State.[62] Although the Department of Justice expressed the view that the criminal provisions applied only to covered entities and not business associates,[63] Congress made clear in the HITECH Act that business associates are subject to the criminal provisions.[64] In addition, criminal liability applies to individuals as well as entities.[65]

The enforcement provisions in the HITECH Act are a significant improvement over the weak enforcement regime under the HIPAA Privacy Rules that took effect in 2003. Resources for OCR enforcement activities will be increased as fines are collected. Moreover, there is a possibility that some of what is collected will be distributed to victims of breaches. Business associates, as well as covered entities, can face criminal liability. Enforcement activity is likely to increase because the 50 state attorneys general will pursue violations that involve significant numbers of residents of their states. However, the HITECH Act could have strengthened enforcement even more had it included a private right of action for victims.

## V. CONCLUSION

The HITECH Act greatly improves privacy protection for health information in the United States. It fills many of the regulatory gaps left by the HIPAA Privacy Rules which took effect in 2003. It expands the scope of entities and individuals who must comply with health privacy requirements, improves the system for tracking the use of health information and strengthens enforcement. Most significantly, it establishes the first federal data breach notification regime. Notification of individuals is required whenever unsecured health information is disclosed, with relatively few exceptions. The HITECH Act's breach notification system may serve as a model for future federal legislation. Some of the HITECH Act's provisions and exemptions will be refined by regulations to be adopted by the Department of Health and Human Services. The regulation defining data security standards for health information will be especially important, not only for protecting health information, but as a possible de facto security standard for protecting personal information generally throughout all sectors of the U.S. economy.

[61] *HITECH Act* § 13410(c).
[62] *HITECH Act* § 13410(e).
[63] *See Additional Protection for Medical Records*, 35 PRIVACY JOURNAL 1 (2009).
[64] *HITECH Act* § 13401(b).
[65] *HITECH Act* § 13409.

# TAX HAVENS: WHERE ARE WE NOW?

by KRISTOFER C. NESLUND*

## I. INTRODUCTION

Tax havens that promote abusive tax shelters and tax evasion impair the ability of governments to pay the costs of civilization.[1] They can even imperil populations by encouraging jurisdictions to join the global infrastructure of secret channels and repositories for assets and income used by criminals, terrorists and corrupt governments.

The temptation to establish tax havens will always exist where there is a meaningfully enforced tax regime with enough "bite" to shift the cost/benefit analysis in favor of risking an illegal escape. Until fairly recently, tax havens were the province primarily of the well-to-do since gaining entry required substantial resources and recourse to privileged expertise. With the advent of globalization and the internet, however, "ordinary" individuals and small businesses can now access the tax haven infrastructure readily and inexpensively, allowing them to emulate the wealthy whom they previously could only envy.

An economic calamity has struck the world, revealing repugnant behavior on the parts of global financial institutions that has stripped them of the immunity of popular support. The artificial paper wealth of the middle-class has disappeared, leading many who can no longer see

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[1] Alluding to the famous paraphrasing of Justice Holmes' dissent in Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87 (1927): "Taxes are the price we pay for civilized society." See Wesley, Jr. v. U.S., 369 F. Supp. 2d 1328 (N.D. Fla. 2005).

themselves as the beneficiaries of upward economic mobility to rethink their alignment with the interests of the wealthy, with whom tax shelters are generally associated.[2] Planet-wide, governments are strapped and facing potentially perilous deficits, making it much harder for those who gain from the existence of tax havens to exert the political pressure that has previously held serious remedial efforts at bay. Perhaps, then, there is now a window of opportunity for a serious attack on the tax haven industry.

This paper will describe the nature, current state, and adverse impact of tax havens. It will identify the specific mechanisms and system flaws that allow them to prosper. Finally, it will consider current efforts to dismantle the tax haven infrastructure and comment on the prospects for success.

## II. THE NATURE AND STATE OF THE TAX HAVEN INDUSTRY

### *A. What Is a "Tax Haven"?*

There is no formal definition of "tax haven." The Organization for Economic Cooperation and Development (OECD), which has assumed a leadership role in addressing harmful tax practices, says that a tax haven has the following characteristics:[3]

1) Little or no tax imposed,
2) Lack of transparency,
3) No requirement that substantial activity take place within the jurisdiction and
4) Unwillingness to provide information to other governments regarding the activities of their domiciliaries.

To illustrate, a middle-income U.S. citizen could, within a single business day, create a fully functional Cayman Islands shell corporation for about $1,500.[4] It would come complete with the required paperwork and a set of nominee (and subservient) directors and officers whose names would be the only ones any government (other than, possibly, the Cayman Islands) could associate with this corporation, its assets or its

[2] IRS Commissioner Douglas Schulman recently said: "With more and more taxpayers under financial distress there will be little tolerance for people who don't pay the proper amount of tax." Joe, Michael, *Shulman Promises Aggressive Agenda in Curbing International Tax Abuse*, 2009 TAX NOTES TODAY 36-1, Feb. 26, 2009.

[3] Organisation for Economic Co-Operation and Development, *Tax Haven Criteria*, www.oecd.org/documentprint/0,3455,en_2649_33745_30575447_1_1_1_1,00.html (last visited March 23, 2009).

[4] U.S. Government Accountability Office, *Tax Compliance: Offshore Financial Activity Creates Enforcement Issues for IRS*, GAO-09-478T (Mar. 17, 2009).

income. The U.S. citizen would have no contact with the Cayman Islands other than surreptitiously moving assets to and from the shell corporation. No Cayman Islands tax would be imposed on any of the corporation's income (unless truly sourced within its jurisdiction). Should the U.S. ask the Cayman Islands for help tracking down this citizen's assets or earnings, its secrecy laws would probably permit only the confirmation of the specific set of facts sent by the U.S.[5] Cooperation beyond that would be unlikely.[6] Perhaps the Cayman Islands facilitator would be the law firm of Maples & Calder, serving the needs of this corporation, along with 18,856 others, from the (in)famous Ugland House.[7]

The above OECD definition is intended to embrace the most opaque and questionable tax havens. A jurisdiction may be considered a tax haven without such egregious characteristics. For instance, the Wall Street Journal reported in 2005 that Microsoft had established Round Island, LLC in Ireland to hold its licenses for $16 billion worth of U.S.-developed software used in 20 countries throughout Europe, Africa and the Middle East. Exploiting rules related to licensed intangibles, it paid a total of only $17 million in taxes to the 20 countries (with 300 million people) where the actual use occurred. It paid $300 million to Ireland in which the licenses were deemed sited, while reducing its U.S. taxes by $500 million. Using such strategies allowed Microsoft to reduce its effective global corporate tax rate from 33% to 26%. As disappointed as the U.S. tax authorities might have been, they could not deny that the asserted intangibles' situs was supported by Microsoft's substantial contacts with Ireland, given that it employed 1,000 people in that country.

Ireland does not have a reputation for secrecy or non-cooperation, but it does vigorously participate in global tax competition to induce the kind of behavior exhibited by Microsoft (as well Google, Oracle, Sun Microsystems and others engaged in intellectual property). Despite not exhibiting three of the four OECD factors, Ireland would be considered by many as a tax haven.

### *B. Where Are the Tax Havens?*

Lists of tax havens tend to be limited to those jurisdictions which have grounded their "value-added" on secrecy and non-cooperation,

[5] U.S. Government Accountability Office, *Cayman Islands: Review of Cayman Islands and U.S. Laws Applicable to U.S. Persons' Financial Activity in the Cayman Islands*, 2008 *TAX NOTES TODAY* 144-16, July 24, 2008.

[6] *Id.*

[7] Ng, Frank, *Written Testimony Before the Senate Finance Committee Hearing on Tax Haven Financial Institutions: Their Formation and Administration of Offshore Entities and Accounts for Use by U.S. Clients*, 2008 TAX NOTES TODAY 144-38, July 24, 2008.

excluding those nations that are simply engaged in tax competition (such as Ireland). The OECD has developed a list of secrecy-based tax havens.[8] Senate Bill 506,[9] sponsored by Senator Carl Levin (the original version of which was cosponsored by then-Senator Obama), is now under consideration. It includes a list of "offshore secrecy jurisdictions." The two lists have significant overlap and appear in the Appendix. Some are third-world countries, many are micronations,[10] a number are closely affiliated with European first-world countries, and some are first-world countries themselves. The common theme is the exploitation of sovereignty to insulate persons engaged in activities within the jurisdiction from scrutiny by outside jurisdictions. As will be noted later, the "insulation" is cracking, but is still substantially intact.

### *C. How Are Tax Havens Used?*

There are no doubt many ways to classify tax havens. This paper segregates them by how they are employed, specifically to engage in: 1) arguably appropriate tax avoidance, 2) clearly abusive tax shelters, and 3) tax evasion. While the first two will be briefly considered, the last will be the focus of the remainder of this paper.

*Category 1:* As noted earlier, the label "tax haven" is often restricted to jurisdictions refusing to behave transparently and with due regard for the legitimate information needs of other nations' tax authorities. The broader definition, which includes non-secrecy-based tax competitors, is used here. Through such tax competitors, U.S persons often engage in tax avoidance of the sort arguably sanctioned by the law. Facts are neither misrepresented nor hidden, and the law is applied in a manner reasonably consistent with maintaining the integrity of the tax system. Illustrations include tax strategies involving property situs (e.g., Microsoft and its intangibles) and those involving transfer pricing.

Of course, sometimes otherwise legitimate tax avoidance strategies go too far. Whereas Microsoft actually employed 1,000 people in Ireland to manage its $16 billion of intangibles, giving substance to its claim of situs in that nation, far less activity has taken place in the Netherlands, which has also strived to attract intangible assets. For example, the Rolling Stones simply decided to treat intangibles which generated $450 million of income over the years as having situs in that country,

[8] Crawford, David, *Tax Havens Pledge to Ease Secrecy Laws*, WALL STREET JOURNAL, Mar. 13, 2009.

[9] S. 506, 111th Cong., 1st Sess. (Mar. 2, 2009).

[10] With her typical bluntness, commentator Lee Sheppard characterizes these nations as "phony governments that call themselves financial centers" and "Lilliputian governments that have been afforded the same privileges as real governments of real countries." Sheppard, Lee A., *Don't Ask, Don't Tell, Part 3: UBS's Sweet Deal*, 2009 TAX NOTES TODAY 39-5, Mar. 3, 2009.

reducing the effective tax rate thereon to 1.5% from the 40% it would have been had the income been taxed in the individuals' home jurisdiction, the United Kingdom. More recently, U2 (which has amassed a net worth of some $900 million) moved the situs of its primary intangible asset (its song catalog) to Holland. Other well known parties housing intangibles in the country's 20,000 corporate shells are the Elvis Presley estate, David Beckham, Nike and Coca-Cola. The OECD identified the Netherlands as one of the world's top five industrialized tax havens for promoting the harmful tax practice of "treaty shopping." That embarrassment led the Dutch to start demanding a bit more substance in their shell corporations.[11]

Transfer pricing is another area that is amenable to legitimate tax planning. Unfortunately, it has devolved to the point that many view it as a failure. One critic characterized transfer pricing not as "rules of law" but rather as "mere invitations to negotiate." There is plausible evidence that business profits are increasingly moving out of the non-tax haven jurisdictions in which the related goods and services are used or produced into tax havens with which business contacts are much more tenuous.[12] The penalty regime fails to deter since it can generally be avoided even where suspect practices are used, and the burden on the IRS to prevail in court on its proposed adjustments is onerous.[13] This once-arguably credible tax strategy has deteriorated into what might be characterized as aggressive tax avoidance.

While not necessarily associated with tax havens per se, the opportunity to use tax-indifferent parties, such as foreign persons or governments,[14] can tempt taxpayers to drift from legitimate tax avoidance to dubious tax sheltering. For example, in testimony before the Senate Finance Committee investigating abusive cross-border leasing schemes (lease-in-lease-out, also known as LILO), a witness stated:[15]

> This morning I will describe a massive scandal that has allowed major U.S. companies to receive huge tax deductions by pretending to lease the infrastructure of foreign countries … and then pretending to lease that infrastructure back[.] This scheme is so pervasive that much of the old and new infrastructure throughout Europe has been leased to,

[11] Browning, Lynnley, *The Netherlands, The New Tax Shelter Hot Spot*, NEW YORK TIMES, Feb. 4, 2007.

[12] Sullivan, Martin A., *Data Show Dramatic Shift of Profits to Tax Havens*, 2004 TAX NOTES TODAy 177-1, Sept. 3, 2004.

[13] McIntyre, Michael J., *A Program for International Tax Reform*, 2009 TAX NOTES TODAY 34-46, Feb. 4, 2009.

[14] An exempt organization makes an equally good counterparty.

[15] *Anonymous Witness Testifies on Cross-Border Leasing at Finance Hearing*, 2003 TAX NOTES TODAY 204-38, Oct. 21, 2003.

> and leased back from, American corporations. The sole purpose of this scheme is to generate a tax shelter for U.S. corporations[.] …
> The foreign municipality will be responsible for operating and servicing the assets over the lease term. At the end of the lease term, the infrastructure assets revert back to the municipality. [T]he municipality makes no [net] lease payments.

Placed into evidence were a New York Times article on the LILO of the Frankfurt, Germany subway system and a Canadian government press release announcing the LILO of the entire Canadian air traffic control system. In these arrangements, the tax-indifferent foreign government gets a substantial cash payment (Canada got $25 million); the other party gets the right to take (or syndicate) depreciation deductions, the present value of which is substantially larger than the cash paid. Essentially, depreciation deductions have been sold by a party who cannot use them to one who can.[16]

*Category 2:* Some uses of tax havens go far beyond the merely dubious and instead constitute abusive tax shelters. In September, 2008, the Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs issued a report on offshore U.S. dividend tax abuse,[17] a shelter benefiting non-U.S. persons. In the subcommittee's words:

> [T]he Subcommittee uncovered substantial evidence that U.S. financial institutions knowingly developed, marketed, and implemented a wide range of transactions aimed at enabling their non-U.S. clients to dodge U.S. dividend taxes. Using a variety of complex financial instruments, … these U.S. financial institutions structured transactions to enable their non-U.S. clients to enjoy all of the economic benefits of owning … U.S. stock, including receiving dividends, without paying the [30%] tax applicable to those dividends. These structured transactions increased the amount of dividend returns obtained by … 30% or more.
> The evidence also showed that use of abusive dividend tax transactions is widespread throughout the offshore hedge fund industry. Offshore hedge funds … played one financial institution against another to elicit

[16] *Id.* In a similar vein, a tax-indifferent foreign party creates a trust (often in a tax haven), the corpus of which is an asset manifesting a substantial built-in loss. The trust purports to exist for the classic purpose of safeguarding corpus. The U.S. person acquires a beneficial interest in the trust by contributing cash equal to the value of the asset. The trustee uses the separate share rule to shift the asset to the U.S. person's share (the entering U.S. person's cash goes to the other share). The asset is then sold for approximately the same amount the U.S. person contributed (making it cash-neutral). However, the U.S. person now has a meaningful loss deduction. In essence, a loss deduction has been transferred by a party who cannot use it to one who can. This became a "listed transaction" for tax shelter purposes in I.R.S. Notice 2008-34, 2008-12 IRB 1.

[17] Staff Report, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends* (Sept. 11, 2008).

> the largest possible tax reduction. …
> Abusive dividend tax practices … have multiplied … due to a variety of factors[, including] the proliferation of hedge funds willing to engage in complex financial transactions; … the general loosening of regulation and oversight of the financial industry …; and the willingness on the part financial institutions, hedge funds, and their legal advisors to adopt more … abusive tax practices.

The subcommittee provided an example:

> [I]n one of the most blatant forms of this type of transaction, a few days before a stock is scheduled to issue a dividend, an offshore hedge fund sells its stock to a U.S. financial institution and simultaneously enters into a swap agreement with the financial institution … tied to the economic performance of the same stock. After the dividend is issued, the offshore hedge fund receives from the financial institution a "dividend equivalent" payment under the swap agreement equal to the full dividend amount less a fee[, which] generally equals 3% to 8% of the dividend amount. The end result is that the offshore hedge fund receives 92% to 97% of the dividend amount instead of the 70% that it would have received if the 30% in taxes had been withheld. A few days after the dividend date, the offshore hedge fund terminates the swap agreement and repurchases the stock, leaving the offshore hedge fund with the same status it had before the transaction was undertaken.

The report estimated lost tax revenues cumulating into the "billions" of dollars, observing, for example, that Morgan Stanley schemes over some five years cost $300 million and a Lehman Brothers scheme in 2004 alone cost $115 million.

*Category 3:* The balance of this paper considers the last category of tax havens—those that promote tax evasion.

## III. TAX EVASION THROUGH THE USE OF TAX HAVENS

In the U.S., tax evasion requires three elements:[18] 1) the voluntary and intentional violation of a known legal duty; 2) the existence of a tax deficiency (i.e., more tax is owed than the amount showing on the return);[19] and 3) an affirmative act of evasion (doing nothing—like not filing a return—is insufficient).

When persons who know they are subject to U.S. taxation take action to hide their beneficial interests in income and/or assets and thereby underpay their taxes, all of the elements are satisfied. Secrecy-based tax havens and the deceptive practices of those who abet taxpayers combine to provide particularly robust opportunities for

[18] Sansome v. U.S., 380 U.S. 343 (1965); U.S. v. Pomponio, 429 U.S. 10 (1976).
[19] I.R.C. § 6211(a).

evasion. The Government Accountability Office (GAO) summarized:[20] "[The] true ownership of income … and assets is hidden to improperly shield financial activities from the U.S. tax system."

### *A. How Bad Is the Situation?*

Although a quality estimate of the tax gap (the shortfall between the taxes which should have been paid and the taxes actually paid (prior to enforcement efforts)) has not been revised since the data for 2001 was analyzed and released in 2005,[21] that estimate is $385 billion annually.[22]

About $100 billion of the annual tax gap results from offshore tax haven abuse.[23] Based on government investigations, there appears to be two main contexts for offshore tax evasion: 1) Direct efforts by taxpayers to move assets and income into secrecy-based tax havens; and 2) indirect efforts to do so, typically by the wealthy, through the use of offshore hedge funds.

No one knows for sure, but estimates developed since 2005 of the assets held in offshore accounts are in the range of $7-11 trillion.[24] (For comparison, the U.S. gross domestic product in 2008 was $14.3 trillion[25].) The estimated losses each year to the world's tax authorities are $255 billion.[26] A 2005 estimate of the amount of offshore assets owned by U.S. and Canadian persons was $1.6 trillion.[27]

Many are concerned about the implications of these enormous sums. For example, more money moves out of developing countries to tax havens each year ($124 billion) than flows in as foreign aid ($103

[20] U.S. Government Accountability Office, *Challenges Remain in Combating Abusive Tax Schemes*, 2003 TAX NOTES TODAY 245-25, Nov. 19, 2003.

[21] Jackson, Randall and White, Dylan, *Finance Committee Members Slam IRS Efforts to Fight Offshore Tax Evasion*, 2008 TAX NOTES TODAY 144-1, July 25, 2008.

[22] *Everson Testifies on IRS Efforts to Close Tax Gap*, 2005 TAX NOTES TODAY 207-24, Oct. 26, 2005. Senator Kent Conrad found the failure to update these numbers "unacceptable" and indicative that the IRS was not taking the problem seriously. Indeed, his disappointment with the IRS' response to offshore tax evasion was so great that he told the head of the IRS Large and Midsize Business Division, which has a major role in dealing with offshore activity, that his 20-year "defense of the IRS is over." *See* Jackson, s*upra* note 21.

[23] Staff Report, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Tax Haven Banks and U.S. Tax Compliance* (July 17, 2008).

[24] Crawford, *supra* note 8.

[25] Bureau of Economic Analysis, *Current-Dollar and "Real" Gross Domestic Product*, http://www.bea.gov/national/xls/gdplev.xls.

[26] Staff Report, *supra* note 23.

[27] Staff Report, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Tax Haven Abuses: The Enablers, The Tools and Secrecy* (Aug. 1, 2006).

billion).[28] Australia knows that A$16-18 billion annually moves between Australia and offshore banks, but does not know how much of it is illegal. It is particularly concerned because an increasing portion of these flows involves individuals and small businesses, suggesting the possibility that offshoring is beginning to permeate "ordinary" taxpayers, as opposed to remaining confined to the wealthy.[29]

Among the largest repositories of offshore assets are Switzerland (about $2 trillion) and Luxembourg (about $1 trillion).[30]

The Cayman Islands has become the world's fifth largest financial center.[31] The president of one of its banks told a Senate subcommittee that, of his 2,000 clients, 95% were from the U.S. and virtually all of those were engaged in tax evasion.[32]

### *B. Direct Efforts to Move Assets and Income to Tax Havens*

For about a decade the IRS has been concerned about the growth in offshore activity on the part of "ordinary" individuals (and their small businesses). As is true with the Australian government (mentioned above), the IRS was becoming worried that large numbers of rank-and-file taxpayers are striving to emulate the already troubling use of tax havens by the well-to-do.[33] Shock reverberated in the media and Congress when the IRS announced in 2002 that as many as 2 million U.S. citizens and residents might have credit cards issued by offshore banks in order to easily bring hidden income into the U.S.[34] Confirming IRS fears, the vast majority of these card-holders were teachers, airline pilots, accountants and the like.

One has to wonder how so many individuals of ordinary means could so easily gain access to the offshore tax haven infrastructure, establishing accounts and readily moving assets back and forth. Senator Kent Conrad reported at a hearing on the Cayman Islands that when he

[28] Jucca, Lisa and Groendahl, Boris, *Tax Havens Agree to Crack Open The Vault*, REUTERS, Mar. 13, 2009, www.reuters.com/articlePrint?articleId=USTRE52C21X20090313.

[29] D'Ascenzo, Michael, *Australian Taxation Commissioner Discusses Strategies to Handle Tax Evasion*, 2008 TAX NOTES TODAY 139-38, July 17, 2008.

[30] Jucca, *supra* note 28; Crawford, *supra* note 8.

[31] Staff Report, *supra* note 27.

[32] Staff Report, *supra* note 23.

[33] McKinnon, John, *Scope of Offshore Credit-Card Use For Tax Evasion Is Huge, IRS Says*, WALL STREET JOURNAL, March 26, 2002.

[34] *Id.* Even though the estimate was later reduced, it still amounted to 400-600,000 individuals. The original data from which the estimate was derived led to summonses being issued to major credit card companies requiring them to reveal which offshore banks had issued credit cards to U.S. persons. Later, 123 additional summonses were issued to merchants to find out who was actually using the offshore cards. U.S. G.A.O., *supra* note 20.

queried the internet with "offshore tax haven" he got almost 2 million hits. After reading a few of the web pages he found himself in disbelief at the "brazenness" of the offshore tax haven facilitators and the apparent simplicity of the process.[35] Indeed, offshoring is no more difficult than was illustrated at the beginning of this paper.

Insight into the mechanics of offshoring can be gleaned from a 2006 Senate report on tax haven abuses. It contained six case studies, three of which spoke to the information and set-up stage. In one case, an U.S. individual used the internet to mass market "one-stop-shop" offshore set-up services to 900 U.S. citizens and residents, helping them establish bank accounts, sham trusts and shell corporations (complete with the necessary local trustees, directors and officers who would adhere to the true owner's every wish and keep secret the true owner's identity). In another case, the promoter wrote a book and a "how-to" manual which were pitched at seminars and sold through bookstores. In the third, an ad in an airline magazine was used to create interest in offshoring among the high-flyers.

The Senate found that money got to the offshore banks, in general, through another service provided by the facilitators—the issuance of phony invoices for services like consulting, feasibility studies and advertising. Alternatively, the U.S. owner could grossly overpay for an asset purchased by the offshore trust or shell company (which, not being subject to income tax, had no qualms about receiving the large gains). Often invoices and purchase monies were routed through multiple offshore entities located in multiple jurisdictions to further daunt any investigator.

Money was extracted from the offshore arrangement by a variety of means, including (as mentioned earlier) credit (and then debit) cards issued by a tax haven bank. Phony loans from the offshore entity were also popular ways to return untaxed income to the U.S.

Direct offshore activities are not always as simple or as (comparatively) small as those indicated above. One case study involved a U.S. investment firm that arranged for the generation of $2 billion in phony capital losses for five clients who had recognized that amount of capital gains. The artificial losses were created by manufacturing the "sale" of about $9 billion of non-existent securities. A host of circular cash flows were put in place to give the illusion of actual sales. The well known Cravath law firm wrote a more-likely-than-not opinion letter supporting this scheme and helped design and implement its various components.

In another case study, two brothers received $190 million in compensatory stock options from the publicly traded crafts store

[35] Jackson, *supra* note 21.

Michaels. These were routed through a Nevada corporation (which can be as opaque—as challenging to identify the true owners—as the entities established in many tax havens) to 58 offshore trusts and shell corporations located in many jurisdictions. Over the years $600 million came back to the brothers via artificial loans and another $300 million was used to acquire real estate for their use and indirect profit. Despite the fact that the involved financial institutions (Bank of America, Lehman Brothers and Credit Suisse) had actual knowledge that the beneficial owners of the various offshore entities were the brothers, they never fulfilled their information return or withholding obligations.

The Senate report concluded:[36]

> Offshore tax havens and secrecy jurisdictions [have] become havens for tax evasion, financial fraud and money-laundering. A sophisticated offshore industry, composed of … attorneys, accountants, bankers, brokers, corporate service providers, and trust administrators, aggressively promotes offshore jurisdictions to U.S. citizens as a means to avoid taxes and creditors[.] These professionals … advise and assist U.S. citizens on opening offshore accounts, establishing sham trusts and shell corporations, hiding assets offshore, and making secret use of their offshore assets here at home.

### *C. Indirect Efforts to Move Assets and Income to Tax Havens via Offshore Hedge Funds*

The SEC defines a "hedge fund" as an entity that "pool[s] investors' money and invest[s] those funds in financial instruments in an effort to make a positive return. [They] seek to profit in all kinds of markets by pursuing leveraging and other speculative investment practices that may increase the risk of investment loss." The SEC warns that hedge funds are unregulated and hence much riskier than their kindred investment vehicle, mutual funds.[37]

Leverage can be extreme. If things work out, the return on equity can be astounding; on the other hand, when things go poorly (as they have of late) the impact is equally powerful in a less agreeable direction. Hedge fund volatility is compounded by the frequent placement of highly speculative investment "bets."

Hedge funds are usually partnerships (or LLCs). Many are domiciled in tax havens to minimize the tax consequences to the U.S. participants.[38]

[36] Staff Report, *supra* note 27.

[37] U.S. Securities and Exchange Commission, *Hedging Your Bets,* http://sec.gov/answers/hedge.htm (last visited May 20, 2009).

[38] Lee Sheppard defined a hedge fund skeptically as "an unregulated investment partnership that, although managed out of … some domestic location, claims to be nonresident merely by virtue of having been organized in a tax and banking haven." She

Hedge funds have grown from $50 billion in 1990 to $1.5 trillion in 2006. Using the methodology developed by Tax Analysts,[39] a rough estimate of the hedge fund interests owned by individuals is $500 billion (i.e., about one-third). There is no way to actually know what portion of this is owned by U.S. citizens and residents, but given that 31% of the world's so-called "ultra-high net worth" individuals reside in the U.S. or Canada,[40] it seems safe to speculate that $125-$175 billion is in the hands of U.S. individuals.

That offshore hedge funds facilitate tax evasion by U.S. investors is an "open secret." For example, Daniel Strachman said in his book, *The Fundamentals of Hedge Fund Management*:[41]

> Most … investors do not care where the fund is domiciled so long as [it is] a tax-haven jurisdiction. If you want to grow your offshore operation, you will need to please U.S.-based investors who seek anonymity and who wish to avoid the U.S. government seeing their investments.

To understand the tax evasion potential and mechanism, basic hedge fund structure must be understood. The classic hedge fund involves four entities: At the top is an LLC which houses the investment manager. Next is a master hedge fund organized as a partnership[42] in a tax haven. The bottom tier has two feeder entities. The domestic feeder, organized as a limited partnership[43] with the investment manager's LLC as the general partner, has only U.S. persons as limited partners. The foreign feeder is a corporation organized in a tax haven which has only non-U.S. persons as shareholders.

The domestic feeder's participants bear the full brunt of the income tax on their share of the hedge fund's various investments. Nonetheless, the U.S. limited partners enjoy the enormous upside potential hedge

goes on: "[F]oolish American residence rules … define a partnership as resident where it is organized, rather than where it is managed and controlled." Sheppard, Lee A., *Offshore Investments: Don't Ask, Don't Tell*" 2005 TAX NOTES TODAY 132-4, July 12, 2005.

[39] Sullivan, Martin A., *Offshore Explorations: Caribbean Hedge Funds, Part 2*, 2008 TAX NOTES TODAY 10-5, Jan. 15, 2008.

[40] Staff Report, *supra* note 23.

[41] Sullivan, Martin A. and Sheppard, Lee A., *Tax Analysts Offshore Project: Offshore Explorations: Caribbean Hedge Funds, Part 1*, 2008 TAX NOTES TODAY 5-4, Jan. 8, 2008, quoting from STRACHMAN, DANIEL, THE FUNDAMENTALS OF HEDGE FUND MANAGEMENT 48 (2007).

[42] This both allows income, deductions and credits to pass through to the owners without entity-level taxation and allows the partners tremendous flexibility in how such items of income, deduction and credit, as well as cash flows, are allocated among them.

[43] This provides the partnership benefits noted in note 42, as well as limited liability for the investors.

funds can bring. The domestic feeder is the vehicle through which the non-evading U.S. individual participates.

The evading U.S. individual participates through the foreign feeder. This would seem at odds with the purpose of the foreign feeder, which is generally to avoid any tax-related obligations to the U.S. government. It is, for that reason, to be owned only by non-U.S. persons; but there is a second requirement that will be discussed first: the foreign feeder must avoid certain species of U.S. income. First, it must be allocated (under the master hedge fund) no "income effectively connected with a U.S. trade or business" (ECI). If ECI is allocated to it, the foreign feeder must file a U.S. corporate tax return. Second, U.S.-sourced dividends (i.e., dividends on U.S. stock) must not be allocated to the foreign feeder. Where that is not the case, the payor of the dividend must withhold 30% for federal income taxes.[44]

Assuming the foreign feeder has neither of these types of income, the presence of U.S. persons as shareholders would nonetheless seem to defeat the goal of being outside the U.S. tax system. The fraud starts here—the "fix" begins with the U.S. person creating a tax haven shell corporation, funding it with the intended investment capital, and directing the shell corporation to invest in the foreign feeder. Seeking substance, the U.S. tax law presumably looks for the beneficial owner of the investment. That, of course, is the U.S. person, not the shell corporation. So how does the aspiring tax evader escape the IRS' clutches? To the rescue come formalism and the foreign feeder's (and the master hedge fund's and the LLC investment manager's) willingness to abet.

The formalism: The U.S. person's foreign shell corporation files a false form W-8 with the foreign feeder, declaring it to be the beneficial owner of the investment. The foreign feeder takes the W-8 at face value and, none of its shareholders being U.S. persons, files its own W-8 with the master hedge fund. The master hedge fund takes that W-8 at face value and passes it along to the appropriate parties in the U.S. to establish that the foreign person rules apply for U.S. tax purposes with respect to the entire foreign feeder. That accomplished, so long as neither of the species of income discussed earlier is allocated to the foreign feeder, the U.S. will glean no taxes from its investors.

The abetting: The recipient of a W-8 is supposed to refuse to accept the form if it knows (or has reason to know) that its representations are false. Somehow, though, it just always seems to happen that no such

[44] Sometimes tax treaties mitigate the amount or existence of this withholding requirement. However, the foreign feeder being incorporated in a tax haven, there will be no mitigating tax treaty.

knowledge is held by the foreign feeder recipient or by the master hedge fund recipient.[45]

### *D. Why No Fix?*

One might wonder, given the magnitude of the stakes and given that it would be fairly straightforward to deal with many of the issues, why so little has been done to lessen the damage done by tax havens. Worthwhile suggestions have not been lacking.

Part of the answer comes from the reality that this is a global problem. Unless the major nations join together to seriously address it, it is in no individual nation's interest to take action. The same conundrum exists with respect to global warming. Taking action is not free of consequences, and nations do not wish to be at a competitive disadvantage by unilaterally undertaking costly steps that might not even work for the very reason that they cannot work without all key parties being joined in the effort.

Beyond that, the financial services industry has been the leading growth industry for many in the post-industrial world, its output representing a large part many nations' gross domestic product. When times are good, few want to push for major changes, even sorely needed ones, that might bring the prosperity to a halt. One need only recall the pre-Sarbanes-Oxley era, during which many financial market weaknesses were evident but reform could gain no traction.

In addition, for many years the U.S. has been running enormous annual budget deficits, approaching $500 billion in 2008 and projected at up to $2 trillion in 2009. Concurrently, the balance of payments have been deteriorating for more than a decade, rising from a deficit of $104 billion in 1996 to a peak deficit of $753 billion in 2006; for 2008, the deficit is estimated at $681 billion. All of this has resulted in the need for massive U.S. borrowing, bringing the national debt to $11 trillion as of March 2009.[46] Some commentators suggest that, given the prodigious past and future need for capital to flow into the U.S., no one has wanted to do anything for quite a while that would jeopardize the willingness of foreigners to bring their cash to our shores.[47]

This hesitancy is compounded by the fragile state of the world's financial institutions. Some reformers are reluctant to push for changes out of fear that corrective measures could further destabilize the global financial network and further damange the world economies.

[45] Sullivan, *supra* note 41.

[46] *U.S. National Debt Clock*, http://www.brillig.com/debt_clock (last visited May 20, 2009).

[47] Sheppard, *supra* note 10; McIntyre, *supra* note 13.

Finally, there are those who believe that, beginning with the Clinton administration, the U.S. itself has wanted to avoid having to identify foreign persons' U.S. income to their home governments. By not mandating a system through which quality information would be accumulated that would help the IRS know whether taxpayers are fulfilling their obligations, the U.S. simply has no quality information to share with other governments which have a similar desire to ensure the integrity and effectiveness of their tax systems. This argument is consistent with the goal of not discouraging investment in the U.S., discussed above. It may also be true that the U.S. wishes to keep this knowledge out of the hands of other governments to secure competitive financial and/or political advantage.[48]

Nonetheless, recent scandals have brought critical attention to the tax haven industry and may precipitate at least some worthwhile change.

## IV. SCANDALS AND THE ECONOMIC CRISIS CHANGE THE REFORM EQUATION

### *A. We Need More Money*

It is argued in the prior section that reform of the offshore tax haven infrastructure might be on hiatus because of the fragility of the global financial markets. The countervailing force is that dealing with the economic crisis while attempting to address major domestic needs (e.g., health care, infrastructure, immigration, spill-over border crime) and fighting two wars is extraordinarily costly. The budget deficits mentioned earlier make clear that the public fisc is in peril. The U.S. and other governments will likely, for this reason alone, need to find ways to enhance revenues. For at least the time being, a more populist sentiment prevails, with the influence of the wealthy substantially reduced. It could well be that reformers will seek to attack the tax haven industry not only to reduce deficits but also to prepare the global financial system to operate with more integrity when the crisis ends.

### *B. Scandals at LGT and UBS*

Another force bringing reform to the fore is the remarkable revelations about the world's wealthy hiding assets and evading taxes through major banks, such as the royal family of Liechtenstein's LGT and Switzerland's UBS.

Beginning with the circulation of LGT bank records (stolen by former employee Heinrich Kieber) first to Germany and then across many nations (U.S., Canada, Australia, New Zealand, France, Sweden,

[48] Sheppard, *supra* note 10.

U.K., Italy), a cascade of discoveries about the sordid world of tax and banking havens has captured the public's attention. Germany has already criminally convicted the former CEO of one of its most important corporations for tax evasion (Klaus Zumwinkle of Deutche Post). Many other prosecutions are under way around the world.[49]

Then similar revelations about UBS emerged. Former private banker Bradley Birkenfeld plead guilty to conspiring with UBS and American billionaire Igor Olencoff to hide assets and income costing the U.S. $7.2 million. Birkenfeld agreed to cooperate with authorities, which led to amazing disclosures about UBS' flagrant efforts to help U.S. persons evade taxes. In once instance alone UBS helped Americans hide $20 billion to defeat new disclosure rules, costing the U.S. about $300 million—little surprise given that UBS was earning fees of some $200 million per year on those accounts. UBS has admitted to the existence of about 19,000 U.S. accounts. The U.S. government is pressing for information about thousands (possibly tens of thousands) more. UBS was forced to accept a deferred prosecution agreement which required it to exit the U.S. private banking business and to pay $780 million in disgorgement and fines.[50]

Credit Suisse and HSBC are also under investigation, suspected of hiding some $30 billion in U.S. assets.[51]

### *C. Efforts of the OECD*

Generally, the OECD's attempts to eradicate tax havens have not been particularly successful. Its principal claim to success is the now widely adopted Tax Information Exchange Agreement (TIEA), to which nearly all of the most egregious tax haven jurisdictions have committed themselves. The fury over the LGT and UBS scandals, combined with the OECD's threat to place non-subscribing haven jurisdictions on a list of uncooperative nations for distribution at the forthcoming G-20 meeting, has led to a rash throughout February and March 2009 of apparent capitulations. Much is being made of this.

But a closer look reveals that the commitment made is of fairly little practical import. Countries like Liechtenstein, Austria and Switzerland

[49] Crawford, David, *LGT Group Quits Tax-Shelter Business*, WALL STREET JOURNAL, Mar. 11, 2009; *Offshore-Account Holders Bite Their Nails*, WALL STREET JOURNAL, May 21, 2008.

[50] Perez, Evan, *Offshore Tax Evasion Costs U.S. $100 Billion*, WALL STREET JOURNAL, July 17, 2008; Stewart, David D. and White, Dillon, *UBS to Discontinue Offshore Banking for U.S. Clients*, 2008 TAX NOTES TODAY 139-1, July 18, 2008; Jackson, Randall, *Former UBS Banker Pleads Guilty to Helping Billionaire Evade Taxes*, 2008 TAX NOTES TODAY 120-3, June 20, 2008.

[51] Jackson, Randall, *IRS Considers Response to Offshore Tax Cheats*, 2008 TAX NOTES TODAY 234-8, Dec. 4, 2008.

have made clear that, even as subscribers to the TIEA, they will not go beyond its express terms and thus will not automatically and systematically share information.[52] Instead, upon request with respect to a specific person based on specific facts making clear the specific conduct under investigation, and after providing a reasonable basis for believing the information is in the jurisdiction, they will respond to the inquiry.[53] At best, this simply provides the inquiring jurisdiction with the ability to have information otherwise obtained confirmed. It is hard to see how this information-sharing arrangement will be of much actual use in containing tax haven abuses.

### *D. Stop Tax Haven Abuse Act*

On March 2, 2009, Senator Carl Levin reintroduced the Stop Tax Haven Abuse Act,[54] which had originally been introduced in February 2007.[55] Senator Levin was active in many Senate investigations of the offshore tax haven industry. Numerous organizations, including the AFL-CIO, Citizens for Tax Justice and OMB Watch, have announced their support.[56] The bill would:

1) Identify offshore secrecy jurisdictions, upon whose financial intermediaries enhanced disclosure obligations would be imposed, such as letting the IRS know when an overseas trust or shell corporation is formed,
2) Establish a presumption that the transferor of assets to an offshore entity is the owner thereof,
3) Extend the statute of limitations on offshore investigations to six years,
4) Make the PATRIOT Act's money-laundering sanctions available to deter offshore tax evasion,
5) Deny miscreant banks the power to issue credit and debit cards,
6) Authorize sanctions on jurisdictions or institutions that "impede U.S. tax enforcement,"
7) Presume that all dividend payments to non-U.S. persons are subject to withholding, and

[52] Jucca, *supra* note 28.

[53] U.S. Government Accountability Office, *GAO Reviews Cayman Islands, U.S. Laws on Financial Activities*, 2008 TAX NOTES TODAY 144-16, July 24, 2008.

[54] S. 506, 111th Cong., 1st Sess. (Mar. 2, 2009).

[55] Parillo, Kristen A., *Levin Reintroduces Stop Tax Haven Abuse Act*, 2009 TAX NOTES TODAY 39-1, March 3, 2009.

[56] *Support for Levin Stop Tax Haven Abuse Bill Grows*, 2009 TAX NOTES TODAY 50-51, March 17, 2009.

8) Classify publicly traded foreign corporations with assets greater than $50 million as domiciled in the U.S. if they are principally managed and controlled here.

Reviews of the act are mixed. Many of the offshore secrecy jurisdictions are important nations that would raise a political furor if singled out either for membership on the list or for sanctions for "imped[ing] U.S. tax enforcement." There is still no provision mandating that recipients "look through" forms like W-8 when presented.[57]

In any case, it will likely be several months before the fruits, if any, of this bill become clear.

## V. CONCLUSION

Tax havens present a serious problem for the world's governments. They siphon away much needed tax revenues and form conduits for the ill-gotten gains of criminals and corrupt governments.

While wealthy individuals have always had access to the tax haven industry, evidence strongly suggests that tax haven accounts, sham trusts and shell corporations are being utilized at an increasing rate by persons of even moderate means, posing an even greater threat to the integrity of the tax system.

Some tax havens are simply aggressive competitors for global economic activity, using low tax rates to induce companies to locate in their jurisdictions. Other tax havens treat their sovereignty as a competitive advantage and sell their powers to hide and obstruct as though they were commodities.

Tax havens cannot prosper on their own; and those desirous of hiding income and assets generally cannot accomplish that goal unassisted. The matchmaking and implementation is provided by a host of banks, lawyers, accountants and other facilitators who aid and abet conduct that harms nations and others with legitimate interests in that income and those assets.

Some of the schemes concocted by the havens and their facilitators are so lacking in substantive merit and often so dishonest as to leave the observer in a state of astonishment—generating phony sales and false invoices, delivering and accepting fraudulent W-8s, brazen mass solicitation, and the use within a given transaction of multiple entities strewn across multiple haven jurisdictions, to name just a few.

It may be that, like the sequential implosions of Enron and WorldCom, today's events will combine to bring about a real dismantlement of the tax haven industry. So far, the accomplishments of the European Union and the OECD have not been impressive. Perhaps the

[57] Sheppard, *supra* note 10.

multinational outrage against the financial services industry and the tax havens with which it deals will provide the tipping point. Senator Levin has put the matter on the table in the U.S. The months to come will reveal whether the days of tax havens are numbered.

APPENDIX: SECRECY JURISDICTIONS

| Country | OECD | Levin bill | Both | Relationship |
|---|---|---|---|---|
| Anguilla | | | X | U.K. |
| Andorra | X | | | |
| Antigua and Barbuda | | X | | |
| Aruba | | X | | Netherlands |
| Austria | X | | | |
| Bahamas | | X | | |
| Barbados | | X | | |
| Belgium | X | | | |
| Belize | | | X | |
| Bermuda | | X | | U.K. |
| British Virgin Islands | | X | | U.K. |
| Cayman Islands | | X | | U.K. |
| Chile | X | | | |
| Cook islands | | | X | |
| Costa Rica | | X | | |
| Cyprus | | | X | |
| Dominica | | X | | |
| Gibraltar | | | X | U.K. |
| Grenada | | X | | |
| Guatemala | X | | | |
| Guernsey/Sark/Alderney | | X | | U.K. |
| Hong Kong | | | X | |
| Isle of Man | | X | | U.K. |
| Jersey | | X | | U.K. |
| Latvia | | X | | |
| Liechtenstein | | | X | |
| Luxembourg | | | X | |
| Macao | X | | | |
| Malasia | X | | | |
| Malta | | | X | |
| Monaco | X | | | |
| Montserrat | X | | | U.K. |
| Nauru | | | X | |
| Netherlands Antilles | | X | | Netherlands |
| Niue | X | | | |
| Panama | | | X | |
| Phillipines | X | | | |
| Samoa | | | X | |
| St Kitts and Nevis | | | X | |
| St Lucia | | | X | |
| St Vincen/Grenadines | | X | X | |
| San Marino | X | | | |
| Singapore | | | X | |
| Switzerland | | X | | |
| Turks and Caicos | | | X | U.K. |
| Uruguay | X | | | |
| Vanuatu | | | X | |

# "HOW MUCH YOU KEEP": ESHELMAN V. AGERE AND TAX GROSS-UPS IN EMPLOYMENT DISCRIMINATION CASES

by PATRICIA QUINN ROBERTSON* AND JOHN F. ROBERTSON**

## I. INTRODUCTION

A plaintiff who has been successful in both winning a wrongful discharge case against the defendant and in collecting pecuniary damages from the defendant may then have both a significant amount of cash and a potentially large tax burden to go along with it.[1] Taxable damage awards are included in the plaintiff's income in the year received. There is no attempt to match the tax liability to the year that the income should have been paid by the defendant.[2] A large one-time payment may push the plaintiff into a higher marginal federal income

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1 The Internal Revenue Code (IRC) provides that "[e]xcept as otherwise provided…gross income means all income from whatever source derived…." 26 U.S.C. §61. If a settlement or judgment would be considered income, it must be included in the plaintiff's taxable income unless some section of the IRC excludes it. The most common exclusion in the area of settlements or judgments is the exclusion for damages received due to physical injuries or sickness under 26 U.S.C. §104(a)(2). Under this section, if the underlying source of the claim is physical harm to the plaintiff's body, all damages except punitive damages are tax-free. This exclusion typically does not apply to cases involving contract claims or wrongful discharge.

2 A cash basis taxpayer includes an item in income when it is received. 26 C.F.R. §1.446-1(c)(1)(i).

tax bracket. A plaintiff in this situation will want the amount of the damage award to be increased by the amount of the additional taxes. Throughout this paper, we will refer to this increase in the damage award as a "tax gross-up." Over the years, a few federal courts have considered whether it is appropriate to include a tax gross-up in the calculation of total damages. There is currently a split among the federal circuit courts of appeals.

The term damages refers to "[m]oney claimed by, or ordered to be paid to, a person as compensation for loss or injury."[3] Damages are generally a legal rather than an equitable remedy. "'Damages,' absent a restrictive modifier like 'compensatory,' 'actual,' 'consequential,' or 'punitive,' is an inclusive term when used in a statute, embracing the panoply of legally recognized pecuniary relief."[4]

Of particular interest in this paper is the term "compensatory damages." In general usage, "'[c]ompensatory damages' are those given as compensation as an equivalent for the injury done, and are awarded to make the injured party whole."[5]

Plaintiffs who successfully bring an action under Title VII of the Civil Rights Act of 1964[6] may recover both equitable and legal damages. These include back pay, reinstatement or hiring as appropriate,[7] compensatory damages, and punitive damages.[8] The question then becomes whether a payment for the plaintiff's increased tax is an appropriate form of compensatory damages.

[3] BLACK'S LAW DICTIONARY 416 (8th ed. 2004).

[4] 25 C.J.S. *Damages* §1.

[5] *Id.*

[6] 42 U.S.C. §2000e *et. sec.*

[7] 42 U.S.C. §2000e-5(g).

[8] 42 U.S.C. §1981 or 1981a. Federal law provides slightly different routes to nearly the same remedies depending on whether the underlying claim is based on race and national origin on the one hand or religion and gender on the other. Under Title VII of the Civil Rights Act of 1964 as originally enacted, a case based on sex or religion was afforded less potential recovery than a case based on race or national origin. This is because claimants basing their suit on racial discrimination could also seek remedies under the 1870 Civil Rights Act. Currently codified at 42 U.S.C. §1981, the earlier act had been found to authorize compensatory and punitive damages while the 1964 Act did not. *See* Johnson v. Railway Express Agency, Inc., 421 U.S. 454 (1975). The Civil Rights Act of 1991 added 42 U.S.C. §1981a for those parties who are not eligible to bring suit under the 1870 Act. This section added compensatory and punitive damages to the list of remedies available under Title VII of the 1964 Civil Rights Act, the Americans with Disabilities Act, and the Rehabilitation Act of 1973. One major difference between the two sets of remedies is that §1981a contains caps on the amounts of compensatory and punitive damages that may be awarded.

## II. THE EARLY "YES" CASE—SEARS V. ATCHISON

In its 1984 opinion in *Sears v. Atchison, Topeka & Santa Fe Railway Co.*[9] the Tenth Circuit Court of Appeals upheld a district court's award of a tax component.[10] In this case, the Tenth Circuit considered a union's appeal in a class action by African American train porters alleging that an employer railroad and union had discriminated on the basis of race in violation of Title VII of the Civil Rights Act.[11] The district court awarded class members back pay for a period in excess of seventeen years. In addition, the district court awarded a tax component to the class members to compensate for the fact that these class members would be in a higher tax bracket for the year in which they received the award.[12]

The *Sears* district court gave several reasons for its inclusion of taxes as part of its award. The court stated that, although Title VII contained no "direct authority" for a tax award, an equitable remedy was appropriate based upon "general principles underlying the Title VII remedy."[13] The district court stated that "Title VII does contemplate 'compensation' for lost earnings, and we believe this must include all economic effects of the wrongful discrimination."[14] The *Sears* district court quoted the U.S. Supreme Court, stating as follows:

> Where racial discrimination is concerned, "the [district] court has not merely the power but the duty to render a decree which will so far as possible eliminate the discriminatory effects of the past. . . ." [15] [T]o make the victims of unlawful discrimination whole, . . . persons aggrieved by the consequences and effects of the unlawful employment practice [should] be, so far as possible, restored to a position where they would have been were it not for the unlawful discrimination.[16]

The district court noted that the discrimination in *Sears* had been perpetrated for almost a century, and more than seventeen years had elapsed between the effective date of Title VII and the date of the district court's opinion.[17] The district court stated that the discrimination perpetrated by the defendant was the cause of the plaintiffs' receipt

[9] 749 F.2d 1451 (10th Cir. 1984).
[10] *Id.* at 1456-7.
[11] 42 U.S.C.S. §§ 2000e-2000e-17 (2000).
[12] 1982 U.S. Dist. LEXIS 16862 (D. Kans. 1982).
[13] *Id.* at *20.
[14] *Id.* at *19.
[15] *Id.* at *20 (quoting Albemarle Paper Co. v. Moody, 422 U.S. 405, at 418 (1975)).
[16] *Id.* at *21 (quoting Albemarle Paper Co. v. Moody, 442 U.S. 405, at 420 (1975). The Supreme Court in *Albemarle* was, in turn, quoting a portion of the Congressional Record. (118 Cong.Rec. 7168 (1972)).
[17] *Sears,* 1982 U.S. Dist. LEXIS 16862 at *19-20.

of a large sum of back pay in one year instead of receiving it over several years in the normal course of employment. The discriminatory actions of the defendant caused the plaintiffs to be in a higher tax bracket for the year of recovery of the back pay. Therefore, the defendant "must bear the financial responsibility for restoring plaintiffs to the positions they would have been in without the discriminatory seniority system."[18]

The Tenth Circuit in *Sears* upheld the district court's award of the tax component.[19] While the Tenth Circuit held that such an award might not always be warranted, the court reasoned that a tax component award is appropriate in a case with a "protracted nature" such as the *Sears* case because the class members would be placed in the highest tax bracket by the award.[20] The U.S. Supreme Court denied the writ of certiorari in *Sears.*[21]

Some other district courts and state courts have also added tax gross-ups to back pay awards in cases where anti-discrimination laws were violated.[22] For example, the district court in *O'Neill v. Sears, Roebuck and Co.*,[23] a case under the Age Discrimination in Employment Act (ADEA),[24] granted the plaintiff a tax gross-up on front pay and back pay. The court stated that "[t]he goal of the ADEA is to allow plaintiff to keep the same amount of money as if he had not been unlawfully terminated."[25] The court quoted an old advertisement that said "[i]t's not how much money you make, it's how much money you keep."[26] However, the *O'Neill* court did not award a tax gross-up on the compensatory and liquidated damages in the case because that would constitute a "windfall" to the plaintiff rather than simply making the plaintiff whole pursuant to the intention of the anti-discrimination laws.[27]

[18] *Id.* at *21-22.

[19] 749 F.2d at 1456-7.

[20] *Id.* at 1456.

[21] United Tranp. Union v. Sears, 471 U.S. 1099 (1985).

[22] *See, e.g.,* Blaney v. International Assoc. of Machinists and Aerospace Workers, 87 P.3d 757 (Wash. 2004) (interpreting Washington's Law Against Discrimination, Wash. Rev. Code § 49.60.010 et seq., broadly to permit tax gross-up of an award, but treating it as a separate equitable remedy rather than actual damages or costs of suit); Ferrante v. Sciaretta, 839 A.2d 993 (N.J. Super. 2003) (broadly construing New Jersey Laws Against Discrimination, N.J. Stat. Ann. § 10:5-3, to permit tax gross-up of an award).

[23] 108 F. Supp. 2d 443 (E.D. Pa. 2000).

[24] 29 U.S.C. §§ 621 et seq. (2000).

[25] *O'Neill*, 108 F. Supp. 2d at 447.

[26] *Id*.

[27] *Id.* at 448. The *O'Neill* court stated:

> Mr. O'Neill would have earned the backpay and front pay had the defendant not unlawfully terminated him. Therefore, he is entitled to receive the value of front pay and backpay that he would have received over his work life. That value is diminished when the lump sum is taxed at a higher level. Therefore, in order for

Also, a Florida district court recognized the appropriateness of a tax gross-up in a Title VII sex discrimination case in *EEOC v. Joe's Stone Crab, Inc.*[28] The court stated that "[t]his accords with a prevailing practice in the settlement of Title VII suits which commonly include an amount to offset the plaintiff/taxpayer's increased liability."[29] However, the court denied a tax gross-up in *Joe's Stone Crab, Inc.* because the EEOC did not provide "sufficient competent foundation evidence to permit the court to make these calculations."[30]

In *Arneson v. Sullivan,*[31] the Eighth Circuit Court of Appeals considered tax enhancement to an award in a Rehabilitation Act of 1973[32] case. The district court held that a tax enhancement was not always warranted, but in the case of "protracted" employment discrimination litigation it would be appropriate. The district court in *Arneson* added a tax enhancement component to the employee's nine-year back pay award, but the Eighth Circuit Court of Appeals reversed this decision. The Eighth Circuit analogized such a tax enhancement to a prejudgment interest recovery "as an element of making persons whole for discrimination injuries."[33] However, since Congress had not waived sovereign immunity as to a tax enhancement, the court held that the plaintiff in *Arneson* was not entitled to such an enhancement from the defendant Department of Health and Human Services, because the defendant was a governmental employer with sovereign immunity. In another case, the Eighth Circuit affirmed a district court's decision to deny a tax gross-up to an employee who was awarded back pay, front pay, pension benefits, and attorney's fees for sexual discrimination under Title VII in 1993, not because the Eighth Circuit disapproved of tax gross-ups, but because the employee did not present evidence or a method for calculation of this amount. [34]

The cases described above indicate the following arguments in favor of tax gross-ups: (1) This is a form of equitable relief authorized by the

> Mr. O'Neill to be made whole, he is entitled to an award of the negative tax consequences on the backpay and front pay portions of the jury's award.
> The compensatory and liquidated damages, however, are only a product of this lawsuit. Mr. O'Neill would not have received these sums but for the defendant's discriminatory action. Hence, allowing the plaintiff to recover the increased tax he will have to pay on these sums does more than make him whole. It gives the plaintiff a windfall.

*Id.*

[28] 15 F. Supp. 2d 1364 (S.D. Fla. 1998).

[29] *Id.* at 1380.

[30] *Id.*

[31] 128 F.3d 1243, 1247 (8th Cir. 1997) *reversing* 958 F. Supp. 443 (E.D. Mo. 1996).

[32] 29 U.S.C. §§ 701-796 (2000).

[33] *Arneson,* 128 F.3d 1243, 1247 (8th Cir. 1997).

[34] Hukkanen v. Int'l Union of Operating Engineers, 3 F.3d 281 (8th Cir. 1993).

anti-discrimination statutes because it is an element of making the plaintiffs whole; (2) The defendant who engaged in discrimination, not the plaintiff who was the innocent victim of discrimination, should bear the burden for any tax increases resulting from the discrimination; (3) "But for" the discriminatory actions of the defendant in a discrimination case, the plaintiff would not be thrust into a higher tax bracket, so justice requires that the defendant pay the tax gross-up; (4) A tax gross-up is an additional deterrent for discriminatory behavior; (5) The tax gross-up is analogous to prejudgment interest which is universally allowed by courts. The tax gross-up, like prejudgment interest, compensates the plaintiff for the defendant's delay in paying sums rightfully due to the plaintiff; (6) The more protracted the litigation, the more burdensome the tax may be to plaintiffs receiving a lump sum back pay award; (7) Common practice in settlement of discrimination cases is to include a tax gross-up in the settlement; and (8) It is fair and just to make victims of discrimination as whole as if the discrimination had not occurred.

## III. THE "NO" CASE – DASHNAW V. PENA

In the 1994 case of *Dashnaw v. Pena,*[35] the U.S. Court of Appeals for the District of Columbia Circuit denied a gross-up of a plaintiff's award for increased tax liability. The *Dashnaw* case was filed by an employee under the Age Discrimination in Employment Act.[36] In *Dashnaw,* the D.C. Circuit affirmed the judgment in favor of the plaintiff employee for age discrimination because promotions were given to younger employees based upon age.[37] Therefore, the plaintiff was entitled to back pay in a lump sum. The plaintiff requested that the court increase the award to cover tax liability that would result from the receipt of this pay in a lump sum instead of over the period of years that it would have been received had the age discrimination not occurred.

The *Dashnaw* court denied the plaintiff's request for a "gross-up" of the award based upon increased tax liability because the court was unable to find authority for such relief. The court stated, "[g]iven the complete lack of support in existing case law for tax gross-ups, we decline so to extend the law in this case."[38] Therefore, the D.C. Circuit disagreed with the Tenth Circuit's *Sears* holding. The U.S. Supreme Court denied the writ of certiorari in *Dashnaw*.[39]

[35] 12 F.3d 1112 (D.C. Cir. 1994).

[36] 42 U.S.C. § 633a (2000).

[37] However, the D.C. Circuit reversed the judgment in favor of the plaintiff to the extent it was based upon the grounds of constructive discharge. *Dashnaw,* 12 F.3d 1112.

[38] *Dashnaw,* 12 F.3d at 1116.

[39] Dashnaw v. Pena, 513 U.S. 959 (1994).

Similarly, in 2007 the D. C. Circuit reversed a district court's grant of a fourteen percent "gross up" of a back pay award to account for increased tax liability resulting from the lump sum payment in *Fogg v. Gonzales.*[40] The *Fogg* case involved an employee's race discrimination claim under Title VII of the Civil Rights Act. The district court's award of back pay was affirmed, but the D.C. Circuit reversed the grant of a tax gross-up by the district court because the district court's decision was directly contrary to *Dashnaw.* The employee argued that *Fogg* was distinguishable from *Dashnaw* because of the lengthy litigation delays in *Fogg* and the large award in *Fogg.* However, the D.C. Circuit held that these factors were not relevant to its decision because there was simply no authority for a tax gross-up.[41]

Some courts have subsequently followed the *Dashnaw* holding. For example, in *Pollard v. E.I. Dupont DeNemours, Inc.,*[42] a sexual harassment case under Title VII, the Tennessee district court held that the plaintiff was not entitled to a tax gross-up based upon the increased tax burden on the plaintiff from a lump sum front pay award because "[s]uch an award would contradict the literature and case law on this topic."[43] Similarly, in *Best v. Shell Oil Co.,*[44] an Americans with Disabilities Act[45] case, the district court cited *Dashnaw* to hold that "the general rule that victims of discrimination should be made whole does not support 'gross-ups' of back pay to cover tax liability."[46] Therefore, the *Best* court upheld the employer's position that the employee, not the employer, should bear the responsibility for the employee's taxes.

Similarly, in *EEOC v. Federal Express Corp.*,[47] a Title VII sex discrimination case, a Pennsylvania district court stated that the award of a tax gross-up was not appropriate in a "typical Title VII case." The court did award prejudgment interest. However, even though the plaintiff's effective tax rate would jump from an estimated 10.13% to an estimate 27.65% due to the lump sum payment, the court denied the tax gross-up as "too speculative and without adequate legal support."[48]

The District Court in the District of Columbia distinguished tax gross-ups on back pay awards from tax gross-ups on attorney's fee awards in the Title VII case of *Porter v. U.S. Agency for International*

[40] 492 F.3d 447 (D.C. Cir. 2007).
[41] *Id.* at 455-456.
[42] 338 F. Supp. 2d 865 (W.D. Tenn. 2003).
[43] *Id.* at 883.
[44] 4 F. Supp. 2d 770 (N.D. Ill. 1998).
[45] 42 U.S.C. §§ 12101-12213 (2000).
[46] Dashnaw v. Pena, 12 F.3d 1112, 1115 (D.C. Cir. 1994), *quoted in* Best, 4 F. Supp. 2d at 776.
[47] 537 F. Supp. 2d 700 (M.D. Pa. 2005).
[48] *Id.* at 720.

*Development.*[49] In that case the court mentioned that sometimes plaintiffs have a tax problem if they must pay tax on an entire award, even if a percentage of that award has been assigned to the plaintiff's attorney as an attorney's fee. Due to this tax burden, plaintiffs who prevail could be worse off than if they had never filed suit. The court stated that it had the equitable power to gross up the award to make the plaintiff whole in the *Porter* case, unlike *Dashnaw* because "[a] backpay award, . . . , unlike an award of attorneys' fees, is actually income to the plaintiff. It might be argued that a gross-up award unfairly penalizes the defendant for something that is not the defendant's fault, but so (for example) does a fee award that makes adjustments to the lodestar to compensate for difficulty and risk."[50] Nevertheless, the court in *Porter* found it unnecessary to gross-up the attorney fee award for taxes, because it made the award payable directly to the attorneys instead of the plaintiff.

The district court in *Pappas v. Watson Wyatt & Co.*[51] denied the plaintiff's request for a tax gross-up for her COBRA payments, penalties and interest, and attorney's fee award because "it is not normally the role of this Court to correct for any claimed inequity in the application of the tax code."[52] In addition, the court was unable to predict with any precision the exact tax consequences of the award to the plaintiff. [53]

The cases described in this section indicate the following arguments against tax gross-ups: (1) There is no specific authority in the statutes for this type of remedy. If legislators desired this remedy, they would have written it in the statutes; (2) It is the role of Congress, not the courts, to remedy any unfairness in the Internal Revenue Code; (3) A defendant should not be required to pay a gross-up because the causation link between the defendant's discriminatory action and the increased tax to the plaintiff is too tenuous or remote; (4) The tax gross-up is different from the universally accepted prejudgment interest. Defendants should pay prejudgment interest because defendants have reaped the benefit (time use of money) by holding back pay that rightfully belonged to the plaintiffs. However, there is no corresponding benefit to defendants in connection with the tax gross-up; (5) Employees should pay income tax on back pay because it is income to the

[49] 293 F. Supp. 2d 152 (D.D.C. 2003).

[50] *Id.* at 156 (citing Copeland v. Marshall, 641 F.2d 880, 892-93 (D.C. Cir. 1980)).

[51] 2008 U.S. Dist. LEXIS 34 (D. Conn 2008).

[52] *Id.* at *39.

[53] *Id. See also* Kelley v. City of Albuquerque, 2006 U.S. Dist. LEXIS 28785 (D.N.M. 2006) (court denied plaintiff's request to amend jury award to add tax gross-up because the Seventh Amendment of the U.S. Constitution does not permit the reexamination of a jury award).

employees; and (6) The amount of the tax component may be difficult to calculate or may be speculative.

## IV. THE LASTEST "YES" CASE—ESHELMAN V. AGERE

In the 2009 opinion in *Eshelman v. Agere Systems, Inc.*,[54] the Third Circuit Court of Appeals affirmed the district court's award of a tax gross-up to a cancer-survivor employee who received a back pay award based upon a violation of the Americans with Disabilities Act (ADA).[55] The Third Circuit in *Eshelman* disagreed with the D.C. Circuit's holding in *Dashnaw*.[56] Instead, the Third Circuit adopted the reasoning of the Tenth Circuit in *Sears* that "the trial court has wide discretion in fashioning remedies to make victims of discrimination whole."[57] The Third Circuit noted that "but for" the defendant's violation of the ADA, the plaintiff would not receive her back pay in a lump sum in one year. Therefore, "but for" the defendant's violation of the ADA, the plaintiff would not be forced to pay higher taxes on this back pay due to placement in a higher tax bracket during the year of the lump sum payment. The Third Circuit permitted the tax gross-up to "make whole" the plaintiff and "restore the employee to the economic status quo that would exist but for the employer's conduct."[58] The Third Circuit cited the "broad equitable powers" given to the district court by the ADA.[59]

The Third Circuit further analogized the grant of a tax gross-up to the practice of granting prejudgment interest on back pay awards. The grant of prejudgment interest on back pay awards is accepted by all of the United States Courts of Appeals because it is necessary to compensate the plaintiffs for their inability to have the use of the money that would have been available to them absent the discrimination by their employer. The purpose of the practice of awarding the prejudgment interest on back pay awards is to "make whole" the employees who have been victimized by their employers' discrimination.[60] Similarly the tax gross-up helps make such employees whole.[61]

For these reasons, the Third Circuit in *Eshelman* held that the district court had the power to increase the plaintiff's award to include

[54] 554 F.3d 426 (2009).

[55] 42 U.S.C. §§ 12101-12213 (2000).

[56] *Eshelman*, 554 F.3d at 441.

[57] Sears v. Atchison, Topeka & Santa Fe Railway Co., 749 F.2d at 1456, *quoted in Eshelman*, 554 F.3d at 441.

[58] In re Continental Airlines, 125 F.3d 120, 135 (3rd Cir. 1997), *quoted in* Eshelman, 554 F.3d at 442.

[59] *Eshelman*, 554 F.3d at 441-442.

[60] *Id.* at 442 (citing Loeffler v. Frank, 486 U.S. 549, 557 (1988); Booker v. Taylor Milk Co., 64 F.3d 860, 868 (3rd Cir. 1995)).

[61] *Eshelman*, 554 F.3d at 441-443.

the increased tax burden to the plaintiff resulting from the lump sum back pay award.[62] However, the Third Circuit hastened to add that *Eshelman* should not be read to create a presumption that discrimination case plaintiffs are always entitled to a tax gross-up. The Third Circuit stated that this determination must be made on a case by case basis, with employees bearing the burden of proving that the tax gross-up is necessary to make them whole.[63]

## V. DISCUSSION

The federal courts have the authority under 42 U.S.C. §§1981 and 1981a to award a wide variety of compensatory damages. The Third, Tenth and maybe Eighth Circuits allow tax gross-up payments as compensatory damages. If the only test for a compensatory damage award is that it is necessary to make the plaintiff whole, then tax gross-up payments meet that test.

Some of the courts that have chosen not to award tax gross-up payments have made multiple arguments against the payments, but the only circuit court to rule "no" had a single basis. The D.C. Circuit Court's conclusion in *Dashnaw* was supported only by the statement that there was no evidence in existing case law for this type of remedy. The D.C. Circuit has, however, stuck by this position as evidenced by its ruling in *Fogg*.

It is not as clear that the federal courts should take advantage of this authority. Some of the arguments made in the "No" cases discussed above have merit beyond what a court may be allowed to do. The additional tax can be no better than an estimate based on many variables. Each individual plaintiff's tax situation will be unique, will be dependent on factors outside of the lawsuit, and cannot be determined at the time that the damages will be awarded and paid. At best, the plaintiff will be able to project or estimate his or her tax liability for the year and compare it to past years' results. Some might argue that this is no different from calculating front-pay or back-pay based on estimates provided by the parties. The two concepts are different in that the plaintiff's tax liability will be determinable at some point in time, whereas the calculation of the other types of remedies will always be based on what might have been had the defendant not engaged in the discriminatory practice.

A second problem is that tax gross-up awards are not the same as interest. As noted above, defendants are commonly required to pay interest on back pay awards. This compensates the plaintiff for the time value of money associated with the unpaid damage award. The

[62] *Id.* at 441-442.
[63] *Id.* at 443.

defendant had the use of the money for the intervening period, and there is some matching between the plaintiff's and defendant's situation. With taxes, the defendant is being asked to compensate the plaintiff for additional payments made to a third party.

A third problem with tax gross-up awards is that that they seem to be something other than compensatory payments. The defendant is obligated to make the plaintiff whole for the injury caused, and there is no requirement that a compensatory damage award be designed to mitigate a benefit that the defendant enjoyed. However, these payments could easily be viewed as consequential damages rather than compensatory damages. They go beyond what is a foreseeable result of the defendant's conduct.

It is also not as clear that the United States Supreme Court should grant *certiorari* just to resolve this issue. The dollar amount for any given taxpayer will be small, and the decision to award a tax gross-up damage award represents an application of the trial court's discretion. In the event that the Supreme Court does review a case that includes this issue, the court ought to side with the Third and Tenth Circuit Courts of Appeals.

The best way to provide the plaintiff with relief from being pushed into a higher marginal tax bracket would be in the form of a change to the tax code. Although there are many potential solutions, a simple one exists in the form of the income averaging provisions given to farmers and fishermen.[64] Farmers and fishermen may calculate their income tax liability by electing to spread some of their current year farming or fishing income equally over the three years preceding the current year. Their tax liability for the current year is the sum of the recalculated tax liability for each of the three prior years plus the tax liability on the current year's income without the elected income.[65] It is likely that the current highest marginal rate will increase soon and many Americans could benefit from income averaging. It is perhaps more likely that the costs of a general increase in income averaging cannot be justified in today's economic climate. However, Congress has already recognized the need to mitigate the additional taxes on judgments and settlements in a special provision related to the Exxon Valdez settlement. Beginning October 3, 2008, qualified taxpayers who receive settlements or judgments related to the Exxon Valdez oil spill are treated as fishermen

[64] 26 U.S.C. §1301. Between 1976 and 1986, income averaging was available to most taxpayers who had large fluctuations in their earnings from year to year. Prior 26 U.S.C. §§1301–1305 allowed taxpayers to average their income over a four-year period. The current rules were extended to farmers beginning in 1998 and fishermen beginning in 2004.

[65] 26 U.S.C. §1301.

for purposes of income averaging.[66] Congress could easily extend this provision to individuals who receive a judgment or settlement related to violations of civil rights laws.

## VI. CONCLUSION

Even though the federal circuit courts of appeals are split on the issue, the better interpretation of the question presented in this paper is that the federal courts do have the authority to award tax gross-up payments. However, for the reasons noted above, this is not the best solution. Instead, the best way to deal with a problem caused by the intricacies of the Internal Revenue Code is by modifying the Internal Revenue Code itself. This could be easily done by allowing successful plaintiffs in civil rights cases to take advantage of the income averaging provisions already in the Internal Revenue Code.

[66] Division C, Act Sec. 504(a) of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). Sec. 504(b) of the 2008 Act also allows the taxpayer the choice to contribute up to $100,000 to a retirement plan and exclude the contribution from income, and Sec. 504(c) of the 2008 Act excludes all of the settlement or judgment award from FICA and Self-Employment taxation.

# RECENT TAX TREATY PROVISIONS AS CONTAINED IN THE NEWLY REVISED U.S.—CANADA TAX TREATY

by ROBERT E. SHAPIRO*

## I. INTRODUCTION

The Fifth Protocol[1] to the U.S.-Canada Tax Treaty entered into force on December 15, 2008.[2] The Protocol signed at Chelsea, Ontario, Canada, on September 21, 2007 amended the Tax Treaty between the United States of America and Canada.[3] The Canadian government finalized legislation to implement the Fifth Protocol in December, 2007 with the passage into law of Bill S-2 which completed Canada's portion of the approval process. The United States Senate ratified the Treaty on September 23, 2008. After the appropriate exchange of notes, the new Treaty went into force.

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1 A protocol is a treaty amending and supplementing another treaty. BLACK'S LAW DICTIONARY 1261 (8th ed. 2004)

2 Davies, Ward, Phillips & Vinberg, Flash: The Fifth Protocol to the Canada-U.S. Tax Treaty Comes Into Force, http://www.dwpv.com/en/17620_23110.aspx (last visited Jun. 17, 2009).

3 Protocol Amending 1980 Tax Convention with Canada, U.S.-Can., Sep. 21, 2007, S. Treaty Doc. 110-15 [hereinafter Treaty], *available at* http://www.fin.gc.ca/treaties-conventions/USA_1-eng.asp. *See also* Catherine Brown & Christine Manolakas, *Tax Discrimination and Trade in Services: The Search for a Balance in Canada-U.S. Relations*, 40 GEO. J. INT'L L. 3 (2008).

This paper will discuss some of the new provisions of the Treaty. In particular, it will discuss (1) elimination of withholding taxes on cross-border interest payments, (2) extension of treaty benefits to limited liability companies and other "transparent entities," (3) provision of access to arbitration for addressing certain double taxation issues, and (4) circumstances in which an enterprise resident in one country that provides services in the other country will be considered to have a permanent establishment in that other country.

## II. WITHHOLDING OF TAXES ON CROSS-BORDER INTEREST PAYMENTS

Cross-border interest payments are no longer subject to withholding taxes. The elimination of withholding taxes on all cross-border interest payments between the United States and Canada has been a top tax treaty priority for both the business community and the Treasury Department for many years. The prior Treaty generally provided for a source-country withholding tax rate of ten percent.[4]

The Treaty now provides for exclusive residence-country taxation of interest. Consistent with U.S. tax treaty policy, the Treaty also provides exceptions to the elimination of source-country taxation with respect to contingent interest and payments from a U.S. real estate mortgage investment conduit.[5] In addition, there are limited exceptions which permit source-country taxation of interest if the beneficial owner of the interest carries on, or has carried on, business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment.[6]

## III. FISCALLY TRANSPARENT ENTITIES

Canada has historically denied transparent entities or flow-through entities any treaty benefits. For example, Canada did not extend treaty benefits to a United States Limited Liability Company (LLC). The LLC was treated by the Canadian Revenue Authority as a U.S. corporation but not as a resident under the treaty. Under the prior treaty, a U.S. "resident" had to be subject to U.S. taxation. However, since the U.S. did not tax the LLC but rather taxed the members themselves, Canada asserted that the LLC was not a resident and therefore could not claim treaty benefits. Now under the treaty, Canada will look through a non-

[4] *Hearing Before the Senate Comm. On Foreign Relations on Pending Income Tax Treaties*, 111th Cong. (2008) (statement of Michael F. Mundaca, Treasury Deputy Assistant Secretary for International Affairs) [hereinafter Mundaca Testimony].

[5] Treaty, *supra* note 3, art. XI, ¶¶ 6(a)-(b).

[6] Treaty, *supra* note 3, art. IV, ¶¶ 6-7.

Canadian transparent entity and treat the income as earned by the member not the entity.

Article IV (Residence) of the Treaty permits a U.S. person to claim the benefits of the treaty when that person derives income through an entity that is considered by the United States to be fiscally transparent (e.g., a partnership). However, if the entity is a Canadian entity it generally is not treated by Canada as fiscally transparent and therefore cannot claim the benefits of the treaty. The Department of the Treasury has issued a Technical Explanation of the Treaty.

> The Technical Explanation is an official United States guide to the Protocol. The Government of Canada has reviewed this document and subscribes to its contents. In the view of both governments, this document accurately reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol and the Convention.[7]

As a general rule, a fiscally transparent entity is one in which the beneficiary, member, or participant is taxed at the beneficiary, member, or participant level rather than at the entity level. Entities that are fiscally transparent for U.S. tax purposes include partnerships, common investment trusts under section 584, grantor trusts, and business entities such as an LLC that is treated as a partnership or is disregarded as an entity separate from its owner for U.S. tax purposes.[8]

United States tax law also considers a corporation that has made a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code (an "S corporation") to be fiscally transparent within the meaning of the Treaty. Thus, if a U.S. resident derives income from Canada through an S corporation, the U.S. resident will under new paragraph 6 of Article IV be considered for purposes of the Convention as the person who derived the income.[9]

Pursuant to Article IV of the Treaty, the treatment of an amount of income, profit or gain derived by a person through a fiscally transparent entity under the tax law of the United States is "the same as its treatment would be if that amount had been derived directly."[10]

Therefore, under the present treaty if a United States LLC is wholly owned by a resident of the U.S. which carries on business in Canada through a permanent establishment and is fiscally transparent for U.S.

[7] Internal Revenue Service, Department of the Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, *available at* http://www.treas.gov/press/releases/reports/tecanada08.pdf [hereinafter Technical Explanation].

[8] *Id.* at 3.

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

[10] Treaty, *supra* note 3, art. IV ¶ 6(b).

purposes, then the United States LLC's profits will be treated as having been derived by its U.S. resident owner inclusive of all attributes of that income (e.g., such as having been earned through a permanent establishment). However, since the United States LLC remains the only "visible" taxpayer for Canadian tax purposes, it is the United States LLC, and not the U.S. shareholder, that is subject to tax on the profits that are attributable to the permanent establishment.[11]

## IV. SERVICE PERMANENT ESTABLISHMENTS

Article V (Permanent Establishment) of the Treaty now contains provisions whereby an enterprise of one country that provides services in the other country may be deemed to have a permanent establishment when it is operating in the other country. This provision does not apply if the enterprise is already considered to have a permanent establishment in that other country. If (and only if) such an enterprise meets either of two tests as provided in subparagraphs 9(a) and 9(b) of Article V of the new treaty, the enterprise will be deemed to provide those services through a permanent establishment in the other country.[12]

The test to determine whether the enterprise is a permanent establishment as set forth in subparagraph 9(a) has two parts:

> First, the services must be performed in the other country by an individual who is present in that other country for a period or periods aggregating 183 days or more in any twelve-month period. This rule refers to days in which an individual is present in the other country. Accordingly, physical presence during a day such as on a holiday or weekend is sufficient for purposes of subparagraph 9(a).
> Second, during that period or periods, more than fifty percent of the gross active business revenues of the enterprise (including revenue from active business activities unrelated to the provision of services) must consist of income from the services performed in that country by that individual. For this purpose, the term "gross active business revenue" means the gross revenues attributable to active business activities that the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes. Such active business activities are not restricted to the activities related solely to the provision of services.[13] The enterprise may have revenue from other business activities. However, the term does not include income from passive investment activities.

[11] Technical Explanation, *supra* note 7, at 6.
[12] *Id.* at 10.
[13] *Id.*

If the enterprise meets both of the requirements of subparagraph 9(a), the enterprise will be deemed to provide the services through a permanent establishment. This test may be utilized to determine whether an enterprise is deemed to have a permanent establishment by virtue of the presence of a single individual (i.e., a natural person).

The application of this test is met in the following scenario. William Jones is a U.S. citizen residing in Boston Massachusetts. He is one of two employees of Back Bay, a company residing in Massachusetts and providing legal services. During the 12-month period beginning December 20, 2008 and ending December 19, 2009, Mr. Jones is present in Canada for a period totaling 183 days, and during that period, 65 percent of the gross active business revenues of Back Bay attributable to business activities are derived from the services that William Jones performs in Canada. Since both of the foregoing tests are met, Back Bay will be deemed to have a permanent establishment in Canada. For purposes of counting days, even if the enterprise sends many individuals simultaneously to the other country to provide services, their collective presence during one calendar day will count for only one day of the enterprise's presence in the other country. For instance, if a Back Bay sends seven employees to Canada to provide services to the client in Canada for thirty days, Back Bay will be considered present in Canada only for thirty days, not 210 days (7 employees x 30 days).[14]

There is a second test which can result in a service enterprise being treated as having a permanent establishment. This test is set forth in subparagraph 9(b) of Article V of the Treaty. Under these requirements, the services provided in the other country by an individual must be provided in that other country for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected projects for customers who are either residents of the other country or maintain a permanent establishment in the other country with respect to which the services are provided. The reason for this later requirement is to provide substance to the idea that unless there is a customer in the other country, such enterprise will not be deemed as participating sufficiently in the economic life of the other country to warrant being deemed to have a permanent establishment.

If we continue with the preceding example, assume that Trebor, Inc., a U.S. corporation, wishes to acquire Brad Communications, a company in Canada. In preparation for the acquisition, Trebor hires Back Bay, a U.S. law firm, to conduct a due diligence evaluation of Brad's legal and financial standing in Canada. Back Bay sends a staff attorney, William Jones to Canada to perform the due diligence analysis of Brad Communications. Jones is present and working in Canada for more than

[14] *Id.* at 12-13.

183 days. If the remuneration paid to Back Bay for the attorney's services does not constitute more than 50 percent of Back Bay's gross active business revenues for the period during which Jones is present in Canada, Back Bay will not be deemed to provide the services through a permanent establishment in Canada by virtue of subparagraph 9(a). Additionally, because the services are being provided for a customer (Trebor) who is neither a resident of Canada nor maintains a permanent establishment in Canada to which the services are provided, Back Bay will also not have a permanent establishment in Canada by virtue of subparagraph 9(b).

It should be noted that paragraph 9 applies only to services provided to third parties.[15] If William Jones provided services to Back Bay in Canada, that would not cause Back Bay to be treated as having a permanent establishment in Canada In addition, the relevant services must actually be furnished to a resident of the other country in that country. Where, for example, an enterprise provides customer support or other services by telephone or computer to customers located in the other country, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other country. Suppose as part of completing the project, William Jones must visit Brad's offices in Canada, his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that William Jones spends working on his report in his home office do not count for purposes of the 183-day threshold, because William Jones is not performing or providing those services within Canada.

A question can arise as to whether the taxpayer services can be aggregated in order to meet the threshold requirements. The purpose for the threshold requirements is to insure that the taxpayer is actually operating in the country. For this purpose, the United States and Canada agreed to permit the aggregation of services where there are connected projects.[16]

When the Protocol was signed, the United States and Canada exchanged two sets of diplomatic notes. Each of these notes set forth provisions and understandings related to the Protocol and the Treaty, and comprised an integral part of the overall agreement between the United States and Canada. The first note, the "Arbitration Note," related to the implementation of new paragraphs 6 and 7 of Article XXVI (Mutual Agreement Procedure), which provide for binding arbitration of certain disputes between the competent authorities. The

[15] *Id.* at 14.
[16] Treaty, *supra* note 3, art. V ¶ 9(b).

second note, the "General Note," relates more generally to issues of interpretation or application of various provisions of the Protocol.[17]

The General Note provides that for purposes of subparagraph 9(b), projects shall be considered to be connected if they constitute a coherent whole. To determine whether projects constitute a coherent whole, the projects are viewed from the point of view of the enterprise (i.e., from the point of view of Back Bay and not Trebor in the preceding example) and this determination will depend on the facts and circumstances of each case. The projects are considered a coherent whole when they are viewed both commercially and geographically.[18]

In determining the existence of commercial coherence, factors that would be relevant include; 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but not determinative, in finding that projects are commercially coherent. This aggregation rule is intended to prevent abusive situations in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. For example, assume that William James' work will take ten months to complete. However, Back Bay purports to divide the work into two five-month projects with the intention of circumventing the rule in subparagraph 9(b). In such case, even if the two projects were considered separate, they will be considered to be commercially coherent.

On the other hand, suppose a technology consultant is hired to install a particular computer system for a Canadian company, and is also hired by that same company, under a separate contract, to train its employees on the use of another computer program that is unrelated to the first system. In that situation, even though the contracts are both concluded between the same two parties, there is no commercial

[17] Exchange of Letters Constituting and Agreement Expanding Upon Article XXVI of the Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, Signed at Washington on September 26, 1980, *available at* http://www.treaty-accord.gc.ca/ViewTreaty.asp?Treaty_ID=105100. Note No. JLAB-0111 exchanged at the signing of the Protocol is the "Arbitration Note [hereinafter Arbitration Note]" and Note No. JLAB-0112 is the "General Note [hereinafter General Note]." Although the Notes were issued by Canada, there was attached to each Note the statement that the United States agrees that the "Note . . . together with this reply, shall constitute an Agreement between the United States of America and Canada." *Id.*

[18] General Note, ¶ 2.

coherence to the two projects, and the time spent fulfilling the two contracts may not be aggregated for purposes of subparagraph 9(b).[19]

As previously indicated, there is an additional requirement of geographic coherence if the two projects are to be considered to be connected, and therefore aggregated for purposes of subparagraph 9(b). An example of projects that lack geographic coherence would be a case in which a David Smith, a U.S. accountant is hired to execute separate auditing projects at different branches of a Canadian bank located in different cities pursuant to a single contract. Although the consultant's projects are commercially coherent, they are not geographically coherent and accordingly the services provided in the various branches would not be aggregated for purposes of applying subparagraph 9(b). The services provided in each branch should be considered separately for purposes of subparagraph 9(b).

Another important factor with respect to subparagraph 9(b) is the method of counting days. Subparagraph 9(b) refers to days during which services are provided by the enterprise in the other country. Accordingly, non-working days such as weekends or holidays would not count for purposes of subparagraph 9(b), as long as no services are actually being provided while in the other country on those days. Thus, this rule differs from the counting rule for subparagraph 9(a).

It is interesting to note that the Treasury Department has indicated that although the U.S.–Canada Tax Treaty contains a provision allowing services to create a permanent establishment, this is not presently U.S. treaty policy. Deputy Assistant Treasury Secretary for International Tax Affairs Michael Mundaca told the U.S. Activities of Foreigners and Tax Treaties Committee of the American Bar Association on January 18, 2008, that the provision in the U.S.–Canada Treaty "doesn't signal a change in the U.S. policy or in the opposition to this as a general rule." He acknowledged that a Permanent Establishment services provision exists in the U.S. treaty with Bulgaria and in accords with smaller developing countries. Just because it is now in a treaty with United States' largest trading partner does not mean it is the future policy of the United States. However, the United States would not rule out the idea that this provision would not arise in future negotiations based on what the other party was offering, but cautioned that the United States would insist on a fair trade. "It is something this administration would consider in the context of the deal. And you would look at what you're getting. . . .[I]t is a concession. It's not something that should be bargained away lightly. . . . This has been an issue in the OECD. . . . This [provision] was not adopted in the OECD model. It was heavily

[19] Technical Explanation, *supra* note 7, at 14.

debated in the OECD. The U.S. was one of the countries that fought hard against that."[20]

## V. COMPETENT AUTHORITY ARBITRATION PROCESS

Under the usual mutual agreement procedures of most tax treaties, when a U.S. taxpayer becomes concerned about implementation of the treaty, the taxpayer can bring the matter to the U.S. competent authority who will seek to resolve the matter with the competent authority of the treaty partner. The competent authorities will work cooperatively to resolve genuine disputes as to the appropriate application of the treaty. The U.S. taxpayer initially presents a problem involving a determination by another country to the U.S. competent authority and participates in formulating the position that the U.S. competent authority will take in discussions with the other treaty partner. Now under the new U.S.-Canada Tax Treaty if the competent authorities cannot resolve the issue within two years,[21] the competent authorities must present the issue to an arbitration board for resolution, unless both competent authorities agree that the case is not suitable for arbitration.[22]

Not all matters are subject to arbitration. The only matters governed by these provisions are as follows:

- Article IV (Residence)(but only in so far as it relates to the residence of a natural person);
- Article V (Permanent Establishment);
- Article VII (Business Profits;
- Article IX (Related Persons); and
- Article XII (Royalties)(but only (i) insofar as Article XII might apply in transactions involving related persons to whom Article IX might apply, or (ii) to an allocation of amounts between royalties that are taxable under paragraph 2 thereof and royalties that are exempt under paragraph 3 thereof).[23]
- In addition, "the competent authorities may, on an ad hoc basis, agree that binding arbitration shall be used in respect of any other matter to which Article XXVI applies."[24]

[20] Alison Bennett, *Tax Treaties: Mundaca Emphasizes Services P.E. Provision In U.S.-Canada Tax Treaty Is Not U.S. Policy*, 13 BNA DAILY TAX REP. I-4 (Jan. 22, 2008).

[21] Treaty, *supra* note 3, art. XXVI, ¶ 7(a).

[22] *Id.* ¶¶ 7(c)(i), 6(b)(i)(B).

[23] Arbitration Note, *supra* note 17.

[24] *Id.*

The competent authority of Canada or the United States must initiate the arbitration proceeding. Generally, the arbitration proceedings are to begin two years after the commencement date of the case to the competent authorities.[25] The competent authority of the country then has sixty days from the date on which the Proceeding begins to appoint one member of the arbitration board. Subsequently, within the next sixty days, the two members of the arbitration board are to appoint a third member.[26]

Thereafter, within 60 days of the appointment of the chair of the arbitration board, each competent authority (U.S. and Canada) may submit a proposed resolution setting forth a proposed disposition of the specific monetary amounts of income, expense or taxation at issue in the case, and a supporting position paper, for consideration by the arbitration board.[27] It is possible for a competent authority to submit, within 120 days after the appointment of the chair, a reply to any the position paper of the other competent authority.[28] The arbitration board is to deliver its determination to the two competent authorities within six month after the appointment of the chair.[29]

The critical factor, however, is that the arbitration board must adopt as its determination one of the proposed resolutions submitted by Canada or the United States.[30] The determination reached by the arbitration board in the proceeding is limited to a determination regarding the amount of income, expense or tax reportable to the United States or Canada.[31] Furthermore, the determination of the arbitration board shall not state a rationale and the determination shall have no precedential value.[32]

The arbitration proceeding is mandatory and binding with respect to the competent authorities. Unless a taxpayer or other "concerned person" (in general, a person whose tax liability is affected by the arbitration determination)[33] does not accept the arbitration determination, it is binding on the treaty countries with respect to the case.[34] However, consistent with the negotiation process under the usual mutual agreement procedure,[35] the taxpayer can terminate the

[25] Treaty, *supra* note 3, art. XXVI, ¶ 7(c)(i).
[26] Arbitration Note, *supra* note 17, ¶ 5.
[27] *Id.*
[28] Treaty, *supra* note 3, art. XXVI, ¶ 7(c)(i).
[29] Arbitration Note, *supra* note 17, ¶ 5.
[30] *Id.*
[31] *Id.* at ¶ 7.
[32] *Id.* at ¶ 8.
[33] *Id.*
[34] *Id.* at ¶ 2.
[35] *Id.* at ¶ 8.

arbitration at any time by withdrawing its request for competent authority assistance. Moreover, the taxpayer retains the right to litigate the matter the United States or in Canada in lieu of accepting the result of the arbitration, just as it would be entitled to litigate in lieu of accepting the result of a negotiation under the usual mutual agreement procedure.

## VI. CONDITIONS IMPOSED ON THE TREATY BY THE UNITED STATES SENATE UPON RATIFICATION

The Joint Committee on Taxation in its testimony before the Senate Committee on Foreign Relations clearly indicated that there are many unresolved issues with respect to the arbitration process:

> It is still too early to assess the effect of the addition of mandatory arbitration provisions to the Germany and Belgium treaties on the competent authority processes with respect to those countries. Therefore, the Committee may wish to better understand how the Treasury Department intends to monitor the competent authority function, as well as arbitration developments with respect to other countries, to determine the overall effects of the new arbitration procedures on the mutual agreement process. The Committee may wish to consider what information is needed to measure whether the proposed arbitration procedures result in more efficient case resolution, both before and during arbitration, and whether they enhance the quality of the outcome of the competent authority cases. In addition, the Committee may wish to inquire as to whether and under what circumstances the Treasury Department intends to pursue similar provisions in other treaties.
>
> The Committee may also wish to consider certain specific features of the arbitration procedures included in the proposed protocol. For example, the mandatory arbitration procedure is available under the proposed protocol only with respect to certain articles specified by the treaty partners in diplomatic notes accompanying the protocol. The Committee may wish to inquire about the basis for selection of those particular articles and the implications of excluding the others. Other points that the Committee may wish to clarify include the extent to which decisions of the arbitration board will be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue and substantially similar facts, and the application of the mandatory arbitration procedures to competent authority cases already pending on the date on which the proposed protocol enters into force.[36]

[36] Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Protocol to the Income Tax Treaty with Canada and the Proposed Income Tax Treaties with Iceland and Bulgaria, Doc. No. JCX-60-08, 5-6 (2008), *available at* http://www.house.gov/jct/x-60-08.pdf [hereinafter Joint Committee on Taxation Testimony].

The Senate Foreign Relations Committee included in its report accompanying the Canada treaty, a condition requiring reports to be submitted to Congress relating to the arbitration provision. The Treasury Department is to submit to the Foreign Relations Committee, the Finance Committee, and the Joint Committee on Taxation the arbitration boards' rules of procedure, including conflict-of-interest rules to be applied to members of the arbitration board. This report is to be submitted within two years of the treaty entering into force and prior to the first arbitration.

In addition, as indicated in the Joint Committee on Taxation testimony that it was too early to assess the effectiveness of the arbitration mechanisms in the treaties with Germany and Belgium, Senate Foreign Relations Committee senators called for another report to update them on the status of all three arbitration mechanisms. Two months after a determination has been reached in the tenth arbitration proceeding conducted pursuant to any of the three treaties, the Treasury Department is to submit a report regarding the operation and application of the arbitration mechanism. This report is to include the aggregate number for each treaty of cases pending on the dates of entry into force; the number of cases resolved through a mutual agreement; the number of cases for which arbitration proceedings have commenced; with respect to disputes settled through arbitration, the amount of income, expense, or taxation at issue in the case and the proposed resolutions submitted by each competent authority to the arbitration board.[37]

[37] The Senate Foreign Relations Committee Report on U.S.-Canada Tax Treaty (Treaty Doc. 110-15) with Conditions. "The Senate advises and consents to the ratification of the Protocol Amending the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital … subject to … the condition of section 3.

> "Section 3. Condition
>
> The advice and consent of the Senate under section 1 is subject to the following condition:
>
> Report
>
> 1. Not later than two years from the date on which this Protocol enters into force and prior to arbitration conducted pursuant to the binding arbitration mechanism provided in this Protocol, the Secretary of Treasury shall transmit the text of the rules of procedure applicable to arbitration boards, including conflict of interest rules to be applied to members of the arbitration board, to the committee on Finance and Foreign Relations of the Senate and the Joint Committee on Taxation. The Secretary of Treasury shall also, prior to the first arbitration conducted pursuant to the binding arbitration mechanism provided for in the 2006 Protocol Amending the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (the "2006 German Protocol")(Treatry Doc. 109 0920) and the Convention

between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and accompanying protocol (the "Belgium Convention")(Treaty Doc. 110 093), transmit the text of the rules of procedure applicable to the first arbitration board agreed to under each treaty to the committees on Finance and Foreign Relations of the Senate and the Joint Committee on Taxation.

2. 60 days after a determination has been reached by an arbitration board in the tenth arbitration proceeding conducted pursuant to either this Protocol, the 2006 German Protocol, or the Belgium Convention, the Secretary of Treasury shall prepare and submit a detailed report to the Joint Committee on Taxation and the Committee on Finance of the Senate, subject to law relating to taxpayer confidentiality, regarding the operation and application of the arbitration mechanism contained in the aforementioned treaties. The report shall include the following information:

I. The aggregate number, for each treaty, of cases pending on the respective dates of entry into force of this Protocol, the 2006 German Protocol, or the Belgium Convention, along with the following additional information regarding these cases:

a. The number of such cases by treaty article(s) at issue;

b. The number of such cases that have been resolved by the competent authorities through a mutual agreement as of the date of the report; and

c. The number of such cases for which arbitration proceedings have commenced as of the date of the report.

II. A list of every case presented to the competent authorities after the entry into force of this Protocol. The 2006 German Protocol, or the Belgium Convention, with the following information regarding each and every case:

a. The commencement date of the case for purposes of determining when arbitration is available;

b. Whether the adjustment triggering the case, if any, was made by the United States or the relevant treaty partner and which competent authority initiated the case;

c. Which treaty the case relates to;

d. The treaty article(s) at issue in the case;

e. The date the case was resolved by the competent authorities through a mutual agreement, if so resolved;

f. The date on which an arbitration proceeding commenced, if an arbitration proceeding commenced; and

g. The date on which a determination was reached by the arbitration board, if a determination was reached, and an indication as to whether the board found in favor of the United States or the relevant treaty partner.

III. With respect to each dispute submitted to arbitration and for which a determination was reached by the arbitration board pursuant to this Protocol, the 2006 German Protocol, or the Belgium Convention, the following information shall be included:

a. An indication as to whether the determination of the arbitration board was accepted by each concerned person;

b. The amount of income, expense, or taxation at issue in the case as determined by reference to the filings that were sufficient to set the commencement date of the case for purposes of determining when arbitration is available; and

c. The proposed resolutions (income, expense, or taxation) submitted by each competent authority to the arbitration board.

The question then arises as to the effect of a "condition" attached to a Treaty. The Senate Foreign Relations Report does not include any language as to what would happen if the Treasury Department failed to submit the reports. One commentator has concluded, "It appears, however, that the condition does not prevent the ratification of the Protocol from proceeding in the regular way so that it will unconditionally come into force when the necessary instruments are executed and delivered. It simply creates an obligation on the Treasury … to be fulfilled in the future."[38]

## VI. CONCLUSIONS

The U.S.-Canada Tax Treaty helps solve certain problems such as the taxation of a United States LLC. In addition, it reaffirms the position that cross border interest between the United States and Canada will not be subject to a withholding tax. More interestingly, the Treaty may be ushering in a new era dealing with the creation of a Permanent Establishment based on the services performed rather than a fixed place of business and a new procedure for handling disputes between the two counties by requiring arbitration to resolve such disputes. These are new areas being handled by tax treaties and it will be interesting to see how these develop not only in this Treaty, but in how future treaties will be fashioned.

3. The Secretary of Treasury shall, in addition, prepare and submit the detailed report described in paragraph (2) on March 1 of the year following the year in which the first report is submitted to the Joint Committee on Taxation and the Committee on Finance of the Senate, and on an annual basis thereafter for a period of five years. In each report, disputes that were resolved, either by a mutual agreement between the relevant competent authorities or by a determination of an arbitration board, and noted as such in prior reports may be omitted."

[38] David R. Tillinghast, *The Continuing Saga of the U.S.-Canada Protocol: The Senate Foreign Relations Committee Adds a Condition,* 37 TAX. MGMT. INT'L J. 686 (2008).