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POLICYMAKING AT THE NLRB UNDER THE BUSH II, OBAMA AND NOW THE TRUMP LABOR BOARD: WHERE DO WE GO FROM HERE?

by David P. Twomey*

I. INTRODUCTION

With recent publications such as the *Wall Street Journal* article entitled: “Trump Appointees are Restoring Reason to the NLRB” and the publication of a book by the U.S. Chamber of Commerce entitled “The Record of the National Labor Relations Board in the Obama Administration: Reversals Ahead?” this article will examine the policy making process at the National Labor Relations Board (Labor Board or NLRB) under President George W. Bush (Bush II), President Barak Obama and now President Donald Trump.¹ It will discuss the evolving politicization of the Labor Board. It will present the U.S. Supreme Court’s analytical framework for reviewing administrative agency policymaking decisions, as set forth in its landmark *Chevron U.S.A. v. Natural Resources Defense Council, Inc.* decision.² Two decisions of the Labor Board will be evaluated under the *Chevron* standards. The article will conclude with comments on whether or not the agency is fulfilling its statutory mission to administer the National Labor Relations Act (NLRA or Act) according

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¹ Michael J. Lotito, *Trump’s Appointees Are Restoring Reason to the NLRB*, WALL ST. J., Feb. 1, 2018 at A15. OGLETREE DEAKINS, *THE RECORD OF THE NATIONAL LABOR RELATIONS BOARD IN THE OBAMA ADMINISTRATION*, (2017).

² 467 U.S. 837 (1984).

to the terms of the Act itself, as interpreted by the U.S. Supreme Court, and offers modest suggestions on how to revitalize the agency.

II. THE POLITICIZATION OF THE NLRB AND ITS CURRENT EFFECTS

A. *The Politicized Appointment Process*

The 1935 Wagner Act Congress recognized that the new agency it was creating to administer this Act would be an adjudicatory body rather than a mediation and arbitration agency like that created by the Railway Labor Act of 1926, as amended in 1934. Consequently, it deleted references to the appointment of partisan members from management and union backgrounds in the final draft of the act, and it was fully understood that the Board was to be staffed by three impartial public members, appointed from government service or academic careers.³ So also, the Congress that expanded the Labor Board to five members in 1947, continued to expect that the Board members would be impartial, neutral adjudicators.⁴ Presidents Roosevelt and Truman filled appointments to the Board with non-partisan appointees. Starting with President Eisenhower, appointment practices changed. Since 1970, a majority of appointments to the Board have come from management and union law practices rather than non-partisan and neutral backgrounds.⁵

While the NLRA is silent on the matter, a tradition has developed whereby both Democrats and Republicans are appointed to the Board, with the President's party holding a three to two majority of appointments including the chair.⁶ Traditionally, at the confirmation stage, each NLRB nominee had been given individual consideration by the Senate Labor Committee and the Senate as a whole and the President had the prerogative of staffing the Board with any reasonably well qualified individual of his choosing.⁷ Starting in the

³ James J. Brudney, *The National Labor Relations Board In Comparative Context; Isolated and Politicized: The NLRB's Uncertain Future*, 26 COMP. LAB. L. & POL'Y J. 221, 243 (2005). William Gould IV, *Politics and the Effect of the National Labor Relations Board's Adjudicative and Rulemaking Process*, EMORY LAW JOURNAL, Vol. 64, 1501 (2015).

⁴ Brudney, *Id.* at 244. The five members of the NLRB are appointed by the President with the advice of and consent of the Senate, and serve five-year staggered terms. The President designates one member chairperson. 29 U.S.C. § 153(a) (2012).

⁵ Brudney, *supra* note 3, at 245; Gould, *supra* note 3, at 1126.

⁶ Mathew M. Bodah, *Congress and the National Labor Relations Board: A Review of the Recent Past*, 22 J. LAB. RES. 699, 700 (2001).

⁷ Jean Flynn, *A Quiet Revolution at the Labor Board: The Transformation of the NLRB, 1935-2000*, 61 OHIO ST. L. J. 1361, 1427 (2000). The full name of the Senate Labor Committee is "The U.S. Senate Committee on Health, Education, Labor &

second Reagan administration and into the George H. W. Bush administration, greater Senatorial control over the appointment process occurred. Board appointments in both the George H.W. Bush and Clinton administrations tended to come in “packaged deals,” whereby Senate power brokers, in consultation with industry and labor interest groups, armed with the threat of the filibuster, insisted that the President acquiesce to certain of their choices as the price of getting his Board nominee(s) confirmed by the Senate.⁸ Moreover, in both these administrations and continuing in the George W. Bush (Bush II) administration, recess appointments were utilized while the Senate and White House bargained over packaged deals.⁹ As will be subsequently discussed, President Obama’s appointments were problematic. Challenges to his recess appointments were resolved by the Supreme Court,¹⁰ and in 2013, when the Senate eliminated the filibuster for all appointments except the United States Supreme Court, this reform diminished the previous Senate dominance of both the Clinton and Obama eras.¹¹ To date, President Trump’s nominations are being processed without significant Senatorial obstruction.¹²

Thus, decision-making at the NLRB has undergone a transformation. Decisions formerly made by impartial neutral adjudicators are now perceived to be made by arguably partisan members from union-and management-side backgrounds, with the President’s party holding the majority appointment. The politicized appointment process has had an adverse impact on the perceived fairness of the agency, as an adjudicative body responsible for applying the explicit policies set forth in the NLRA as well as the

Pensions.”

⁸ *Id.* at 1429.

⁹ With the adjournment of Congress in January 2008 the Bush II Board consisted of just two members. Former Chairman Robert J. Battista’s term expired on December 16, 2007 and the recess appointment of members Peter Kirsanow and Dennis Walsh expired with the adjournment of Congress in January. Members Liebman and Schaumber, as a quorum of a three member group which included member Kirsanow prior to the expiration of his appointment, issued decisions and orders in unfair labor practices and representation cases. See Daily Lab. Rep. No. 221 (BNA) Nov. 16, 2007 at A-11. In *New Process Steel v. NLRB*, 560 U.S. 674 (2010), the Supreme Court, in a 5-4 decision, held that under Section 3(b) of the NLRA, a two person quorum board was unauthorized to resolve the nearly 600 cases decided over a 27 month period of time.

¹⁰ *New Process Steel v. NLRB*, 560 U.S. 674 (2010); *NLRB v. Noel Canning*, 573 U.S. ___ (2014).

¹¹ Gould, *supra* note 3, at 1524, 1525.

¹² See Erin Mulvaney, *John Ring of Morgan Lewis, Trump Pick for NLRB*, NAT. L. J., *www.law.com Jan. 26, 2018*.

formulation of policies to fill in gaps left implicitly or explicitly by Congress to respond to the developing intricacies of our highly competitive global economy.

B. The Bush II Board: Partisan Decision Making

The Bush II Board, which had a majority of Republican appointees since December 2002, overruled all of the major Clinton Board decisions.¹³ On December 12, 2007, a letter signed by fifty-seven labor law professors was sent to all members of Congress criticizing the actions of the Bush Board. It stated in part:

Recent decisions by the National Labor Relations Board reflect an ominous new direction for American labor law. By overturning precedent and establishing new rules, often going beyond what the parties have briefed or requested, the Board has regularly denied or impaired the very statutory rights it is charged with protecting—the rights of employees to join and form unions and to engage in collective bargaining. The Board’s persistent efforts to undermine NLRA protections also have dramatized the need for Congress to enact serious labor law reform after nearly half a century with no substantial legislative change. . . .¹⁴

The following day a joint House and Senate subcommittee hearing listened to criticism and defense of the Bush Board’s record.¹⁵ AFL-CIO General Counsel Jonathan Hiatt testified that the cumulative effect of the Bush Board’s decisions has been to narrow worker protections while expanding the scope of anti-union conduct.¹⁶ Then

¹³ *N. Y. Univ.*, 332 N.L.R.B. 1205 (2000), *overruled by Brown Univ.*, 342 N.L.R.B. 483 (2004). *Sturgis*, 331 N.L.R.B. 1298 (2000), *overruled by Oakwood Care Ctr.*, 343 N.L.R.B. 659 (2004). *St. Elizabeth Manor*, 329 N.L.R.B. 321 (1999), *overruled by MV Transp.*, 337 N.L.R.B. 770 (2002). *Epilepsy Found.*, 331 N.L.R.B. 676 (2000), *overruled by IBM Corp.*, 341 N.L.R.B. No. 148 (2004). For other Bush Board decisions reversing Clinton Board precedent, *see, e.g., Jones Plastic & Eng’g Co.*, 351 N.L.R.B. No. 11 (2007) (addressing significance of at-will employment relationship to status as permanent striker replacement), *overruling Target Rock Corp.*, 324 N.L.R.B. 373 (1997); *TruServ Corp.*, 349 N.L.R.B. No. 23 (2007) (permitting decertification petition to be processed after post-petition settlement of unfair labor practice charges against employer), *overruling Douglas-Randall, Inc.*, 320 N.L.R.B. 431 (1995); and *Crown Bolt, Inc.*, 343 N.L.R.B. 776 (2004) (rejecting presumption that employer’s plant-closure threat was widely disseminated), *overruling Springs Indus.*, 332 N.L.R.B. 40 (2000).

¹⁴ www.americanrightsatwork.org/dmdocuments/NLRB/nlrb_legal_scholars_sign_on_letter.pdf

¹⁵ Susan J. McGolrick, *Congressional Democrats Criticize NLRB for Decisions Undermining Workers Rights*, Daily Lab. Rep. No. 218 (BNA) Dec. 14, 2007 at AA-1.

¹⁶ *Id.* at AA-2. Mr. Hiatt testified in part about the September 2007 Board decisions that in September alone, in a number of highly divided partisan decisions, dubbed the “September massacre,” the Board has: (1) Made it significantly harder for workers who were illegally fired or denied employment to recover backpay. *St. George Warehouse*,

NLRB Chairman Robert J. Battista testified that the spurt of decisions in September was not politicized and that complaints are politically motivated and tied to the coming election cycle. He referred to the high enforcement achievement rate of his Board's decisions in the federal appeals courts.¹⁷ University of Illinois Law Professor Matthew Finkin testified that the Bush II Board majority had effectively removed whole categories of workers from the Act's coverage; stripped away protections promised by the Act; and further diluted the strength of already inadequate remedies.¹⁸ Professor Finkin disagreed with Mr. Battista that the rate of judicial affirmance was an indication that the Board had been performing responsibly.¹⁹

351 NLRB No. 42 (2007); *The Grosvenor Resort*, 351 NLRB No. 86 (2007); *Domsey Trading Corp.*, 351 NLRB No. 33 (2007). (2) Made it a certainty that employers who violate the Act will incur only the slightest monetary loss and be required to undertake as little remediation as possible. *Internet Stevensville*, 350 NLRB No. 94 (2007); *Albertson's Inc.*, 351 NLRB No. 21 (2007). (3) Made it harder for workers to achieve union recognition without being forced to endure the hostile, divisive, delay-ridden NLRB representation process, *Dana Corporation*, 351 NLRB No. 28 (2007), while at the same time doing just the opposite for employers who wish to get rid of an incumbent union. *Wurtland Nursing & Rehab. Ctr.*, 351 NLRB No. 50 (2007). (4) Made it easier for employers to deny jobs to workers who have exercised their legal right to strike. *Jones Plastics & Eng'g*, 351 NLRB No. 11 (2007). (5) Made it easier for employers to file lawsuits in retaliation for protected union activities and to punish workers and their unions for their lawful, protected conduct. *BE&K Constr.*, 351 NLRB No. 29 (2007). (6) Made it easier for employers to discriminate against employees and job applicants who are also union organizers even though the U.S. Supreme Court has specifically held that such workers are employees entitled to the Act's protections. *Toering Elec. Co.*, 351 NLRB No. 18 (2007).
http://help.senate.gov/Hearings/2007_12_13/Hiatt.pdf

¹⁷ *Id.* at AA-1, AA-2. Mr. Battista testified in part:

Our critics declare that the National Labor Relations Act was passed by Congress in 1935 "to encourage workers to have unions and to bargain collectively." However, they lose sight of the fact that the statute was amended in 1947 by the Taft-Hartley Act to give employees the equal right to refrain from union activities and representation, and to protect employees from not only employer interference but also union misconduct. Often critics fail to comprehend that the Board's mission to enforce the *entire* law as enacted by Congress despite what any affected party may wish for—a return to 1935 or to some future legislative result.

http://help.senate.gov/Hearings/2007_12_13/Battista.pdf

¹⁸ *Id.* at AA-2.

¹⁹ Professor Finkin testified in part:

...In principle, an agency may not alter the basic focus or function of its organic law, but that principle fails to address the systematic narrowing of the organic statute's mission by a combination of numerous decisions none of which, taken only on its own, can be said to lie outside the ambit of administrative decision. The appearance of legal continuity is thus maintained even as the Act's stated

*C. The Obama Board: Appointment Hurdles;
Partisan Decision Making*

In December of 2007, the Labor Board, finding itself with only four members and expecting two more vacancies, delegated its power to a group of three members.²⁰ On December 31, one of the three member's appointment expired, and the others, as a two-member quorum of the properly designated three member group, proceeded to issue Board decisions at the start of the Obama administration and thereafter for a 27 month period.²¹ In *New Process Steel v. NLRB*, the Supreme Court in a split 5-4 decision held that under the provisions of Section 3(b) of the National Labor Relations Act, this board was unauthorized to resolve the nearly 600 cases decided by the two person panel.²²

Faced with Senate opposition to his nominees, President Obama sought to utilize the recess appointment process where the advice and consent of the Senate could not be obtained.²³ In *NLRB v. Noel Canning*, the Supreme Court held however that the three appointments he made during the three-day January 2012 recess in question were too short a time to bring a recess within the scope of the Recess Appointment clause of the Constitution.²⁴ On July 16, 2013, an agreement was reached between the Senate Republicans and the President to end the impasse over NLRB appointments²⁵ and on July 30, 2013 the Senate confirmed all five of President Obama's nominees.²⁶

While off to a rocky start, the Obama Board very aggressively expanded and/or reversed a wide range of Board precedents. Some of its many modified precedents include: changing the law for joint employment;²⁷ and allowing for the formation of micro bargaining

purpose, of "encouraging the practice...of collective bargaining," is transformed or the rights of employees are curtailed or eviscerated. That is just what has happened in the course of the past few years.

http://help.senate.gov/Hearings/2007_12_13/Finkin.pdf

²⁰ *New Process Steel v. NLRB*, 560 U.S.1 (2010).

²¹ *See id.* at 3.

²² *See id.* at 1.

²³ *See NLRB v. Noel Canning*, 573 U.S. 1, 2, 5 (2014).

²⁴ *See id.* p 2.

²⁵ Everett, Burgess and Bresnahan, John. "Obama Selects NLRB Replacement Picks" (<http://politico.com/story/2013/07/white-house-consults-with-afl-cio-head-on-nlrp-picks-94280.html>), *Politico*, July 16, 2013; accessed March 14, 2018.

²⁶ NLRB official website (<https://www.nlr.gov/who-we-are/board/board-members-1935>), nlr.gov; accessed March 14, 2017.

²⁷ *Browning-Ferris Industries, Inc.*, 362 N.L.R.B. No. 186 (2015); *Miller & Anderson Inc.*, 364 N.L.R.B. No. 39 (2016).

units.²⁸ This Board expanded individual speech rights in the field of electronic communication.²⁹ Moreover, it authorized “employee status” for graduate teaching assistants³⁰ and made deferral to labor arbitration awards more difficult.³¹ Further, the Board significantly re-wrote its election rules shortening the time between the date of the petition and the *election* from an earlier standard of 42 days to an average of between 24-26 days.³²

D. The Trump Board: The Partisanship Continues; Reversing Precedents

On January 12, 2018 President Trump made an appointment to fill a final vacant position on the NLRB, replacing the departed Republican board chair Philip Miscimarra with John Ring, a management-side labor law attorney.³³ With the confirmation of Mr. Ring by the U.S. Senate on April 11, 2018, the five member board was returned to a 3-2 Republican majority.³⁴

In December 2017, an initial temporary Trump Labor Board majority had reversed the Obama Board’s new joint employer standard, which had been expanded to allow that the “control” exercised by the potential joint employer can be direct, indirect or even a reserved right to control;³⁵ and it returned to the previous standard of control for establishing a joint employer of being “direct and immediate” as to employment actions.³⁶ Two months later, however, the Labor Board vacated its December 14, 2017 decision after an NLRB inspector general report determined that a newly appointed Republican board member, William Emmanuel, had improperly participated in the case.³⁷

²⁸ Specialty Health Care, 357 N.L.R.B. No. 83 (2011).

²⁹ Purple Communications, 361 N.L.R.B. No. 126 (2014) (regarding employee rights to use workplace email for protected concerted activity).

³⁰ Columbia University, 364 N.L.R.B. No. 13 (2016).

³¹ Babcock & Wilcox, 361 N.L.R.B. No. 132 (2014).

³² See the Final R-Case Rules which took effect on April 14, 2015, 79 Fed. Reg. 74308 (Apr. 14, 2015). In *Associated Builders & Contractors of Texas v. NLRB*, 826 F.3d 215 (5th Cir. 2016), the Fifth Circuit Court of Appeals held that the Board acted within its authority in adopting the new election rules.

³³ Steven M. Swirsky, *President to Nomininate Management Labor Lawyer John Ring to NLRB*, NAT. L. REV., Jan. 15, 2018, www.natlawreview.com.

³⁴ *Senate Confirms John Ring as Newest Member of NLRB*, NAT. L. REV. April 11, 2018, www.natlawreview.com.

³⁵ Browning-Ferris Industries, Inc. 362 N.L.R.B. No. 186 (2015).

³⁶ Hy-Brands Indus. Contractors, Ltd. 365 N.L.R.B. No. 156 (2017).

³⁷ Chris Opfer and Hassan Kanu, *Labor Board Scraps Controversial Joint Employer Decision*, bna.com. Feb. 26, 2018.

This temporary Trump Board majority also overturned the Obama Board’s “overwhelming community of interest” standard required of employers challenging the makeup of a union petitioned-for micro-unit, where the employer asserts that a larger group of employees who also shared a community of interest were not included in the requested unit.³⁸ In that case the Board reinstated the traditional “community of interest” standard.³⁹

III. STANDARDS FOR COURT REVIEW OF BOARD DETERMINATIONS ON “LAW AND POLICY”

The United States Supreme Court set forth the role of the federal judiciary in reviewing an administrative agency’s application of its organic statute (the statute(s) it administers) in *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*⁴⁰ The *Chevron* Court designed a two-step analytical framework for the reviewing court. First, the court must ask whether Congress has directly spoken on the question at issue.⁴¹ If so, the reviewing court and the agency itself must give effect to this Congressional intent.⁴² Second, if the statute is silent or ambiguous on the question at issue, the reviewing court then must ask whether the agency’s interpretation is “based on a permissible construction of the statute.”⁴³ The power of an agency to administer a Congressionally created program necessarily requires the formulation of policy to fill gaps left implicitly or explicitly by Congress. If it is a reasonable policy choice, the agency’s construction of the statute is controlling, even if the reviewing court would have chosen a different interpretation.⁴⁴ The agency’s interpretation is to be given “controlling weight unless [it is] arbitrary, capricious or manifestly contrary to statute”.⁴⁵

A reviewing court may, under the first *Chevron* step, conclude that the issue is one of law rather than one of delegated policy, and reject the agency’s decision or rule. For example, in *Lechmere, Inc. v. NLRB*, dealing with the resolution of conflicts between Section 7 employee rights and employer property rights, a divided U.S. Supreme Court rejected the Board’s interpretation of Section 7 as permitting a balancing of interests allowing non-employee union

³⁸ Specialty Healthcare, 357 N.L.R.B. No.83 (2011).

³⁹ PCC Structural, Inc., 365 N.L.R.B. No. 160 (2017).

⁴⁰ 467 U.S. 837 (1984).

⁴¹ *Id.* at 842.

⁴² *Id.* at 843.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 844.

organizers the right of access to an employer's parking lot that was open to the public.⁴⁶ The Court rejected the Board's interpretation of the Act as contrary to the Court's prior interpretation of the Act in its *NLRB v. Babcock & Wilcox Co.* decision.⁴⁷ The dissent asserted that the majority's decision was "... at odds with modern concepts of deference to an administrative agency charged with administering a statute."⁴⁸

Under its second step, the *Chevron* Court noted that for "judicial purposes" in reconciling conflicting policies, the administrator's interpretation is entitled to deference as opposed to the reviewing judges, who are not experts in the field.⁴⁹ The Court stated in part:

...[A]n agency to which Congress has delegated policymaking responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments. While agencies are not directly accountable to the people, the Chief Executive is, and it is entirely appropriate for this political branch of the Government to make such policy choices—resolving the competing interests which Congress itself either inadvertently did not resolve, or intentionally left to be resolved by the agency charged with the administration of the statute in light of everyday realities.⁵⁰

In addition to the general principles of administrative law discussed in the landmark *Chevron* decision, the United States Supreme Court has specifically emphasized that the Labor Board has the primary responsibility for developing and applying national labor policy.⁵¹ The Court has stated that it will uphold a Board rule as long as it is rational and consistent with the Act.⁵² And, it has stated that a Board rule is entitled to deference even if it represents a departure from the Board's prior policy.⁵³

⁴⁶ *Lechmere, Inc. v. N.L.R.B.*, 502 U.S. 529, 537 (1992).

⁴⁷ *Id.* at 538.

⁴⁸ *Id.*

⁴⁹ *Chevron*, 467 U.S. at 865.

⁵⁰ *Id.* at 865, 866. *NLRB v. Curtin Matheson Scientific*, 494 U.S. 775, 786 (1990).

⁵¹ *Fall River Dyeing & Finishing Corp. v. N.L.R.B.*, 482 U.S. 27, 42 (1987).

⁵² *N.L.R.B. v. J. Weingarten, Inc.*, 420 U.S. 251, 265-266 (1975).

⁵³ *Id.*

IV. EVALUATING TWO BOARD DECISIONS UNDER *CHEVRON* STANDARDS

A. *The IBM Corp. Decision*

The Bush Board's *IBM Corp.*⁵⁴ decision is an example of permissible administrative agency action in resolving conflicting policy considerations which is not to be set aside by a reviewing court.

In 1973, the Labor Board issued its *Weingarten* decision, which held that an employer violates Section 8(a)(1) of the NLRA when it denies an employee's request for the presence of a union representative at an investigatory interview which the employee reasonably believes might result in disciplinary action.⁵⁵ The Board's decision was upheld by the Supreme Court in *NLRB v. Weingarten, Inc.* in 1975.⁵⁶ The *Weingarten* right of an employee to request and obtain the presence of a coworker at an investigatory interview was extended to nonunion workplaces by the Board in *Materials Research Corp.* decision in 1982.⁵⁷ Three years later, in 1985, the Reagan Board reversed this decision in the *Sears, Roebuck Co.* holding that *Weingarten* principles do not apply in nonunion settings.⁵⁸ In *Epilepsy Foundation of Northeast Ohio* in 2000, the Clinton Board decision, reimposed its *Materials Research* holding, concluding that unrepresented employees have a right to have a coworker present during investigatory interviews.⁵⁹ The Court of Appeals for the District of Columbia Circuit upheld the Board's renewed interpretation of the statutory language in question stating in part:

It is a fact of life in NLRB lore that [the meaning of] certain substantive provisions of the NLRA invariably fluctuate with the

⁵⁴ 341 N.L.R.B. 1288 (2004).

⁵⁵ 202 N.L.R.B. 446 (1973).

⁵⁶ 420 U.S. 251, 260 (1978).

⁵⁷ 262 N.L.R.B. 1010 (1982).

⁵⁸ 274 N.L.R.B. 230 (1985). In *Slaughter v. NLRB*, 794 F.2d 128 (3rd Cir. 1986), the Third Circuit Court of Appeals remanded to the Board the case of an employee discharged by his employer, E.I. Dupont, for refusing to submit to an investigatory interview with his supervisor without the presence of a coworker. The court determined that it is permissible, though not required, to determine that Section 7 of the NLRA protecting concerted activity as guaranteeing union members and unorganized employees alike the right to have a representative present at investigatory interviews. *Id.* at 128. On remand in *E.I. Dupont*, the Board determined that although the Act did not compel its interpretation, nevertheless it was a permissible interpretation of the Act to conclude that the Act did not confer *Weingarten* rights on nonunionized employees. 289 N.L.R.B. 627, 629-630 (1988). Thus, the conclusion set forth in *Sears Roebuck* that *Weingarten* rights do not apply in nonunion settings continued as a result of the *Dupont* decision.

⁵⁹ 331 N.L.R.B. 676 (2000).

changing compositions of the Board. Because the Board's new interpretation is reasonable under the Act, it is entitled to deference.⁶⁰

Three years later on June 9, 2004, with the makeup of the Board changed again, the Bush Board reversed *Epilepsy Foundation in IBM Corp.*, ruling that nonunion employees do not have the right to have a coworker present during an investigatory interview.⁶¹

The *Chevron* principles recognize that the agency to which Congress delegated policymaking responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments when resolving competing policy interests which Congress itself did not resolve.⁶² The *Epilepsy Foundation* decision which for the first time in eighteen years had extended the right to have a coworker present during an investigatory interview to all unrepresented employees in the private sector, was considered a major adverse decision by American business interest groups.⁶³ That is, while less than 10

⁶⁰ *Epilepsy Foundation of Northeast Ohio v. NLRB*, 269 F.3d 1095, 1097 (3rd Cir. 2001).

⁶¹ 341 N.L.R.B. 1288 (2004).

⁶² *Chevron*, 467 U.S. at 865, 866.

⁶³ Major business groups filed amicus curiae briefs in support of the employer's petition for review of the *Epilepsy Foundation* decision before the U.S. Court of Appeals for the D.C. Circuit in 2001, including the Chamber of Commerce of the United States, the National Association of Manufacturers, the Associated Builders and Contractors, Inc., the International Mass Retail Association and the Florida Hospital Association. The AFL-CIO filed an amicus curiae brief in support of the Board's application for enforcement of the decision against the employer.

It is interesting to note that in the *IBM Corp.* case the Board granted the joint request of LPA, Inc., The Equal Employment Advisory Council, Associated Builders and Contractors, the Chamber of Commerce of the United States, the Society for Human Resource Management, the International Mass Retail Association, and the National Association of Manufacturers, to file an *amicus* brief on behalf of the employer. The AFL-CIO did not file a brief in this case. However, Wal-Mart Stores, Inc. filed a response in support of the amici briefs because an Administrative Law Judge, following the Board's *Epilepsy Foundation* decision had found that Wal-Mart had unlawfully discharged an unrepresented employee because he refused to participate in an investigatory interview, which he reasonably believed might result in discipline against him, unless Wal-Mart granted his request for his own witness. Since the *Epilepsy Foundation* decision was overruled by *IBM*, the ALJ's ruling was later overturned by the Board and Wal-Mart could lawfully deny the employee's request for a witness and could lawfully require that he continue the investigatory interview without the presence of the requested witness. *Wal-Mart Stores, Inc. and UFCWIU Local 343*, 343 N.L.R.B. No. 127 (Dec. 16, 2004). The decision, however, did not resolve the legality of the dismissal of the employee in question. This matter was referred to a three member panel, consisting of members Liebman and Walsh, the dissenting members in the *IBM Corp.* case, along with Chairman Battista. *Wal-Mart Stores, Inc.*

percent of private sector employees were unionized, prior to *Epilepsy Foundation* only they had *Weingarten* rights. After *Epilepsy Foundation*, all private sector individuals meeting the broad statutory definition of “employee,” were entitled to these rights.⁶⁴ The Bush Board determined that policy considerations supported its decision to deny unrepresented employees, the right to have a coworker present during an investigatory interview that could lead to discipline. The policy considerations were that coworkers do not represent the interest of the entire work force as would a union representative;⁶⁵ that coworkers cannot redress the imbalance of power between employers and employees;⁶⁶ that coworkers do not have the same skills as union representatives;⁶⁷ and that the presence of a coworker may compromise confidentiality of information divulged at the interview.⁶⁸

Section 7 of the NLRA provides in part that employees shall have the right “to engage in...concerted activities for the purpose of ... mutual aid or protection.” The plain language of Section 7 does not limit coverage to “unionized employees” nor does it turn on the skills or motives of the employees’ representative.⁶⁹ Issues of confidentiality are the very same for the coworker representative as a union representative. The Board carefully shaped the contours and limits of the statutory Section 7 rights enunciated in *Weingarten*. The employer can end the interview at any time at its discretion. It need not bargain with the representative permitted to attend the interview. It ordinarily will refuse disclosure and discussion of medical records, if relevant, in the presence of a representative. The *Weingarten* representative is present to assist the employee and may attempt to clarify facts or suggest other employees who may have knowledge of the event.⁷⁰ The Board’s stated policy reasons simply do not make out a strong “policy” case for refusing to allow nonunion

and *UFCWIU Local 343*, 351 N.L.R.B. No. 17 (September 28, 2007). Members Liebman and Walsh concluded that retroactive application of *IBM* to the employee would work “a manifest injustice” effectively permitting Wal-Mart to punish the employees for relying on his then-existing rights under the Act. *Id.* at 6, 7. The employee was ordered reinstated with backpay. *Id.* at 7; Chairman Battista dissented. *Id.* at 8.

⁶⁴ In 2003 8.2 percent of private-sector employees were unionized. See Bureau of Labor Statistics, “Union Members in 2003” News Release USD L 04-53 (Jan. 21, 2004). Union membership in the private sector in 2007 was 7.5 percent, up from 7.4 percent in 2006, see <http://www.bls.gov/news.release/union2.toc.htm>

⁶⁵ *IBM Corp.*, 341 N.L.R.B. 1288 at 1291.

⁶⁶ *Id.* at 1292.

⁶⁷ *Id.*.

⁶⁸ *Id.*.

⁶⁹ *Id.* at 1308 (members Liebman and Walsh dissenting)

⁷⁰ *Weingarten*, 420 U.S. at 260.

workers the right to a coworker witness or representative at an investigatory interview.

In their dissent in *IBM Corp.*, Members Liebman and Walsh wrote, “Today American workers without unions, the overwhelming majority of employees, are stripped of a right integral to workplace democracy.”⁷¹ The dissent refers to the following language of Section 7 of the NLRA, “the right to...engage in...concerted activities for the purpose of...mutual aid or protection;” and states that it is hard to imagine an act more basic to “mutual aid or mutual protection” than an employee turning to a coworker for help when faced with an interview that might result in the employee’s termination.⁷² Citing the District of Columbia Court of Appeals’ approval of *Epilepsy Foundation*, the dissent explained that the presence of a coworker gives an employee a potential witness, advisor, and advocate in an adversarial situation, and ideally militates against imposition of unjust discipline by the employer.⁷³ They conclude:

[I]t is our colleagues who are taking steps backwards. They have neither demonstrated that *Epilepsy Foundation* is contrary to the Act, nor offered compelling policy reasons for failing to follow precedent. They have overruled a sound decision not because they must, and not because they should, but because they can.⁷⁴

The Bush Board was in compliance with *Chevron* and labor law precedent when it made the policy choice to overrule the *Epilepsy Foundation*. A reviewing court would not have a basis under administrative law to set aside this decision even though the court might have chosen a different interpretation.

B. Reversing *IBM*?

For the Obama Board to reverse the *IBM* decision, the General Counsel needed to progress an appropriate case to the board members to have them consider returning *Weingarten* rights to non-union employees. NLRB General Counsel Richard Griffin authorized two unfair labor practice complaints intended to put the matter before the Board but these cases were resolved before reaching the Board and time ran out as the composition of the Board changed back to a Republican majority.⁷⁵

⁷¹ 341 N.L.R.B. at 1305.

⁷² *Id.* at 1305.

⁷³ *Id.* at 1310, quoting *Epilepsy Foundation v. NLRB*, 268 F.3d 1095, 1100 (D.C. Cir. 2001).

⁷⁴ *Id.*

⁷⁵ See Lawrence E. Dube, *Time Runs Out in NLRB Battle Over Co-Worker Reps* DAILY LABOR RPT., bna.com, April 18, 2017.

C. The Process of Overturning BFI

In its August 27, 2015 *Browning-Ferris Industries of California, Inc.* (BFI) decision, the Obama Board issued a new joint employer standard whereby private employers would be considered joint employers under the National Labor Relations Act even if they merely shared indirect control through an intermediary or a reserved right to control over another employer's employees whether or not that right is ever exercised.⁷⁶ The majority 3-2 *BFI* opinion sets forth the reason for revisiting the standard that had been in effect for some thirty years, whereby the level of control exercised by the potential joint employee needed to be "direct and immediate" regarding employment activities such as hiring, firing, discipline, supervision and direction.⁷⁷ The Board pointed out that the number of jobs in the employment service industry, which includes employment placement agencies and temporary help services, will increase to almost 4 million by 2022, making it one of the largest and fastest growing industries in terms of employment.⁷⁸ The Board majority stated that this development is reason enough to revisit the Board's current standard, for not doing so would be failing in what the Supreme Court has described as the Board's "responsibility to adopt the Act to the changing patterns of industrial life."⁷⁹

Under its new standard, the Board majority determined that BFI was a joint-employer of some 240 employees of Leadpoint Business Services, an independent business which actively hires, manages and maintained the work of these employees performing service inside BFI's recycling facility in San José California.⁸⁰ BFI itself solely employs some sixty unionized employees working on its property as the equipment operators outside the facility's sheds.⁸¹

In its December 14, 2017 *Hy-Brand Industrial Contractors, Ltd.* Decision, the new Republican majority overruled the *BFI* precedent and returned to the traditional joint employer standard – employers must exercise direct and immediate joint control over the essential employment terms of workers in a significant, not merely routine, joint manner to be classified as a joint employer under the NLRA.⁸²

⁷⁶ *Browning-Ferris Industries of California, Inc.* 362 N.L.R.B. No. 186 at p. 2 (2015).

⁷⁷ *Id.* at 10. *See also* *Airborne Express*, 338 N.L.R.B. 597, 597 fn 1(2002).

⁷⁸ *Id.* at 11. *See also* *NLRB. v. J. Weingarten, Inc.*, 420 U.S. 251, 266 (1975).

⁷⁹ *Id.* *See* *Ford Motor Co. v. NLRB.*, 441 U.S. 488, 496 (1979) quoting *NLRB v. Insurance Agents*, 361 U.S. 477, 499 (1960); *N.L.R.B. v. Erie Resistor Corp.*, 373 U.S. 221, 236 (1963); and *N.L.R.B. v. Steelworkers*, 357 U.S. 357, 362-363 (1958).

⁸⁰ *See Id.* at 2, 3 and 20.

⁸¹ *Id.* at 2.

⁸² *Hy-Brand Industrial Contractors, Ltd.*, 365 N.L.R.B. No. 156 at 5 (2017).

The detailed opinion by the *Hy-Brand* majority asserted that the *BFI* decision was a distortion of common law as interpreted by the Board and courts, and wrong as a matter of policy.⁸³

1. Ethical Issues Involving The *BFI/Hy-Brand* Cases

The three votes needed to overturn the *BFI* decision in *Hy-Brand* were cast by Republican appointees Miscimarra, Kaplan and newly appointed William Emanuel, who had been a management-side senior partner and shareholder at Littler Mendleson before his appointment to the Board on September 25, 2017.⁸⁴ The Littler law firm was counsel to one of the employers before the Board in *BFI*. The NLRB's inspector general launched an ethics inquiry into Member Emanuel's involvement in the *Hy-Brand* case.⁸⁵

NLRB Inspector General David Berry issued a report finding that Member Emanuel should not have participated in the *Hy-Brand* case because of the way it was pushed through by former Chairman Philip Miscimarra who, in an email, urged members Kaplan and Emanuel to adopt his draft opinion with minimal or no tinkering, because the purpose of the decision was to undo *Browning Ferris*.⁸⁶ Subsequently, on February 26, 2018 the Labor Board vacated its *Hy-Brand* decision in light of the inspector general's report, setting aside the case for additional proceedings in the future.⁸⁷

2. The Future of *BFI* Under A Republican-Controlled Board

With the appointment of management-side attorney John Ring (R) to the Board on April 11, 2018, the 2-2 partisan split was broken and a Republican controlled board is now able to revisit the *Hy-Brand* case with a full *de novo* consideration of the case. Or, alternatively, the Board may choose a new case. However, in either eventuality, it is highly likely that the Republican partisan majority will overturn the *BFI* precedent.

⁸³ See *id.* at 1 and 5.

⁸⁴ During his confirmation process, Member Emanuel identified dozens of cases and clients in which he would recuse himself stating "I am committed to performing my official duties in an impartial manner and have and will continue to adhere to the ethical standards set forth for political appointees, federal officials, attorneys and adjudicators." Erin Mulvaney *Labor Advocates Quarrel Over Ethics at NLRB as Board moves against Obama Legacy*, <https://www.law.com/corpcounsel/sites/nationallawjournal/2018/02/01labor-advocates-quarrel-over-etics-at-nlr-b-as-board-moves-against-obama-legacy>

⁸⁵ See *id.*

⁸⁶ See Chris Offer and Hassan Kanu, *Labor Board Scraps Controversial Joint Employer Decision*, bna.com/daily-labor-report/labor-board-scraps-controversial-joint-employer-decision, Feb. 26, 2018.

⁸⁷ *Id.*

Under a *Chevron* review where Congress has not directly spoken on the matter of “joint employers,” the analysis of a new Republican majority precedent will move to the second step question, “is the agency’s interpretation based on a permissible construction of the statutes?”⁸⁸ The new ruling, returning to the well established thirty-year traditional joint employer standard set forth in *TLI, Inc.* and *Laerco Transportation*, should pass muster with a reviewing court.⁸⁹

V. COMMENTS AND CONCLUSION

The Congresses that enacted the Wagner Act and the Taft-Hartley Act expected that the Labor Board members would be nonpartisan, neutral adjudicators of the disputes brought before them for resolution. Through the evolution of the appointment process it is now evident that many Board members are perceived to operate in a partisan way as they, in their adjudicative functions, fulfill their responsibilities for developing and applying national labor policy within the scope and confines of the Act. “Democrat” appointees assert that they build their policymaking positions on the explicit policy of the Act as set forth in Section 1 of the NLRA:

to encourag[e] the practice and procedures of collective bargaining ... and protect the exercise by workers of full freedom of association, self organization and designation of representatives of their own choosing, for the purposes of negotiating the terms and conditions of their employment or other mutual aid or protection.⁹⁰

“Republican” appointees counter that their policymaking positions are drawn from the entire Act recognizing that the NLRA was amended in 1947 by the Taft Hartley Act with the additional purpose of giving employees the equal right to refrain from union activities and representation and the Board must enforce the entire law.⁹¹

Adjudicating cases along party lines goes against the doctrine of *stare decisis*, the foundational judicial doctrine of following precedents, where both labor and management attorneys can confidently advise their clients when resolving issues in dispute by looking back to past decisions in similar cases.⁹² This doctrine enables

⁸⁸ *Chevron*, 467 U.S. at 843.

⁸⁹ *TLI, Inc.*, 271 N.L.R.B. 798 (1984), *enfd.* 772 F.2d 894 (3d Cir. 1985); *Laerco Transportation*, 269 N.L.R.B. 324 (1984).

⁹⁰ 29 U.S.C. § 151 (20012).

⁹¹ Testimony of NLRB Chairman Robert J. Battista before the Senate Committee on Health, Education, Labor and Pensions Subcommittee on Employment and Workplace Safety and House Committee on Education and Labor Subcommittee on Health, Employment Labor and Pensions. (December 13, 2007). http://help.senate.gov/Hearings/2007_12_13/Battista.pdf

⁹² JAMES L. HOUGHTELLING JR., *THE DYNAMICS OF LAW*, 69 (1963).

Board members to take advantage of the accumulated wisdom inherent in each precedent. It provides certainty, predictability and continuity of process whereby many disputes are avoided, and others are settled without litigation because labor and management know how the Board will respond to matters before it.⁹³ The repeated precedent changes and flip-flopping in Labor Board jurisprudence in recent years have accelerated now to an unacceptable point. Appointment patterns utilizing management-side and union-side appointees have led to overreaching goals by each side while in power and unstable precedents with members who serve short terms or moderate terms on the Board ever aware that an adverse decision against “their” side will hurt them politically and financially when they return to their practices.

Recognizing that the doctrine of *stare decisis* does not strictly apply to the Labor Board’s decision making process because the Board must meet the changing industrial conditions by corresponding changes in policies,⁹⁴ nevertheless, necessary policy changes made by nonpartisan, public-minded board members should serve as acceptable precedents to both labor and management. The agency itself with its highly qualified, nonpartisan professional staff, and other candidates with proper professional and academic credentials can well provide the neutral pool of nonpartisan leadership for future appointments to the Board, as was the original intent of the Congresses that enacted and first amended the NLRA.

Former NLRB Chairman William B. Gould IV believes that one way to insulate Board appointees from the political process is to both provide appointments over a more substantial period of time such as seven or eight years and to preclude reappointments.⁹⁵ He believes that such would decrease the fear of political retribution and lead to conduct more akin to a judicial process itself.⁹⁶

Amending the Act to provide longer terms coupled with the appointment of non-partisan public minded Board members are modest and doable proposals that would revitalize the NLRB.

⁹³ *Id.*

⁹⁴ See *N.L.R.B. v. Kostel Corp.*, 440 F.2d 347 (7th Cir. 1971).

⁹⁵ William B. Gould IV, *Politics and the Effect on the National Labor Relations Board’s Adjudicative and Rulemaking Process*, 64 EMORY LAW J., 1526, 1527 (2015).

⁹⁶ *Id.* at 1527.

COMPETITIVE ADVANTAGE VERSUS BUSINESS ETHICS IN A CHANGING POLITICAL ENVIRONMENT: GLAXOSMITHKLINE IN CHINA

by Amy Hummel* and Christine M. Westphal**

INTRODUCTION

China began its rapid economic growth in the 1990's with a strategy that relied on foreign investment. It encouraged Western European and American firms to build plants in China, and offered low-wage workers and lax enforcement of labor and environmental laws in exchange for that investment.¹ Western European and American firms could substantially lower their overall costs by moving production to China and gain substantial competitive advantages.² Virtually all of the products produced by Western firms in China in the 1990's were exported back to their home countries or other developed countries. This preceded China's aggressive program of infrastructure investment and efforts to strengthen enforcement of its labor laws and raise wages in the early 2000's.

The unwritten rule in Chinese economic development since the 1990's and the Tiananmen Square protests has been that in exchange for limits on personal freedom the Chinese government would work to

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¹ Max North et al., *A Concise Review of Economic Flourishment of China*, 13 INTL. MGMT. REV., 17 (2017).

² Timothy A. Canova, *International Law Symposium: Introduction: International Law Confronts the Global Economy: Labor Rights, Human Rights, and Democracy in Distress*, 8 Chap. L. Rev. 1, 4 (2005).

increase the prosperity of the population in China.³ The goal has been the creation of a Chinese middle class that could cement China's position as a developed nation.⁴ The Chinese government has worked to keep economic growth high, averaging 9% for most of this period, and as a result China has seen large segments of its population lifted out of poverty.⁵ This rapid economic development has come at a substantial cost; pollution in cities, political corruption and political protests have all caused serious concern for the Chinese government.⁶ This has been compounded by a slowdown in Chinese economic growth since the 2008 economic meltdown in Western Europe and the United States. Economic growth in China now stands in the 5-7% range, still significantly higher than the growth of Western economies, but worrying for the Chinese.⁷

China's entry into the World Trade Organization (WTO) in 2001⁸ required it to "...follow the values and norms of a functioning free market..."⁹ and in 2005 China amended the Company Law of the People's Republic of China¹⁰ to require firms to "...abide by social ethics, business ethics, honesty, and trustworthiness, as well as fulfilling social responsibility."¹¹ Business ethics and social responsibility are explicitly stated in laws and regulations governing corporate behaviors.¹² Even though China took these steps in order to meet the WTO standards, there was no immediate indication authorities were going to change their enforcement priorities. Not until 2012, at the conclusion of the 18th National Congress of the Communist Party, did Xi Jinping, the head of the Chinese

³ Minxin Pei, *The Dark Side of China's Rise*, 153 FOREIGN POLICY 32 (9) (2006).

⁴ Yi Wen and George E. Fortier, *The Invisible Hand: The Role of Government in China's Long-Awaited Industrial Revolution*, FED. RES. BANK ST. LOUIS REVIEW, Third Quarter 2016 at 200.

⁵ Ronald Jean Degen, *China's Challenges to Future Sustainable Economic Growth and the Implications for the United States*, 1 ISM J. Intl. Bus. 2 (2011).

⁶ Max North et al., *supra* note 1, at 20.

⁷ NATIONAL BUREAU OF STATISTICS OF CHINA, <http://data.stats.gov.cn/english/ks.htm?cn=BO1> last visited May 30, 2018.

⁸ China became the 143rd member of the World Trade Organization in December 2001 after a lengthy accession process that began in 1987. For a complete review of accession documents see https://www.wto.org/english/thewto_e/acc_e/a1_chine_e.htm. (last visited Mar. 28, 2017).

⁹ Po Keung Ip, *The Challenge of Developing a Business Ethics in China*, 88 J. Bus. Ethics 216 (2009).

¹⁰ Company Law of the People's Republic of China (promulgated by the Standing Comm. People's Cong., Dec. 28, 2013, effective Mar. 1, 2014), http://www.fdi.gov.cn/1800000121_39_4814_0_7.html (China).

¹¹ *Id.*

¹² *Id.*

Communist Party, make clear that addressing corruption would be a pillar of the Congress' five-year tenure, launching the largest organized anti-corruption effort in the history of Communist rule in China. The announcement came as a result not only of China's firmer economic footing, but also as a counter-balance to growing public discord. While there has been speculation this was just Xi's way of consolidating his political power, the reality is these very public spectacles have played well with the general Chinese population. Since 2013 there have been a number of high profile corruption trials of high-ranking government officials. In addition, a significant number of lower ranking local and provincial officials (some 70,000 individuals) have been convicted of corruption and removed from office.¹³

China had already begun to alter its relationship with multinational companies that had driven its development. By 2010 it was clear that with economic growth in Western countries stagnating, many of the companies that had initially come to China to lower manufacturing costs were now looking to Chinese consumers to fuel their future business expansion. Marketing to the emerging Chinese middle class has become a key strategy for American and European firms. From the Chinese perspective the tables had turned. Multinational companies now needed to sell into the Chinese market, and China was no longer desperate for their investments.¹⁴ Domestic Chinese firms were also entering the Chinese market, encouraged by economic growth and governmental infrastructure, development, and often, government subsidies.

The Chinese government contributed to this shift by re-writing its labor laws to encourage wage growth and using its anti-monopoly laws to pressure multinational firms to hold down prices in China and to "share" their intellectual property with emerging Chinese firms. Firms needed to respond to these and other requirements, in addition to President Xi's anti-corruption campaign. Walmart was forced to recognize the All-China Federation of Trade Unions as the union representing its workers, making China the only country where Walmart employs union workers.¹⁵ Apple was forced to re-file its

¹³ Andrew Jacobs, *In China's Antigraft Campaign, Small Victories and Bigger Doubts*, N.Y. TIMES, Jan. 15, 2015, <http://nyti.ms/1G3RVBQ> (last visited Mar. 28, 2017).

¹⁴ Gady Epstein and Robyn Meredith, *U.S. Companies That Invest Big In China*, FORBES, Jul. 5, 2010 <https://www.forbes.com/2010/07/05/us-investments-china-markets-emerging-markets-fdi.html#7dfbbc394822>.

¹⁵ Allen T. Cheng and Lee Spears, *Wal-Mart to Allow Unions in China*, WASH. POST, Aug. 8, 2006, <http://www.washingtonpost.com/wp-dyn/content/article/2006/08/09/AR2006080901924.html>.

taxes in China, and pressured its suppliers to improve working conditions in the plants that produce its products.¹⁶ Mercedes-Benz was forced to lower its prices for parts and service in China.¹⁷ These companies and many other multinational firms adjusted their business practices to the new Chinese regulatory environment because the Chinese market for their products had become too important to their future to leave. Those that failed to adapt did so at their peril.

DIFFICULTIES OF IMPOSING ETHICAL STANDARDS ON CHINESE OPERATIONS

The majority of American and European multinational firms have devoted substantial resources to the creation of ethics and compliance programs. As one *Business and Society Review* article has noted, “Nowadays the social responsibility of organizations is no longer disputed.”¹⁸ Whether organizations have put ethics programs and codes of social responsibility in place because they hope to minimize the penalties for violations¹⁹ or because their managers believe “you can make money without doing evil,”²⁰ or because their stakeholders have used public forums to shame them into acting responsibly, they have all acknowledged that aligning their business practices with Codes of Conduct is necessary for long term success.

When many of these multinational companies began doing business in China they were confronted with issues that challenged their Codes of Conduct and ethical standards. Initially, China did not have coherent rules or laws governing property ownership, workers’ rights, land use, or environmental protections. The Chinese government was eager for foreign investment dollars and made it clear authorities would be flexible when enforcing the rules that did exist. For example, Walmart executives were initially assured they would not have to recognize the All-China Federation of Trade Unions and they could run their stores without union interference. Because the rules governing the business activities of multinational

¹⁶ David Barboza, *China Tightens Its Grip, and Glaxo Pays a Price*, N.Y. Times, Nov. 2, 2016 at A1.

¹⁷ Tom Mitchell, *European Companies Slam Chinese Antitrust Probes*, CNBC (Aug. 13, 2014), <http://www.cnbc.com/id/101918483>.

¹⁸ Maarten J. Verkerk, Jan De Leede & Andrew H. J. Nijhof, *From Responsible Management to Responsible Organizations: The Democratic Principle for Managing Organizational Ethics*, 106 BUS. SOC’Y REV. 353-378 (2001).

¹⁹ Gary R. Weaver et al., *Corporate Ethics Programs as Control Systems: Influences of Executive Commitment and Environmental Factors*, 42 ACAD. MGMT. J. 41-44 (1999).

²⁰ Justin Tan & Anna E. Tan, *Business Under Threat, Technology Under Attack, Ethics Under Fire: The Experience of Google in China*, 110 J. BUS. ETHICS 407 (2012).

companies appeared to be either less rigid or absent by Western standards, there was ample opportunity for local managers and government officials to engage in practices clearly illegal or unethical in the West. Many government officials were poorly paid and could be easily persuaded to cooperate with the company's wishes by receiving relatively small gifts or bribes. In addition, when President Deng Xiaoping initially announced the economic reforms that would encourage foreign investment, he also famously announced, "Let some people get rich first."²¹ Many local Chinese officials were sure he meant them, and they accepted bribes to supplement government salaries that were inadequate in the new economic environment. These "gifts" became their way of sharing in the prosperity multinational companies were bringing to China.

There were also cultural differences that made the practice of giving government officials small "gifts" seem reasonable, even though the firms were clearly in violation of their home country's laws.²² Traditionally, the Chinese give each other gifts of moon cakes during the August Moon Festival, and friends and family members exchange red envelopes containing cash during the Chinese New Year. It was natural that the Western managers of multinational firms would participate in these traditions. Over time the firms' gifts and red envelopes became not only more elaborate and expensive, but also expected.²³ Even though such gifts clearly violate the Foreign Corrupt Practices Act and the British Bribery Act of 2010,²⁴ once a company has begun to participate in these "cultural traditions" they are difficult to discontinue.

Guanxi is another facet of Chinese society that poses an ethical hazard for multinationals. Rooted in a Confucian concept of social, moral and economic duties, guanxi involves building and using influence through relationships among individuals and organizations²⁵. Guanxi is far more complex than the Western concepts of personal or professional networks that are often used to

²¹ Bao Tong, Op-Ed., *How Deng Xiaoping Helped Create a Corrupt China*, N.Y. TIMES, Jun. 3, 2015 <https://www.nytimes.com/2015/06/04/opinion/bao-tong-how-deng-xiaoping-helped-create-a-corrupt-china.html> See also Deng Xiaoping <http://www.great-quotes.com/quotes/author/Deng/Xiaoping>.

²² *Unspoken Rule: Chinese Employees Say Very Few Businesses can Avoid the Taint of Corruption*, 23 CHINA ECONOMIC REVIEW, 34, 37(2012).

²³ *Risk is Back: Whatever Happened to Good Old-Fashioned Bribery?*, 27 CHINA ECONOMIC REVIEW, 46, 47 (2013).

²⁴ BRIBERY ACT 2010, c. 23, <http://www.legislation.gov.uk/ukpga/2010/23/contents>.

²⁵ Yadong Luo et al., *Guanxi and Organizational Performance: A Meta-Analysis* (March 2012) 8 Mgmt. & Org. Rev., 139-172 (2012).

describe it.²⁶ Foreign managers, failing to appreciate these nuances, may have thought they were participating in this custom by giving “gifts” and hiring or working with well connected Chinese nationals. Instead, these favors were simply bribes, and the connections did not build the relationships and garner the influence the managers may have expected.²⁷

Another ethical challenge inherent in China’s corporate landscape is the limited control afforded to foreign firms over their employees. For companies with employees who work in or travel outside of primary cities and into more localized regions, the lack of control is particularly pronounced.²⁸ Even for Western companies that may otherwise comply with legal and ethical standards, managing hundreds or thousands of employees over which they have little direct control puts them at risk²⁹. This is particularly true with Chinese employees, both public and private, because gift-giving is the norm. Even as the central government has begun broader and harsher crackdowns on gifts, kickbacks, price-fixing and fraud, it is difficult for managers and employees to independently extricate themselves from a practice many view as normal.³⁰ Decision makers in procurement departments, suppliers, intermediaries, and sales people likely all give or receive some benefits in the course of business; the only variables are how much and how often.³¹ Another common practice is to keep multiple sets of accounting books,³² so gifts hidden as commissions or consulting fees are difficult to unpack. Even if a company’s local accountants disagree with this practice, they may be reticent to object, fearing they will lose their jobs.³³

Business incentives for middle managers further compound the difficulties of enforcing ethical practices and altering entrenched employee behaviors. While the misdeeds and excesses of high-profile senior executives are easier to identify and make for salacious exposes, middle managers may more often run afoul of Western ethical norms as they compete to get ahead. Managers who lack clear guidelines, oversight or incentives to behave ethically, and who are at the same

²⁶ *Id.*

²⁷ Chenting Su & James E. Littlefield, *Entering Guanxi: A Business Ethical Dilemma in Mainland China?*, 33 *J. Bus. Ethics* 199-210 (2001).

²⁸ Elizabeth Rosenthal, *West’s Medicine is Raising Bills for China’s Sick*, *N.Y. TIMES*, Nov. 19, 1998 at A1, A12.

²⁹ *Risk is Back: Whatever Happened to Good Old-Fashioned Bribery?*, 27 *CHINA ECONOMIC REVIEW*, 46, 47 (2013).

³⁰ *Laying Down the Law: Western Companies in China Toe the Line between Corruption and Compliance*, 23 *CHINA ECONOMIC REVIEW*, 31, 32 Jul. (2012).

³¹ *Id.*

³² *Id.*

³³ *Unspoken Rule: Chinese Employees Say Very Few Businesses can Avoid the Taint of Corruption*, 23 *CHINA ECONOMIC REVIEW*, 34, 37(2012).

time tasked with closing deals and winning business, are ethical and legal-risk time bombs.

GSK'S ENTRY INTO CHINA

GlaxoSmithKline (GSK) is a British pharmaceutical company that aggressively entered the Chinese healthcare market when it opened a research facility in Shanghai in 2007. This was followed by its acquisition of a Chinese Pharmaceutical firm and a company that made traditional Chinese medicines.³⁴ By 2012 GSK had begun to see rapid growth in its drug sales in China, which increased by 17% that year, to 1.2 billion dollars.³⁵ This increase in sales was attributed to the aggressive sales practices that were encouraged by the head of its China operations, a British citizen named Mark Reilly.³⁶

GSK's Chinese operations were in the precarious position of operating where "pay-to-play" and "gifts" were often expected, and at a time when China was investing in and expanding the country's entire healthcare system at a break-neck pace. China was and is experiencing some of the same healthcare challenges seen in the West: demand for better and more comprehensive services, accompanied by increasing costs and reimbursement shortfalls. Given those shortfalls, hospitals administrators and physicians were resorting to ethically problematic means to cover costs and to profit personally.³⁷ They ordered unnecessary tests, medications and procedures to secure additional reimbursements for their institutions and themselves, while doctors solicited gifts from patients and their families.³⁸ The environment was also ripe for a similarly fraught relationship between doctors and pharmaceutical companies. While some jurisdictions heavily regulate or forbid these companies from providing gifts of conference travel or speaking fees to doctors, multinational corporations perceived China as having no real prohibitions on these practices.

Even absent local regulation, multinational companies operating in China, including GSK, should have been well positioned to avoid

³⁴ See, John A. Quelch and Margaret L. Rodriguez, *GlaxoSmithKline in China (A) (B) and (C)* for the history of GSK in China. Harvard Business School Case 9-514-049, available at <https://hbr.org/store>.

³⁵ David Barboza, *GlaxoSmithKline Accused of Corruption by China*, N.Y. TIMES, Jul. 12, 2013 at B1.

³⁶ David Barboza and Katie Thomas, *Former Head of Glaxo in China is Accused of Bribery*, N.Y. TIMES, May 15, 2014 at B1.

³⁷ Benjamin Shobert, *Three Ways To Understand GSK's China Scandal*, FORBES, Sep. 4, 2013, <https://www.forbes.com/sites/benjaminshobert/2013/09/04/three-ways-to-understand-gsks-china-scandal/> (Last visited March 28, 2017).

³⁸ Benjamin Shobert, *Three Ways To Understand GSK's China Scandal*, FORBES, Sep. 4, 2013, <https://www.forbes.com/sites/benjaminshobert/2013/09/04/three-ways-to-understand-gsks-china-scandal/> (Last visited March 28, 2017).

systematic ethics violations due to their familiarity with the cadre of laws and practices designed to elicit ethical behavior in the West. The United Kingdom, where GSK is based, specifically imposes business ethics standards beyond its borders with the Anti-bribery Act of 2010, which permits the prosecution of individuals and companies with links to the United Kingdom regardless of where the crimes occur.³⁹ As a multinational enterprise, GSK has its own code of conduct, polices and professionals providing guidance for ethical and legal conduct, which includes a zero tolerance policy for bribery.⁴⁰ In China, the company employed more compliance officers than in any country other than the United States,⁴¹ and conducted up to 20 internal audits a year.⁴² Despite corporate policies against bribery GSK claimed to be unaware of the extent of corruption embedded in its business in China.⁴³

ALLEGATIONS OF UNETHICAL PRACTICES, AND GSK'S INITIAL RESPONSE

In 2012 a whistleblower began to send emails to the Chinese authorities alleging GSK was illegally bribing doctors and hospital employees in order to increase its sales. In January 2013 a whistleblower sent a long, detailed email to the company's London headquarters, and copied the chairman, senior executives, and the company's outside auditors, alleging the managers in China were engaged in bribery of doctors and hospital employees.⁴⁴ The Wall Street Journal received a similar email.⁴⁵ It does not appear GSK took any corrective action after receiving the initial email, although as the scandal first began to unfold they announced a review had found no wrong-doing by their Chinese management team and dismissed the 5,200 word document as part of a smear campaign.⁴⁶

³⁹ BRIBERY ACT 2010, c. 23, available at <http://www.legislation.gov.uk/ukpga/2010/23/contents>.

⁴⁰ See *Anti-Bribery and Corruption Policy POL-GSK-007*, <https://ca.gsk.com/media/538033/anti-bribery-corruption.pdf> (last visited November 24, 2017).

⁴¹ Ben Hirschler *How GlaxoSmithKline Missed Red Flags in China*, Reuters, July 19, 2013, <https://www.reuters.com/article/us-gsk-china-redflags/how-glaxosmithkline-missed-red-flags-in-china-idUSBRE96I0L420130719> (last visited November 24, 2017).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ David Barboza, *Hearing the Whistle, Not Ending the Fraud*, N.Y. TIMES, Nov. 1, 2016 at B9.

⁴⁵ David Barboza, *GlaxoSmithKline Accused of Corruption by China*, N.Y. TIMES, Jul. 12, 2013, at B5.

⁴⁶ David Barboza, *Glaxo Rehires An Executive Linked to Exposing Bribes in China*, N.Y. TIMES, Aug. 5, 2015 at B3.

Then, in March 2013, GSK received another “whistleblower” email, this one accusing head of China operations Mark Reilly of being complicit in a travel agency bribery scheme, among other allegations.⁴⁷ It also contained a video of Mr. Reilly having sex with a woman who was characterized in the media as his girlfriend.⁴⁸ This email, unlike the prior emails that identified widespread corporate malfeasance, finally spurred GSK to action.

GSK’s response to the allegations was fatally compromised from the outset and primarily focused on discrediting the whistleblower⁴⁹ and improperly preempting any governmental inquiry. GSK inexplicably placed Mr. Reilly in charge of its internal investigation into the whistleblower allegations, in which he was implicated, and into a break-in at his own apartment related to the video.⁵⁰ His conflict of interest and personal stake in the investigation should have precluded other GSK executives from placing Mr. Reilly in an investigative role, and when they did, it should have motivated him to decline the role, which he did not.⁵¹ It is difficult to imagine how any unbiased investigation into the whistleblower allegations would have found no wrongdoing, which was GSK’s conclusion.⁵² The GSK management team in China had used some 700 travel and consulting firms from 2007 to 2013 to skim off 500 million dollars⁵³ they used to bribe hospitals and doctors, and probably government officials as well, though the Chinese never charged GSK with bribing government officials.⁵⁴ Meanwhile, GSK’s managers in China were

⁴⁷ David Barboza, *Hearing the Whistle, Not Ending the Fraud*, N.Y. TIMES, Nov. 1, 2016 at B9.

⁴⁸ John Ruwitch et al., *Sex Video New Twist in GSK China Bribery Scandal*, Reuters, June 30, 2014, <https://www.reuters.com/article/us-gsk-china/sex-video-new-twist-in-gsk-china-bribery-scandal-idUSKBN0F52CV20140630> (last visited May 3, 2018).

⁴⁹ Jane Perlez, *China Reveals Charges for British-American Couple in Case Involving Glaxo*, N.Y. TIMES, Jul. 14, 2014 at B8.

⁵⁰ David Barboza, *China Tightens Its Grip, and Glaxo Pays a Price*, N.Y. TIMES, Nov. 2, 2016 at A1.

⁵¹ *Id.*

⁵² Malcolm Moore & Denise Roland, *Top Chinese Official Targets GSK in Bribery Probe*, TELEGRAPH, July 11, 2013, <http://www.telegraph.co.uk/finance/newsbysector/pharmaceuticalsandchemicals/10175151/Top-Chinese-official-targets-GSK-in-bribery-probe.html> (last visited Nov. 21, 2017).

⁵³ David Barboza, *Files Suggest a Graft Case in China May Expand*, N.Y. TIMES, Jul. 21, 2013, <http://nyti.ms/1dOzaPm> (last visited March 28, 2017).

⁵⁴ David Barboza, *GlaxoSmithKline Accused of Corruption by China*, N.Y. TIMES, Jul. 12, 2013 at B5.

attempting to bribe the regulatory authorities in China in order to have any investigation of the firm's sales practices dropped.⁵⁵

When GSK did launch an outside investigation, it was not directed at the alleged corporate and executive misbehavior.⁵⁶ Instead, it hired Shanghai-based compliance company ChinaWhys to do "due diligence" to determine who had videotaped its manager having sex and to identify and discredit the whistleblower.⁵⁷ GSK had identified Vivian Shi as the probable whistleblower and had already fired her in December 2012, ostensibly for falsifying travel expenses.⁵⁸ She was an employee who had worked in its government affairs office and whose father was a former official in the Chinese Government's health office. GSK had essentially hired ChinaWhys to find information that would discredit Vivian Shi.⁵⁹ The initial investigation by ChinaWhys, conducted by its two principals, could not connect the company's suggested prime suspect to the GSK whistleblowing, but did characterize her as a person who had engaged in a similar "attack" against a previous employer.⁶⁰ In obtaining information about Vivian Shi, the ChinaWhys organization violated a number of Chinese laws by bribing government officials.⁶¹

This response strategy proved to be costly, both for GSK and ChinaWhys. The investigation of Vivian Shi's credentials and connections, including her ties to high-ranking officials and regulators, may have helped put both companies in the crosshairs of the Chinese government.⁶² Within seven months of their involvement, the two principals of ChinaWhys, who prided themselves in "discreet investigations,"⁶³ were thrown in jail. Peter Humphrey and Yu Yingzeng, who were also husband and wife, were interrogated and indicted on charges of illegally gathering private information,

⁵⁵ David Barboza, *China Tightens Its Grip, and Glaxo Pays a Price*, N.Y. TIMES, Nov. 2, 2016 at A1.

⁵⁶ Jane Perlez, *China Reveals Charges for British-American Couple in Case Involving Glaxo*, N.Y. TIMES, Jul. 14, 2014 at B7.

⁵⁷ *Id.*

⁵⁸ David Barboza, *GlaxoSmithKline Accused of Corruption by China*, N.Y. TIMES, Jul. 12, 2013 at B5.

⁵⁹ *Id.*

⁶⁰ David Barboza, *China Tightens Its Grip, and Glaxo Pays a Price*, N.Y. TIMES, Nov. 2, 2016 at A1.

⁶¹ Nate Raymond, *U.S. Judge Dismisses Ex-Sleuths' Lawsuit Against GlaxoSmithKline*, Reuters, Oct. 2, 2017, <https://www.reuters.com/article/us-gsk-china-lawsuit/u-s-judge-dismisses-ex-sleuths-lawsuit-against-glaxosmithkline-idUSKCN1C72OB> (last visited Nov. 22, 2017.)

⁶² David Barboza, *GlaxoSmithKline Accused of Corruption by China*, N.Y. TIMES, Jul. 12, 2013 at B5.

⁶³ *Id.*

including personal household registrations, entry and exit records, phone records and business registrations.⁶⁴ They both served about two years in Chinese prisons.⁶⁵

The Chinese government also escalated its own investigation into the allegations against GSK, delegating power to review the case to the Ministry of Public Security.⁶⁶ The Chinese police raided GSK offices in June of 2013, and a number of GSK employees, including Mr. Reilly were arrested over the summer of 2013.⁶⁷ Several senior GSK employees including Mr. Reilly, along with Peter Humphrey, admitted their crimes on Chinese television and were sentenced to prison. The GSK employees had their prison sentences suspended, pending good behavior. Mr. Reilly was deported, and GSK paid almost \$500 million in fines.⁶⁸

Both GSK and ChinaWhys failed to understand the legal and regulatory environment they were operating in was changing rapidly. By the time this scandal started to unravel President Xi Jinping had already announced his crackdown on corruption. Peter Humphrey had acknowledged an awareness of the changing regulatory environment in a posting he wrote for a fraud examiners group web site early in 2013.⁶⁹ There had already been an arrest and conviction of another group of consultants engaged in due diligence for a Western firm in 2012,⁷⁰ and public corruption trials of Chinese officials had already occurred.⁷¹ In addition it was clear by then the Chinese government was starting to pressure Western firms.

GSK'S CHANGE OF DIRECTION

Once GSK's leaders realized they had misread the legal and regulatory changes in China, they moved quickly to try to change

⁶⁴ Jane Perlez, *China Reveals Charges for British-American Couple in Case Involving Glaxo*, N.Y. TIMES, Jul. 14, 2014 at B8.

⁶⁵ *Id.*

⁶⁶ Malcolm Moore and Denise Roland, *Top Chinese official targets GSK in bribery probe*, TELEGRAPH, July 11, 2013, <http://www.telegraph.co.uk/finance/newsbysector/pharmaceuticals/andchemicals/10175151/Top-Chinese-official-targets-GSK-in-bribery-probe.html> (last visited Nov. 21, 2017).

⁶⁷ David Barboza and Katie Thomas, *Former Head of Glaxo in China is Accused of Bribery*, N.Y. TIMES, May 15, 2014 at B1.

⁶⁸ Keith Bradsher and Chris Buckley, *China Fines GlaxoSmithKline Nearly \$500 Million in Bribery Case*, N.Y. TIMES, Sep. 19, 2014, https://www.nytimes.com/2014/09/20/business/international/gsk-china-fines.html?_r=0 (last visited Mar. 28, 2017).

⁶⁹ Jane Perlez, *China Reveals Charges for British-American Couple in Case Involving Glaxo*, N.Y. TIMES, Jul. 14, 2014 at B8.

⁷⁰ *Id.*

⁷¹ *Id.*

their position. While it seems unlikely GSK leadership did not know how Mark Reilly was running their operations in China, they disavowed his actions in an attempt to salvage their market position in China. On July 15, 2013, GSK issued a public statement expressing concern and disappointment over the allegations of bribery, fraud and unethical behavior. It declared an immediate termination of the use of travel agencies that apparently facilitated GSK's misconduct, and promised a thorough review of past travel agency transactions in order to uncover other potential abuses. GSK further promised a thorough review of all compliance procedures in China. The statement declared respect for China's laws and regulations, and pledged to abide by those laws and work with China as it worked towards reforming the medical sector.⁷² GSK then took quick steps to begin the slow process of regrouping and reinventing themselves. Within days of the initial GSK statement on the matter, GSK chief executive Andrew Witty commissioned the law firm of Ropes & Gray to carry out an independent review, and appointed an executive from its European operations to replace Mark Reilly in China.⁷³ On July 22, 2013, the new head of GSK in China said: "Certain senior executives of GSK in China who know our systems well appear to have acted outside of our processes and controls, which breaches Chinese law."⁷⁴ It was the first step on a long road to redemption, or at least a start down the path forward.

In addition, Witty sent GSK's President of Emerging Markets, Abbas Hussain, to meet with the Ministry of Public Security to discuss the corruption charges.⁷⁵ Hussain came out of initial meetings with the Ministry of Public Security thanking the Chinese for their time, and pledging not only to review processes and controls, but to ensure GSK medicines would be more affordable to Chinese patients.⁷⁶

⁷² Press Release, GlaxoSmithKline, GSK Response to China Investigation (Jul. 15, 2013), <http://www.gsk.com/en-gb/media/press-releases/gsk-response-to-china-investigation/>.

⁷³ Ben Hirschler, *GSK Replaces China Chief Amid Corruption Scandal*, REUTERS, Jul. 25, 2013, <http://www.reuters.com/article/us-gsk-china-idUSBRE96O12720130725> (last visited Mar. 28, 2017).

⁷⁴ Peter J. Henning, *Lessons from Glaxo Case in China*, N.Y. TIMES, Jul. 29, 2013, <https://dealbook.nytimes.com/2013/07/29/lessons-from-the-glaxosmithkline-case-in-china/> (last visited Mar. 28, 2017).

⁷⁵ Ben Hirschler, *GSK Sends Three Executives to China to Handle Crisis*, REUTERS, Jul. 19, 2013, <http://www.reuters.com/article/us-gsk-china-idUSBRE96I0NL20130719> (last visited Mar. 28, 2017).

⁷⁶ See Press Release, GlaxoSmithKline, GSK Statement Regarding Recent Meeting with the Chinese (Jul. 22, 2013), <http://gsk.com/en-gb/media/press-releases/gsk-statement-regarding-recent-meeting-with-chinese-authorities/>.

It is clear GSK's policies and protocols failed to provide adequate warning in China. Those same policies and protocols were also failing in the West. In the United States, as a result of four employee-whistleblower complaints, GSK had been in extended litigation. Consequently, GSK agreed to pay \$3 billion dollars in fines. The settlement was the largest any pharmaceutical company had paid for its misdeeds in the United States to date.⁷⁷ The fines were the result of alleged practices of illegally marketing drugs, failing to report safety data and associated misconduct that extended over a ten year period.⁷⁸ Even after paying \$1 billion dollars in criminal fines and \$2 billion dollars as part of a civil settlement, GSK still admitted no wrongdoing in the civil settlement.⁷⁹ CEO Andrew Witty stated the settlement reflected a past era for GSK, and said GSK had learned from its mistakes.⁸⁰ GSK was attempting to reposition itself in both Western and Chinese markets in order to move beyond the whistleblower scandals.

By December 2016, GSK announced significant changes to its entire enterprise. The changes, which it projected would take three years to complete, acknowledged seismic shifts in corporate practices were required if GSK hoped to stay and prosper in the Chinese market. Notably, GSK announced the restructuring of its compensation program. Instead of rewarding sales people for the number of prescriptions written by health care professionals they served, GSK would instead compensate sales force personnel for their technical knowledge, the quality of their service in support of improved patient care, and their overall performance. By removing pay structures that provided an incentive to sales people to focus on quantity of sales over people, GSK provided a means for its sales force to succeed, while at the same time reducing the temptation to work outside legal and ethical boundaries.⁸¹ GSK also announced plans to move away from making direct payments to healthcare professionals for speaking engagements and for attending medical conferences, a practice prohibited in the United States. Instead, the company planned to fund education for health care professionals through unsolicited, independent

⁷⁷ Alexandra Sifferlin, *Breaking Down GlaxoSmithKline's Billion-Dollar Wrongdoing*, TIME, July 05, 2012, <http://healthland.time.com/2012/07/05/breaking-down-glaxosmithklines-billion-dollar-wrongdoing/> (last visited November 24, 2017).

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ Katie Thomas and Michael S. Schmidt, *Glaxo Agrees to Pay \$3 Billion in Fraud Settlement* N.Y. TIMES, July 02, 2012, <http://www.nytimes.com/2012/07/03/business/glaxosmithkline-agrees-to-pay-3-billion-in-fraud-settlement.html> (last visited August 8, 2017).

⁸¹ Press Release, GlaxoSmithKline, *GSK Announces Changes to Its Global Sales and Marketing Practices to Further Ensure Patient Interests Come First* (Dec. 17, 2013), <http://us.gsk.com/en-us/media/press-releases/2013/gsk-announces-changes-to-its-global-sales-and-marketing-practices-to-further-ensure-patient-interests-come-first/>.

education grants. GSK also signaled it would be more transparent with clinical trial data and disclosure of payments to health care professionals.⁸²

The potential Chinese market for medical supplies and health care is projected to keep growing at a rapid rate, and multinational companies operating in the health care sector want to participate in that market. That means they have to adjust to the evolving legal and regulatory market in China. This will not be a simple process. It is easy to misread the motives of the Chinese government because it often has several motives driving its actions. In this most recent crackdown on multinational firms, the Chinese are accomplishing three basic goals. First, the Chinese government needs to control health care costs, while increasing the quality and quantity of care. China's pursuit of bribery and anti-competitive charges against multinational companies are forcing pharmaceutical companies to moderate their prices and profits, as GSK pledged following the government's enforcement action. Other companies were also implicated in the bribery of doctors and hospital personnel, and all of the multinational pharmaceutical companies doing business have also agreed to lower their prices. Second, President Xi Jinping has promised to end government corruption due to the serious concerns of and protests by large numbers of Chinese citizens. Punishing the officials who take bribes, but not the companies that pay them, would undermine this goal. It could also lead to a rift with the nationalist part of Xi's party, and a sense government officials would have behaved correctly if they had not been corrupted by the multinational companies. Public arrests and televised admissions of bribery by multinational company managers can moderate those risks while trumpeting the government's anticorruption efforts. Finally, the Chinese government wants to support and encourage the growth of Chinese companies, and the investigations of and charges against multinational firms often result in agreements to share technology or use local Chinese companies as suppliers, both of which strengthen the position of the Chinese firms.

On August 2, 2015, GSK rehired Vivian Shi, the executive whom they had fired and investigated as a whistleblower almost two and a half years earlier.⁸³ Beyond confirming Ms. Shi was once again employed by the company, GSK

⁸² Katie Thomas, *Glaxo Says It Will Stop Paying Doctors to Promote Drugs*, N.Y. TIMES, Dec. 16, 2013, <http://www.nytimes.com/2013/12/17/business/glaxo-says-it-will-stop-paying-doctors-to-promote-drugs.html> (last visited Mar. 22, 2017).

⁸³ David Barboza, *Glaxo Rehires Executive Investigated as a Whistle-Blower*, N.Y. TIMES, Aug. 4, 2015, <https://www.nytimes.com/2015/08/05/business/international/glaxo-rehires-executive-linked-to-whistle-blowing.html> (last visited Nov. 21, 2017).

would not comment on the reason or circumstances of her rehiring.⁸⁴ The two principals of ChinaWhys, who had investigated Ms. Shi at GSK's behest, and were subsequently imprisoned for violating Chinese law during their investigation, were released from prison after serving about two years.⁸⁵ Following their release, Peter Humphrey, a British national, and his wife, Yu Yingzeng, an American citizen, sued GSK in the United States under the federal Racketeer Influenced and Corrupt Organization Act (RICO). They alleged the company misled them about the whistleblower's accusations and induced them to investigate an innocent person, which led to their arrest and imprisonment, during which they both suffered physically and psychologically.⁸⁶ The U.S. District Court dismissed the lawsuit in September 2017 because the plaintiffs lacked standing to assert civil RICO claims for injuries that occurred outside of the United States.⁸⁷ In a separate proceeding however, in September 2016, GSK agreed to a \$20 million fine to the U.S. Securities and Exchange Commission (SEC) for bribing Chinese officials to boost sales.⁸⁸

CONCLUSION

The Corruption Perceptions Index, published annually by Transparency International, ranks China 77th out of 180 countries on its perceived level of public corruption, near the median, but significantly worse than those of Western European countries and the United States.⁸⁹ The cultural norms that influence China's ranking contributed to the haze that lulled Western companies into the ebb and flow of corruption disguised as "business as usual." In fact, for many years the Chinese government did not rigorously seek out corrupt behaviors it now seems poised to prosecute. Instead, it was in China's best interest to focus on developing and growing its economy by welcoming and facilitating multinational companies' interests and investments. New jobs, manufacturing opportunities and the wealth of ideas multinational investments brought helped grow the Chinese economy, and with it Chinese infrastructure. At the same time, the Chinese government did not want to appear as though it

⁸⁴ *Id.*

⁸⁵ Nate Raymond, *U.S. judge dismisses ex-sleuths' lawsuit against GlaxoSmithKline*, Reuters, Oct. 2, 2017, <https://www.reuters.com/article/us-gsk-china-lawsuit/u-s-judge-dismisses-ex-sleuths-lawsuit-against-glaxosmithkline-idUSKCN1C72OB> (last visited Nov. 22, 2017).

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ Sarah N. Lynch, *GlaxoSmithKline to pay \$20 million to settle U.S. foreign bribery case*, Reuters, Sept. 30, 2016 <https://www.reuters.com/article/us-sec-glaxosmithkline-corruption/glaxosmithkline-to-pay-20-million-to-settle-u-s-foreign-bribery-case-idUSKCN1202F3> (last visited, November 20, 2017).

⁸⁹ See, Transparency International, http://www.transparency.org/news/feature/corruption_perceptions_index_20177.

tolerated corrupt practices. According to Jerome A. Cohen, a legal advisor to Western companies, “For a long time, there’d been this policy of going easy on foreign enterprises. The government didn’t want to cause embarrassment or give outsiders the impression China was plagued with corruption. But they’re not thinking like that anymore.”⁹⁰ China, now an economic powerhouse in its own right, has begun to turn its eyes more fully to corruption, focusing on barring practices it once tolerated. Western firms doing business in China need to recognize the legal and regulatory environment in China has changed, and the firms must adjust their business practices accordingly.

Shortly after the GSK scandal, the central government in China altered the laws regulating the behavior of doctors, hospitals and medical supply companies, including pharmaceutical companies. Chinese law now clearly lists prohibited acts. The government also created a legal mechanism allowing it to blacklist medical suppliers found to have violated bribery laws. These legal changes make the regulators in China a much bigger threat to multinational companies. While GSK may have written off its earlier penalties as a cost of doing business, the new laws hold the potential of ending its business in China which would be a much greater economic blow to the company’s future profits and competitive position. Although GSK has avoided being blacklisted in China for this scandal, it may not be so lucky if there is a next time.⁹¹

⁹⁰ David Barboza, *China Tightens Its Grip, and Glaxo Pays a Price.*, N.Y. TIMES, Nov. 2, 2016 at A1.

⁹¹ Sherry Tao, *Anti-Bribery Battle in China’s Healthcare Industry and New Blacklisting Rules: A Treatment with Side Effects*, Association of Corporate Counsel, March 3, 2015, <http://www.accdocket.com/articles/anti-bribery-in-chinese-health.cfm> (last visited, May 30, 2018).

DRIVEN DATA: CONNECTED CARS AND PRIVACY LAW

by Carter Manny*

I. INTRODUCTION

As cars have become increasingly loaded with electronics, large amounts of information about drivers and passengers are being collected, stored and transmitted for a variety of uses.¹ Vehicles that can connect to the Internet are part of what has been described as the “Internet of Things.”² “A connected car is the ultimate Internet of Things device. It has the potential to download data stored on your phone and makes it possible to determine where you work, live, worship, and can reveal several details about your personal life and habits.”³

Some electronic devices in cars, however, lack wireless connectivity. For example, event data recorders, also known as “black

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¹ See, e.g., Kelley Chittenden, *Warning Light: The FTC is Monitoring the Connected Car Marketplace*, available at <https://www.technologylwdispatch.com/2018/01/privacy-data-protection/warning-light-the-ftc-is-monitoring-the-connected-car-marketplace/> (last visited Mar. 13, 2018).

² See, e.g., Federal Trade Commission, *Internet of Things: Privacy and Security in a Connected World* (Jan. 2015), available at <https://www.ftc.gov/system/files/documents/reports/federal-trade-commission-staff-report-november-2013-workshop-entitled-internet-things-privacy/150127iotprt.pdf> [hereinafter IOT Report].

³ Electronic Privacy Information Center, *Benefits and Privacy and Security Issues Associated with Current and Future Motor Vehicles* (May 1, 2017), at 7, available at <https://epic.org/apa/comments/EPIC-ConnectedCar-Workshop-Comments.pdf> (comments submitted to the Federal Trade Commission & National Highway Traffic Safety Administration in advance of a conference on connected car technology).

boxes,” have been present in most cars sold in the United States since the 1990s. The recorders provide information about vehicle speed, braking performance, and other matters at the time of an accident.⁴ In addition, diagnostic information about a vehicle’s mechanical performance is available to service technicians through a wired connection known as an onboard diagnostic port, required on cars sold in the United States since 1996.⁵ Insurers sometimes use the information available through the port to set “pay-as-you-go” rates for vehicle policies.⁶

More recently, electronic systems in vehicles collect information about the car’s occupants. Navigation systems using global positioning satellite (GPS) technology are widely available, both as plug-in units and in-dash features. They can be used to provide a history of a car’s location and where the vehicle’s occupants have traveled.⁷ Many cars have infotainment systems that connect to the Internet through the user’s smartphone, transforming the car’s dashboard touchscreen into a larger version of the phone’s screen, thus facilitating hands-free phone calls and text-to-voice “reading” of text messages.⁸ Music stored on the phone, or available through an online streaming service, can be played through the car’s sound system. One of the earliest U.S. infotainment systems, OnStar, has additional features including automatic post-accident notification of public safety agencies, and anti-theft features reducing engine power and activating vehicle tracking technology when an owner notifies OnStar that a theft has occurred.⁹ These are but a few of the many systems that collect information about users of vehicles.

Most new cars today have some sort of automated driving assistance, which could be blind spot sensing, lane departure warning and automated parking.¹⁰ Driver assist systems also collect

⁴ See, e.g., Joseph J Lazzarotti, *Driver Privacy Act of 2015 re: Event Data Recorders*, available at <https://natlawreview.com/article/driver-privacy-act-2015-re-event-data-recorders> (last visited Mar. 12, 2018).

⁵ See FTC Bureau of Consumer Protection, *Connected Cars Workshop Staff Perspective* (Jan. 2018), available at https://www.technologylawdispatch.com/wp-content/uploads/sites/26/2018/01/staff_perspective_connectd_cars_0.pdf. [hereinafter FTC Staff Perspective].

⁶ *Id.* at 2.

⁷ See, e.g., Lisa Weintraub Schifferle, *Leaving info behind, in (rental) cars*, available at <https://www.ftc.gov/news-events/blogs/business-blog/2016/08/leaving-info-behind-rental-cars> (last visited Mar. 13, 2018).

⁸ *Id.*

⁹ See generally Onstar Technology: Keeping You Connected to Things That Matter, available at https://www.onstar.com/us/en/why_onstar/technology/ (last visited Mar. 15, 2018).

¹⁰ See, e.g., Maureen K. Ohlhausen, *Acting Chairman’s Opening Remarks Connected Car*

information about the driver. Although sensors largely focus on the car's surroundings, systems that warn a driver that the car is going out of its lane or is getting too close to another vehicle could lead to an inference about the driver's skills.¹¹ Cars may be equipped with biometric devices for user recognition.¹² For example, once a driver has been identified by a fingerprint or iris scan, an insurer of a vehicle shared by family members could adjust the automobile insurance premium depending upon how much time the car is being driven by an inexperienced teenager.¹³

Intelligent transportation system (ITS) technology being developed in the United States, Europe and elsewhere employs wireless communications to reduce traffic congestion and improve safety for occupants of vehicles and pedestrians.¹⁴ Using communications equipment in vehicles, wireless devices along roads and smartphones in pedestrians' pockets, traffic can be regulated to improve efficiency and safety. Although the technology has great potential to benefit society, it also presents risks to personal privacy. In addition, fully autonomous "self-driving" vehicles are expected to be in wide-spread use in the near future, providing additional benefits and risks. The number of connected vehicles and the quantity of data they produce may be enormous. For example, the world-wide number of connected cars has been projected to be 152 million by the year 2020 and 2 billion by 2025.¹⁵ Each connected vehicle is expected to produce more than one terabyte of data per hour.¹⁶

Workshop (June 28, 2017), at 3, available at https://www.technologylawdispatch.com/wp-content/uploads/sites/26/2018/01/ohlhausen_-_connected_cars_workshop_opening_remarks_6-28-17.pdf [hereinafter Ohlhausen Opening Remarks].

¹¹ See Electronic Privacy Information Center, *supra* note 3.

¹² See, e.g., Justin Lee, *Automotive Industry Increasingly Adopting Biometric Technologies*, available at <http://www.biometricupdate.com/201702/automotive-industry-increasingly-adopting-biometric-technologies> (last visited Mar. 13, 2018).

¹³ *Id.*

¹⁴ See, e.g., U.S. Department of Transportation, *Connected Vehicle Pilot Deployment Program*, available at https://www.its.dot.gov/pilots/pilots_thea.htm (last visited Mar. 14, 2018) (describing intelligent transportation systems in the U.S.); Article 29 Data Protection Working Party, *Opinion 03/2017 on Processing personal data in the context of Cooperative Intelligent Transport Systems(C-ITS)*(Oct. 4, 2017), available at http://ec.europa.eu/newsroom/article29/item-detail.cfm?item_id=610171 (describing intelligent transportation systems in Europe).

¹⁵ See SAS Institute Inc., *The Connected Vehicle: Big Data, Big Opportunities*, at 1, available at https://www.sas.com/content/dam/SAS/en_us/doc/whitepaper1/connected-vehicle-107832.pdf (last visited Mar. 13, 2018).

¹⁶ *Id.* at 7. One terabyte is one trillion bytes or 1,000 gigabytes. See, e.g., <https://techterms.com/definition/terabyte> (last visited Apr. 6, 2018.)

With such a large amount of data being generated, the privacy implications of connected vehicle technology need to be considered carefully. This article explores privacy risks and protective responses presented by existing and soon-to-be introduced electronic systems in motor vehicles in the United States and Europe. Some of the responses are in the form of legislation. Others are in the form of guidance from regulators and self-regulatory principles adopted by members of the automotive industry. Although the United States has federal and state statutes narrowly tailored to some of the older technology, the broadest authority to protect the privacy of users of connected cars is held by the Federal Trade Commission (FTC) pursuant to general prohibitions against deception and unfairness under Section 5 of the Federal Trade Commission Act.¹⁷ In the European Union, privacy law is much more explicit pursuant to the detailed provisions of the General Data Protection Regulation which took effect in May, 2018.¹⁸

II. THE UNITED STATES APPROACH

A. Event Data Recorders

Most new cars sold in the United States include an event data recorder (EDR) which records information about speed, braking, seat belt use and other characteristics of the vehicle.¹⁹ The device is intended to record information prior to and during a crash. However, under the federal definition of an EDR, “event data” do not include audio or video recordings.²⁰ Both federal and state laws protect driver privacy with respect to EDR data. Under the federal Driver Privacy Act of 2015,²¹ the data is the property of the owner or lessee of the vehicle and cannot be retrieved by others without the owner’s or lessee’s consent. There are several exceptions that permit access to the information: (1) by order of a court or administrative agency, (2) pursuant to an investigation authorized by federal law, (4) in connection with emergency medical response or (4) in connection with safety research if personally identifiable information of the owner or

¹⁷ 15 U.S.C. § 45(a)(1).

¹⁸ Regulation 2016/679, of the European Parliament and of the Council of 27 April 2016, on the Protection of Natural Persons With Regard to the Processing of Personal Data and on the Free Movement of Such Data, 2016 O.J. (L119) 1 [hereinafter GDPR].

¹⁹ See, e.g., Joseph J Lazzarotti, *Driver Privacy Act of 2015 re: Event Data Recorders*, available at <https://natlawreview.com/article/driver-privacy-act-2015-re-event-data-recorders> (last visited Mar. 12, 2018).

²⁰ See 49 C.F.R. § 563.5(b).

²¹ 49 U.S.C. §§ 30101, et seq.

lessee of the vehicle is not disclosed.²² Seventeen states also have privacy statutes covering EDR data.²³ Most of the state statutes require that notices about the devices be made in owners' manuals and agreements for subscription services. Some statutes prohibit insurers from conditioning payment of a claim, or renewal of a policy, on an owner's consent to the release of EDR data.²⁴ In other respects, however, the state statutes generally are consistent with federal law.²⁵ While lawmakers should be commended for recognizing the need for privacy protection of EDR data, it is disappointing that it took Congress over a decade after the technology was widely implemented before federal legislation was passed.

B. The Federal Trade Commission

1. Connected Cars and "Regulatory Humility"

The FTC has followed a cautious approach regarding its role in protecting privacy with respect to devices connected to the Internet.²⁶ Although the FTC has recommended that Congress pass broad-based privacy legislation, it does not favor legislation targeted specifically at Internet of Things devices and practices.²⁷ Instead, out of concern that premature regulation might stifle innovation, the FTC favors the more flexible approach of working with various stakeholders to formulate guidelines for best practices and to engage businesses and consumers in public education activities.²⁸ In addition, the FTC encourages trade groups to develop industry-specific self-regulatory programs.²⁹ The FTC has also asserted that it lacks authority to mandate certain basic privacy protections, absent a specific showing of deception or unfairness.³⁰

²² 49 U.S.C. § 30102(b).

²³ See, e.g., National Conference of State Legislatures, *Privacy of Data from Event Data Recorders: State Statutes*, available at <http://www.ncsl.org/research/telecommunications-and-information-technology/privacy-of-data-from-event-data-recorders.aspx> (last visited Mar. 12, 2018).

²⁴ See, e.g., Ark. Code § 23-112-107; Mont. Code §§ 61-12-1001, et seq.; Ore. Rev. Stat. §§ 105.925, et seq.

²⁵ See, e.g., National Conference of State Legislatures, *Privacy of Data from Event Data Recorders: State Statutes*, available at <http://www.ncsl.org/research/telecommunications-and-information-technology/privacy-of-data-from-event-data-recorders.aspx> (last visited Mar. 12, 2018).

²⁶ See, e.g., Alexi Alesis, *FTC Backs Self-Regulation for 'Internet of Things' Market*, available at <https://www.bna.com/ftc-backs-selfregulation-n17179922544/> (last visited Mar. 23, 2018).

²⁷ IOT Report, *supra* note 2, at vii, 50, 55.

²⁸ *Id.* at ix, 53.

²⁹ *Id.* at vii, 55.

³⁰ *Id.* at vii, 51.

In 2013, the FTC held a conference on the Internet of Things,³¹ and in 2017 convened a joint workshop with the Department of Transportation entirely devoted to connected car technology.³² In her opening remarks at the 2017 conference, the agency's Acting Chair described the FTC's approach as having two parts. The first is to promote consumer and business education.³³ The educational efforts include the FTC's Start with Security campaign and its Careful Connections guide.³⁴ In addition, the Commission has published guidance for consumer and rental car companies on protecting privacy with respect to infotainment systems in rental cars.³⁵ Rental companies have been advised to disable any automatic settings that synchronize or save data from a smartphone or other connected device. Employees should be trained to delete data from the car's infotainment system to prepare the car for the next rental. Rental companies should warn consumers about the types of data that may be downloaded from mobile devices and stored on the rented car's infotainment system, and should provide clear instructions on how the information can be deleted.³⁶ While helpful, these educational efforts are modest and may not be sufficient to affect business and consumer behavior.

The second part of the FTC's approach is to bring enforcement actions "where necessary and appropriate" against manufacturers and service providers under Section 5 of the FTC Act.³⁷ Although no such actions have been brought with respect to privacy issues related to connected car technology, there have been several cases against manufacturers of other types of connected devices, as explained in the following section. The Commission, however, is cautious with respect to connected car technology. For example, the FTC's Acting Chair has described the Agency's role as protecting consumer privacy and preventing unreasonable security practices, within a framework that allows continued innovation and growth, using "regulatory humility" as its approach.³⁸ Excessive "humility," however, could cause the FTC to neglect its leadership responsibilities in the development of privacy practices protecting the legitimate interests of consumers.

³¹ See Ohlhausen Opening Remarks, *supra* note 10.

³² See, e.g., FTC Staff Perspective, *supra* note 5.

³³ See Ohlhausen Opening Remarks, *supra* note 10, 7.

³⁴ *Id.*

³⁵ *Id.*

³⁶ See Lisa Weintraub Schifferle, *Leaving info behind, in (rental) cars*, available at <https://www.ftc.gov/news-events/blogs/business-blog/2016/08/leaving-info-behind-rental-cars> (last visited Mar. 13, 2018).

³⁷ See Ohlhausen Opening Remarks, *supra* note 10 at 7.

³⁸ *Id.* at 5.

2. FTC Cases Pertaining to Other Types of Connected Devices

Although the FTC has not brought any cases involving privacy issues regarding connected cars, there have been several enforcement actions with respect to other types of connected devices used in the home. The FTC's approach in these cases may offer some insight into how the FTC will handle privacy issues with respect to connected vehicles. The first case, which was settled in 2013, was against the seller of a video camera intended to be used for remote monitoring of a consumer's home.³⁹ The company, TRENDnet, described the camera as "secure," when it actually had faulty software that permitted open viewing online. Computer hackers were able to exploit the flaw and post live feeds on the Internet from nearly 700 of the cameras. The feeds showed babies asleep in cribs, young children playing and adults going about their daily lives. The settlement required the company to stop misrepresenting the camera's security features, to notify consumers of the security issues and to provide them with technical support to update the camera's software to eliminate the security problem.

A second case involved an in-the-home wireless router which the seller, ASUSTek, claimed could protect computers from viruses, unauthorized access and hacking.⁴⁰ Despite the claims, the router's software had security flaws that enabled hackers to gain access to storage devices connected to the computers of almost 13,000 consumers. The FTC found that the seller was too slow in notifying users of the security problems and the availability of corrective software. The company was also found to have inaccurately told consumers that their routers were using up-to-date software. As part of the settlement, the company was required to notify consumers of ways to mitigate the security flaws and to implement a comprehensive security program that would be subject to biennial assessments by an independent software professional for a period of 20 years.

³⁹ See Decision and Order, *In re TRENDnet Inc.*, FTC Docket No. C-4426 (Sept. 4, 2013), available at <https://www.ftc.gov/system/files/documents/cases/140207trendnetdo.pdf>; Marketer of Internet-Connected Home Security Video Cameras Settles FTC Charges It Failed to Protect Consumers' Privacy, FTC press release (Sept. 4, 2013), available at <https://www.ftc.gov/news-events/press-releases/2013/09/marketer-internet-connected-home-security-video-cameras-settles>.

⁴⁰ See Decision and Order, *In re ASUSTeK Computer Inc.*, FTC Docket No. C-4587 (Feb. 23, 2016), available at <https://www.gov/system/files/documents/cases/1607asustekdo.pdf>; ASUS Settles FTC Charges That Insecure Home Routers and "Cloud" Services Put Consumers' Privacy At Risk, FTC press release (Feb. 23, 2016), available at <https://www.ftc.gov/news-events/press-releases/2016/asus-settles-ftc-charges-insecure-home-routers-cloud-services-put>.

The third case involved internet-connected television sets sold by VIZIO.⁴¹ Buyers of the TVs were not told that they included software that would collect viewing data, including age, gender, income, marital status, household size, education level, home ownership and household value. In addition to the payment of a civil penalty of over \$2 million, the seller agreed to delete data that had been collected and to obtain affirmative express consent for future collection and sharing of viewers' personal data.

These cases largely involve deceptive behavior following inaccurate or incomplete notices to consumers. When applied to connected cars, these cases demonstrate that manufacturers of connected vehicles and providers of connected car technology must provide notices that are accurate and thorough with respect to collection, use and sharing of information. In addition, consumers must be promptly notified of security issues and offered effective corrective measures. The cases, however, do not address other privacy issues, particularly the extent to which a consumer can exercise control over the information. For example, should consumers have rights of access to, rectification of, and deletion of the data? Should they be offered an opportunity to opt-out of, or switch off, some of the connected features when buying, leasing or renting a car?⁴² Accordingly, these FTC enforcement actions are relatively narrow and do not address some important issues regarding consumer privacy and connected vehicle technology.

C. Self-Regulation by the Automotive Industry

Automobile manufacturers have attempted to address privacy issues through self-regulation. In November 2014, a group of manufacturers⁴³ sent the FTC a set of privacy protection principles

⁴¹ See Stipulated Order For Permanent Injunction and Monetary Judgment, *FTC v. VISIO, Inc.* (U.S. District Court, District of New Jersey)(Feb. 6, 2017), *available at* https://www.ftc.gov/system/files/documents/cases/170206_vizio_stipulated_proposed_order.pdf; *Visio to Pay \$2.2 Million to FTC, State of New Jersey to Settle Charges It Collected Viewing Histories on 11 Million Smart Televisions without Users' Consent*, FTC press release (Feb. 6, 2017), *available at* <https://www.ftc.gov/news-events/press-releases/2017/02/vizio-pay-22-million-ftc-state-new-jersey-settle-charges-it>.

⁴² See, e.g., Electronic Privacy Information Center, *supra* note 3.

⁴³ The manufacturers are American Honda Motor Co., Inc., Aston Martin Lagonda of North America, Inc., BMW of North America, LLC, Chrysler Group LLC, Ferrari North America, Ford Motor Company, General Motors LLC, Hyundai Motor America, Kia Motors America, Maserati North America, Inc., Mazda North America Operations, Mercedes-Benz USA, LLC, Mitsubishi Motors North America, Inc., Nissan North America, Inc. Porsche Cars North America, Subaru of America, Inc., Toyota Motor Sales, USA, Volkswagen Group of America, Inc. and Volvo Car Group. See Commitment of the Alliance of Automobile Manufacturers, Inc. and the Association of Global Automakers, Inc. to the Consumer Privacy Protection Principles for Vehicle Technologies and Services, at 13, *available at*

for vehicle technologies.⁴⁴ The principles are based on the Fair Information Practice Principles, also known as “FIPPS” which were first formulated during the 1970s.⁴⁵

The definition of the data protected by the Automakers’ Privacy Principles follows the concept of “personally identifiable information,” which is described as including information linked to the vehicle from which it is retrieved, the owner of the vehicle or the “registered user” using vehicle technologies or services associated with the vehicle.⁴⁶ A registered user could include a renter or passenger who provides subscription information to a vehicle manufacturer in order to use “vehicle technologies or services.”⁴⁷ For example, a passenger who links a smartphone to the car’s infotainment system and connects to a music streaming service could become a “registered user.” The phrase “covered information” includes both “identifiable information” and subscription information, but excludes information that has been de-identified so that it can no longer reasonably be linked to the vehicle, the owner, or any other individual.⁴⁸ However, if the information is re-identified so that it can be linked to identified individuals or vehicles, it regains its status as “covered information.”⁴⁹

The Automakers’ Privacy Principles follow the United States approach known as “notice and choice.” With respect to notice, manufacturers have a general duty to provide individuals with ready

https://www.technologylawdispatch.com/wp-content/uploads/sites/26/2018/01/Auto_Alliance_Global_Automakers_letter_to_FTC_RE_Privacy.pdf (last visited Mar. 15, 2018).

⁴⁴ Commitment of the Alliance of Automobile Manufacturers, Inc. and the Association of Global Automakers, Inc. to the Consumer Privacy Protection Principles for Vehicle Technologies and Services, *available at* https://www.technologylawdispatch.com/wp-content/uploads/sites/26/2018/01/Auto_Alliance_Global_Automakers_letter_to_FTC_RE_Privacy.pdf (last visited Mar. 15, 2018)[hereinafter Automakers’ Privacy Principles].

⁴⁵ See letter from Mitch Bainwol, President and Chief Executive Officer of the Alliance of Automobile Manufacturers, Inc., and John Bozzella, President and Chief Executive Officer of the Association of Global Automakers, Inc. to Edith Ramirez, Chairwoman of the FTC (Nov. 12, 2014), *available at* https://www.technologylawdispatch.com/wp-content/uploads/sites/26/2018/01/Auto_Alliance_Global_Automakers_letter_to_FTC_RE_Privacy.pdf. The Fair Information Privacy Practices originated in a report issued by the U.S. Department of Health, Education and Welfare in 1973. *See* U.S. Department of Health, Education and Welfare, RECORDS, COMPUTERS AND THE RIGHTS OF CITIZENS, REPORT OF THE SECRETARY’S ADVISORY COMMITTEE ON AUTOMATED PERSONAL DATA SYSTEMS (1973). The FTC issued a revised version of the Fair Information Practices in the year 2000. *See* Federal Trade Commission, Privacy Online: Fair Information Practices in the Electronic Marketplace, *available at* <https://www.ftc.gov/reports/privacy-online-fair-information-practices-electronic-marketplace-federal-trade-commission> (last visited Mar. 29, 2018).

⁴⁶ Automakers’ Privacy Principles, *supra* note 44, at 5.

⁴⁷ *Id.* at 5.

⁴⁸ *Id.* at 4.

⁴⁹ *Id.*

access to clear, meaningful notices about the collection, use and sharing of “covered information.”⁵⁰ Notices can take the form of information in owners’ manuals, on paper or electronic forms or on in-vehicle displays.⁵¹ At a minimum, however, notices about collection, use and sharing of information must be publicly available online.⁵² Although manufacturers commit to providing notices prior to the initial instance of collection of covered information, notices need not be provided prior to every collection when a prior notice has been given.⁵³

The content of a notice must include the following: (1) the type of information collected, (2) the purposes for which the information is collected, (3) the third parties with whom the information may be shared, (4) the deletion or de-identification of information, (5) the choices that individuals have with respect to the information, (6) whether and how access to the information may be obtained and (7) where individuals may direct questions about the collection, use and sharing of the information.⁵⁴ Absent from this list is notice of how, or whether, an individual can obtain correction or erasure of inaccurate information.

Because the Automakers’ Privacy Principles are subject to change over time,⁵⁵ manufacturers commit to take “reasonable steps” to alert individuals prior to changing the collection, use and sharing practices associated with “covered information.”⁵⁶ The notice of changes applies only when the changes will have a “material impact” on individuals. However, if the new practices will use the covered information in a “materially different manner” than claimed when the covered information was collected, the manufacturer will obtain “affirmative consent” from individuals to the new practices.⁵⁷ “Affirmative consent” is defined as clear action performed in response to a clear, meaningful and prominent notice disclosing the collection, use and sharing of “covered information.”⁵⁸ These phrases leave considerable room for interpretation. What is sufficient to be a “clear action?” What is a “clear, meaningful and prominent notice?” What is “material” with respect to impact on an individual and in the manner in which information is used? The use of such vague terms gives

⁵⁰ *Id.* at 6.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 7.

⁵⁵ *Id.* at 2.

⁵⁶ *Id.* at 7.

⁵⁷ *Id.*

⁵⁸ *Id.* at 4.

manufacturers considerable discretion in determining when consumers must be notified of changes and when manufacturers must obtain affirmative consent from owners and registered users.

Ironically, the provisions on “choice” do not provide consumers with control over much of the information. There is vague language stating that “certain safety, operations, compliance and warranty information may be collected by necessity without choice.”⁵⁹ These terms are not defined or explained. In addition, there is a broadly worded provision stating that an individual’s “acceptance and use” of vehicle technologies and services constitutes consent to the associated information practices.⁶⁰ The only “choice” that individuals can exercise relates to location information, biometrics or driver behavior information.⁶¹ The manufacturer cannot use such information for marketing, or transfer that information to an unaffiliated third party for its own purposes, unless the manufacturer obtains “affirmative consent” from the individual.⁶² Consent is not needed, however, when the location/biometric/behavioral information is used or shared for a wide variety of purposes including safety, operations, compliance, warranties, internal research, product development, mergers/acquisitions, lawful government requests and vehicle theft.⁶³ In addition, consent is not needed when the location-biometric-behavioral information is shared with a third party service provider who is supplying vehicle technologies and services, if that third party is not permitted to use the information for its independent use and if sharing is consistent with notices that the manufacturer of the vehicle has provided.⁶⁴ There is flexibility surrounding the timing of affirmative consent. It may be obtained when a vehicle is leased or purchased, when registering for a service, or at another time.⁶⁵ As was the case with respect to notice of changes in the Automakers’ Privacy Principles noted above, the provisions regarding location information give manufacturers considerable discretion in determining when they must obtain affirmative consent.

The Principles include a provision labeled “Respect for Context” that contains a loosely worded commitment to use and share covered information in ways that are consistent with the context in which the information was collected. It largely duplicates standards set forth in

⁵⁹ *Id.* at 8.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* at 8 - 9.

⁶⁴ *Id.* at 9.

⁶⁵ *Id.* 9.

the provisions on notice and emphasizes that uses and sharing of information are governed by what is “reasonable.”⁶⁶ The examples of such uses and sharing set forth in the “respect for context” provision largely duplicate those in the notice provisions.⁶⁷

Collection of information is limited only by a general commitment by manufacturers to gather data solely as needed for “legitimate business purposes.”⁶⁸ Similarly, storage is limited only by the vague duty to retain information no longer than the manufacturer determines is necessary for “legitimate business purposes.”⁶⁹ Because each manufacturer has broad discretion to determine what is legitimate, the Automakers’ Privacy Principles lack meaningful limits on collection and storage.

The data security provision is also very vague. Manufacturers commit to implementing reasonable measures to protect information against loss and unauthorized access or use.⁷⁰ Reasonable measures include standard industry practice which evolves over time.⁷¹ The use of general language in this provision is understandable considering the rapid pace of change in information technology.

A reasonableness standard governs the commitment of manufacturers to maintain the accuracy of information.⁷² Manufacturers also agree to adopt reasonable means for individuals to review and correct subscription information.⁷³ But consumers have no right under the Principles to gain access to or correct “covered information,” including potentially harmful data involving location, biometrics, driving behavior and wireless communications through the vehicle’s infotainment system. The only commitment by the manufacturers is to “explore” additional means of providing

⁶⁶ “Participating Members commit to making reasonable and responsible use of Covered Information and may share the information as reasonable for those uses. Reasonable and responsible practices may vary over time as business practices and consumer expectations evolve.” Automakers’ Privacy Principles, *supra* note 44 at 10.

⁶⁷ Examples of reasonable and responsible use and sharing include use: (1) to provide requested or subscribed services, (2) to respond to an emergency, (3) to conduct vehicle research or analysis, (4) connected with a merger or acquisition, (5) for sharing with affiliated companies for operational purposes, (6) to prevent fraud or criminal activity, (7) to improve existing products and services, and to develop existing products and services, (8) for marketing, (9) for sharing to comply with lawful governmental requests, and (10) to protect the safety, property or other rights of manufacturers, vehicle owners and others. Automakers’ Privacy Principles, *supra* note 44, at 10 - 11.

⁶⁸ Automakers’ Privacy Principles, *supra* note 44, at 11.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

“reasonable access” to “covered information.”⁷⁴ The failure of the Principles to provide consumers with rights of access and rectification is a major deficiency in the level of privacy protection.

The absence of meaningful enforcement is another short-coming of the Automakers’ Privacy Principles. Manufacturers commit to taking “reasonable steps” to ensure that they, and other entities receiving information, adhere to the Principles.⁷⁵ There is a listing of “accountability mechanisms” that manufacturers “may implement,” including training programs for employees, internal privacy review boards and reporting mechanisms for consumers.⁷⁶ Manufacturers may also commit to taking reasonable steps to ensure that third party service providers adhere to the Principles.⁷⁷ While these suggestions are helpful, there is no mechanism for holding a manufacturer or third party accountable for violation of any of the standards.

Although the Automakers’ Privacy Principles are a step in the right direction, they fall short of providing consumers with adequate protection for their personal information collected by connected car technology. The terminology is vague and the manufacturers’ commitments can be changed. There is no enforcement mechanism. Accordingly, the Principles could be viewed as more of a public relations exercise than a meaningful commitment to protect the privacy of consumers.

D. Intelligent Transportation Systems

Technology that enables vehicles to communicate with each other and with highway equipment, known as “intelligent transportation systems,” has great potential to improve traffic safety and efficiency. The U.S. Department of Transportation has an Intelligent Transportation Systems Joint Program Office that is working on development of connected vehicle technology.⁷⁸ Safety systems include left turn assist and intersection movement assist which could prevent over 500,000 collisions and save over 1,000 lives per year.⁷⁹ Other systems warn drivers of collisions, pedestrians in cross walks, traffic signals, stop signs, and other vehicles in the driver’s blind spot.⁸⁰ Traffic flow can be improved through traffic jam warnings,

⁷⁴ *Id.*

⁷⁵ *Id.* at 12.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ See, e.g., The Intelligent Transportation Systems Joint Program Office (ITS JPO), available at <https://www.its.dot.gov/index.htm> (last visited Mar. 14, 2018).

⁷⁹ See Connected Vehicle Basics, available at https://www.its.dot.gov/cv_basics/cv_basics_20as.htm (last visited Mar. 14, 2018) [hereinafter Connected Vehicle Basics].

⁸⁰ *Id.*

coordination of traffic signals and adaptive cruise control which matches a car's speed to surrounding traffic.⁸¹ In 2015, the Department of Transportation launched pilot projects in Wyoming, New York City and Tampa, Florida. The Wyoming project is intended to improve safety and efficiency of truck traffic on Interstate 80.⁸² The New York City system focuses on improvement of pedestrian safety and traffic flow at intersections.⁸³ The project in Tampa, described below, involves complicated coordination between roadway vehicles, trolleys and pedestrians.

The system in Tampa involves reversible lanes on an expressway, nearby streets with heavy traffic, and a trolley line with many street crossings.⁸⁴ Participating vehicles include 1600 cars, 10 buses, and 10 trolleys, all of which communicate with each other through wireless devices. In addition, the project has 500 pedestrians who are connected through smartphone applications. Approximately 40 roadside units are part of the system. The project is expected to reduce wrong-way vehicle entries into reversible expressway lanes, reduce collisions between vehicles, increase pedestrian safety, reduce conflicts between cars, buses and trolleys at intersections, and improve traffic flow.⁸⁵

The Department of Transportation has assured the U.S. public that vehicle-to-vehicle technologies being developed as part of the Intelligent Transportation System project “do not pose a significant to privacy and have been designed to help protect against vehicle tracking by the government and others.”⁸⁶ The Agency has asserted that the system will not collect or store any financial information, personal communications or any other data on people or individual vehicles, nor will it provide a conduit into the vehicle for extracting data.⁸⁷ However, the Department of Transportation has stated that the system will be operated by private entities, which raises a question as to whether companies running the system might try to use location data to generate revenue by selling it to advertisers or others. The Agency has discounted this risk by assuring the public that the system will not permit tracking of vehicles linked to specific

⁸¹ See Lisa Weintraub Schifferle, *Leaving info behind, in (rental) cars*, available at <https://www.ftc.gov/news-enants/blogs/business-blog/2016/08/leaving-info-behind-rental-cars> (last visited Mar. 13, 2018).

⁸² See Connected Vehicle Basics, *supra* note 79.

⁸³ *Id.*

⁸⁴ Connected Vehicle Pilot Deployment Program, available at https://www.its.dot.gov/pilots/pilots_thea.htm (last visited Mar. 14, 2018).

⁸⁵ *Id.*

⁸⁶ See Connected Vehicle Basics, *supra* note 79.

⁸⁷ *Id.*

owners, drivers or other persons.⁸⁸ While these representations are a welcome sign that privacy protection is being considered as part of intelligent transportation system design, a more thorough explanation of the safeguards should be made through a formal privacy impact assessment.

III. THE EUROPEAN UNION APPROACH

A. Recommendations by the French Data Protection Authority

Privacy regulators in Europe have been active in examining connected car technology. The leader in this effort has been the French Data Protection Authority, known by the acronym “CNIL,” which issued a report in October 2017 giving detailed guidance on steps automobile manufacturers and others should take in order to comply with French Data Protection Law and the EU’s General Data Protection Regulation (GDPR).⁸⁹ In preparing the report, CNIL consulted a number of organizations including professionals in telecommunications, electronics, insurance, government, vehicle manufacturers and a major car rental company, Avis.⁹⁰ The scope of the report is limited to use of vehicles by consumers for their personal needs, and excludes the use of company vehicles by employees.⁹¹ Another limitation is that the report deals only with existing technology and does not address systems under development, including intelligent transportation systems.⁹² After a thorough explanation of general compliance obligations under the GDPR, the report considers three scenarios: (1) systems in which data remain in the vehicle (for example a lane departure warning system), (2) systems that transmit data to a service provider but which do not trigger automatic action in the vehicle (for example, a system which automatically contacts emergency responders immediately after an accident) and (3) systems that transmit data to a service provider to remotely trigger an automatic action in the vehicle (for example, a service provider that receives location and destination information from the vehicle and sends back routing information on how best to avoid traffic congestion).⁹³

⁸⁸ *Id.*

⁸⁹ Commission Nationale Informatique & Libertés, Compliance Package: Connected Vehicles and Personal Data (Oct. 2017), available at https://www.cnil.fr/sites/default/files/atoms/files/cnil_pack_vehicules_connectes_gb.pdf [hereinafter CNIL Report].

⁹⁰ *Id.* at 3.

⁹¹ *Id.*

⁹² *Id.* at 4.

⁹³ *Id.* at 19, 23 and 32.

The GDPR contains detailed requirements for giving notice to consumers, known as “data subjects.”⁹⁴ The notice must include the purposes for which the data will be processed, the recipients of the data, the right to obtain access to the data and rectify errors, the length of time the data will be stored, and information about transfer of the data to third parties.⁹⁵ Notice may be given in a purchase and sale contract, a contract for the provision of services, in an owners’ manual or on the vehicle’s dashboard computer display using standardized icons.⁹⁶

Under European Data Protection law, someone who determines how data will be collected, used and stored is known as a “controller.”⁹⁷ A business that carries out the manipulation of data at the direction of the controller is known as a “data processor.”⁹⁸ In the context of connected cars, vehicle manufacturers and companies that provide connected car services would all be controllers.

Generally, personal data can be collected and processed for a specific, explicit and legitimate purpose.⁹⁹ Under certain circumstances, the data subject has the right to restrict processing. The right can be exercised when the accuracy of data is contested, when processing is unlawful and in other situations.¹⁰⁰ When processing is thus restricted, the data normally may only be processed with the data subject’s consent.¹⁰¹ In addition, there is a right to object to processing for direct marketing purposes.¹⁰² A number of reasons enable a data subject to request erasure of data, thus establishing “the right to be forgotten.”¹⁰³

The first scenario described in the CNIL Report includes communications within the vehicle without transferring data to the outside.¹⁰⁴ Examples include a lane departure warning system, an automatic parking system, a collision warning device, an “eco-driving” feature which encourages fuel efficient driver behavior, an automatic seat adjustment feature, a system notifying the driver that maintenance is needed, a voice recognition feature to operate vehicle systems, and biometric systems that use a fingerprint to unlock or

⁹⁴ GDPR, *supra* note 18, at Art. 4(1) (defining “data subject”).

⁹⁵ CNIL Report, *supra* note 89 at 12 with references to GDPR Arts. 12, 13 & 14.

⁹⁶ CNIL Report, *supra* note 89 at 13.

⁹⁷ GDPR, *supra* note 18, at Art. 4(7) (defining “controller”).

⁹⁸ *Id.* at Art 4(8) (defining “processor”).

⁹⁹ CNIL Report, *supra* note 89 at 9; GDPR, *supra* note 18, at Art. 5.1.b

¹⁰⁰ CNIL Report, *supra* note 89 at 16; GDPR, *supra* note 18, at Art. 18.

¹⁰¹ *Id.*

¹⁰² CNIL Report, *supra* note 89 at 14; GDPR, *supra* note 18, at Art. 17.

¹⁰³ *Id.*

¹⁰⁴ CNIL Report, *supra* note 89 at 19.

start a car.¹⁰⁵ As long as processing is being carried out for the performance of purely personal activities, the processing would not be subject to data protection law.¹⁰⁶ This would not be true, however, when an employee drives an employer-owned car.¹⁰⁷ Users should have full control over the information, including the ability to delete stored data from the vehicle's systems.¹⁰⁸ Use of a smartphone application in connection with these types of systems would not raise issues under data protection law, as long as vehicle data are not transmitted to the application provider and smartphone data are not being transmitted to the manufacturer.¹⁰⁹ Of course, all the systems should have adequate security features, including authentication and encryption.¹¹⁰

The second scenario outlined in the CNIL Report covers situations in which data are transmitted from the vehicle to a service provider, but the service provider does not send a signal back to the vehicle.¹¹¹ Examples include a system for compiling information about wear of vehicle parts, a "pay-as-you-drive" billing system for insurance, a breakdown assistance service, an "e-Call" system that automatically calls an emergency number in the event of an accident, and a vehicle finding system activated after a theft.¹¹² Notification of data subjects can be provided in a purchase and sale agreement, the owner's manual, in a service contact and through standardized icons appearing on the vehicles dashboard screen.¹¹³ The content of a notice should include all the generally required provisions under the GDPR including contact information for the controller's data protection officer, the right to bring a complaint with the appropriate regulatory authority, an explicit mention of the "legitimate interests" of the controller, the existence of any automatic decision-making including profiling, and various rights of the data subject including erasure, data portability and the ability to withdraw consent at any time.¹¹⁴ Additional information about the types of data collected and storage periods should be provided, depending upon the system in question. For example data collected for detecting wear of parts should be stored for no more than three years while a "pay-as-you-drive"

¹⁰⁵ *Id.* at 21.

¹⁰⁶ CNIL Report, *supra* note 89, at 20. GDPR, *supra* note 18, at Art 2(2)(c).

¹⁰⁷ CNIL Report, *supra* note 89, at 20.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 19.

¹¹⁰ *Id.* at 22.

¹¹¹ *Id.* at 23.

¹¹² *Id.*

¹¹³ *Id.* at 29.

¹¹⁴ *Id.* at 28.

insurance system should retain information only for the duration of the insurance contract.¹¹⁵ A service provider should minimize collection of location data to what is absolutely necessary for the purpose of the processing.¹¹⁶ Moreover, the collection of location information should be activated only when the user launches a functionality that requires location data, which should trigger a signal to the user (perhaps through an arrow moving on the dashboard screen) that such information is being collected.¹¹⁷ Users should have the ability to turn off the location system at any time.¹¹⁸

The third scenario described in the CNIL Report is one in which the vehicle's systems lack sufficient computing power or when external data are needed to perform a service.¹¹⁹ Consequently, information is sent from the vehicle to the service provider which then remotely triggers an automatic action in the vehicle. An example of this type of system is a dynamic traffic information service which notifies the driver of route to use to avoid traffic congestion.¹²⁰ Another example is a remote vehicle diagnostic system which notifies the driver of poor engine performance or brake wear.¹²¹ Methods of notification and the content of notices to users are similar to those in the second scenario.¹²² Likewise, the principle of data minimization should be followed so that only personal data strictly necessary for the provision of the service are collected. Usage data should be retained only for a limited time, while vehicle diagnostic information can be retained by the service provider for the life of the vehicle.¹²³

In contrast to the vague assurances of the U.S. automakers' self-regulatory Principles and the FTC's relatively passive "regulatory humility," the CNIL Report gives manufacturers and service providers practical advice about what they need to do to make sure that existing connected car technology complies with privacy law. With respect to the development of new technology, including intelligent transportation systems, the group of European data protection regulators, known as the Article 29 Working Party, has also provided guidance, as explained in the next section.¹²⁴

¹¹⁵ *Id.* at 26.

¹¹⁶ *Id.* at 25.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 35.

¹²⁰ *Id.* at 32.

¹²¹ *Id.*

¹²² *See, e.g., Id.* at 33–34.

¹²³ *Id.* at 33.

¹²⁴ *See* Article 29 Data Protection Working Party, *Opinion 03/2017 on Processing personal data in the context of Cooperative Intelligent Transport Systems(C-ITS)* (Oct. 4,

A. Recommendations by the Article 29 Working Party of Data Protection Regulators

Since 2014, the European Commission's Directorate for Transport and Mobility has been working on development of an intelligent transportation system for motor vehicles known as the Cooperative Intelligent Transport System ("C-ITS").¹²⁵ Implementation is expected to begin in 2019.¹²⁶ C-ITS uses peer-to-peer wireless communications for continuous transmission of data between vehicles and roadway infrastructural equipment without the intervention of a network operator.¹²⁷ The system will enable a driver to learn of the condition of the vehicle and the surrounding environment.¹²⁸ Similar to the ITS system in the United States, C-ITS is expected to improve safety and the flow of traffic.¹²⁹ Early applications are likely to be limited to providing information about construction zones and weather conditions.¹³⁰ Eventually, C-ITS may gradually take over driving decisions from the driver.¹³¹ Security of communications will be provided through encryption known as Public Key Infrastructure architecture.¹³²

In an opinion released in October 2017, the group of European data protection regulators known as the Article 29 Working Party analyzed privacy and data protection issues surrounding C-ITS.¹³³ Although the Opinion acknowledged safety benefits of C-ITS, it focused largely on identification of privacy risks.¹³⁴ For example, location data could be used for behavioral tracking that might lead consumers to experience an uncomfortable sense of stealthy surveillance.¹³⁵ The information might be used by advertisers, car manufacturers and insurance companies to assemble profiles.¹³⁶ "Function creep" might occur causing distortions from the original scope of the communications, and even causing people to drive to

2017), available at http://ec.europa.eu/newsroom/article29/item-detail.cfm?item_id=610171 [hereinafter Working Party C-ITS Opinion].

¹²⁵ See, e.g., *Id.*

¹²⁶ *Id.* at 6.

¹²⁷ *Id.* at 3.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 4.

¹³¹ *Id.*

¹³² *Id.*

¹³³ See generally Working Party C-ITS Opinion, *supra* note 124.

¹³⁴ *Id.* at 8.

¹³⁵ *Id.*

¹³⁶ *Id.*

unintended places.¹³⁷ Data transmitted throughout the system qualifies as personal data under the GDPR because location data and certificates used in Public Key Infrastructure can be used to identify data subjects.¹³⁸

Under Article 6 of the GDPR, all processing of data must be done pursuant to a lawful basis.¹³⁹ Accordingly, the Article 29 Working Party's Opinion considered whether any of the following provisions in Article 6 could be used: (1) processing necessary to perform a contract to which the data subject is a party (2) consent by the data subject, and (3) legitimate interests of the data controller.¹⁴⁰ After noting that each of the provisions was insufficient, the Working Party concluded that the long term basis for processing needed to be a "legal obligation" to which the controller is subject.¹⁴¹ Accordingly, the Opinion recommended the enactment of an "EU-wide legal instrument" for C-ITS, and urged the European Commission to initiate the law-making process for formulation and adoption of the legal instrument as soon as possible.¹⁴²

IV. RECOMMENDATION OF WORLDWIDE DATA PROTECTION REGULATORS

Privacy regulators around the world are also concerned about privacy implications of connected car technology. At their annual international conference in September 2017, data protection and privacy regulators adopted a resolution recommending that vehicle manufacturers, rental companies and other service providers in the automotive sector fully respect users' privacy rights.¹⁴³ Many of the recommendations are consistent with the European approach as set forth in the GDPR. For example, industry members should give data subjects comprehensive notice of what data are collected, for what purposes and by whom.¹⁴⁴ Data should be stored no longer than necessary.¹⁴⁵ In accordance with the principle of data minimization,

¹³⁷ *Id.* at 9.

¹³⁸ *Id.* at 6. See GDPR, *supra* note 18, at Art. 4(1) (defining "personal data").

¹³⁹ GDPR, *supra* note 18, at Art. 6.

¹⁴⁰ Working Party C-ITS Opinion, *supra* note 124, at 5.

¹⁴¹ *Id.* at 9.

¹⁴² *Id.*

¹⁴³ Thirty Ninth International Conference of Data Protection and Privacy Commissioners, Hong Kong, 25 – 29 September, 2017, *Resolution on Data Protection in Automated and Connected Vehicles* (Sept. 27, 2017), available at <https://www.huntonprivacyblog.com/wp-content/uploads/sites/18/2017/10/connected-car-pdf.pdf> [hereinafter DPA Resolution].

¹⁴⁴ *Id.* at 3.

¹⁴⁵ *Id.*

anonymization should be used when feasible.¹⁴⁶ Data subjects should be provided with control over the data through technical means to grant or withhold access to data, and should otherwise be able to restrict the collection of data and to erase data, especially when the vehicle is sold or returned to its owner at the end of a lease.¹⁴⁷ Consumer control should also be promoted by providing privacy-friendly default settings.¹⁴⁸ Industry members should prepare privacy impact assessments for new technology, and follow the principles of “privacy by design” and “privacy by default.”¹⁴⁹ Any self-learning systems for connected or automated vehicles should be “transparent in their functionality,” and should be subject to a prior assessment by an independent body in order to reduce the risk of discriminatory automated decisions.¹⁵⁰

The DPA Resolution also contains privacy and security recommendations for Intelligent Transportation Systems. There should be safeguards against illegal tracking and limitations of “illegitimate” tracking and driver identification.¹⁵¹ Drivers should be able to limit the sharing of location information while still receiving road hazard warnings.¹⁵² Communications of personal information to and from the vehicle should be secure from interception.¹⁵³

Although the Resolution’s recommendations are not legally binding, they signal that privacy regulators around the world look to Europe for leadership regarding privacy protections involving new technology. Not surprisingly, the FTC abstained from the resolution.¹⁵⁴

V. CONCLUSION

Connected car technology promises to make road travel safer and more efficient, but presents significant risks to personal privacy. Regulatory responses to that risk in the United States and Europe are much different. In the United States, the Federal Trade Commission is mindful of limits on its authority and fearful of stifling innovation, so it has been reluctant to assert leadership on protection of privacy. Perhaps motivated by a desire to deter legislators from imposing legal protections for privacy, automobile manufacturers

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 4.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 5.

have formulated a self-regulatory system. The Automakers' Privacy Principles, however, rely on vague terminology and avoid implementation of any meaningful enforcement mechanism. Consequently, they are not likely to provide consumers with effective privacy protection. In contrast, regulators in the Europe Union have been active in explaining how connected car technology should be implemented in order to comply with data protection law. Elsewhere, regulators in countries with comprehensive privacy laws are following the European Union's lead. Because the approaches of the United States and Europe are so different, it is possible that connected car systems in the United States will evolve differently from those in other countries, at least with respect to how personal information is collected, used and shared. In the United States, personal information used in connected car technology is much more likely to become integrated into general online commercial activity, while in Europe and other parts of the developed world, the use of that information is more likely to be limited to purposes connected with transportation.

DEFINITION OF “RETURN” FOR BANKRUPTCY PURPOSES REMAINS UNCLEAR

by John F. Robertson*

I. INTRODUCTION

The Internal Revenue Code¹ includes a general provision that requires taxpayers to file a “return” using forms provided by, and following regulations prescribed by, the Secretary of the Treasury.² The term “return” is not defined. It is up to the courts in bankruptcy proceedings to determine whether a document provided to the taxing authorities by the taxpayer/debtor should be considered a return. Individuals are required to file their income tax returns by the fifteenth day of the fourth month following the end of their tax year.³ Some individuals do not file their returns on time. Some individuals do file their returns on time but are not able to pay the full amount of their tax liability. When an individual with an outstanding tax liability seeks protection under the bankruptcy laws, his or her outstanding tax liability may or may not be a debt eligible to be discharged depending on whether the individual filed a return, and if so, whether he or she filed on time.

The Bankruptcy Code⁴ provides that taxes or customs duties may not be discharged in three cases.⁵ Some taxes are classified as priority

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¹ 26 U.S.C.A. §1 *et seq.* (Westlaw through P.L. 115-171).

² 26 U.S.C.A. §6011 (Westlaw through P.L. 115-171).

³ 26 U.S.C.A. §6011 (Westlaw through P.L. 115-171) and 26 C.F.R. §1.6072-1. Most individuals file using the calendar year, thus the due date without regard to holidays and weekends is April 15 of the year following the tax year.

⁴ 11 U.S.C.A. §1 *et seq.* (Westlaw through P.L. 115-171).

claims and are not dischargeable in bankruptcy.⁶ Under Section 523(a)(1)(B) of the Code, taxes are not dischargeable in bankruptcy if the taxpayer failed to file a return, report, or notice, or filed it late and within two years of the bankruptcy petition.⁷ Finally, a tax debt is not subject to discharge in bankruptcy if the taxpayer filed a fraudulent return or willfully attempted to evade or defeat the tax.⁸

The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA),⁹ enacted in 2005, made changes to §523(a) of the Bankruptcy Code. In two places, §523(a)(1)(B) was amended to add the phrase “or equivalent report or notice” after the word return, in two places §523(a)(1)(B) was amended to include the words “or given” after the verb filed, and an unnumbered paragraph was inserted after §523(a)(19).¹⁰ The unnumbered paragraph – often called the “hanging paragraph of §523(a)” – provides that a return is defined under nonbankruptcy law.¹¹ On its face, the hanging paragraph seems to have simply codified what the courts were doing before the BAPCPA was enacted. However, after the changes, courts have adopted different ways to determine when a late filed return is eligible for discharge in bankruptcy. Although there appears to be a split among the Circuit Courts of Appeals, the United States Supreme Court has not granted certiorari to resolve the split.

⁵ 11 U.S.C.A. §523(a) (Westlaw through P.L. 115-171).

⁶ 11 U.S.C.A. §§507(a)(8) and 523(a)(1)(A) (Westlaw through P.L. 115-171).

⁷ 11 U.S.C.A. §523(a)(1)(B)(i) and (ii) (Westlaw through P.L. 115-171). If the taxpayer did not file a “return,” even though materials submitted to the taxing authorities took the form of text and data entered on official forms created by the taxing authorities, then the taxpayer/debtor is not eligible for discharge in bankruptcy under § 523(a)(2) of the Bankruptcy Code.

⁸ 11 U.S.C.A. §523(a)(1)(C) (Westlaw through P.L. 115-171).

⁹ Public Law 109-8, 119 Stat. 23, April 20, 2005.

¹⁰ §714 Public Law 109-8. After amendment, 11 U.S.C.A. § 523(a)(1)(B) (Westlaw through P.L. 115-171) reads:

(B) with respect to which a return, or equivalent report or notice, if required--

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

¹¹ 11 U.S.C. §523(a) (Westlaw through P.L. 115-171). The hanging paragraph reads: For purposes of this subsection, the term “return” means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986 [26 USCS § 6020(a)], or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986 [26 USCS § 6020(b)], or a similar State or local law.

This article reviews the way courts defined "return" prior to BAPCPA, and then examines the split in the circuits under current law. The specific fact-pattern for each taxpayer/debtor is important to the issue. For many taxpayers/debtors, the result is likely to be the same in most or all circuits. Some taxpayers/debtors would get a different result in different circuits. This article considers the specific fact-pattern that could lead to different outcomes and discusses the need for a policy change to eliminate the distinction.

II. CATEGORIES OF TAXPAYER/DEBTORS

The focus of this article is on federal and, in a few circumstances, state individual income tax liabilities. The taxpayer/debtors all have a few things in common. They had taxable income, they failed to pay their tax liabilities, and they filed for bankruptcy. Taxpayer/debtors are treated differently depending on when, or if, they filed official forms with the regulatory authorities. The first category of taxpayer/debtors includes those individuals who filed the appropriate forms by the due date but did not pay their tax liabilities. With the small exception of individuals who make tax protestor modifications to the official forms, these taxpayer/debtors have filed returns. Their tax debts may be eligible for discharge or they may be priority claims under Bankruptcy Code §§507(a)(8) and 523(a)(1)(A).

For individuals who do not file their returns on time, the Internal Revenue Service (IRS) uses several tools to identify delinquent taxpayers. These include identifying taxpayers who filed returns in a prior year and taxpayers who received information returns such as Forms 1099 and W-2 from third parties.¹² The IRS typically sends taxpayers several notices before moving forward.¹³ The options for these taxpayers are as follows.

A taxpayer could file a late Form 1040 either before being contacted by the IRS or in response to a notice. These individuals make up the second category of taxpayer/debtors. The IRS has stated that the tax debt associated with a return filed late, but before assessment, is eligible for discharge in bankruptcy.¹⁴ However, this rule could change and does not apply to state tax debts.

Another option for a taxpayer after receiving a notice is to contact the IRS for help in calculating his or her tax liability. This is the substitute for return under Internal Revenue Code §6020(a). The

¹² I.R.M. 5.1.11.1.1 (2010), available at https://www.irs.gov/irm/part5/irm_05-001-011r.

¹³ I.R.M. 5.1.11.1.2 (2010), available at https://www.irs.gov/irm/part5/irm_05-001-011r.

¹⁴ Chief Counsel Notice CC-2010-16, 2010 WL 3617597 (September 2, 2010), available at https://www.irs.gov/pub/irs-ccdm/cc_2010_016.pdf.

hanging paragraph specifically says that these taxpayers have filed returns. They make up the third category of taxpayer/debtors.

Finally, a taxpayer who receives a notice can take no action. Eventually, the taxpayer who does nothing will be flagged as delinquent. Once the IRS has identified a delinquent taxpayer, a case is created. The IRS calculates a tax liability for the delinquent taxpayer using the information that is available, which is often unfavorable to the taxpayer. This is the substitute for return under Internal Revenue Code §6020(b). The case may be processed manually or using the automated substitute for return program.¹⁵ The taxpayer may then file a Form 1040, and the IRS may adjust any outstanding tax liability to match the taxpayer's calculations.¹⁶ Taxpayers who file forms after the taxing authorities have assessed tax make up the fourth category of taxpayer/debtors.

III. CONSIDERATION OF "RETURN" BEFORE THE 2005 CHANGES TO THE BANKRUPTCY CODE

Numerous courts considered the definition of the word "return" before the passage of the BAPCPA. In general, they referred back to *Beard v. Comm'r of Internal Revenue*,¹⁷ a tax protester case from 1984. Beard had modified his Form 1040 to show wages as non-taxable receipts.¹⁸ The IRS proposed a penalty for failure to file a return and the Tax Court had to determine if the modified Form 1040 was a return for this purpose. It stated that a return for statute of limitations purposes must be a return for purposes of the late filing penalty under Internal Revenue Code §6651(a)(1).¹⁹ It referenced a United States Supreme Court rule which it said had been applied in *Florsheim Bros. Drygoods Co. v. United States* and in *Zellerbach Paper Co. v. Helvering*.²⁰

¹⁵ *Id.* The automated substitute for return program does require resources, and the IRS suspended the program in 2017. See, A Significantly Reduced Automated Substitute for Return Program Negatively Affected Collection and Filing Compliance, Treasury Inspector General for Tax Administration, September 29, 2017, No. 2017-30-078, available at <https://www.treasury.gov/tigta/auditreports/2017reports/201730078fr.pdf>.

¹⁶ The IRS noted that it is possible for a taxpayer to file a return that shows a greater tax liability than the amount calculated using the substitute for return program, and that its position is that the additional tax should be dischargeable in bankruptcy. CC-2010-16, page 3.

¹⁷ *Beard v. Comm'r of Internal Revenue*, 82 T.C. 766 (1984), *aff'd sub nom. Beard v. C.I.R.*, 793 F.2d 139 (6th Cir. 1986).

¹⁸ *Id.* at 769.

¹⁹ *Id.* at 777.

²⁰ *Id.* at 777-78, citing *Florsheim Bros. Drygoods Co. v. United States*, 280 U.S. 453 (1930) and *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934). The Internal Revenue Code mentions return or returns in several places, but contains no definition.

In the bankruptcy case *In Re Hindenlang*²¹, the District Court for the Southern District of Ohio and Sixth Circuit Court of Appeals reordered the factors of the test laid out in *Beard* to create what has come to be known as the *Beard* test.

In order for a document to qualify as a return: "(1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law."²²

Although the *Beard* test presents a facts and circumstances test, many of the cases that used it in bankruptcy prior to the BAPCPA involved the substitute for return process under Internal Revenue Code §6020(b) with many courts finding that the taxpayer/debtor had not made an "honest and reasonable attempt to satisfy the requirements of the tax law."²³ The calculation of a tax liability by the IRS under Internal Revenue Code §6020(b) cannot be a return because the taxpayer did not execute it under penalty of perjury, and any forms filed by the taxpayer/debtor only after the IRS threatens immediate collection activity do not show that the taxpayer/debtor was trying to comply with the tax law. As noted above, the IRS may adjust the tax due when the taxpayer/debtor files a return after the Service has calculated tax using the substitute for return program. Taxpayer/debtors who intend to pay their tax debts have an incentive to file a return when it results in a reduction of their tax liability.

26 U.S.C. 6011(a) provides "When required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms or regulations."

²¹ *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999). *Hindenlang* was also a case involving the IRS substitute for return program and discharge. The Sixth Circuit concluded that ". . . a Form 1040 is not a return if it no longer serves any tax purpose or has any effect under the Internal Revenue Code. A purported return filed too late to have any effect at all under the Internal Revenue Code cannot constitute "an honest and reasonable attempt to satisfy the requirements of the tax law." Once the government shows that a Form 1040 submitted after an assessment can serve no purpose under the tax law, the government has met its burden." *Id.* at 1031. In the fifth footnote of the opinion, the Sixth Circuit stated that the government presented as an example of a return filed after assessment that did serve a valid purpose the possibility of a taxpayer filing a return that showed a higher tax liability than the IRS had assessed. *Id.* at 1034.

²² *Id.* at 1036, citing *In re Hindenlang*, 214 B.R. 847, 848 (S.D. Ohio 1997), rev'd, 164 F.3d 1029 (6th Cir. 1999).

²³ See, e.g., *In re Washburn*, 290 B.R. 162, 166–67 (Bankr. M.D. Fla. 2002) citing *In re Hatton*, 220 F.3d 1057 (9th Cir.2000), *United States v. Ralph*, 266 B.R. 217 (M.D.Fla.2001), and *In Re Sgarlat*, 271 B.R. 688 (Bankr. M.D. Fla. 2001).

The Eight Circuit Court of Appeals is an exception. In *In re Colsen*,²⁴ the Eight Circuit reviewed the case of a taxpayer who filed returns after the IRS had calculated tax under the substitute for return program. The Eight Circuit applied the *Beard* test in a case that originated before, but that was published after, the enactment of the BAPCPA. Colsen, the taxpayer/debtor, filed returns for 1992 through 1996 in 1999 after the IRS had assessed tax under the substitute for return program.²⁵ Colsen filed for bankruptcy in 2003, was granted discharge, and asked the Bankruptcy Court to rule on the dischargeability of his unpaid federal income tax liabilities.²⁶ The Bankruptcy Court ruled for the taxpayer using an interpretation of the fourth factor of the *Beard* test that differed from that of the Sixth Circuit in *Hindenlang*. It adopted a narrower approach than the Sixth Circuit's broad inquiry into intent under the fourth factor of the test and concluded that Bankruptcy Code §523(a)(1)(C) already contained a limitation on discharge for taxpayer/debtors who showed bad intent.²⁷

Colsen filed unmodified Forms 1040 that provided all the information needed to calculate tax liability for the year.²⁸ Upon review, the Eighth Circuit also applied the *Beard* test. It described the approach taken by the Fourth, Sixth, and Seventh Circuits as creating a subjective standard of timeliness in the fourth factor of the *Beard* test.²⁹ The Eighth Circuit stated “. . . the honesty and genuineness of the filer's attempt to satisfy the tax laws should be determined from the face of the form itself, not from the filer's delinquency or the reasons for it. The filer's subjective intent is irrelevant.”³⁰

IV. THE ONE-DAY LATE RULE

Some courts have decided that the BAPCPA added a timeliness requirement to the definition of a return. Under this interpretation, no tax debt associated with a late filed return, regardless of the taxpayer's circumstances or intent, is eligible for discharge. The cases presented below address this specific rule as it relates particularly with state taxes.

²⁴ 446 F.3d 836 (8th Cir. 2006).

²⁵ *In re Colsen*, 311 B.R. 765, 767 (Bankr. N.D. Iowa 2004), *aff'd*, 322 B.R. 118 (B.A.P. 8th Cir. 2005), *aff'd*, 446 F.3d 836 (8th Cir. 2006).

²⁶ *Id.*

²⁷ *Id.* at 773.

²⁸ *Id.* The returns that Colson filed showed a decrease in tax of \$160,138. The IRS eventually abated \$91,286 of tax. *See, Id.* at 767-68.

²⁹ 446 F.3d at 839-40.

³⁰ *Id.* at 840.

Fifth Circuit Court of Appeals: McCoy v. Miss. State Tax Comm’n (In Re McCoy)

In the following case, the plaintiff is a typical example of a member of the second category of taxpayer/debtors. Under the pre-BAPCPA *Beard* test, a court could have found that Ms. McCoy had made a reasonable attempt to comply with the Mississippi tax laws. However, the Fifth Circuit decided that her late-filed forms were not returns.

Plaintiff McCoy had filed for Chapter 7 bankruptcy in 2007 and was granted a discharge in early 2008.³¹ Later in 2008, McCoy returned to the bankruptcy court seeking a declaration that her Mississippi state income tax debts from 1998 and 1999 had been discharged in bankruptcy.³² The Mississippi State Tax Commission (MSTC) filed a motion to dismiss on the grounds that the plaintiff had not shown that she had filed a return.³³

Ms. McCoy introduced evidence that she filed her returns, and tax was assessed based on those returns, in September of 2002.³⁴ She did not introduce copies of the returns into evidence.³⁵ The bankruptcy court and subsequent courts began with the assumption that McCoy had given the MSTC copies of Mississippi forms, but then had to determine if those late-filed forms were in fact returns.

One provision of the Bankruptcy Code is that taxes may not be discharged if a return was not filed.³⁶ The hanging paragraph adds its requirement that a return must satisfy the “requirements of applicable nonbankruptcy law (including applicable filing requirements).” The courts in *McCoy* evaluated the hanging paragraph by reference to Mississippi state law. According to the Fifth Circuit, “a state income tax return that is filed late under the applicable nonbankruptcy state law is not a “return” for bankruptcy

³¹ *McCoy v. Miss. State Tax Comm’n (In re McCoy)*, 666 F.3d 924, 925 (5th Cir. 2012).

³² *In re McCoy*, No. 07-02998-EE, 2009 WL 2835258, at *1 (Bankr. S.D. Miss. Aug. 31, 2009), *aff’d sub nom. McCoy v. Mississippi State Tax Comm’n*, No. 3:09-CV-575 HTW-LRA, 2011 WL 8609554 (S.D. Miss. Feb. 8, 2011), *aff’d sub nom. In re McCoy*, 666 F.3d 924 (5th Cir. 2012).

³³ *Id.* The MSTC also raised a sovereign immunity argument, but did not brief the argument. The bankruptcy court did, however, consider the issue and ruled that sovereign immunity did not apply in this case. *Id.* at *4.

³⁴ *Id.* at *5.

³⁵ *McCoy v. Mississippi State Tax Comm’n*, No. 3:09-CV-575 HTW-LRA, 2011 WL 8609554, at *1 (S.D. Miss. Feb. 8, 2011), *aff’d sub nom. In re McCoy*, 666 F.3d 924 (5th Cir. 2012).

³⁶ 11 U.S.C. § 523(a)(1)(B)(i).

discharge purposes under §523(a).³⁷ Ms. McCoy attempted to appeal this decision, but the United States Supreme Court denied certiorari later in 2012.³⁸

Plaintiffs belonging to the second category also have the potential to include some of the most sympathetic taxpayer/debtors: individuals who intend to fully comply with the tax laws, but circumstances beyond their control prevent them from filing their returns on time and eventually from paying their taxes. These circumstances could include a family's loss of the breadwinner, destruction of the taxpayer's home or business by fire, tornado, or another natural disaster, and medical expenses. Although the IRS currently does not challenge the discharge of federal tax debts for taxpayer/debtors in the second category, Ms. McCoy's case shows that the same is not true for state taxes.

Tenth Circuit Court of Appeals: In Re Mallo

The Tenth Circuit also adopted the one-day-late rule in a case involving consolidated appeals where the taxpayer/debtors had taxes calculated by the IRS using the substitute for return process.³⁹ The judges in the Bankruptcy Court reached different conclusions, and the cases were consolidated for briefing purposes by the District Court for the District of Colorado.⁴⁰ The district court did not follow *McCoy*, but still found that the debts were not eligible for discharge under the fourth factor of the *Beard* test.⁴¹

The Tenth Circuit considered the first sentence of the hanging paragraph. A return must be a return under applicable nonbankruptcy law, and the parenthetical clause modifies that to include filing requirements. The Tenth Circuit did not have to apply

³⁷ 666 F. 3d 924, 932. The Mississippi statute read: Returns of individuals, estates, trusts and partnerships shall be filed on or before the fifteenth day of the fourth month following the close of the fiscal year; or if the return is filed on the basis of a calendar year, it shall be filed on or before April 15th of each year. MISS CODE ANN. § 27-7-41 cited by *Id.* at 928.

³⁸ *McCoy v. Mississippi State Tax Comm'n*, 568 U.S. 822, 133 S. Ct. 192, 184 L. Ed. 2d 38 (2012).

³⁹ *In re Mallo*, 774 F.3d 1313, 1316 (10th Cir. 2014). The Mallos were a married couple, and the IRS assessed separate tax liabilities against the two spouses. The returns that they filed post-assessment were joint returns. *Id.*

⁴⁰ *Id.* at 1313.

⁴¹ *In re Mallo*, 498 B.R. 268, 281 (D. Colo. 2013), *aff'd*, 774 F.3d 1313 (10th Cir. 2014) and *In re Martin*, 500 B.R. 1, 8 (D. Colo. 2013), *aff'd sub nom. In re Mallo*, 774 F.3d 1313 (10th Cir. 2014). The district court did note that a taxpayer could still meet the "honest and reasonable attempt to comply with the tax law" factor of the *Beard* test if he or she could prove that late filing was through no fault of his or her own. 498 B.R. at 281.

the *Beard* test as part of defining return under nonbankruptcy law because it concluded that tax returns must be filed on time under the applicable filing requirements.⁴² The court of appeals followed *McCoy* and formally held “. . . that the plain and unambiguous language of §523(a) excludes from the definition of “return” all late-filed tax forms, except those prepared with the assistance of the IRS under §6020(a).”⁴³

First Circuit Court of Appeals: In Re Fahey

The First Circuit adopted the one-day-late rule in a case involving a group of late-filed state of Massachusetts returns. The four debtors filed returns before the Massachusetts Department of Revenue assessed taxes against them.⁴⁴ They all later declared bankruptcy, were discharged, and attempted to have their outstanding state tax debts discharged. The cases in Bankruptcy Court split three to one in favor of discharge. Two cases were appealed to the Bankruptcy Appellate Panel and two were appealed to the District Court.⁴⁵ The Bankruptcy Appellate Panel heard two cases where the Bankruptcy Court had granted discharge, and it agreed with the Bankruptcy Court.⁴⁶ The District Court for the District of Massachusetts reviewed the remaining two cases, and it found that there could be no discharge.⁴⁷

The First Circuit, in a divided opinion, considered the parenthetical clause of the hanging paragraph. That clause requires that a return satisfy “applicable filing requirements.” The First Circuit considered whether this meant all the filing requirements, and whether timely filing was one of them in Massachusetts.⁴⁸ The majority answered both these questions in the affirmative.⁴⁹ The majority considered some of the arguments against the one-day late rule. One such argument is that the one-day late rule makes the language in Bankruptcy Code §523(a)(1)(B)(ii) unnecessary. This is the section that prevents discharge for a late-filed return filed within

⁴² 774 F.3d at 1320.

⁴³ *Id.* at 1327.

⁴⁴ *In re Fahey*, 779 F.3d 1, 8 n.7 (1st Cir. 2015).

⁴⁵ 779 F.3d at 3.

⁴⁶ *In re Gonzalez*, 506 B.R. 317, 328 (B.A.P. 1st Cir. 2014), *rev'd sub nom. In re Fahey*, 779 F.3d 1 (1st Cir. 2015) and *In re Brown*, No. ADV 11-04150-MSH, 2014 WL 1815393, at *6 (B.A.P. 1st Cir. Apr. 3, 2014), *rev'd sub nom. In re Fahey*, 779 F.3d 1 (1st Cir. 2015).

⁴⁷ *Perkins v. Massachusetts Dep't of Revenue*, 507 B.R. 45, 54 (D. Mass. 2014), *aff'd sub nom. In re Fahey*, 779 F.3d 1 (1st Cir. 2015).

⁴⁸ 779 F.3d at 4.

⁴⁹ *Id.*

two years of the bankruptcy petition. The First Circuit concluded that the statement in the hanging paragraph that tax calculations under Internal Revenue Code §6020(a) are considered returns was sufficient to keep Bankruptcy Code §523(a)(1)(B)(ii) useful.⁵⁰ The First Circuit also considered whether the one-day late rule made the last clause of the hanging paragraph unnecessary. This clause states that a calculation under Internal Revenue Code §6020(b) is not a return. Since the substitute for return program necessarily contemplates a late return, this language is unnecessary if the one-day late rule is correct. The court was willing to accept the redundant set of rules.⁵¹

In its opinion, the First Circuit considered several arguments about statutory construction, and whether Congress was simply trying to codify the *Beard* test. It concluded:

... it is more plausible that Congress intended to settle the dispute over late filed tax returns against the debtor (who both fails to pay taxes and fails to file a return as required by law) than it is that Congress sought to preserve some version of the unsettled four-pronged *Beard* test by using language that has no reference to that case law and that certainly suggests no four-pronged definition. Particularly noteworthy is the fact that Congress's chosen test called for satisfying the filing requirements of applicable law, not merely making an "honest attempt" to do so.⁵²

Thus, the question remains, will the *Beard* test will survive and in what form.

V. THE *BEARD* TEST STILL APPLIES IN SOME CIRCUITS

There are some examples of the *Beard* test being applied to date in certain Circuit courts that are worth examining.

Eleventh Circuit Court of Appeals: In Re Justice

Christopher Justice filed returns for the tax years 2000, 2001, 2002, and 2003 in 2007 after the IRS had estimated his tax liability for the four years and assessed tax based on those estimates.⁵³ After Justice filed Forms 1040 for the four years, the IRS abated some of the tax it had assessed.⁵⁴ Justice filed for bankruptcy in 2011, and

⁵⁰ *Id.* at 6. The First Circuit found a case where the IRS had prepared a substitute for return under Internal Revenue Code § 6020(a) to show that the membership of the third category of taxpayer/debtors is greater than zero. *Id.* at 7 citing *In re Kemendo*, 516 B.R. 434, 438 (Bankr.S.D.Tex.2014).

⁵¹ 779 F.3d at 7.

⁵² *In re Fahey*, 779 F.3d 1, 10 (1st Cir. 2015).

⁵³ *In re Justice*, 817 F.3d 738, 741–42 (11th Cir. 2016), *cert. denied sub nom. Justice v. I.R.S.*, 137 S. Ct. 1375, 197 L. Ed. 2d 554 (2017).

⁵⁴ *Id.* at 742.

was discharged in that same year.⁵⁵ Justice's attorney filed a claim with the IRS requesting that the government "write-off" his tax debts from 2000-03.⁵⁶ This claim was denied, and Justice then brought a case in Bankruptcy Court to establish whether the tax debts were eligible for discharge in bankruptcy.⁵⁷

The Bankruptcy Court rejected the *McCoy* court's reading of the hanging paragraph, applied the *Beard* test, and found in the government's favor.⁵⁸ According to the court, under the fourth element of the *Beard* test, a return filed after the IRS has already assessed tax can serve no purpose under the tax law and could not be ". . . an honest and reasonable attempt to comply with the requirements of the tax law."⁵⁹

On appeal, the U.S. District Court for the Middle District of Florida stated that the hanging paragraph incorporated the *Beard* test into 11 U.S.C. §523. Therefore, the question becomes whether a given return filed after the IRS has assessed tax can be considered a return under §523(a)(1)(B)(i).⁶⁰ In other words, the District Court concluded that the same facts and circumstances test that applied before the 2005 amendments to the Bankruptcy Code still applied. The parties agreed that Justice's filings met the first three parts of the *Beard* test.⁶¹ With regard to the fourth part of the *Beard* test, Justice argued that he made an honest and reasonable attempt to comply with the tax law by preparing returns and delivering them to the IRS.⁶² In fact, he claimed that he submitted the returns for 2000-03 twice. He claimed that he resubmitted copies after the IRS failed to process the originals.⁶³ The District Court inferred that Justice believed he met the fourth part of the *Beard* test because the IRS made use of the forms he submitted and reduced his tax liability. However, it did not accept Justice's position finding that he filed his

⁵⁵ *Id.*

⁵⁶ *In re Justice*, No. 3:11-BK-5392-JAF, 2014 WL 11294741, at *2 (M.D. Fla. Dec. 23, 2014), citing the Bankruptcy Court order.

⁵⁷ *Id.*

⁵⁸ *Id.* at *4. The District Court noted that the Bankruptcy Court specifically rejected the insertion of a timeliness requirement into 11 U.S.C. § 523(a)(1)(B)(i) as § 523(a)(1)(B)(ii) already contained a timeliness requirement. *Id.*

⁵⁹ No. 3:11-BK-5392-JAF, 2014 WL 11294741, at *2

⁶⁰ *Id.* at *4. The District Court cited *In re Smith*, No. 13-CV-871 YGR, 2014 WL 1727011, at *7 (N.D.Cal. Apr. 29, 2014) *In re Rhodes*, 498 B.R. at 367, *In re Martin*, 500 B.R. 1, 8 (D.Colo.2013), and *In re Mallo*, 498 B.R. 268, 277 (D.Colo.2013) as cases supporting the interpretation that the *Beard* test was still applicable to §523 after the 2005 amendments.

⁶¹ No. 3:11-BK-5392-JAF, 2014 WL 11294741, at *5.

⁶² *Id.*

⁶³ *Id.*

returns late and only after the IRS assessed tax for the years in question.⁶⁴

On appeal, the Eleventh Circuit Court noted that the First, Fifth, and Tenth Circuits read the phrase “applicable filing requirements” in the hanging paragraph to include filing deadlines, and left debtors only the narrow protection of allowing discharge for late-filed returns filed in accordance with 26 U.S.C. §6020(a).⁶⁵ The Eleventh Circuit assumed for the case of argument, but did not decide, that the one-day-late rule was incorrect.⁶⁶ It went on to decide Justice’s case based on the fourth factor of the *Beard* test.

Timeliness comes into play in evaluating whether the taxpayer/debtor had made an honest and reasonable attempt to comply with the law, the Eleventh Circuit adopted the majority view that the entire time frame must be considered.⁶⁷ It stated:

A taxpayer who does not file a timely return and who submits no information at all until contacted by the IRS frustrates the requirements and objectives of that system. Indeed, filing tax documents only after the IRS has gathered the relevant information and assessed a deficiency significantly undermines the self-assessment system. Delinquency in filing, therefore, is evidence that the taxpayer failed to make a reasonable effort to comply with the law.⁶⁸

The Eleventh Circuit affirmed the district court’s decision finding that Justice did not meet the *Beard* test because the forms he submitted to the IRS were not returns and his tax debt was not eligible for discharge in bankruptcy.⁶⁹ The United States Supreme Court denied certiorari in March of 2017.⁷⁰

Ninth Circuit Court of Appeals: Smith v. US IRS (In Re Smith)

The facts of this case are very similar to the Justice case described above. The taxpayer/debtor failed to file returns until after the IRS had assessed tax. The Ninth Circuit noted that it had adopted the

⁶⁴ *Id.* at *6.

⁶⁵ *In re Justice*, 817 F.3d 738, 743 (11th Cir. 2016), cert. denied sub nom. *Justice v. I.R.S.*, 137 S. Ct. 1375, 197 L. Ed. 2d 554 (2017). Returns prepared under 26 U.S.C. §6020(a) are those rare returns prepared by the Secretary of the Treasury with assistance from the taxpayer. Most of the returns prepared by the IRS are prepared under §6020(b) using information from third parties such as that contained on Forms W-2 or 1099, but without the taxpayer’s cooperation.

⁶⁶ 817 F.3d at 743

⁶⁷ *Id.* at 744. The Eleventh Circuit identified the Eight Circuit Court of Appeals as holding the minority position.

⁶⁸ 817 F.3d at 744.

⁶⁹ *Id.* at 747.

⁷⁰ *Justice v. I.R.S.*, 137 S. Ct. 1375, 197 L. Ed. 2d 554 (2017).

Tax Court's definition of a return in *Hatton*.⁷¹ It continued to apply the four-factor test, and found that the taxpayer failed to meet the requirement of an ". . . 'honest and reasonable' attempt to comply with the tax code."⁷²

The Supreme Court denied certiorari in February of 2017.⁷³

The Eighth Circuit Court of Appeals

The Eighth Circuit has not considered the hanging paragraph. It is possible that it could take the position that the amendments to Bankruptcy Code §523 added a timeliness provision, and adopt the one-day-late rule. It is also possible that the Eighth Circuit could continue to apply the objective standard it created for the fourth factor of the *Beard* test in *In re Colsen*.

VI. SUMMARY

The Bankruptcy rules are consistent for taxpayers in the first and third categories of taxpayers described above. The debate over timeliness as part of the definition of "return" does not impact taxpayers who meet the filing deadline. The hanging paragraph includes in the definition of return calculations of tax liability under Internal Revenue Code §6020(a) and similar state laws.

After the 2017 decisions in *Justice* and *Smith*, there is a clear split among the circuit courts of appeals for taxpayer/debtors in the second and fourth categories of taxpayers discussed above. Taxpayer/debtors in the second category are most likely to see a different result because of the split. A return filed after the due date but before the regulatory authorities have assessed a tax may or may not be considered a return depending on the taxpayer/debtor's state of residence. Tax debts for late filed returns are not eligible for discharge in the geographic area covered by the First, Fifth, and Tenth Circuits. Although the position of the IRS is that federal debts for these taxpayer/debtors are eligible for discharge,⁷⁴ the Internal Revenue position could change at any time. Bankruptcy relief applies to state tax debts as well as federal ones. Just like the federal statutes, state laws include due dates. In these three circuits, the one-day late rule will prevent discharge if the state taxing authorities challenge discharge.

⁷¹ *In re Smith*, 828 F.3d 1094, 1097 (9th Cir. 2016), cert. denied sub nom. *Smith v. I.R.S.*, 137 S. Ct. 1066, 197 L. Ed. 2d 176 (2017) citing *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000).

⁷² 828 F.3d at 1097.

⁷³ *Smith v. I.R.S.*, 137 S. Ct. 1066, 197 L. Ed. 2d 176 (2017).

⁷⁴ CC-2010-16.

For taxpayers in the fourth category, results have been generally unfavorable both before and after the BAPCPA. Courts have not viewed filings made after the IRS has assessed tax as returns. This means that the taxpayer/debtor's tax debt for any years covered by the substitute for return program is not eligible for discharge. *Justice* is a perfect example of this situation. *Justice* would have lost in any of the circuits except perhaps the Eighth. There is a potential three-way circuit split if the Eighth Circuit precedent in *In re Colsen* is still valid.

VII. CONCLUSION

There are two questions that Congress should answer. First, does good policy require a legislative intervention to resolve the circuit split? The strongest argument for resolving the circuit split is that similarly situated individuals should be treated the same way under the law. This is not currently the case for taxpayer/debtors in the second category. Even if this is a small group, *McCoy* and *Fahey* show that it is a real group. The United States Supreme Court has had several chances to review this issue, including *Smith* and *Justice* in 2017. It has declined to hear each case. That leaves legislative intervention. Congress should address the hanging paragraph.

The second question is what should Congress do? In the simplest terms, Congress should revise the statute to reflect its intention when it passed the BAPCPA. The courts have not been able to determine what that intention was, so Congress should make it clear. It does seem that the better policy position would be to revise the statute to show that the intent was to codify the *Beard* test. A facts and circumstances test rather than a bright line test allows the courts to consider taxpayer/debtors who have found themselves in financial difficulty through no fault of their own. For example, a catastrophic illness or injury could cause a taxpayer to miss the filing date for a tax return and, if the taxpayer was uninsured, could lead to expenses that eventually lead the taxpayer to bankruptcy. Further, this construction means that Bankruptcy Code §523(a)(1)(B)(ii) and the reference to Internal Revenue Code Section 6020(b) in the last part of the hanging paragraph are relevant parts of the bankruptcy law. The one-day late test makes these two sections unnecessary. There is a potential state law issue as well. States in the circuits that continue to apply the *Beard* test could revise their statutes to specifically include a timeliness requirement in the definition of a return. This could force the one-day late rule into the language of the hanging paragraph for those states. Both the American Bar Association and

the Taxpayer Advocate recommended legislative changes in 2014 before the circuit split developed.⁷⁵ The American Bar Association Section on Taxation suggested changing the hanging paragraph by adding "other than timeliness" to the parenthetical clause.⁷⁶ If the one-day late rule expresses the intent of Congress, then the modification would be to add the phrase "including timeliness" to the parenthetical clause. Either of these changes would resolve the current circuit court split and the possible split with the Eighth Circuit.

⁷⁵ AMERICAN BAR ASSOCIATION SECTION OF TAXATION PROPOSED AMENDMENT TO SECTION 523(a) OF THE BANKRUPTCY CODE, available at <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/072914letter.authcheckdam.pdf>, last accessed April 11, 2018, and Taxpayer Advocate Service, 2017 Report to Congress, LR #19.

⁷⁶ The proposed wording was "(including applicable filing requirements other than timeliness)." AMERICAN BAR ASSOCIATION SECTION OF TAXATION PROPOSED AMENDMENT TO SECTION 523(a) OF THE BANKRUPTCY CODE p. 8.

